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HISTORY AND PROBLEMS OF INDIAN CURRENCY

HISTORY AND PROBLEMS OF INDIAN CURRENCY

1835—1959

AN INTRODUCTORY STUDY

By

D. K. MALHOTRA M.A., PH.D.

1960

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PREFACE

THIS book was first written during 1938-39 with the limited objective of providing a clear and concise account of the main developments in our currency system during the last hundred years and its first edition came out a few months after the outbreak of war. The impact of the War on the international monetary relations was bound to be severe and generally disruptive. In the sphere of Indian currency also it gave rise to important developments such as an increase in the volume of currency, an inflationary rise of prices, introduction of exchange control and price control and accumulation of sterling balances. The termination of the hostilities first in Europe and later in Japan in 1945 was followed by renewed efforts to bring orderliness and cohesion in the currency and exchange relationships among the nations. The post-war period witnessed the establishment of two important institutions, namely, the International Monetary Fund and the International Bank of Reconstruction and Development which have played a crucial role and left an unmistakable impress on the monetary and economic developments in subsequent years. India's membership of these institutions was one of the significant events of the post-war period. It was followed by a number of more momentous developments including the advent of Independence, the partition of the country, balance of payments crisis and devaluation of the sterling and the rupee. The central monetary institution of the country, the Reserve Bank of India, was nationalised early in 1949 and early in 1950 the setting up of the Planning Commission marked the inauguration of the era of planning. The successful completion of the First Five Year Plan, the formulation of a bigger and bolder Second Five Year Plan, and the difficulties attending its implementation, the foreign exchange crisis, the appearance of external assistance as a factor of considerable importance, the role of deficit financing, the reorientation given to methods and techniques of monetary management appropriate to the regime of planning—all these and many others provide the landmarks in a panorama unfolding itself in the years that have rolled by. We are too near them yet to assess their precise contribution in shaping the trends in Indian economy and the monetary system.

As this book still continues to be in demand after a fairly long run of twenty years, opportunity has been taken in the present edition to bring the story of events and developments up to date and to revise some portions of the earlier chapters: The book is modest in its claims as before. The approach and spirit also continue to be one of tempering rigorous scientific purism by a keen appreciation of the immense problems of a big democratic nation recently freed from thraldom, still heavy with the burden of many infructuous decades but now on the move with courage and quiet determination.

I am indebted to Prof. P.S. Sood of R.R. College, Alwar for undertaking the task of bringing together and analysing the material for revising or writing afresh the later chapters relating to the post-war developments as also some of the appendices. But for his valuable assistance, the preparation of this edition might have been delayed even longer.

My daughter, Renu, has assisted me in looking through the proofs and preparing the index and also by impressing on me persistently the testimony of her experience as a student that the book has not outlived its utility.

11th July, 1959. D. K. MALHOTRA

INTRODUCTION

A GENERAL acquaintance with the mechanism of foreign exchange is necessary to understand properly the history and problems of Indian currency. The history of Indian currency is very largely a history of its fortunes vis-a-vis the British currency. It may not, therefore, be out of place to give in the beginning of this treatise a general idea of the causes underlying fluctuations of exchange between countries with different monetary systems.

The need of exchanging one currency into another arises on account of differences in the currencies of a large number of countries all over the world. The currency of one country is useless *as currency* when taken out to another country. England has its pound, United States of America its dollar, France its franc, Russia its rouble, Japan its yen, and India its rupee. When payments have to made by the government or people of one country to the government or people of another country, one currency must be exchanged into another. This raises the important question: how much of one currency will be given to get a certain quantity of the other? In other words, how will the rate of exchange be determined?

To answer this question in a way which will accord with the conditions of the actual world, it is necessary to consider two different sets of conditions, *viz.*, conditions of free competition and conditions of control. Rate of exchange is determined in a certain way and by certain forces in a free market for foreign exchange and in quite a different way and by different factors under conditions of control. Conditions of free competition will have to be considered at some length and may be taken up first.

Broadly, four cases may be considered to know how the rate of exchange is determined under conditions of free competition and how far its variations can go. These four cases are of:

(*i*) Two countries both on metallic standard—gold standard or silver standard.

(*ii*) Two countries, one on gold standard and the other on silver standard.

(*iii*) Two countries, one on metallic (gold or silver) standard and the other having paper currency not convertible into gold or silver.

(*iv*) Two countries, both having inconvertible paper currencies.

Case: Two countries on metallic standard

A country is said to be on gold (or silver) standard when its unit of account is a gold (or silver) coin freely minted by the government, its paper currency is freely convertible into gold (or silver) coins and free export and import of gold (or silver) are allowed. The unit of account may also be a certain fixed quantity of gold (or silver) in uncoined form. In that case, too, the country is said to be on gold (or silver) standard, though more strictly it should be said to be on gold (or silver) *bullion* standard.

Between two countries both of which have gold coins as units of account, the rate of exchange will *tend* to equal the ratio between the legally prescribed amounts of gold contained in the coins. This ratio is described as the *mint par of exchange*. Before the last Great War, for instance, both England and France were on gold standard, the mint par of exchange being 25 francs to the pound. The rate of exchange that *actually comes to prevail* in the foreign exchange market is seldom equal to the mint par. It varies in response to changes in trade and a few other causes[1] but limits to its variations are set by the cost of transporting gold from one country to the other. This requires a little explanation. It is obvious that imports into a country from another country must *ultimately* be paid for in the currency of the exporting country. Imports into England from France, for example, must be paid for by British importers in francs. Similarly imports into France from England will have to be eventually paid for in British currency. Imports thus create a demand for the currency of the country from where they come and exports give a command over the supply of the currency of that country to which they are sent. The price that people in a country will pay in terms of their own currency for the currency of another country will depend on

[1] Among these other causes are movements of capital, speculation, apprehension or actual occurrence of political disturbances and changes in the rate of interest.

the demand for and the supply of foreign currency. In other words, the rate of exchange at any time will depend upon the relative amount of exports and imports. If exports increase, the supply of foreign currency at the disposal of the country is enlarged and its price in terms of the currency of the exporting country will tend to fall, *i.e.*, a smaller amount of home currency will tend to purchase a given amount of it. If, on the other hand, imports increase, the demand for foreign currency is enlarged and more in home currency will have to be given to purchase a given quantity of it or, in other words, the same amount of home currency will tend to purchase less of foreign currency.

The mint par, let it be assumed, is: One £: 25 Francs.

If now exports from England increase, one £ will *tend* to exchange for 25 francs.

If imports into England increase, one £ will *tend to* exchange for 24 francs.

These fluctuations in the rate of exchange due to changes in the balance of trade and other causes cannot, however, go beyond certain points under normal conditions. Exchange of one gold coin into another gold coin will stop as soon as it becomes less profitable than a direct shipment of gold (contained in the coin) from or to the other country. If the cost of sending out gold contained in the coin is less than the cost of exchanging the coin for a foreign gold coin, export of gold will be preferred to exchange of currency in the foreign exchange market. The rate of exchange cannot thus rise above or fall below certain points. As soon as these points are reached, people find export or import of gold cheaper than purchase or sale of foreign currency. These points are called *gold points* and are found by adding to and deducting from the mint par the cost of transport of gold.

It only remains to add that foreign currency is bought and sold through banks (which collectively make up the foreign exchange market) and the media used for the purpose are bills of exchange which are simply orders to pay specified amounts of currency of a country.

An example may be given here to bring out the meaning of gold points:—

Upper gold point

Mint par: one £ = 25 francs

If exports from England increase, 1 £ will tend to exchange for more than 25 francs.

Cost of transport of gold contained in a £ is, let us say, ¼ francs.

As soon as the rate of exchange in the market rises above 1£ = 25¼ francs, a British exporter will find it cheaper to get gold direct from France. He will receive minus cost of transport more than 25 francs which are equivalent to more than a £ (Mint par: 1 £ = 25 francs). No exporter will, therefore, receive less than one pound for every 25¼ francs from a bank. This is the upper gold point. The rate of exchange cannot rise higher than this, for an import of gold into England will be induced.

Lower gold point

Mint par: one £ = 25 francs

If imports into England increase, 1 £ will tend to exchange for less than 25 francs.

Cost of transport of gold in a £ = ¼ francs.

As soon as the rate of exchange in the market falls below 1 £ = 24¾ francs, a British importer will find it cheaper to export gold contained in a pound than to get francs through the bank. By exporting gold directly he can remit, after paying cost of transport, 24¾ francs. The rate of exchange cannot, therefore, fall below this point. This is the lower gold point. A fall below this point will lead to export of gold.

The rate of exchange will, therefore, fluctuate between 24¾ and 25¼ francs to the £.

Fluctuations of exchange and limits to them between two countries on silver standard are determined in the same way.

II. Case: Two countries—one on gold standard and the other on silver standard

In this case there is no mint par as such. The ratio between the metallic contents of the two currencies is variable, depending

on the price of silver in terms of gold. The rate of exchange, therefore, depends on three factors: (*i*) the volume of exports and imports, (*ii*) gold price of silver, and (*iii*) cost of transport of gold or silver from one country to the other. The value ratio between silver and gold from the middle of the seventeenth century and throughout the eighteenth varied between $13\frac{3}{4}$:1 and $15\frac{1}{4}$:1 but after 1870 this ratio was disturbed.[1]

A very good illustration of the determination of rate of exchange between a gold standard and a silver standard country is provided by the currency relationships of India and England during the nineteenth century. From 1835 to 1893 India was on silver standard and England on gold standard. In 1871-72 when the price of silver was $60\frac{1}{2}d.$ per ounce, the Indian rupee was equivalent to a little less than 2*s.* After 1873, the price of silver in terms of gold fell. Naturally the price of silver in the rupee in terms of gold in the pound also fell. In 1893, when gold price of silver was 39*d.* per ounce, the Indian rupee became equivalent to only 1*s.* 3*d.* During the same period fluctuations of exchange took place in response to changes in the balance of trade also—within the limits set by cost of transport of gold or silver from one country to the other.

III Case and IV Case: Two countries—one of which or both which are on inconvertible paper standard

These two cases may be considered together because they bear the same explanation. In these cases, there is no mint par as such and the question of cost of transport of metal from one country to the other does not arise because in one or both of the countries the currency is not convertible into bullion or coin.

In such cases the rate of exchange between the countries tends to equal the ratio between the purchasing power of the currencies of the two countries. If, for instance, one paper pound has the same purchasing power against commodities as five paper dollars, the rate of exchange will oscillate about the parity: 1£: $5. Exchange fluctuations will no doubt take place in response to changes in the balance of trade and other causes but will *centre round this purchasing power parity.*

1. Knut Wicksell: *Lectures on Political Economy,* Vol. II. p. 36.

During the last Great War many countries went off metallic standards and inflated their paper currencies. The old way of explaining fluctuations in the rate of exchange became utterly inadequate. A new explanation was necessary and this was provided by Prof. Gustav Cassel, the Swedish economist who propounded the now famous theory of Purchasing Power Parity. The essence of the theory is that exchange rates reflect the relation between the internal purchasing powers of the currency units of different countries. Confusion and misunderstanding have, however, been caused by this very simple statement of the theory and it has become necessary to distinguish between, what are described as, its positive and comparative forms. In its positive form, the theory states that the ratio of purchasing powers of two currencies furnishes the equilibrium or normal rate of exchange round which the actual market rate fluctuates. It was in this form that the theory was first expounded by Cassel but as it was found open to a number of objections by the critics, a different mode of its exposition was emphasized by the author. In its comparative form, the theory asserts that if an equilibrium rate of exchange has already been established between two countries and a change occurs in the purchasing powers of their currencies, then the new equilibrium or normal rate of exchange can be found by multiplying the old by the ratio of the change in the purchasing powers of the two currencies. In Cassel's own words:—

"Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money possesses a purchasing power against commodities and services in that foreign country. On the other hand, when we offer so and so much of our money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries.....When two currencies have undergone inflation, the normal rate of exchange will be equal to the old rate multiplied by the quotient of the degree of inflation in the one country and in the other. There will naturally always be found deviations from this new normal rate and during the transition period these deviations may be expected to be fairly wide. But the rate that has been calculated by the above method must be regarded as the new parity between the currencies, the point of balance towards which,

in spite of all temporary fluctuations, the exchange will always tend. This parity I call *purchasing power parity*".[1]

The usual, though not always a satisfactory, method of measuring the purchasing powers of currencies is the use of index numbers of prices. Changes in the general level of prices furnish the changes in the purchasing power of currencies. The example given below will give an idea of the purport of the purchasing power parity theory as also a rough method of calculating the parity.

Mint par or the old equilibrium rate:

Year	*England*		*France*
1913	1 £	=	25 Francs

	Index Nos. of prices	
	England	*France*
1913	100	100
1920	300	500

Purchasing power parity or the new equilibrium rate:

$$£ = 25 \times \tfrac{500}{300} \text{ francs}$$

or £ = 41.7 francs.

The figures taken here are true to facts to a small extent and the parity thus worked out also accords to some extent with the actual rate in January, 1920.

Into the refinements and criticisms of the theory it is needless to enter here. The theory has been accepted in essentials and used to explain the normal rates of exchange and exchange fluctuations not only of inconvertible paper currencies but of currencies based on metallic standards as well. The mint par of exchange may in fact be considered just as much a ratio of the purchasing powers of the metallic contents of the currency units as a ratio of the metallic contents themselves. The parity of purchasing power is thus a wide parity and includes mint of par of exchange.

Normal rate, Overvaluation, Undervaluation, Devaluation, Depreciation

Terms like overvaluation and undervaluation are so much a part of the jargon of the currency expert that it is impossible to follow

1. **Cassel:** *Money and Foreign Exchange after 1914*, pp. 138-40.

any serious discussion on currency matters without knowing their meaning. They describe—as indeed the prefixes de- and under- indicate—an *abnormal* valuation of currency. To know their meaning, therefore, one must ascertain what constitutes the normal valuation of the currency unit of a country. It is not easy to give a short and precise definition of the normal exchange value of currency or the normal rate of exchange. Far less easy is it to state exactly what the normal rate of exchange is under given conditions. In a general way, the normal rate of exchange may be defined as one which prevails in, and brings about, conditions of equilibrium in the balance of payments and of general economic stability. This rate imposes no strain either on the balance of payments or on export industries: causes, consequently, no continuous outflow or inflow of gold; subjects the internal economy of a country to no undue stress and reflects the basic economic relations, including the relations of price levels, of one country and another. It follows that any other rate will give rise to a series of disturbances, maladjustments and disharmonies. As a matter of fact, the normal rate can be picked out more by the absence of such unfavourable reactions than by any formal definition of its own.

But the more important, because more practical, question is one of finding out the normal rate at a given point of time. As a good approximation it may be said that the purchasing power parity constitutes the normal or equilibrium rate; that is to say, a rate at which the purchasing power of currency unit at home is equal to its purchasing power abroad (on its conversion into foreign currency) is the normal rate. At this rate, the currency is neither overvalued nor undervalued. If the rate of exchange is higher than the normal rate so that the currency unit has more purchasing power abroad than at home, the currency is said to be overvalued. An overvalued currency depresses exports and export industries, stimulates imports and upsets the balance of payments, causes export of capital and gives rise to drain of gold. The British pound between 1925 and 1931 provides a good example of an overvalued currency. A currency is said to be in a state of undervaluation if it purchases less abroad (on conversion into foreign currency) than it does at home. An undervalued currency handicaps imports and encourages exports and stimulates an inflow of gold. The French franc was, at the parity chosen for it in 1928, considerably undervalued.

When a currency is overvalued, *i.e.*, when its external purchasing power is higher than its internal purchasing power, it can be brought back to its normal valuation in either of two ways: either its external purchasing power can be lowered or its internal purchasing power raised. Devaluation is the term used for the first alternative and may be defined as a reduction in the quantum of gold or foreign currency into which the currency unit is exchanged in the foreign exchange market. The second alternative is deflation which may be defined, in this context, as a contraction of the quantity of currency in circulation with a view to raising the purchasing power of the currency unit. Such contraction leads to a fall in prices and as certain items in cost of production, such as wages, may not fall to the same extent as prices, it may pare off profits and considerably discourage trade and enterprise. From the standpoint of the requirements of internal economy, therefore, a country will usually prefer devaluation to deflation. Considerations of international prestige and international economic relations may, however, dictate the other but less attractive course of deflation. It is necessary to mention here that devaluation may be resorted to not only to cure the disadvantageous state of overvaluation but also bring about the advantageous state of undervaluation.

The term 'devaluation' is often used interchangeably for 'depreciation' but devaluation implies a deliberate and definite reduction in value while depreciation means simply a fall in value which may not necessarily be deliberate and is generally not definite and predetermined.

Exchange control

At this stage it is necessary to turn from conditions of free competition and the concepts relevant thereto to a brief treatment of conditions of control.

The foreign exchange market in which currencies acquire their value from the interplay of the forces of demand and supply functions more or less freely in normal times. In times of disturbance or crisis, however, it is controlled or superseded by the monetary authority of the country which may be the government, the central bank or a special organisation created for the purpose. Exchange control is the compendious term covering all those measures of control which involve considerable intervention by the monetary authority in

the foreign exchange market. It aims at changing *directly* the demand or supply on the foreign exchange market and thus marks a departure from the conditions of free competition.

The chief aim of exchange control is, of course, to make the rate of exchange different from what it would be in a free exchange market. This aim obviously implies that the monetary authority is not satisfied with the rate determined by forces of demand and supply and wants a different rate to prevail. This control rate may be higher or lower than the rate of the uncontrolled market or it may be just a very much stabilised rate free from the fluctuations of a free market.

Exchange control is a product of unsettled times such as war, political upheaval or currency disturbance and is relaxed or removed with the return of normal conditions. It was adopted in most countries during the first World War, was gradually relaxed and removed between 1926 and 1931 but was re-adopted in many countries after the currency crisis of 1931. With the outbreak of the last war in 1939 it was introduced in countries where it did not already exist and was intensified in others.

Inflation, Deflation, Reflation

The three terms above do not refer to the state of the foreign exchange market but to the state of currency within a country. A brief explanation of them is being given here for two reasons: firstly, the state of home currency has a direct bearing on its valuation in terms of foreign currencies and secondly, the last war has impinged on, and altered the state of, almost all the currencies of the world. From the standpoint of war economy and also of post-war monetary reconstruction a clear understanding of the significance of these terms is advisable.

Inflation is one of those economic terms which cannot be precisely defined and some well-known writers on money have either confessedly left some 'mistiness" about it or not attempted to define it with scientific precision.[1] The general idea conveyed by the term is, however, happily not very much at variance with its common definition: it signifies an excess or superfluity of media of exchange,

1. Pigou in *Economics in Practice*, p. 85 and L. Von Mises in *Theory of Money and Credit* p. 240.

including notes and bank credit. And when this much has been agreed upon, further discussion can only turn on what constitutes 'excess' or 'superfluity' and how and when such excess may manifest itself. It is here necessary not to forget that the total effective supply of money or currency in any country is the combined result of its quantity and its velocity of circulation. This effective total supply is used for meeting the requirements of economic activity and from this interaction of money-supply and money-work, there results a certain general level of prices. It is difficult to say what relationship between money-supply and economic activity[1] is the optimum or the best and how it can be identified (if it ever exists) but some such optimum relationship will have to be visualised in order to obtain even a tolerably good definition of inflation.

Assuming, therefore, that equilibrium between money-supply and economic activity has been established and a desirable level of prices prevails, if now this equilibrium is disturbed by an expansion of the total effective supply of money, inflation will be said to have occurred. An invitable outcome of a larger supply of money acting upon an unchanged quantum of economic activity will be a rise in prices which is the most important manifestation of inflation. It is, however, possible that the equilibrium relationship between money-supply and economic activity may be disturbed not from the money side but from the commodity-side, that is to say, the requirements of the economic system for money may shrink but the supply of money may remain the same. In this case also, inflation will occur and prices rise, not by the active act of increasing money-supply but through the passive act of letting it remain as it was.

It is further necessary to note that though a large and continuous *general* rise in prices is an important symptom of inflation, a rise in prices need not always indicate presence of inflation just as a stable level of prices need not necessarily indicate absence of it. Prices in a country may rise because of the scarcity of many important commodities (caused, for instance, by failure of harvests) or because of the rise in world price level. Again, prices may be heading downward because of rapidly increasing productivity but the monetary authority of a country may, by putting increasing quantities of money

1. The term 'economic activity', used here in a comprehensive sense to cover production, trade, emploment etc., appears to be more suitable than the alternative terms sometimes employed, such as, production, real income, real values, etc.

in circulation, endeavour to maintain them at their old level. There would be no inflation in the former case but there would be one in the latter. The state of price level does not, in other words, furnish an unfailing clue to the presence of inflation; it is necessary to go further and enquire why the price level is changing as it does. A large and continuous rise in prices may however, safely be taken to furnish a fairly strong evidence of inflation.

It is necessary now to know why the equilibrium relationship of money-supply and economic activity should be disturbed at all. Normally, it may be said, there will be a tendency for such relationship to be established by the constant endeavour of the monetary authority of a country to adjust the money-supply to the need for it. It must, therefore, be an exceptional circumstance or emergency which hampers this process of adjustment and creates a maladjustment. Inflation, as a rule, occurs when a government, unable to meet its expenditure by the usual methods of levying taxes and raising loans, resorts to means which involve substantial additions to the total money-supply not offset by any corresponding need for them. These means may be either the direct one of printing currency notes and using them for making the requisite purchases or the indirect one of borrowing from the central bank against securities and thus bringing about an expansion of the more widely used medium of exchange, *viz.*, bank credit. Inflation brought about by means of the former kind is often called currency or fiat money or paper-money inflation and that resulting from means of the latter type is generally described as banking or credit inflation.[1]

Inflation is thus, to begin with, an easy and more or less inexpensive device for meeting an emergency which imposes a heavy strain on government finance. But if the emergency lasts, it gradually gathers momentum. For, as prices rise, the government has to bring forth a rapidly swelling volume of fresh purchasing power to obtain a steady command over goods and services. This accentuates the rise in prices further. Goods and services thus become progressively dearer in terms of money or, what is the same thing, money becomes

[1]See for an elaboration of this definition of inflation *Public Finance* by A. de Viti de Marco, p. 403n. ; also articles by Pigou in *Economic Journal* for the years 1918 and 1940. Anatol Murad's essay on 'Inflation in Current Economic Literature' included in Parker and Wills' *Economics of Inflation* is helpful ; so is American Research Institute's *What will inflation and devaluation mean to you*, 1941.

progressively cheaper in terms of goods and services. In the later stages of this vicious process prices begin to rise more than in proportion to the increase in the quantity of money in circulation because of the increased velocity of turnover of means of payment. This process cannot continue *ad libitum*; for no one would wish to keep his assets in a currency that is fast losing in value and a time may come when no one would care to accept it at all.[1] This 'flight from currency' has its counterpart in the hoarding of commodities particularly precious metals, jewellery, works of art and investment in dependable foreign currencies. The flight is complete when the currency is no longer acceptable and a substitute is found for it. This culmination marks the crash of the currency system—and the finale of inflation. An odious feature of inflation is the uneven rise in the money incomes of the different sections of the community; the fresh supplies of means of payment injected into the economic system find their way into some corners and crevices in greater profusion than in others. The resultant rise in prices affects most adversely the persons with small or fixed incomes while for the traders, manufacturers and speculators, it creates a spell of illusory prosperity. Inflation is, in effect, a measure of taxation, transferring to the government command over real resources but it is extremely indiscriminate, haphazard and inequitable in effects, inasmuch as it places the heaviest burden on the weakest shoulders and brings about arbitrary redistribution of wealth.

Deflation is, broadly speaking, the opposite of inflation and may be defined as a contraction in the total effective supply of money which is not offset by a corresponding diminution in the demand for money. Such contraction leads to a fall in the general level of prices, that is, to a rise in the value of money. Usually deflation is practised with the object of dealing with the excesses or aftermath of an inflation. The motive behind it is to raise the value of currency to its previous level, in terms of gold or in terms of other currencies.

[1]During the German inflation of 1920-23—the classical example—prices and bank note circulation touched staggering figures. The increase in note circulation proceeded at such a rate that "in the last months before the collapse, more than 300 paper mills worked at top speed to deliver note paper to the Reichsbank and 150 printing companies had 2,000 note presses running day and night to print the Reichsbank notes Prices rose daily, almost hourly... Money in the purse burned like fire and everyone thought only how to get rid of it at the earliest opportunity See Stopler: *German Economy*, 1870-1940: pp. 152-55. Inflation in China under the Kuomintang regime during the years following 1946 was equally severe.

Reflation is the term used for that specific and limited kind of expansion of currency which aims at raising prices from a lower level which is considered unsatisfactory to a higher level. Such an expansion is advocated in times of depression when a large fall in prices has wiped out the margin of profit and reduced business and enterprise to a stagnant state. Pumping money into circulation—'priming the pump,' as it is called—by judicious means is considered, under such conditions, a wholesome stimulant for industry and enterprise. But a policy of reflation is beset with the risk of gradually lengthening out into one of inflation.

CHAPTER I

A BRIEF OUTLINE

The history of Indian currency can be divided into more or less defined periods. It may be taken to date from 1835—the year in which the rupee was established as the standard coin throughout the territories of the East India Company. The following periods may be marked:—

I Period: 1835—1893, during which India was on silver standard. This period may further be split up into two periods (*a*) 1835—1874, during which efforts made to secure gold currency for the country proved abortive and (*b*) 1874—1893, during which the gold price of silver fell and led eventually to the suspension of silver standard.

II Period: 1893—1898: A period of transition which was to precede introduction of gold standard with gold currency.

III Period: 1899—August, 1917: A period during which the Government set out to establish gold standard but drifted on to gold exchange standard.

IV Period: August, 1917—1920: A period of unstable exchange during which the Government took measures to regulate currency.

V Period: February, 1920—September, 1920: A short period during which the Government tried unsuccessfully to restore stable gold exchange standard by holding the exchange at 2*s.* (gold) and involved Indian exchequer in a huge loss.

VI Period: 1920—27: A period during which the Government gave up attempts to *maintain* a particular exchange rate, but not those to *secure* a particular exchange rate.

VII Period: 1927—September, 1931: A period during which gold exchange standard (actually sterling exchange standard) was restored and efforts continuously made to maintain the rate at 1*s.* 6*d.*

VIII Period: September, 1931—August, 1939: A period of crisis and uncertainty which began with rupee being linked to sterling and during which the Indian currency system weathered the economic storm.

IX Period: September, 1939—August, 1945: Six years of the war during which the Indian currency system underwent some unprecedented and startling changes and during which the monetary authorities, led by the necessities of war, imposed various controls over currency and exchange.

X Period: September, 1945—March, 1951: The five and a half years of post-war period during which adjustments required by the post-war conditions were made, foundations of a reconstructed international monetary system were laid and problems arising from the partition of India and strain on balance of payments were dealt with. It was also the period during which India assumed control of her monetary system.

XI Period: April, 1951—March, 1959: The period of the Five-Year Plans for the rehabilitation and building up of the country's economy during which the monetary system was increasingly adapted to the requirements of planned economy.

It would be helpful to know that running like two threads through the history of Indian currency upto 1931, are the desire of Indian people to have a gold standard and the anxiety of the Government to maintain a stable exchange rate at all costs. The last war put the monetary systems of the world into the melting pot. From the discussions and decisions of the United Nations Financial and Monetary Conference held at Bretton Woods in July, 1944 emerged a new pattern of international monetary relations. The partition of India, advent of Independence and the adoption of planning are the more recent events which have influenced and shaped the currency system.

CHAPTER II

I Period : 1835—1893

FROM ADOPTION TO ABANDONMENT OF SILVER STANDARD

Attempts by the East India Company to reform Indian currency had begun much before 1835 and the silver rupee weighing 180 grains (11/12th fine) was made the standard coin in Madras in 1818 and in Bombay in 1823[1]. In 1835 (by the Act No. XVII) the silver rupee of 180 grains (11/12th fine) was made the standard coin throughout British India.[2] Mints were opened to the free coinage of silver. The face value of the rupee was equal to its intrinsic value, *i.e.*, the value of the rupee against gold or commodities was equal to the value of silver contained in the rupee. It must be obvious that coinage being free to public it was not possible for the Government to make the rupee circulate at a value higher than that of silver put in the rupee.

§1. Attempts to Introduce Gold in Circulation (1835—1874)

By the Act of 1835, which made the silver rupee standard coin, gold coins were deprived of their legal tender quality, *i.e.*, legally they could not be paid and accepted. The Act permitted, however, the coinage of gold mohars if required by the public. These mohars were to be equal in value to 5, 10, 15 or 30 rupees. It is difficult to understand why the gold coins struck under the Act were not to be legal tender. A proclamation issued in 1841 authorised receipt of gold coins at public treasuries in payment of public dues at their face value unless they had passed a certain limit of lightness when they were

1. Reform was needed because of the large variety of coins of gold and silver circulating in different parts of the currency. 994 coins of varying weight and fineness are said to have been circulating about this time.

2. The weight and fineness of the rupee remained unaltered upto 1940.

to be taken as bullion only, by weight. The rate at which gold coins were to be received was 15:1. Some encouragement was thus given to gold currency but it was to be very brief. Gold discoveries in California and Australia from 1848 to 1851 made it cheaper for the people to pay in gold rather than silver at the rate of 15:1. Gold began to flow to the treasuries in large quantities and the Government lost by accepting it at a rate higher than the market rate. From 1st January, 1853, therefore, receiving of gold coins in payment of public dues was stopped. Gold, however, continued to be received into the mint for coinage under the Act of 1835.

Mansfield Commission, 1866

Proposals were made after 1853 to introduce gold currency in India. Several Chambers of Commerce and Sir Charles Trevelyan (in his Minute of 20th June, 1864) pressed for the introduction of gold coins in India and the Government of India agreed to receive and pay, when convenient, sovereigns, and half-sovereigns minted at any authorised mint in England or Australia at the rate of Rs. 10 and Rs. 5 respectively. The gold coins were not to be legal tender, however. At these rates gold coins were not tendered at the treasuries. A Commission was appointed in 1866 under the chairmanship of Sir William Mansfield to report on the best way of meeting the currency demands of the country. It made the following recommendations:—

(*i*) gold coins of 15, 10 and 5 rupees should be issued.

(*ii*) currency should consist of gold, silver and paper.[1]

(*iii*) the possibility of issuing a universal note should be considered.[2]

Nothing resulted from these recommendations. In 1868, the rate for sovereigns and half-sovereigns was raised to Rs. 10–4 and Rs. 5–2 respectively to attract gold to the treasuries. Shortly after this the gold price of silver began to fall and in May, 1875, the

1. Currency notes had been issued and made full legal tender within their respective circle of issue by the Paper Currency Act of 1861. The Commission were to report on the working of this Act also.

2. To anticipate things a little, it may be mentioned here that five rupee note was made universal legal tender in 1909, ten and fifty rupee notes in 1910 and hundred rupee note in 1911. Five hundred and one thousand rupee notes were made universal legal tender in 1931.

Governor-General-in-Council expressed his unwillingness to take any step to recognize gold as the standard of value in India.

§2. Fall in the Gold Price of Silver

(1874—1893)

From 1874 onwards the gold price of silver began to fall. From 60½*d.* per ounce in 1871–72 it fell to 39*d.* in 1892–93. From 1873 to 1893, the fall amounted to 40 per cent. As the silver rupee was a freely minted coin, the value of silver in the rupee in terms of gold also began to fall and the rate of exchange fell from 1*s.* 11⅛*d.* to 1*s.* 3d. in 1892–93. There were two kinds of causes accounting for the fall in the gold price of silver:—

(*a*) Depreciation (fall in value) of silver due to increased production of silver and demonetization of silver by several countries such as Germany, Sweden, Denmark, Norway, etc.

(*b*) Appreciation (rise in value) of gold owing to its decreased production and increased demand from countries adopting gold standard such as Germany and Scandinavian countries.

For a long time the Government took no action and waited for the introduction of international bimetallism. The last of the International Monetary Conferences held at Brussels in 1892 adjourned without arriving at any agreement. The difficulties of the Government and people had in the meantime become acute owing to the following reasons:—

(*i*) To meet their Home Charges (*i.e.*, expenditure in England) they had to remit a larger number of rupees and this necessitated increased taxation.

(*ii*) Fluctuations of exchange introduced uncertainty so harmful to trade. It is sometimes said that a falling exchange stimulates exports but there was evidence to show that the progress of export trade was less with a rapidly falling than with a steady exchange.[1]

(*iii*) The European officials who made remittances abroad claimed compensation for the loss they suffered due to a fall in exchange. The prices in England had no doubt fallen at that time but even allowing for that the amount of sterling which the same number of rupees procured had been largely reduced.

1. Report of Herschell Committee, (1893), para 27.

(*iv*) A falling exchange greatly checked the investment of British capital in India because there was uncertainty as to the interest received from such investment and the reduction that the principal sum may suffer when it was transferred to England at a lower rate.

(*v*) A falling exchange, involving as it did smaller remittances for the same number of rupees, made it more difficult to arrange for the services of European employees to carry on industrial undertakings in India.

The Herschell Committee, 1892

In 1892, a committee was appointed under the chairmanship of Lord Hershell to consider if it was expedient to close the mints to the free coinage of silver with a view to the introduction of gold standard, as was suggested by the Government of India. The object of closing the mints to the free coinage of silver was to secure control over the supply of rupees and thus prevent a fall in the exchange value of the rupee. The Herschell Committee recommended that:—

(*i*) Mints should be closed to the free coinage of both silver and gold,[1] but the Government should retain the liberty to coin rupees if required by the public in exchange for gold received in Government treasuries at the rate of 1*s*. 4*d*.: Re.

(*ii*) The rupee must remain full legal tender.

Regarding the introduction of gold coins in India, the Committee did not attach any importance to the objection that Indian people were not used to them. "Gold", they said, "has never been entirely out of use in India" and, in any case, the ordinary currency in India would still be silver or paper though based on gold. Moreover, if gold coinage were introduced on proper basis, much of the uncoined gold in India would be brought to the mints.[2]

By Act No. VIII 1893, mints were closed to the free coinage of silver, though the Government retained the power to coin rupees

1. This deserves notice because the Act of 1835 and the Indian Coinage Act of 1870 permitted coinage of gold for the public though gold was not legal tender. The Act of 1893 stopped even the coinage of gold.

2. Report of the Herschell Committee, 1893, paras 99-103.

on their own account. Three notifications (Nos. 2662–64) were also issued making arrangements for (*a*) the receipt of gold at the mints at the rate of 7·53344 grains of fine gold per rupee or 16*d.*: Re.[1] (*b*) receipt of sovereigns and half-sovereigns in payment of public dues at 16*d.* : Re. and (*c*) issue of currency notes to the Controller General in exchange for British gold or gold bullion.[2] The aim of the Act and the notifications was to raise the gold value of the rupee to 1*s.* 4*d.* by restricting its supply, make it effective at that rate and then to introduce gold standard.[3]

It may be of some interest to note that the total coinage of rupees during the currency of silver standard in India from 1835 to 1893 amounted to 335½ crores of rupees.[4]

1. This notification was later on withdrawn in 1906.

2. This notification was supplemented by the Paper Currency Act of 1910 which provided for issue of notes against British gold coin.

3. Lords T. H. Farrer and R. E. Welby, two members of the Herschell Committee, had pointed out in a separate note that if gold does not flow into Government reserve against paper issue automatically, "a reserve (of gold) should be provided before the Indian Government takes the final step of announcing gold as the standard, coupled with the correlative obligation to give gold for silver." *Report*, p. 56.

4. Report of the Head Commissioner of Paper Currency, Calcutta, for the year 1896-97, p. 19.

CHAPTER III

II Period : 1893-1898

A PERIOD OF TRANSITION

In a telegram of the 22nd January 1893, the Government of India had said : "We think that an interval of time, the length of which cannot be determined beforehand, should elapse between closure of the mints and any attempt to coin gold here." During this interval which extended from 1893 to 1898, the exchange value of the rupee fell in the beginning so low as 1s. 1*d.* in 1894[1] but recovered later and was 15.9*d.* in 1898. The Government of India now made proposals to end the period of transition and to take "active steps to secure the early establishment of a gold standard and a stable exchange." These proposals were (*i*) to raise the rate to 16*d.* (it was then a little less) by withdrawing some rupees from circulation and melting them, (*ii*) to raise a loan in England and to remit part of it to India in sovereigns to serve as gold reserve against note-issue, (*iii*) to sell silver bullion obtained from melted rupees and add gold to the reserve and (*iv*) to part with gold only after the rate had been established at 16*d.*

The Fowler Committee, 1898

In 1898, a Committee was appointed presided over by Sir Henry Fowler to consider these proposals for making effective the policy initiated in 1893. The Committee had also to suggest ways of securing a satisfactory system of currency and stable exchange.

The Committee had before them three broad alternatives : (*i*) re-opening the mints to the free coinage of silver *i.e.*, reversion

1. This was due to suspension of silver purchases by America and an apprehension about a fall in the value of silver rupees which were, therefore, brought out of hoards to be disposed of before further fall occurred.

to silver standard, (*ii*) continuance of the existing arrangements and (*iii*) the introduction of gold standard, with or without gold currency. The Committee was against reverting to silver standard because it would result in renewed instability of exchanges between India and gold standard countries, hamper international trade and revive the difficulties that the Government of India had to face in meeting their obligations in England. They were also against allowing the *status quo* to continue because it would cause additional uncertainty and raise doubts as to the ultimate success of gold standard in India.

The Committee, therefore came to the conclusion that the government should proceed with measures for the effective establishment of a gold standard. Among the three different schemes of gold standard placed before the Committee, those of Mr. Lesley Probyn and Mr. A. M. Lindsay provided for gold standard without gold currency while the Government of India's scheme favoured gold standard *with* gold currency. The Committee rejected the first two schemes and made the following recommendations :—

(*i*) The British sovereign should be made a legal tender and a current coin in India. Indian mints should be thrown open to the unrestricted coinage of gold on such terms and conditions as govern the three Australian branches of the Royal Mint.

(*ii*) The rate of exchange should be made stable at 1*s.* 4*d.* : Re.

(*iii*) Rupees should remain unlimited legal tender.

(*iv*) The Government should continue to give rupees for gold but fresh rupees should not be coined until the proportion of gold in the currency is found to exceed the requirements of the public.

(*v*) Any profits on the coinage of rupees should be accumulated in a special reserve fund.

(*vi*) No legal obligation should be imposed on the Government to give gold for rupees; for this would make the Government liable to find gold at a moment's notice in undefined amounts.

(*vii*) The Government should make gold available for export if exchange shows a tendency to fall below the specie point.

In two respects the currency system recommended by the Committee differed from the ordinary gold standard. In the first place, though gold coins were to be freely minted and were to be full legal tender, there was to be no *legal* obligation on the Government to convert rupees into gold. Secondly, the rupees, quite unlike subsidiary coins under gold standard, were to remain full legal tender[1] The Committee, it is clear, looked forward to the ultimate establishment of gold standard with gold currency and had meanwhile recommended for adoption a close approximation of it.

1. *Cf.*, however, "It is sometimes erroneously believed....that the proper position of a rupee under a gold standard is not to be unlimited legal tender." L. C. Jain *Monetary Problems of India*, p. 29. The question was discussed by the Fowler Committee, vide *Report*, paras. 56-59.

CHAPTER IV

III Period : 1899—*August*, 1917

EVOLUTION, MECHANISM AND BREAKDOWN OF GOLD EXCHANGE STANDARD

§1. Evolution Of Gold Exchange Standard

The effective establishment of gold standard was the paramount object which the Fowler Committee set before the Indian authorities. The Government of India decided to take action on the recommendations of the Committee. The Indian Act No. XXII of 1899 made the sovereign and half-sovereign legal tender throughout India at Rs. 15 : £ (1*s*. 4*d*. : Re.). Active steps were taken to open a mint for the coinage of gold in India but the scheme was dropped after nearing completion in 1902. A reserve, called the Gold Reserve, was created to set apart the profits on the coinage of rupees. An active effort was made to induce the people to use sovereigns as a medium of exchange and currency offices, post offices and government institutions were instructed to pay out sovereigns to the public. The results were unsatisfactory and a large number of gold coins were returned to the Government treasuries. In many places sovereigns went to a discount of as much as 4 annas. At the same time there was such a large demand for rupees that the Government was compelled to resume the coinage of rupees early in 1900. The profits on the coinage were credited to the Gold Reserve.[1] After 1900 the experiment of putting gold coins into circulation was not repeated. Apparently it was concluded by the Government that people did not want gold coins.

1. From 1894 to 1897 there had been no coinage of rupees; from 1897 to 1899 no new rupees were coined: coinage was on a small scale and was done mostly on account of some Indian States adopting British rupees in place of their own silver coin. There was a phenomenal coinage in 1900-1901 of a little over Rs. 17 crores and "the Currency Department was hardly able to comply with the demand." (vide *Report of the Head Commissioner of Paper Currency*, 1896-97 to 1903-04).

The conclusion was wrong because both the time and manner of putting gold coins into circulation were ill-chosen. Famine conditions prevailed about this time and rupees were needed for small payments. The method of forcing sovereign simultaneously from several sides on the people was hardly correct. With the odds heavily against them the Government tried to take the citadel by storm and when the first attack was repulsed they threw up their hands in despair.

After this, the currency system steadily deviated away from the aim of an effective gold standard. In 1900 the experiment of making people use gold coins failed. In 1902, the scheme of gold mint was dropped owing to the disapproval of British treasury authorities.[1] In the same year the arrangement initiated in 1893 of issuing currency notes against gold received by the Secretary of State in London was made permanent.[2] In 1904 the Secretary of State notified his willingness to give rupees for sterling without limit at a rate based on 1*s.* 4*d.* : Re. The reserve constituted out of the profits on the coinage of rupees—the Gold Reserve—was remitted, according to the Secretary of State's decision, to London in gold and invested in sterling securities. The original object of this reserve was to ensure convertibility of Indian currency into gold at 1*s.* 4*d.* : Re. and thereby make gold standard effective. The Secretary of State, however, held that as a large demand for conversion of rupees into gold would arise only in an emergency when balance of trade turned against India and large payments had to be made in London, the Reserve should be kept in London. The Fowler Committee never intended that the reserve should be so kept nor could they ever dream that the Reserve would be drawn upon, as it was actually drawn upon in 1907 to the extent of £1,123,000,

1. One of the reasons for disapproval was that "sovereigns were being rapidly attracted to India whenever required and there was no reason for believing that the position of gold standard in India would be strengthened or public confidence in the intentions of the Government of India confirmed by the mere provision of machinery for the manufacture of gold coins in the country."

(*Government of India Despatch quoted in the minute of Dissent to the Hilton Young Commission's Report*, p. 105).

2. The gold received by the Secretary of State was kept as part of the reserve to back Indian paper currency. This reserve known as the Paper Currency Reserve——was meant to ensure convertibility of currency notes into rupees and gold coins and was held hitherto in securities, silver and gold. Now a part of it came to be held in gold in London.

for expenditure on railway development. In 1907 a rupee branch of the Gold Reserve was created to ensure ready supply of rupees in exchange for gold tendered in India at 1*s.* 4*d.* : Re. and to prevent thereby a rise in the exchange rate. The name of the Reserve after the creation of this branch was changed into Gold Standard Reserve which now consisted of a rupee portion and sterling securities portion[1]. In 1908 when the balance of trade turned against India, exchange tended to fall and there was a strong demand for gold for export, the Government after much hesitation made available gold out of the London branch of Gold Standard Reserve against rupees received by them in India.[2] More than £8 millions were withdrawn out of the London branch of gold Standard Reserve.

All the various steps taken by the Government of India were nowhere recommended by the Fowler Committee. It appears that after having got loose of the sheet anchor of gold standard, the Government policy steadily drifted quite unconscious of the destination to be reached. The various steps the Government took during this period were in the nature of experiments to maintain the value of the rupee at 1*s.* 4*d.* These steps led, however, to the adoption by India of a new kind of currency system known as Gold Exchange Standard. This system had no basis in law ; for it was the result of a series of administrative acts. It was not adopted as a consistent whole ; for it was never consciously designed.

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1. The composition of the Gold Standard Reserve at the beginning of 1908-09 was as follows :—

	£
Purchase value of sterling securities	13,186,521
Coined rupees held in India	4,000,000
Gold temporarily forming part of balances of Secretary of State	1,131,223
Outstanding debt from treasury balances	310
Total ..	18,318,054

2. By the end of the year, the value of coined rupees held in India increased to £10,586,734 and that of sterling securities declined to £7,414, 510.

(*Report of the Head Commissioner of Paper Currency for* 1908-09 and 1909-10).

As this system functioned upto 1917 in spite of the stress and strain of early war years, its mechanism may be clearly explained.

§2. Mechanism of Gold Exchange Standard

The germs of a system resembling Gold Exchange Standard are to be found in the writings of Ricardo, the famous British economist, who believed that a currency was in its most perfect state when it consisted of a cheap material which had an equal value with the gold it represented. The gold is available for purposes of export only and does not enter into the internal circulation of the country. A system resembling the one advocated by Ricardo was introduced in several countries in an imperfect form but India was the first country to adopt it in a complete form.[1]

The essentials of Gold Exchange Standard system are three:—

(*i*) A cheap currency consisting of tokens. In India it consisted of silver rupees, half-rupees and currency notes which were unlimited legal tender.

(*ii*) The currency is not convertible into gold for internal use but the Government or the Central Bank of the country makes gold (or the currency of a country on gold standard) available to the people for purposes of foreign payments at a fixed rate in return for cheap internal currency. In India, the Government made arrangements for converting internal currency into British currency based on gold.

(*iii*) Funds or reserves are kept in a foreign country to make gold (or currency of a gold standard country) available to the people for foreign payments. In the case of India the Gold Standard Reserve was constituted.

One great merit of such a system is that the country avoids the use of a costly gold currency but has gold at its command to make foreign payments.

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1. J.M. Keynes: *Indian Currency and Finance*, p. 33.

The Gold Exchange Standard in the form in which it was adopted in India is known as the Lindsay Scheme. Mr. A. M. Lindsay, the Deputy Secretary of the Bank of Bengal[1] in his evidence before the Fowler Committee proposed a system only slightly differing from the one which was ultimately adopted. The Committee rejected the scheme on three grounds:

(*a*) Any system without a visible gold currency would be looked upon with distrust.

(*b*) Flow of capital to India would be checked.[2]

(*c*) India's gold standard would come to be based on a few millions of gold (or rather command over gold) kept in London.

Mr. Lindsay had always maintained that "they *must* adopt my scheme despite themselves" and he was right.

The Gold Exchange Standard system was worked in India by the sale of Council Drafts and Reverse Council Drafts. Council Drafts or Rupee Drafts were orders by the Secretary of State to the Government of India to pay rupees. These orders could be sent by post when they were called Council Bills or in a telegraphic form when they were called Telegraphic Transfers. These "orders" were sold to British banks, firms and importers in exchange for sterling (*i. e.*, British money) received from them. The net result of the sale of Council Drafts was that the Secretary of State received sterling and the Government of India released an equivalent amount of rupees. The rate at which Council Drafts were to be sold was announced by the Secretary of State. Council Drafts had been sold even before 1893 but only to the extent to which funds were required by the Secretary of State to meet certain expenses (called Home Charges) on behalf of the Government of India. Instead of British importers of Indian goods sending sovereigns to India, people tendering them to the Government in exchange for rupees and the Government of India sending them back to London to meet their Home Charges, sovereigns were received by this method by the Secretary of State directly from British importers, the Indian exporters being paid in rupees. After 1893, however,

1. Before to establishment of Imperial Bank in 1920 there were three presidency Banks, in Bombay, Bengal and Madras.

2. Presumably due to the distrust and uncertainty of foreign investors about the return on their investments in the absence of an effective gold standard.

the sale of Council Drafts was extended beyond the requirements of Secretary of State and in 1940 the Secretary of State announced his willingness to sell Council Bills on India *without limit* at 1*s.* $4\frac{1}{8}$*d.*: Re. By this means the balance of exports over imports could be paid for in London without the export to India on private account of more gold than was required by the people. By offering Council Bills in London the Secretary of State began to facilitate the course of Indian trade. He also got a lever by which he could prevent the rate of exchange from rising higher than 1*s.* $4\frac{1}{8}$*d.* : Re. It is obvious that so long as the Secretary of State offered one rupee for every 1*s.* $4\frac{1}{8}$*d.* received by him, no person wishing to remit money to India would have paid more than 1*s.* $4\frac{1}{8}$*d.* for a rupee to any other person or bank. Nor would any one care to ship gold or sovereigns direct to India.

The sale of Council Drafts was one facet of the Gold Exchange Standard system, the other being the sale of Reverse Council Drafts. The Reverse Council Drafts or Sterling Drafts[1] were orders by the Government of India to the Secretary of State to pay sterling (*i.e.*, British currency) in return for rupees received by them. The result of the sale of Reverse Council Drafts[2] was that the Government of India received rupees and the Secretary of State released from his funds sterling. The demand for Reverse Councils, unlike that for Councils, arose rarely, for Reverse Councils would be demanded only when the payments to be made abroad were larger than those made by foreigners to this country and this could happen only when imports were larger than exports. Reverse Councils were not sold below the rate of Re. : 1*s.* $3\frac{29}{32}$*d.*

By the sale of Council and Reverse Councils the exchange was prevented from deviating very much from a fixed rate—1*s.* 4*d.* : Re. It could fluctuate between 1*s.* $3\frac{29}{32}$*d.* and 1*s.* $4\frac{1}{8}$*d.* to the rupee.

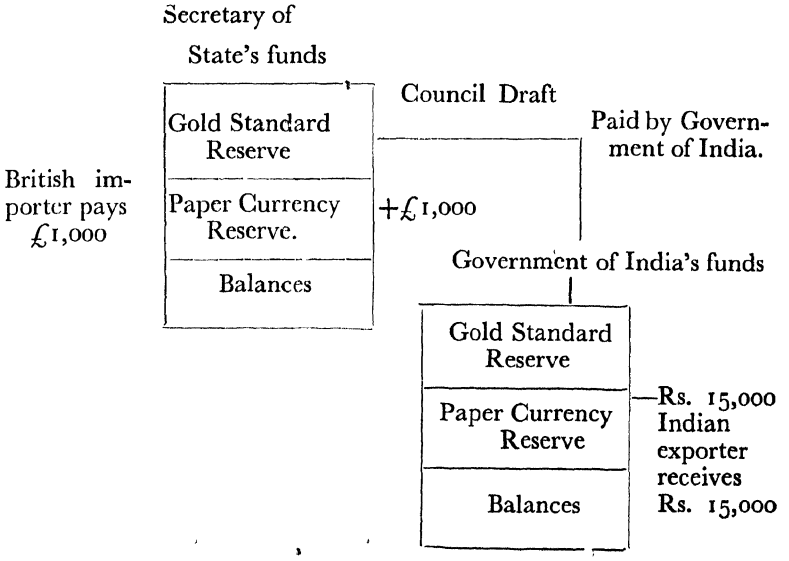
To complete the explanation, a few words may be added about the funds out of which the Councils and Reverse Councils were paid out. The proceeds of the sale of Councils were credited partly to the Secretary of State's balances, partly to Paper Currency Reserve

1. So called because they were sold in a reverse direction to Council Drafts.

2. Council Drafts and Reverse Council Drafts are often referred to shortly as "Councils" and "Reverse Councils."

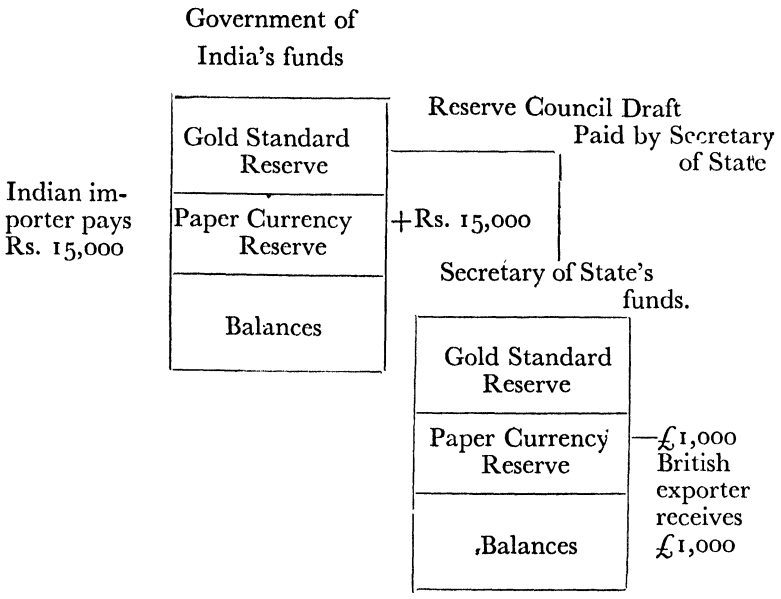
held in gold in London[1], and partly to Gold Standard Reserve. The Councils were paid out of the Government of India's balances, the Indian portion of Paper Currency Reserve or rupee branch of Gold Standard Reserve. The proceeds of the sale of Reverse Councils were credited to balances or Paper Currency Reserve by the Government of India and they were paid out of balances or Gold Standard Reserve by the Secretary of State. Thus the balances, Paper Currency and Gold Standard Reserve (with their respective functions of meeting current requirements, backing paper currency and meeting Reverse Councils) were in practice used indiscriminately to maintain the exchange value of the rupee. The diagram given below illustrates the mechanism of gold exchange standard.

The sale of a Council Draft of £1,000 = (*Rs.* 15,000)



1. The Paper Currency Reserve was the Reserve held against currency notes in circulation in India. The Act of 1861 provided for the issue of a maximum of Rs. 4 crores of currency notes against securities held as part of the Reserve, the rest of the Reserve being held in silver coin. By 1911 many changes had taken place in the composition of the Reserve. The amount of note-issue against securities had been raised to Rs. 14 crores and the Reserve had come to consist of, besides securities (both rupee and sterling securities), gold coin and bullion and silver coin and bullion. It was held partly in England and partly in India subject to the proviso that all coined rupees were to be kept in India.

The sale of a Reverse Council Draft of Rs. 15,000=(£1,000)



The Chamberlain Commission, 1913

The views of the Chamberlain Commission about this system may be stated briefly. The Commission was appointed under the chairmanship of Mr. Joseph Austin Chamberlain in 1913 to enquire into the methods of maintaining exchange and the location and use of the reserves and balances and to report whether the existing practice was conducive to the interests of India.[1] The Commission found the Gold Exchange Standard most suited to the conditions in India. They were of opinion that to encourage an increased use of gold in internal circulation was not to India's advantage and that the people of India neither desired nor needed gold as currency. There was no need of a mint for the coinage of gold but if Indian sentiment demanded it and the Government were prepared to incur the expense, one might be established for the coinage of sovereigns and half-sovereigns. If a mint could not be opened, the Govern-

1. The Commission did not visit India and examined only a limited number of witnesses from India.

ment should renew the notification withdrawn in 1906[1] to receive gold at the Bombay mint in exchange for notes or rupees.

About Gold Standard Reserve they held that no maximum limit to its amount could be laid down but a much larger portion of it should be held in gold. The proper place for the location of the Reserve, they said, was London. The abolition of rupee (Indian) branch of the Reserve was recommended.

The Paper Currency system, they recommended, should be made more elastic by issuing a larger amount of notes against securities.[2] The use of notes as part of the currency should be encouraged and 500 rupee note universalised.

The Commission also recommended that the Government should definitely undertake to sell bills in India on London at the rate of 1*s.* $3\frac{29}{32}$*d.* per rupee whenever called upon to do so. (It may be recalled that during the crisis of 1907–08 they were sold only after considerable hesitation).

The report of the Commission was published in February, 1914 and in July, 1914 the war broke out. The Government could not, therefore, take action on most of the recommendations of the Commission but they abolished the silver branch of the Gold Standard Reserve and readily offered Reverse Councils for sale when the demand for them arose at the outbreak of war.

§3. War and breakdown of gold exchange standard

The outbreak of the war in July, 1914 caused in India general dislocation of trade and business. Exchange became weak,[3] savings bank deposits were withdrawn, notes were presented for encashment in large quantities and gold was demanded in exchange for notes. All these were signs of panic and the Government took speedy action

1. See page 7, footnote 1.

2. The amount of note-issue against securities (fiduciary issue) could be increased only by resort to legislation and so a large metallic reserve had to be kept. This made a sudden and large increase in note issue difficult for the Government, making the system of note issue inelastic. The Commission recommended a larger amount of fiduciary issue.

3. This generally happens due to capital being withdrawn from the country in panic and a loss of confidence in the currency.

in dealing with them.[1] To deal with the weak exchange, sterling drafts were sold to the extent of £ 8,707,000. Demand for withdrawal of savings bank deposits was met by continuous payments and about Rs. 8 crores were paid within a few months. Notes were readily encashed to the extent of Rs. 10 crores. The demand for gold in exchange for notes was met in the beginning but the issue of gold to private persons (*i. e.*, apart from genuine trade purposes) was stopped on the 5th August, 1914. All these prompt measures led to the restoration of public confidence by the beginning of 1916.

About the end of 1916, however, complications began to arise in the Indian currency system. The balance of trade began to turn abnormally in favour of India and during 1916–17, 1917–18, and 1918–19 the balance was much larger than the average pre-war balance. This was due to two causes: (*a*) increase in exports due to demand at high prices for raw materials and foodstuffs required for the use of the Allied Powers and (*b*) contraction of imports from United Kingdom and her Allies and complete cession of imports from Germany and Austria. Owing to this favourable balance of trade, a tendency was set up towards a rise in the rate of exchange and there was a heavy demand on the Government for rupees and currency notes. This heavy demand was further intensified by other payments that had to be made on behalf of the British Government, British Dominions and America for expenses of war in Mesopotamia, Persia etc., and for purchases made in India. The Government of India would not have been called upon to meet this heavy demand all by themselves if gold and silver had flowed freely into India as in pre-war years. Restrictions had, however, been imposed on the export of gold and silver by countries engaged in war and the world production of silver had also fallen. The burden of liquidating the balance of trade was thus thrown wholly on the Government.

The large purchases of silver by the Government of India, in order to meet the additional demand for currency, combined with a decrease in the world supply of silver and the increased demand

1. Fortunately the banking crisis of 1913-14 had already had 'the salutary effect of purging the country of unsound institutions whose collapse at a later stage would have greatly aggravated the situation'. (*Report of the Controller of Currency* for 1913-14).

from other countries, led to a rise in the price of silver. From 27¼*d.* per standard ounce in 1915 the price of silver rose to above 43*d.* per standard ounce in August 1917 and 55*d.* in September 1917. The price of 43*d.* per standard ounce deserves notice because at this price the exchange value of the rupee was equivalent to its bullion value. If the price rose higher than 43*d.* per ounce, the exchange value of the rupee could not be maintained at 1*s.* 4*d.* The rupee became worth far more than this in gold and if the Government did not give more than 1*s.* 4*d.* in exchange for a rupee, the rupee itself would be melted or exported. On the other hand, the Government could not continue to sell Council Drafts at the rate of 1*s.* 4*d.* *i.e.*, give rupees, whose value was rapidly rising, in exchange for sterling at that rate. With every rise in the price of silver above 43*d.*, the government had to raise the rate of exchange accordingly. The Gold Exchange Standard which depended for its satisfactory working on the sale of Council Drafts without limit and on rupee remaining a token coin broke down. The exchange value of the rupee now began to move in step with its intrinsic value as it had done from 1873 to 1893.

The Gold Exchange Standard was an accidental find for India. It was almost a case of Jupiter going out to find fire and finding God. The system had received the praise and approval of Mr. J. M. Keynes and the Chamberlain Commission. India, they had seemed to say, had discovered a wonderful standard which lay in the "main stream of currency evolution."[1] India had been saved from the cruel fate of being crucified on the cross of gold. She could well spread her tails like a peacock to the sun. But now that the standard broke down, 'the enchantment was at an end, the mirrage evaporated, the soap bubble burst and the chariot of Cinderella relapsed into its original pumpkins and mice' !

1. J. M. Keynes, *Indian Currency and Finance*, p. 29.

CHAPTER V

IV Period : August 1917—1920

WARTIME REGULATION OF CURRENCY

§1. Government Measures to Regulate Currency

In September, 1917, the Government of United States took measures to control silver market and upto April, 1919, the price of silver did not rise higher than 50*d.* per standard ounce. When the control over the silver market was withdrawn in May, 1919, the price began to rise again. It rose to 58*d.* per oz. in May, 1919 and to 78*d.* per oz. in December, 1919. As the price of silver rose, the rate at which Council Drafts were sold had also to be raised. It was raised as follows :—

28th August,	1917	..	1*s.* 5*d.*
12th April,	1918	..	1*s.* 6*d.*
13th May,	1919	..	1*s.* 8*d.*
12th August,	1919	..	1*s.* 10*d.*
15th September,	1919	..	2*s.*
12th December,	1919	..	2*s.* 4*d.*

To meet the demand for rupees, the Secretary of State for India purchased silver for coinage into rupees but the demand was so enormous that the ordinary market could not satisfy it and an approach had to be made to the Government of U.S.A. for sale of silver dollars in their reserve. In April, 1918, the United States Government passed the Pittman Act authorising sale of silver from their reserve and the Government of India purchased 200 million fine ounces of silver. If this huge quantity of silver had not been received, there might have been a serious currency crisis in India and the convertibility of currency notes into silver rupees would have had to be suspended.[1]

1. At one time in the year 1918, the rupees in the Currency Reserve available for encashment of notes amounted to a little more than 4 crores against a total note circulation of 115 crores.

Besides raising the rate of exchange and purchasing silver, the Government of India also took measures to exclude private buyers from the silver market, conserve their stocks of gold and silver and to economise the use of silver. From 3rd September, 1917, the import of silver into India on private account was prohibited. The melting of silver or gold coin was made illegal in June, 1917 and the export of silver coin and bullion from India was prohibited in September, 1917. Rs. $2\frac{1}{2}$ and one-rupee notes were issued[1] and nickel coins of eight, four and two annas were put into circulation. On 29th June 1917 an Ordinance was issued requiring all gold imported into India to be sold to the Government. Gold mohurs and sovereigns equivalent to 15 rupees were also coined and issued to supplement the currency. The fiduciary portion[2] of the note-issue was increased from November, 1915 onwards rising from Rs. 14 crores in 1911 to Rs. 120 crores in 1919 and restrictions were imposed on the encashment of notes. This led to a small discount or *batta* on notes in many parts of the currency.

§2. A Post-War Review

The Babington Smith Committee, 1919

All these measures were taken to cope with an unforeseen situation of great difficulty. As the tension created by the war relaxed, restoration of stability in exchange became necessary.

In May, 1919, therefore, a Committee was appointed under the chairmanship of Sir Henry Babington Smith to examine the effect of the war on Indian exchange and currency system, to suggest modifications in it and to make recommendations with a view to ensuring stable exchange standard. These terms of reference precluded the Committee from considering or recommending any other system of currency.

The Committee emphasized the importance of stability of exchange for production and trade and recommended that the exchange value of the rupee be fixed at 2*s.* (gold) *i.e.*, Rs. 10 : one Sovereign.[3] Two points about this recommendation deserve notice:

1. The issue of these notes was stopped from 1st January, 1926.
2. The portion of note-issue not backed by metallic reserve but by securities.
3. At this rate one Rupee = 11.30016 grains of fine gold.

firstly, a high rate of exchange was to be fixed and, secondly, the value of the rupee was to be fixed in terms of gold rather than sterling. During the war, sterling, *i.e.* British paper money, did not remain equivalent to the gold it represented. It had depreciated in relation to gold. The Committee were in favour of linking the rupee to gold rather than depreciating sterling.

A high rate of exchange was recommended by the Committee to ensure that the rupee would remain a token coin. By making the rupee a token coin the Gold Exchange Standard could be made to function as before.[1] The Committee favoured a high rate of exchange on other grounds also. A high rate of exchange would secure imports of goods at lower prices or at least check the rise of prices and thus reduce social and economic discontent.[2] It would have no adverse effect on exports of Indian goods because of the large world demand for Indian raw materials and foodstuffs. It would help industrialists, too ; for it would keep down the prices of imported stores and machinery and by keeping low the cost of living check a rise in the wages of the workers. Finally, it would secure economy in Home Charges, for a given amount of them could be remitted with a smaller number of rupees.

Mr. D. M. Dalal, a member of the Committee, was opposed to the stabilization of the rate at 2*s.* (gold) and wrote a minority report. He was in favour of maintaining the old ratio of 1*s.* 4*d.*: Re. The rise in the price of silver was the chief argument for raising exchange ratio but Mr. Dalal held that the rise in the price of silver was artificial and could have been prevented by allowing export of silver from India after the War. He also believed that a rise in exchange ratio would cause setback to several Indian industries and big losses to Indian exporters. It would also involve enormous loss to India on account of revaluation in terms of rupees of reserves invested in sterling securities and of gold held as part of the metallic

1. It may be mentioned here that the fixation of a high rate of exchange was not the only possible way of restoring the token character of the rupee. Two other ways of achieving the same end were the debasement of the rupee coin (*i.e.* reduction in its weight or fineness) and the complete or partial suspension of the convertibility of rupee notes into rupee coin. These were in the prevailing state of public confidence impracticable.

2. If the rate of exchange be 2*s.* (gold) or Rs. 10 to one Sovereign, 10 rupees had to be paid for an imported commodity like cloth or sugar worth one sovereign; if the rate be lower, say, 1*s.* 4*d.* or 15 Rs.: £, the price paid is higher.

reserve against the note-issue. Mr. Dalal regarded Gold Exchange Standard as unsuitable to Indian conditions and was generally in favour of abolishing the control exercised by the Secretary of State. over Indian exchange and removing restrictions on the free movement of gold and silver bullion to and from India.

The main conclusions and recommendations of the Babington Smith Committee may be set down as follows—

Those relating to stabilisation of the Rupee

(*i*) It is desirable to restore stability of the rupee and to re-establish automatic working of the currency system.

(*ii*) The exchange value of the rupees should be fixed in terms of gold rather than sterling and stabilised at 2*s*. (gold) or Rs. 10 to one sovereign (one rupee=11.30016 grains of fine gold).

Those relating to restoration of automatic working of the system

(*iii*) Council Drafts may be sold by the Secretary of State in excess of his immediate needs when a trade demand for them exists.

(*iv*) During periods of exchange weakness, the Government of India should be authorised to sell Reverse Councils without previous reference to the Secretary of State. Inconvenience and delay were caused by the necessity of consulting the Secretary of State beforehand and public confidence in the system was not ensured.

(*v*) The import and export of gold into and from India should be free from government control.

(*vi*) The prohibition on the import of silver and import duty on silver should be removed as soon as convenient. The prohibition on the export of silver should be retained to prevent depletion of silver.

Those relating to use of gold currency

(*vii*) To encourage the increased use of gold in internal circulation would not be to India's advantage. Gold is best kept in Government reserves where it is available to meet demand for foreign remittance. Gold coins may, however, be issued in moderate quantities and sovereigns may be coined and issued.

(*viii*) The obligation of the Government to give rupees for sovereigns should be withdrawn but opportunities should be given to the public when introducing the new ratio to exchange sovereign in their possession at the rate of £ 1 : Rs. 15.

Those relating to reserves

(*ix*) Profits on the coinage of rupees should continue to be credited to Gold Standard Reserve, the amount of which cannot yet be fixed. The Reserve should contain a considerable proportion of gold, not more than one-half of the gold being held in India. The invested portion should continue to be held in London in liquid securities.

(*x*) The metallic backing behind paper currency in the Paper Currency Reserve should be fixed by law at a minimum of 40 per cent of the gross circulation. The maximum for fiduciary issue should be retained at Rs. 120 crores for a limited period. The portion invested in Government of India securities should be limited to Rs. 20 crores. To meet the seasonal demand for additional currency, notes upto Rs. 5 crores, over and above the fiduciary issue, may be issued as loans to the Presidency banks against export bills of exchange.

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

CHAPTER VI

V Period : February, 1920—September, 1920

POST-WAR DEVELOPMENTS

(1920—1927)

§1. Failure of the Government Attempt to Restore Stability

The recommendations of the Committee were accepted by the Secretary of State in February, 1920, and various notifications were issued to give effect to them. It was notified that Council Drafts would be offered for sale at no fixed minimum rate and Reverse Council Drafts would be offered in future, if required, at a rate based on 2*s*. gold., Wartime restrictions on the import (but not export) of silver bullion, melting of silver coins and import and export of gold bullion and coin were removed. By the Indian Coinage (Amendment) Act of 1920 the sovereign was made legal tender.

About the beginning of February, 1920 a keen demand arose for remittances to London owing to an enormous increase in imports and a fall in exports. The anxiety of European businessmen to transfer their accumulated profits from India to London also added further to the demand. Steps were at once taken to maintain the new exchange rate of 2*s*. (gold), by offering Reverse Councils at a rate based on the sterling equivalent of 2*s*. (gold). The sterling equivalent of 2*s*. gold could be calculated only from the dollar sterling rate.[1] As sterling was not equivalent to gold in England, its depreciation in relation to gold could be measured only from its ratio to dollar which was at par with gold. If the value of sterling in terms of dollar fell, the sterling equivalent of 2*s*. (gold) would

1. Often referred to as London-New York cross rate.

rise and sterling-rupee exchange ratio based on 2*s.* (gold) would also rise. This may be made clearer by an example.

A definite quantity of gold=4.8 dollars=one pound sterling =one sovereign=10 Rs.

If sterling depreciates by 50% in relation to dollar, then

The same quantity of gold=4.8 dollars=1.5 pound sterling =one sovereign=10 Rs.

As sterling depreciates, therefore, the same number of rupees begin to purchase a larger amount of sterling.

In the beginning of February, 1920, the cross rate fell and the value of the rupee in terms of sterling rose. The Indian exporters fearing further rise began to sell their export bills. This accentuated the tendency towards a rise and the market rate reached 2*s.* 10½*d.* (sterling) on 11th February, 1920. After this, however, the sale of export bills, fell off and the sterling value of the rupee began to fall. Three other forces began to operate to accentuate this tendency towards a fall—

(*i*) More rapid fall in the level of sterling prices than rupee prices.[1]

(*ii*) Unfavourable balance of trade which commenced in June, 1920.

(*iii*) Fall in the price of silver, the price in June, 1920 being 44*d.* per standard ounce.

The Government tried to maintain the rate at first at 2*s.* (gold) and then from 24th June to 28th September, 1920 at 2*s.* (sterling), the market value of the rupee having fallen lower. The Reverse Councils sold at the above rates were met by the sales of sterling securities and Treasury bills in the Paper Currency Reserve at prices much lower than those at which they were purchased. The amount paid out of Paper Currency Reserve from the beginning of 1920 to the end of September was nearly £55.4 millions but the sterling value of the rupees purchased was only £25 millions. The loss to the Indian exchequer caused by the ill-advised attempt to maintain

1. The British Government had begun to deflate currency with a view eventual to making sterling equivalent to gold.

the rupee at 2*s*. amounted to Rs. 40 crores. The Indian importers who had ordered goods from abroad expecting to pay one rupee for every 2*s*. also suffered serious losses owing to the failure of the Government to maintain the rate. They were also put to great hardship by the fall in prices and the rise in bank rate caused by the contraction of currency by the Government.[1] Many of them were driven the verge of bankruptcy.

§2. Abandonment of Attempt to Maintain Stable Exchange

VI Period : October 1920—1927

The Babington Smith Committee based their recommendation for the stabilisation of 2*s*. rate on the wrong conjecture that the price of silver would continue to rule high for some time to come. The conditions of the contemporary world were, however, much too uncertain and a wiser course for the Committee should have been not to recommend any definite exchange rate. In fact, they did say while examining the possibility of a large and rapid fall in world prices that if such a fall occurred ('contrary to expectation'), the maintenance of exchange at the proposed rate might be endangered. "In that case it would be necessary to consider the problem afresh".[2] But otherwise, they were against the postponement of decision in this regard for three reasons: first, they had been called upon to recommend measures for the restoration of a stable gold exchange standard and they did not want to shirk their responsibility; second, they did not consider stability unattainable; and third, they considered continuance of the existing uncertainty, involving as it did prolongation of Government control over currency, open to serious criticism.[3]

The Government of India showed an extraordinary alacrity in taking action on the Committee's recommendation. They could have waited a little longer.

But even after the Committee had made its recommendation and the necessary action had been taken on it, it was open to the

1. Currency was contracted to prop up the tottering exchange ratio. When the supply of money in the market becomes less, the rate of interest on rises. Currency contraction lowers prices also.

2. *Report*, para. 51.

3. *Ibid.*, para, 58.

government to retrace their steps as soon as they found the new ratio untenable. They need not have prolonged an egregious blunder at a heavy cost.

Eventually the attempt to maintain the rate at 2*s.* had to be abandoned. At the end of September, the Government suspended entirely the sales of the Reverse Councils. The intervention of the Government thereafter grew less but exchange was not left entirely to look after itself. For some time, the exchange rate fluctuated from day to day according to the supply of and demand for exchange and at a time of general slackness in foreign trade, it was naturally particularly sensitive to the export and import of gold and silver bullion.[1] The Government continued to effect some measure of currency contraction to attain some parity between internal prices and the falling world prices. But as the world prices were falling rapidly, the adjustment took the form of a fall in exchange rather than a rapid and heavy fall in internal prices.

In 1921 the balance of trade was still against India and the rate of exchange which had fallen to nearly 1*s.* 5*d.* in December, 1920, fell still lower to 1*s.* $2\frac{7}{8}$*d.* (under 1*s.* gold) in March, 1921. In 1922, the balance of trade began to turn favourable to India and the sterling value of the rupee rose till it reached its pre-war level—1*s.* 4*d.* sterling—in January, 1923. From January, 1923 to June, 1924, the sterling rate moved between 1*s.* $4\frac{1}{32}$*d.* and 1*s.* $5\frac{7}{32}$*d.*, the gold rate being more or less stable round 1*s.* 3*d.* (the limits being about 1*s.* $3\frac{9}{32}$*d.* and 1*s.* $3\frac{1}{2}$*d.*)[2] It rose to 1*s.* 6*d.* sterling (about 1*s.* 4*d.* gold) in October, 1924 and the action of the Government was now directed towards preventing its rise above that rate. After the end of May 1925 the rupee ratio was kept in the vicinity of 1*s.* 6*d.* gold.

A rise in exchange rate above 1*s.* 6*d.* sterling was prevented by the Government by introducing the practice of purchasing sterling in India. The purchase of sterling *in India* has the same effect as the sale of Council Drafts *in London, i.e.*, sterling is given by banks and firms in London for credit to the account of the Secretary of State

1. *Cf.* Sir W. M. Hailey's Budget Speech for 1921-22.

2. Appendix 3 to the Report of the Royal Commission on Indian Currency and Finance, Vol. ii, p. 33.

and rupees paid to them in India. The advantages claimed for the system of sterling purchases are the following—

(*i*) the initiative in making remittances of sterling to London is transferred to the Government of India to whom it should rightly belong.

(*ii*) the purchases of sterling can be regulated with reference to the conditions of Indian exchange market and heavy fluctuations in exchange rate avoided.

The system of purchase of sterling gradually displaced after 1924 that of the sale of Council Drafts.

In pursuance of the recommendations of the Babington Smith Committee, changes were also made in the Acts governing the paper currency system. These were incorporated in the Consolidating Act of 1923 as amended in 1923 and 1925. The Act laid down permanent provisions for the regulation of paper currency but as the permanent provision could be carried into effect only after some time owing to the aftermath of abnormal war conditions, certain transitory provisions were also laid down. The *permanent provisions* were— (*i*) the metallic portion of the Reserve was to be at least 50 per cent of the whole; (*ii*) the Government of India securities in the Reserve were to be Rs. 20 crores in amount and of these, the created securities were not to exceed Rs. 12 crores; (*ii*) the Governor-General-in-Council was empowered to issue currency notes upto Rs. 5 crores in amount against inland bill of exchange maturing within 90 days.[1] This additional issue of currency could be made on payment to the Government by the Imperial Bank of India of a rate not lower than 8 per cent. The amount of extra note issue was raised from Rs. 5 crores to Rs. 12 crores by an Amending Act of 1923 and in 1924 it was laid down that of these, Rs. 4 crores were to be issued when the Imperial Bank rate rose to 6 per cent and the remaining Rs. 8 crores when it rose to 8 per cent. The *transitory provisions* were: (*i*) the amount of securities in the Reserve was to be Rs. 85 crores (raised later to Rs. 100 crores in 1925), (*ii*) the Government were authorised to create securities (*ad hoc* securities) and issue them to the Controller of Currency but the amount of securities was to be gradually reduced to Rs. 12 crores—the maximum amount permissible under permanent provisions.

1. This provision was introduced to make the note issue more elastic in order to meet the seasonal demand for currency.

CHAPTER VII

VI Period: October 1920—1927 (*Contd.*)

THE HILTON YOUNG COMMISSION

§1. The Recommendations of the Hilton Young Commission

In April 1925 England returned to gold standard and 1*s.* 6*d.* sterling became equivalent to 1*s.* 6*d.* gold. In August 1925 a Commission was appointed under the chairmanship of Mr. Edward Hilton Young "to examine and report on the Indian exchange and currency system and practice, to consider whether any modifications are desirable in the interests of India and to make recommendations."

The report of the Commission was published in 1926. The three main recommendations of the Commission related to:—

(*i*) the selection of a standard of currency.

(*ii*) the establishment of an authority to control the currency.

(*iii*) the rate at which the rupee should be stabilised.

The Commission made the following recommendations—

(*i*) Gold bullion standard should be adopted as the system of currency. Gold coins should not be introduced into circulation but an obligation should be imposed by law on the currency authority to buy and sell gold in the form of gold bars without limit in exchange for rupees and currency notes. The legal tender quality of sovereigns and half sovereigns should be removed. There should be no legal obligation on the Government to give rupees for currency notes.

(*ii*) The control and management of currency should be entrusted to a central bank (to be called the Reserve Bank of India).

(*iii*) The rate of exchange should be stabilised at 1*s.* 6*d.*

(*iv*) One rupee notes should be reintroduced and should be full legal tender.[1] Notes other than the one rupee notes should be

1. See p. 23, footnote 1.

legally convertible into legal tender money, *i.e.* notes of smaller denominations or silver rupees *at the option of the currency authority.*

(*v*) The Paper Currency Reserve and the Gold Standard, Reserve should be amalgamated. Not less than 40 per cent of the combined Reserve should consist of gold securities.

Sir Purshotamdas Thakurdas, a member of the Commission, wrote a minute of dissent in which he emphasised that the change from gold standard to gold exchange standard in the past was "in absolute contravention of the currency value officially adopted in 1899, binding on the Government and the country." He, however, agreed to the gold bullion standard recommended by the Commission *provided there was no interference with the free inflow of gold into India except with due publicity and the concurrence of the legislature.* He was of opinion that the demonetisation of sovereign and half sovereign was unnecessary.

As regards a central bank he held that in the special conditions of India, the ends in view would be better served by developing the Imperial Bank of India into a full-fledged central bank. If, however, the share-holders of the Imperial Bank did not agree to a restriction of their dividends, there would be no alternative left but to start a new central bank.

As to ratio he disagreed that 1*s.* 6*d.* ratio was the *de facto* ratio and that prices, wages and finance had adjusted themselves to it. He recommended that the rupee should be stabilised at the rate which prevailed for nearly 20 years, *viz.*, 1*s.* 4*d.* to the rupee.

The conclusions and recommendations of the Hilton Young Commission relating to currency standard, currency authority and exchange rate gave rise to acute controversy. These are examined further in the next three sections.

§2. The Problem of a Monetary Standard for India

A sound monetary standard must satisfy certain essential requirements, such as simplicity, certainty and stability and the suitability of the standard must be judged by the extent to which it satisfies them. The Hilton Young Commission had to select a standard that would

meet these requirements. The choice had to be made out of four possible standards:

(*i*) The pre-war sterling exchange standard in a perfected form, *i.e.* with its defects removed.

(*ii*) Gold exchange standard.

(*iii*) Gold standard with gold currency.

(*iv*) Gold standard without gold currency or gold bullion standard.

The Commission rejected the first three alternatives and recommended for adoption gold standard without gold currency.

Gold Exchange Standard: A Critique

The standard which worked in India from about the beginning of the present century to 1917 was in fact sterling exchange standard. Under it Indian currency was convertible into sterling but so long as pound sterling was convertible into pound gold, it was as good or as bad as gold exchange standard. This standard worked fairly well and secured stability of exchange for about fifteen years. It had the merit of being cheap because gold did not circulate as currency. It has, however, certain serious defects which may be described as follows:—

(*i*) It was not simple and intelligible to the people. The internal currency consisting of rupees and currency notes was not convertible into anything tangible and visible (such as gold). It was convertible into sterling for making payments outside the country on those rare occasions when the balance of trade turned against India. The working of the standard involved a good deal of government control and interference and this did not inspire confidence in the minds of the people.[1]

(*ii*) It had resulted from a series of administrative notifications. It was not subject to any statutory regulation or control but depended for its working on a policy of the Government. There was, for

1. "However complete the integrity and however great the intelligence on which official action is based, an automatic system which does not depend upon such action for its operation is greatly to be preferred."—*Babington Smith Committee's Report para*, 35.

"We believe..... that a pure exchange standard is no more and no less liable to manipulation than a gold standard; but that is not the opinion of the Indian public and it is essential that whatever system of currency is adopted should be one that is capable of securing the confidence of Indian public opinion".—*Hilton Young Commission's Report, para.* 30.

example, no statutory obligation on the Government to sell Reverse Councils by which the rate of exchange was prevented from falling below 1*s.* 4*d.* The standard had thus no definite legal basis.

(*iii*) It depended for its satisfactory working on rupee remaining a token coin. If the price of silver rose above a certain point the intrinsic worth of the rupee became greater than its exchange value and it became profitable to melt it or export it. The standard was thus subject to the danger of rupee disappearing from circulation. It broke down in 1917 when the gold price of silver rose above 43*d.* per standard ounce.

(*iv*) It was a dependent standard because under it the internal currency was linked not to gold but to the currency of a foreign country. It was thus exposed to the currency and credit changes in England. As the Hilton Young Commission remarked, "there is undoubted disadvantage for India in dependence on the currency of a single country, however stable and firmly linked to gold."

(*v*) It was not automatic in its working because the sale of Councils and Reverse Councils did not lead to an automatic expansion and contraction of currency. The expansion and contraction were regulated by the Government. In 1919–20–1921, for example, Reverse Councils of the value of more than £55 millions were sold and under an automatic system, internal currency of the value of about Rs. 47 crores would have been withdrawn from circulation. But the actual contraction amounted to only a little over Rs. 34 crores. Similarly when Council Bills were sold, currency was not expanded to the same amount.

(*vi*) It was not elastic, *i.e.*, it did not make a satisfactory provision for an increase in currency in busy seasons and times of financial crisis. When crops have been harvested and are mowed, there arises an increased demand for currency but under the pre-War system this could not be properly satisfied.[1] Nor was there any provision for an emergent issue of currency.

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1. Currency could be expanded only by the sale of Council Bills which would be demanded when goods were exported. There was no provision by which currency could be expanded to meet the demands of internal trade. The following passage occurs in the evidence of Lord Inchcape, who was for some years the chairman of the Finance Committee of the Secretary of State's Council, before the Chamberlain Commission:—

Mr. J.M. Keynes: "But there is no means by which the amount of currency in India can be increased from within India, as is the case in every civilised country in the world."

Lord Inchcape: "There is no means."

(*Minutes of Evidence, Vol. II, P.* 101.)

(*vii*) The two-reserves—the Gold Standard Reserve and Paper Currency Reserve—which were kept to maintain the value of token currency were governed in practice by transitory provisions. Their functions also were confused and there was overlapping of the purposes for which they were maintained. The original function of the Paper Currency Reserve was to provide for the convertibility of notes into rupees and that of the Gold Standard Reserve was to maintain the external value of the rupee. In practice, however, the Reserve were used indiscriminately to maintain the external value of the rupee and notes. There was also duality in the control of currency and credit policy.

Most of these defects were pointed out by the Commission who concluded that an exchange standard whether based on sterling or gold would not remedy the defects of the Indian currency system.

Pros and Cons of Gold Standard with Gold Currency

Gold standard with gold currency had been demanded by the Indian commercial opinion as far back as the middle of the last century and the demand had been reiterated many a time since then. The Fowler Committee recommended in 1898 a close approximation of gold standard with gold currency with a view to the "effective establishment in India of a gold standard and currency based on the principles of free inflow and outflow of gold." That aim was gradually deviated from and gold exchange standard came to be adopted. The Chamberlain Commission (1913) were not in favour of introducing gold currency but they conceded that "if Indian sentiment demands it and the Government of India are prepared to incur the expense", a mint for the coinage of sovereigns may be established, adding that "it is pre-eminently a question in which Indian sentiment should prevail". The Babington Smith Committee (1919) were precluded by their terms of reference from recommending any standard other than gold exchange standard. When the Hilton Young Commission was appointed in 1925, the question of a suitable standard for India came once again into prominence.

The officials of the Finance Department of the Government of India submitted to the Hilton Young Commission a scheme for the introduction of gold standard with gold currency. The scheme assumed that the management of paper currency and the conduct of Government remittances to London would be transferred to the

Imperial Bank of India. The main features of the scheme were as follows:—

(*i*) Gold coins and bank notes to be unlimited legal tender. Rupees to remain unlimited legal tender in the beginning but after some years to be made limited legal tender upto Rs. 50 only.

(*ii*) A statutory obligation to be imposed on the Government to give gold coin in exchange for gold bullion.

(*iii*) Bank notes to be payable on demand in gold coin.

(*iv*) A statutory obligation on the Bank to buy gold.

(*v*) A Reserve containing a certain percentage of gold and securities (gold and sterling) to be maintained.

(*vi*) The Imperial Bank to supply funds to the Secretary of State for meeting Home charges.

This scheme was to be introduced gradually over a period of about 10 years. It involved the sale of a large quantity of silver and the purchase of gold to the extent of about £ 103 millions.

The Commission rejected the scheme and the objection they raised against it are the main objections that could have been raised against any proposal to introduce gold standard and currency in India. The grounds on which the scheme was rejected may, therefore, be stated.

Objections to the scheme of gold standard with gold currency

(*i*) "A large extra demand (for gold) from India would cause increased competition for gold among the countries of the world and lead to a substantial fall in gold prices and a substantial curtailment of credit". India in common with other countries would suffer from such fall in prices and curtailment of credit.[1]

1. Gold is the basis of credit because in countries whose currency is convertible into gold, it is the backing behind the paper currency in circulation. If India purchased large quantities of gold to maintain them as a backing behind its paper currency, the demand for gold would increase. A rise in the demand for gold would raise its price in terms of commodities, *i.e.*, more of commodities would be given to get a certain quantity of gold. In other words, the prices of commodities in terms in gold would fall. A fall in prices would lead to depression in trade and India as a unit in the world trade system would suffer. An increased demand for gold from India would also mean that there would be less of gold available for other countries as a backing behind their paper currencies. This may necessitate contraction of paper currency with a view to maintain its convertibility into gold—and this would involve contraction of credit.

(*ii*) The amount of gold that would be required for ensuring convertibility of notes and rupees cannot be accurately estimated. For it is possible that people may begin to prefer gold coins to notes and to that extent notes would be replaced by gold coins. The fear of a fall in the status of the rupee might similarly bring out a huge number of rupees for conversion into gold coins. The actual demand for gold might thus turn out to be much greater than the estimated demand.

(*iii*) The fall in the demand for silver due to the adoption of gold standard would depress the price of silver. This would not only involve the sale of surplus silver at a low price but would also lower the value of the savings of poorer Indian people who invest their savings in silver ornaments.

(*iv*) The adoption of gold standard by India might lead to the demonetization of silver by China also. This would raise the price of gold and depress the price of silver still further. In any case, the exchanges with China would be dislocated by any fall in the price of silver, China being a silver standard country, this would effect adversely trade with China, 'the only great, undeveloped market left for the expansion of international trade.'

(*v*) It would not be easy to obtain the large amounts of gold without the co-operation of Great Britain and U.S.A. and both the countries viewed with alarm the prospect of a large demand for gold from India inasmuch as it would upset world prices.

(*vi*) The scheme would prove costly and though the costs could not be estimated accurately, it would be considerable. It might be in the neighbourhood of Rs. 3 crores a year for about ten years.

To these objections of the Commission may be added a few others which apply to gold standard and currency in general (rather than to any particular scheme of it).

(*vii*) Gold currency standard is expensive in that it involves the circulation of a very costly metal as currency. It would be better by far that gold should remain in the reserves to lend stability to exchange.

(*viii*) Gold currency is a sign of backward civilization and an obsolete ideal. Many countries which returned to gold standard after the last War did not introduce gold currency.

(*ix*) The bulk of internal transactions in India involve small payments for which rupees rather than gold coins are required by the people. Gold coins will, therefore, be of no use unless they are of very small value.

As there had been an insistent demand in this country for gold standard with gold currency, it is necessary to know the reasons for which it was favoured.

Merits of Gold Standard with Gold Currency

(*i*) Gold standard with gold currency is an automatic standard and prevents undue government interference with currency and exchange. Under it the inflow and outflow of gold are free and by producing their reaction on prices set into operation the natural correctives to fluctuating exchange.[1]

It is however, difficult to say if the standard would have worked automatically in India. If the imported gold was hoarded by the people and thus 'sterilised', prices might not rise and if gold did not come out of circulation for being exported when the balance of trade is against India, prices might not fall.[2] The natural correctives to exchange would not then operate. This was, however, on the assumption that the hoarding habit of the people would persist even after the introduction of gold currency.

(*ii*) The introduction of gold currency would discourage the uneconomic habit of hoarding gold. It would make the rural masses familiar with gold coins and hold out the assurance that all other forms of currency being convertible into gold are as good as gold.

The Hilton Young Commission differed from this view and held that "the mere act of putting gold into circulation would not....

1. When exports exceed imports, the rate of exchange tends to rise and gold begins to flow into the country. Normally the gold will be handed over to the currency authority in return for internal currency. The consequent expansion of currency will result in raising internal prices. The rise in prices will make the country a good market to sell goods in and a bad market to buy goods from, thus increasing imports and checking exports. The initial tendency towards a rise in exchange rate set up by an excess of exports over imports will thus be arrested. A similar corrective will begin to operate if exchange tends to fall due to the excess of imports over exports.

2. "All experience goes to show that so long as the public have the option of making payments in tokens or in gold it is the surplus tokens and not the gold in circulation which will seek an outlet at a time of weak exchange",—*Chamberlain Commission's Report, Para,* 62.

develop the banking and investment habit". What was needed, they said, was confidence in the stability of currency.

(*iii*) Gold standard with gold currency would inspire confidence of the people because the backing behind currency would be visible and tangible, much more so than under any other form of gold standard.

(*iv*) The Indian people wanted gold in circulation, as was evident from the large absorption of imported sovereigns from 1900 to 1914.[1] Besides, the 'weight of good academic opinion' was in favour of gold currency and this was pre-eminently a question in which Indian sentiment should prevail'.

(*v*) Gold currency is a stage in monetary evolution towards an ideal system under which currency would be convertible into gold but gold coins will not circulate on any appreciable scale India would have to pass through this stage.[2]

Gold Bullion Standard as recommended by the Commission

The Commission recommended gold bullion standard, as they called it, for adoption by India. The main features of the standard were the following—

(*i*) An obligation was to be imposed on the currency authority to buy and sell gold at a certain fixed rate in quantities of not less than 400 fine ounces (=1065 tolas). In other words, the rupees and currency notes were to be made convertible into gold bars weighing not less than 400 fine ounces. There was to be no limitation as to the purpose for which gold was required but the conditions as to the sale of gold were to be so framed that normally the currency authority would not be called upon to supply gold for non-monetary purposes.

(*ii*) Sovereign and half-sovereign were not to remain legal tender,[3] but the rupee was to continue to be full legal tender.

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1. It is of interest to note that in 1911—12 and 1912–13 the Controller General and the Head Commissioner of Paper Currency made special enquiries to find out the actual use to which sovereigns were put by the people and the Accountant Generals, Punjab who made detailed enquiries in 1911–12 reported that "the popularity of the sovereign as currency is greatly on the increase and there is practically no part of the Punjab or Frontier Province where it is not eagerly sought after and accepted," Similar reports were received from other parts of India. *Report of Controller General*, for 1911–12, pp 14–21, 1912–13, pp. 22–26 and 1913–14, Appendix III.

2. Sir Basil Blackett's address before Delhi University in 1926, para 15.

3. They were made legal tender by the Act No. XXII of 1899 (see p. 11). Their demonetization was necessary to secure automatic contraction and expansion of currency. Gold coins in circulation by taking the place of rupees and notes would prevent the automatic working of gold bullion standard.

(*iii*) Government Savings Certificates were to be issued to bring home to the masses that gold was the standard of value and that gold and rupees were mutually convertible. People could purchase these certificates and invest their savings in them. After three or five years, they could receive the principal along with the interest in rupees or gold *at their option.*

(*iv*) The existing currency notes were to remain convertible into rupees but the new notes to be issued were not to be legally convertible into rupees. Facilities for conversion of currency notes into rupees were, however, to continue to be provided.

(*v*) One rupee notes which would be full legal tender but not legally convertible into rupees were to be issued.

(*vi*) Gold Standard Reserve and Paper Currency Reserve were to be amalgamated.

The effect of the adoption of this system would be that (*a*) internal currency would consist of tokens—rupees and currency notes and (*b*) currency notes would not be convertible into rupees but both currency notes and rupees would be convertible into gold bullion.

Many advantages were claimed for the system by the Commission. *Firstly*, it would secure stability of exchange by ensuring convertibility of currency into gold at a fixed rate. *Secondly*, it was simple and certain because the backing behind the currency was one of gold into which internal currency would be convertible. It would, therefore, inspire confidence of the people. *Thirdly*, it was automatic because currency would be expanded when gold bars were given to the currency authority to obtain notes or rupees and would be contracted when notes or rupees were given to the currency authority to obtain gold bars. *Fourthly*, gold would remain in the reserves and costly gold currency would not be introduced into circulation. *Fifthly*, it would pave the way for the introduction of gold currency at some future date if it was thought desirable to do so. Gold currency could be introduced when sufficient gold had accumulated in the Reserves.

The gold bullion standard recommended by the Commission was not full-fledged gold standard. The backing behind internal currency was not very tangible for ordinary people. Only bankers

and bullion brokers could take advantage of the facilities for obtaining gold bars of 400 fine ounces (400 ounces = 1085 tolas = Rs. 23,000 (approximately) at the price proposed to be fixed). The device of the sale of Savings Certificates was therefore, recommended by the Commission for bringing home to the people the change in the previous system. The conditions laid down for the sale of gold were such that gold would not be demanded by the people from the currency authority at all. Owing to certain difficulties pointed out by the Commission,[1] gold currency standard could not be adopted forthwith. Under the circumstances, the gold bullion standard though not conforming to the proper definition of gold bullion standard[2] was not an unsatisfactory system to be adopted and worked.

§3. The Question of a Monetary Authority

The Hilton Young Commission found unsatisfactory the existing system of monetary control under which the Government controlled the currency and the credit was controlled, in as far as it was controlled at all, by the Imperial Bank. This divided control of currency and credit prevented co-ordination of currency and credit policies. It also kept the banking and currency reserves of the country separate, thus diminishing their capacity to be used in the most effective manner for the stabilisation of exchange.

To bring about unity of policy in the control of currency and credit, the Commission recommended the establishment of a central bank, to be called the "Reserve Bank of India". It was to be a shareholders' Bank with a capital of Rs. 5 crores. Its management was to be conducted by a Central Board consisting of fourteen members of whom five (including the Managing Governor and Deputy Managing Governor). were to be nominated by the Governor-General-in Council. To eliminate the danger of any political influence, no member of Governor General's Council, Provincial Governments and Central and Provincial Legislatures was to be appointed President or Vice-President of a local Board of the Bank or nominated as a member of the Central Board. The representatives of the commercial banks were to be ineligible in the same manner.

1. The most important being the opposition of Great Britain and U.S.A.
2. See B.R. Shenoy's article in *The Indian Journal of Economics*, October, 1933.

The proposed Reserve Bank of India was to perform all the functions of a central bank. It was to make and issue bank notes, receive deposits from and collect money for Central and Provincial Governments, banks and bankers and give loans to and make remittances on behalf of the Central and Provincial Governments. It was to maintain the external and internal stability of purchasing power of the rupee It was to buy and sell gold at a fixed rate in quantities of not less than 400 ozs. By taking over the remittance operations of the Government, the bank was to displace the Government from the Exchange market. It was to take over the management of Gold Standard Reserve and Paper Currency Reserve (which were to be amalgamated into one) and pay a share of its profits to the Government of India. Finally, it was to act as banker's bank.

The Reserve Bank of India was thus to be the monetary authority to work the gold bullion standard recommended by the Commission.

The Commission were against entrusting Central banking functions to the Imperial Bank of India which in their opinion had useful work to do in extending commercial banking facilities in the country. Sir Purshotamdas Thakurdas who wrote the Minute of Dissent held, however, that the Imperial Bank would not be hindered in its commercial business if it was entrusted with central banking functions. He thought that proposed Reserve Bank would be a rival institution to the Imperial Bank and recommended the evolution of the Central Bank from the Imperial Bank. If, however, the shareholders of the Imperial Bank were opposed to their rights being restricted in the matter of getting their dividends, there would be, he said, "no alternative left but to start a new Central Bank".

§4. The Ratio Question

The Hilton Young Commission considered the time fully ripe for the stabilisation of the rupee and recommended that the rupee be stabilised forthwith in relation to gold at a rate corresponding to an exchange rate of 1*s.* 6*d.* for the rupee. The value of the rupee, they said, should be fixed in terms of gold and the rupee should be equivalent to 8.47512 grains of fine gold.[1]

1. One gold pound contains 113.0016 grains of fine gold. 8.74512 grs. =3/40 of gold pound=1*s.* 6*d.* (gold).

The Commission pointed out the advantages of adopting 1*s.* 6*d.* ratio as well as disadvantages of reverting to the pre-war 1*s.* 4*d.* ratio. The arguments given by the Commission *in favour of* 1*s.* 6*d.* *ratio* have been set down below.

1. At the existing (1*s.* 6*d.*) ratio,[1] prices in India "have attained a substantial measure of adjustment with world prices and any change in the rate would mean a difficult period of readjustment, involving widespread economic disturbance". Since June 1925, exchange had been steady and the rupee prices and world prices had been falling together, showing that adjustment between exchange and prices had taken place. This conclusion was further confirmed by the absence of any adverse reaction on Indian trade.

2. Wages also had adjusted themselves to the prices at the existing exchange rate of 1*s.* 6*d.* Though there was depression in jute industry and cotton mill industry, it was due to causes which the manipulation of exchange rate could not remedy.

3. As regards contracts, least injury would be caused by adhering to 1*s.* 6*d.* ratio. It was true that land revenue and other long term contracts were settled when the ratio was 1*s.* 4*d.*, but owing to the rise of prices since 1914, the incidence of land revenue as calculated in terms of commodities had become lighter. The contracts concluded after 1918 could not have been on the basis of 1*s.* 4*d.* rate which was effective only for a very short period after 1918. As most of the contracts must be short term contracts, least injury would be done by adopting 1*s.* 6*d.* ratio.

The Commission gave the following *arguments against reverting to* 1*s.* 4*d.* *ratio.*

1. Though 1*s.* 4*d.* rate had been called the 'natural' rate, it was difficult to understand in what sense it could be so described. If the Indian exchange were left to itself, there would be wide fluctuations in it and it would be impossible to find out the 'natural' rate.

2. 1*s.* 4*d.* rate would not be easier to maintain in times of adverse balance of trade, as had been argued by its supporters.[2] If the

1. The exchange rate had been 1*s.* 6*d.* (gold) since June, 1925.

2. The argument probably was that at 1*s.* 4*d.*, ratio, less of gold would have to be given out of the reserves in return for a rupee when the internal currency was converted into gold.

reserves are adequate as they would be, 1*s.* 6*d.* ratio could be made as effective as 1*s.* 4*d.* ratio.

It had been suggested that the stabilisation of the rupee at 1*s.* 4*d.* (Rs. 15=one pound gold) would raise the price of gold and check the abnormal import of gold into India for being hoarded. But the import of gold was due to causes (such as the people's appetite for gold) which could not be removed merely by adopting a lower ratio.

It was argued that if world prices would fall in future, 1*s.* 4*d.* rate would cause less rapid fall in Indian prices than 1*s.* 6*d.* rate. But any abnormal price fall in future was not expected and any prolonged fall in prices would react on Indian price level whether the rate is 1*s.* 4*d.* or 1*s.* 6*d.*

5. 1*s.* 4*d.* rate was not effective from 1917 to 1925 and it could not be contended that there had been an adjustment of prices and wages to that ratio. As there had been no such adjustment to 1*s.* 4*d.* rate, the fixing of this rate would lead to profound disturbance in economic conditions. It would lead to a rise in prices, causing hardship to consumers and wage-earners. It might also by raising cost of living lead to a demand for higher wages and salaries.

6. The reversion to 1*s.* 4*d.* ratio would upset the finances of the Government of India. Increased taxation might become necessary to meet the sterling obligations of the Government. If the budgetary equilibrium was upset, the credit of India as regards borrowing might also be impaired.

The Minute of Dissent

Sir Purshotamdas Thakurdas dissented from the conclusions and recommendations of his colleagues in favour of 1*s.* 6*d.* ratio. His *arguments against* 1*s.* 6*d. rate are* summarised below:

1. The Government of India had been aiming at 1*s.* 6*d.* rate and, therefore, instead of stabilising the ratio at 1*s.* 4*d.* gold in September, 1924, as they ought to have done, they contracted currency, or unduly limited its expansion, to push up the value of the rupee to 1*s.* 6*d.* 1*s.* 6*d.* rate had thus been secured by currency manipulation and was not a "natural" rate.

2. There had been no adjustment of Indian prices since the rupee touched 1*s.* 6*d.* gold in June, 1925. Though Indian prices had fallen since June, 1925, the fall had been in response to a fall in world prices and not due to an adjustment of rupee prices to the higher (1*s.* 6*d.*) rate. The full adjustment of rupee prices to 1*s.* 6*d.* rate was yet to come. If world prices fell lower as was expected, the fall in Indian prices would be accentuated because, besides the adjustment already due, further adjustment would become necessary. This heavy fall in prices would hit Indian producers very hard.

3. There had been no adjustment of wages to 1*s.* 6*d.* ratio and such adjustment if it had to be enforced by lowering wages, would "entail a long and bitter struggle between Labour and Capital, with consequent disturbance in the economic organisation of the country."

4. Until wages got adjusted to 1*s.* 6*d.* rate—which would involve a long and painful process—the foreign manufacturers would enjoy a bounty of 12½ per cent.[1] This indirect help to the foreign manufacturers would intensify competition with Indian industries.

5. It had been argued that 1*s.* 6*d.* rate had had no adverse influence on Indian trade. In respect of exports, the absence of adverse influence was due not to the suitability of the rate but to successive good harvests and the low holding power of the Indian agriculturist (who must sell and export his produce in any case). As regards imports there had been slackness in the demand for imports—an indication of lower purchasing power of the masses—and it was due to 1*s.* 6*d.* rate.

6. The adoption of 1*s.* 6*d.* rate would be injurious to the debtor class. There was no justification for imposing an additional burden on a class already overburdened.

Sir Purshotamdas Thakurdas rested his *case for reversion to* 1*s.* 4*d.* rate on the following arguments:—

1. 1*s.* 4*d.* rate had been in force for about 20 years and it should not be changed unless it was absolutely unmaintainable or unattainable.

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1. At 1*s.* 4*d.* rate, a foreign article selling for Rs. 15 in the Indian market would fetch the foreign manufacturer one pound. At 1*s.* 6*d.* rate, the same article worth Rs. 15 would give him 12½ per cent more.

2. It would have no adverse influence on Indian finances because the loss in sterling remittances would be made up in other directions. In any case, the gain in respect of sterling remittances obtained from 1*s.* 6*d.* ratio would be at the expense of the producer who would have to accept fewer rupees for the produce he has to sell.

3. It would cause no hardship to those whose contracts were entered into before 1917 and they included the vast mass of Indian agriculturists whose interests deserved full consideration.

4. The adoption of 1*s.* 4*d.* rate would appreciably diminish the risk of a depletion of the reserves in times of an adverse balance of trade.

5. No other country, even in the most prosperous circumstances, had considered it just or advisable to adopt a rate of exchange higher than its pre-war rate. India also should revert to pre-war rate and thus establish public confidence in its currency system.

Sir Purshotamdas Thakurdas having ably put forward his case in favour of 1*s.* 4*d.* concluded on a note of apprehension saying that if 1*s.* 6*d.* ratio was accepted, "India will be faced during the next few years with a disturbance in her economic organisation the magnitude of which it is difficult to estimate but the consequences of which may prove disastrous".

§5. Government Action on the Commission's Report

The publication of the Commission's report in 1926 gave rise to strong controversy which centred for the most part round 1*s.* 6*d.* ratio. Steps were taken by the Government to give effect to all the three main recommendations of the Commission.

In January, 1927, the Government introduced the "Gold Standard and Reserve Bank of India" Bill to give effect to the recommendations relating to the adoption of gold bullion standard and the establishment of the Reserve Bank of India. The Bill was referred to a Select Committee. There was a stout opposition by a majority in the Committee to the main features of the scheme incorporated in the Bill, that is, to the bank being a shareholders' bank and to the exclusion of members of legislature from its directorate. The majority of the Select Committee also wanted an Indian as the

Governor or Deputy Governor of the Bank and recommended the coinage of gold mohars. Owing to differences between the Government and the opposition particularly on the question of directorate, the Bill was dropped finally in February 1928. So neither the Reserve Bank of India could be established nor gold bullion standard adopted.

To give effect to the Commission's recommendations relating to the stabilisation of 1*s.* 6*d.* ratio, the Currency Act of 1927 was passed. The Act established 1*s.* 6*d.*(gold) ratio[1] by imposing statutory obligation on the Government (1) to purchase gold at Rs. 21-3-10 per tola in the form of bars containing not less than 40 tolas (15 ozs.) of gold and (2) to sell gold for delivery at Bombay *or* sterling for delivery in London in amounts of not less than 1,065 tolas (400 ozs.) of fine gold (or the equivalent amount of sterling). The Controller of Currency had the option to sell sovereigns[2] but an obligation was placed on the Government to receive them at Currency Offices and Treasuries at their bullion value at the rate of 8:47512 grains of gold: Re.

The Act did not at all introduce gold bullion standard because the Government retained and actually exercised the option of selling, in return for internal currency, sterling for delivery in London. Strictly speaking, therefore, the standard adopted was sterling exchange standard. But so long as sterling was convertible into gold (as it was upto September 21, 1931) the standard was actually gold exchange standard, In a way, therefore, gold exchange standard, criticised and discarded by the Hilton Young Commission, was resumed.

1. An amendment to fix the ratio at 1*s.* 4*d.* was lost in the Indian Legislative Assembly by 65 votes against 68.

2. See page 40, footnote 3.

CHAPTER VIII

VII Period : 1927—*September*, 1931

ADJUSTMENT AND STRAIN

§1. Period of Adjustment (1927—September 1929)

From 1st April 1927, when the Currency Act of 1927 was brought into force to September 1929, trade conditions in India were generally favourable, both exports and imports registering a rise.

Value of merchandise [*including Government Stores* (*In crores of rupees*)]

	1926–27	1927–28	1928–29	1929–30	1930–31
Export	311	330	339	319	226
Imports	241	261	263	250	173
Total value	552	591	602	569	399

The total value of exports and imports in the three previous years *i.e.*, 1923–24, 1924–25 and 1925–26 was 600, 653 and 623 crores of rupees respectively[1]. The improvement in trade need not be attributed to the stabilisation of 1*s.* 6*d.* ratio; it might have been in a large measure the counterpart of much greater improvement in world trade. Perhaps a lower ratio would have communicated that improvement to Indian trade in greater measure.

The Calcutta Index Number of prices, however, showed a noteworthy decline:

July 1914=100

Year	*Index No.*
1926	148
1927	148
1928	145
1929	141

1. As prices of the articles of export and import vary from year to year, the course of trade is better shown by the following table made on the basis of declared values in 1913–14:–

Values of export and imports on the basis of declared values in 1913–14 (*In crores of Rupees*).

	1923–24	1924–25	1925–26	1926–27	1927–28	1928–29	1929–30	1930–31
Exports	240	250	246	228	248	260	263	235
Imports	120	137	143	156	181	190	189	157
Total value	360	387	389	384	429	450	452	392

The exchange, in spite of temporary recovery now and then,[1] showed signs of weakness for the most part of this period. The measures taken by the Government to strengthen it were:—

(*i*) Raising the rate at which it was prepared to lend emergency currency to the Imperial Bank of India.

(*ii*) Sales of treasury bills in large amounts to prevent the outflow of funds.

(*iii*) Contraction of currency.

§2. PERIOD OF STRAIN (OCTOBER, 1929—SEPTEMBER, 1931)

After September, 1929, India became involved in the world trade depression—a depression unprecedented in magnitude and intensity. The prices of both agricultural and manufactured goods began to fall, but the decline in agricultural prices was much heavier[2]. Indian exports, therefore, received a severe setback. The Indian exchange became definitely weak and Civil Disobedience movement started in 1930 weakened it further by paralysing trade and industrial production and causing a flight of capital from India.

The Government issued Treasury Bills in large amounts and contracted currency by selling sterling[3] and meeting these sales by transfers from the Gold Standard Reserve and Paper Currency Reserve to the Treasury balances of the Secretary of State.

The measures taken by the Government to maintain 1*s.* 6*d.* ratio created stringency in the money market[4] and accentuated the fall in prices. Strong protests against them were made by Indian commercial interests.

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1. It was strong from December, 1927 to February, 1928 and during October and November, 1928.

2. From September, 1929 to September, 1931, the prices of exported articles fell by about 46 per cent and of imported articles by o nly 17 per cent.

3. From June to September, 1931, Reverse Councils worth £ 14 millions were sold. From 1926–27 to September, 1931, currency of about Rs. 138½ crores was withdrawn from circulation.

4. The financial year 1928–29 opened with 7 per cent bank rate. After a drop of 2 per cent by November, 1928 it rose to 7 per cent in December 1928, and to 8 per cent in February, 1920. (See the article by J.C. and H. Sinha in the *Sankhya*, December, 1929).

§3. Ratio in Retrospect

During the twenty years that fell between the two wars, the ratio question dominated Indian monetary thought almost continuously. At times it began to appear as if the economic system of India was suffering from the cancer of a wrong ratio which was leading by painful degrees to a state of complete collapse. Both the proponents and opponents of 1*s.* 6*d.* hotly pursued their arguments during the fateful years of 1925-27. For a year or two after the legalisation of 1*s.* 6*d.* ratio in 1927, the controversy appeared to subside but the onset of depression released a fresh spate of accusations, arguments and counter-arguments. After the eventful year of 1931, the ratio controversy grew livelier still, though it changed somewhat in form. It might be useful to review briefly the main issues of the controversy upto 1931 at this stage and defer their examination subsequent to that date to the next chapter.

A careful perusal of the available contemporary accounts of the ratio controversy shows that the criticism of Government's exchange policy after the 1920 episode was directed mainly along two lines. The first line of criticism was that the Government did not avail themselves of the opportunities that came in and after September, 1924 to stabilise the rate at 1*s.* 4*d.* The contention here was that Government did not intend to fix the rate at 1*s.* 4*d.* and wanted to leave the question open. The unwillingness of the Government to remove the dead and ineffective ratio of 2*s.* from the statute book was cited in support of his contention. It is necessary in this connection to recount a few events in chronological order. In January, 1921, Sir Vithaldas Thackersey moved a resolution in the Central Legislature asking for a revision of 2*s.* ratio but the resolution was opposed by the Government and was lost.[1] In September, 1924, a suggestion was made in the Legislative Assembly for the stabilisation of the ratio at 1*s.* 4*d.* (gold) but it was opposed by the Government.[2] In January, 1925 the Assembly passed a resolution recommending the appointment of a Committee with a majority of Indian non-officials on it and with an Indian chairman to examine the whole question of exchange and currency. In February, 1925 two Bills were introduced by Sir Purshotamdas Thakurdas to amend the Indian Coinage Act, 1906 and Indian

1. Sir Purshotamdas Thakurdas's speech; *Leg. Ass. Debates.*, 1927, Vol. 2, p. 1797.

2. *Leg. Ass. Debates*, 1924, Vol. 4, pp. 3808–12.

Paper Currency Act, 1923, the common purpose of the two Bills being the fixation of the rate at 1*s.* 4*d.* gold.[1] It would appear from this that the Government did not wish to fix the value of the rupee at 1*s.* 4*d.* gold or any other rate but wanted to wait until the economic and monetary situation had become sufficiently clear to enable them to make up their mind. They must have been naturally watching the developments in England where through a steady deflationary process the old gold parity of the pound was being gradually approximated to and they might have been reluctant to commit themselves to any course of action in advance. The second line of criticism of Government's exchange policy was that the Government deliberately raised the ratio from 1*s.* 6*d.* sterling (1*s.* 4*d.* gold) to 1*s.* 6*d.* gold by resorting to considerable deflation between June, 1924 and February, 1926. It was contended that the Government manipulated the currency with a view to presenting the Hilton Young Commission, when it met, with a *fait accompli*[2]. In defence of the Government's policy it was argued that "currency requirements naturally contracted with the fall in prices." and "the Government would have failed in their duty if they had not acted accordingly to prevent any risks to stability arising out of the existence of a surplus of currency in circulation".[3]

But after 1*s.* 6*d.* ratio had been attained, no matter how, the important issue was whether it was the 'natural' or the correct ratio. And correct ratio was defined as one to which prices, wages and cost of living had adjusted themselves. During 1926-27, therefore, the really vital part of ratio debate became co-extensive with the arguments to prove or disprove that adjustment between 1*s.* 6*d.* ratio, on the one hand, and prices, wages etc. on the other, had already taken place. For if it could be proved that the adjustment had already taken place, the case for maintaining and legalising 1*s.* 6*d.* ratio would be the strongest and the adoption of any other ratio could be shown to be highly disturbing and dislocating. A lower ratio like 1*s.* 4*d.* would involve inflation of currency, rise in prices, a rise in worker's cost of living and, if his money wages remained the same, a concealed cut in his wages. But if adjustment

1. *Leg. Ass. Debates*, 1925, Vol. 51 Pt. 1., pp. 715 and 719.

2. See the Telegraphic Correspondence between Government of India and Secretary of State. Hilton Young Commission's Report Appendix 98. Also *Leg. Ass. Debates*, 1927, Vol. 2, pp. 1859–60.

3. Sir Basil Blackett's speech at Delhi University on November 23, 1926.

was yet to take place—and it could plausibly be argued that the process of adjustment was long and protracted in a country like India—then the reversion to 1*s*. 4*d*. ratio was not only not fraught with any evil consequences but was necessary and desirable in order to prevent the serious effects that 1*s* 6*d*. ratio might drag in its trail. The maintenance of a higher ratio—to which prices had not yet adjusted themselves—would, in that case, involve deflation, monetary stringency, fall in prices and disastrous repercussions on India's export industries, particularly agriculture. The bearing of the ratio on the Government of India budget was also a material consideration, at least from the official standpoint and while presenting the Budget for 1927-28, the Finance Member, Sir Basil Blackett, estimated the loss to the Government that a reversion to 1*s*. 6*d*. ratio would cause at Rs. 5.26 crores.[1]

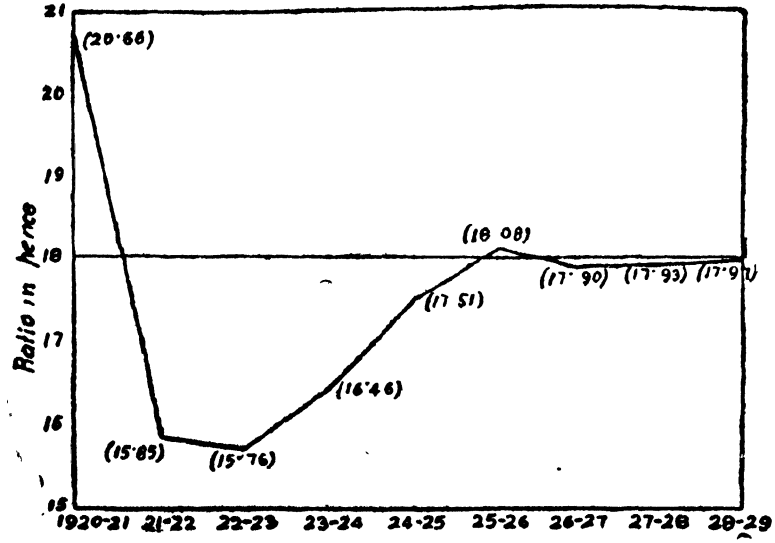
Though the comparative merits of stability of exchange and stability of internal prices were never made a prominent issue in the ratio discussions, it is interesting to find that a choice between the two was implicit in whatever position was taken by the participants. Those who began to urge on the government the advisability of stabilising exchange from 1924 onwards—*i.e.*, in an admittedly unstable world—were unconsciously showing a preference for exchange stability. On the other hand, the Government by allowing the exchange to rise and fall—whether by folly, helplessness or design—contributed in an unpremeditated way towards the maintenance of internal price stability. The debate on the ratio in 1926-27 would perhaps have been conducted on a higher plane and to better purpose if the necessity of flexibility in exchange and the importance of the internal stability of prices had been brought out as the crucial points.

Examining the ratio controversy in retrospect, it seems that the opponents of 1*s*. 6*d*. had better judgement on their side. It is true that there can be no such thing as "natural" ratio because given a certain amount of deflation, or inflation, any ratio can be accomplished for the time being and the internal price level will get adjusted to such a ratio. The argument for 1*s*. 4*d*. that it was the "natural" rate was meaningless. Nor should the case for 1*s*. 4*d*. have rested on its being the pre-war parity, for the decision

1. *Leg. Ass. Debates*, 1927, Vol. 2, p. 1464. When , however, Mr. T. Gavin-Jones pertinently asked if the Government had gained an equal amount by a rise in ratio to 1*s*. 6*d*. the Finance Member gave a flat but unconvincing denial (*Ibid.*, 1881).

to adopt a particular ratio has to be made with reference to the prevailing facts as regards prices, trade conditions, wages, etc. The economic conditions prevailing in India from 1927 to 1931 furnish no evidence that 1*s*. 6*d*. rate contributed to stability and progress. The two years 1927-28 and 1928-29 were no doubt years of comparative stability and expansion of trade. It is probable, however, that the stability or trade expansion was secured in spite of 1*s*. 6*d*. ratio. It was the Indian counterpart of increasing world stability and expansion of world trade. When the downward trend of prices and trade began, 1*s*. 6*d*. rate, which itself was never firm in the saddle, accentuated their fall in India. The Government refused to accept such view.[1]

The following graph based on the average of the daily telegraphic transfer rates from Calcutta on London shows exchange fluctuations from year to year:—



1. Sardar Sant Singh asked in the Legislative Assembly on September 9, 1931 for a statement on the loss caused to India by fall in prices due to action of Government of India in maintaining exchange at 1*s* 6*d*.

Sir George Schuster replied: "I regret I do not understand the question. The fall in prices has been due not to the maintenance of exchange at 1*s*. 6*d*. but to the general world causes. If, for example, exchange had been fixed at 1*s*. 4*d*. in 1927, India would have felt the full shock of the fall in world prices for all her main commodities just as much as she is feeling it now. The percentage fall would have been the same".—*Legislative Assembly Debates*, 1931 Vol. V, pp. 108-09,

CHAPTER IX

VIII Period : September, 1931—August, 1939

CRISIS AND AFTER

§1. Linking the Rupee to Sterling

On September 21, 1931, the British Government in consultation with the Governing Body of the Bank of England suspended sub-section (*ii*) of Section I of the Gold Standard Act of 1925. This sub-section laid an obligation on the Bank of England to give gold bars in exchange for internal currency. When this obligation was removed, sterling was divorced from gold and England was off the gold standard. Sterling, no longer convertible into gold, began to depreciate steadily in relation to it. It is not possible here to go into the causes of abandonment of the gold standard by England. Nor is it necessary to do this to understand the reaction of that event on the Indian currency system.

The rupee was linked to sterling by the Currency Act of 1927 at the rate of 1*s.* 6*d.* but so long as sterling was convertible into gold the rupee was virtually on a gold basis. Now when sterling had no longer a fixed relation to gold the Government of India had to decide about the basis and the rate of the rupee afresh. Five alternative courses were open to them :—

(*i*) To link the rupee to sterling at 1*s.* 6*d.* *i.e.*, to maintain the statutory obligation laid on the Government of India to sell sterling in exchange for internal currency at 1*s.* 6*d.* : Re.

(*ii*) To link the rupee to gold at 1*s.* 6*d* rate *i.e.*, to make the rupee convertible into gold at one rupee=8.47512 grains of gold.

(*iii*) To link the rupee to gold at a rate lower than 1*s.* 6*d.*

(*iv*) To link the rupee to sterling at a rate lower than 1*s.* 6*d.*

(*v*) To leave the rupee free *i.e.* to link it neither to gold nor to sterling but to allow its exchange value to fluctuate according to its purchasing power relatively to that of other currencies and to

other market influences. This implied, of course, a kind of controlled inflation because left completely to itself, the exchange value of the rupee would fall to its bullion value.

Of these, the Government ultimately chose the first course. As soon as England went off the gold standard, the Governor-General-in-Council issued an Ordinance (No. VI of 1931) removing the obligation placed on the Government by the Currency Act of 1927 to sell gold or sterling.[1] The position thus created was that the rupee was delinked from both gold and sterling.[2] Three bank holidays were declared presumably to prevent a run on the banks by the public in an unreasoning fear.

A third event of outstanding importance which occurred on the same day *i.e.*, the 21st September, 1931, was that the Secretary of State for India made a statement before the Federal Structure Sub-Committee of the Indian Round Table Conference informing them that it had been decided "to maintain the present standard on sterling basis."

On 24th September, 1931, therefore, Ordinance VI was repealed and another Ordinance (No. VII of 1931)[3] was passed. This Ordinance restricted sales of gold or sterling to genuine trade purposes and reasonable personal requirements. The rules made under the Ordinance laid down £25,000 as the maximum amount of gold or sterling to be sold to any recognised bank and empowered a Managing Governor of the Imperial Bank to call upon any recognised bank to satisfy him that it was purchasing gold or sterling only for purposes permitted under the Ordinance.[4] The object underlying all these restrictions was to maintain the sterling value

1. The purchase of gold at the Mint was, however, not stopped.

2. Mr. Arthur Moore asked in the Legislative Assembly on 21st September, 1931 if steps would be taken to link the rupee with sterling during the period when it might be temporarily divorced from gold. Sir George Schuster replied that they had not had time to settle their detailed plans. (*Legislative Assembly Debates*, 1931, Vol. V. page 714).

3. The Gold & Sterling Sales Regulation Ordinance, 1931.

4. This does not mean that sales of gold were provided for by the Ordinance or a link with gold established. The position was that the Ordinance modified the Currency Act of 1927. The option of the Currency authority to sell gold *or* sterling remained but the amount of gold or sterling was restricted to £25,000. When the Ordinance was cancelled on 30th January, 1932, the Currency of Act of 1927 came into force again.

of the rupee at 1*s.* 6*d.* In the absence of such restrictions, it was feared, rupee would seek conversion into foreign currencies in large quantities, causing weakness in exchange.[1]

The action of the Government in linking the rupee to sterling was probably the best under the circumstances but it led to a good deal of criticism partly because it was taken without consulting the Indian Legislature or public opinion but largely because the old ratio was maintained. The ratio question has been discussed in section 6 of this chapter. As for linking the rupee to sterling, was any other course of action feasible ?

The alternatives to a link with sterling were a link with gold and a "free" rupee. If the rupee had been linked to gold at 1*s.* 6*d.* or 1*s.* 4*d.* rate (*i.e.*, made equal to 8.47 or 7.53 grains of gold), strong gold reserves would have been necessary to maintain the link. But at that time, the gold portion of the Paper Currency Reserve was very low and the gold stock amounted to £32½ millions sterling (£ sterling on its previous parity).[2] To maintain the convertibility of the rupee into gold at a time when there was a rush for gold in other countries, deflation might have become necessary. Besides, a fixed ratio in terms of gold would have meant a fluctuating ratio in terms of sterling so long as sterling depreciated in relation to gold. A fluctuating sterling rate would have reacted adversely on India's trade not only with Great Britain but also those countries which had linked their currencies to sterling. If 1*s.* 6*d.* sterling rate was regarded as unduly high for India, 1*s.* 6*d.* gold rate (which meant much more than 1*s.* 6*d.* sterling) would have been still more objectionable.

A "free" rupee—the other alternative course—implied some kind of controlled inflation. It might have meant somewhat unstable

1. "....The Government of India have had to take into account the possibility that in present conditions of uncertainty as to the international position, there might be an inducement to speculators to take advantage of unlimited facilities offered by the Government to acquire sterling exchange and that might operate to the detriment of genuine traders and of public interest."—*Sir George Schuster's statement in the Legislative Assembly.*

"In Bombay, in the first ten minutes after business opened and before the markets were aware of the issue of the Ordinance, demands for 4.25,000 pounds sterling were received."—*Sir Schuster's reply ; Legislative Assembly Debates*, 1931.

2. Sir George Schuster's statement in the Legislative Assembly on 24th September, 1931.

exchange but in any case it involved greater currency control with some definite object or objects in view *e.g.*, raising or maintaining the internal price level in parity with cost. Such control requires initiative, foresight and boldness of action and does not offer the advantage of comparative stability. The Government, however, wanted primarily an anchor for the rupee so that in paying off sterling loans and meeting other sterling obligations they might be relieved of the inconveniences and risks of an unstable exchange.

The linking of the rupee to sterling tied the rupee to the chariot wheels of depreciating sterling. In relation to gold or currencies based on gold, it depreciated along with sterling. The depreciation of the rupee raised Indian prices and tended to stimulate exports to countries having currencies based on gold and to discourage imports from them.[1] In actual fact, the stimulus to exports was in large part neutralised by declining world prices and high import duties and other restrictions imposed by most of such countries. As for imports from these countries, they became dearer in the Indian market and the British goods obtained an advantage in competition—a sort of preference by the back door. The advantage or preference was not enjoyed for long because other countries too either went off gold or devalued their currencies one by one. It may be added here that this advantage would have accrued to Great Britain even if the rupee had been linked to gold.

The stabilisation of the rupee in terms of sterling enabled the Government to meet its sterling obligations without embarrassment or uncertainty and led to marked improvement in India's credit.

The most important and probably the most far-reaching effect of linking the rupee to sterling was the export of gold from India in enormous quantities. The Government did not interfere with the export of gold which went on unchecked. An embargo or a

[1] An example would make this clear. If before England went off the gold standard, one £ was equal to 4.86 dollars (gold), an American commodity worth 4.86 dollars could be purchased for one £ or Rs. 1-5-4 (at 1*s.* 6*d.* rate). After England went off the gold standard, the pound sterling or paper pound was no longer equivalent to 4.86 dollars (gold), it became owing to depreciation equivalent to, let us say 4.25 dollars (gold). In other words, to purchase the same American commodity worth 4.86 dollars gold, more than one pound sterling had to be paid and since the rupee was linked to sterling at the old ratio, more than Rs. 13-5-4 had to be paid. And for an Indian commodity selling for 4.86 dollars more than Rs. 13-5-4 were received.

high duty on gold exports or the purchase of gold by the Government was vehemently urged by those who considered export of gold injurious to the country[1]. The Government did not share this view and took no action. The issues raised by gold experts are important and have been discussed below (§2). Only this need be mentioned here that the gold exports strengthened the exchange rate which consequently showed a tendency to rise above 1*s.* 6*d.* At a time when export of merchandise had fallen and the balance of trade in merchandise had shrunk greatly, the gold export created a large balance of trade in favour of India. The exchange became firm and during the next 4 or 5 years remained at a premium except for very brief intervals.

§2. Gold Exports

After England went off the gold standard on September 21, 1931, and the rupee ratio was fixed in terms of sterling at 1*s.* 6*d.* the price of gold rose from about Rs. 21 per tola to Rs. 25 and in December 1931 stood above Rs. 30. At the same time export of gold from India commenced on a large scale and continued over a number of years though in progressively decreasing amounts.[2] The quantity and value of gold exported and the average price of gold are given on the next page.

	Net amount of exported gold (millions of fine oz).	*Value (crores of rupees)*	*Average price of gold per tola (in rupees)*[3]
1931–32 ..	7·73	57·98	25–9–0
1932–33 ..	8.35	65·52	30–9–0
1933–34 ..	6.70	57·05	33–4–0
1934–35 ..	5·69	52·54	35–7–0
1935–36 ..	4·02	37·36	35–8–0
1936–37 ..	3.01	27.85	35–10–0
1937–38 ..	1·77	16.33	36–1–0
1938–39 ..	1·35	13.05	37–12–0
1939–40 ..	3.16	34.67	41–14–0

1. The Federation of the Indian Chambers of Commerce and Industry passed on the 26th March 1932, a resolution strongly urging on the Government of India the desirability of placing an immediate embargo on the export of gold from India and the necessity of purchasing gold in the open market.

2. It increased somewhat in 1939-40.

3. Statistical Abstract for British India ; 1930-31 to 1939-40.

The issues raised by gold exports may be discussed under the following headings :—

1. The relation between gold exports and the linking of the rupee to sterling at 1*s.* 6*d.* rate.

2. The relative influence of economic distress and rise in the price of gold in causing gold exports.

3. The possible effect on gold exports of the adoption of an alternative course, say, linking the rupee to gold.

4. The economic implications of gold exports and of the measures that might have been taken to check them.

Owing to the economic distress caused by the heavy fall in agricultural prices during 1930–31 and possibly intensified by 1*s.* 6*d.* ratio, gold had begun to be sold by the people in rural areas much before England went off the gold standard. Mr. (now Sir) M. L. Darling, the Registrar of Co-operative Societies, Punjab who undertook a tour of the Punjab villages in the cold weather of 1930-31 found gold being sold to meet Government dues. "The following summer", he says "the market price of wheat having fallen to Re. 1-6-0 a maund, sale in canal irrigated tracts became very brisk. Even when the price of gold rose 50 per cent, nearly all the gold that came upon the market from the village—and most of it came from this source—was distress gold, and those who were not obliged to sell, for instance, the larger land-owners, did not do so. In the town, too, it is only the very modern minded who are prepared to part with their ornaments for any other reason but necessity."[1]

Another enquiry undertaken by the Punjab Board of Economic Enquiry in 120 Punjab villages also showed that the sales of gold were due to stern pressure of economic necessity.[2] No such information about other provinces is available but it appears that upto September, 1931 at least, gold was sold mostly out of necessity. A

[1] M. L. Darling: *Wisdom and Waste in the Punjab villager*, pp, 320-321.

[2] *Note on the sales of gold and ornaments in the Punjab villages. Chapter IV*—'There is a mass of evidence coming from all parts of the Province to bear out the conclusion that necessity and economic pressure were the predominant forces behind the larger part of the sale of gold". P. 10.

large part of it went ultimately into the hands of bullion dealers in the cities but a good deal was acquired by the Government also.[1]

Two questions at once arise : Why did the price of gold rise ? Why was gold exported ? The price of gold in terms of rupees rose because sterling was depreciating in relation to gold and as the rupee was chained to sterling, it, too, depreciated. In other words as more sterling had to be given to get the same amount of gold, more rupees had also to be given.[2] The depreciation of sterling in relation to gold could be measured by its depreciation in relation to a currency still based on gold *i.e.*, dollar or franc. The rupee price of gold, therefore, varied with fluctuations in sterling-dollar rate and later, in sterling-franc rate.

It may be pointed out that even if the rupee had not been linked to sterling but left free, the price of gold in terms of rupees would have risen. The rupee would have depreciated in relation to gold and the rupee price of gold risen. Only if the Government had linked the rupee to gold at a definite rate, such a rise could have been avoided.

A rise in the rupee price of gold naturally created a strong inducement for the people to sell gold. Those who were forced by economic necessity parted with it more freely and others who wanted to take advantage of its high price began to convert their gold hoards into productive investments such as deposits in banks, purchase of land etc. In both the cases the rise in the rupee price of gold brought gold out of the hoards in big amounts. How much of this gold was "distress gold" and how much "investment gold" must, however, remain very much a matter of conjecture.

The *export* of gold as distinct from its *sale* within the country was, however, due not to a rise in its price but to the difference

1. .....Although we have lost a certain amount of our Currency Reserve in the last two months, we have not lost a single penny of our gold reserve and ....our actual gold reserves stand at about £ 7 millions sterling higher than they did a year ago, owing to the receipts of gold from up-country"—*Sir George Schuster, Legislative Assembly Debates, September*, 1931.

2. A small example would make this clear. Suppose, on 19th September, one pound sterling was equal to 113 grains of gold. On 25th September, owing to depreciation of sterling 1½ pound sterling, let us say, became equal to 113 grains of gold. If the sterling ratio of the rupee remains the same *i.e.*, 1*s.* 6*d.*, Rs. 13-5-4 will purchase 113 grains of gold on the first date and Rs. 16-10-8 the same amount of gold on the second.

between the sterling price and rupee price of gold. The sterling price being higher, the bullion dealers found it profitable to export gold. The fixed ratio of 1*s.* 6*d.* sterling helped this outflow of gold by keeping up this margin of profit while a rising exchange ratio would have extinguished it by bringing the bullion dealers less rupees in return for the sterling obtained for gold sold.

The exchange left to itself might have risen in response to the stimulus of gold exports. It may be recalled that a free rupee was suggested as one of the alternatives to fixed sterling rate. But a "free" exchange would have been a rising exchange and though it would have checked gold exports, it might have completely disorganised trade. The only other alternative was to have linked the rupee to gold at a low rate, thus to have raised the rupee price of gold higher than its sterling price and made the export of gold unprofitable. The Government could then have purchased gold in the market at that price and sold part of it to pay off its sterling debts and to meet other obligations.

The whole position must, therefore, be examined with reference to the economic benefit or loss to the country caused by gold exports. If gold exports were beneficial on the whole no criticism of the sterling link or ratio need be made on that account. If gold exports were injurious to the interests of the country, the measures that could be taken to check them, including a change in the basis or exchange value of the rupee, deserve consideration.

The case in favour of gold exports being left unchecked was ably put forward by Sir George Schuster, the Finance Member and other official spokesmen.[1] Gold was sold, they said, to tide over a period of exceptional difficulty and the Government were not justified in interfering with people's right to sell gold and reap the benefit of high price. If gold hoards were not to be drawn upon by the people in hard times, what purpose did they serve? Besides it was far better that gold was taken out of hoards and relieved economic distress or got converted into profitable investment than that it should have continued to lie barren and unproductive.

1. Budget Speech, 1932, paras, 69-75 ; 1933, paras. 17-27—*Legislative Assembly Debates*, 1932, *Vol. II and* 1933, *Vol. II.*

Also the Address of His Excellency the Viceroy to the Legislative Assembly 1932—*Legislative Assembly Debates*, 1932, *Vol. I.*

Gold exports also enabled the country to maintain a favourable balance of accounts and their quantity was small compared to the vast reservoir of gold built up in years preceding 1931.

Gold exports enabled the Government to obtain large quantities of sterling and to pay off the sterling debt of £15 millions which matured on 1st January, 1932. They also made it easy for the Government to meet recurring sterling obligations and to reduce the floating debt in India. The credit of the Government, therefore, greatly improved and the rates at which the Government could borrow were substantially lowered. To cancel the sterling obligations by selling gold at a time when sterling price of gold was high was definitely a wise measure.

The position of the reserves was strengthened by the addition to them of sterling securities. During the 15 months from September 1931 to December 1932 gold of the value of £80 millions was sold. External balances of currency of £80 millions were thus acquired of which the Government acquired £69¼ millions by open purchases in the market as currency authority. Out of this they used £34 millions for meeting current requirements and £35¼ millions to reduce India's external obligations and strengthen the reserves.

There were other arguments also in favour of gold exports which supported the official point of view. The export of gold strengthened the rupee-sterling exchange in particular and sterling in general. It stimulated Indian exports by raising the purchasing power of countries importing gold and also encouraged imports into India by enabling sellers of gold to purchase imported commodities. The sellers of gold made an enormous gain because they purchased it when it had a lower value in goods and rupees and sold it when it had appreciated in terms of both goods and services.[1] Above all, sterling had had a more or less steady value in terms of goods, was a more secure international currency than gold and while the future price of gold was uncertain, sterling was appreciating in terms of other currencies.[1] It was highly improbable that gold would have the same position in the world's monetary

1. B. P. Adarkar: 'A Review of Gold Export Fallacies' in the *Indian Journal of Economics*, January, 1936. Paras 10, 12 and 21. Also A. D. Gayer: "The paper moneys of the Sterling area retained a remarkably steady purchasing power on the whole..while gold underwent an outrageous appreciation in value" *Monetary Theory and Economic Stabilisation*, p. 175.

systems (even if they went back on gold) as it had before and for India at least an independent standard—not a gold standard but a standard backed by moderate quantity of gold and aiming at internal stability—would be most desirable. It was better, therefore, to have sold out gold and invested part of it in interest-bearing securities than to have retained it in the country as a dead asset.

Indian commercial and public opinion was, however, opposed to unrestricted outflow of gold. An embargo on gold exports and the purchase of gold in the open market by the Government were urged by the Federation of the Indian Chambers of Commerce and Industry.[1] The main grounds on which the Government policy of non-interference with gold exports was criticised were five: *firstly*, the Government had been parting with an appreciating commodity, gold, for a depreciating commodity, *i.e.*, sterling and the loss thus incurred was far in excess of any interest that might be earned on sterling securities; *secondly*, it was doubtful if "the dethronement of King Gold from his proud position" had really been accomplished and so long as it was not accomplished there was an obvious advantage in retaining within the country a metal which the world might in future once again adopt as the basis of credit ; *thirdly*, if the Government had bought the gold and after selling a part of it to meet its sterling obligations retained the rest, they could have used it later to strengthen the banking reserves of the country ; *fourthly*, if the price of gold rose in future due either to increased world demand for gold or decline in its production, the gold that was exported would have to be purchased, if it was required, only at a loss. *Fifthly*, gold exports had thrown a veil over the seriously shrinking balance of trade and prevented a clear appreciation of the alarming deterioration in the country's position as an agricultural producer and as a debtor on international account.

The role of gold in the future monetary systems of the world was an important consideration in the discussion about gold exports. If gold was going to occupy the same position as before 1931 and the countries were to return to some form of gold standard, the Government policy of non-interference with gold exports justly deserved criticism. It could be maintained, however, that even in the event

1. Resolution of the Federation of Indian Chambers of Commerce, dated, 26th. March, 1932.

of other countries returning to gold after building up their gold reserves, India might find it advisable to have an independently managed monetary system not based on gold. This would bring the discussion back to the old question : would any currency standard without a tangible gold backing inspire public confidence and would not, in the absence of such confidence, the uneconomic habit of hoarding continue ? If the end in view was an independent monetary system managed with a view to internal stability only a drastic remedy like a liquidation of the entire stock of gold at an early date to be followed by prohibitive duties on both gold and silver[1] could meet the demands of the situation. This negative remedy might have been supplemented by a positive one *i.e.*, the establishment of a network of some kind of savings banks adapted to the needs of rural people all over the country.

Leaving side for the present the question of the monetary standard of the future,[2] it might be asked if there was a way by which the Government could retain gold within the country. If the rupee had not been linked to sterling, an embargo could be placed on gold exports and gold purchased by the Government. The Government could then have stabilised the rupee in terms of gold and sold the gold thus acquired to purchase sterling which was progressively depreciating, to cancel sterling debts. The inflation caused by gold sales could have been neutralised to the required extent by raising loans in the market. A planned 'reflation' could thus have been undertaken.

After the rupee had been linked to sterling, an interference with gold exports was unnecessary. The Government required sterling to pay off sterling debts and strengthened the reserves by purchasing sterling securities. Inasmuch as the rupee was linked to sterling, a definite advantage was obtained by cancelling sterling debts and adding sterling securities to the reserves. One benefit of gold exports, *i.e.*, a rise in prices due to issue of fresh currency was, however, not obtained owing to the replacement of a part of gold in hoards by rupees and currency notes and the depressing effect of the rapid decline in world prices.

1. See *Indian Journal of Economics*, January, 1936.

2. See Chapter XI.

While an embargo on gold or the purchase of gold by the Government had very little to recommend it after the rupee had been linked to sterling, the same could not be said of a small export duty on gold. If the duty had fallen ultimately on the bullion dealers, it was amply justified and even if it had come out of the unexpectedly high price obtained by the seller of gold, it would have been unexceptionable. The proceeds of such a duty could be utilised to relieve the economic distress in rural areas.

§3. Government's Sales of Silver

The export of silver from India was also stimulated by the abandonment of gold standard in September 1931.[1] It was, however, small compared to the large quantities sold by the Government of India from 1927 onwards. The silver sales were undertaken in accordance with the recommendations of the Hilton Young Commission. The Commission held that when convertibility of notes into rupees was abolished under the system proposed by them and one rupee notes were introduced, big reserves of silver would be unnecessary. They, therefore, recommended that the unduly large stocks of silver in the Paper Currency Reserve should be gradually reduced from about Rs. 85 crores to Rs. 25 crores in about ten years. They also recommended that 'no favourable opportunity of fortifying the gold holding in the Reserve should be allowed to escape.'[2]

When the Commission reported there were 91 crores of rupees in the Reserve. The Government of India began to sell silver in 1927 and upto 31st March, 1934 had sold a little over 196 million fine ounces of silver or about 57 crores of rupees. They still held 104 crores of rupees in September, 1933, *i.e.*, there was an increase in stocks owing to the return of silver coins to the Reserve; for people had begun to substitute gold for depreciating silver in their hoards. A loss of about Rs.33 crores was incurred by the Government on the sales. The proceeds of silver sales were utilized not to increase gold reserve but to meet the current requirements.[3] The silver sales depressed the price of silver and also resulted in deflation of currency.

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1. Report of the Controller of Currency, 1931-32, para 25.
2. Report of the Hilton Young Commission, paras 78 and 80.
3. "Out of the silver we have sold we have realized about £ 15½ millions which has.....helped us to avoid borrowing.....*Sir George Schuster's speech on 21st November*, 1933.

By the International Silver Agreement of July 1933, the Government of India bound themselves to sell not more than an average of 35 million ounces (equivalent to 9 crores of rupees) annually for four years, *i.e.*, from 1st January, 1934 to 31st December, 1937. This coupled with the agreement of U.S.A. and other silver producing countries not to sell silver but to purchase 35 million ounces annually stabilised the price of silver. During 1938-39 the price remained fairly steady varying between Rs. 48 and Rs. 53 per 100 tolas. The purchasing policy of the United States Government was during this period the main prop of the silver market.

§4. The Reserve Bank of India

The determination of the Government to maintain the sterling link of the rupee at 1*s.* 6*d.* was made clear beyond doubt in 1934 when the Reserve Bank of India Act was passed. The question of monetary standard best suited to India was left to be considered when the international monetary position became clear and stable and the Reserve Bank of India was placed under a legal obligation to maintain rupee-sterling ratio at 1*s.* 6*d.*

The establishment of the Reserve Bank of India in 1935 ended duality in the control of currency and credit. It gave promise of a new era of systematised currency and credit control exercised to secure monetary stability. The constitution of the Bank bears most of the features incorporated in the Bill of 1927 which was dropped finally in 1928. The Bank is a shareholders' bank with an original capital of Rs. 5 crores divided into shares of Rs. 100 each. The risk of political influence entering the Bank has been sought to be eliminated by making it a private shareholders' bank. To check the tendency towards the concentration of shares in a smaller number of hands a provision was made in 1940 that no shareholder of the Bank can come in possession after the 26th March, 1940 of additional shares of the value of more than twenty thousand rupees. The supervision and the direction of the Bank's affairs have been entrusted to a Central Board of Directors composed of sixteen members —one Governor and two Deputy Governors, twelve Directors and one Government official.[1] Of these the Governor and two Deputy

1. The description of the Bank's Constitution and functions is based here on the Reserve Bank of India Act 1934. Consequent on the Independence and the partition of the country in 1947 necessary changes have followed. See also section 9 of Chapter XI and section 8 of Chapter XII.

Governors, four Directors and the Government official (*i.e.* eight members in all) are to be appointed by the Governor-General-in-Council—the remaining being elected—but a Deputy Governor and the Government official are not entitled to vote. There are five Local Boards of the Bank, in Delhi, Madras, Bombay, Calcutta and Rangoon. Salaried officials of the Government or Indian States, insolvents, people of unsound mind, bank employees and Directors of banks other than co-operative banks cannot become Directors or members of a local Board of the Bank but the Governor, Deputy Governors and the Government official on the Central Board are eligible even if they are salaried officials, bank directors or bank employees.

The Reserve Bank of India has been assigned the role and the functions of a central bank and transacts such business as it has been authorized to transact by the Reserve Bank of India Act, 1934. It has the sole right to issue bank notes which have replaced gradually the Government of India currency notes.[1] The Reserve Bank notes are legal tender and are guaranteed by the Governor-General-in-Council. Bank notes of the denominations of Rs. 5 and Rs. 10 were issued in January and Februarv 1938 and those of Rs. 100, 1000, and 10000 later during the same year. Notes of the denomination of Rs. 2 were issued in 1943 to meet the special requirements of war conditions.

The Bank has to receive money and make payments on behalf of the Secretary of State and Central and Provincial Governments. It receives the cash balances of Central and Provincial Governments and carries out remittance, exchange and banking business on their behalf. It has been entrusted with the management of public debt and the issue of new loans. It can accept money on deposit without interest from, and collect money for, the Secretary of State, Central and Provincial Governments, local authorities, banks, and other persons. It can also make short-term advances for periods generally not exceeding three months to Central Government, Provincial Governments, Indian States, local authorities, scheduled banks and Provincial Co-operative Banks. It can act as agent for the Secretary of State, Central and Provincial Governments, States

[1] As the Bank was (and continued to be even after the separation of Burma in 1937) the central bank for Burma, it issued notes of distinctive design for Burma.

and local authorities for purchasing and selling gold and silver, bills of exchange, shares and securities and for collecting interest and dividends.

Besides these various kinds of business transacted for the Government, the bank can purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India or England. It can purchase and sell specified securities, gold coin and bullion. It can borrow money for a period not exceeding one month and enter into agency agreements with an international bank or central banks of other countries.

The Bank has been empowered to undertake open market operations, that is, on special occasions it can discount bills of exchange and make loans and advances directly and thereby expand, contract or stabilise credit. Normally the Bank will deal with scheduled banks and Provincial Co-operative banks and only on special occasions will it have to come into the open market *i.e.*, deal directly with the public at large. Open market operations furnish a powerful instrument by which a Central Bank can regulate credit on emergent occasions.

The Bank is under an obligation to maintain rupee-sterling rate at 1*s.* 6*d.* by buying sterling at a rate not higher than 1*s.* $6\frac{3}{16}d.$ for a rupee and selling sterling for immediate delivery in London at a rate not lower than 1*s.* $5\frac{49}{64}d.$ for a rupee. The amount of the sterling bought or sold is to be not less than £10,000.

The Bank has an Issue and a Banking Department. The liabilities of the Issue Department arise from the note issue and the assets of the Department consist of gold coin, gold bullion, sterling securities, rupee coin, rupee securities and bills of exchange and promissory notes payable in British India. Of the total amount of assets not less than 40 per cent is to consist of gold coin, gold bullion or sterling securities and the amount of gold coin and bullion is to be not less than Rs. 40 crores in value.[1] Of the total gold coin and bullion not less than 85 per cent is to be held in British India.[2] The Bank

1. The most notable change in the composition of the assets brought about by the war was the enormous increase in sterling securities (from Rs. 59.5 crores on the last Friday of August 1939 to Rs. 1120.3 crores on 29th March, 1946).

2. The whole of gold bullion and coin is now held in India and is valued at the old rate to 8,47512 grains of gold per rupee or Rs. 21–3–10 per tola giving at the present value of gold in March 1946 a hidden reserve of over Rs. 120 crores.

has taken over the whole of the gold coin and bullion in the Gold Standard Reserve and the Paper Currency Reserve and has assumed the liability of the currency notes of the Government of India. The liabilities and assets of the Issue Department for the week ended 29th March, 1946 are shown below :—

Liabilities	Rs.	*Assets*	Rs.
Notes held in the Banking Department	19,63,56,000	A. Gold coin and bullion— (*a*) Held in India ..	44,41,45,000
Notes in circulation	12,18,77,42,000	(*b*) Held outside India ..	
		Sterling securities ..	11,20,32,89,000
		Total of A ..	11,64,74,34,000
		B. Rupee coin	15,82,59,000
		Government of India rupee securities ..	57,84,05,000
		Internal bills of exchange and other commercial paper ..	
Total notes issued	12,38,40,98,000		
Total liabilities	12,38,40,98,000	Total Assets ..	12,38,40,98,000

Ratio of total of A to Liabilities : 94.052 per cent.

The Reserve Bank of India is a banker's bank and Scheduled Banks which numbered 89 on 30th June, 1945, have to maintain with it a balance amounting to at least 5 per cent of their demand liabilities and 2 per cent of their time liabilities. Demand liabilities generally mean deposits withdrawable on demand and time liabilities deposits repayable after some period. The maintenance of a balance by the Scheduled Banks with the Reserve Bank is necessary because to make its policy effective, the Bank must have adequate resources and must be able to influence the credit policy of member banks. In actual fact, however, the banks had ample resources of their own to lend and rarely sought accommodation from the Bank. The bank rate remained unchanged from 28th November 1935 until a few years ago at 3 per cent.

The greatest difficulty in controlling the monetary system in India arises from the existence of a vast mass of indigenous bankers and money-lenders who are responsible for about 90 per cent of the credit transactions. These bankers must be linked up with the Reserve Bank. In August 1937, the Bank formulated a Draft Scheme for the direct linking of private bankers but as the conditions laid down in the scheme, such as closing other than banking business within a certain period and proper maintenance and audit of accounts did not suit the indigenous bankers, nothing came out of it. Meanwhile the Bank collected and published information[1] about the operations of the non-scheduled banks with capital and reserves of rupees 50,000 and over and tried to develop contracts with them. Some non-scheduled banks and indigenous bankers—numbering 78 and 4 respectively at the end of June 1945—have been included in the list of banks approved by the Reserve Bank for concession rates of remittances. With effect from the 15th February, 1945, non-scheduled banks desirous of opening accounts with the Reserve Bank have been allowed to do so on specified terms and conditions.

A more conclusive manner in which the Bank has been trying to secure proper regulation and control of the banking system is by urging the need of enacting comprehensive banking legislation. The necessity and importance of such legislation were enhanced by the spate of bank floatations during the war and by the apprehended danger of widespread banking collapses in the post-war period. Proposals for an Indian Bank Act were first made by the Bank in 1939 but in July 1941, the Government of India informed the Bank of its decision not to undertake comprehensive banking legislation in the existing abnormal war conditions. In 1942, however, the Government amended Section 277 F of the Indian Companies Act with a view to imparting preciseness to the definition of banking. On 30th December, 1942, again the Bank made two suggestions to the Government for the regulation of banking : firstly, that provision should be made in the Companies Act that subscribed capital must not be less than half the authorized capital and the paid-up capital not less than half of the subscribed capital and secondly, that no banking company should have other than ordinary shares. The Government of India invited opinions on the Bank's suggestions in

1. *Memorandum on Non-scheduled Banks*, 1939.

March 1943, and in March 1944 they amended the Companies Act again to control the capital structure of banks and to restrict the periods for which an individual could hold the appointment of managing agent of a bank. All this did not, however, dispose of the need for comprehensive banking legislation and on the 16th November, 1944, the Government introduced in the Central Legislative Assembly a Bill to consolidate and amend the law relating to banking companies. The main features of the Bill were as follows: (*i*) a simple definition of banking with the object of limiting the scope of the legislation to institutions in which the funds are deposited primarily to ensure their safety and ready withdrawability; (*ii*) prescription of minimum capital standards ; (*iii*) prohibition of trading with a view of eliminating non-banking risks ; (*iv*) inclusion in the scope of the legislation of banks incorporated or registered outside British India ; (*v*) provision of an expeditious procedure for legislation ; (*vi*) inspection of the books and accounts of a bank by the Reserve Bank, when necessary ; (*vii*) empowering the Central Bank to take action against banks conducting their affairs in a manner detrimental to the interests of the depositors, and (*viii*) prescription of a special form of balance-sheet and conferring of powers on the Reserve Bank to call for periodical returns.

The Bank has also created, in compliance with its statutory obligation, a special Agricultural Credit Department to link its machinery with rural credit agencies and to maintain an expert staff to study all questions of rural credit and give advice to governments and banks. A preliminary report of the Department on the main features of the rural credit problem was published in December 1936. A full report was submitted to the Government in 1937 indicating the various directions in which improvements might be made to enable the rural credit agencies to render better service to the agriculturist and pointing out the manner in which the Reserve Bank could render assistance. In a series of circular letters issued since 1938, the Bank defined the conditions under which it would be prepared to provide finance to co-operative banks. Meanwhile the Department is engaged in an intensive study of problems relating to rural finance and in tendering advice to provincial agencies purveying rural credit.

The outbreak of the war in September 1939 led to the establishment of a new Department of the Bank—the Exchange Control Department— to administer the various regulations relating to dealings in foreign exchange. The Department kept in close touch with the Empire Exchange Control on the one hand and with the banking institutions and dealers authorised to deal in foreign exchange on the other.

The Bank has to pay a part of its profits to the Government after meeting expenses and paying a dividend, fixed at 3½ per cent upto 1942 and raised by an Ordinance to 4 per cent since 1943, to the shareholders. The net profits and the amounts paid to the Government have been as follows:—

In lacs of rupees approximately

Year	*Net Profits*	*Amount paid to the Government*
1935 (nine months)	56.06	42.9
1936	43.42	35.9
1937	27.91	10.4
1938	38.45	20.9
1939	22.50	5.0
1940 (six months)	29.29	20.5
1940–41 (June—May)	279.26	261.7
1941–42 (June—May)	341.54	324.0
1942–43 (June—May)	769.81	749.81
1943–44 (June—May)	1026.58	1006.58
1944–45 (June—May)	1489.27	1469.27

The Bank keeps up a continuous exchange of information with the foreign central banks and watches closely the economic and financial trends in other countries. Through its Research Section it collects data and organises research into subjects which are its direct concern. It also issues, besides its Annual Report on Currency and Finance, a number of other periodical and topical publications.

In maintaining stability of exchange and regulating credit. the Reserve Bank of India has acted in close collaboration with the Government of India. Mutual consultation and advice between the central banking institution of a country and the Government are part of a well established procedure all over the world and as the ultimate end of the two authorities is the same, chances of difference of opinion between the two are reduced to the minimum. In

India, however, it was felt by some, that the expectations of the public from the Reserve Bank whom they are learning to regard as the supreme national banking institution may not always square with the predilections of the Government in certain important matters of policy. The resignation of Sir Osborne Smith, the first Governor of the Bank, in 1936 owing to differences (as the rumour had it) with the Finance Member of the Government of India and the appointment of the late Sir J. B. Taylor, a member of the Indian Civil Service, as Governor did not seem to augur well for the growth of sound traditions of central banking. But on an appraisal of the first eleven years' record of the Bank's working it could be said that it endeavoured to serve India well and in spite of several difficulties and obstacles laid firm and secure foundations for its future progress. The scope and value of its activities have steadily grown and it may safely be asserted that in the absence of the Reserve Bank, the handling of the monetary problems created by the war in India would have been a far more difficult affair. The appointment of Mr. (now Sir) C. D. Deshmukh as the first Indian Governor of the Bank in August, 1943 was both a pleasing and significant event in the Bank's career. For the Bank was being called upon to offer its counsels to the Government not only on the complex problems of the post-war period but also in respect of the important arrangements initiated in pursuance of the decisions of the United Nations Monetary and Financial Conference in July 1944 for the regulation of world's monetary future and the presence of an Indian of outstanding ability at the head inspired confidence that India's interests would be properly looked after.

§5. Prices, Trade, Exchange and Finance (1931-1939)

The fall in prices which commenced towards the end of 1929 was particularly heavy in the case of agricultural commodities. As India produced and exported largely foodstuffs and raw materials, the depression made a deeper mark on its economic life than on that of industrially advanced countries. The prices of both Indian exports and imports fell from 1929 onwards but the fall was much heavier in those of exports.[1] As the exports consist mostly of agricultural commodities and imports mostly of manufactured goods, the real terms of trade turned against India. In other words, the

1. From September 1929 to June 1932, the prices of exported articles fell by about 47 per cent and of imported articles by about 16 per cent.

unequal fall in the prices of agricultural and non-agricultural goods left India worse off inasmuch as a larger quantity of exports was needed to get the same quantity of imports in exchange.

After 1929 there was for some years a continuous decline in the general level of prices as shown by the index numbers of wholesale prices. Both the Calcutta Index Number based on prices of 45 different commodities and the Bombay Index Number based on prices of different commodities registered a decline as shown below:—

Index Numbers of wholesale prices : 1929=100

	Year	*Calcutta*	*Bombay*
	1930	82	87
	1931	68	75
	1932	65	75
	1933	62	68
	1934	63	66
	1935	65	68
	1936	65	66
	1937	72	73
	1938	68	70
	1939	76	75
January	1939	68	69
February	,,	70	68
March	,,	69	68
April	,,	71	69
May	,,	72	70
June	,,	72	70
July	,,	71	69
August	,,	71	71

The bottom of prices was reached in 1932-33 when the fall was a little less than 40 per cent compared to the level in 1929. There was some recovery in the next two years but it was in the latter part of 1936 that prices began to rise and the rise was almost continuous till August, 1937. After that the prices begar to fall and were generally on the decline till the end of June, 1938 when they showed an insignificant rise which was more or less maintained till the end of 1938.

The agriculturists who form the bulk of Indian population were in acute distress on account of the heavy fall in prices up to 1932-33. "When the upward movement started in 1932-33, the rise in the

prices of commodities in which he (*i.e.*, the Indian agriculturist) was interested was painfully slow and halting."[1] With the exception of a short period extending from the middle of 1936 to about the middle of 1937, there was during the period extending upto September 1939 no definite upward movement in the prices of primary commodities. Besides an almost constant low level of prices, trade restrictions and currency depreciation resorted to by most of the countries led to a shrinkage of Indian exports and deepened the misery of the Indian agriculturist. The misery was relieved only to a limited extent by the trade agreements which the Government of India concluded with Great Britain in 1932 and 1935 and with Japan in 1934.

The value of both exports and imports having fallen heavily after 1931, the balance of trade in merchandise in favour of India shrank rapidly. The actual position in respect of the total balance of trade was, however, marked by the heavy exports of gold which supplemented exports of merchandise. The table given below shows the position in respect of exports and imports since 1931.

In crores of rupees

Year	*Value of exports of merchandise including re-exports*	*Value of imports of merchandise*	*Total visible balance of trade in merchandise*	*Net exports or imports of treasure*	*Total visible balance of trade*
1931-32 ..	160.55	125.72	+34.83	+55.65	+90.48
1932-33 ..	135.49	132.27	+ 3.22	+64.93	+68.15
1933-34 ..	149.73	114.99	+34.74	+57.23	+91.97
1934-35 ..	155.22	131.80	+23.42	+52.54	+75.96
1935-36 ..	164.29	133.69	+30.60	+36.37	+66.97
1936-37 ..	202.33	124.58	+77.75	+14.50	+92.5
1937-38 ..	202.63	159.18	+43.45	+15.11	+58.66
1938-39 ..	180.29	137.22	+43.07	+22.79	+65.82
1939-40 (April-August only.) ..	80.99	60.86	+20.13	+ 5.84	+25.61

(Figures for Kathiawar and Travancore ports have been excluded. Figures for Burma have been included.)

1. *Review of the Trade of India*, 1937-38, *p.* 12.

It may be noticed that while the total visible balance of trade in favour of India was fairly large throughout, the balance of trade in merchandise fell as low as Rs. 3 crores in 1932-33, increased thereafter reaching a figure about Rs. 78 crores in 1936-37 and fell again in 1937-38 and 1938-39. For India excluding Burma, the balance of trade in merchandise and the total visible balance of trade were as follows:—

In crores of rupees.

Year	*Balance of trade in merchandise*	*Total visible balance of trade*
1935-36	.. + 5.1	+40.5
1936-37	.. +51.2	+64.9
1937-38	.. +15.9	+30.2
1938-39	.. +17.4	+29.3
1939-40 (April-August) ..	.. + 7.0	+12.2

If gold exports had not taken place on a large scale, the total visible balance of trade in favour of India would have been very small and both the payment of foreign obligations and the maintenance of exchange would have been rendered exceedingly difficult. Gold exports thus saved a very bad situation. They steadily fell off, however, and the decrease in them was more than made up by an increase in exports. The growth of exports was almost continuous after 1933-34 but the course of imports was somewhat erratic. During 1937-38 exports remained more or less steady but imports recorded a rise of about Rs. 35 crores. In the second half of 1937-38 there was an excess of imports over exports in each month except October and February. One reason given for it was that "a lag of this kind is to be expected in a country such as India which exports mainly raw materials and imports mainly manufactured goods. Her exports are affected comparatively quickly by world prices and conditions but imports arranged during a time of prosperity continue to arrive after the upward trend has been reversed."[1] The large imports during the latter half of 1937-38 were thus a "carry over" from a period of brisk trade preceding it. It did not appear, therefore, that the increase in imports represented a permanent tendency. During 1938 39, both exports and imports registered a

1. *Reserve Bank Report on Currency and Finance*, 1937-38, p. 3. Also *Review of the Trade of India*, 1937-38, p. 69.

decline as compared to 1937-38, the balance of trade being *plus* Rs. 66 crores against *plus* Rs. 59 crores for 1937-38.[1]

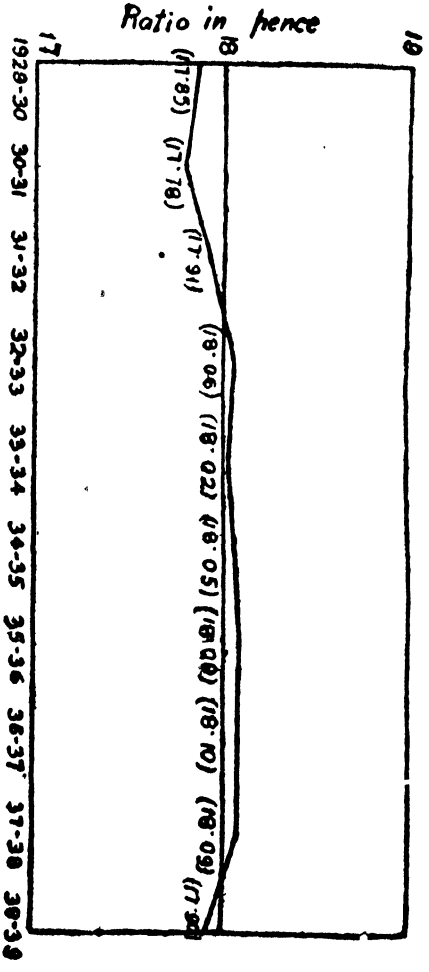
From September 1931 to 1935-36, gold exports kept the total balance of transactions largely in favour of India and the rate of exchange remained firm. Left to itself it might have risen even higher than 1*s.* 6*d.* During the next 3 years (*i.e.*, from 1935-36 to 1937-38) also ,the exchange remained firm but the firmness was due to a marked improvement in India's balance of trade in merchandise. Throughout the year 1937-38 as during the previous two years, the rate remained near the upper limit fluctuating between 1*s.* 6$\frac{1}{2}$*d.* and 1*s.* 6$\frac{3}{32}$*d*[2]. From April 1938, however, the effect of falling exports and increasing imports began to be visible on the exchange rate which began to fall and reached a point lower than 1*s.* 6*d.* in the first week of June 1938. On June 6, 1938, the Government of India issued a *communique* making it clear that "they are satisfied that the maintenance of the present value of the rupee is required in the interests of India and that the resources available for this purpose are more than ample" and pointing out that "the gold and sterling assets actually in the hands of the Reserve Bank and the Government of India are at the present time worth more than Rs. 160 crores." The Government announcement steadied exchange slightly but until the end of 1938, the rate did not rise higher than 1*s.* 5$\frac{15}{16}$*d.* In the month of December forward exchange rates weakened and the Government issued another *communique* attributing exchange weakness to movements of funds to United Kingdom by speculators who wanted to bring them back at a profit when the ratio was lowered. They reiterated their decision to maintain the exchange at the existing statutory rate. During the last quarter of 1938-39, there was an improvement in the balance of trade and the exchange rate improved to 1*s.* 5$\frac{31}{32}$*d.* in March 1939. The graph given on the next page is based on the average of daily telegraphic transfer rates from Calcutta on London and shows exchange fluctuations from 1930-31 to 1938-39.

The demand for a lower exchange value of the rupee was pressed on the Government throughout the seven years preceding

1. There was a comparatively greater fall in the values of goods imported after the beginning of 1938–39 which was attributable partly to the reduction in the volume of imports and partly to the fall in prices.

2. *Reserve Bank Report on Currency and Finance*, 1937–38.

the war of 1939 by important sections of commercial opinion. One after another England, Scandinavian countries, Egypt, Japan, United States, Belgium, France, Holland, Switzerland, Italy and Czecho-Slovakia depreciated or devalued their currencies and each addition to the list of devalued currencies created an alarm in India and renewed agitation in favour of a lower exchange rate. The large influx of Japanese imports during 1932 due to depreciation of Japanese yen had to be counteracted by the Government by raising high the import duties on cotton piecegoods of other than British manufacture. In 1933, some prominent businessmen and industrialists



formed the Currency League of India "to educate and organize public opinion with a view to opposing the continuation of 18*d.* sterling ratio as is sought to be done through the Reserve Bank Bill and to bring about an immediate devaluation of the rupee." An amendment to the Reserve Bank of India Bill was moved in the Legislative Assembly to secure lower sterling exchange rate but was defeated. In October 1936 after the devaluation of franc and other currencies of the gold bloc, the Indian commercial interests grew apprehensive that India's export trade with these countries would receive further setback while imports from them into India would be stimulated.[1] The failure of the Government of India to revise Indian currency and exchange policy in view of the devaluation of these currencies was discussed in the Indian Legislative Assembly on October 8, 1936. In May 1938, the Prime Ministers of the Congress-governed Provinces resolved to secure the cooperation of all the Provinces to send representations to the Government of India for the devaluation of the rupee. This was a significant move showing that most of the Provincial Governments had come to regard 1*s.* 6*d.* ratio as injurious to Indian interests. The matter was taken up by the Indian National Congress which passed a comprehensive resolution on the subject on December 14, 1938. The policy of the Government was all along clearly stated ; it could be summed up in the words of the then Finance Member, Sir James Grigg : "I will be no party to any monkeying about the present ratio."[2]

The fall in prices and the shrinkage of trade along with internal political disturbances led to a fall in both Central and Provincial revenues during 1931-32 and 1932-33. To make up the deficiency in central revenue, both retrenchment and fresh taxation were provided for in the Supplementary Finance Act of September 1931. Most of the Provincial budgets also showed deficits and the Provinces which did not receive a square deal under the Meston Award felt the pinch most. Economy, retrenchment and taxation were all used to restore budgetary equilibrium but the sagging agricultural prices did not permit any substantial improvement in finances. After

1. This is shown by the condition of agricultural debtors and moneylenders both of whom suffered, the latter through inability to recover even interest not to speak of the principal lent.

2. Sir James Grigg's reply to the address of Indian Merchants' Chamber (August 1935).

1933-34, there was a definite improvement in the central finance but most of the provincial governments continued to experience difficulties in balancing their budgets. After 1937 these difficulties became particularly acute in the provinces under Congress Governments which were losing excise revenue owing to the gradual introduction of prohibition and were undertaking reforms involving increasing expenditure. Sir Otto Niemeyer's recommendations embodied in an Order - in-Council[1] provided for financial assistance to all the Provinces by cancellation and consolidation of debts, assignment of a share of the proceeds of jute export duty (to jute-growing provinces), grants-in-aid to some provinces and the distribution of fifty per cent of the yield of income-tax among all the Provinces. The additional funds thus made available were readily absorbed in either filling up the gap in revenue or meeting fresh expenditure. In 1937-38 and 1938-39 sums of Rs. 125 and Rs. 150 lakhs out of the proceeds of income-tax were distributed among the provinces and a much larger sum of Rs. 279 lakhs accrued as the provincial share in 1939-40 . Sums of Rs. 265 lakhs, Rs. 251 lakhs and Rs. 256 lakhs were distributed in 1937-38, 1938-39 and 1939-40 respectively as the provincial share in the proceeds of jute export duty. Subventions amounting to Rs. 312 lakhs, Rs. 303 lakhs and Rs. 303 lakhs respectively were also paid to the provinces in the three years. The provinces, therefore, received extra resources amounting altogether to over Rs. 22 crores in three years (from 1937-38 to 1939-40). Yet the Provinces wanted more funds and it was clear that no lasting benefit could be obtained by them without a substantial rise in agricultural prices and recovery in trade.

§ 6. The Ratio Controversy

Controversy about the correct rate of the rupee in terms of British currency is at least as old as the Fowler Committee of 1898.[2] The Committee had to decide between 1*s.* 4*d.* and a lower ratio and though the majority recommended 1*s.* 4*d.* ratio, a minority

1. The Government of India (Distribution of Revenues) Order, 1936.

2. Even earlier than this the Herschell Committee in 1893 had considered the proposal of the Government of India that English coinage should be made legal tender in India at a rate of not less than 13½ rupees for one sovereign (roughly 1*s.* 6*d.*: Re.) but had recommended that the ratio between gold coin and silver rupees should be fixed in the first instance not much above the rate then prevailing *i.e.*, 1*s*, 4*d.* to the rupee though they said that if circumstances required it, the Government of India might be empowered to raise it with the sanction of the Secretary of State (*Report*, paras 40 and 150). At that time, however, the question was not a controversial one.

argued in favour of a lower rate. The controversy arose again when the majority of the Babington Smith Committee of 1919 recommended 2*s.* (gold) rate and Mr. Dalal wrote a strong minute of dissent. It became acute after the publication of the Hilton Young Commission's report in 1926 and centred round 1*s.* 6*d.* rate recommended by the Commission and given effect to by the Government. It may be noted that 1*s.* 6*d.* ratio of 1927—31 was virtually a gold rate and 1*s.* 6*d.* ratio of post-1931 period was a sterling rate—a material difference, considering that in terms of gold the value of the rupee had fallen by about 40 per cent from September 1931 to the end of 1938.

The critics of 1*s.* 6*d.* ratio included important Indian commercial and agricultural interests besides politicians and economists.[1] They considered the existing ratio highly injurious to India and would have it reduced to 1*s.* 4*d.* sterling or even a lower figure if necessary. The demand for devaluation of the rupee was before September 21, 1931 a demand for lower value of the rupee in terms of gold but was later on, when sterling had no longer a fixed relation to gold, a demand for lower value in terms of sterling.

The devaluation of the rupee involved so many issues and touched so many interests that it was not easy to venture a categorical pronouncement in favour of or against it. An attempt to understand the issues as they were discussed during the years 1931—39 might be made by finding answers to four questions :—

1. What should be the object or objects of currency policy in India ?

2. How far can that object be achieved by currency policy alone (*i.e.*, unaided by measures of another kind).

3. Has stabilisation of exchange rate at 1*s.* 6*d.* failed to secure that object ? What evidence is there that it has failed to do so ?

4. If 1*s.* 6*d.* ratio has failed to do so, can devaluation of the rupee secure it ? If so, what should be the extent of devaluation ?

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1. For an illuminating academic discussion of the ratio question, see *The Sankhya* of March and September 1937, and November and December, 1938. See also *Economic Problems of Modern India* Vol. II (edited by R. K. Mukerjee and H. L. Dey), Chaps. XXVI—XXVIII.

There was general agreement that the objective of currency policy in India should be determined with reference to her economic position. India had been a debtor country, with a vast rural population, large internal trade and struggling industries. As a debtor country she had to meet foreign obligations amounting to more than £32 millions. An exportable surplus of merchandise of that amount at least had to be maintained year after year. The alternatives were to export precious metals or to raise foreign credits. The interests of the vast rural population demanded that the prices of agricultural produce should cover the expenses of agricultural production. The growing industries required protection from foreign competition and the large internal trade had to be saved from violent strains due to forces originating outside the country.

As a debtor country India had naturally to attach great importance to the stability of exchange value of the rupee. Small changes in exchange ratio might cause big differences in the amount of foreign remittances. It could not be maintained, however, that an exportable surplus to meet foreign obligations could under all circumstances be maintained by keeping exchange stable. Currency might have to be devalued and was actually devalued by several countries to rectify an unfavourable or falling balance of trade. Otherwise, too, rigid stability of exchange was too narrow an objective for a country like India with a large rural population and internal trade. An exchange kept rigidly fixed was bound to be a good conductor of disturbances occurring in the outside world. It would expose the internal economy of the country to the stress and strain of external forces. In a very much disturbed world, exchange rate had to be used as a 'shock absorber' of price disturbances occurring outside the country so that the prices inside the country might remain in level with costs and production and employment might follow a steady course. For India the maintenance of stable cost-price parity appeared to be a much more desirable objective than mere stability of exchange. An exchange rate that secured adjustment between world prices and internal prices was not enough unless the internal prices were also brought into level with internal costs. It was obvious that no exchange rate rigidly clung to could secure that object.

It would have been claiming too much for currency policy to say that it alone could secure stability of production and employment.

Currency policy by itself cannot rectify all maladjustments in the economic organization of a country.[1] Yet it is a powerful instrument which if wielded at a psychological moment can 'stop the rot' caused by an incipient or even deep depression and stimulate industries and trade. In Australia this instrument was used to the best effect and admirable results were obtained. It is true that certain special conditions in Australia such as the greater flexibility of wages and, therefore, cost of production made currency devaluation effective. But good results could be secured elsewhere also if the devaluation was well-timed.

Ever since 1*s.* 6*d.* ratio was fixed in 1927, the Government expressed, reiterated, affirmed and reaffirmed their determination to maintain it and took all possible measures to that end. In 1929-30 and 1930-31 they experienced difficulty in maintaining it and contracted currency to the extent of over Rs. 40 crores. The abandonment of gold standard by England relieved them of the task of maintaining 1*s.* 6*d.* gold rate. The linking of the rupee to sterling was a disguised depreciation in relation to gold. The pressure of inexortable forces thus made the Government adopt in September 1931 a course which they had refused to follow voluntarily. The heavy contraction of currency during 1929-30 and 1930-31 was justified by Sir George Schuster as a consequence of slackness in trade.[2] Even allowing for trade slackness, it appears that the currency contraction was made necessary by the attempt to maintain 1*s.* 6*d.* rate. Those opposed to 1*s.* 6*d.* ratio, therefore, pointed out that the maintenance of 1*s.* 6*d.* ratio had not only fully exposed Indian economy to world depression but actually intensified some of its effects by accentuating the fall in internal prices. The deflationary effects of the ratio had spread out like a heavy blanket over the Indian economy obstructing recovery and expansion.

It was difficult to say how far there had been an adjustment between prices and costs during the 6 or 7 years between 1932 and 1938 and whether in 1938-39 the rupee was overvalued. The statistics available in this country about prices and costs were neither very

1. "The entire economic system cannot be controlled by operating a single lever, through monetary mechanism alone, but control of that lever is indispensable in the pursuit of balanced economic advance". A. D. Gayer in *Monetary Theory and Economic Stabilisation*, p. 195.

2. Address to the Conference of Finance Secretaries, October 1930.

accurate nor very reliable. The information about changes in price level was based on Calcutta or Bombay index numbers of prices, the method of construction of which could be greatly improved. There were no statistics directly relating to cost of production and use was, therefore, made of Bombay cost of living index number and statistics of agricultural wages (obtained from agricultural wages census reports) and of industrial wages (from other sources) to find out the trend of movement of costs—a procedure open to criticism. It is clear, however, that while a definite tendency towards a marked rise in the index numbers of wholesale prices was noticeable in the United Kingdom, U. S. A. and other countries after 1934, Indian prices exhibited no appreciable rise. The following table shows the movements of prices in India and a few other countries—

Index numbers of prices : 1929=100

	1930	1931	1932	1933	1934	1935	1936	1937	1938
U. K. (Board of Trade) ..	87.5	76.8	74.9	75.0	77.1	77.9	82.7	95.2	88.8
U. S. A. ..	90.7	76.6	68.0	69.2	78.6	83.9	84.8	90.6	82.5
Australia (Melbourne) ..	88.5	79.2	78.3	78.2	81.6	81.5	85.6	91.9	92.9
Japan ..	82.4	69.6	73.3	81.6	80.8	84.4	89.9	108.4	114.3
Canada ..	90.6	75.4	69.8	70.2	74.9	75.4	78.0	88.4	82.2
India (Calcutta) ..	82.3	68.1	64.5	61.7	63.1	64.5	64.5	72.3	76.6

It was possible that the disparity between the price level in India and abroad was due to (1) heavier fall in agricultural prices and their halting upward movement and (2) rearmament programmes of several countries which led to a spurt in prices. Any persistent failure of Indian prices to catch up to world prices could, however, be attributed to 1*s.* 6*d.* ratio. Even if it could be established that this failure was not due to 1*s.* 6*d.* ratio, there still remained case a for devaluing the rupee to initiate a rise in prices to benefit the vast agricultural population.

An important argument advanced against devaluation of the rupee was that a measure of stability in international exchange relations had already been attained and India should not cause a disturbance just then by devaluing the rupee. It might be pointed out, however, that the disturbance might not have been so great as was feared and it would have been worthwhile to risk some of it in the interests of the agriculturists who form the bulk of population.

Intensive enquiries in rural areas showed that at the prevailing level of prices the agriculturist could not meet his costs (including in "costs" ordinary wages and some return for enterprise). Many of the agriculturist's costs such as rent, land revenue and maintenance charges of livestock are more or less fixed and did not fall in proportion to the fall in prices. If agriculture had been a business and not a way of life in this country, many of those engaged in agricultural production would have closed the shop long before. That they did not do so or could not do so was no reason why they should not have been put in a position to meet their costs. Any relief given to agriculturists was bound to have a tonic effect on the entire economic system of the country.

There could be difference of opinion as to how far devaluation of the rupee would stimulate our exports. The linking of the rupee to sterling at 1*s.* 6*d.* and the consequent depreciation of the rupee in relation to currencies based on gold did raise prices a little in India. Some advantage was undoubtedly secured in export trade with those countries which still remained on gold standard such as France, U. S. A., Italy and Germany but this advantage was largely neutralised owing to the imposition by these countries of high tariffs, quota systems and exchange restrictions or due to their resort to currency devaluation. It was highly problematic if any devaluation of the rupee would have stimulated demand for our exports or secured a passage for them through the iron bars of numerous trade restrictions. It might, on the other hand, have led to competitive depreciation of currencies by other countries or retaliation in some other form. This danger could to some extent be mitigated by entering into trade agreements on the basis of a devalued rupee, if on other grounds devaluation was found desirable. As regard exports to countries of the sterling group, even a temporary improvement in trade could not be secured owing to the maintenance of the old rate of 1*s.* 6*d.* A lowering of exchange rate to stimulate exports to these countries was subject to the same risk of retaliation. On the whole it would appear that no lasting increase in our exports could be secured without a general revival of world demand for them. This in turn depended upon the relaxation of international tension and the removal of barriers to international trade. Devaluation would, however, have enabled India to maintain or strengthen her competitive position in the articles of export.

The devaluation of the rupee could be used as a lever to raise internal prices. The prices of exports and imports would have risen first and the rise might have slowly spread to other commodities which did not enter into India's foreign trade. This would have stimulated production and trade. It was pointed out, however, that while the rise in the prices of exports might take time in percolating to the primary producer, the price that he had to pay for imported goods would immediately increase. The Indian agriculturist would, therefore, obtain no advantage from the devaluation of the rupee. If his costs rose as fast as prices, it was clear that no net benefit could accrue to him. A plausible reply given to this agrument was that most of the farmer's costs did not depend on the prices of imported goods inasmuch as such goods formed only a small part of the agriculturist's consumption and in any case there was bound to be a time lag between the rise in prices and rise in costs. The agriculturist could obtain the benefit of this time lag.

A rise in the prices of imports was, no doubt, undesirable from the point of view of the consumers. It should not have been overlooked, however, that consuming is not the sole function of consumers ; they also work and produce. If opportunities for work and production are enlarged, the burden of slightly higher prices is lightly borne by the consumers. A rise in prices of imported goods would also have given added protection to Indian industries,[1] particularly those which did not come under the scope of the policy of discriminating protection. It could not be ignored, however, that the protection given by currency devaluation is indiscriminate and could be justified only if the Government policy was so halting and vacillating that indiscriminate protection was the only alternative to inadequate protection.

The existing position with regard to exports and imports could hardly be called healthy and normal. The merchandise balance of trade in favour of India (including Burma) amounted to about Rs. 43 crores in 1937,-38 as against Rs. 71 crores in 1937-38. This was primarily due to an increase in imports. Excluding Burma,

1. In the case of large manufacturing industries, devaluation was advocated not as a measure of additional protection but to remove the handicap of an overvalued currency under which they had been labouring since 1927. It may be noted here that devaluation would have raised the prices of imported machinery, appliances and stores and to that extent handicapped Indian industries.

the balance of trade in favour of India in 1937-38 was only Rs. 16 crores in 1937-38 as against Rs. 52 crores in 1936-37. It is said that "in fact the best proof of a well-chosen ratio consists of its harmony with a steady and moderate price level and a healthy and normal condition of imports and exports."[1] If this be the proof of a well-chosen ratio, 1*s.* 6*d.* ratio could hardly be said to have furnished it.

The fall in prices in India not only upset price-cost parity, thus damaging production and increasing unemployment but also brought about profound disturbances in distribution. It strained relations between debtors and creditors, landlords and tenants (particularly those paying contract cash rents), employers and workers and gave too arbitrary an advantage to men with fixed or gradually increasing incomes such as the government employees or pensioners. A rise in prices, if it could be brought about through devaluation, would not only have taken a load off the productive activity but also eased in great measure class relations. The interests of different classes might diverge up to a point but just as depression ultimately overwhelms all alike,[2] any lifting of it would have brought, sooner or later, relief to all.

An important interest to consider in any discussion of the ratio was the Government of India who had to remit annually Home Charges amounting to about £32 millions. A reduction in exchange rate by two pence would have increased the burden of Home Charges by about Rs. 6 crores and upset the budgetary equilibrium and credit of the Government of India. The Hilton Young Commission said that this was not a "decisive factor". It could not, however, be ignored. A decrease in central revenue might not only have made fresh taxation necessary but might have also put a stop to the distribution of the provincial share in the proceeds of income-tax. All this followed from a short range view of the matter and if this view alone had to prevail, the argument against an alteration of the ratio was strong. It stood to reason, however, that the fall in central revenue due to devaluation might have been more than covered by increased receipts from income-tax, railway contributions, customs

1. J.C. Coyajee in *The Asiatic Review*, Vol. XXV, p. 41°.

2. This is shown by the condition of agricultural debtors and money-lenders both of whom suffered, the latter through inability to recover even interest, not to speak of the principal lent.

etc., which a rise in prices and general trade revival would have brought about.

Devaluation of the rupee, it is true, could give only a temporary stimulus to prices. Devaluation is never a get-rich-quick device. But when a country is emerging from the nadir of depression it requires just that temporary stimulus to put it on the way to recovery. Devaluation is also a defensive weapon which may be used to protect internal economy. For permanent results, however, remedies of another kind which would increase productive efficiency and lower costs of production must be applied. Devaluation is no panacea for economic ills. Furthermore, currency is a delicate instrument and when it is used to achieve non-monetary objects, it has to be used with care and precision. The time and manner of its use must be properly judged. Perhaps it could be used to the best effect in India in 1931 and later on in 1933 or 1934.

ADDENDUM TO § 6

The Latest Pre-war Phase in Ratio Controversy

The ratio controversy entered a new phase and assumed a political complexion towards the end of 1938. The Working Committee of the Indian National Congress passed the following resolution on 14th December, 1938:—

> "Since the fixation of the ratio at 1*s.* 6*d.* to the rupee all trade interests in India and public bodies have protested that this measure is against the vital economic interests of India and have insistently demanded its revision. The Government of India have hitherto resisted all these attempts and at last issued a *communique* on June 6, 1938, declaring that it did not intend to make any change in the ratio for the time being and in support of that declaration sought to rely merely on the instability and uncertainty during the period of readjustment which, according to them, was likely to cause greater loss to Indian interests than any corresponding gain from the change to a lower ratio. Since June last the balance of trade has turned more and more against India. The Committee are of opinion that the rate of 1*s.* 6*d.* to the rupee has hit hard the agriculturist of this country by lowering the prices of agricultural commodities and give an undue and unfair advantage to imports into this country.

The Working Committee is satisfied that the rate of 1*s.* 6*d.* cannot any longer be maintained by large exports of gold which have been very injurious to the country. Matters have now reached a stage when the rate can only be maintained by a policy of contraction of currency and credit and by further depletion of the gold and sterling resources of India and particularly the Paper Currency Reserve. Those sterling resources have already been used up to an alarming extent and there is a danger of further serious depletion taking place if efforts continue to be made by the Government of India to maintain the present ratio. The Working Committee look upon such prospect with the utmost concern and anxiety. In view of this situation the Working Committee have come to the conclusion that the best interests of the country demand that efforts to maintain the present exchange level should henceforth cease and urge upon the Governor-General-in-Council the necessity of taking immediate steps to lower the rate to 1*s.* 4*d.* to the rupee".

The Working Committee's criticism of the Government policy in maintaining 1*s.* 6*d.* ratio could be reduced to the following:—

1. Since June 1938, the balance of trade had turned more and more against India, indicating the unnaturalness of the ratio under the existing economic conditions.
2. 1*s.* 6*d.* rate had hit hard the Indian agriculturist by lowering the prices of agricultural commodities.
3. 1*s.* 6*d.* rate had given an undue and unfair advantage to imports into India.
4. 1*s.* 6*d.* rate could be maintained only by contraction of currency and credit and further depletion of gold and sterling resources.
5. Sterling resources had already been used up to an alarming extent to maintain the ratio.

The Government of India issued a *communique* on the 16th December 1938, disputing the facts and countering the arguments set forth in the Working Committee's statement. It ran as follows:—

"The Government of India wish to make it clear that they have no intention of allowing a lowering of the present exchange value of the rupee. On the contrary, intend to defend it by every means in their power and are confident of their entire ability to maintain it.

It is said that since their previous declaration of June 6, 1938, the balance of trade has turned more and more against India. The fact is that, in every month since June, the balance of trade, even excluding treasure, has been in favour of India and to an extent greater than in the corresponding month of the previous year.

It is said that the sterling resources of India, particularly those of the Paper Currency Reserve, have been used up to an alarming extent. The facts are that the assets of the Paper Currency Reserve were merged in those of the Reserve Bank in April 1935, and that the gold and sterling resources of the bank are as high now as they were at the time of its inception and are in any event more than 50 per cent of the total liabilities as opposed to a statutory requirement of 40 per cent only. Moreover, since the inception of the Bank, 60 crores of sterling debt have been repatriated.

It is said that the 1*s.* 6*d.* ratio has hit hard the agriculturist by lowering the price of agricultural commodities. The fact is that, since June last, the trend of the price-index of the chief articles of export has been definitely upwards.

The Government of India are convinced that a lowering of the ratio in the existing international market conditions would produce no appreciable rise in what the cultivator can realize for his produce. They are equally convinced that it would produce an immediate rise in the cost of what he buys.

It would also seriously weaken the budgetary position of the Central Government and the larger Provincial Governments.

In fact, a lowering in the ratio would do no good to anybody except the moneyed and speculative interests who profit from conditions of uncertainty and disturbance or who secure an additional but unseen all round increase of 12½ per cent in the protection afforded to them at the expense of the consumer.

Altogether the Government of India have no doubt that it is their clear duty in the interests of India generally and the cultivator, in particular, to defend the present ratio to the utmost of their power. As already stated, they have every belief in their ability to do this and they are confident that drastic measures of contraction will not be necessary, except to the extent that they are forced on them by

the action of speculators who place their funds abroad in the hope of bringing them back at a profit. Incidentally, they are convinced that the exchange would be materially stronger today, were it not for the fact that there have been large movements of funds to the United Kingdom by these same speculative interests during the last year."

The Government *communique* was cleverly worded and, while exposing to attack the weak points in the Working Committee's statement, concealed many weaknesses in the position it sought to defend. It was, for example, true that from June to October 1938, the balance of trade had been in favour of India to an even greater extent than in the corresponding period of 1937. But the period of 1937 did not furnish the correct basis for comparison; for during it imports had been stimulated by the preceding boom conditions and the balance of trade had begun to shrink. A comparison with conditions in 1936 or three or four years preceding it showed considerable fall in the total visible balance of trade.

The *communique* pointed out that the price-index of chief articles of export had an upward trend since June 1938. The trend was, it may be said, not well-marked and in any case the rise of agricultural prices during the previous four years of recovery had been painfully slow and inadequate.

The Government met the argument that 1*s*. 6*d*. ratio had given an undue advantage to imports into India by a counter-argument that a lowering of the ratio would only benefit those who would secure 12½ per cent increase in the protection afforded to them at the expense of the consumer (meaning the Indian industrialists) or those speculators who profited from instability in exchange.

The Government denied any depletion of the resources which were available to maintain exchange. Actually, however, the sterling balances of the Reserve Bank had fallen and the sterling assets of the Bank could not have been maintained unimpaired but for gold exports.

The Government attributed the weakness of exchange to the speculative movement of funds outside the country and expressed confidence in their ability to maintain the ratio without

contraction of currency. The weakness in exchange, it is unnecessary to emphasize, is generally due to causes more fundamental than the action of some speculators and unless an adaptation to the fundamental shift in economic conditions is brought about through devaluation, contraction of currency has to be resorted to.

The arguments given in the *communique* against the devaluation were: *firstly*, it would produce no appreciable rise in the prices of agricultural products and would on the other hand, raise the costs of the former: *secondly*, it would seriously weaken the budgetary position of the Central Government and the larger Provincial Governments; *thirdly*, it would benefit nobody except "moneyed and speculative interests" and Indian industrialists.

These arguments were familiar enough and have been dealt with in § 6.

CHAPTER X

IX Period: September, 1939—August, 1945

CURRENCY DURING THE SECOND WORLD WAR

§1. On the Eve of War

On the eve of the outbreak of War, there were, broadly speaking, three debatable issues of Indian currency, *viz.*, suitability of the currency standard, correctness of the exchange ratio and the desirability of gold exports, the first two having a much longer history behind them than the third. Discussion about all three of them had lost none of its liveliness in the first half of 1939, though it was not keyed in the same high pitch of controversy as in the years between 1931 and 1938. There were, of course, reasons more substantial than mere love of polemics for this controversy not being laid finally to rest. The reasons were, firstly, that neither the economic developments in the international sphere nor the economic conditions within the country had furnished any firm evidence in favour of the view that sterling exchange standard, 1*s.* 6*d.* ratio and gold exports were more beneficial than harmful to the country's interests; secondly, that the government had consistently refused to reconsider or modify in any way the decisions they had once taken on these questions. It appeared, therefore, that only a major catastrophe like a war would clinch the issues and bring about their reconsideration by effecting a radical transformation in the economic *milieu*. But wars do not generally solve old problems except by raising new ones and, so far as the outstanding Indian currency problems are concerned, the war may be said to have solved the old ones only by casting them into the background and raising new ones.

§2. Rupee-sterling Ratio

The demand for finding a suitable exchange parity of the rupee, other than 1*s.* 6*d.* rate, lost all its force after the outbreak of the war.

1s. 6d. rate had never been firmly established ever since its adoption in 1927 and the linking of the rupee to sterling and the consequent conversion of 1s. 6d. gold rate into 1s. 6d. sterling rate at a time when sterling was depreciating in relation to gold amounted to a disguised devaluation of the rupee in terms of gold. And though for some years after 1931 the exchange firmed up, its strength was derived mainly from the adventitious aid of gold exports. When gold exports began to decline in volume and the balance of trade began, after June 1938, to turn more and more unfavourable to India, the exchange began to show signs of weakness. Since September 1939, however, it had been, on the whole, very steady, finding solid support from a very favourable balance of trade as well as from intensive measures of trade and exchange control. In the early weeks of war the forward exchange rates weakened and the Reserve Bank took the unprecedented step of entering the forward market and announcing its readiness to purchase sterling for forward delivery at a rate somewhat higher than its spot buying rate. This had the effect of steadying the market.

As the rupee-sterling rate and the balance of trade have normally a close relation to each other, the state of trade balance may be referred to here in passing. The total balance of trade in merchandise of India and Burma together (for the two formed one unit for currency and exchange purposes) was +Rs. 20.12 crores during April-August 1939 and + Rs. 56.94 crores during September 1939—March 1940 as against +17.51 crores and +25.70 crores in the corresponding periods of 1938–39. During the six years from 1939-40 to 1944–45, the balance of trade in merchandise of India and Burma together varied as follows:—

Period	*Balance of trade (in crores of rupees)*
1939–40	+78·02
1940–41	+68·54
1941–42	+79·88
1942–43	+84·25
1943–44	+91·32
1944–45	+26·08

After the outbreak of the war, the rates of Telegraphic Transfers from Bombay on London remained in the neighbourhood of 1s. 6d.

and the amount of sterling purchased by the Reserve Bank steadily increased. From August 1939 to March 1940, the Bank made record purchases of sterling of the total amount of £70.5 million; in 1940–41, 1941–42, 1942–43, 1943–44, and 1944–45, the purchases amounted to £57.1 million, £73.3 million, £91.7 million, £105.3 million and £ 91.8 million respectively at an average rate of 1*s.* 6*d.* In addition to these open market purchases, the Reserve Bank also received large amounts of sterling on account of the purchases made by the British Government in the Indian market. Two other notable items accounting for the receipt of sterling were gold and silver exported and sold abroad and the grants received from the British Government for the modernisation of the Indian army. The sterling holdings of the Bank considerably increased and even after the utilization of sterling for repatriation schemes and for meeting other sterling commitments, the holdings stood at £709 million or Rs. 945 crores at the end of March, 1944.

Attention may be drawn here to one significant aspect of the rupee-sterling exchange; the fixed rupee-sterling rate with a very favourable balance of trade had been conducive to a large rise in prices in India. The balance of exports over imports had been paid off by the issue of fresh rupees against sterling accumulations in England. An exchange rate left free to rise in response to a favourable balance of trade would have operated to some extent as an automatic corrective by discouraging exports and would have to that extent checked the rise in internal prices. Even if exports were not discouraged, it would have involved a smaller issue of rupees in India against a given amount of sterling received in payment for exports. The contrast between a rising exchange during the first world war[1] and a fixed exchange during the last war is of considerable interest.

§3. Exchange Control

The institution of the system of exchange control was one of the most important wartime developments in the Indian currency system. Provision for it was made in the Defence of India Ordinance promulgated on the outbreak of war, the Financial Provisions in Part XIV of the Ordinance providing, *inter alia*, for:—

(*i*) restrictions on purchases of foreign exchange,

1. *Vide* page 22.

(*ii*) acquisition by the Central Government of foreign exchange.
(*iii*) restrictions on purchases and export of securities, and
(*iv*) acquisition by the Central Government of foreign securities.

The powers taken by the Government of India in these matters were delegated by them to the Reserve Bank of India. On the 4th September, 1939, the Bank issued an explanatory memorandum to the public giving the general lines of exchange control instituted in India.[1] All dealings in foreign currencies including sterling were now required to be made through only such dealers as were authorized by the Reserve Bank to deal in foreign exchange. Transactions in the currencies of the Empire countries (with the exception of those of Canada, Newfoundland and Hong Kong) were to be free from any restriction but those in non-Empire currencies were restricted to genuine trade purposes, travelling expenses and small personal remittances. All transactions were to be done on the basis of the rates quoted by the London Exchange Control combined with the current rupee rate of exchange.

Although the exchange control was operated on the general lines indicated above, modifications and changes in the original system had to be made as the war dragged on to meet the ever present need of conserving foreign exchange. All the functions of the Reserve Bank regarding exchange control were directed by the Exchange Control Department specially organised in October 1939 and working under the direct supervision of the Governor of the Bank. Developments since the exchange control was instituted in September 1939 are too numerous to be mentioned in detail but the chief among them can be grouped under the following broad headings:—

(*i*) *Extension of free sterling area*

The free sterling area *i.e.*, the area within which funds move freely, constituted as it is by all the countries in the British Empire excluding Canada, Newfoundland, Hong Kong, the mandated territories, Egypt and Iraq, was extended by the inclusion of Belgian Congo, Iceland and Foroe Island, Syria and Lebanon and Madgascar and its dependencies. From January 1944, the French Overseas Empire not under enemy control and the French establishments in India were excluded from the sterling area.

1. Economic Resources Board: *Statutory and other Notices*, pp. 59-66 and *Reserve Bank Report on Currency and Finance*, 1939-40 pp. 10-11.

(*ii*) *Restrictions on the disposal of foreign exchange*

Under an Export Control Scheme which covered all the exports, the value received for exports in foreign (non-sterling area) currencies had to be utilized in a manner approved by the Reserve Bank.[1] The scheme ensured that the foreign exchange proceeds, were not retained abroad and the regulations of the London Control in the matter of official rates at which currencies are dealt in were not evaded.[2]

Under a system of import restrictions introduced from 20th May, 1940, the sales of foreign currencies, especially those of 'hard currency' countries,[3] were severely restricted to payments for licensed imports and a few private remittances.[4] Some relaxation of these restrictions was allowed during 1944–45 to permit larger imports of consumer goods and grant greater facilities for foreign travel for business and educational purposes.

(*iii*) *Acquisition of dollar balances and securities*

Dollar balances held in United States by the residents in India as also the holdings of such residents in certain American securities were acquired, rupee equivalents of the amounts acquired having been paid out by the Reserve Bank.

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1. The despatch of parcels from India to any place outside the sterling area was also subjected to a similar system of control.

2. In the early months of the War, two rates for sterling in terms of dollars came to be quoted—the controlled rate of the London Exchange Control and the free sterling rate. The latter was the rate of the free market and was lower than the former. The unfavourable consequence of the simultaneous existence of the two markets in sterling for India was that payment was received for those of her exports to which controlled rate did apply at the rate of £ or Rs. 11–5–4 for every $4.02 worth of goods, while at the free sterling rate of $3.50=£1=Rs. 13–5–4, the same goods worth $4.02 would have brought to the Indian exporter 12 per cent more in terms of rupees. Payment for the exports of goods to which the controlled rate did not apply was, on the other hand, received through the free sterling market. The East India Cotton Association drew the attention of the Reserve Bank of India to this matter (*vide The Statesman* dated May 3, 1940 for a summary of the correspondence between the Association and the Bank). By the Export Control Scheme, the free sterling market was gradually eliminated.

3. The term 'hard currency' was used for a currency which is based on gold or is linked to a currency based on gold *e.g.* U. S. dolars and Swiss francs.

4. It need hardly be laboured that restrictions on and control of exports and imports are essential adjuncts of exchange control . In fact, trade control and exchange control reinforce each other and one would not be so very effective without the aid of the other.

(iv) Restrictions on exports and imports of coins, currency notes, etc.

To prevent any person getting round the exchange control regulations by taking cash and jewellery out of India, limits were laid to the extent to which they could be taken out. From November 1940, the export from India of any currency notes or coins, whether Indian or foreign, except under a license from the Reserve Bank was prohibited. Taking out of gold in any form from India without permission of the Reserve Bank was also prohibited.

Restrictions on dealings in the Bank of England notes were imposed in September 1940 and further tightened in October 1941 with the object of preventing any market developing in such notes smuggled from the enemy-occupied territories. From September 1943, the import of all currency or bank notes other than the Reserve Bank and Government of India notes issued in India,[1] Ceylon rupee notes, Iranian rials and Afghanis was prohibited, except with the permission of the Central Government or the Reserve Bank of India and from January 1944 even the import of notes which were legal tender in India was prohibited in order to control the import of British Indian notes emanating from enemy sources. The import and export of Russian rouble notes were also prohibited in accordance with the regulations in force in U.S.S.R.

(v) Restrictions on Chinese and Japanese accounts in India

With a view to assisting China to conserve her supplies of foreign currency, restrictions were imposed on the operations of the accounts held in India by the nationals of Free China. Regulations were also framed with the same object to ensure that the full proceeds of the imports from China were credited to the account of banks approved for the purpose.

The balances of all Japanese companies and firms resident in India were frozen on the 28th July, 1941, *i.e.*, they could not be used except with the permission of the Reserve Bank of India. After the outbreak of the war with Japan in December 1941, all Japanese accounts were taken over by the Custodian of Enemy Property. At the beginning of 1942, the accounts of persons and firms resident in Japanese occupied territories such as Hong Kong, Malaya,

1. *i.e.*, the import of Burma notes of the Reserve Bank was also brought under control.

Netherlands East Indies and British possessions in Borneo were frozen and could not be operated without the permission of the Reserve Bank.

(vi) Restrictions on remittances in foreign currencies

The remittance of profits and royalties by companies operating in India to any person resident outside the sterling area was subjected to license from October 1941 with a view to restricting the amount of such remittances. During 1943–44 the dollar position became easier and the remittances of profits by American firms were freed from restrictions. In the case of other remittances in U.S. dollars as also remittances in certain other currencies, the restrictions were relaxed. In February 1944, the entire French Overseas Empire not under enemy occupation became a single monetary area and remittances to it were confined to transfers through special sterling accounts known as French overseas accounts.

(vii) Restrictions on travel

Restrictions on travel to places outside the sterling area involving disbursements of foreign exchange were imposed. On the 17th July, 1943 the Government of India issued a notification prohibiting any person from proceeding outside India without a written permit issued by the Reserve Bank of India. The restriction did not apply to persons proceeding to countries adjoining India or to Iraq, Arabia, British East Africa and the United Kingdom.

All these measures of exchange control were designed to subserve the general objective of war economy, namely, the fullest economic mobilisation of the country. Their main purpose was to raise the economic potential of the Allied war effort by acquiring, conserving and utilizing in the best possible manner all resources in foreign exchange. Subsidiary to this but no less essential was the introduction of every possible safeguard against the use by the enemy of any assets within the country. Other wider considerations were the economising of shipping space by cutting out non-essential exports and imports, the working out of a system of priorities by which the more urgent trade transactions precede the less urgent and the conserving of productive capacity in countries like U.S.A. for essential war purposes.

The various restrictions, regulations and scrutinies which make up the system of exchange control must necessarily cause a good deal of inconvenience to those engaged in legitimate foreign exchange dealings. Their application may sometimes be associated with considerable red-tapism, delay, favouritism and abuse. It is obvious that the successful operation of the system in war as well as in peace requires an extremely high degree of state interference with, and control of, all branches of economic life. The State not only prevents exporters from disposing freely the proceeds of their sales abroad but also allots the available supply of foreign exchange according to criteria which it frames and modifies in the light of experience and necessity.[1] Its decisions regarding the apportionment of foreign exchange have a vital bearing on the whole economic organisation of the people. For, it may favour certain home industries, manufacturers, or firms at the expense of others and bring about a redistribution of income among the different sections of the people and thus alter the entire economic set-up of the country. The effects of war-time exchange control may not be so apparent as of several other economic developments but among the various elements that have gone towards the making of Indian war economy, exchange control has already found a prominent place. With the return of peace, the release of national economic systems from the zariba of restraints and controls and their freer inter-communication, the retention or relaxation of exchange control—and the extent of it—was among the most immediate issues to be faced.

§4. Currency Circulation, Public Finance and Prices

Among the various war-time developments in the sphere of Indian currency, the enormous expansion of currency over-shadowed all others by its spectacular character, its wide sweep and its direct impact on the daily life of the common man. Its actual effects were fairly serious but of greater moment perhaps was the potential threat that it at one time held of disrupting the entire fabric of Indian economy. The analysis made of its underlying causes and the conclusions reached regarding its character and the extent of its seriousness by different groups of thinkers in the country brought into sharp relief three conflicting points of view about the character,

1. For a short and objective account of the pre-war system of exchange control *vide* League of Nations: *Report on Exchange Control.*

magnitude and consequences of currency expansion. These viewpoints were those of the economist, the Government and the businessman. The weighty nature of this development as well as the controversy which it provoked enjoins the most rigid adherence to facts and cautious analysis in dealing with it.

Currency circulation—volume and velocity

The total effective supply of currency in India is constituted by the amounts of Government of India (mainly one rupee) notes, Reserve Bank of India notes, rupee coin and small coin and demand deposits of Banks, combined with their rapidity of circulation. This total has to be broken down to examine the change that has occurred in each constituent during the war and to obtain a correct idea of the magnitude of the total change.

The Reserve Bank of India notes of the denominations of Rs. 2,5,10,100,1,000 and 10,000 constituted by far the most important part of currency circulation in India. Deposit currency not having developed in India to any appreciable extent owing to insufficient growth of banking and banking habits, bank notes and coin formed the most widely used media of exchange. In August 1939, the total amount of notes (including Government of India notes of mainly Rs. 50 and Rs. 500) in active circulation stood at a little less than Rs. 179 crores. By March 1945 it had increased to Rs. 1085 crores, *i.e.* by over Rs. 905 crores or 506 per cent. This phenomenal increase was, however, not accomplished by easy stages or at a steady and uniform rate, as the following figures will show:—

Year	*Month*	*Notes in circulation*[1] (in crores of rupees)
1939	August	179
1940	February	240
	May	249
	October	229
1941	January	245
	August	277
1942	January	356
	August	474
1943	January	593
	August	755
1944	January	854
	August	927
1945	January	1034
	June	1152

1. These figures are for the last Friday of each month and have been taken from statement XXXII of the *Report on Currency and Finance* for the year 1944-45 and the *Monthly Statistical Summary* of the Reserve Bank. Figure from 1942-43 onward exclude Burma notes.

In the first six months of the war, note circulation expanded at a more or less steady pace by about 60 crores; it increased further by another 9 crores during the next three months but fell off between May and October 1940 by about 20 crores, so that the net increase upto October 1940 amounted to only 50 crores. From the level reached in October there was an unbroken rise, the increase amounting to about 50 crores by August 1941, another 200 crores by August 1942 and a further 460 crores by August 1944. Between August 1944 and June 1945 another 225 crores were added to circulation.

A different way of representing the increase is to divide it into units of 50 crores and set it against the approximate number of months in which it was accomplished.

Magnitude of increase	*Period*	*Number of months*
1st 50 crores	.. September—November 1939	3
2nd ,,	.. December 1939—September 1941	22
3rd ,,	.. October—December 1941	3
4th ,,	.. January—February 1942	2
5th ,,	.. March—May 1942	3
6th ,,	June—September 1942	4
7th	.. October—November 1942	2
8th ,,	.. December 1942—January 1943	2
9th ,,	.. February—March 1943	2
10th ,,	.. April—May 1943	2
11th ,,	.. June—July 1943	2
12th ,,	.. August—October 1943	3
13th ,,	.. November—December 1943	2
14th ,,	.. January—March 1944	3
15th ,,	.. April—September 1944	6
16th ,,	.. October—November 1944	2
17th ,,	.. December 1944—January 1945	2
18th ,,	.. February—March 1945	2
19th ,,	.. April—May 1945	2

It is clear that after an initial briskness lasting for the first few months of the war period, the pace of expansion of currency considerably slackened, only to quicken once again from September 1941 and develop into something like a gallop from September 1942. Since then the only period during which some abatement in speed was noticeable was from April to September, 1944.

Turning now to the Government of India notes, they formed only a negligible fraction of the note circulation and consisted now

mostly of one-rupee notes (issued since July 1940) which occupy a peculiar position in the currency system in that while notes of bigger denominations are convertible into them, they themselves are not convertible into rupee coin and are treated in the assets of the Reserve Bank like rupee coin.[1] As the convertibility of notes of higher denominations into rupee coin was considerably restricted during the war, the whole of the note-issue could be described as inconvertible for all practical purposes. Statistics for the one-rupee issue are not furnished separately but are merged in those of rupee coin circulation.

Besides the enormous expansion in the circulation of currency notes noted above, there was also a large increase in the absorption of rupee coin as well as small coin during the war. The total absorption of rupee coin (including one rupee notes) from the outbreak of the war to the end of March 1945 amounted to Rs. 138 crores, being composed as follows:—

Year	*Rupee coin absorbed (in crores of rupees)*
September 1939—March 1940	19.53
1940—41	33.23
1941—42	7.18
1942—43	44.93[2]
1943—44	23.14[2]
1944—45	10.05[2]

No less striking was the absorption of small coin (including half rupees) of silver, copper and nickel—which amounted from the outbreak of war to March 1945 to Rs. 60 crores, the amounts absorbed in different years being as follows:—

Year	*Small coin absorbed (incrores of rupees)*
September 1939—March 1940	2.64
1940—41	4.28
1941—42	5.06[3]
1942—43	11.64[2]
1943—44	18.46[2]
1944—45	19.20[2]

1. Government of India notes of the denominations of 50 or 500 were also in circulation, the Reserve Bank having decided not to issue such notes.

2. Excluding Burma.

3. Excluding Burma for February and March, 1942.

Finally, the bank deposits, too, which form a significant part of the media of payment, recorded considerable increase. The only deposits relevant in this connection are those subject to cheque, namely the demand deposits. Figures for such deposits are available for the scheduled banks and are given for the war period below. The total increase in these deposits since the war started upto March, 1945 was about 460 crores[1] of rupees of which a little less than 300 crores are accounted for by the two years, 1942 and 1943.

Year	*Month*	*Amount of demand deposits (in crores of rupees)*
1939	August	133·5
1940	February	137.1
	May	140.2
	October	161.8
1941	January	169.2
	August	195·4
1942	January	217.0
	August	294.7[2]
1943	January	344·7
	August	437.8
1944	January	502.7
	August	584·4
1945	January	608.4
	March	596.7

Velocity of currency circulation

Thus the increase in all the various media of payment up to the end of March 1945, that is, during practically the whole period of war totalled up to nearly 1565 crores of rupees of which note circulation accounted for 906 crores, rupee coin, 138 crores; small coin, 60 crores and bank (demand) deposits 461 crores. But to find out the really *effective* increase it is not enough to know the quantitative increase; the rapidity of turnover of the media of payment must also be taken into consideration. Here, unfortunately, no reliable information is forthcoming and while an approximately correct idea of the velocity of circulation of bank deposits can be formed from the Clearing House Returns, the velocity of note circulation remains wholly a matter of conjecture. The velocity of bank deposits distinctly

1. Upto June 1945 the increase was Rs. 494 crores.

2. Burma figures have been excluded since February, 1942.

declined during the five years from 1939–40 to 1944–45 as shown in the last column of the table below[1] :—

(*In crores of rupees*)

Period	*Average demand deposits*	*Total Clearing House Returns*	*Number of times 3 to 2*
(1)	(2)	(3)	(4)
1938—39 ..	123.8	1,929	15.6
1939—40 ..	132.6	2,211	16.7
1940—41	155.8	2,019	13.0
1941—42	201.9	2,569	12.7
1942—43 ..	306.3	2,773	9.1
1943—44 ..	456.3	4,349	9.5
1944—45 ..	584.8	5,279	9.0

It may be inferred from this in a rough and general way that the rapidity of note circulation also showed a similar decline. Among the several reasons that can be adduced for this decline in the activity of money, probably the foremost was the strong propensity towards hoarding of rupee and small coin engendered by the uncertain conditions of war. To this was added the higher preference shown by the people, banks and business houses for liquid positions and, consequently, for holding idle cash balances. The plethora of money in the money market combined with a paucity of suitable outlets for investment was another contributory factor.

Currency Circulation and prices

Contemporaneously with the heavy expansion in currency circulation, tempered as it was by a somewhat diminished velocity, there occurred a marked rise in the general level of prices. Prices began to rise as soon as the war broke out and the first four months witnessed a strong upthurst of the price level. After that there was a break and by July 1940 prices had subsided to a little higher than the pre-war level. Soon after, however, they resumed their upward movement which became progressively quicker and steeper with the passage of time. There was a short period extending roughly from October 1943 to April 1944 during which the rise in prices was not only arrested but was actually converted in to a fall; but from May 1944 prices began moving slowly upwards. In the table on next page, the index numbers of prices, note circulation and demand deposits have been shown in juxtaposition.

1. It may be noted that while the figures in column 2 are for scheduled banks only, those in column 3 include the value of cheques of other banks also.

Year	Month	Note Circulation (in crores of rupees)	Demand deposits	PRICES Calcutta (August 1939=100)	Bombay (July 1939=100)	Economic Advisors' (Week ended 19th Aug. 1939—100)
1939	August ..	179	136	100	103	100.3
	December ..	236	138	137	135	138.3
1940	January ..	238	139	130	128	133.2
	July ..	238	143	114	115	112.1
	October ..	229	162	121	115	112.1
1941	January ..	245	169	121	117	114.8
	August ..	277	195	151	144	142.5
1942	January ..	356	217	155	184	145.0
	August ..	474	295	192	228	161.1
1943	January ..	593	345	250	255	195.6
	August ..	755	438	345	258	236.1
	October ..	782	466	334	244*	241.5
1944	March ..	882	524	300	†	232.1
	April ..	897	535	297	†	234.6
1945	January ..	1034	608	299	†	250.3
	March ..	1085	597	306	†	247.8

Thus while note circulation increased upto the end of January 1945 by 478 per cent[1] and demand deposits 347 per cent[2] the general level of prices shows, on the average, an increase of 200 per cent. It may be pointed out that the index numbers of prices, being based on control prices, do not take account of the much higher black market prices prevailing for several commodities and, therefore, underrate somewhat the actual rise in prices.

The facts set out above may now be summed up in three plain statements:—

1. The various constituents of the monetary circulation recorded a steep and progressive rise.
2. The decline in the activity of bank demand deposits suggested a general fall in the velocity of circulation of money.
3. The general level of prices showed a large increase but was outpaced by the increase in money supply.

*Figure for September 1943. After October 1943, the index number was discontinued.

†Figure not available.

1. Upto June 1945 by 506 per cent.
2. Upto June 1945 by 362 per cent.

Inflation—character and development

It was this simultaneous occurrence of the expansion of currency and the rise in prices that flung into focus the issue of inflation. The co-existence of rapidly expanding currency and sharply rising prices furnishes under any circumstances a strong *prima facie* evidence of the presence of inflation but when a causal relationship can be established between the two by a reference to all the attendant circumstances, the evidence becomes irresistible and the conclusion inescapable that inflation exists. The inflation issue in India had during the years 1943–45 become the pivot round which every discussion of Indian war economy revolved and no account of war-time currency developments which fails to give it a prominent place can be really complete.

Any discussion of the war-time inflation in India gets down, sooner or later, to four basic questions: *first*, what is inflation? *second*, what evidence is there that it existed in India? *third*, to what extent was it serious in magnitude and grievous in consequences? *fourth*, how could it be prevented or the severity of it effects mitigated?

There would appear to be two ways of looking at inflation: as an inflationary issue and as an inflationary situation.[1] An inflationary issue of currency may be said to occur when purchasing power whether in the form of paper currency or bank credit is expanded *beyond* the needs of trade, employment and production. That is to say, so long as the expansion of purchasing power occurs *in response to* the expansion of trade, employment and production or *evokes* such expansion, it may not be called inflationary in character. It follows that an increase in purchasing power may not be described as inflationary so long as it is leading towards fuller utilization of resources, *i.e.* towards a state of full employment. Inasmuch as this increase will spend itself in bringing dormant and idle resources into activity, it will not result in a rise in prices until the state of full employment is reached. This general statement may, however, be qualified by the proviso that a rise in prices of a sporadic character may occur, even before the state of full employment is reached, due to the development of bottlenecks, impediments and frictions which hamper the mobility of resources. War usually leads to the stimulation,

1. A short explanation of the phenomenon of inflation has already been given in the Introduction (pp. *xii-xvi*).

energising and mobilisation of resources, to the taking of 'slack' and the use of idle capacity. The expansion of economic activity it brings about may, not unreasonably, be compared to the boom phase of the business cycle. It obviously demands an expansion of currency to facilitate and finance it. But as soon as the expansion has performed this task, it becomes inflationary. It is necessary to point out here that the state of full employment in the present context means not necessarily a state in which every unit of productive resources—every man, plot of land and machine—is employed but one in which the fullest employment possible under the circumstances of a country has taken place.

An inflationary situation, on the other hand, may develop during war even when some of the resources are unemployed, *i.e.* when there has been no inflationary issue as such. This will happen when the total stock of purchasing power is not properly bifurcated so as to correspond to the volume of goods and services required for war purposes and of those required for civil consumption. The increased income accruing from the increased employment of labour and other resources then exerts its pressure on the limited supplies of goods of civil consumption raising their prices. To have a clearer picture of this situation, the economy of a country during war may be visualised as having two sectors—the war sector and the civil sector. Prosecution of war involves the use of steadily increasing proportion of a country's real resources for military needs and of a steadily diminishing proportion to provide for civil consumption. An expanding war sector and a contracting civil sector of economy give a new twist, as it were, to a country's economy and the total money-supply, if it is not to become a disturbing factor, must facilitate and faithfully interpret this twist. In other words, purchasing power must be drained off from the contracting civil sector by taxes, loans or such other means and poured into the expanding war sector. The penalty for the inability to do it is the development of inflation.

Now to know whether inflation developed in India during the war period and if so, in what form, two enquiries have to be made. It is necessary, on the one hand, to ascertain whether the expansion of currency went beyond the requirements of economic activity or was merely evoked by the latter and on, the other, to find out if the government was pursuing a lenient or wrong budgetary policy in not

denuding the civil sector of economy of the surplus purchasing power flowing into it. The first enquiry leads to an examination of the relation between currency expansion and wartime production, trade and employment and the second to an analysis of the methods and policy of war finance.

Inflation in the sense of an inflationary issue of currency could be said to exist in India only if the expansion of currency outpaced the demand for it for sustaining economic activity at a higher wartime level. It is well known that in 1939 when war broke out, Indian economy was still suffering from the after-effects of the Great Depression of 1929–33. There were not only large reserves of man power in an idle or semi-idle state which could be put to work but there was also very considerable margin for stepping up both agricultural and industrial production. Great hopes were aroused, therefore, when the war broke out of the inauguration of a new era of economic prosperity characterised by an all round economic development. But it was not long before the collapse of France and its sequel in May-June 1940 damped those hopes by causing a big loss of markets for Indian agricultural produce on the European continent and depressing prices in India[1]. It was not until October 1940 that the psychological effects of this setback wore out and fresh advance in production and prices was resumed. After this period, Indian economy was subjected to opposite sets of forces, one tending to stimulate its expansion and the other the hamper it. The first set included such factors as bountiful harvests, the increasing tempo of war, the steadily growing volume of war orders to Indian industry, heavier internal demand due to increasing money incomes coupled with the curtailment of imports, and lastly, the gradual transformation of India into a vital supply base for the Allied forces in the Middle and Far East. The second set comprised such factors as the growing strain on the available shipping space and the consequent difficulty of sending out exports and obtaining some vital imports, in particular the difficulty of getting machinery and machine tools; curtailment of road transport due to petrol shortage and heavy pressure on rail transport; the lack of clear insight on the part of the framers of economic policy into the nature and magnitude of forces at work; and above all, the lack of foresight and perhaps also of the

1. The total value of the exports for which markets were lost was estimated at the pre-war level of prices at Rs. 29 crores. (*Report by Dr. T.E. Gregary and Sir David Meek*, 1940, p. 14.)

will to draw up and execute with public co-operation a comprehensive and co-ordinated plan to deal with the new forces. The net effect of all these forces at work was an expansion of economic activity which fell far short of both the needs of the country and of the opportunities opened up by the war. Statistics of agricultural and industrial production (set out in the form of indices in the three tables below) do not support any estimate of more than 20–25 per cent increase on the average in India's production during the war.

Indices of Agricultural Production

	1938–39	1939–40	1940–41	1942–42	1942–43	1943–44
Rice ..	100	107.6	92.4	105.8	102.4	127.7
Wheat ..	100	108.2	100.4	101.1	110.7	97.3
Cotton ..	100	71.2	83.4	88.3	65.6	73.1
Jute ..	100	143.0	193.3	80.3	132.2	102.7
Sugarcane ..	100	137.6	171.1	129.1	168.1	160.9
Groundnut ..	100	98.3	115.1	80.3	84.3	118.8
Linseed ..	100	105.7	97.3	81.7	93.0	89.4
Caster seed ..	100	87.4	94.6	82.0	132.4	126.1
Sesamum ..	100	104.8	106.6	104.5	113.9	114.9
Rape and mustard ..	100	118.9	117.3	118.0	113.0	103.5
General Average[1] ..	100	108.3	117.1	97.1	111.6	111.4

Indices of Industrial Production[2]

Commodity	1938–39	1939–40	1940–41	1941–42	1942–43	1943–44
Pig iron ..	100	116.6	125.6(*e*)	130.3(*e*)	120.2(*e*)	125.5(*e*)
Steel ingots ..	100	109.5	122.8(*e*)	138.7(*e*)	127.2(*e*)	131.6(*e*)
Finished steel	100	115.7	137.7(*e*)	150.7(*e*)	150.1(*e*)	150.5(*e*)
Cotton twist and yarn ..	100	94.8	103.7	121.0	117.7	128.9
Cotton piece-goods ..	100	94.0	100.0	105.2	96.1	114.4
Sugar ..	100	182.1	149.5(*e*)	119.2(*e*)	140.4	159.6
Paper ..	100	*119.6	148.1	153.1	109.7	121.3
Matches ..	100	104.3	109.8	78.4	70.4	70.4(*e*)
General Average*	100	117.1	127.6	124.5	116.5	125.3

*Simple Arithmetical (e) estimated

1. Simple arithmetical average.

2. Figures of production for 1944-45 not being available for a number of industries, index for 1944-45 has not been given but as production declined in several industries such as paper, cotton textile etc., the index for 1944–45 would be very likely lower than that for 1943–44.

"Capital" Index of Industrial Activity[1]

Items	1938–39	1939–40	1940–41	1941–42	1942–43	1943–44
Indian cotton consumption	100	94.9	106.5	124.8	128.2	139.0
Jute manufactures	100	105.1	91.0	100.2*	96.7*	81.8*
Steel ingots ..	100	109.6	122.7	138.7(e)	127.2(e)	131.6(e)
Pig iron ..	100	117.0	125.6	130.3(e)	120.2(e)	125.5(e)
Paper ..	100	118.1	146.7	134.4*	123.0*	118.3*
Coal ..	100	101.1	104.8	98.1(e)	96.5(e)	93.9(e
Rail and river borne trade	100	105.7	102.3	100.7*	887.7*	90.2*
Cheque clearances	100	99.3	89.1	91.8*	69.0*	70.2
General Index..	100	102.4	105.6	110.4*	97.9*	98.5*

*Provisional (e) Estimated

Some more data which unfortunately are not available, particularly of employment and internal trade are necessary for correlating expansion of currency with economic activity.[2] But even with such data of production and prices as are available it is hard to escape the conclusion that the supply of currency far outran the demand for it.

It is, of course, difficult to trace the relationship between supply and demand since the outbreak of war and to say exactly when currency expansion took the lead and upset the balance between the two. The general level of prices, the rise in which has been chosen as the most obvious manifestation of inflation, was by no means in the normal or the optimum state at the outbreak of war. The initial rise in agricultural prices after the war was indeed welcomed as a well-deserved recompense to the agriculturist for the hard days he had known. By the end of the second year of war, note circulation had gone up by a little more than 50 per cent and prices by a little less than 50 per cent. Considering that the velocity of circulation of money had declined somewhat and a number of factors such as higher charges of labour, raw material and transport were tending to raise cost of production and therefore prices and considering

1. Based on the table in *Capital*, May 1945.

2. It was pointed out by Mr. G. D. Birla that the volume of transactions which were done in cash increased a good deal during the war. Moreover, the number of stages through which commodities had to pass in also increased under the wartime system of selling and buying (*Cf.* his *Inflation and Scarcity*, p. 13). This would mean that the economic activity *for which currecy was required* had greatly expanded.

also that the rise in prices represented to some extent a much needed measure of reflation or 'pump-priming', the situation at the beginning of the third year of war could not be pronounced to be very perturbing. Note circulation and prices, however, were being pushed forward by the dynamic urge of war expenditure. In the third and fourth years of war currency expansion went forward at a breath-taking pace causing a veritable price flurry. Every addition to currency now represented a fresh draft on the real resources, and, owing to the resulting rise in prices, each successive dose of currency had to be followed by a larger one to 'rake off' the same amount of real resources. As more and more real resources were absorbed for the prosecution of war without corresponding additions being made to them, the already low standards of living were undermined further and by the middle of 1943, food and cloth—the two vital necessaries of life—became so scarce as to be almost unobtainable for the vast majority of people. Deaths by ghastly starvation occurred in the streets of Calcutta in August 1943 and in despair it was asked (by inverting Adam Smith's well-known dictum) if defence was after all better than indigence. Clearly, a big inflationary issue of currency had been under way piling up heavy burdens.

This inflationary issue might not have led to the development of what has been termed earlier, an inflationary situation if strong measures had been taken from the very beginning to bring the volume of purchasing power in the war sector and civil sector of economy into some correspondence with the respective amounts of real resources in the two sectors. While the remedy for the inflationary issue was an expansion of the volume of goods and services offered against money, the prophylactic against the onset of an inflationary situation was a sound system of war finance. The effects of the inflationary note issue could be mitigated by expanding production; given the inflationary issue, no matter how caused, the situation could be retrieved by drawing off the purchasing power running in an ever swelling stream into the civil sector and pressing on the limited supplies of real resources. But the economic policy of the Government did not bring about the former and their peculiar system of war finance failed to achieve the latter. A discussion of the Government's policy relating to production, involving as it does an examination of their attitude towards Indian industry and of their measures for increasing food supply, will stray into many fields that have no direct

relation to currency.[1] But an expatiatory treatment of the system of war finance which was really the *fons et origo* of both inflationary issue and inflationary situation is both necessary and relevant.

War Finance—magnitude and methods

The amount of defence expenditure that India had to bear was governed by the provisions of the Financial Agreement reached between the British Government and the Government of India shortly after the outbreak of war and brought into force with retrospective effect from 1st April 1939. By the terms of this Agreement the British Government was to implement the programme laid down by the Chatfield Committee for the modernization of Indian army and involving a capital outlay of Rs. 46 crores.[2] The expenditure on defence measures undertaken by India and debitable to Indian revenues was reduced to a formula and it consisted of the following items:—

(*i*) a fixed annual sum representing the normal net effective costs of the army in India under peace conditions, fixed at Rs. 36.77 crores,
(*ii*) an addition to allow for rise in prices,
(*iii*) the cost of such war measures as were undertaken by India in her own interest such as mobilisation of Indian Territorial Force and Auxiliary Forces, measures of port and naval defence etc., and
(*iv*) a lump sum payment of one crore of rupees towards the extra cost of maintaining India's External Defence Troops overseas.

To these items of expenditure have to be added the non-effective charges *i.e.*, pensions and gratuities paid to personnel or the defence services and their dependants. An agreement regarding the apportionment of these charges between His Majesty's Government and Government of India was concluded in 1944–45. The liability of India for surplus war stores was to be determined by negotiation at the end of war.

1. For a short critique of the Government's industrial policy during the war, refer to my *Review of Indian Fiscal Policy*, Section VI.

2. This Committee was appointed with Lord Chatfield as chairman shortly before the war to go into the whole question of modernization of Indian army and its recommendations had been accepted by both the British Government and the Government of India.

Any expenditure in addition to the sum total of these five items, though it might be immediately borne by India , was to be eventually recovered from the British Government.

Proposals for revising the basis of the allocation of defence expenditure between the two countries were made by the British Government towards the middle of 1942 but the Government of India successfully resisted them. The original agreement, therefore, continued though a new interpretation of some of its provisions led to larger expenditure being debited to India's account.

The defence expenditure of India was bound to record an increase with the extension of the scale and the acceleration of the intensity of hostilities but the extent to which the increasing tempo of the war upset the estimates of the Finance Member of the Government of India was somewhat unexpected. Upto March 1940, the *increase* in expenditure attributable to the war did not exceed Rs. 4 crores and the improvement in revenue more than covered it. For 1940-41, the total defence expenditure was estimated at a figure of Rs. 53.5 crores in March 1940, a little over Rs. 68 crores in November 1940 and at a little over Rs. 72 crores in March 1941. For 1941-42, the defence expenditure was estimated at Rs. 84 crores in March 1941 but the revised estimate one year later exceeded this figure by more than 18 crores. For 1942–43, the expenditure was estimated at Rs. 133 crores but the accounts for the year yielded a figure of Rs. 214 crores excluding capital charges or over Rs. 267 crores (or about 75 lakhs per day) including the capital charges. For 1943–44, the defence expenditure exceeded estimates by about Rs. 96 crores. The table given below shows the magnitude of the defence expenditure for 1943-44 (actual), 1944-45 (budget and revised) and 1945–46 (budget).

	1943–44 (*Account*)	1944–45 (*Budget*)	1944 45 (*Revised*)	1945–46 (*Budget*)
Revenue	358.4	376.6	297.2	394.2
Capital portion	37.4	24.6	59.4	17.8
Total	395.8	301.2	456.6	412.0

To this purely defence expenditure must be added the civil expenditure, both central and provincial, directly attributable to war in order to know the total outlay on defence measures debited

to revenue. The following table gives the total expenditure on defence measures from April 1939 to March 1945:—

	(*in crores of rupees*)
Central defence expenditure (including expenditure on capital account)	1346.71
Central civil expenditure directly attributable to war	178.40[1]
Provincial expenditure directly attributable to war	275.68[1]

By far the most important item in the expenditure arising out of the war which was not included in the central budget but without which no computation of the money cost of war to India would be complete was the expenditure incurred in India on behalf of British and other Allied Governments. No figures about this expenditure were furnished by the Government but some measure of it could be obtained from the total sterling payments made on this account by the British Government which amounted for the war period upto 31st March, 1945 to Rs. 1292 crores.[2] War expenditure recoverable from the British Government was estimated at Rs. 439 crores for 1944–45 and was placed for the whole of the war period upto March 1945 at nearly 1394 crores of rupees.

Thus a total amount of about 2700–2900 crores of rupees exclusive of the extra expenditure of Provincial Governments represents the total *direct* money cost to India during the war period upto March 1945. Of this, Rs. 2,500 crores might be taken as the direct financial burden of the war.

How was the money cost of war met? The methods used by the Government to meet it may be divided into (*a*) taxation (*b*) borrowing (including the saving schemes) and (*c*) currency inflation. While taxation and borrowing enabled the Central Government to balance their budgets, they did not suffice to cover the total money cost of war mentioned above. It follows that the gap between the total expenditure and the total income (accruing from taxes and loans) was filled up by the issue of fresh currency.

(*a*) *Taxation*: It is significant that to cover the additional expenditure arising from the first impact of the war on India, the

1. These figures are for the total increase in central and provincial civil expenditure during the war and are found by deducting from the estimated total expenditure from 1939-40 to 1944-45 expenditure on the basis of 1938-39.

2. *Report on Currency and Finance*, 1944-45. p. 38.

Government turned to taxation, directing attention first of all, to excess profits of business. It was some months later, in June 1940, that they launched their borrowing programme. The extent and range of new taxation during the war are shown below:—

Period	*Tax*	*Levied for the first time or increased*	*Rate*
1940–41	Excess profits tax	levied	50 per cent
	Sugar excise	increased	Rs. 2 per cwt. to Rs. 3 per cwt.
	Sugar import duty	increased	By Re. 1 per cwt.
	Excise duty on motor spirit	increased	-/10/- to -/12/- per gallon.
	Surcharge on income-tax including super tax and corporation tax.	levied	25 per cent.
	Postal letter and packet rate	increased	From 1a. to 1½a. for the first tola. From 6ps. to 9 ps. for parcels.
	Surcharge on telegrams	levied	-/1/- on ordinary and -/2/- on express.
	Surcharge on telephone calls.	levied	10 per cent.
1941–42	Excess profits tax	increased	From 50 to 66⅔ per cent.
	Surcharge on income tax.	increased	From 25 to 33 per cent.
	Excise duty on matches	increased	By 100 per cent.
	Import duty on artificial silk yarn and thread.	increased	Specific duty from -/3/- to -/5/- per lb.
	Excise duty on pneumatic tyres and tubes.	levied	10 per cent *advalorem*.
1942–43	Income-tax.	increased	Exemption limit lowered to Rs. 1,500
	Corporation tax	increased	To 1½a. in the rupee.
	Surcharge on income-tax and super-tax.	increased	From 33⅓ to roughly 50 per cent.
	Emergency surcharge on import duties (raw cotton, salt and motor spirit exempted).	levied	20 per cent.
	Excise duty and import duty on motor spirit.	increased	To 15 as. per gallon.
	Excise duties on kerosene and silver	increased	To 3 as. 7½ ps. per oz. (silver). To -/3/9 per imperial gallon.
	Postal letter rate	increased	From 1¼ to 1½ as.
	Rates for telegrams	increased	From -/10/- to -/12/- for ordinary and Rs. 1/4/- to Rs. 1/8/- for express.
	Surcharge on trunk telephone calls.	increased	From 10 to 20 per cent.
	Telephone rentals	increased	By 16⅔ per cent
1943–44	Income tax-surcharge and super-tax.	increased	On income above Rs. 5,000.

Period	*Tax*	*Levied for the first time or increased*	*Rate*
	Excise duty on tobacco produced and manufactured in India	levied	Ranging between 1 a. and Rs. 1/12/- per lb for unmanufactured and 2as. and Rs. 6 for manufactured.
	Excise duty on *Vanaspati*	levied	Rs. 5 per cwt.
	Postal and telephone rental rates	increased	Letter rate to 1 a. for each tola after the first. Parcel rate to 6 as. for first forty tolas. Telephone surcharge from 1/6 to 1/3.
1944-45	Income tax		Taxable minimum raised to Rs. 2,000.
	Surcharge on Income-tax	raised on income above Rs. 10,000	By 2 pies on incomes between Rs. 10,000 and Rs. 15,000 and by 4 pies above Rs. 15,000.
	Surcharge on supertax	increased	By 6 pies on incomes between Rs. 35,000 and Rs. 2 lakhs.
	Corporation tax	increased	From 2 as. to 3 as.
	Surcharge on customs	increased	From 20 per cent to 50 per cent in the case of tobacco and spirits.
	Excise duty on unmanufactured tobacco and on cigars and cheroots.	increased	According to a complicated scale.
	Excise duties on tea, coffee and betelnuts.	levied	2 as. per lb.
1945-46	Surcharge on income-tax	increased	On slabs of incomes above Rs. 15,000.
	Excise duty on high class tobacco.	increased	At varying rates.
	Custom duty on tobacco	increased	
	Postal parcel rate and surcharge on telephone rentals and trunk call fees.	increased	

The total taxation revenue from 1939-40 to the end of March 1945 was reckoned at Rs. 827 crores of which direct taxes accounted for Rs. 443 crores and the main indirect taxes at Rs. 384 crores.[1]

Two other measures were adopted after the outbreak of war to strengthen the revenue position of the Government. Firstly, the Distribution of Revenues Order, 1936 (embodying the Niemeyer

1. *Explanatory Memorandum to the Budget for* 1945-46 p. 23.

Award) was amended to provide that during 1939–40, 1940–41 and 1941–42, the Central Government would retain out of the distributable 50 per cent of the income-tax proceeds an amount of Rs. 4½ crores.[1] Secondly, the railway fares and freights were raised and the moratorium on the payment of the arrears of railway contribution to general revenues continued till 1941-42 so that a larger contribution from the railway revenues to general revenues was rendered possible. In 1942 all the arrears of railway contribution were paid off and, therefore, in 1943, interim wartime changes in the Railway Convention of 1924 were adopted so as to permit a substantial contribution by the railways in consonance with the war needs of general revenues. The railway contribution to general revenues during 1944–45 and 1945–46 was stabilised at Rs. 32 crores and for the war years was as follows:—

(*In crores of rupees*)

1939–49	4·33
1940–41	12.16
1941–42	20.17
1942–43	20.13
1943–44	37.64
1944–45 (R.E.)	32.00
1945–46	32.00
TOTAL ..	158.43

(*b*) *Borrowing:* The borrowing programme of the Government, described as the Indian Defence Saving Movement, was put into effect from June 4, 1940 and to begin with comprised Three-year Interest-free Defence Bonds. 3% Six-year Defence Bonds and ten-year Defence Savings Certificates. The Six-year Defence Bonds were issued in two series, the first with effect from the 10th June and the second to which conversion from 5% 1940–43 Loan was allowed, from the 1st August, 1940. The sale of these Bonds was discontinued from the 25th January, 1941 and their place taken by 3% Second Defence Loan 1949–52 issued with effect from 1st February. From 1st April, 1941, a new scheme of Post Office Saving Bank Accounts to facilitate popular savings was brought into operation. The amounts in these Accounts were repayable not on demand

1. This provision was extended to 1942–43 and subsequent years in terms of the direction of Governor-General.

but one year after the end of war, the rate of interest carried by them being 2½ per cent *i.e.*, one per cent higher than the existing rates on Savings Bank Accounts. On the 14th February, 1942, the 3 per cent. Second Defence Loan was closed and on the 4th July, 1942, the 3 per cent Third Defence Loan was issued in the form of a reissue of an earlier Loan first issued in 1935. On the 1st October, 1942, a special issue of 3 per cent Loan 1963–65 was made in connection with the arrangement made for the funding of sterling obligations in respect of railway annuities. Subscriptions to the Third Defence Loan were closed from 1st July, 1943 and a Fourth Defence Loan was issued in its place. From 1st October, 1943, it was decided to close the issue of Ten-year Defence Savings Certificates and to substitute for them a new attractive scheme of Twelve-year National Savings Certificates. The rate of interest allowed on Post Office Savings Bank accounts was also raised from the same date. On 22nd October, the 3 per cent. Funding Loan 1966-68 of Rs. 25 crores was floated and in January 1944 a special issue of Rs. 50 crores of this loan was created. On the 31st March, 1944 the Fourth Defence Loan was closed and a new 3 per cent Victory Loan was issued from 1st April, 1944. Other loans floated during 1944–45 were a special issue of Loan 1948–52, a third issue of Funding Loan 1966–68 and a Second Victory Loan.

Among the other items in the borrowing programme, the most important was the sale of the rupee counterparts of those sterling loans which were repatriated under the voluntary and compulsory repatriation schemes.[1]

The total amount subscribed to all Defence Bonds and Loans, the Defence Savings certificates and Defence Savings Bank Account was upto the 31st March, 1945 Rs. 857.75 crores, being composed as follows[2] :—

	(*In crores of rupees*)
Interest-Free Defence Bonds ..	2.90
Three Per cent Defence Bonds	
(1) First Series ..	.71
(2) Second Series ..	64.43
Three Per cent Second Defence Loan ..	59.16
Post Office Savings Bank ..	1.89
Post Office Cash Certificates ..	—21.21

1. Vide § 6.
2. Report on the Currency and Finance, 1944–45, P. 63.

Defence Savings Certificates	..	6.42
National Savings Certificates	..	28.03
Defence Savings Bank	..	8.33
Three Per cent Loan 1951–54		54.80
Rupee counterparts (nes investments)	..	224.26
Three Per cent Loan 1963–65	..	30.21
Three Per cent Funding Loan 1966–68		110.12
Three Per cent Loan 1953–55	..	114.58
Five-year Prize Bonds	..	4.15
3 per cent Victory Loan	..	112.82
Second Victory Loan	..	6.15
2¾ per cent Loan 1948–52	..	50.00
	TOTAL	857.75

In addition to this long-term borrowing, the Government of India also increased their short-term borrowing in the form of Treasury Bills and Ways and Means Advances from the Reserve Bank of India. The total amount of outstanding Treasury Bills and Ways and Means Advances increased from Rs. 46.3 crores at the end of 1938–39 to Rs. 264.7 crores at the end of 1942–43 but dropped due to the successful borrowing operation of the Government to Rs. 86.7 crores at the end of 1944–45, *i.e.*, there was a net increase of Rs. 40.4 crores. To a substantial extent, the Treasury Bills were merely substituted for the sterling securities in the assets of the Reserve Bank's Issue Department and there was no additional issue of currency against them.[1]

The rupee debt of the Government on account of the borrowing and sterling repatriation operations increased during the war by nearly Rs. 800 crores (up to the end of 1944–45) and the sterling debt was reduced by about Rs. 400 crores, showing a net addition of Rs. 400 crores to India's total public debt. The rate of interest paid on the loans raised by the Government was kept low—at about 3 per cent—due to the successful maintenance of cheap money conditions during the war.

Saving Schemes. In their borrowing programme, the Government did not place much direct reliance on saving schemes, though a few of them were brought into operation as auxiliaries of taxation

1. This was pointed out by the Finance Member during the course of his Budget speech (February 1943) probably in reply to Prof. Vakil's statement in his *The Falling Rupee* to the effect that the Government was obtaining rupee finance by means of Treasury Bills and thus engineering 'inflation in its naked form'. Vakil's well-reasoned rejoinder, in the first issue of the *Eastern Economist* (dated 22nd May, 1943), does not seem to be very convincing on this point.

or control measures. Three schemes, two of them voluntary in character, were introduced along with the changes made in 1942-43 in the rates of income-tax, surcharge on income-tax and excess profits tax. Under the first scheme, income-tax leviable on incomes between Rs. 1,000 and Rs. 2,000 on the excess over the first Rs. 750 of total income was not to be levied if the assessee exercised the option of depositing a prescribed sum in a Savings Bank Account. The prescribed amount was one rupee for every 25 rupees by which the total income exceeded Rs. 750 and was, therefore, approximately $1\frac{1}{4}$ times the amount of tax to which the assessee would otherwise be liable. Under the second scheme, which was compulsory in effect, the incidence of the newly introduced rates of surcharge on incomes not exceeding Rs. 6,000 was mitigated by funding $\frac{1}{2}$ per cent of the assessee's total income for his benefit and providing for its repayment to him after the war. Under the third scheme, the Government was to contribute an amount *upto* 10 per cent of the net excess profits tax (the rate of which stood at 66.$\frac{2}{3}$ per cent) provided the assessee deposited a sum equal to double this amount. The contribution placed in reserve by the assessee would be repayable within 12 months of the end of war while the contribution made by the Government would be paid out at such time and subject to such conditions as might be determined. This scheme, optional in character upto 17th May, 1943, was converted into a compulsory scheme by an Ordinance of that date and a deposit at the rate of 20 per cent of the excess profits tax, *i.e.* 13.$\frac{1}{3}$ per cent of excess profits was made compulsory for all assessees, the Government making their contribution at the rate of 6.2/3 per cent. In 1944-45 the amount of the excess profits tax required for compulsory deposit was raised from 20 per cent to 19/64th in the case of companies and 17/64th in other cases, thus immobilising the whole of the excess profit remaining after the payment of excess profits tax, income-tax and the super tax. A 'pay-as-you-earn' scheme, as it was called, for income tax collections was also introduced to provide for the temporary deposit of advance payments of tax on those incomes from which tax was not deducted at the source, such as income from property, business, profession or vocation. The assessee had under the scheme the option to pay tax quarterly either on the basis of his last assessed income or his estimate of current earning. The sums thus collected were not treated as revenue but as deposits to be taken to revenue when the regular assessments were made.

Lease-Lend aid: India was receiving goods and services from U.S.A. under the Lease-Lend arrangements and the value of these was estimated at Rs.515 crores upto the end of 1944-45. Lease-Lend represented an innovation in the sphere of international finance during the war: the aid rendered under it was in the nature of foreign borrowing though it was not clear in what form the liability of the recipient would be discharged at the end of war. A direct agreement between India and U.S.A. concerning Lease-Lend was not concluded until May 1946 but India incurred expenditure on U.S. troops stationed in India and on various supplies and services—Reciprocal Lease-Lend aid, as it was called—which was estimated upto the end of 1944–45 at Rs. 124 crores. A direct Mutual Aid Agreement between the Government of India and of Canada was signed during 1944–45 entitling India to participate in the benefits of Mutual Aid accorded by the Canadian Government to the Allied Nations. This meant a small reduction—of the order of Rs. 5 crores per annum —in India's Defence expenditure.[1]

(*c*) *Inflation:* As was pointed out earlier, taxes and borrowing were not adequate to cover the total expenditure incurred by the Government of India in connection with defence measures. The Government had no doubt been able by these means to balance their budget but they were *not* able to draw to themselves sufficient purchasing power to balance their budget *as well as* meet the expenditure incurred by them on behalf of the British and Allied Governments. The question which naturally arises and which forms the core of inflation issue is: how was this expenditure met?

The question admits in a way of the simple answer that the British and other allied Governments were making payments to the Government of India in sterling and the Government of India were releasing the equivalent amount of rupees for the expenditure incurred by or on behalf of these governments. Further details worth mentioning about this process are that sterling accumulated in London with the Reserve Bank of India and was invested in sterling securities which were then lodged in the Issue Department of the Bank and formed the backing behind the notes issued in India.[2] The table on the next page brings out the increasing extent to which sterling securities supported the note issue during the war.

1. *Budget*, 1945–46, Finance Member's Speech, para 14.

2. For an illuminating account of the whole process, *vide* Sir C.D. Deshmukh Rotary Address (*Commerce*, 5th September, 1943).

(*In Crores of rupees*)

Year	*Month*	*Total Note issue*	*Notes in Circulation*	*Gold Coin and Bullion*	*Sterling Securities*	*Rupee Coin*	*Rupee Securities*
1939	Aug.	216. 8	178.9	44.4	59.5	75.5	37.4
	Sept.	221. 4	202.9	44.4	64.5	75.1	37.4
1940	Feb.	254. 6	239.6	44.4	113.5	58.3	38.3
	May	257. 0	248.5	44.4	123.5	46.6	42.5
	Oct.	257. 2	228.7	44.4	131.5	31.6	49.6
1941	Jan.	260. 5	245.0	44.4	135.5	31.0	49.6
	Aug.	293. 0	276.6	44.4	131.6	38.5	78.5
1942	Jan.	366. 2	356.4	44.4	248.6	31.6	41.5
	Aug.	487. 3	474.3	44.4	311.8	28.7	102.4
1943	Jan.	604. 2	593.3	44.4	355.8	14.6	189.4
	Aug.	766. 3	754.6	44.4	618.8	14.7	88.4
1944	Jan.	862. 9	853.7	44.4	744.8	15.3	58.3
	Aug.	945.58	927.0	44.4	828.3	15.0	57.8
1945	June	1146. 7	1136.9	44.4	1029.3	15.2	57.8

1. Figures after June, 1942 exclude Burma. Figures for rupee coin include one rupee notes after July, 1940 .

In normal times any accumulated sterling in England could have been utilized for purchasing and importing tangible goods and services as well as gold but this procedure was not found practicable for the duration of war. In effect, therefore, India extended to Great Britain a huge commodity credit which was to be repaid after the war. The amount of credit was obtained internally not so much by depriving those who had of the utmost they could give as by a process of nibbling at the paltry stocks and subsistence of those who had never risen very much above the poverty line. The investment of sterling balances in British securities made available large funds to the British Government who were to this extent able to avoid resorting to credit inflation. The release of corresponding amounts of rupees in India swelled the volume of currency circulation. It was thus that inflation was kept at bay in England and unleashed in India. The war entered, at it were, a *minus* item of goods and a *plus* item of note issue in India's national balance sheet and added, at the same time, a *plus* item of goods and a *minus* item of currency circulation in England's national balance-sheet.

On a very rough appraisal of the relative contributions of taxes, loans and inflation towards India's war finance, it might be said that

the share of each was one third. With the intensified drive for borrowing, however, the share of this lucrative method of war finance tended to increase steadily and that of inflation—which had undoubtedly been high—to decrease.

Some Aspects of Inflation

Inflation and sterling balances: The relation between sterling balances and inflation may be viewed from three angles: firstly, the precise connection between sterling accumulation and currency expansion; secondly, the extent to which the presence of large sterling assets and the possibility of their conversion into tangible goods in future could be considered an inflation-damping factor; and thirdly, whether in spite of the presence of these assets, Indian currency could be described as 'fiat money'.

As regards the first, it was clear that sterling must accumulate with the Reserve Bank so long as the British and Allied governments made purchases in India and paid for them in sterling. But it was not inevitable that internal expansion of currency should result from the accumulation of sterling. If, for example, the whole of the purchases in India could be made by rupees obtained from Indian people themselves by taxes or loans, no additional currency needed to be issued at all against sterling accumulating in England. It was because the Government of India could not get hold of sufficient rupees to meet all their liabilities for expenditure by the normal means that they had recourse to the Reserve Bank machinery for obtaining rupee currency against sterling. Again, it was open to the Government of India, even if they were not receiving sterling, to secure additional rupee currency by the simple expedient of borrowing from the Reserve Bank against its own securities. "Thus there is no natural or necessary relation between the growth of foreign assets and internal expansion or monetary inflation and the link between the two phenomena is optional. Inflation may, and generally does, develop without any growth in foreign balances and foreign balances may in theory grow without causing a corresponding degree of inflation."[1]

As regards the anti-inflationary effect of sterling balances, it was possible to exaggerate it. Just as the mere accumulation of foreign balances need not give rise to inflation, the mere presence of such

1. Rotary address of Sir (then Mr.) C.D. Deshmukh, Governor of the Reserve Bank, 31st August, 1943.

balances need not counteract it. For inflation arises basically from the disturbance of currency—economic activity ratio, though at a certain stage the lack of confidence in the currency may become an inflation—aggravating factor. The backing of sterling assets behind expanded currency could possibly strengthen the confidence factor and could to that extent damp inflation but then there must be unshaken public faith in the future value and availability of these assets.

The Manifesto issued by the twenty Indian Economists in April, 1943 characterised the inflation in India as 'deficit-induced fiat money inflation'. The description might be generally correct but was not explicit on two points. In the first place, the deficit that had induced the inflation was not caused by a gap between the ordinary war-time expenditure and revenue of the Government of India, but by the *extraordinary* expenditure which it had been called upon to meet. Secondly, the notes going into circulation could be described as fiat money only if the sterling securities against which they were issued were treated as worthless assets incapable of being converted later on into tangible goods and gold.[1] As a matter of fact, it is hard to find an exact precedent for the Indian inflation, and, therefore, difficult to classify it. It was inflation *sui generis* and could be treated as such.

Inflation and Velocity of Currency Circulation: It would be difficult to deny that the fall in the velocity of circulation acted during the war period to some extent as an inflation-damping factor. It was, however, difficult to assess its existing magnitude or predict its future course. Figures of velocity of circulation have a limited utility as indices in so far as a large volume of payments during war-time is made in cash. This must be so more particularly when black markets are rampant and when the small incomes of those who keep no bank account increase.[2] But the broad trend suggested by the figures could hardly be doubted, though it could in no way lull disquietude for the future. For lower velocity of circulation represents a reserve of immobilised purchasing power which, whenever it comes into operation, would be a factor of serious magnitude.

1. Fiat money by its very definition circulates by the authority of the Government which regulates its issue and not by any intrinsic value of its own. It is doubtful if paper currency fully backed by and convertible into, say, gold immediately or proximately can be described as fiat money. (*Cf.* however, the opinion of Gadgil and Sovani in their *War and Indian Economic Policy;* 1944, P. 140).

2. B.C. Ghose; *The War and the Rupee,* pp. 3–4.

Inflation and Social Justice: Inflation as a means of meeting the cost of war achieves no doubt the same objective as the two other methods of taxation and borrowing but it does so by effecting the most arbitrary and inequitable changes in the economic position of different classes and persons and by introducing into the economic system the germs of distemper.[1] The lessons of the havoc worked by inflation in the post war years of 1919–23 had been learnt so well by thoughtful men that when the war broke out, clearest warnings were sounded in belligerent countries like England against letting the spectre of inflation raise its ugly head.[2] The close bearing of the methods of war finance on the social distribution of wealth also received firm emphasis. The 'deferred pay' scheme put forward by the eminent economist, Lord (then Mr.) J.M. Keynes, for England soon after the war aimed at greater social justice no less than at efficient finance of war.[3] In India, however, there did not seem to be sufficient appreciation of the social and distributional implications of war finance. The burdens imposed by the war (and the gains accruing from it) could not be claimed to have been equitably distributed among the different sections of population. Some groups were able to secure most of the gains and escape many of the burdens; these included, broadly speaking, the bigger landlords, war contractors, profiteers and speculators. There were others who did not bear their proper share of the burden and these included all persons with large incomes including industrialists, bigger traders and highly skilled personnel in war employment. Then there were also groups about whom it could not be said that their gains in the form of fresh or more lucrative employment were not outweighed by heavier burdens imposed by scarcity, high prices etc.; these

1. *Cf.* "An endless period of rising prices destroys two very important social things; it destroys the value of saving and it destroys the worker's standard of living" (Gregory: *Current Problems of International Finance;* 1930).

2. In England, the financial control was very effective; for while the total Central Government expenditure rose from £ 3,340 million in 1940 to £ 5,782 million in 1943, the proportion of it covered by ordinary revenue rose from 37 per cent to over 50 per cent. A little more than half the expenditure was covered by savings of which small savings formed a considerable part. The extent of inflationary finance was extremely small. (*Economic Journal, Dec.* 1941 *and Sept.* 1943 *and An Analysis of the Sources of War Finance,* London, 1944).

3. Summing up the advantages of the scheme the central feature which was the proposal for compulsory savings, Keynes observed: "It retains a stronger incentive to effort, gives less sense of sacrifice and inded requires less and spreads through the community the advantages of security which saved resources afford, far more widely than before." (*How to pay for the war,* 1940, p. 44).

included small landholders, tenants; small artisans and traders, domestic servants and the organised industrial workers.[1] And finally, there were persons having more or less fixed incomes and low-paid workers, such as the salaried employees in Government or private employment, professional men, unorganised industrial workers, pensioners and agricultural labourers who were called upon to bear a disproportionately heavy share of the burden. Broadly and roughly, it might be said that the propotion of the country's real wealth which fell to the share of the low paid manual worker, the fixed income black-coat employee and the small producer was diminishing while the proportion commanded by the big supplier and middle-man, the war profiteer and speculator, the large investor and producer was increasing.[2]

It may also be pointed out that Indian people, as a whole, with their low average income per head were called upon to bear under the existing financial arrangements an unbearably heavy burden. The burden was felt to be particularly intolerable because the present generation was being called upon to bear almost the whole of it. The gains from the extinction of past debts and the growth of sterling balances opened promising vistas for the future generation but provided little relief to the present.

Inflation and the Agriculturist. The severe criticism levelled by Indian economists against inflationary expansion of currency and the consequent rise in prices was treated with scepticism by some representatives of agricultural interests. It was pointed out that the rise in prices had opened the sluices of prosperity for the agriculturists which might not be closed by committing the error of deflation. It is necessary to examine the point with special reference to the Punjab which was generally considered to enjoy a higher degree of agricultural prosperity than many other Provinces. The agriculturists in India form such a vast mass that it would be foolish to try to cover them by a single general statement. There are some nine groups into which those connected with agriculture may be divided: the bigger, the middle and the smaller landowners, tenants, landless labourers, artisans, menials, traders and money-lenders. The line of

1. One gain generally recognised to have accrued to landowners in some parts of the country was the reduction or the complete repayment of past debts.

2. For the general effects of the rise in price during the first world war, see *Babington Smith Committees Report*, Para, 47.

division between the bigger, the middle and the smaller landowners the smaller owner and the tenant, and the tenant and the landless labourer cannot be drawn very sharply. In the Punjab, the smaller, the middle and the bigger landowners would be those who own 3–15, 15—50 and above 50 acres respectively; those owing less than 2—3 acres would approximate in material status to smaller tenants.[1]

No data are available as to how the nine groups were affected by inflation and it is, therefore, impossible to measure improvement or deterioration in standard of living in quantitative terms, but some *ad hoc* enquiries regarding war-time changes in rural life would suggest some broad conclusions. The bigger landowner, by all accounts, had gained on balance, *i.e.* even after allowing for the rise in the prices of goods such as cloth etc., which he consumed. He purchased more land or house property wherever he could or made investments in gold and ornaments. He was also hoarding cash or alternatively, increasing his deposits with the post office or co-operative societies. He also cleared off or considerably reduced his debts and redeemed mortgages. In real terms his position was much better than before the war. The middle landowner also improved his material condition by reducing debt, redeeming mortgages, purchasing land or accumulating some cash, though not to the same extent as the bigger landowner. The smaller landowner (who may at the same time be a tenant) who is little more than a subsistence farmer both gained and lost and it is difficult to strike the balance. Whenever he had a surplus to sell, his money income increased and he utilized it to pay off his old debts.[2] Whenever he could get the necessary materials, he spent more on improvements in land such as sinking or repair of wells, better seed, implements, etc. and also on the purchase of milch cattle and improvement or extension of the dwelling house. He was also able to pay up the government demand by parting with a smaller amount of his produce and to that extent was enabled to retain and/or consume more. The supplementary occupations pursued by him also fetched more and when a member or two of a family joined the army, a small stream of money flowed

1. The percentage of the bigger, the middle and the smaller owners in the Punjab was roughly 2.5, 10 and 38. The proportion of those below 3 acres was about 50 per cent. As regards area held, the corresponding figures for the four classes were roughly 38.0, 28.0 and 6.0 respectively.

2. It may be mentioned here that agrarian legislation of 1934–39 had already enabled him to wipe off a part of his debt.

into the family from that direction. There was a noticeable rise in the material standard of living in such cases, inasmuch as the newly-acquired money was spent on the purchase of fountain pens, watches etc., and, in at least some cases, also on indigenous intoxicating beverages. The rise in the value of land was utilised in some cases to sell a part of the holding to redeem the mortgage over another and a larger part. Against these, one must place, first of all, the higher prices of goods that enter into the cost of cultivation—livestock, wood and iron for the plough and the sinking of the well. The prices of articles of consumption—cloth, kerosene, matches etc.,—had gone up, though it would be wrong to think that they affected the agriculturist to the full extent of their rise because of his capacity to limit his wants or use substitute (village made) articles of inferior quality. Transport—both by road and rail—became more costly and the price of gold and silver which were used both for personal adornment and investment increased. On the whole, it cannot be said that the small landowner made any definite real gain during the war, though he was able to extricate himself from a substantial part of his encumbrances. Where he had the misfortune to lose any of his cattle (whose prices had risen tremendously), his position remained almost the same as before the war. As regards tenants, the cash contract tenant would gain when prices are rising but in the Punjab about 75 per cent of the area under tenancy was held by batai tenants (or share croppers). Moreover the cash rents rose along with a rise in prices. As for the share-cropper, his position was in many respects similar to that of the small landowner, though it was weaker and less satisfactory. The crown tenant in the canal colonies appeared, however, to have improved his position by acquiring proprietory rights over the land cultivated by him.

The landless agricultural labourer suffered heavily in some parts of the country such as Bengal on account of starvation as well as scarcity of cloth. He forms the submerged section of rural population and the tendency reported from some parts of the country for kind wages to be replaced by cash wages exposed him more than before to hunger and want. In the Punjab, however, he did not seem to be worse off because the greater demand for his services in a period of labour shortage caused by recruitment to the army led to a rise in wages almost proportionate to the prices. The rural artisan and the menial obtain a customary share of the crop from the threshing floor and there appeared to be no signs of the custom giving

way (not at any rate in the Punjab) in the conditions created by the war. Moreover, it is to this group that the war opened up several opportunities of employment—alternative or additional—in the army or outside. Had it not been for these opportunities, he would have fared perhaps only a little better than the landless labourer but not very much better than before the war. The village money-lender suffered both on account of the agrarian legislation and the war and began drifting to the cities.[1] The village trader (where he was not a money-lender) suffered a small loss through scarcity of supplies of goods he used to sell and a smaller turnover of foodgrains due to hoarding of direct sales to the buyer but he largely or wholly made it up either through higher prices or through a larger quantity of foodgrains handled (because of larger production). On the whole he was a little worse off.

It would, thus appear that the larger landowner and to a smaller extent the middle landowner definitely gained and the village money-lender definitely lost. The other groups gained slightly in some directions and lost in others.

From the long range point of view, inflation is an ill wind that blows no agriculturist any good. *Some* rise in prices was bound to benefit him and was in fact very much his due after a protracted depression but a large continuous inflationary rise heightened the certainty of an eventual, sudden and steep downward reversal. Altogether, therefore, the agriculturists at large should have had very little cause to hail inflation with any genuine satisfaction.

Progress of thought about Inflation. Timely and effective measures to deal with the various consequences of the method of war finance adopted in India might have been undertaken if there had been clearer understanding of the character and gravity of what was happening. There was instead a series of ill-conceived, irresolute and sporadic measures emanating from the varied and conflicting views and opinions jostling one another for mastery in the general *melee.*

Even as late as July 1942, the Central Board of Directors of the Reserve Bank said in their Annual Report presented to the shareholders: "Although most of the recognised elements of inflation

1. The situation was somewhat analogous to that in the United States in the later years of the American Revolution when creditors were found 'running away from their debtors', and the debtors pursuing them in triumph and paying them without mercy'.

are present, there is no evidence that inflation is present in the country in any serious form". There was furthermore, a reluctance to recognise that the sequence of cause and effect ran from currency expansion to rise in prices.[1] But the magnitude and rate of fresh additions to currency were growing so heavy and the rise in prices so mercurial that it became difficult to deny that a condition of fairly serious inflation was developing in the country. In January 1943, Professor C.N. Vakil crystallized the floating mass of views and partial analyses of the seriousness of inflation in India into a compact and clear analysis in his *The Falling Rupee*. Denials that there was inflation in the country did, however, continue to be made supported with plausible arguments by even some of the best informed persons. The Finance Member of the Government of India in the course of his speech introducing the Budget in March, 1943 made a number of important observations on the inflation problem in India.[2] The most important among these were: (1) currency expansion was due to larger cash payments arising from the intensification of Government's war activities and also the increased demand for cash from the public; (2) there was no credit inflation in India but only a "temporary situation in which an increase in the volume of purchasing power impinges for a time on a stationary or diminishing volume of consumable goods"; and (3) if war results in victory for the United Nations and, therefore, the British and Indian Government can pursue sound financial policies, "there is not the remotest risk of inflation of the nature and on scale which occurred in some of the countries which suffered utter defeat in the last war". A few weeks later Mr. G.D. Birla, a prominent businessman and industrialist circulated a pamphlet entitled 'Inflation or Scarcity?" wherein he categorically denied the existence of inflation in India and attributed the rise in prices to the scarcity of commodities.[3] On the 12th April, 1943, twenty Indian economists issued a Manifesto which stated that the inflationary spiral was already at work in India and that

1. Speech of the Governor of the Reserve Bank, August 1942.

2. *Budget Speech*, 1943–44, paras 50–55.

3. Apropos of Birla's views, the following remarks of Cannan relating to the last war are of interest: "During the war and afterwards, when a currency began to depreciate, it was often said that the cause of the rise of prices was a growing scarcity of commodities. This was supposed to be an argument in favour of increasing the currency though it is difficult to see how any sane person could believe that the fact that commodities had declined in quantity was a reason for making that decline greater in proportion to currency by increasing the quantity of currency", (*Money*, p. 104).

the inflation was 'deficit-induced fiat money inflation' caused by the peculiar system of war-finance under which British and Allied purchases made in India were paid for in sterling assets against which currency was expanded in India. The Manifesto affirmed the existence of a causal relation between expansion of currency and rise in prices and recommended a comprehensive series of measures for checking inflation and bringing prices under control. In May 1943, the Government of India in a resipiscent frame of mind appointed a Special Officer to report what deflationary measures were necessary to counteract the effects of the expansion of currency. Thereafter the disinclination to recognise the existence of growing inflationary tendency steadily weakened and along with it the determination to combat its menace grew keener. The Central Board of Directors of the Reserve Bank in their Annual Report presented in August 1943 significantly observed that "during 1942-43 inflationary tendencies steadily gathered strength encouraging and being in turn encouraged by scarcities of essential commodities including foodstuffs and cloth .....Psychological factors super-added to the basic monetary and economic facts operated towards creating a highly unsatisfactory and unstable situation, although it is not possible with any degree of accuracy to assess the relative significance of the former. Nor is it possible to measure the relative contribution of rising money incomes and the growing scarcity of goods to the rise in prices".[1] The first explicit recognition from the official standpoint of the presence and basic cause of inflation was contained in the Finance Member's Budget Speech delivered in March 1944. It was admitted that rather more than half of the war expenditure in the country was incurred by His Majesty's Government and other allied governments and that while the expenditure debitable to the Indian Budget had been fully met by taxation and borrowing throughout the period of the war, the Government had not at all times been able to raise sufficient rupees from the market to finance its total outlay. The rupees issued to fill the gap had led to an increase in the free purchasing power and though they had been backed by sterling assets had produced inflationary effects.

1. In November 1943 appeared a pamphlet entitled *War-time Prices* by Dr. P.J. Thomas containing a powerful plea for saving and lending to the Government. Among the arguments used were: (1) that the rupee is on the high road to appreciation, and will fetch more after the war, (2) if people don't save, they themselves will be hit the hardest and (3) saved purchasing power will be available to sustain post-war industrial expansion.

Measures to Combat Inflation: From this brief review of the financial operations of the Government and their consequences, their inevitably emerges the question if there was a more suitable alternative method in the past of conducting operations of public finance. It is also necessary to enquire how far the measures that had been taken, particularly since the middle of 1943, were inflationary in character and effect. The more general form in which these questions may be asked is: how could inflation be checked at the root or in its effects?

At the very outset it is necessary to mention that the non inclusion of disbursements made on behalf of the Allied Governments in Government of India's budget created a wrong perspective for viewing the whole financial situation. Even fresh taxation and borrowing may appear unnecessary when it is found that the Government's own budget is easily balanced. It might be suggested, therefore, that if the incorporation into the annual budget of figures relating to the disbursements in India on behalf of the Allied Governments was not possible the Government should have prepared and presented at the time of the budget a separate set of accounts showing the *total* disbursements and the *total* amounts raised by the Government of India and the inflationary gap.[1]

There could indeed be no single sovereign remedy for the evil of inflation; a number of measures had to be combined to overcome its menace. The measures that could possibly be taken fall under the following heads:—

(*i*) Reduction in the volume of the Government's total disbursements (including those undertaken on behalf of other countries) to a point where the whole of them could be covered by non-inflationary methods of finance.

(*ii*) Covering in full, without reducing, the Government's total disbursements (including those on behalf of other countries) by the non-inflationary methods of taxes, compulsory and voluntary loans, liquidation of foreign private investments in India, etc.

1. It might have been worth while attempting in however imperfect form something on the lines of *Analysis of the sources of War Finance and Estimates of* the *National Income and Expenditure* presented to British Parliament by the Financial Secretary to the Treasury.

(*iii*) Refusal on the part of the Government of India to furnish rupee finance to other Allied countries, *i.e.*, throwing on these countries the responsibility of raising the required finance themselves in the Indian market.

(*iv*) Adding to the reservoir of real resources by expanding production , stimulating imports, scaling down exports, importing and selling gold and forcing out hoarded stocks.

(*v*) Preventing the incomes from getting inflated by the Government's disbursements or from exercising pressure on the limited quantities of real resources, by instituting various controls such as control of investment, wages and profits, price control, rationing, control of speculation, etc.

Measures falling under the first head necessarily involved a contraction of India's war effort and could not appeal to those who would have India make an all out effort in a large scale offensive against Japan. Though the victory in Europe might bring relief elsewhere, it was argued that it could mean no relaxation of effort in India so long as Japan remained unbeaten. The view taken by those who suggested such measures was that in the existing economic and political set-up of the country, India's capacity to bear the burdens of war had already been overstrained. The task assigned to India was so heavy that already she had to resort to concealed and indiscriminate taxation by inflationary methods in order to accomplish it. So long as India's capacity to make her voluntary contribution to war was not considerably expanded by altering the whole political and economic set up, there could be no escape for the Government from inflationary methods of finance. From this it followed that in the prevailing circumstances inflation could be checked at the root only by reducing the total amount of Government disbursements. This was not so impracticable as it might appear provided the Allied countries could come forward to shoulder all further burdens of the war. Several issues, some of them political and military in character, arose from such a suggestion but it should be sufficient here to draw attention to the fact that before the war Indian economy rested on precarious margins and nothing very much by way of development was done during the war to justify any great hopes of India's capacity to furnish the resources for war without pushing large sections of population below the bare subsistence line.

Measures coming under the second head did not at all concern themselves with India's capacity to bear the burden of war but sought to substitute for the inequitably distributed burden imposed by inflation, a more equitably distributed, and therefore, more bearable (though not less onerous) burden imposed by steeply graded taxes, compulsory and voluntary saving, etc. On principle there was nothing to be said against them; they are an efficacious antidote to inflation.[1] Only under the prevailing circumstances they could not always fulfil the expectations entertained of them. Attention in this context might be drawn to the fact that the large amount of purchasing power created during the war was not spread evenly over the whole mass of population but lay in a heavy deposit in some crevices and corners of the economy and in a thin veneer in others. While, therefore, heavy pressure would have had to be directed to some points, some withdrawal of pressure was desirable at others. The war contractors, bigger landlords and holders of highly-paid war jobs at the one end and the newly employed, particularly the better paid, workers at the other could well be made to pay more either through heavier taxation or compulsory savings. Saving schemes should have been given a very prominent place in the borrowing programme which should indeed have been shaped in such a way as to tap every little reservoir of genuine savings.[2]

It was also suggested by some persons that the Government should raise the rate of interest offered on loans in order to make them more attractive. But raising the rate of interest was open to

1. It may, however, be pointed out that there is, even when non-inflationary methods of war finance are being used, a time lag between Government disbursements and the inflow of income into government exchequer. This lag might well create an inflationary gap but this would not be so wide as to be serious.

2. The 'save and lend' campaigns launched in some of the provinces like Madras and U.P. succeeded beyond expectations and illustrated the possibilities of a well-planned savings drive. That such a drive should be above all suspicion of undue or indiscriminate coercion need hardly be stressed. After 1943–44 a small savings campaign on an intensified scale was organised by the Central Government. A National Savings Commissioner was appointed to direct and control the small savings movement from the Centre. A scheme was also evolved to provide for the employment of authorised agents on a commission basis whose function was to be to collect money for investment from villages, purchase certificates on their behalf and deliver them to the villages. In this connection it is necessary to point out that to make intensive drives for saving without at the same time taking direct measures to push down prices and ration consumption may for some time resemble nibbling at the consumer's cake from two ends, though it is recognised that increased saving (if it is genuine) is anti-inflationary.

two serious objections: first, it would have adversely affected the value of gilt-edged securities with its inevitable reaction on banks and insurance companies and second, it would have marked a reversal of the cheap money policy hitherto maintained and left for post-war period a structure of high interest rates.[1] A good method of raising a few hundred crores of rupees finance would have been to enforce a scheme for the liquidation of all the private foreign investments. The process of liquidation would have required the preparation of an inventory of different kinds of investments and the calculation of their value. To some extent, the liquidation of these investments had been occurring spontaneously through change of hands under the scare of war conditions. The process needed, however, to be hastened and intensified by judicious administrative pressure.

Measures falling under the third head were strongly urged in this country by some prominent economists.[2] The suggestion was made that the responsibility for finding rupee finance for purchases made in India should have been made to rest on British Government who should, therefore, have been asked to raise loans in India. In some respects such loans would have been better than the accumulation of sterling balances; firstly, in that they would have been repayable in rupees and therefore, free from the risks attendant upon depreciation of sterling; secondly, the Allies would have known at first hand the limits to which India could pay for the war; and thirdly, the creditor-debtor relationship of India in relation to the Allied countries, particularly Great Britain, would have been clearly revealed. But it is obvious that they could be successfully floated only if the atmosphere in India was favourable to their reception. It may also be noted that if the securities of the British Government against

1. Besides such a rise "will be a directly inflationary step which would inflate the whole structure of interest rates, raise the costs of industrial production and therefore industrial prices and increase the size of budget deficit". (*Cf.* B.K. Madan: *This Inflation Problem in Commerce:* January, 1944). There were ways of making the borrowing programme of the Government attractive even without raising the rate of interest. A change in the whole psychological atmosphere in the country was about the most efficacious way. But short of it, there are a few devices like the Price Bond issue which could help to draw off the purchasing power. The issue which was announced in December, 1949, was a limited one, consisting of several series of one lakh pieces each of Rs. 10 and Rs. 100 interest-free bearer bonds repayable in 1949. Twice a year a lot was drawn for each series of bonds for awarding prizes. The issue introduced the principle of state lottery and was open to the objection that it pandered to the less noble—the speculative and the gambling—instincts of men.

2. *Cf.* C.N. Vakil: *The Falling Rupee.*, 1934 *and Financial Burden of the War on India,* 1943.

which people would have lent were later used to secure credits from the banks, they might have become the basis of credit inflation and thus defeated their own object. From the standpoint of the yield of these loans also the suggestion was not very helpful considering that the yield of even the Government of India loans had not been on the whole very encouraging (although from 1943-44 onward the borrowing operations of the Government of India were on an ampler scale and met with greater success). It might perhaps have been more straightforward to tell these countries not to depend on India for resources to the extent to which they had done in the past. Reference may be made in this context to another suggestion sometimes put forward that it was the rupee-sterling link which had enabled the Allied countries to obtain rupee finance by the facile process of unlimited note issue and that the non-existence of this link at the outbreak of war or its rupture later would have automatically shifted the responsibility for finding rupee finance on to the shoulders of the Allied nations. Coupled with this suggestion was another that a ceiling should be placed on the accumulation of sterling in the assets of the Reserve Bank of India. How the rupee was linked to sterling in 1931 has been explained in an earlier chapter of this book.[1] The manner in which it was done makes it clear beyond doubt that the rupee-sterling link was merely a symbol of economic and financial relations between India and England. It was as futile to tilt against the symbol as it would be to think that if the rupee-sterling had not been there at the outbreak of war it could not have been established. As for the ceiling on sterling balances, it would have been a circuitous approach to the same problem; for its obvious implication was that beyond a chosen point, the existing method of obtaining finance should have been suspended and replaced by some more satisfactory and acceptable method.

Measures under the fourth head had a distinctive character in that they sought to combat inflation from the side of commodity supply rather than currency issue. In respect of these, the record of achievement remained rather disappointing. With a more or less static, if not in several cases actually diminishing, production of food articles and industrial commodities and with the expanding requirements of the war, the sector of civil consumption had undergone

1. See page 55.

severe contraction. A strong, well-organised food production drive along the lines recommended by the Foodgrains Policy Committee and the grant of every possible facility to the Indian industry to import machinery, tools and technical advice could moderate the intensity of burdens imposed by inflation. These measures should have been supplemented by a suitable trade policy, the anti-inflationary potentialities of which had not in the past received the attention they merited. By scaling down exports and stimulating imports, the reservoir of real tangible goods and services available within the country could be expanded. Early in 1945, a Government of India Supply Mission under the headship of Sir Akbar Hydari visited United Kingdom to arrange for the import of several essential articles of consumption and with the removal of shipping difficulties, larger supplies of goods of certain varieties were imported. Among the imports, both capital goods and consumers' goods were required but care had to be taken that imports of only those consumers' goods were stimulated which would supplement and not supplant home production. Import and sale of gold was also recommended both to withdraw currency from circulation and to coax the hoarders, particularly those in rural areas, to part with their stocks.[1] From the 16th August, 1943 the Reserve Bank of India started selling in an intermittent manner gold received from an undisclosed source. Silver procured under lease-lend arrangements from U.S.A. was also sold from August 1944. The veil of secrecy which was deliberately thrown over the amounts of gold and silver sold, the profits made on the sales and the basis of distribution of profits were the subject of considerable critical comment.[2] Hoarding was an evil that could be dealt with directly by a rigorous control of prices, by tightening the machinery for procurement, by controlling the movement of stocks and by introducing rationing of essential articles of consumption. The measures taken to force out hoarded stocks represented a move in the right direction. It is, however, necessary to point out that the effects

1. The suggestion for the import and sale in India of 30 million ounces (69 million tolas) of gold was made by Sir Chunilal B. Mehta (*Cf.* his letters to the *Times of India*, Bombay, dated 17th May and 3rd September 1943). In the second letter he suggested acquisition of gold from U.S.A. under Lease-Lend arrangements.

2. Sir J. Raisman in reply to a question in the Legislative Assembly on February 8, 1944 said that gold was provided by the British and American Governments from their own resources and the proceeds were utilized to meet the war expenditure of these Governments. But he was not prepared to disclose the amount of sales or the profits made. Unofficial estimates placed the estimated value of gold and silver sales upto the end of April 1945 at Rs. 148 crores and Rs. 14 crores respectively.

of such measures would wear out soon unless steps were taken to bring about an all round increase in production. There is after all a difference between normal trade stocks and hoards and moreover, no country can live long on its hoards which are a fund and not a flow.

Measures falling under the fifth head could to some extent check currency expansion at the source but mainly they were to be valued for their effect in forcing excess purchasing power to lie idle or flow into Government loans. The various economic controls—price control, wage control, profit control, control of investment, control of speculation, control of private consumption through rationing—are designed mainly to prevent purchasing power from exerting its fullest pressure on the limited or dwindling quantity of consumers' goods. The application of checks to the rise in prices, for instance, prevents the expansion of currency from going as far as it would otherwise go. With keen discernment, a writer remarks, "we agree that given an inflationary fiscal policy, any procedure which keeps down the cost to the government of goods and services will correspondingly reduce the amount of monetary expansion which such a policy requires. This is the element of truth in the doctrine that it is possible to check inflation by direct price control. The better the bargains that the government is able to drive, the less the pressure on the Treasury for the creation of more and more new money."[1] Price control in India was all along unco-ordinated, ill-conceived and irresolute and needed to be screwed up as a part of an anti-inflationary drive. Wage control which is an essential adjunct of price control was not attempted in India at all except that under the Ordinance of the 17th May, 1943, the funds set apart out of profits by way of bonuses and commissions could be regulated for income-tax purposes. Dearness allowances were given by both government and private employers and, in so far as they were paid out of funds which would otherwise have remained idle or been invested in Government loans, must have had an inflationary effect.[2] Yet it would be as rash to question their desirability as it would be to exaggerate in comparison with other factors at work, their price-inflating activity. On the other hand, the employment of many

1. Hardy; *Wartime Control of Prices*, 1940, pp. 43–44.
2. Refer for further discussion of this question to Appendix B.

'experts' by the governments at very high salaries, the creation of a number of war jobs and the laxity sometimes displayed in the matter of expenditure deserved more critical notice than was given to them. Direct limitation of dividends and profits was not enforced and the only advance made in this direction was the taxation of excess profits made during the war. Later on, however, the Central and Provincial governments followed the line of invigorating and intensifying the economic controls, particularly those on investment, speculation and consumption. The Defence of India Rule of the 17th May, 1943, prohibited, except with the consent of the Government, new capital issues of every kind. By a series of Orders and Notifications issued since March 1943 by the Government, forward trading in grains, oilseeds, sugar, cotton and bullion was prohibited. The declaration and disposal of all stocks of yarn and cloth by specified date was ordered under the Cotton Yarn and Cloth Control Order of June 1943, and ceilings were imposed on the prices of a large number of varieties of cloth. Rationing of food articles was introduced in a large number of centres all over India. In October 1943 an Ordinance for the prevention of hoarding and profiteering was passed and notifications for limiting profits of dealers in a large number of commodities to 20 per cent above the landed cost or cost of production were issued under it. Although taken together, these controls, especially the later ones, brought about a modest alleviation of the situation, they could not be considered more than commendable palliatives for a malady that called for drastic remedies.

Economic controls of the kind mentioned above must form an essential part of any plan to combat inflation. They are, however, like the elements of a jigsaw puzzle which must be fitted together into a composite plan to produce the desired effect. There was something to learn in this respect from the American experience which President Roosevelt conveyed to the Congress on the 7th September, 1942 in these words, "Our experience has proved that a general control of prices is possible only if the control is all-inclusive. Our entire effort to hold the cost of living at the present level is now being sapped and undermined by further increases in farm prices and wages and by the ever-increasing pressure of prices resulting from the rising purchasing power ..... It is impossible for the cost of living to be stabilised while farm prices continue to rise. It is impossible to keep any prices stable if wage rates continue to rise.... What is needed is overall stabilisation in prices, salaries, wages and

profits." Such a comprehensive scheme of economic controls depends for its successful enforcement and operation on the presence of organised systems of production and distribution and on the widest public approval and co-operation. Without such co-operation, the war-time economic system is like clay with lots of stones in it, refractory in parts and an intractable material on the whole. With such co-operation it becomes pliant and malleable and spontaneously responsive to control and regulation.[1]

Price movements and price control

The close interrelation of currency and prices and the role of price control as an anti-inflationary factor have been touched upon in the foregoing paragraphs. In view of the importance of the topic, some further treatment of it at this stage appears to be necessary.

Perhaps the most striking and in some ways the most far-reaching among the changes brought about by the war was the rise in prices. Prices did not indeed rise continuously or steadily; sharp advance in one period was followed by strong reverse in another, only to be followed again by a powerful and disconcerting upward thrust. An examination of the price index numbers—by which changes in general price level are usually measured—for every one of the first 67 months of war will hardly yield any significant results; it is, therefore, proposed to split up the whole of this period into shorter periods in order to bring out the broad movements of prices. Seven periods clearly stand out and the table on next page shows the magnitude and direction of price changes in each.

The initial spurt in prices which lasted well into the middle of January 1940 was largely speculative in character, being based on anticipations of intensified demand and reduced supplies. Partly it was due to real factors such as higher freight and insurance charges, depreciation of sterling (and therefore of the rupee) in relation to dollar, rise in the replacement cost of goods and expansion of currency.

The inevitable break from the high levels reached was initiated by the announcement of excess profits tax in the third week of January 1940 and assisted by the more determined regulation of prices by the Government. The low tempo of the war upto April 1940 had as

1. A brief discussion of the conditions necessary for the successful operation of economic controls will be found in my article on 'Limits of Economic Control' (*The Eastern Economists*, November 19, 1943).

Period	*Duration*	*Index numbers in the first and last month of the period*	*Maximum variation during the period in points*
I (4 months)	Sept. 1939—Dec., 1939	Calcutta (August 1939=100) .. 114–137 Economic Adviser's (Week ended with 19th August=100) .. 108–138	+23 +30
II (7 months)	Jan., 1940—July, 1940	Calcutta .. .. 130–114 Economic Adviser's .. 137–111	—16 —26
III (10 months)	August, 1940—May, 1941	Calcutta .. .. 115–130 Economic Adviser's .. 110–119	+15 +9
IV (11 months)	June, 1941—April 1942	Calcutta .. 137–157 Economic Adviser's .. 126–146	+20 +20
V (16 months)	May, 1942—August, 1943	Calcutta .. .. 169–345 Economic Adviser's .. 148–128	+176 +90
VI (9 months)	Sept., 1943—April, 1943	Calcutta .. .. 349–297 Economic Adviser's .. 241–236	—52 —5
VII (10 months)	May, 1944—March, 1945	Calcutta .. .. 292–306 Economic Adviser's .. 239–249	+14 +10

its concomitant low prices which dipped lower still after the fall of France and the consequent loss of important markets on the Continent.

In August 1940, recovery in prices started at a slow and sure pace and grew quicker and more definite during the next twenty-one months. Behind it was the influence of a combination of factors, the major ones among them being the large purchases of the British Government, the growing physical shortage of some goods, increasing shipping difficulties, hoarding and profiteering, rising money incomes and the rise in cloth prices resulting from the hostilities with Japan.

After May 1942, prices registered an enormous rise which originating largely from the heavy expansion of currency was aggravated by the wild orgy of speculation in the commodity markets. Difficulties of internal transport and reduced imports contributed to the increasing complexity and gravity of the price situation. Some abatement in the speed of currency expansion as well as rise in prices was noticed when the Government brought into operation after May 1943, a series of new controls on the production, sale, and movement of goods.

After September 1943 and right upto April 1944, prices recorded a more or less continuous decline. During this period, economic controls were tightened all round and a serious effort was made to remove the loopholes and laxities in the system of price control.

After May 1944, the prices became more or less steady, with a slight upward tendency for most of the time. The intensification of anti-inflationary measures such as borrowing and the continuous drive for better procurement and distribution of foodgrains and better distribution of cloth contributed towards the improvement in price situation.

Movements of price during this recent war furnish a striking and instructive contrast with those during the first world war. (See table below). Price rise was on a smaller scale and was spread more evenly during the first world war. A close parallel movement of prices during the two wars was, however, hardly to be expected in view of the differences in the character of the two wars, in the sequence and intensity of their varied phases and in the impact made by them on Indian economy.

Prices during the two wars

(*Calcutta Index Number of prices*)

July 1914=August, 1939=100

	1st war year		*2nd war year*		*3rd war year*		*4th war year*		*5th war year*	
Months	*Last*	*Present*	*Last*	*Present*	*Last*	*Present*	*Last*	*Present*	*Last*	*Present*
I.	104	114	113	119	126	149	142	198	190	349
II.	100	118	114	121	128	151	143	209	197	334
III.	102	131	114	122	132	157	154	227	190	314
IV.	104	137	116	120	140	154	171	238	183	301
V.	106	130	116	121	144	155	168	250	188	297
VI.	110	126	124	119	142	153	168	253		300
VII.	112	121	122	123	141	152	177	272		300
VIII.	108	121	123	127	143	157	176	293		297
IX.	108	117	122	130	137	169	170	325		292
X.	110	114	128	137	145	182	173	319		300
XI.	111	114	127	150	137	182	172	345		299
XII.	112	115	125	151	142	192	178	332		298

The various components of the general price level did not show any uniformity of movement. Some items showed larger rise than others. In view of the acute food situation in the country, the course of food prices was of special interest. In the table below, index numbers of food prices have been set against the general index number. The course of prices of non-food articles can be roughly deduced from the disparate movements of the two sets of index numbers. Food prices, it will be noticed, rose much less than non-food prices up to the end of 1942 but in subsequent months right up to September 1943 completely outpaced them.

Food Prices

(Quotations for the last week of each month).

		Calcutta (*July* 1914=100)			*Bombay* (*July* 1913=100)		*Economic adviser's* *Week ended 19th August*=100)	
		Cereals (8 *items*)	*Pulses* (6 *items*)	*General*	*All Food* (*More than* 15 *items.*)	*General*	*Food and tobacco* (8 *items*).	*General*
Sept.	1939	93	105	114	118	120	111	113
Dec.	1939	105	119	137	132	135	127	138
July	1940	97	100	114	115	115	106	112
June	1941	114	99	137	108	127	115	130
May	1942	126	127	169	153	203	145	150
Dec.	1942	250	241	238	226	266	181	186
March	1943	334	309	272	222	256	271	220
Sept.	1943	530	450	349	252	244	311	241
Jan.	1944	234	234	297	*Discontinued*		286	237
April	1944	243	319	297			271	236
May	1944	241	296	292			272	239
March	1945	240	269	306			274	249

Another notable wartime development affecting prices was the disruption of those processes by which the prices of the various commodities in different provinces and parts of the country were brought to a more or less uniform level after allowing for cost of transport and small variations due to certain local factors affecting demand and supply. Prohibitions of, or restrictions on, the movements of good simposed by the Provinces and States along with difficulties of transport led to wide divergences in the magnitude as well as the

speed of the rise in the prices of the same commodity in different Provinces and States. Free mobility of goods which integrates and unifies the market in normal times having been greatly hampered, the Indian market presented the appearance of a loose and disjointed series of narrower markets. The resulting price differentials often encouraged hoarding, corruption and profiteering.

During the larger part of the years 1942 and 1943, many sections of the population found themselves exposed to the increasingly heavy pressure of growing scarcity and want. Scarcity manifested itself as a double-barelled problem of physical shortage and high prices involved the most painful reductions in the daily consumption of persons with small and fixed means. In this atmosphere of unabating hardship, criticism of the policy and measures adopted by the Government naturally turned more and more bitter and destructive. What had the Government been doing, it was asked, to impede the sharp advance of prices and why did they fail?

It is hardly necessary to go into all the measures taken by the Government to control prices of various commodities. Nor is it necessary to refer except in passing to the machinery set up for price control. The main feature of this machinery was that the Government of India acted as the co-ordinating authority controlling prices at the producer's and wholesale stage while the Provincial Governments controlled them at the retail stage. The Central Government called from time to time Price Control Conferences to examine the situation and assist in the formulation of schemes and measures of price control. These Conferences—and six of them were held in October, 1939, January 1940, October 1941, February 1942, April 1942 and September 1942—were attended by the representatives of three chief units of administration, namely, the Central Government, the Provincial Governments and the Indian States. The Provincial Governments and some of the States carried out the measures of control through the agency of Controllers of Prices functioning at the headquarters and the executive officers in the districts and local areas. Price Advisory Committees were set up in several provinces and States to assist both Price Controllers and local officials. In addition to Price Control Conferences, five Food Conferences were also held after October 1942 to tackle the problems of the production and prices of food. In December 1942, a

separate Food Department was set up at the Centre under the charge of the Commerce Member; in August 1943, one of the members of the Viceroy's Executive Council was appointed Food Member and the Department passed under his charge. Non-official and expert opinion was made available to the Department through the Food Advisory Council and its special committees. In July 1943, the Government appointed the Foodgrains Policy Committee to examine the past policy and the existing position in India in relation to the supply, distribution and prices of foodgrains, and to make recommendations. The report of the Committee was published in November 1943 and the recommendations and conclusions embodied in it were made the basis of the subsequent food policy of the Government.

A bare summary of the measures taken during the war to control prices should suffice to delineate the evolution of price control in this country. As soon as prices began to soar after the outbreak of the war, powers taken by the Government of India under the Defence of India Rules to control prices belonging to the category of necessaries were delegated by them to the Provincial Governments by Notification No. 20 of 8th September, 1939. The motive behind this first application of price control was the protection of the consumer against profiteering. Towards the end of September 1939, the replacement cost of goods, *i.e.* the cost at which the producer or importer could produce or replace his stock of goods along with a minimum margin of 10 per cent above pre-war prices was made the standard with reference to which the maximum prices were to be fixed. Later in May 1940, the requirement as to a minimum margin of 10 per cent compared with pre-war prices was abandoned, for it was felt that the pre-war prices did not furnish any longer a proper standard for comparison and that prices should be fixed with reference to costs after determining the latter by a careful scrutiny. Most Provinces, therefore, began to publish fair price lists of wholesale and retail prices for the information of the public. Hoarding, refusing to sell and profiteering were all made punishable under the Defence of India Rules.

On the whole it would be correct to say that until July 1941, the problem of price control did not assume any acute shape. This was largely because the general level of prices, after an initial rise,

began to decline and though there was again a steady rise from June 1940 or June 1941, it was so gradual that it was easily acquiesced in as the inevitable resultant of a number of wartime factors such as increased war demand for certain commodities, restricted supply in certain cases, increased cost of imported materials, transport difficulties, etc. Moreover, some rise in prices was even welcomed as an overdue measure of relief to the agriculturist. After July 1941, however, prices of various commodities including essential foodstuffs and textiles began to rise sharply. In December 1941, the maximum price for wheat was fixed at Rs. 4/6 (Lyallpur and Hapur) and was revised upwards to Rs. 5 in March, 1942. The price of sugar was also brought under control in May 1942. A distressing development arising from the enforcement of these and other controls over prices was the transfer of the controlled commodities to the black markets, creating acute shortages in the ordinary markets. The control over wheat was lifted on the 25th January, 1943 and immediately stocks of wheat flowed into the markets in response to the higher uncontrolled prices. But in spite of the alternation of control and decontrol and in spite of the stern though sporadic action taken against hoarders the scarcity of food steadily grew worse and prices soared until in August 1943 scores of deaths by starvation occurred in the streets of Calcutta and revealed the gravity of the situation with painful vividness. The hard core of official complacence then began to melt and the next few months witnessed a determined drive to roll back the centrifugal forces by a series of Ordinances, directions and instructions issued by the Central Government. The first effective step in securing control over the prices of cloth was taken by passing the Cotton Cloth and Yarn(Control)Order in June 1943 and control was tightened further by appointing a Textile Commissioner who was assisted by a Textile Control Board consisting of the representatives of textile industry, raw cotton, labour, cloth trade and the consumer. The Hoarding and Profiteering Prevention Ordinance was promulgated in October 1943 to herald the first comprehensive and serious effort to deal with the chronic evil of price ballooning by traders and profiteers. During 1944, statutory price control was instituted for wheat, gram, barley, bajra, jowar and maize. As regards rice, an all-India statutory price was not fixed but the Provincial Governments themselves imposed statutory maxima on rice prices. In July 1944 the Consumer Goods (Control of Distribution) Order was issued with the object of regulating supplies,

distribution and prices of consumer goods including imported commodities.

Though the measures taken towards the end of 1943 as also the growing confidence in the prospects of Allied victory eased in some measure the price situation, checking the rise of some prices and securing decline in others, yet on a complete and comprehensive review of the whole position since the outbreak of war, it would be correct to maintain that wartime price control was a dismal failure in India. It was week, vacillating and half-hearted and its failure was inherent in its very character. Any enumeration of all the reasons for its failure would soon run into a long list but the more important reasons could be brought under the following five heads: an imperfect understanding of the principle of price control; tardiness in evolving an effective administrative machinery; lack of proper co-ordination even in such machinery as was set up; the limits to control set up by the distinctive organization of Indian economy and, finally, the uncongenial political, psychological and monetary set-up of Indian war economy. A brief study of these may suggest some useful lines of thought and action for the future.

It would be hardly necessary to enter upon the definition of price control here if the whole approach to the subject did not seem to depend largely on it. Price control, ordinarily understood as a body of measures to fix prices backed by the coercive apparatus of the Government, must really be defined as *the removal of the control of prices over the different sectors of a country's economy.* Now it is widely recognised that prices, which are themselves the external manifestation of numerous forces working within the economic system, exercise a profound control over a country's economy as allocators of productive resources among different uses and as regulators of production, consumption and distribution. But what is perhaps not so well appreciated is the fact that price control involves precisely the removal of this control by prices and its replacement by control of a different kind. In other words, the price controlling authority must neutralize or 'sterilize' the price mechanism by reaching down to those forces that form prices themselves and bringing them under control. Only after a fairly long record of failure was it realized in India that 'controls over supplies and distribution are essential and vital corollaries of price control.' The importance of control over the monetary factor also took some time to leap to the eye. On the

other hand, suppression of profiteering and hoarding and control of speculation were relied upon as the main props of price control from the very beginning.

Nor was the rationale of price control always clearly present to all minds. While putting down of the middle-man profiteer was recognised as a legitimate and essential objective of price control, the agricultural interests in some Provinces looked askance at the fixation of agricultural prices as a kind of deprivation and the consumers faced with acute shortage of the commodities under control often failed to find any particular merit in price control. In all this confusion, the vital issue seemed to be overlooked that removal of price control means the restoration of the control of prices over economic activity and that this removal was opposed to the whole logic of war economy; for war economy by its very nature is an economy consciously planned and directed by the State to achieve a single unified objective, *i.e.*, victory, and obviously a controlled economy and uncontrolled prices go ill together.

This imperfect insight into the forces at work was, of course, not a little due to the absence of any accumulated body of experience and knowledge handed down from the past. There was, therefore, bound to be a certain amount of feeling of the way and groping about. But the changes in price situation after the outbreak of war were themselves of such a nature as to induce at first complacency and relaxation of effort and then to demand, with the crack of a whip, as it were, swift and resolute action. It is obvious that the best period for framing plans and formulating procedure for price control was from January 1940 to October 1941, when the price situation was easier and inexorable events did not press for hasty and improvised solutions. It is interesting to observe that this was also the period falling between the second and third Price Control Conferences. As a matter of fact, every worsening of the price situation in India was marked by the calling of a Price Control Conference and the history of price control may be said to be very largely the history of decisions taken by the Conferences and the subsequent action of the Central and Provincial Governments on them. There was no single comprehensive and co-ordinated plan drawn up and enforced with the co-operation of the public to meet a situation of grave difficulty both for the Government and the people. On the other hand, centrifugal

forces were allowed to have their sway and more latitude than was warranted by the facts of prevailing situation was allowed to the Provinces, States and even districts in controlling prices and trans-frontier movements of foodgrains.[1] Furthermore, programmes for the acceleration of production and regulation of consumption were pondered over and laboured until the storm was on the country. Quick changes continued to be rung in the composition of the Viceroy's Executive Council and the responsibility for feeding the country passed from one member to another like a shifty shuttlecock, telling visibly on the firmness and continuity of policy.

A successful policy of price control presupposes not only an effective machinery of price control but also a clear conception of fair price and the establishment of suitable parities between different groups of prices. Furthermore, it requires the determination of the number and range of prices that will be brought under control. In any economy subject to the change and flux of the dynamic conditions of war, the determination of fair prices is bound to be a difficult task but in India it was not squarely faced. A systematic machinery for investigation into the farmer's costs or the parities between different sets of prices—those, for example, of food articles and non-food articles; of raw materials and manufactured goods; of prices in one area and another area—was conspicuous by its absence. The unfortunate consequence of it was that when the prices of articles not subject to control moved upwards, they tore asunder the ceilings or maxima imposed by the controlling authority on the prices of other articles. Perhaps nowhere was it more evident than in the case of control over prices of foodgrains like wheat without a corresponding control over prices of minor foodgrains or those of goods consumed by the cultivator. The question whether price control should be comprehensive (*i.e.* a blanket control) or selective was also not finally answered in this country. The logic of control leads, of course, to an ever widening extension of its scope—from the price of one article to that of its substitutes and satellites, from the price of a manufactured commodity to that of the raw materials entering into its composition and from the prices of goods in general to the prices of the services of factors of production, *i.e.*, wages,

1. Towards the last quarter of 1943, however, there was a significant reversal of policy and the Central Government by bold self-assertion was able to make the Provincial Governments agree to a uniform policy in the matter of price control and rationing.

rent, interest and profits—until it covers every price in the whole national pattern. But the administrative difficulties of such a control would have been formidable. Nor are all prices which make up the price system equally important. There are some prices which have a strategic value in the sense that they exercise a decisive pull on the whole price system, for example, prices of foodgrains, wages and rents, and these cannot be left out of the scope of any well-conceived price control scheme. Moreover, a comprehensive control of all prices in India had a greater chance of success if it had been applied at an early stage when prices had not had a chance of raising one another by mutual stimulation. But at a late stage and particularly with an expanding currency circulation constantly blowing up the 'blanket', it could not but transgress the bounds of an administrator's legitimate ambition. Related to this blanket *versus* selective price control issue but pertaining particularly to foodgrains was the statutory *versus* ceiling price issue. In respect of the major foodgrains, the verdict of the majority of the Foodgrains Policy Committee went in favour of statutory price control.[1] The statutory price control, according to the Committee, "takes the form of enacting legislation prohibiting a seller from taking, or a buyer from offering more than a given amount, or of legislation prohibiting a buyer from offering or a seller from taking *less* than a certain amount." The system of ceiling price, on the other hand, "is a form of market manipulation, in which the Government abstains from purchasing when the price touches a certain figure in the hope that its purchases are such a large proportion of the total that the price will fall below the ceiling limit". Now both statutory and ceiling control require certain conditions to be fulfilled if they are to be effective. Neither of them can be made effective if the fundamental forces of supply and demand are not brought under control. Statutory control has the merit of fixing a definite price and thereby discouraging the tendency on the part of producer or seller to withhold stocks in the expectation of a future rise. Two objections could be raised against it: firstly, its failure in the case of wheat prejudiced its case and, secondly, it could not be made effective without an effective control over supply. These objections did not very much damage the case for statutory control because it was possible to steer clear of the mistakes made in the past by instituting an efficient machinery for the procurement

1. Report of the Foodgrains Policy Committee, 1943, p. 85.

of foodgrains, controlling simultaneously the prices of a number of foodgrains as also those of non- food articles, controlling the movements of foodgrains, taking deterrent measures against the hoarders, setting up government reserves of foodgrains and finally by vesting in the Central Government the right to suggest levels at which prices should be fixed and the changes that should be made in them[1]. The ceiling system has no doubt the advantages of not being rigid and not bringing the law into contempt through its failure but one essential condition for its success is governmental possession of, or control over, a very large part of the total supply and this could not be easily satisfied in India.

Given a proper comprehension of the principle of price control, an efficient administrative machinery and a suitable co-ordination of price parities, an effective system of price control was not impossible of achievement in India. But it was necessary to recognise some of the limitations and difficulties of the task in this country. Some of these were such as could not be easily overcome but others were amendable to remedial treatment. The large size of the country, the small, individualistic and unorganised character of production and trade agencies and the very large number of small agricultural producers whose operations are not easy to bring under control set definite limits to the achievements of price control in India. The difficulties were more or less basic but there were others which arose largely during the war. Among these, the foremost was, of course, the large and continuous expansion of currency. Price control like other forms of economic control is no doubt itself an anti-inflationary factor but without monetary control no control over prices can be sustained for long[2]. It is well known that beyond a certain stage inflationary expansion of currency creates a vicious spiral of rising prices which feed on themselves and against which price control

1. The Foodgrains Policy Committee recommended the appointment of a small Standing Prices Committee, representative of the Centre, the Provinces and States, agriculturists and trade to review periodically the price situation and suggest changes in prices. The recommendation was given effect to by setting up a Price Advisory Committee.

2. Dishoarding and dissaving by certain classes of persons during war-time has also been mentioned as a price-raising factor (*Cf.* V.K.R.V. Rao: *War and Indian Economy*, p. 168). It is difficult to assess the magnitude or effect of this factor but it must have been comparatively a very small factor in the total situation.

provides no effective check.[1] Difficulties of transport were another factor in the situation but their general effect was to create local shortages—of *some* commodities in *some* areas—and cause a rise in their prices. Again speculation complex with which the markets were periodically seized accelerated the upsurge of prices. And finally and above all, the political situation in the country was not helpful to the spread of that popular enthusiasm and the willingness to view things from a larger standpoint which makes measures of governmental control less of an unwanted imposition and more of an acceptable war-time necessity.

§5 Public Confidence and the Currency System

The outbreak of the last war did not cause any *immediate* panic or loss of confidence in the paper currency such as was witnessed in the early months of the first world war. The earliest reaction of the war on the Indian currency system was in fact a large and unprecedented absorption of currency notes.

After the first four months of war, however, a demand for rupee coin for purpose of hoarding arose. It is likely that there was some infiltration of rupee coin into private hoards occurring even during these four months; for the trend towards a large and almost continuous return of rupee coin from circulation which had gone on since 1920–21, had been reversed as soon as the war broke out and a steady outflow of rupees had ensued. But it was towards the last week of May 1940 when the news of French reverses were received that the craze for hoarding was accentuated and turned in subsequent months into a scramble. From the 15th June to the end of August 1940, Rs. 21.93 crores of notes were returned to the Reserve Bank. Between 1st September, 1939 and 21st June, 1940, the holding of rupee coin in the Issue Department of Reserve Bank fell from Rs. 57.87 crores to Rs. 35.1 crores.

To deal with the situation thus arising, the Government of India made it an offence by a notification of the 25th June, 1940 for any person to acquire rupee coin in excess of his personal or business requirements. This notification, while it succeeded in its objective of reducing the total demand for conversion of notes, intensified the

1. In the Indian Economic Conference held at Madras in December 1943, it was mentioned by Mr. S.K. Rudra, Secretary and Economic Advisor to U.P. Government, that in some *mandis* of U.P., the prices of the same article varied according to the media of payment used, being higher for currency notes and lower for rupee or small coin.

demand for smaller coin. This necessitated the adoption of special measures. The issue of small coins was limited in both Bombay and Calcutta and in Bombay small change depots were opened to cope with the rush for small coin.

The situation was greatly eased by the introduction of the Government of India one-rupee notes by an Ordinance issued on the 20th July, 1940. The notes were to be current in the same manner and to the same extent and as fully as the silver rupee coin. To begin with, one-rupee notes which had been printed in 1935 to meet a possible contingency but had not been used were put into circulation. Later in the first week of July 1941, a new issue of the Government of India one-rupee notes printed in larger size and on better quality paper was made. In February 1943, bank notes of the denomination of Rs. 2 were also issued by the Reserve Bank of India.

Besides the issue of one-rupee notes, other measures were also taken to deal with the situation. First of all, the fineness of the silver half-rupee was reduced from 11/12 to 1/2 by an Ordinance issued on the 26th July, 1940. By another Ordinance of 23rd December, 1940, the fineness of the rupees coin was similarly reduced from 11/12th to 1/2.

A second measure was the recall of old coins from circulation. By an Ordinance promulgated on the 11th October, 1940, all victoria rupee and half-rupee coins were required to be returned by 1st April, 1941. It was decided later on to withdraw King Edward VII rupees and half-rupees from circulation and by a notification issued on the 4th November, 1941, these coins ceased to be legal tender after the 31st May, 1942 (although they could be accepted until the 30th September 1942 at Government treasuries, post offices and railway stations and thereafter, until further notice, only at the offices of the Reserve Bank). On 1st October, 1942, another Notification was issued by the Government of India calling in with effect from 1st May, 1943 all George V and George VI rupees and half-rupee coins of 11/12ths fineness. By two subsequent notifications of the 16th November, 1942, Queen Victoria and King Edward VII standard rupees and half-rupees were declared to cease to be legal tender even at the offices of the Reserve Bank from the 1st May, 1943 and George V and George VI standard rupees and half-rupees were to cease to be legal tender at the offices of the Reserve Bank with

effect from 1st November, 1943.[1] Thus practically the whole of the silver rupee and half-rupee coin with the exception of the new quaternary silver coin was demonetised.

A third measure which was directed to deal with the increased demand for small coin was the issue in January 1942 of a new half-anna coin of square shape and rounded corners and made in nickel-brass alloy. Similar alteration in the metallic contents of one-anna and two-anna pieces was also made also made and the new one-anna and two-anna pieces were issued from the Bombay Mint on the 7th March and 27th March respectively. In January 1943, when the disappearance of copper pice from circulation due to a rise in its intrinsic value to the level of face value had begun to cause considerable discomfort, a new pice, less than half in weight, having a smaller diameter and a circular hole in the centre and of lower fineness was minted. The new pice was issued from 1st February, 1943 but owing to the unusual non-monetary uses to which it was put, its issue did not prove very helpful in improving the situation.

A perturbing development in the currency situation was the manifestation of an acute shortage of small coin in the months of October and November 1942, which caused great inconvenience to the public in making small payments. After the war broke out, the absorption of small coin went on at a rapid rate but the rate became almost phenomenal in the first half of 1942-43. The total amount of small coin (excluding half-rupees) absorbed since the out-break of war upto the end of 1942-43 was Rs. 15.6 crores of which Rs. 3¼ crores were absorbed in the first half of 1942-43 and another Rs. 4½ crores in the latter half. A *communique* of the Government of India issued on the 27th November, 1942 attributed the prevailing scarcity of small coin to hoarding, though it was recognised that a part of the increased demand for small coin had been due to the increased economic activity in the country, the acceleration of public works and the large disbursements to the military forces maintained in India. But even hoarding, as was pointed out, can be of two types, one prompted by fear and the other motivated by a desire to make profit. The main contributory factor according to the Government of India

1. The total amount of silver coin including half-rupees, quarter-rupees and one-eight rupees withdrawn from circulation during 1939-46 aggregated nearly 94 crores of rupees.

to the prevailing scarcity of coin was hoarding for profit, either with a view to selling small coin at a premium or, as in the case of pice, in anticipation of a rise in the price of metal to a level which might make coin-melting profitable. This kind of speculative hoarding could be discouraged only by public vigilance and co-operation between the Government and the people to expose the activities of the profiteers. The remedy for the other and the less vicious type of hoarding, that is the one promoted by fear, was the restoration of public confidence in the small coin position as a whole and in the Government's capacity to meet all reasonable small coin requirements. The magnitude of the Government's effort in this direction can be estimated from the fact that by December 1942, the Government mints were turning out small coin at the rate of 72 million pieces a month and in the month of August 1944 touched the peak level of 219 million pieces as against a monthly average of 16 million only in August 1939. The output however, declined thereafter and stood at 199 million in March 1945. From October 1943, the mint at Lahore commenced operations and made a substantial contribution to the expansion of small coin output.

The small coin position improved in later years and though shortages of a local character did not completely dis-appear, they were even in mofussil areas much less acute than one or two years earlier. While the Government endeavoured to put down hoarding by making acquisition and possession of small coin in excess of personal or business requirements a penal offence, the people tried to make their own adjustments to the new situation by using improvised substitutes such as postage stamps and coupons and by varying the size of their purchases.

§6. Disposal of Sterling

Another development, besides the heavy currency circulation, which held far-reaching possibilities for the future was the large accumulation of sterling balances as a credit item in India's balance of payments. A part of the accumulated sterling was utilized for effecting repatriation of India's sterling debt but the disposal of the remainder continued to be a subject of acute discussion and anxious speculation.

Sterling accumulated in very large amounts with the Reserve Bank of India largely as the result of a favourable balance of trade

and the war purchases made by the British Government in the Indian market both of which were paid for in sterling in England. This led to the adoption of a large scale programme by the Government of India for the repatriation of India's sterling debt. It may not be supposed that repatriation (which simply means the substitution of rupee liabilities to residents for sterling liabilities to non-residents) commenced only after the war, for it had in fact begun to be effected some two years before the war. The amounts repatriated in the pre-war period were, however, small and the schemes under which they were repatriated were voluntary in character.[1] Even after the outbreak of the war, these schemes remained in operation for a year or so but after February 1941, two compulsory schemes were brought into operation and it is under these that almost the whole of the sterling debt of India was repatriated.

The total sterling debt of India inclusive of railway stocks, debentures and annuities was £ 356 million or Rs. 475 crores at the end of 1936–37. Of this £ 322.84 million were repatriated upto the end of March 1945 including £ 266.93 million of dated and undated sterling loans and £ 55.91 million of Railway Annuities and Railway Debenture Stock in the manner indicated in the following table:—

	Face Value (£ million)
Open Market Purchases ..	53.49
License Scheme of 22nd February, 1940 ..	2.02
Compulsory Schemes:	
First ..	74.83
Second ..	136.59
Funding of Railways Annuities ..	27.06
Repatriation of Railway Debenture Stock ..	28.85
TOTAL ..	322.34

Repatriation of sterling loans of the face value of over £ 260 million was carried out by three methods: (*i*) open market purchases of sterling (*ii*) the licence scheme and (*iii*) compulsory schemes. Under the open market purchases which commenced in 1937-38, were suspended in 1938–39 but resumed the next year, £ 53.49 million of debt were repatriated. The Reserve Bank was

1. "The sterling payment by the British Government and sterling purchases made by the Reserve Bank during war (upto March 1945) amounted in all to Rs. 1,936 crores of which Rs. 411 crores were utilised for repatriation schemes.

authorised under this system to purchase Indian sterling non-terminable securities in the open market out of its surplus sterling balances and to transfer the securities so purchased to the Government for cancellation. In their place additional rupee paper of 3½ per cent and 3 per cent non-terminable loans was created which was issued gradually by the Bank in accordance with the requirements of the market. The second method, *i.e.*, of license system was introduced on the 22nd February, 1940 and £2.02 million sterling were acquired under it. It consisted in offering the holders of sterling loans the option of converting their holdings into rupee securities. The rupee counterparts of six India terminable sterling loans were created and the holders of the loans were given the option of transferring their holdings from the books of the Bank of England to the Rupee registers of the Reserve Bank. The difference between the two methods, *i.e.*, the open market purchases and licence system consisted in this that while under the first method the securities were purchased for cash and the Reserve Bank had to use its sterling balances, under the second, the holders were given the option of conversion and, therefore, the use of sterling balances was not required. The third method of repatriation *i.e.*, of compulsory schemes, was used in February and December 1941 and £211.42 million of sterling debt was repatriated by this method upto the end of March 1945. Under the *first compulsory scheme* brought into effect from the 8th February, 1941, the British Treasury issued a vesting order on the 7th February, 1941 requiring all residents in the United Kingdom to surrender their holdings of India's sterling terminable loans at prices fixed on the basis of market price on the 7th February and the Government of India issued a notification to the same effect requiring residents in British India to surrender their holdings of these sterling loans, payments being offered in rupee counterparts or cash at the holder's option. The following loans were covered by the scheme: 5% 1942-47, 4½% 1950–55, 4½% 1958–68, 4½% 1948–53, 3½% 1954–59 and 3% 1949–52. The total amount of debt repatriated under this scheme upto the end of Macrh 1945 was £74.93 million. The *second compulsory scheme* which was announced on the 24th December, 1941 covered the following non-terminable sterling loans: 2½ per cent stock 1926, 3 per cent stock 1948 or after, and 3½ per cent stock 1931. Notice for the repayment of the 3½ per cent stock 1931 having a nominal value of £77 million was given to the holders and vesting orders were passed for the other two loans requiring their surrender and providing for the payment of purchase price

in the same manner as under the first compulsory scheme. Upto the end of March 1945, £136.59 million of these loans had been repaid.

Besides this repatriation of sterling loans extending over a period of more than five years, £ 55.91 million of sterling balances were also used to fund the sterling obligations in respect of Railway Annuities and to repatriate Railway Debenture Stocks.

Repatriation of sterling had a very marked effect on the composition of India's public debt, the sterling portion of the debt being very nearly wiped out and the rupee portion having more than doubled. The total sterling obligations were at the end of 1936–37 and 1944–45 Rs. 493 crores and Rs. 67 crores respectively, the corresponding figures for rupee obligations being Rs. 707 crores and Rs. 1781 crores.

The following table shows the changes in the composition of India's public debt:—

(*In crores of rupees*)

	1936–37	1938–39	1944–45 (*Revised*)	1945–46 (*Budget*)
In India:—				
Loans	437.33	437.87	1190.98	1484.3
Treasury Bills and Ways and Means Advances	28.54	46.30	86.61	86.61
Unfunded Debt	219.93	225.13	263.56	316.77
Deposits (Depreciation and (Reserve Fund)	20.82	27.34	240.17	255.17
Total obligations in India	706.62	736.64	1718.32	2142.98
In England:—				
Loans	400.96	396.50	13.48	13.42
War Contribution	22.29	20.62	20.32	20.62
Railway Annuities	53.15	47.82	29.45	26.01
Unfunded Debt	16.67	4.18	3.60	3.55
Total obligations in England..	493.07	469.12	67.15	63.60
Total Interest bearing Obligations	1199.69	1205.76	1848.47	2206.58

Process of the Finance of Repatriation of Sterling

There are two stages in the operations by which the repatriation of sterling has been financed. In the first stage, sterling was acquired from the Reserve Bank to pay off the holders of sterling stock and in the second stage, rupees had to be obtained to pay for the acquired sterling. The first stage presented no difficulty because the Reserve Bank had ample resources in sterling which were made available to the Government. The second stage, however, was more complex because of the difficulty of borrowing immediately large funds in the

Indian market. Operations of various kinds were used to cover this stage. To the extent to which the sterling loans were held by Indian investors, direct payment was made in the form of rupee counterparts. As regards the remainder of the loans, it was either taken over by the Reserve Bank in the form of counterparts or was met out of Government balances or financed by *ad hoc* Treasury Bills and Ways and Means advances from the Bank. A part of the rupee counterparts of the repatriated sterling stock was cancelled because it was considered to be in excess of the absorptive capacity of the Indian market. Cash payments on account of the cancelled counterparts were made almost entirely out of the proceeds of Defence Loans. Of the remaining counterparts, a very large amount was taken by the public in the form of existing loans. For the balance rupee resources were found from the Treasury Bills taken by the Reserve Bank, Ways and Means advances from the Bank, and Government balances. The amount of Treasury Bills sold to the Issue Department of the Reserve Bank and the Ways and Means advances taken from the Bank both increased greatly as a result of the financing of the repatriation operations.[1] A natural consequence of the operations was an increase in the rupee debt of the Government of India and in the rupee interest charges. The net result of the various repatriation operations at the end of 1944–45 was that sterling debt of the value of about Rs. 430 crores was repatriated, Rupee counterparts of the value of the Rs. 277 crores were created of which Rs. 200 crores were held by the public, Rs. 24 crores by the Reserve Bank of India and a little less than Rs. 3 crores by the Government[2]. A little less than Rs. 142 crores of debt was cancelled on repatriation and Rs. 50 crores of rupee counterparts were cancelled, bringing the consequent reduction in debt to Rs. 192 crores.

Critical Appraisal of Repatriation Operations

There is hardly any difference of opinion that the repatriation of sterling debt was a well-timed and successful operation and brought

1. To facilitate repatriation operations, the Reserve Bank of India Act was amended in 1941 so as to enable the Bank to hold three-fifth of the total assets in the Issue Department in the Government of India rupee securities. The provision in Section 33 (3) of the Act, that the amount of such securities cannot exceed one-fourth of the total amount of assets or fifty crores of rupee, whichever amount is greater, was waved.

2. Budget Speech, 1943, para 47, Also Report on Currency and Finance 1944–45, p. 69–71.

solid gains both to the United Kingdom and India. The gain to United Kingdom consisted in the release of sterling resources which could be mobilised by the British Government for investment in British war loans. The gain to India lay in the words of Sir J. Raisman, the ex-Finance Member of the Government of India "in the liquidation of external obligations which might prove an embarrassment in future and their replacement by internal debt." There was also a substantial but temporary gain to the Indian revenues in so far as the holders of sterling stock were paid out of the short term obligations contracted by the Government of India at low rates of interest. But the more important and permanent gain to Indian revenues accrued by the heavy reduction in, what are known as, the Home Charges. The virtual disappearance of these charges removed one of the complicating factors in the Indian currency system. Furthermore the Government of India had now to raise large rupee funds in India and this could impart the much needed strength to the Indian gilt-edged market which suffered in the past from a plentitude of resources and inadequate demand. Above all, the repatriation of sterling enabled India to pass at a stride, as it were, from the position of a debtor to that of a creditor country.

Some doubts were raised in the beginning about the effects which large scale repatriation transactions might have on the sterling reserves of the Reserve Bank and through them on the value of Indian currency and on the credit of the Government of India. Whatever validity these doubts might have had in the beginning, they had none when the Bank's assets came to consist of superabundant sterling. A more pertinent criticism of repatriation operations was that the Government failed to purchase sterling loans at the most favourable rates and thus made these operations unduly expensive. This, however, overlooks the fact that sterling loans could be purchased or paid off only when the Government of India had sufficient amounts of sterling at their disposal and these did not accumulate until some time after the war.[1] In any case, there does not appear to have been any wasteful negligence on the part of the Government in carrying through these operations.

1. For an illuminating argument on this point by Sir J. Raisman in reply to J.M. Mehta, *see Leg. Ass. Debates*, 1942, Vol. I, pp. 778–87.

CHAPTER XI

X. Period: September, 1945—March, 1951

POST-WAR DEVELOPMENTS

§1. The International Background

The war had left agriculture and industry of the European countries in a devastated state and the recovery in these countries, despite the Marshall Aid from the United States of America, was painfully slow[1]. In 1945 and 1946 some measure of deflation was widely anticipated and in some countries was actually experienced. There was indeed a transient fall in both real and money incomes in some countries. In the United States money income fell by 13 per cent between the second quarter of 1945 and the first of 1946; in the U. K. it was 3.5 per cent lower in 1946 than in 1945. The national income of Germany fell by more than half.

Although prices fell in some countries, the world price-level, on any reasonable interpretation of that elusive term, continued to rise slightly.

From the middle of 1946 to middle of 1948 both real and money incomes increased in almost every country. For this there were two main reasons:

(*a*) Physical process of reconversion from war to peace economy was nearing completion or was actually

1. Recovery was rendered all the more difficult by the emergence of two distinct political blocks in the world. The countries of Eastern Europe under the influence of U.S.S.R. refused to co-operate with the countries of Western Europe who, under the inspection of the United States of America joined together in a Union of Western Europe, drew up a programme of recovery and submitted a report to the Government of the United States of America giving details of their requirements of American aid for rehabilitating their economies and closing their trade gap for the period between 1948 and 1951. The whole programme of European recovery envisaged an aid of $17 billions to the 16 European nations and a grant of $5.3 billions was authorised by the United States Congress on 2nd April, 1948 for the year ending 31st March, 1949. The Marshall Aid was scheduled to come to an end by 1951, but recovery in Europe as indeed in many other countries like India was so slow that even by that year, the world did not return to normal conditions.

completed and the supply of goods and services began to expand.

(*b*) Everywhere there was eagerness as well as accumulated purchasing power to buy the increased supply of goods—capital goods to remedy the enormous depletion of the war years and consumer goods to repair war-time wastage and to indulge desires long repressed by the necessities of war and the claims of patriotism. In most countries, however, the increased eagerness to purchase consumer goods was more important in this phase than the pressure of capital re-equipment.

A recession of business activity and income took place from August, 1948 to August, 1949. The volume of notes in circulation and of bank deposits declined. A slight recession occurred in the U.S.A. which caused a serious fall in the volume of British exports to that market. The situation was aggravated by rumours of impending devaluation of the sterling and it led to some with-holding of purchases by American buyers in the British market in the expectation that after devaluation British goods would become cheaper in price.

Devaluation of sterling and several other currencies came in September, 1949 and its impact was felt especially from September, 1949 to June, 1950. The value of most of the important currencies of the world was reduced in relation to gold and the United States dollar. The course of world prices was sharply influenced by devaluation. Exports to the dollar area countries rose steeply while imports were curtailed by a policy of rigid control.

In June, 1950 the Korean War boom started and lasted upto May, 1951. The outbreak of war in Korea in June, 1950 made a marked impact on the world economy. Its economic effects were twofold; in the first place, it brought about a rapid, though short-lived, rise in commodity prices which was followed by the usual chain of consequences extending to the markets for finished products and labour; secondly, it led to decisions to rearm on a substantial scale in some of the principal countries of the world.

One of the biggest problems of the world in the years following the war was the emergence of inflationary pressures. The soaring price level coupled with rising costs without a proportionate increase in production was still the most important economic problem of

many countries in the world. The index number of wholesale prices in the United States of America which stood at 123 in 1945, rose sharply to 140 in 1946, 176 in 1947, 191 in 1948 and stood at 184 in March, 1949. In the United Kingdom also the rise was continuous, the index being 155 in 1945, 161 in 1946, 176 in 1947, 202 in 1948 and 203 in March, 1949. In Canada the index moved up from 122 at the end of the war to 181 in 1948 and 194 in 1949. One of the worst sufferers was France where the price index rose from 421 in 1945 to 1920 in 1948 and 2,100 in March, 1949. The worst year in regard to inflationary rise in prices in the case of all these countries was 1948.

Although the basic cause of inflation all the world over was the excess of effective demand over the available supply of goods and services, the pattern as well as the extent of inflation varied from country to country in accordance with the impact of national and international forces operating in each. In the United States, for example, the rise in the general price level was due to great demand for her goods both in the country as well as abroad, expansion of bank credit, speculative activity in the country and rise in wages. In the United Kingdom, increased costs of production including increased prices of coal and enhanced freight rates, reduction in imports with a view to closing the adverse balance of payments and large capital investments made by the government contributed to the inflationary pressure on prices. In countries of Western Europe, deficit budgets, acute shortage of consumer goods, political instability, unstable financial position, heavy adverse balance of payments and shortage of raw materials helped in the persistence of inflationary conditions.

Some decrease was noticed in the volume of notes in circulation in some important countries like United States, United Kingdom and Australia in the latter part of 1947 but on the whole the volume continued to be very large as is shown in the following table:—

NOTES IN CIRCULATION

	End of 1945	*End of* 1946	*End of* 1947	*Percentage Increase(+) or decrease (—) over* 1946
	In Millions			
United Kingdom £	1380	1422	1350	—5.1
Australia £ A	200	207	205	—1.0
Canada $ C	992	1031	1046	+1.5
New Zealand £ NZ	46.2	50.2	52.0	+3.6
United States $	27.2*	27.6	27.5*	—0.4
France Fr.	570*	722*	921*	+27.6

*in 1000 millions)

Thus apart from the deficit finance and other contributory causes mentioned above, the excessive supply of money continued to exert its pressure on the price level. Contrary to all expectations, prices did not fall and the world continued to experience one of the worst periods of inflation ever recorded in history.

But inflation was not the only headache of the world. There was a serious disequilibrium in the world trade relations. Countries of Europe, United Kingdom and other countries in the sterling area found it impossible to balance their balance of payments accounts particularly with the United States. There developed in 1947 a "dollar crisis" which for the time being was resolved in the case of Great Britain and countries of the Western Europe by European Recovery Programme aid from the United States. But the economies of these countries failed to show sufficient recovery and the aid that was received by them from America did not prove enough to bridge the gap between imports and exports. These countries were losing heavily their gold and dollar reserves in order to square their international account. Taking sterling area only, the gold and dollar reserves of this area at the end of March 1948 when the Marshall Aid plan was set in motion were £552 millions. They fell to £406 millions in June, 1949. The net deficit of Great Britain on dollar account was £226, £1024 and £423 millions respectively in 1946, 1947 and 1948. In the first half of 1949 the deficit was £239 millions. In the beginning of 1949, suggestions began to appear in the press that the pound sterling would have to be devalued in order to encourage exports and discourage imports. The British Chancellor of Exchequer repudiated categorically the reports that the British Government had any intention to devalue the pound. But this declaration was not taken seriously by any one and such leading journals as the London "Economist" suggested that despite her best efforts, Britain would not be able to maintain the existing value of the pound. The fact was that while the world continued to suffer from shortage of consumer goods, machinery and raw materials, prices in the United States were showing a downward trend in the early months of 1949. On the other hand, on account of the existence of inflationary conditions in other countries, prices and costs had remained high. The prices of British manufactures were much higher than those of American goods with the result that the British goods were being priced out

of the American market. The productive efficiency of the the United States of America in almost all lines stood much higher than that in any other country of the world. While the productive efficiency in other countries remained lower, their costs remained inflated on account of high wages, deficit budgets and shortage of raw materials and machinery. The United Kingdom as also Western European and sterling area countries were trying to meet the existing shortage of dollars by cutting down drastically their imports from dollar area and increasing their exports to it. But this accentuated inflationary conditions still further. Another suggestion being put forward was that a general devaluation of currencies vis-a-vis dollar be effected in order to encourage exports to dollar areas and discourage imports. But this step seemed to be of dubious value for achieving the objectives in view. A conference was held at Washington in 1949 to evolve a plan to resolve the "dollar crisis" of the sterling area. The conference resulted in further cuts in imports from the United States by these countries and in an increased aid from America to these countries. However, these steps did not restore the equilibrium nor did they resolve the crisis. What was needed was an increase in productivity in these countries and reduction in costs in order to enable the goods of these countries to compete freely with the American goods.

There was only one way to resolve the existing difficulties of the world. The political squabbles between the power blocks should have been stopped and expenditure on defence and armament ruthlessly cut down. Retrenchment in public expenditure at home, reduction in cost, increased production and additional financial aid from America to the war-devastated as well as economically undeveloped countries were the measures which were necessary to restore the world to its economic health. But the chances of taking these steps being remote conditions did not improve for a long time to come.

§2. International Monetary Agreements

One of the urgent tasks in the post-war period was to prevent currency chaos by placing the international monetary system on sound footing. In the earlier months of 1944, the British, American and Canadian monetary experts put forward their respective plans, outlining the administrative arrangements for operating an inter-

national monetary system. To understand the essential features of the proposals which arose out of the plans it is necessary to review briefly the events of inter-war years because the plans marked the culmination of a process of thinking and groping which had gone on for a long period.

Among the many changes brought about by the war of 1914-18 an important one was the suspension of gold standard by most of the countries. At the end of the war only a few countries such as the United States and Sweden adhered to gold and that, too, more in name than in effect. For over forty years gold had functioned as the common basis of currencies and provided to the world a reasonably stable measure of values as well as an integrated structure of prices and money incomes. Whether gold standard was wholly automatic in operation might be doubted but two advantages that were claimed for it by its supporters could not be denied even by its worst detractors. It prevented the perpetual interference with currency systems by governments acting under political pressure and it greatly facilitated the conduct of international commercial and financial relations. Besides, there was no satisfactory alternative to it in sight. The only feasible course in 1918, therefore, appeared to be to heave the currencies back to stability and anchor them to gold. This was by no means an easy task, for currencies broken loose from gold had greatly expanded and in some countries such as Germany, Austria and Hungary, expansion was growing into inflations of very serious dimensions bringing in its wake serious economic and social consequences. The period from 1919 to 1925 was, therefore, one of confusion, uncertainty and instability accompanied, of course, by international conferences (at Brussels in 1920 and Geneva in 1922) to formulate principles and procedures for currency reform and by policies and measures to give effect to them. The general objective of the measures of currency reform was the restoration of gold standard at preferably the pre-war parity. Lord (then Mr.) J.M. Keynes who advocated the adoption of a managed currency at the time found very few supporters even in his home country. In April 1925, Great Britain returned to gold standard at the pre-war parity and between 1925 and 1928, almost all the leading countries including France, Italy and Germany restored the gold basis of their currencies. The restored gold standard functioned upto 1931 when it again broke down.

Between the gold standard of 1915-31 and the pre-1914 gold standard there were important points of difference both in respect of internal structure as well as the external environment. A distinctive feature of the structure of the gold standard during 1925-31 was the considerable economy practised in the use of gold in various ways: by abandoning the use of gold coins, by fixing a reasonably large minimum for the amount of gold bullion which could be demanded in exchange for paper currency and adopting the system of keeping the whole or part of the gold reserves in the form of balances in foreign countries whose currencies were based on gold.[1] Another feature was the greater element of management or conscious control in contrast with the more automatic operation of the pre-war standard. Under the pre-war system, export and import of gold acted as automatic correctives to exchange fluctuations and to disequilibrated balances of payment by altering the relative price levels but under the restored gold standard gold exports were 'offset' and gold imports 'sterilized' so that the disequilibrium was not speedily corrected. The discount policy of the central banks, too, was not used in the same way as before the war to anticipate and prevent gold movements.[2] A further feature of the post-war gold standard was the complication introduced in its working by the short-term balances —'hot money' as they came to be called—held by a number of countries in other countries. Whenever confidence was shaken by political uncertainty or other causes, these balances were moved from one country to another, causing gold outflows and disturbing, even imperilling, the whole basis of currency and credit. Equally great was the complication caused by the adoption of exchange parities which either over-valued or under-valued the currencies of different countries and caused the greatest strain on their balances of payments. Moreover, the dominating position which London held before 1914 as the financial centre of the world was undermined after the first world war so that the excess and deficit balances on international account of different countries could not longer be cleared with the

1. But in spite of these economies, the view was held that reserve ratios of central banks were too high and that the world production of gold was not keeping pace with the demand for it. Moreover there was a maldistribution of gold creating scarcity in some countries. Cf Cassel's *Crisis in the World's Monetary System* 1932, also Gregory:. *The Gold Standard and its Future*, 1934 pp. 36-37.

2. Robbins: *The Great Depression*, (p. 28 et seq.). In U.S.A. complaint was made that the pound went off gold in 1931 with the Bank rate at not more than 4½ percent.

former facility or automatism. But, perhaps, even more important than these structural changes in gold standard was the wholly transformed environment in which it was to function. It was an environment highly charged with economic nationalism and characterised by an all-round rigidity of costs, prices and interest-bearing obligations. Gold standard, as is well known, is a symbol as well as an instrument of monetary internationalism and can hardly fit in with narrow nationalistic commercial and monetary policies. Nor does it fit in with a whole complex of valorisation schemes, monopoly price fixations, cartels, pools, trade union-controlled wages and inelastic governmental expenditure; for it demands a fair measure of flexibility in the matter of adjustments of domestic prices, wages and contractual obligations to the fixed norms of exchange.

It could not be expected that set in the context of such conditions the gold standard would function smoothly or effectively. It is possible, however, that it might have continued to function for some time after 1931 had the Great Depression which started in 1929 not released forces which hastened its downfall. The heavy fall in prices, particularly of agricultural commodities, put a heavy strain on the balances of payments of debtor countries and led to the intensification of trade and exchange restrictions culminating in defaults, moratoria, depreciation of currencies and abandonment of gold. These measures taken by the debtor countries had their inevitable repercussions on other countries and led to defensive action on their part. Great Britain who was finding her gold reserves running down due to withdrawal of short-term funds and was experiencing, with an over-valued pound, an adverse trend in her balance of payments sought relief by departing from gold standard on September 21, 1931. This became a signal for other countries to leave gold or devalue their currencies. A bloc of European countries comprising France, Belgium, Netherlands, Italy, Switzerland and Poland, however, decided to stick to gold standard. Germany also remained on gold though only in a nominal sense. Defections from the gold bloc began to take place from 1934 onwards and by the end of September 1936, the last fortresses of gold had surrendered. Taken as whole, the decade from 1929 to 1939 was characterised by a decided trend towards disintegration of international monetary relations and the growth of a network of nationally controlled and operated systems, devices and arrangements such

as exchange control, exchange clearing and stabilisation and equalisation funds.[1] That the statesmen and thinkers were not unaware of this trend or of its definitely depressing effects on trade and production was evident from the attempts that were made at intervals to find a basis for international monetary stabilisation.[2] Though no international agreement could be reached in this regard, monetary stability was attained over limited areas by setting up currency blocks (such as the sterling area) and by arriving at currency agreements among groups of countries.

From this brief review of the monetary developments of the two decades of inter-war period it would be clear that the smooth flow of economic operations is both a necessary condition and a natural result of a smoothly operating international monetary mechanism. The synchronisation of periods of rapid economic expansion with monetary stability and those of slow advance with monetary instability is not fortuitous. The tidal sweeps in the volume of business activity, the alternation of prosperity and depression, which lend to the economic system an appearance of chronic instability can be attributed very largely to monetary causes. Even when they are not so attributable, they may be found to be amenable to treatment by monetary remedies.

Reference may be made here to one fact of considerable significance. Even during the period of the suspension of gold standard, the economic and monetary thought (as reflected in the published works of major importance) was concentrated more on analysing and defining the conditions necessary for its restoration than on discovering a substitute for it.[3] Among these conditions were included the satisfactory settlement of war debts and reparation questions, the removal of the odious prohibitions, restrictions and restraints on international trade, the restoration of the automatic action of gold movements on price levels, continuous co-operation

1. Ropke gives a succinct analysis of this trend and its effects (Cf. his *International Economic Disintegration*, 1942, pp. 191-97).

2. For example, the World Monetary and Economic Conference held in London in June, 1933 had currency stabilisation as the chief item on its agenda and in 1936 the Tripartite Currency Agreements signed by U.S.A., France and England established de facto dollar-franc-pound exchange stability.

3. An alternative to gold standard—which implies both stable and free exchanges—was, of course, a regime of stable but *controlled* exchanges but the latter could hardly be called a substitute for the former.

among the central banks to lower their reserve ratios and for other matters of common concern, control over the movement of short-term foreign balances and also over the volume of foreign lending and a direct attack on the rigid elements in the national economic structures. The discovery of means by which the demands of internal wage, investment and employment policies could be harmonised with the fixed exchange rates of the gold standard was indeed considered one of the primary pre-requisites for going back to gold. Given these conditions, gold standard could be successfully re-established; without them, all talk of gold standard or, for that matter, of any international monetary system was fruitless. After all, the world could not have an international monetary system 'unless it showed itself deserving of it by manifesting a truly international spirit'.

Gold standard, whatever its shortcomings, had the merits, given certain conditions, of being international in character, impersonal in management and automatic in operation.[1] These minimum qualities had to be satisfied for any institutional arrangement that might be set up to take the place of the old gold standard. But there were a few more norms in terms of which such an arrangement had to be judged. For instance, it was expected to carry through smoothly the transition from war to peace. And when that had been accomplished, it had to provide a smooth and effective procedure for clearing international balances of payment, ensuring the unimpeded flow of capital to the less developed areas of the world and assisting in bringing about a steady and unbroken advance in the material standards of living all over the world. Furthermore, it had to be neutral between creditors and debtors, was not to be linked too closely to gold and was not to hamper, by imposing uniform rates of economic advance, rapid economic progress of the less developed areas of the world.

Returning from this brief review of the working of the international monetary system until the outbreak of the war to the British, American and Canadian currency plans put forward in 1944,

1. One of the obvious shortcomings in the mechanism of the gold standard was that if gold-receiving country began to 'sterilize' gold, the automatic check to gold inflow did not operate so that the gold-losing country went on losing gold until it rescued itself from the disaster of failing prices, shrinking money incomes and growing unemployment by going off gold.

it may be pointed out that the plans are now only of historical interest because they were superseded by the proposals formulated by the United Nations Monetary and Financial Conference held at Brettonwoods in July, 1944. All the three plans had a basic similarity in their aims and objectives in that they sought to establish an international monetary mechanism which would secure exchange stability, assist in the development of international trade and allow sufficient scope to the countries to carry out policies for attaining a high level of employment and incomes. They were discussed by the technical experts of thirty-four nations and a new scheme—called the International Monetary Fund Scheme—was put forward in April, 1944. This scheme was placed before the Brettonwoods Conference for approval. Forty-four nations participated in the deliberations of the conference through their delegations of varied size and composition, the American, British, Russian, Chinese and Indian delegations being headed, respectively by Henry Morgenthau Junior, Secretary of the Treasury, the late Lord Keynes, Director, Bank of England, M.S. Stepanov, Deputy People's Commissar for foreign trade, Hsiang-Hsi Kung, Vice-President of Executive Yuan and Sir Jeremy Raisman, Member for Finance.

The proposals formulated at the Conference were embodied in the text of its Final Act and covered the agreements relating to the International Monetary Fund and the International Bank for Reconstruction and Development.

The International Monetary Fund

The Agreement to set up the International Monetary Fund came into force when it was signed on May 1, 1945 on behalf of Governments having sixty-five per cent of the total quotas.

Objectives and Purposes

The purposes of the Fund were to promote international monetary co-operation, facilitate the expansion and balanced growth of international trade, promote exchange stability, assist in the establishment of a multilateral system of payments, make available resources to member countries in order to enable them to correct maladjustments in their balances of payment and to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. The Fund was not

intended to provide facilities for relief or reconstruction or to deal with international indebtedness arising out of the war.

Membership, Quotas and Management

The original members of the Fund were those of the forty-four nations represented at the Brettonwoods Conference whose governments had accepted membership before 31st December, 1945. Governments of other countries were admitted to membership on such terms as the Fund prescribed. Any member could withdraw from the Fund at any time by giving a notice in writing and any member who persistently failed to fulfil his obligations might be asked to withdraw.

Each member country was assigned a quota which was subject to review and readjustment at intervals of five years and, with the consent of a member, even earlier. The subscription of each member was equal to its quota and was paid as follows: twenty-five per cent of the quota or ten per cent of net official holdings of gold and United States dollars (whichever is less) in gold and the remaining seventy-five per cent either wholly in the member's own currency or partly in currency and partly in securities. The quotas actually assigned to the United Nations represented at the Conference varied from 2750 million (United States) dollars for U.S.A. to 5 million dollars for Panama and Siberia. The first six countries came in the following order: U.S.A. (2750); U.K. (1300); U.S.S.R. (1200); China (550); France (450) and India (400).

The management of the Fund vests in a Board of Governors, Executive Directors, a Managing Director and a staff. The Board of Governors which is the custodian of all the powers of the Fund consists of one governor and one alternate appointed by each member. Except in specified cases, the decisions of the Fund are made by a majority of the votes cast. The Executive Directors to whom powers are delegated by the Board conduct the general operations of the Fund. They are not less than twelve of whom five are appointed, one by each of the five members having the largest quotas, and seven elected. The Managing Director who is neither a governor nor an executive director is selected by the Executive Directors and is the Chairman of the Directors with no right to vote except in case of an equal division. In appointing the staff, the Managing Director, consistently with the maintenance of efficiency has due regard to geographical distribution.

Determination and Variation of Exchange Parities

When the Fund started operations, it requested the members to communicate the par values of their currencies. If however, such values were considered unsatisfactory, the Fund in consultation with each member determined the par value of its currency. The par value of the currency of each member was expressed in terms of gold or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944. All dealings in foreign exchange and purchases of gold by the members were based on the par values and each member undertook to promote exchange stability and to avoid competitive exchange alterations.

Changes in par values were allowed only on a proposal made by a member and in consultation with the Fund. The Fund did not object to a proposed change if it did not exceed ten per cent of the initial par value. It might agree or object to a further change of 10 per cent or more of the initial par value but would make its attitude known to the member concerned within a definite period. No proposed change was allowed unless it was necessary to correct a fundamental disequilibrium and no such change was objected to because of the domestic social or political policies of the member proposing the change. Uniform proportionate changes in the par values of the currencies of all members might be made by the Fund by a majority vote.

Obligations in respect of Restrictive Exchange Practices

Except under certain specified conditions, no member was to impose restrictions on current payments without the approval of the Fund nor to engage in any discriminatory currency arrangements or multiple currency practices. The specified conditions under which exchange restrictions might be imposed or maintained are: (*i*) when the Fund's holdings of a member's currency become scarce (in which case other members may, in consultation with the Fund, temporarily impose limitations on the freedom of exchange operations in the scarce currency) and (*ii*) the post-war transitional period (during which the members may maintain and adapt to changing circumstances exchange restrictions). In both the cases the restrictions were to be relaxed and removed as rapidly as conditions permitted. Members were allowed to exercise such controls as were necessary to regulate international capital movements. They also

could impose restrictions on exchange transactions with non-members unless such restrictions were contrary to the purposes of the Fund.

Operations of the Fund

In entering into transactions with the Fund, each member acted through its Treasury, central bank, stabilization fund or other similar agency. The Fund sold the currency of a member country in exchange for another member currency or gold, subject however, to certain specified conditions which might be waived in particular cases. Of these conditions, the first related to scarce currencies. In this case, *i.e.*, when the Fund's holdings of a currency became scarce, the Fund made a formal declaration to that effect and proceeded to apportion the supply of scarce currency according to the relative needs of members. The second condition was that the Fund's holdings of the purchasing member's currency would not exceed two hundred per cent of its quota nor increase by more than twenty-five per cent of its quota during the period of twelve months preceding the date of purchase. The third condition was that the resources of the Fund would not be used in a manner contrary to the purposes of the Fund.

Any member may purchase the currency of another member by the sale of gold to the Fund. It may also re-purchase by tendering the gold to Fund any part of the Fund's holdings of its own currency in excess of its quota. At the end of each financial year of the Fund, a member has to use a specified part of its monetary reserves to re-purchase from the Fund the Fund's holdings of its own currency.

The Fund levies a graduated and steadily increasing charge on the average daily balances of a member's currency when these exceed the quota. All charges are generally payable in gold.

The resources of the Fund are not allowed to be used for meeting a large or sustained outflow of capital. Capital transactoins of a reasonable amount are, however, allowed when they are for ordinary commercial purposes. They are met out of a member's own resources of gold and foreign exchange.

In the event of a general scarcity of a particular currency arising, the Fund informs the members and issues a report on the causes of scarcity and the measures necessary to that end. It also takes steps

to replenish its holdings of that currency by raising a loan in that currency or by purchasing the currency in exchange for gold.

Arrangements during the Transitional Period

During the post-war transitional period, members were to maintain and adapt to changing circumstances restrictions on payments and transfers for current international transactions but they were to withdraw them as soon as the balance of payments got properly adjusted. Within three years of the commencement of its operations, the Fund was to report on restrictions still in force and five years after the commencement of operations, any member still retaining any restrictions was to consult the Fund as to their further retention. The Fund was also to represent to any member that conditions were favourable for the withdrawal of any particular restriction or for the general abandonment of restrictions. If it found any member persisting in maintaining restrictions which were inconsistent with its purposes, it was to declare such member ineligible to use the resources of the Fund.

The International Bank for Reconstruction and Development.

The Agreement to bring the International Bank for Reconstruction and Development into existence was to come into force when governments with minimum subscriptions of not less than 65 per cent of the total subscriptions decided to join but in no event before May, 1945.

Objectives and Purposes

The purposes of the Bank were to assist in the reconstruction and development of the territories of members by facilitating investment of capital for productive purposes, to promote private foreign investment by means of guarantees or participation in loans and other private investments, to supplement private investment by providing finance out of its own resources, to promote the long range balanced growth of international trade by encouraging international investment for the development of the productive resources of members, and to assist in the immediate post-war years in effecting a smooth transition from a war-time to a peacetime economy.

Membership, Capital and Management

The original members of the Bank were those members of the International Monetary Fund which accepted membership before

December 31, 1945. Other members of the Fund were admitted to membership on such terms as the Bank prescribed. Any member could withdraw from the Bank by giving a notice in writing and a member who failed to fulfil its obligations was to be suspended. A member who ceased to be a member of the International Monetary Fund (unless retained by three-fourth majority vote) automatically ceased after three months to be a member of the Bank.

The authorized capital stock of the Bank was $10,000,000,000 divided into 100,000 shares of $100,000 each which was to be available for subscription only by members. The capital stock could be increased by three-fourths majority vote. The subscriptions prescribed for the original members varied from 3175 million dollars in the case of the United States to 2 million dollars for Paraguay and the six countries with the largest subscriptions came in the following order: U.S.A. (3175), U. K. (1300), U.S.S.R. (1200), China (600), France (450) and India (400). Twenty per cent of the subscription of a member was to be paid and the remaining eighty per cent was subject to call by the Bank. Of the paid up capital, two per cent was payable in gold or United States dollars and the remaining eighteen per cent in the currency of the member. The capital subject to call was to be paid either in gold, United States dollars or in the currency required for the purpose for which call was made. Shares of the Bank were kept unencumbered by the Bank and were transferable only to the Bank.

The management of the Bank vests in a Board of Governors, Executive Directors, a President and staff. The Board of Governors which has all the powers of the Bank consists of one governor and one alternate appointed by each member. Except in specified cases, the decisions of the Bank are taken by a majority vote. The Executive Directors to whom powers are delegated by the Board conduct the general operations of the Bank Of the twelve Directors, five are appointed, one by each of the five members having the largest number of shares and seven are elected. The President who is not to be a Governor or an Executive Director or an alternate is selected by the Executive Directors and is the chairman of the Directors with no right to vote except in case of an equal division. He conducts under the direction of the Executive Directors the ordinary business of the Bank and in appointing the staff pays due regard to the

importance of recruiting personnel on as wide a geographical basis as possible.

An Advisory Council of not less than seven persons selected by the Board of Governors including representatives of banking, commercial, industrial, labour and agricultural interests was to be set up to advise the Bank on matters of general policy. A Loan Committee was to be appointed to study and report to the Bank on the suitability of particular projects for purposes of loans.

Loans and Guarantees

The Bank was to guarantee, participate in or make loans to any member, to any political sub-division of a member and to any business, industrial and agricultural enterprise in the territories of a member. Loans made or guaranteed were to be for the purposes of specific project of reconstruction or development. The Bank was to satisfy itself that the borrower was unable to obtain the loan in the market at reasonable conditions and that the borrower or the guarantor was in a position to meet its obligations under the loan. It was also to make arrangements to ensure that the proceeds of any loan were used only for the purposes for which the loan was granted. In determining the conditions and terms of loans made to those members whose metropolitan territories had suffered great devastation from enemy occupation or hostilities, the Bank was to pay special regard to lightening the financial burden and expediting the completion of such restoration and reconstruction.

Operations of the Bank

The Bank makes or facilitates loans of three kinds: (*i*) direct loans out of its own funds, (*ii*) direct loans out of funds raised in the market of a member or otherwise borrowed by the Bank and (*iii*) wholly or partly guaranteed loans made by private investors through the usual investment channels. Free-est possible conversion of currencies into one another is ensured for purposes of loans and in the case of direct loans *i.e.*, category (*i*) and (*ii*) above-made by the Bank, it furnishes, to the extent possible, the borrower with such currencies as are required for expenditures in connection with the loan. The terms and conditions of interest and a mortization payments, maturity and dates of payment or direct loans are determined by the Bank. In the case of guaranteed loans, the Bank charges a guarantee commission at a rate which the Bank determines and which

during the first ten years of the Bank's operations is to be not less than one per cent per annum and not more than one and a half per cent per annum.

The amount of commission received by the Bank in respect of direct and guaranteed loans is set aside as a special reserve which is used to meet the liabilities of the Bank in cases of default on loans. The reserve furnishes the first line of defence in cases of default; other reserves, the surplus and the unpaid capital provide the second.

The Bank has the power to buy and sell securities which it has issued or guaranteed or invested in, to guarantee securities in which it has invested, to borrow the currency of any member with the approval of that member and to buy and sell other suitable securities in order to secure investment of the special reserve accumulated out of commissions.

In their decisions, the Bank and its officers are to be guided only by economic considerations. They are not to be influenced by the political character of the members nor to interfere in the political affairs of any member.

An Examination of the Agreements

The Brettonwoods Agreements had the most un-exceptionable objective of providing both an international code of monetary conduct and a machinery for consultation and adjustment of monetary relations among nations. They not only offered a way out of the chaos created by the narrow antarchistic policies which the nations adopted especially during and after the Great Depression of 1929-33 but were intended to provide something of a substitute for the gold standard which was found so unworkable in the inter-war years. Unless the nations wished to revert to the utterly unsatisfactory arrangements instituted during the thirties, they had to accept an essential international framework of the type embodied in the Agreements. A measure of monetary integration on the international scale was the only alternative to complete monetary disintegration.

In the existing temper of nations, even the ensuring of a certain guaranteed minimum of international monetary co-operation was a definite achievement. For there was a strong disposition to view every act of international co-operation primarily from a national

angle and to beat a hasty retreat from all international commitments which seemed to restrict unduly the area of national freedom. Each nation wished to retain for itself a large elbow-room for its domestic economic and financial policies. The Agreement relating to the International Monetary Fund has given due recognition to this fact by attempting a compromise between international co-operation and national freedom of action. While on the one hand, it permits the enjoyment of benefits of the Fund only to those members who accept certain obligations including the obligation of consulting the Fund and abiding by its decisions, it also allows them considerable latitude in the matter of fixation of initial par value of currency, exchange variation, exchange restrictions and pursuit of domestic, social or political policies.

The functions and spheres of the International Monetary Fund and of the International Bank for Reconstruction and Development are distinct but complementary. While the Fund helps the nations in tiding over temporary deficits in the balance of payments by extending to them short-term credits, the Bank assists in the more permanent tasks of reconstruction and long range development by granting or assisting in raising long term credits. The Fund by ensuring stability of exchages and abandonment of restrictive exchange practices, helps in opening up the channels of international investment and the Bank by stimulating the economic development of nations and the expansion of international trade reduces the necessity of short-term credits. It is worth noticing that no nation can utilize the machinery of the Bank unless it accepts the membership of the Fund.

In respect of management, both the Fund and the Bank ensure a strong representation for five countries, viz., United States, United Kingdom, U.S.S.R., France and China. These countries have been allotted the biggest quotas and the quota of a member in both the Fund and the Bank determines not only the voting rights and share in management but also the extent to which it is able to draw upon the resources of the two institutions. The prominent position assigned to the bigger countries does not prejudice the chances of smooth working of the Fund or the Bank but it certainly calls for the highest degree of impartiality and fairness on the part of the management. The two institutions have to be judged by their actual working and if they fail to inspire the confidence of smaller

nations, they fail in their main objective of making a contribution to the task of international monetary and financial collaboration.

In the discussions on the Fund, the important point raised was whether the monetary system embodied in the Fund was not after all a slightly modified version of the gold standard and whether it would not on that account be beset with the same kind of dangers and pitfalls.[1] There is no doubt that the Fund does give a place to gold as such, firstly, by laying down that a part of the subscription of a nation must be made in gold; secondly, by ensuring convertibility of a currency into gold and *vice versa* and, thirdly, by prescribing that the par value of currencies was expressed in terms of the United States dollar and transactions in gold are made at a price which differs from the par value by a certain prescribed margin. Gold has not been thrown overboard; in fact, considering the interest that all the three big powers, viz., U.S.A., U.S.S.R. and United Kingdom have either as stockists or producers of gold, it would have been too much to expect that it would be. But it is far from the truth to say that the Fund pushed out gold standard from the front door and brought it back from the backdoor. There is nothing of the essential mechanism of gold standard incorporated in the constitution of the Fund. There is for example, no stipulation or implicit understanding that each country would provide convertibility of its currency into gold or regulate the volume of internal currency or credit in some proportion to the amount of its gold reserves. Exports and imports of gold do not, therefore, have the same significance as they had under the gold standard. An adverse balance of payments is met by a nation not by the adoption of deflationary policy at home but by seeking temporary accommodation from the Fund. Moreover, under gold standard the volume and the rate of growth of gold production in the world impinged directly on commercial and economic activity by regulating the volume of currency and credit—so much so that some writers cited the failure of gold production to keep pace with trade as an important cause of the Great Depression of the late twenties—but the Fund on the other hand, by providing for uniform changes in the par values—in effect, gold values—of all currencies weakens the link between gold and the values of currencies. If the Fund, at all, restored

1. See particularly *The Banker* (Sept. to November 1945). Also *Economica* (November, 1944).

the gold standard, it was a very flexible type of gold standard—sans mechanism, sans rigidity, sans dominance.

The Fund excluded from its purview international indebtedness arising out of the war. The liquidation of large war balances built up in foreign currencies, particularly sterling area, therefore, were to be dealt with by bilateral negotiation between the countries concerned. This obviously militated against the multilateral flow of trade which the Fund was actually intended to promote. At the same time it became difficult to see how the Fund with its limited resources of $8800 million could undertake the unlimited obligation of converting balances of very much bigger magnitude. A *via media* could perhaps be found by making a provision in the Fund for the multilateral conversion of portion of the balances but even this was not acceptable to the vast majority of the nations participating in the Bretton Woods Conference. The exclusion of war balances from the scope of the Fund naturally caused the greatest disappointment and dissatisfaction in countries like India which had accumulated large balances abroad.

§3. India and the International Monetary Fund

Link with Sterling

The Central Assembly in a resolution passed on 29th October, 1946 approved of India's continued membership of the International Monetary Fund and the International Bank for Reconstruction and Development. A corollary of India's membership of the International Monetary Fund was the weakening of the link between the rupee and the sterling. As soon as India undertook the obligations under the Articles of the Fund, she entered the framework of an international monetary system and to that extent the ties that bound her to the sterling area were loosened. The concrete form in which the link with sterling existed was the statutory obligation laid on the Reserve Bank of India under sections 40 and 41 of the Reserve Bank of India Act to convert rupees into sterling and *vice versa* at specified rates. These sections were repealed in April 1947 and rupee was thus freed from the sterling. In their place a section was inserted which required the Reserve Bank to buy and sell foreign exchange at such rates and on such terms and conditions as the Central Government might determine from time to time in conformity with their obligations as a member of the International

Monetary Fund. This amendment of the Act broke the link of rupee with sterling in theory but in practice the link continued and as a result of India's decision to remain in the British Commonwealth of Nations, it was actually strengthened. India is a full-fledged member of the sterling area and in view of the major portions of her foreign exchange resources being in sterling she has been intereested in keeping pound sterling in a strong position.

The rupee-sterling link in the past was an index of the political and financial relationships between India and England. India's membership of the Fund did not involve a complete severance of the link because the establishment of the Fund did not exclude the possibility of close monetary co-operation among groups of countries like the sterling area. It did provide however, an opportunity to review the whole question from the standpoint of India's own interests.

There was no doubt that the link with sterling had not been wholly beneficial to India during the pre-war-years and during the war, it contributed a great deal towards the development of an inflationary situation. However, India decided to continue her association with Great Britain even after the independence. That association involved economic obligations as well. Further, on account of the balance of payment difficulties, she decided to be a member of sterling area. The rupee sterling link under the circumstances was not merely a matter of political expendiency but became virtually an economic necessity.

Par value of the Rupee

One of the principal objectives of the Brettonwoods Monetary Agreements being the easy interchange of currencies of member countries for the settlement of obligations arising on current account, much attention was given in the Agreements to the determination and maintenance of par values on the basis of which the currencies were made exchangeable for one another. At the time of adhering to the Agreements each member determined the par value of its currency either in terms of gold or of the U.S.A. dollar.

The Government of India communicated the par value of the rupee as 1*s.* 6*d.* (*i.e.* the equivalent of 1*s.* 6*d.* in dollars or gold) to the International Monetary Fund without consulting the legislature but it was open to them to intimate to the Fund within 90

days that this par value was unsatisfactory and to suggest another parity. Subsequently the Legislature decided that no change in the par value was called for and the period of 90 days was, therefore, allowed to lapse without making any change in the exchange rate of the rupee. It is interesting to observe that there was surprisingly enough a complete unanimity in the country as well as among the legislators with regard to the suitability of the existing rate of exchange and even those interests which were clamorous of a change in exchange rate before the war were now insistent on no change being made.

The constitution of the Fund, however, allowed a country to make a change of 10 per cent in the par value of its currency without permission of the Fund and another change of 10 per cent with the permission of the Fund. There was thus an assurance that if any contingency arose requiring devaluation of the rupee, it would not be difficult for India to reduce the exchange value of the rupee upto 20 per cent.

§4. Indian Economy on the Morrow of War

It was Edmund Burke who said that war never leaves a nation where it found it and a careful student of the economic, especially the monetary, situation in India before and soon after the war will not have the slightest difficulty in testifying to the truth of that observation. Between August, 1939 and August, 1945, the currency arrangements in India had been altered so radically in several essential respects as to be almost beyond recognition. The war had bequeathed to the country an inflated structure of currency and prices, an intensive and complicated system of exchange control, a large volume of accumulated sterling balances, membership of the Empire Dollar Pool and a system of coinage materially different in composition from the pre-war system. And though it had preserved intact the rupee-sterling link and the 1*s.* 6*d.* ratio, it had furnished through the Brettonwoods agreements a window from which India could look out from her narrow pocket and scan new horizons of her monetary destiny. The over-all picture of currency situation in India on the morrow of war was thus one of baffling problems and intense anxiety for the immediate present and of easing strain and brighter outlook for the future.

Although India did not become a theatre of war and Indian agriculture and industry escaped devastation at the hands of enemy, the economic activity in this country had shown the same trends that had been observed in the countries directly affected by the war. Rising prices, mounting costs, budget deficits and trade gaps were the most outstanding problems of the country at that time.

There was a general depression psychology in the country at the end of the hostilities in the East in August, 1945. It was believed that with the cessation of hostilities the inflationary pressure would come to an end. There would be no need to issue any more currency to finance the war and the budgets would be balanced. With the decrease in defence and other public expenditure, and without a corresponding increase in the private expenditure, the total outlay on goods and services would decrease. This would be an important deflationary force. It was assumed that prices of food and other agricultural commodities had reached their peak and with normal agricultural production these prices would fall. As agricultural prices were the basic factor in price level in India, there would be a general fall in prices. The continuance of controls was assumed and there was a general inclination to discount the possibility of a post-war inflation. Budget proposals were framed in 1946 with a view to avoiding deflation and making transition from war to peace smooth. Thus introducing the budget, Sir Archibald Rowland said : "In one important respect, however, the situation in India resulting from the cessation of hostilities differs from that in other important belligerent countries such as United States of America. In largely agricultural countries such as India, and the Middle Eastern States, war expenditure though in absolute amounts much less than in the industrialized states of the West had had a proportionately greater effect in stimulating the growth of national income. It follows, therefore, that with the fall in war expenditure which is now inevitable, a greater proportionate effort will have to be made if the national income is not to fall below its war level. In other words deflationary tendencies will in the event of countervailing measures begin to manifest themselves before long." In actual fact, however, the trends turned out to be different from what had been expected. There was a good deal of repressed inflation in the country which burst out into an open inflation as soon as war time controls were relaxed. The process of reconversion in India as in other countries was much easier

than it had been thought it would be. The fall in public expenditure, the decrease in demand for stores for defence forces and demobilization had no perceptible effect on the price level or the level of employment in the country. Shortage of labour countinued to be felt in spite of demobilization and no difficulty was encountered in the re-employment of personnel released from the army. During the war the industrial and agricultural labour had not been able to increase its wages in proportion to the rise in prices. After the war, there was a wave of strikes and good deal of industrial unrest. The industrial labour got the belated relief after the war and wages showed a constant tendency to rise. Agricultural labour was also much better off after the war than it was during the war. The Government employees also got several upward revisions of their salaries in the form of enhanced dearness allowances, etc. The impact of the rise in salaries in the Government offices was felt in private offices as well. The all round rise in wages and scarcity of labour in the country as also the peculiar difficulties arising out of the partition of the country resulted in an unprecedented rise of prices which created a good deal of discontent in the country.

In fact the major developments in India during the post-war period may be dealt with under the following heads:—

(*i*) Currency circulation and price trends.

(*ii*) Consequences of partition.

(*iii*) Balance of payments and sterling balances.

(*iv*) Devaluation, and

(*v*) Nationalisation of the Reserve Bank of India.

§5. Currency circulation and price trends.

The process of financing U. K. Government's purchases in India by the issue of paper currency against sterling acquired in London continued for some time even after the war. The total note issue increased from Rs. 1154 crores on 31st December, 1945 to Rs. 1248 crores in January, 1946 and Rs. 1254 crores in June, 1946. The notes in circulation similarly showed an increase from Rs. 1141.84 crores in September, 1945 to Rs. 1237.84 crores in June,

1946. The following table gives the increase in the currency upto August, 1947:

(*In crores of rupees*)

(*Figures relate to the last Friday of every month*)

	Total notes Issued	*Notes in Circulation*	*Sterling Securities with Reserve Bank*
September 1945	1162.74	1141.84	1042.33
1946-47			
April ..	.. 1245.95	1235.12	1124.70
May ..	.. 1249.93	1237.05	1129.32
October ..	.. 1258.26	1197.09	1135.32
November ..	.. 1258.89	1201.29	1135.32
February ..	.. 1257.49	1234.52	1135.32
March ..	.. 1257.47	1243.03	1135.32
1947-48			
April ..	.. 1261.51	1247.28	1135.32
August ..	.. 1268.90	1190.40	1135.32

The table shows that there was no addition to the amount of sterling securities with the Reserve Bank after June, 1946 which means that so far as inflationary process for financing U. K. Government's expenditure in India was concerned, it came to an end in that month. Thereafter inflation was resorted to to finance the deficit of the Indian Government. This deficit became pronounced after August, 1947 on account of the partition, refugees relief, war in Kashmir, and Police Action in Hyderabad. The note-issue reached the high water-mark of Rs. 1316.68 crores in March, 1948 and the notes in circulation rose to Rs. 1303.78 crores. Thus it was the deficit of the British Government which gave rise to inflation in India during the war and for one year after the war. It was our own deficit which was financed by the issue of additional paper currency after that. The method essentially remained the same but the object was different. In their second Manifesto issued in the first week of February, 1946 the Indian Economists had warned the Government that "by continuing to finance the purchases of His Majesty's Government in India

by the same inflationary procedure as during the war, the Government of India is driving Indian economy almost to the brink of disaster". The protest had its effect and the financing of His Majesty's Government purchases by the same inflationary procedure as during the war was stopped three months later. But the dangers of expansion of paper currency were not realized and by financing their own deficits by the inflationary procedure, the Government of India created inflationary pressures which caused considerable stress and strain on the economy.

Budget Deficits

Despite the sharp fall in the defence expenditure in the Central Government and the civil expenditure in the provinces, the budgets of both Central and Provincial Governments remained grossly unbalanced.

The following table shows the deficit from year to year both in the Central and Provincial budgets after the war :—

Central Government (In Crores of Rupees)

	1945–46	1946–47 (*Revised*)	1947–48 (*Revised*)	1948–49 (*Revised*)	1949–50 (*Budget*)	1950–51 (*Revised*)
Revenue ..	360.67	336.19	178.77	338.32	322.98	387.21
Expenditure	484.57	381.48	185.29	339.87	322.53	379.28
Surplus(+) Deficit(—)	—123.90	—45.29	—6.52	—1.55	+.45	+7.93

All Provinces (In crores of Rupees)

	(*) 1946–47 (*Accounts*)	(**) 1947–48 (*Revised*)	1948–49 (*Budgets*)	(***) 1949–50 (*Budgets*)	(****) 1950–51 (*Budgets*)	(*****) 1950–51 (*Revised*)
Revenue	169.78	207.04	242.77	254.83	282.56	375.11
Expenditure	162.17	211.08	258.27	264.15	284.29	380.33
Surplus(+) or Deficit(—)	+7.61	—4.04	—15.50	—9.32	—1.73	—5.22

(*) Excludes figures for East Punjab and West Bengal.
(**) Includes figures of Budget estimates of West Bengal.
(***) Excludes Assam.
(****) Part A States.
(*****) Part A and Part B States excluding Rajasthan.

The Budget estimates for 1949-50 for the Central Government disclosed a small surplus of Rs. 45 lakhs after a series of deficit budgets. The capital budget for the interim period of 1947-48 disclosed a deficit of Rs. 134.34 crores. In 1948-49, the deficit on capital account was budgeted at Rs. 112.50 crores and for 1949-50 at Rs. 134 crores. The revised estimates for 1950-51 showed a surplus of Rs. 7.93 crores as compared with a nominal surplus of Rs. 71 lakhs originally budgeted for. The same trend was visible in the provinces. Except for 1946-47, the provincial budgets showed deficits from year to year. And even in 1946-47 if we include the figures of East Punjab and West Punjab, the two big deficit provinces, the surplus of Rs. 7.61 crores between them would be turned into a net deficit. The tension existing between India and Pakistan kept the defence expenditure high which stood at Rs. 155.43 crores in the revised estimates for 1948-49 as compared with Rs. 240 crores for the undivided India in 1946-47. If we add the expenditure incurred by Pakistan on defence in 1948-49 we will find that the total expenditure of the two dominions under this head was as high in 1948-49 as in 1946-47. The deficit in budgets for the year 1949-50 and 1950-51 was as much as 9.32 and 1.73 crores respectively. The revised estimates of State Governments for 1950-51 showed a deficit of Rs. 5.22 crores. The overall deficit for 1950-51, stood at Rs. 45 crores.

So long as the relations between the two dominions remained what they were to begin with, expenditure under Defence could not be reduced. But it was not only military expenditure that was responsible for the deficit. Civil expenditure had shown a tendency to rise beyond all proportions. In 1945-46 for the undivided India, total civil expenditure was Rs. 124.34 crores. For the Indian Dominion only the revised estimates for 1948-49 put the civil expenditure at Rs. 184.44 crores. The increase was caused by food subsidies, refugee relief and increased expenditure on civil administration. In the provinces, development plans, security services and civil administrations were mainly responsible for the increased expenditure. The increase in public expenditure and consequent budget deficits without any increase in the production in the country contributed a good deal to the rise of prices after the war and particularly after the partition. Formerly the budget deficits were financed by expansion of paper currency. The Government later turned to balances with the Reserve Bank. The balances which

stood at Rs. 83.6 crores in 1948-49 came down to Rs. 54.7 crores in 1949-50 and to Rs. 32.8 crores in 1950-51.

Decontrol

Another factor which contributed to the inflationary crisis in India in the post-war period was the policy of decontrol adopted in December, 1947 by the Government of India on the recommendation of Foodgrain Policy Committee. It was contended that controls were creating artificial scarcity in the country and once they were lifted goods would appear on the market which would automatically bring down prices. Mahatma Gandhi advocated decontrol of foodgrains, sugar and cloth on the ground that controls bred immorality, black markets and corruption. Many people[1] opposed the policy of decontrol but the Government unmindful of the consequences announced the decontrol of foodgrains on 10th December, 1947. Sugar had already been decontrolled. Cloth did not take long to be decontrolled. The immediate effect of this policy was a great spurt in prices. The index number of wholesale prices rose from 290 in November. 1947 to 311.6 in December, 1947 and 383 in August, 1948. The policy of decontrol having failed, the Government reverted to a policy of control in October, 1948. Prices were held stable after that but a rise again appeared making necessary the adoption of a policy to check it.

Fall in production

Goods continued to be in short supply even after the war when there was an all round increase in demand on account of the desire on the part of the consumers to satisfy the wants they had postponed during the war. As against this increased demand, production in the country both in the agricultural and the industrial field began to fall due to variety of causes. The fall in industrial production was attributed to the undefined attitude of the Government in the matter of nationalization of industry, non-availability and slow rate of renewals of the industrial plant, increased wages, labour troubles, high level of taxation and difficulties of obtaining industrial raw materials. The Government consistently followed a policy of encouraging industrial production in the pst-war years but the results were none too satisfactory.

1. Cf. Pt. Kunzru's speech in the Parliament on 10th December, 1947.

Another important factor which contributed greatly to the post-war inflationary conditions in India was the critical food situation in India which particularly became grave after the partition. In 1946 rains failed in large parts of the Punjab, Madras and Bombay. In all a shortage of 6 million tons of food was announced by the Government and the greatest pressure was brought to bear on the Allied Food Board for the allotment of more foodgrains to India. Basic ration was cut down and rationing was extended to many other areas. In January, 1947 conditions were a little better as famine had been avoided but they were by no means satisfactory. The situation grew worse after the partition and the Indian dominion found itself in the grip of a chronic shortage of foodgrains. Out of the total all-India annual production of 7.9 million tons of wheat and 22.9 million tons of rice, Pakistan's share geographically was 2.8 million tons of wheat and 6.4 million tons of rice. Considering that she had only one fifth of the total population of India to support, the share of Pakistan in the food supplies of the country was much more than proportionate. In 1948, a shortage of 4 million tons was estimated in the Indian dominion while a total of 2.8 million tons were imported at a cost of Rs. 150 crores. The shortage for 1949 was estimated at 4 million while for 1950 the estimate was 3 million tons.

The imports of foodstuffs from abroad at a heavy cost not only made the balance of payments position grave but coupled with the decontrol of foodgrains in India resulted also in a great rise in the price level in the country. The price index of rice rose in U. P. from 338 in November, 1947 to 540 in September, 1948 and that of wheat from 382 to 769. Taking all cereals the rise was from 406 to 583. Since food prices form the core of price structure in India on account of the poverty of the people, rising food prices inevitably led to a rise in the general price level.

Inflationary pressures

While the production outlook was thus somewhat dismal, the Governmental investment on development programme rose suddenly after the cessation of hostilities. The gaining of the independence encouraged the Government to launch on several development plans and investment rose to higher levels. There was the sudden and unplanned removal of controls on prices and distribution of essential goods. At the same time money was moving

actively due to a large scale conversion of capital into cash due to the vast migratory movements consequent on the partition. The open market operations of the Reserve Bank in support of Government securities increased the money supply. Pressure of money made in the black market and of incomes evading taxation on prices swelled the actual and potential purchasing power. The agricultural producer was disinclined to sell due to the fall in the burden of his cash obligations and rise in his money income. The industrial output had declined from war time peak because of shortage of materials, fuel, stores as well as increased wages. Money incomes of several classes had mounted. The borrowing and saving campaigns of Government which might have mitigated the situation by mopping up surplus purchasing power could not be launched successfully.

To sum up, while scarcity of consumer goods had been a factor contributing to increase inflationary pressures, the fundamental causes were the increased expenditure and reduced savings, low productivity of industry, economic imbalance caused by the partition, deficit budgets, decline in agricultural production etc. The outbreak of the Korean War in June, 1950 and stock piling by U.S.A. had also given a great stimulus to inflationary trends in India.)

The effects of these various factors were manifested in a steady upward trend of prices. When the war came to an end in August, 1945, the wholesale prices index issued by the office of the Economic Adviser stood at 244.1. It rose steadily to 289.6 in November, 1946. For a year, till November, 1947, price level was more or less stable, the index moving within the narrow range of 289.6 and 299.3. In November, 1947, prices began their upward trend once again and the index number shot up to 311.6 in December, 1947, 333.4 in January, 1948, 341.8 in February and 343.6 in March, 1948. The rise in prices did not stop even there and in August 1948 the index rose to 383. The Government announced its anti-inflationary measures in October, 1948 and it was expected that prices would come down but a year after in September, 1949 price index was still at 388.3. Prices had been stabilised but they had not been brought down. As a matter of fact, they were showing a tendency to rise again as the index number after going down to 370 had risen to 388. The largest increase had taken place in the case of agricultural commodities, where the index rose from 264.2 in September,

1945 to 351.8 in August, 1947 and 402.4 in March, 1948. Another item which had shown a large increase in prices was the industrial raw materials. Prices of manufactured goods had not risen as high as the prices of agricultural commodities and raw materials. From 1949-50 to 1950-51, the index number of wholesale prices of food articles rose from 391.3 to 416.4, of industrial materials from 471.7 to 523.1, of manufactured articles from 347.2 to 354.2 and of all goods from 385.4 to 409.9. Several causes had contributed to this rise of prices. The suppressed demand of the war years became free to manifest itself after the war was over. There was a continuous rise in the supply of currency. There were chronic deficits in the budgets of the Central and State Governments. There was a decline in agricultural and industrial production. The economic dislocation created by the partition and by famines and floods aggravated the situation. The outbreak of the Korean War caused a sudden spurt in speculative and hoarding activity.

The post-war inflation was different in its effects on the people in India than the war-time inflation. During the war, it was business, trading and the industrial classes that had benefited from the rise of prices. Profits increased enormously partly as a result of the rise of prices and partly because of stoppage of imports and increase in the demand for goods. Wages of industrial labour rose but not to the extent of prices so that in terms of real wages labour did not gain. The agriculturists also gained to an extent as a result of the rise in prices but the gain was not substantial; they were just compensated for the fall in prices that they had suffered during the period of depression. Labour as a whole gained on account of the increase in employment.

After the war, as a result of general unrest, both industrial and agricultural labour was able to get substantial increase in wages. Prices of agricultural commodities rose more than prices of industrial goods with the result that there was a substantial increase in the incomes of agricultural classes. The increase in costs and fall in production brought about a decrease in industrial profits and in some cases there were even losses in industrial concerns. This explained why at a time when commodity prices were high, the stock markets were at a low ebb. The greatest sufferers in the post-war inflation were the middle class people. In a sense both the poor and the rich gained but the middle class was on the verge of elimination. Savings

in the country dried up as the capacity of the middle classes who were in the habit of saving was greatly impaired and the poorer classes who got additional income had not developed banking and investment habits.

Anti- inflationary measures:

The Government became very much concerned over the rapid rise of prices towards the middle of 1948 and held hurried consultations with leading economists in the country, representatives of labour, trade and industry and its own officers. On the advice tendered by them, the Government formulated the anti-inflationary policy which was announced in the first week of October, 1948. The main features of this policy were a reversion to control of foodgrains and other essential commodities, bridging up the budgetary gap by effecting economies in public expenditure and by increasing revenues, increasing agricultural and industrial production in the country by tax relief and other measures, encouragement of small savings in order to mop up the surplus purchasing power and limitation of dividends. By the Limitation of Dividends Act, the dividends that could be declared by joint stock companies were limited to defined limits. Ordinarily it was not to exceed 6 per cent. Nothing effective could be done to increase savings in the country and they continued to decline. One method of encouraging savings was to increase the rates of interest. It is however, doubtful whether an increase in the interest rates would have had a perceptible influence on the volume of savings. Savings were low in the country because those who had the power to save had not developed banking and investment habits while those who had banking and investment habits did not have sufficient capacity to save. The Government rightly did not adopt the suggestion for raising rates of interest. But if savings were to increase it had to approach rural classes in the country to obtain the funds that had percolated there on account of high agricultural prices. To the industrialists, the Government were willing to give all conceivable help and assurances about the future in order to encourage production in the country. A large number of tax reliefs were announced to the industry by the Finance Minister at the time of introducing the budget for 1949-50. The Finance Minister was also able to show, by means of new tax proposals, a surplus of Rs. 45 lakhs in the revenue budget for 1949-50, though he left a deficit of Rs. 134 crores uncovered in the capital budget.

The most effective means that the Government adopted to prevent inflation from assuming more threatening proportions was the reversion to the policy of control of foodgrains. It was announced that complete control over production, procurement, distribution and prices of foodgrains would be reached in October 1949. Meanwhile all the provinces were asked to set up machinery for procurement and rationing. Except in Madras and Bombay, rationing had been completely abolished, but the Government reverted to it and was able to effect substantial reduction in prices. Wheat, which was selling at Rs. 26 to Rs. 30 per maund before recontrol came to be distributed through ration shops at Rs. 15 to Rs. 16 per maund in various parts of the East Punjab.

The price level was held stable and to some extent even brought down as a result of the anti-inflationary measures. But the policy lacked vigour and efficiency in its execution with the result that it failed to be effective in its long range aspects. Inflationary tendencies once began to re-assert themselves in July, 1949 and in August, 1949 the index rose once again to 388.3 after having fallen to 370 as a result of anti-inflationary measures. There was sugar shortage in August, 1949 which resulted in a sudden jump of 25 per cent in the price of sugar. The Government had to take immediate action and freeze all stocks of sugar with the factories. The cancellation of Open General Licence No. XI, XV and XVI with a view to resolving the balance of payment difficulties also resulted in a rise in the prices of manufactured and imported goods.

Although the situation was brought under control, it did not permit any complacency. The shortage of consumer goods continued in the country. Savings had almost disappeared and production in industry or agriculture was not increasing. Balance of payments position was getting critical, as big amounts had to be spent on the imports of food-grains to feed the vast population. The Government was finding it difficult to balance its budget. Labour and salaried classes were resisting stoutly any reduction in wages and salaries and any attempt at retrenchment. Productivity was very low in the country. All these factors created anxiety about the future of Indian economy. The situation was full of dangerous possibilities and required skilful handling on the part of the Government. It appeared that it was impossible to dispense with controls for another 3 to 4 years and the Government as well as the

people had to take to austerity for a number of years to come. Some of the development plans had to await execution until the economic situation in the country improved.

§6. Consequences of Partition

The partition of the country into two Dominions on the 15th August, 1947, created a number of problems for the monetary authorities. Pending the establishment by the Government of Pakistan of machinery to regulate currency and banking, the Pakistan (Monetary System and Reserve Bank) order was promulgated on the 14th August, 1947. The aim of this order was to provide for the maintenance of a unified monetary system for the two Dominions till 30th September, 1948. The terms of this order laid down that the Reserve Bank of India was to remain as bankers to the Government of Pakistan. It was to have the sole right to issue notes in Pakistan upto 30th September, 1948. The Bank was, however, to issue, after March 31st, 1948, distinctive bank notes inscribed with the words, "Government of Pakistan." These notes were to be legal tender only in Pakistan. Indian rupees and subsidiary coins were also to continue to be legal tender in Pakistan for such period or periods, not later than one year from the introduction of corresponding Pakistan coins. This order was later amended to provide that the Reserve Bank would continue as the currency authority in Pakistan upto 30th June, 1948, instead of 30th September, 1948. Arrangements were also made to determine the share of Pakistan in the assets of the Reserve Bank of India.

The Government of Pakistan set up the State Bank of Pakistan on 1st July, 1948, and from that date the Reserve Bank ceased to be the currency authority in Pakistan. The Reserve Bank's offices at Karachi, Lahore and Dacca were taken over by the State Bank of Pakistan. That Bank also took over all outstanding liabilities in respect of inscribed Pakistani notes, and accordingly, assets of the Reserve Bank in the Issue Department of the value of Rs. 51.57 crores were handed over to the State Bank. In the meantime the Indian notes in circulation in Pakistan were gradually withdrawn from circulation in that country, and handed over to the Reserve Bank against the transfer of assets of equal value to Pakistan. The total amount of India notes returned from circulation in Pakistan and the Reserve Bank's purchases of India notes was Rs. 127.17

crores in 1948-49. Under the orders of the Government of Pakistan all Indian notes and coins ceased to be legal tender in that country with effect from 1st September, 1950.

Upto 20th September, 1949, there was parity between the Indian and Pakistani rupees. There was an agreement between the two Governments that the value of the rupee was not to be changed except after mutual consultation with each other. Following the devaluation of the sterling, the Government of India decided on 20th September, 1949, to devalue the Indian rupee in terms of gold and dollar. The Government of Pakistan, however, refused to devalue the Pakistani rupee. The value of the Indian rupee thus became equal to 21.00 cents per rupee, while that of the Pakistani rupee remained at the old level, *i.e.* 33.23 cents per rupee. As there was no agreement between the Governments of the two countries about the new exchange value of their respective currencies, currency and trade relationships were disrupted for some years.

§7. Balance of Payments Position and Sterling Balances

The balance of payments problem consisted of two parts: (*i*) the overall deficit in the balance of payments and (*ii*) the deficit in relation to the dollar area countries. The two parts exhibited certain special peculiarities.

In 1948, the deficit on current account was to the tune of Rs. 122.5 crores, of which Rs. 60 crores represented an extraordinary payment made by the Government of India to the U. K. for the purchase of stores, thus leaving the net deficit at only Rs. 62.5 crores. This was made up of a deficit of nearly Rs. 50 crores in relation to the hard currency area and had arisen owing to the relaxation of import controls. The deficit in relation to the hard currency areas was financed by the purchase of $68 million (Rs. 22.8 crores) from the International Monetary Fund and by utilising the convertible sterling released by the U. K. Government.

The magnitude of the payments deficit in 1949 was strikingly large. The overall deficit amounted to Rs. 146.6 crores after excluding an extraordinary payment of Rs. 11.9 crores for defence stores. The full impact of the libralisation of imports in the second

half of 1948, began to be felt early in 1949. Imports increased from a monthly rate of Rs. 38 crores during the first six months of 1948 to a maximum of Rs. 62 crores in May, 1949. Government imports had also increased to a large figure of Rs. 109 crores in the first half of 1949 owing mainly to the purchases of foodgrains. The downward trend in exports persisted throughout.

This growing imbalance caused serious concern. Import restrictions were made more stringent from May, 1949 and attempts were also made to increase exports. As a result the deficit was reduced to Rs. 34.1 crores during July to September, 1949. In September, 1949, the devaluation of the rupee accelerated the process of improvement in exports and fall in imports. The last quarter of 1949, showed a surplus of Rs. 29.4 crores, its value being 38 per cent more than that in previous quarter. Imports also declined and the volume index came down to 115.1 in the last quarter of 1949 from 127.8 in the third quarter. The deficit in relation to hard currency areas was also large, being Rs. 49.5 crores in the first half of 1949. This was principally due to the low level of exports to these countries and the high level of Government imports. Owing to devaluation, exports rose steeply from an annual rate of Rs. 106.8 crores in the third to Rs. 173.2 crores in the last quarter of 1949. Imports were restricted by import control. The last quarter of 1949, thus showed an actual surplus of Rs. 18 crores. The overall deficit was financed by some over-drawing on the Central Reserves of the sterling area and by recourse to the dollar balances of the India Supply Mission.

The year 1950 revealed a striking improvement. The balance on current account turned from a very large deficit in 1949 to a surplus amounting to Rs. 61.5 crores. This improvement was brought about by a record increase in exports, due partly to a rise in export prices and partly to some increase in the volume exported. There was also a substantial decline in the value of imports which fell from Rs. 628 crores in 1949 to Rs. 510 crores in 1950. The surplus was unevenly distributed over the two halves of the year 1950. It amounted to only Rs. 7 crores in the first half and Rs. 54.4 crores in the second half. The extremely favourable position in the second half was due primarily to the impact of the accelerated rearmament and stock-piling programme adopted in the U.S.A. and Western Europe after the outbreak of the Korean War in June, 1950.

The surplus on current account in the dollar areas achieved in the last quarter of 1949, was continued in 1950, the total surplus for the year being of the order of Rs. 29.0 crores. This was due to the intensified stock piling demand for certain Indian commodities and the consequent increase in their prices. Similarly the surplus achieved in the last quarter of 1949, in relation to the sterling area countries continued in 1950 and amounted to Rs. 60 crores. This was mainly due to the large increase in cotton textile exports. After devaluation the cotton goods of the U.S.A. and Japan became very expensive to the soft currency countries which turned to India and purchased large quantities of Indian cotton goods.

Sterling Releases

Prior to August 1947, India was free to utilise her sterling balances in any manner in sterling area and was also entitled to convert them into dollars or any other hard currency at her own discretion. But this position was altogether changed by the provisions of Article 10 of the Anglo-American Loan Agreement 1946, which divided these balances into three categories, viz., (*a*) balances to be released immediately and convertible into any currency for current transactions; (*b*) balances to be similarly released by instalments over a period of years beginning in 1951 and (*c*) balances to be adjusted as a contribution to the settlement of war and post-war indebtedness.

On 14th August, 1947 was signed in London an interim agreement designed to cover the period upto 31st December, 1947 for release of sterling to India. Under this agreement the balances of Reserve Bank of India were to be kept in two accounts. In Account No. 1 were to be kept the sterling released for multi-lateral convertability and also the currently earned amount of sterling. This was to be the main operative account. In Account No. 2 were to be kept the remainder of the accumulated balances which were blocked. Under the agreement Britain released £35 millions to be credited to Account No. 1 for covering the deficit on India's balance of payments account for the period from 15th July to 31st, December 1947. In addition to this amount of £35 million, another sum of £30 million was realeased and put in Account No. 1 to cover any temporary deficit on balance of payment account. Thus for practical purposes the total amount released was £65 millions. The agreement was renewed in January, 1948 for another 6 months.

A new agreement was signed by the Indian delegation which visited London for further negotiation on July 9, 1948. Under this agreement the Government of India took over all the stores and installations of H.M.G. lying in India for a sum of £100 millions (Rs. 133 crores) paid out of sterling balances in full and final payment. Further a sum of £ 147½ millions (Rs. 197 crores) was agreed to be paid by India to Britain in payment of pensions to British personnel who had served in India. The British Government took up the responsibility of payment of these pensions beginning with a sum of £ 6¼ millions (Rs. 8 crores) and falling gradually to nothing in 60 years. Similarly another sum of £ 20½ millions (27 crores) was agreed to be paid in payment of pensions payable by provinces in India. The total amount thus paid out of the sterling balances was Rs. 357 crores. On the other hand a sum of Rs. 73 crores was credited to India on account of the liabilities of Britain in the defence expenditure outstanding and not adjusted so far. The total amount left after making all adjustments was £ 800 millions or Rs. 1,040 crores.

England agreed to release for a period of 3 years beginning from July 1, 1948, £ 80 millions to be put in Account No. 1 in addition to a carry over of £ 80 million from the previous unspent balances. In the first year (1948) a sum of £ 15 millions was made available for convertibility after which the position was to be reviewed. The agreement was regarded satisfactory especially in view of the fact that out of the previous releases of £ 83 millions, £ 80 millions had remained unspent. This made India's case weak for more liberal releases.

The Government of India, as a part of its anti-inflationary policy, initiated a policy of liberal imports in 1948. This resulted in heavy adverse balance of payments and rapid depletion of sterling available in Account No. 1. By January 1949, £ 43 millions more had been spent than what had been provided for and India asked the United Kingdom for release of this amount. The United Kingdom refused to do it and by April 1949 the position in respect of balance of payments became precarious. Negotiations were, therefore, started again and a new agreement was signed between the two countries in London in July, 1949. The terms of the agreement surpassed the most optimistic expectations of India. The agreement covered the period of next two years. Britain

agreed to write off £ 81 millions drawn in the past year from Account No. 2, though it had been agreed that India would not draw any amount from this account. It provided for drawing of £ 50 millions per annum for each of the two years 1949-50 and 1950-51. The British Government also agreed to release sterling to cover the orders placed for goods by India before July, 1949. This amounted to another £ 50 million.

So far as convertibility is concerned, in the July 1948 Agreement India was limited to drawing not more than £ 15 millions (60 million dollars) in hard currency from the Central Reserves, during the period July 1948 to June 1949. But the new agreement provided that India would have the right to draw on the Central Reserves to the extent of about 140 to 150 million dollars as compared to 60 million dollars of the last agreement for the period of July 1948—June 1949. As regards 1949-50, the problem of convertibility was discussed not on a bilateral basis with the U. K. Government but was negotiated as part of the Commonwealth Finance Ministers' discussions. According to these discussions, India was required to limit her dollar imports during the 12 months ending June 1950 to 75 per cent of her dollar imports during the calendar year 1948. This, however, was exclusive of any imports India might finance by loans from the International Bank. In other words, imports financed from International Bank loans were to be in addition to the 75 per cent of 1948 import level.

The agreement was hailed as very liberal to India and City Editors of London papers criticized it on the ground of over-generosity on the part of England to India. But with a study of the agreement in the context of devaluation of pound sterling that took place two months later, the generosity was easily explained. The value of sterling releases as also the sterling lying blocked in London to India's credit had been reduced by 30.5 per cent in terms of gold and dollars and India was in a position to buy much less with the amount released than she could have bought if sterling had not been devalued.

If India had not drawn more than what had been agreed to, only £ 360 millions would have been left to the credit of India at the end of 1951. India's balances were spent more rapidly than the usual normal rate. And almost the whole of the amount was spent on

financing the purchase of food and consumer goods which were so badly needed. It did not, therefore, help India in building up new industries or financing agricultural plans that were considered essential at that time. Nor did the problem of deflation arise in the country as a result of their utilisation as was feared at one time. The country had still to face the problem of inflation even after a considerable part of the balances had already been consumed.

Sterling balances' and Dollar Pool

Sterling balances accumulated to India's credit during and after the second world war and were held by the Reserve Bank of India in London. It is quite usual for a central bank to hold foreign currencies but these sterling balances were different in so far as the Reserve Bank could not spend them except as agreed between the Indian and the British Government.

These balances accumulated to our credit during and after the second world war because : (1) the British Government made use of a provision in the Reserve Bank of India Act under which the Bank was obliged to give rupees, in exchange for sterling, which the British Government spent on its war efforts in India (In this way sterling accumulated to India's credit in London and inflation resulted in India causing immense hardship to the people); (2) the expenditure undertaken by the Government of India on behalf of His Majesty's Government was repaid in the shape of sterling credits and this also added to our sterling balances; and (3) India's favourable balance of trade during the war period and exchange control, under which Indians had to declare and hand over their possession of foreign currency to the Reserve Bank, resulted in further accumulation of sterling balances. In this way, these sterling balances represented some sort of 'forced savings' on the part of Indians who could not get for their money in real terms enough goods.

The manner of the disposal of sterling balances during the war years aroused far too little comment at the end of the war compared to the question of their future utilization. For, substantial amounts of sterling—of the value of about Rs. 1,600 crores still awaited disposal in October 1946, though in the following months the pace of accumulation had considerably slowed down due to the termination of hostilities. The Government had already liquidated the Chatfield Debt of one quarter of £ 34 million, being India's share

of the estimated pre-war capital cost of modernising Indian army. They had also in hand a scheme for utilizing a part of the accumulated sterling to create a fund which might be used to meet their obligations on account of pensions, family pensions and provident funds. The remainder of the sterling accumulations embodying as they did the sacrifice of consumption of the Indian people in the past and representing their claim on the products of the labour of other people in the future was to be so liquidated that the structure of Indian economy received the maximum nourishment and strength and the fabric of world economy suffered the least possible injury.

Clearer visualisation of the future of these balances became urgent in view of the penumbra of suspicion and fear gathering round them. Apprehensions gained strength in some quarters that the perfidious Albion might, by a sleight as it were, sweep all the balances out of existence. Several dark possibilities were hinted at. It was said, for instance, that the Government would just watch the balances being squandered away by continuing the statutory obligation imposed on the Reserve Bank to maintain the 1s. 6*d.* rate, *i.e.*, a rate which would be rendered wholly untenable and obsolete by the postwar relationship of British and Indian price levels. Another possibility indicated was the revision or reinterpretation of the Financial Settlement governing the allocation of war expenditure in such a manner that India found the remainder of sterling balances just enough to clear off the heavy debts on account of her share of war expenditure[1] or alternatively, India might be got round by wily means to make a big gift to the United Kingdom as a token of goodwill and comradeship-in-arms. It was also hinted that under the post-war monetary and economic arrangements, plans for which were being prepared, India's sterling balances might be cleared out of the way as a dead weight on international trade and an obstacle to fruitful international economic collaboration. Only a little less disquieting was the suspicion that it might be made out that the sterling balances were inflated due to the high prices at which war purchases were made in India and that,

*Apprehensions regarding this possibility were raised by some unnecessary and unjustified statements in some British papers (Cf. *Economist* 7th August, 1944) to the effect that India had become a creditor of England, not through the normal processes of trade and investments but through negotiated division of defence cost. India was said to have driven a hard bargain and the financial agreement was represented as being very liberal to India and less than fair to England.

therefore, 'water should be squeezed' out of them.[1] Then there was the fear that sterling might grossly depreciate bringing down the commodity return for the balances. Further, it was said that even if the balances remained intact and were liquidated in full the speed at which they would be released for realization might be very slow and the purposes for which they could be utilized might be severely restricted in practice.

It was not difficult to detact in those speculations, not all of which could be brushed aside as rambling or wild, the shadow of the unpleasant memories of the past. There was the obvious reluctance to believe that a war contribution (of £ 100 million in the last war) and the dissipation of sterling resources through an ill-advised attempt to maintain a high exchange ratio (as in 1920) were episodes that belonged to the dead past and could not be repeated in future.

Even if all the fears inherited from the past were not projected into the unknown dimensions of the future ceaseless vigil was still necessary to ensure that in the rush of post-war adjustments the pitch was not so queered for India that her hard-won foreign resources were whittled away. Certain eventualities were to be guarded against. In the first place, no revision or further interpretation of the Financial Settlement regarding allocation of defence expenditure between England and India was to be permitted to augment India's share of the total financial burden of war, and it was fortunate that Britain in spite of unofficial suggestions did not officially ask for it. Secondly, no scaling down of the balances under the provisions of the Anglo-American Financial Agreement of 1945 was to be permitted. Thirdly, no post-war currency agreements which hampered in any way the fullest and freest utilisation of sterling balances were to be subscribed to. Fourthly, no financial or commercial arrangements among the victorious nations or between England and India were to be allowed to impair India's liberty to utilize her sterling resources to purchase such goods and

1. This line of attack on the integrity of sterling balances was adopted by some of the British economic and financial journals but was effectively countered by the Selected Committee on British Expenditure in India which reported that taking all the circumstances into consideration fair price had on the whole been secured for war stores and for food bought on account of His Majesty's Government in this country.

in such countries as she decided upon in her own interest.[1] Fifthly, any loss to India from depreciation of sterling should be made good by the British Government as part of a bargain in which the debtor paid a commodity debt unimpaired in amount by a change in prices[2]. Sixthly, no relaxation of the control over the exchanges should be allowed until a suitable parity of the rupee in relation to sterling had been determined after taking into account the relative price levels and other basic facts of the economic relationships of the two countries.

The sterling balances, it should be made clear, represented neither abnormal gains made by India out of a world devastating war nor were they the outcome of any wartime profiteering. The whole process of war purchases in India and payments for them involved forced abstention from consumption for a large part of India's population and brought very little accession to their total real income. There is no disagreement that Indian economy was strained to the utmost during the war and with the depletion of exiguous reserves that the population possessed only in the best of years, shortages and scarcity were intensified. The liquidation of sterling balances was therefore, no distribution of largeesse but an amply deserved measure of economic restitution on the part of United Kingdom. In fact, the use of the term 'reparation' was not inappropriate but for its odious associations in that context.

The fears regarding scaling down of sterling credit or revision of Indo-British Financial Agreement to the detriment of India fortunately proved unfounded. England stood by its pledged word and was committed to pay the whole amount. The balances standing at the credit of India came down to Rs. 635 crores (September 1949) as compared to Rs. 1600 crores in October 1946 and Rs. 1093 crores in July 1948. Most of this money had already been spent for payment of pensions etc. to British officers in Britain,

1. It was mainly this consideration that aroused opposition to the otherwise excellent suggestion made by Sir J. C. Raisman in his Budget speech (March 1943) for the institution of a Post-war Reconstruction Fund. The Fund was to be constituted by setting apart portion of the accumulated sterling and was to be utilized after the war to purchase machinery and other industrial equipment.

2. Mr. G. D. Birla suggested in this connection that sterling balances should be linked up with the U. K. commodity price index number so that if the prices in United Kingdom rose, *i.e.* if sterling depreciated, the amount of sterling balances should be raised proportionately. (Cf. his article on 'Our sterling balances' in The Hindustan Times of March 27, 1943).

and purchase of goods and foodstuffs from abroad. The balances were not utilized to any appreciable extent for the purchase of capital goods or an increase in the productive capacity of the country but largely for meeting current deficit on trade account.

One fear, however, was realized. Sterling was devalued in terms of dollar by 30.5 per cent and the value of the balances had thus decreased by 30 per cent. This was a heavy loss for a poor country like India and an assurance was sought from Great Britain that she would compensate India for any devaluation of pound sterling. But no such assurance was forthcoming.

Dollar Pool

The Empire Dollar Pool was really an old arrangement, continued with modifications necessitated by the war, under which the countries belonging to the sterling area settled their transactions on international account in sterling through London. Before the war sterling was freely convertible into other currencies and every sterling area country could at any time obtain through London whichever currency it wanted. During the war, however, dollars and certain other currencies at the disposal of London became scarce due to increased payments on account of war requirements and reduced supply. It was, therefore, found necessary to institute a pool of these currencies. The principle of the pooling arrangement was that all participating countries contributed what they could according to their ability and each country drew from the pool according to its needs. Like other sterling area countries, India too, made its contributions to the pool and drew from it what was needed for winning the war or for meeting essential civil requirements.

The position of India with respect to the Dollar Pool and hard currencies is given in the following table[1]:—

(In crores of Rupees)

	U.S.A.	*Canadian*	*Swiss*	*Swedish*	*Portugese*	*Total*
Accrued to India	405	40	$1\frac{1}{2}$	2	$4\frac{1}{2}$	453
Used by India	237	83	$13\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{1}{2}$	339
Balance	$+168$	-43	-12	$-\frac{3}{4}$	$+2$	$+114$

1 Extracted from Manu Subedar's report dated 29th July, 1946 vide *Indian Information*, volume 19, No. 196, page 324.

During the first four years of war India put more into the pool than she obtained from it but from towards the end of 1944, the balance of trade between India and the United States began to turn unfavourable to India and the pool was utilized to finance the deficit. Besides the amounts thus used, specified sums were also earmarked for capital equipment required by India from non-sterling countries for her post-war development.

In the post-war years, the balance of payments position of the sterling area, and of the U. K. in particular, vis-a-vis, the dollar area, was fast deteriorating. There were several causes responsible for this dollar crisis. In the first place, the sterling area had come increasingly to depend on supplies from America. Secondly, food scarcity and inflationary pressures were hampering speedy recovery of production. Thirdly, the cost and price structures of the countries were out of tune both internally and externally. Fourthly, during the war, the American industry had attained a much higher technical efficiency leaving the countries of the old world far behind. Finally, private loans and commercial credits were practically non-existent in the post-war world. The result was that in the post-war years the dollar gap assumed large dimensions. From £ 226 millions in 1946 it rose to a big figure of £ 1,024 millions in 1947. In spite of rigorous exchange control and restrictions on trade, American Loan, Marshall Aid, borrowings abroad, utilization of the machinery of the I.M.F. and the International Bank, the bilateral clearing, payments and financial agreements, the sterling area failed to restore equilibrium in its balance of payments with the dollar area. The situation was indeed very serious and could not be allowed to continue. The only method left for Great Britain was that of devaluation.

The mechanism of the Empire Dollar Pool was to be abolished shortly after the coming into operation of the Indo-British Financial agreement which stipulated that the United Kingdom would abolish the sterling area dollar pool within one year of the coming into operation of that agreement and make available to each member country of the Sterling Area, its current sterling and dollar receipts at its free disposition for current transactions anywhere. This was hailed in India by some sections as a wise decision and satisfaction was expressed on India's getting out of the Empire Dollar Pool arrangement.

This jubilation however proved to be short-lived. The partition of the country put the Indian dominion in a more difficult position with regard to its earnings of dollar out of exports. With other countries India had also experienced in the previous four years a perpetual deficit on dollar account. India's decision to remain in the British Commonwealth of Nations as a free partner made her association with Great Britain in the economic field inevitable. The economic difficulties of the United Kingdom and the "dollar crisis" of the Sterling Area led to the restoration, once again of the Dollar Pool arrangements and India out of her free will joined these arrangements under the terms of sterling balance agreement of July, 1949. Under this agreement, India had been admitted to all rights and duties of full membership of the sterling area Dollar Pool. At a time when the country was in difficulties about getting dollars, the arrangement was to India's advantage, but whether it would remain so in the coming years would depend on the economic development of the countries of the sterling areas and their foreign trade.

The decision to join the dollar pool again had many implications, two of which must be clearly understood. The first was that while we were entitled to a share in the Central Dollar Pool, our fortunes were linked up with those of the pool. Had there been any shrinkage in the dollar resources of sterling area India would have been affected in the same way as any other country of the sterling bloc. For instance, it had been stipulated that sterling area countries should cut down their imports by 25 per cent from U. S. To begin with this might not seemed a hardship in view of our own prevailing balance of payments position but before long such a condition could become unbearable in view of our needs for machinery and other capital goods. Of course a clause had been inserted in the agreement which laid down that the cut in the dollar expenditure when necessary, would be distributed among various members in accordance with their economic conditions and standard of living of their people. In other words, a rich country might be asked to cut down expenditure more than a poor country. Much of course, depended on how this clause would be worked. Secondly, it was also clear that the Dollar Pool arrangements created bilateralism and blocks in the world trade which would reduce the volume of world trade. This was a bad omen for the world and India,

which believed in internationalism, by joining the dollar pool, was creating difficulties in the way of the establishment of free multilateral international trade. This was true but so long the major portion of India's foreign exchange resources remained in sterling, as a matter of self-interest she had a definite stake in keeping sterling strong.

§8. Devaluation

Between the period May, 1947 to September, 1949 the general index number of prices continued to rise from 271.3 to 389.8, in spite of a decline in the total money supply with the public from Rs. 2069.00 crores in August, 1947 to Rs. 1806.16 crores in September, 1949. There was a decline both in the volume of notes in circulation and of the deposits of the scheduled banks, induced partly by the continuing deficit in the balance of trade. The deficit in the balance of trade led to a fall in the holdings of foreign assets of the Reserve Bank of India from Rs. 1523.42 crores in August, 1947 to Rs. 781.05 crores in September, 1949. A disquieting factor was the existence of considerable deficit in India's balance of payments with the hard currency areas which amounted to Rs. 10.4 crores in the first six months of 1948, to Rs. 32.3 crores in the latter half of 1948 and to Rs. 49.7 crores in the first six months of 1949. This steep rise in the deficit with hard currency areas was mainly due to a decline in exports which dropped progressively upto June, 1949, and to the high level of Government imports which rose from an annual rate of Rs. 50 crores in the first half of 1948 to about Rs. 70 crores in each of the two following half years. India's exports were meeting with resistance not only in the hard currency areas, but also in relation to other countries of the world. Thus the index number of the volume of exports (Base 1938–39=100) registered a decline from 69.9 in 1947–48, to 61.8 in 1948–49 and to 54.1 in the three months, April to June, 1949. At the same time the index number of imports rose from 111.1 to 151.5 during the same period. The net terms of trade declined from 84.6 in 1947–48 to 80.9 in April-June, 1949. This growing imbalance between exports and imports was causing serious concern. To cope with this situation, the Government of India adopted the policy of cutting down imports from the dollar areas by 25 per cent from the 1948 level, following

the recommendation of the Commonwealth Finance Ministers' Conference. Exports, however, remained at a low level.

Events leading to devaluation

While the position with regard to the balance of payments was causing anxiety, devaluation was forced on India as a result of happenings in Great Britain and other sterling area countries. In the post-war years Great Britain was finding it extremely difficult to meet the so-called "Dollar gap". She had to import large quantities of goods from the dollar areas, while her exports could not be expanded to the desired extent. The existence of inflation and the high cost of production of British goods prevented a considerable expansion in exports. As a result, Great Britain had to use up her gold and dollar reserves to meet the dollar gap and the central reserves of the sterling area declined from £552 million in March, 1948 to £ 471 million in March, 1949 and further to £406 million in June, 1949. In the meantime a slight recession occurred in the U.S.A. in the early part of 1949 and this caused a serious fall in the volume of British exports to that market. The situation was aggravated by rumours of impending devaluation of the sterling and it led to some withholding of purchases by American buyers in the British market in the expectation that after devaluation British goods would become cheaper in price. Events moved to a rapid climax in September, 1949. On 18th September, 1949, Sir Stafford Cripps made the dramatic announcement that Britain had decided with the concurrence of the International Monetary Fund to devalue the pound sterling by 30.5 per cent. The value of pound was reduced from 4.43 dollars to 2.80 dollars. The fall in the value of pound had been anticipated for sometime past. But even the worst prophet had not anticipated a fall of 30.5 per cent in the value of British currency.

Sterling was thus devalued by 30.5 per cent at a stroke. This was followed by devaluation by a large number of other countries, both within and outside the sterling area. Even Canada, a dollar area country devalued its currency by 10 per cent.

The Government of India had three alternatives: (*i*) it could decide to continue with the existing parity with dollar and refuse to devalue the rupee as Pakistan had done, (*ii*) it could reduce the

rate of exchange more than the fall in the value of sterling and establish a parity of 1*s.* 4*d.* which had been so much desired in the country in some quarters and (*iii*) it could keep the rate of exchange stable in terms of sterling while reducing the value of rupee in terms of dollar in proportion to the fall in the value of sterling.

The first course had the disadvantage that our exports would have been ousted from the world markets. We were already in a precarious condition in respect of balance of payments. If we continued with the old rate of exchange, conditions would have become still worse. The conditions in Pakistan were different. She had a favourable balance of trade. She exported cotton and jute which were demanded all over the world. Her exports were absolutely inelastic. She had no industry worth the name exposed to face the competition from countries with devalued currencies. Her decision not to devalue her currency was understandable. However, India could not adopt this course.

As regards the second course, this had the disadvantage of raising price level in India still further. Prices of goods coming from sterling area would also have risen. The index number already stood at 390 in September, 1949. It would have risen much higher.

The Government adopted the third course which had been adopted by 24 other countries. India did not want devaluation; it was not in her interest, but it had been thrust upon her by the force of circumstances. On the 19th September, 1949 Government of India announced its decision to devalue the rupee by 30.5 per cent. The new ratio was fixed at 0.18662 grains of fine gold per rupee in terms of gold or 20.94 cents in terms of dollar. This ratio became effective from the 21st September, 1949 as banks were closed before that date. The value of the rupee was kept fixed in terms of sterling at 1*s.* 6*d.* per rupee.

Reasons for devaluation

The Government of India gave a number of reasons for their decision to devalue. One was the fact that the major portion of India's foreign trade was conducted in terms of sterling, and the sterling area countries which had devalued their currencies constituted our best customers. Had we refused to devalue, the value of

the rupee goods would have increased in the sterling area countries. This would have led to decline in our exports to these countries, creating fresh problems in regard to our balance of payments. Secondly, most of the sterling area countries were also the principal competitors of our exports in foreign markets. For example, Ceylon was an important competitor of Indian tea in the British market. As Ceylon had devalued her currency, non-devaluation by India would have meant a rise in the prices of Indian tea while Ceylon tea would have remained at the old levels. Indian tea would, then, have had to face serious competition.

Another related reason was that devaluation would help India to sell more goods in the dollar markets. India was facing a persistent dollar gap in her balance of payments, and devaluation, by cheapening Indian goods in dollar markets, might enable her to bridge the dollar gap.

Devaluation entailed, of course, a serious disadvantage in that India had to pay higher prices for the foodstuffs imported from the dollar areas. The prices of American machinery and other essential goods also rose, thereby imposing greater burden on the industries which had to import these goods.

Effects of devaluation

The immediate effects of devaluation in regard to the balance of payments were favourable. As against a deficit of Rs. 175.9 crores in the first nine months of 1949, the last quarter showed a surplus of Rs. 29.4 crores. Exports showed a record increase for the last quarter of 1949 of nearly 38 per cent over the previous quarter, the volume index reaching 92.9—the highest figure for the post-war period. Part of this increase in exports was no doubt caused by deferred purchases as importers in the dollar countries had postponed their normal purchases in anticipation of devaluation. But there was no doubt that the devaluation of the rupee enabled Indian exporters to sell larger quantities both in the dollar area and sterling area countries. Exports to the dollar area countries rose steeply from an annual rate of Rs. 106.8 crores in the third quarter of 1949 to Rs. 173.2 crores in the last quarter of that year. In the sterling area countries India did not, of course, enjoy any price advantage. But the devaluation of the rupee led in a number of these countries, to a substitution of commodities

from the dollar area or commodities with a high dollar content by Indian exports.

It should, however, be noted that this improvement in the balance of payments after devaluation was due not only to the increase in exports, but also to a decline in imports, brought about mainly by a policy of rigid import control. Following the recommendations of the Commonwealth Finance Ministers' Conference, Governments of the Commonwealth countries agreed to cut down imports from the dollar areas by at least 25 per cent. The results of this policy were obtained in the last quarter of 1949.

This improvement in the balance of trade did not, however, continue on the same scale in the first six months of 1950. There was a net deficit in the trade balance for this period, though the position was much better when compared to the same period of 1949. This slow rate of improvement in exports was due primarily to low level of exports of jute manufactures whose production had declined substantially. Pakistan's policy of non-devaluation led to the cessation of trade between the two countries, as a result of which the supply of raw jute became extremely scarce in the Indian market, and this was the most important reason for lower production and smaller exports of Jute goods.

Pakistan remained unmoved by the universal devaluation of the currencies of the sterling area. As a result the Pakistani rupee became the equivalent of about 2*s.* 2*d.* or 1.44 Indian rupees. The Government of India refused to accept the new rate for the Pakistani rupee. It was suggested in some quarters that considerations other than economic swayed Pakistan in the matter. Pakistan, however, tried to justify her action on the ground that she had a favourable balance of trade, that she had relatively a much lower price-level than India and that this decision was bound to result in cheap purchases of industrial equipment. Several other considerations, *e.g.*, the belief that Indian demand for jute and cotton from her was inelastic, that thereby her debt to India would be reduced and that she would be able to bring about deflation, also seem to have influenced Pakistan's decision. At any rate, this non-devaluation decision created a complete trade deadlock between the two countries. India finally accepted the official rate for the Pakistani rupee, as the

International Monetary Fund after detailing various reasons had come to the conclusion that the Pakistani rate was tenable. The new Indo-Pakistan Trade Agreement of 1951 recognized the exchange rate of Rs. 144 Indian rupees to Rs. 100 Pakistan rupees.

Devaluation stimulated a rise in prices in India and the general index number of prices increased from 389.0 in August, 1949 to 395.6 in June, 1950 when the Korean War broke out. A large rise took place in miscellaneous index number which rose from 541.6 to 692.0 during the same period, and in the index number of industrial raw materials which registered an increase of 30 points.

In the second half of 1950 the entire position was changed on account of the development of boom conditions throughout the world under the stimulus of the outbreak of the Korean War and the stock-piling of the essential raw materials by the U.S.A. It was no longer possible to observe separately the effect of devaluation on the balance of payments or prices.

On the whole it cannot be said that the devaluation of the rupee exercised any material influence over the balance of payments except in the immediate period. The balance of trade was favourable in the last quarter of 1949 and the first quarter of 1950, after devaluation in September, 1949. But in the second quarter of 1950 (April to June), the balance of trade had again turned adverse, the net deficit being of the order of Rs. 20.5 crores. The total value of exports which rose from Rs. 102.1 crores in July to September, 1949 to Rs. 133.3 crores in the next 3 months, fell to Rs. 129.4 crores in the first quarter and to Rs. 112.5 crores in the second quarter of 1950. Even then part of this improvement in the balance of trade had to be ascribed to the severe restrictions imposed on imports. Thus devaluation of the rupee failed to provide any solution for the intractable problem of "the comparative inelasticity of India's exports".

§9. Nationalisation of The Reserve Bank of India.

If monetary policy is to be utilized as an instrument for the attainment of higher levels of income and employment, the central banking authority should be amenable to persuasion and pressure from Government. Any contrariness or conservatism in the Board

of Directors of the Central Bank will be highly prejudicial to the successful working of such a policy . If the Government and the Central Bank cannot move forward in the same direction and at the same pace, a possible way out of the difficulty is for the Government, acting on behalf of the nation, to assume direct ownership and control of the Bank by buying out all its share-holders.

The Bank functioned as almost a department of the Government of India and during the war period it shared the criticism levelled against the policies leading to the development of inflationary conditions. On behalf of the Bank, of course, it could be pleaded that it did tender advice, whenever occasion demanded it, to Government and it sought to act in the best interests of the country. The public was however prone to judge the record of the Bank by results visible to the naked eye and these sometimes showed that either the Bank gave wrong advice or the Government did not listen to it. It was not always able to decide whether to accuse the Bank of collaboration or to excuse it for its helplessness.

After the independence of the country there was no danger of the policies of the Bank being directed to serve extra-territorial interests if it was nationalised. Moreover, Government was committed to the policy of economic planning which could not be carried out without complete control over monetary and financial mechanism. The Government of India, therefore, following the example of the British Government passed the Nationalization of Reserve Bank of India Act.

The Reserve Bank of India was nationalised on 1st January, 1949 under the Reserve Bank of India (Transfer to Public Ownership). Act 1948 and became a State-owned institution. The view of those who supported a State-owned central bank in the early phase of discussions, when the Reserve Bank had not yet come into existence, after all proved correct.

Nationalisation of the Reserve Bank was supported on many grounds: (*i*) the central banks in a number of Commonwealth and other countries, including Great Britain, were nationalised and there was a world-wide trend for State-owned central banks. The nationalisation of the Reserve Bank was in confirmity with this trend; (*ii*) the war-time experience had shown that the Reserve

Bank of India was not so independent of Government as was believed. The Bank had functioned almost like a department of the Government subordinate to the Finance Ministry. The nationalisation of the Reserve Bank, so to say, gave *dejure* recognition to a *de facto* position; (*iii*) there was a concentration of shares in few hands when the Reserve Bank was a privately owned institution and there was a risk of a misuse of the enormous powers which the Bank enjoyed for the regulation of money and banking. The Banking Companies Act, 1949 had placed enormous powers of regulation and control in the hands of the Reserve Bank and if the Bank remained privately owned, there might have been some danger of the misuse of these powers; and (*iv*) in the interest of implementing the five-year Plan it was necessary that there should be complete harmony between the Planning Commission and the Reserve Bank. This could not have been secured unless the Bank became a State-owned institution. In exercising control of currency and credit, the Reserve Bank played a vital role which had great significance for the financing of the Plan.

CHAPTER XII

XI Period : (April, 1951—March, 1959)

PERIOD OF PLANNING

§1. Adoption of Planning

The setting up of the Planning Commission in March, 1950 and the formulation of the First Five Year Plan to cover the period from April, 1951 to March, 1956 marked the beginning of a new and significant period in India's economic history. The functions of the Planning Commission include (*i*) assessment of the resources of the country, (*ii*) formulation of a Plan for the most effective and balanced utilisation of the resources, (*iii*) determination of priorities and definition of the stages in which the Plan should be carried out, (*iv*) study of the factors which tend to retard economic development and determination of conditions to be established for the successful execution of the Plan, (*v*) determination of the nature of the machinery required for the successful implementation of the Plan, (*vi*) appraisal of the progress achieved in the execution of each stage of the Plan and (*vii*) making recommendations in regard to matters falling within its purview or specifically referred to it for advice by Central or State Governments.

Broadly speaking, planning implies centralised control of the entire economy with a view to securing more efficient organisation and utilisation of the resources of the country for attaining determinable objectives within a measurable period of time. Planning is basically an attempt on the part of a country to take charge of her economic destiny. It is the opposite of leaving things to chance or accepting passively the results of the working of economic forces without trying to bring them under control. There can be no planning in any real sense unless there is centralised control of the entire economy. State control does not mean that every small activity and every detail of the economy is controlled and directed

by the central planning authority or the Government. It does, however, mean that the planning authority or the Government has control of all the strategic points and is able to operate all the levers in order to take the economy in a particular direction and at a certain speed. It is possible to envisage a public sector and a private sector of the economy existing side by side so long as the private sector accepts the discipline of the plan and so long as the Government has all the essential or strategic points under its control. At the same time, centralised control of the entire economy does not imply regimentation or lack of initiative on the part of individuals or local communities. Within the broad framework of centralised direction and control there can always be scope for decentralised activities and local initiative.

The adoption of planning has a direct bearing on the fiscal and monetary policies of the country. Since planning implies assessment of resources and their purposeful utilisation for achieving development, public finance becomes an instrument for attaining the objectives of the Plan. Resources are obtained through taxation, public borrowings, small savings and other sources and are utilised according to the priorities indicated in the plan. Allocations of resources are made for different kinds of development in accordance with their priorities. In this manner a certain pattern of investment is laid down. The monetary policy of the country has also to be framed in such a way that it supports the purposes and broad objectives of the Plan. For instance, if achievement of plan objectives requires that prices should be kept under control, the monetary and credit policies have to be so shaped that they subserve the aims and objectives of the plan. The adoption of planning, therefore, is an event of great importance from the point of view of monetary policy and it would be correct to say that with the inauguration of planning in India in 1951, a new chapter was opened in the history of Indian currency.

The broad objectives of the First Plan were to rehabilitate the economy of the country which had run down due to the strain imposed by the last War and the economic setback caused by the partition, to achieve a measure of self-sufficiency in food production and to initiate the process of all-round economic development. The broad objectives of the Second Plan are to secure a sizeable increase in national income, rapid industrialisation with particular

emphasis on the development of basic and heavy industries, large expansion of employment opportunities, reduction of inequalities in income and wealth and a more even distribution of economic power. There are adequate reasons for some differences in the objectives of the two Plans. The First Plan was drawn up to strengthen a rundown economy and to make up for the loss of large irrigated areas to Pakistan. High priority was, therefore, assigned to irrigation and agriculture. Substantial success was achieved in attaining the objectives of the Plan. Emphasis in the Second Plan, therefore, shifted more to the building up of a sound and well-balanced industrial structure, to a more rapid pace of development and to the social objectives of wider employment opportunities for all and the reduction of inequalities of income and wealth.

It may be useful to mention the main features of the two Plans. The First Five Year-Plan proposed a total outlay of Rs. 2069 crores by the Central and State Governments together. Later the Plan was expanded and various adjustments were made mainly with a view to stepping up the total outlay and to provide more employment opportunities. These adjustments raised the size of the Plan to Rs. 2378 crores. Actual expenditure during the five years, 1951-56, was about Rs. 2012 crores *i.e.* in financial terms the Plan was fulfilled to the extent of over 85 per cent. The Second Five-Year Plan envisaged an outlay of Rs. 4800 crores in the public sector and Rs. 2400 crores in the private sector. The domestic resources were estimated at Rs. 2400 crores of which Rs. 800 crores were to be raised by taxation, Rs. 1200 crores by public borrowings and small savings and Rs. 400 crores from other sources including Railway contribution, provident fund etc. Another Rs. 800 crores were estimated to be obtained from external assistance and Rs. 1200 crores were to be found by deficit financing. This still left a gap of about Rs. 400 crores which was left uncovered. In the working of the Plan in the first three years it was found that resources did not keep pace with expenditure. Particularly serious difficulties arose in regard to foreign exchange and the foreign exchange gap which was estimate at Rs. 1100 crores for the five years was, on revised estimate found to have increased to over Rs. 2000 crores. These difficulties led to the re-appraisal of the Plan and the National Developments Council which is the supreme body for considering policy issues in regard to planning decided that the Plan outlay in the public sector should be limited to Rs. 4500 crores.

§2. Impact of the Korean War (1950–51)

Among the initial effects of the outbreak of hostilities in Korea in June, 1950 was a speculative rise in prices. It was feared that this might be a prelude to another world war. Rearmament programme and stock piling by the U.S.A. and European countries and a world-wide scramble for essential goods and scarce raw materials began to affect trade and prices . In India, the index number of wholesale prices which stood at 397.1 on 24th June, 1950, rose to a peak of 462 by the middle of April, 1951. As compared with a rise of 4 per cent during the first half of 1950 there was an increase of 16 per cent between June, 1950 and April, 1951.

The strong inflationary impulses generated in the U.S.A. through higher price offers for primary commodities were imparted to the economies of other countries through the higher prices of these commodities until about March, 1951. After that date the stock piling programme was somewhat moderated and prices of several commodities fell considerably. But the price of rubber in June, 1951 was still 100 per cent higher than in 1950, of jute 83 per cent, tin 58 per cent, wool 46 per cent and cotton 33 per cent. The higher prices earned by the primary producing countries led to a sharp rise in their foreign exchange reserves and added to the money supply and incomes with far-reaching effects on their internal economies.

These developments necessitated measures for curbing inflation through judicious use of monetary policy and physical controls. Price controls were re-imposed in a number of countries. Credit curbs were tightened and interest rates were allowed to rise. In the U.K. the yield on 'Consols' touched 3.85 per cent in June, 1951. The influence of higher interest rates was also reflected in the loans of mortgage corporations, over-draft rates, discount rates on fine trade bills, etc. Similar developments were noticed in the U.S.A. where the discount rate of the Federal Reserve Banks was raised from $1\frac{1}{2}$ per cent to $1\frac{3}{4}$ per cent. Controls were reimposed on mortgage credit and reserve and margin requirements were raised. Apart from these measures a voluntary credit restraint programme was introduced and a National Voluntary Credit Restraint Committee

with 12 Sub-Committees for banks and 4 Regional Sub-Commti-ttees each for Insurance Companies and investment banking houses was organised.

The post-Korean inflationary pressures, which had been generally halted by the end of 1951, eased further in many parts of the world during 1952, and in spite of the growth of defence spending in many countries, inflation did not re-emerge. In many parts of the world, there were sporadic symptoms of a price recession, with wholesale prices generally remaining either stable or experiencing a slight decline. The important exceptions were some of the Latin American and Commonwealth countries, notably Australia and South Africa. In most of these countries too, the price rise was much smaller than in 1951.

In the sphere of international trade there was considerable improvement in the position of the non-dollar countries. The surplus of the U.S.A. with the rest of the world on current account fell from $6.2 billion in 1949 to $2.2 billion in 1950 and during the first part of 1951 the surplus declined further. On the other hand, the sterling area was able to achieve a dollar surplus. The sterling areas gold and dollar reserves stood in June, 1951 at $3,867 million, recording a rise of $1,445 million during the period from July, 1950 to June, 1951. Canada registered an increase of $534 million in its gold and dollar holdings between July and September, 1950. This improvement in the reserves in the non-dollar currency countries and the outflow of gold from the U.S.A. led to persistent rumours of possible revaluation of the Canadian dollar and the pound sterling. This speculation brought about an increased flow of private capital away from the U.S.A. into Canada and the U.K., with the result that the existing inflationary pressures in these countries were intensified, while the foreign debt and annual service charges, especially in Canada were enhanced. Under these circumstances the Canadian Government, unwilling to hold its rate of exchange at the existing level, but unable to determine an appropriate parity, decided on October 1, 1950, to free the rate of exchange and allow its parity to be determined in a free market. As a result of this the Canadian dollar which stood at 90.15/16 U.S. cents on October 1, 1950, rose to 96–11/16 cents by November 9, 1950, but subsequently reached a parity of 93–1/16 cents at the end of June 1951. The

developments in Canada were followed by general rumours regarding the revaluation of other currencies and these were stimulated by the possibility that the U.K. might decide to revalue in order to arrest the deterioration in her terms of trade which rising prices of primary products had induced. The Economic Commission for Europe in its Annual Report for 1950 released in May 1951, urged the revaluation of West European Currencies as a disinflationary measure. The International Monetary Fund urged the view that countries which had improved significantly the position of their external reserves since devaluation should first relax the existing restrictions on exchange transactions.

The markets for Government securities reflected the hardening of interest rates during 1950–51 in many of the leading countries. In the U.S.A. the mounting inflationary pressures generated after the outbreak of the Korean War led the Federal Reserve system strongly to advocate a return to a more flexible monetary policy with a view of restoring its initiative in regard to open market operations and restriction of credit. In the U.K. the gilt-edged market was firm during the second part of 1950. After mid-January 1951, however, prices tended downwards, the deteriorating international situation and the Iranian oil dispute adding to the uncertainty which developed in the market.

Imports into the U.S. declined sharply from 1950-51 levels, exports recorded a continuous increase. There was no increase in the total of the U.S. Government grants, loans and private capital outflow. In consequence the surplus of imports from America by the rest of the world could not be fully financed and from the third quarter of 1951 onwards many of the countries, especially countries in the sterling area, had to meet their dollar obligations by running down their gold and dollar reserves. Thus in place of an outflow of gold from the U. S. amouting to $2,459 million during the period July 1950-June 1951, there was a net inflow of gold into the U.S. of about $1000 million during the second half of 1951.

The Korean War had its impact on India's foreign trade as well as internal monetary situation. The average index of import prices rose from 122 in the first quarter to 157 in the third quarter of 1951 and that of export prices from an estimated 140 to 189 in the same period. Currency and credit, with commodity prices ruling high,

showed unusual expansion. Money supply with the public rose by Rs. 99.2 crores in 1950.51 as against a decline of 18.4 crores in 1949–50 and scheduled bank credit showed an expansion of Rs. 84.6 crores as against a contraction of Rs. 34.2 crores in 1949–50. The war also gave rise to a sudden spurt of speculative and hoarding activity. Price movements in respect of bullion were mainly governed by external factors, the Korean War situation and the general rise in the price of gold in free markets. Prices of the two metals generally receded until early November, 1950. Thereafter prices resumed the uptrend, the main factors influencing higher prices being the growing seasonal demand, the sharp rise in silver in the world markets, restricted arrivals of smuggled gold in view of the vigilant measures taken by the customs authorities to prevent smuggling and the grave turn in the war situation in Korea following Chinese intervention. To meet the situation the Finance Minister enunciated in Parliament in August 1950 an eight point programme outlining the major objectives of Government's economic and financial policy, which envisaged measures to hold the price line and to ensure, through increased production, economies and larger supplies, that the inflationary pressures did not get out of hand.

The terms of trade after showing an improvement during the first three quarters of 1950 deteriorated in the last quarter of the year, in 1951 they significantly improved in the second and third quarters, followed by a deterioration in the fourth quarter, but remained significantly above the level of the average for 1950. The payments position improved considerably on account of the Korean boom and consequently the restrictions on imports were gradually relaxed during the latter half of 1950 and 1951, though imports from the dollar area continued to be regulated on the strict test of essentiality. In the quarter July-September, 1950 there was a surplus of Rs. 13.4 crores and during the quarter October–December, 1950 it increased phenomenally to Rs. 41.2 crores. The surplus in the third quarter, however, was relatively small owing to a sharp increase in the payments for imports largely on private account. During the 9 months July, 1950–March, 1951 the surplus in the balance of payments aggregated Rs. 70 crores as compared to Rs. 27 crores in the period July, 1949–March, 1950.

The payments position with the hard currency countries showed still greater improvement. The surplus with these countries during

the first three quarters of 1950 totalled Rs. 40 crores compared to Rs. 11.5 crores in the corresponding period of the previous year. This enabled India to contribute in the calendar year 1950, a sum of $85 million to the Central Reserves of the sterling area on which she had drawn heavily during the earlier period.

Owing to intensified stock-piling demand for Indian export commodities and the consequent increase in their prices, exports recorded a rise from Rs. 35.7 crores in the second quarter of 1950 to Rs. 39.8 crores in the third quarter and to 49.9 crores in the fourth quarter. At the same time commercial imports shrank to less than half the second quarter level, from Rs. 37.8 crores to Rs. 15.5 crores and Rs. 16.8 crores in the third and fourth quarters respectively. Despite this severe reduction in commercial imports there was a marked rise in the total payments for imports in the fourth quarter mainly owing to a large increase in Government imports.

On becoming a member of International Monetary Fund in July 1950, Pakistan communicated the initial par value of her rupee, but owing to various circumstances the Fund's decision was delayed. In the meantime the impetus given by the developments in Korea intensified the international stockpiling and rearmament programmes of the countries in the West. Consequently, the prices of essential raw materials were pushed up to abnormally high levels to the advantage of primary producing countries like Pakistan. India on the other hand experienced acute shortage of jute at a time when the demand for her jute manufactures was at its peak. In view of this radical change in the economic situation, India took the initiative in resuming trade negotiations with Pakistan and concluded an agreement on February 25, 1951 on the basis of India's acceptance of the official par value of the Pakistan rupee. Exchange control with Pakistan was instituted on February 27, 1951. The International Monetary Fund announced on March 19, 1951 its acceptances of the par value of the Pakistan rupee as communicated to it by Pakistan earlier.

Economic events in India during 1952 were inevitably influenced by the continuous retreat from the boom conditions generated by the Korean war in international trade.

§3. Question of Rupee Revaluation

As has already been mentioned in the previous section, the outbreak of the Korean War in June, 1950, the stock-piling of essential materials by the U.S.A. and the rearmament drive by almost all the countries led to a considerable increase in exports and prices. The total value of exports from India increased to Rs. 600.57 crores in 1950–51 and Rs. 732.86 crores in 1951–52. The General Index of prices rose from an average of 385.4 in 1949–50 to 409.7 in 1950–51 and to 434.7 in 1951–52. The presence of these two factors led to a demand for the revaluation of the rupee ratio in the upward direction.

Dr. John Mathai, who was the Finance Minister in the Government of India at the time of devaluation pleaded for the fixation of a higher value of the rupee. Others also favoured this step, in view of an inflationary rise in prices. It was argued that a higher rupee ratio would result in lowering prices and would serve as an anti-inflationary device. Secondly, it was said that a reasonable price level would improve the competitive position of our exports and would counteract any adverse influence caused by the higher ratio. Thirdly, revaluation would lower the prices of imports, and would enable this country to purchase its food imports, machinery and other essential goods at lower prices. The lowering of the costs of food imports would reduce to some extent the strain on the budget of the Government. Lastly, higher ratio would do away with quarrels with Pakistan over the value of rupee. It would lower the price of raw jute imports from Pakistan, and thus would lead to larger production of jute manufactures. Production of more jute goods at lower prices would provide stimulus to jute exports which were then being hampered on account of the difficulties of raw material supply.

Those who opposed revaluation of the rupee pointed out that in the prevailing unsettled conditions in the world revaluation was not feasible and in any case, India could not take unilateral action in this matter. Shri Chintaman Deshmukh told Parliament in the course of debate in April 1951: "We are not satisfied that a revaluation of our currency is likely to be, in the present circumstances, in the interest of the country. The conclusion that the Reserve Bank experts have arrived at is that a 15 per cent revaluation would probably involve a balance of payment deficit of round about

Rs. 50 crores and a 30 per cent revaluation would involve a deficit in the balance of payment of Rs. 135 crores whereas, if we do not revalue, we shall probably hold things square". Those who favoured revaluation of the rupee pointed out that in these estimates of balance of payments deficit much higher degree of elasticity for India's export was being assumed than was actually the case. Some of our export articles are jute goods, cotton textiles, tea, hides and skins, oil seeds, spices, mica, manganese and shellac. In the case of jute and cotton goods, in 1951 there was a seller's market and world prices were higher than Indian prices. It was on this account that the Government of India was able to levy high export duties on these commodities without reducing the exports much. If revaluation of the rupee would have led to a rise in the rupee prices of these goods and the export duty were either withdrawn or reduced, the chances were that Indian prices would have still remained within the limit of world prices. An important point to consider in this case was that due to revaluation raw material for these goods would have been available cheaper from Pakistan. This would have reduced their cost of production and their export prices need not have risen to the full extent of appreciation in the exchange value of the rupee. The same argument applied, though to a limited extent, in the case of hides and skins and oil seeds. It was likely that our exports of tea and some minor commodities might have fallen because of an appreciation in the exchange value of the rupee but, it was argued by protagonists of revaluation, by no stretch imagination could this lead to a deficit of Rs. 135 crores in India's balance of payments if the rupee were revalued by 30 per cent.

As an argument against revaluation, it was pointed out that Pakistan would increase the prices of its raw material and would thereby deprive India of the advantages of revaluation. The sellers of capital goods needed for the Government development projects or private projects, where the sellers are few and charge discriminatory prices rather than competitive prices, would have split the advantage of revaluation between themselves and India would not have got much advantage. But there was no reason to believe that the mere fact of revaluation would have brought about these consequences. The exporters of capital goods and machinery to India and Pakistani suppliers of raw jute and cotton were charging as high a price as they could under the circumstances and the mere

fact of revaluation of the rupee might not possibly have made them charge higher prices.

The present exchange value of the rupee, whether it was right or wrong at the time of devaluation, has got itself adjusted. A certain amount of dislocation was being caused by Pakistan's refusal to fall in line with the other Commonwealth countries. But this cause of irritation was also removed in September 1955, by devaluation of the Pakistani rupee to the level of the Indian rupee. Under the present circumstances there is no question of revaluing the rupee unless either the conditions in India's foreign trade change in such a way as to make this course of action necessary, or some other countries of the world alter the exchange value of their currencies and thus make it necessary for India to re-examine the matter. At present the problem of exchange value of the rupee is only of historical importance.

§4. Financing of the Development Plans

The manner in which a plan for the country is financed is of great significance for the soundness of its monetary policy and the stability of its currency. It is, therefore, of great interest to study how India's two plans—the first and the second—have been financed.

The outlay proposed in the first Five-Year Plan was Rs. 2,069 crores for which the resources were to be found as follows:—

In Rupees Crores

		Centre (including Part 'C' States)	*Part A and B States*	*Total*
(1)	Public Savings from:—			
	(*a*) Current revenues ..	160	408	568
	(*b*) Railways	170	—	170
(2)	Private Savings from:—			
	(*a*) Loans from the public ..	36	79	115
	(*b*) Small savings and other unfunded debts	270	—	270
	(*c*) Deposits, funds and other miscellaneous sources ..	90	45	135
	Total of (1) & (2) ..	726	532	1,258
(3)	External aid ..			156
				1,414
	Gap			655
	Total of (1), (2) and (3)			2,069

With the expanded outlay of Rs. 2378 crores, the gap was increased by another Rs. 310 crores, made up of Rs. 175 crores on account of the additional outlay and of Rs. 135 crores on account of the estimated shortages in the bugdetary resources of the Central and the State Governments over the five year period. In the Plan it was estimated that during the period of the plan, India would be able to draw upon its sterling balances to the extent of Rs. 290 crores. To the extent to which these balances would be utilised, it would add to the total resources available in the country either for consumption or for investment or for both. The gap in excess of this amount had to be met from further external resources if available, or in the absence of it, by additional measures of internal taxation and borrowing and from deficit financing.

The financial resources for the Second Five-Year Plan were expected to come from the following sources:

(In Crores of Rupees)

1.	Surplus from current revenues at existing levels of taxation	.. 350
2.	Additional taxation	.. 450
3.	Railway contributions	.. 150
4.	Provident Funds etc.	.. 250
5.	Market loans	.. 700
6.	Small savings	.. 500
7.	External Assistance	.. 800
8.	Deficit financing	.. 1200
9.	Uncovered gap	.. 400
	TOTAL Rs.	.. 4800

It will be obvious that the total of budgetary resources, including additional taxes were to bring in Rs. 1,200 crores, while public borrowings were expected to yield another Rs. 1,200 crores. The problem, then, was to find another 2,400 crores. In the Plan it was estimated that over the next five years, the balance of payments deficit would amount to Rs. 1,100 crores. This was to be financed by drawing down the sterling balances to the extent of Rs. 200 crores. Inflow of private capital was expected to bring in another Rs. 100 crores, leaving a gap of Rs. 800 crores. This gap was to be met from external assistance.

Even if external assistance to the extent hoped for was available, there would still be a gap of Rs. 1,600 crores in the Plan. It was considered that Government could finance its deficit by the creation of new money upto a maximum of Rs. 1200 crores. There would still be a gap of Rs. 400 crores, which was to be met somehow, either from additional taxation or borrowing or external assistance.

Capital formation from domestic savings

Capital formation has been defined as the process of accumulating savings funds. Looked at from another point of view, it might also be defined as the process of utilizing such funds in new construction, in maintaining and expanding producers' durable equipment, in the enlargement of inventories and in making foreign investments. Capital formation in a monetary sense means the savings themselves. In a physical sense it means new construction, the maintenance and enlargement of technical equipment in factories and in agriculture and the net flow of goods from abroad.

The economic progress of a country vitally depends on the rate of capital formation. In all the countries of the world economic progress has resulted from an increase in capital formation, which means in the savings of the people and the investment of these savings. In order to develop the country economically and to make the people rich it is necessary to increase the rate of national savings in India and to increase the rate of investment of these savings in industry, agriculture and development projects.

As stated in the Plan, "the proportion of national income that is saved and made available for investment depends upon psychological and institutional factors. Social customs and habits, the distribution of incomes, the rate at which incomes of different classes go up and the efficacy of banking and other institutions for mobilising savings —all these play a part in determining the rates of savings attained". Psychologically, people have a desire to save as much as they can. But it is not savings alone that are important; they must also be invested for productive purposes.

The first five year plan aimed at increasing the rate of savings from some 5 per cent of the national income in 1950–51 to 6¾ per cent of the national income by 1955–56. This would have made it possible to increase capital formation to Rs. 675 crores by 1955-56. The actual result has been much better. India's national income increased from Rs. 9,110 crores in 1950-51 to Rs. 10,800 crores in 1955-56 (estimated) and the total investment increased from Rs. 450 crores (*i.e.* 4.9 per cent of national income) in 1950–51 to Rs. 790 crores.

At the time of finalising the First Five Year Plan, it was estimated that in the second and subsequent periods it would be possible to increase the rate of capital formation. If from 1956–57 onwards the marginal rate of savings could be stepped up each year by an amount equal to 50 per cent of the additional output, the national savings would have increased to about 11 per cent by 1960–61 and to 20 per cent by 1967–68 and in the subsequent period. If investment proceeded at these rates the per capita income, taking the increase in population into account, would be doubled by 1977-78.

This would have been a very gratifying achievement. But the real question was whether it would be possible to save 50 per cent of the additional annual income for investment in the production of producers' durable goods rather than for consumption. A vast majority of people in India are poor and have a low standard of living. If their income rises as a result of economic planning they might not have the patience to wait and allow half the income to be invested. This will impose a heavy sacrifice on them. If the people are not prepared to make this sacrifice, the rate of progress envisaged in the five year Plan might not be achieved. These fears which were entertained at the beginning of the first plan have come true. It is now realised that these were "excessively high expectations". The Second Five Year Plan takes a more conservative view and, as shown in the table below it is now expected that the rate of investment shown in the economy would go up from nearly 7 per cent in 1955-56 to 11 per cent in 1960–61, 14 per cent in 1965–66 and 16 per cent in 1970–71. It would remain practically stable after that date and would probably rise to 17 per cent by 1975-76.

Growth of income and investment in India from 1951-56 *to* 1971-76

(*At* 1952-53 *prices*)

Item	*1st Plan*	*2nd Plan*	*3rd Plan*	*4th Plan*	*5th Plan*
National Income at the the end of the period (*Crores of Rs.*) ..	10,800	13,480	17,260	21,680	27,270
Total net Investment (*Crores of Rs.*) ..	3,100	6,200	9,900	14,800	20,700
Investment as percentage of national income at the end of period ..	7.3	10.7	13.7	16.0	17.0

It is rather doubtful whether a rate of even 16 to 17 per cent would be achieved in India by the end of the fifth five year plan.

In India the rate of capital formation and the rate of investment have been low for various reasons. Investment activity depends on

the Government's taxation, fiscal, labour and other policies, on the psychological attitude of the entrepreneurs, and on the availability of machinery and equipment, technical knowledge and the supply of skilled labour. High taxation increases the costs of production of industry and reduces the profits of the entrepreneurs below what they would like to get for undertaking the risks of production. According to Keynesian analysis, when people have to pay higher taxes, they at least partly reduce their current expenditure. A reduction in the marginal propensity to consume retards the process of increase in the aggregate national income as a result of 'new' investment.

Deficit financing

The term 'deficit finance' is generally used to connote borrowing by Government from the central bank to meet the excess of its expenditure over its current revenues raised by means of taxes and borrowings from the public. The central bank meets this requirement of the Government by issuing more currency notes against *ad hoc* Government securities. Deficit financing can thus be broadly defined as a deficit in the over-all internal operations of the Government on revenue and capital accounts together and the supplementation of the general monetary and credit needs of the country by created money.

This kind of excessive spending can also take place in private sector. This happens when the private expenditure over and above the current saving is financed by an expansion of bank credit or by an activation of the idle resources of the community, such as hoarded money or bank deposits. The effects of excessive spending by the Government or private sector are the same on the economy of the country, as both are excessive in relation to the currently available savings.

Governments usually adopt three methods, *viz* taxation, internal borrowings from genuine investors and from central bank and external loans, for meeting the excess of planned expenditure over it. The purpose of resorting to deficit financing is generally to place sufficient resources at the disposal of Government in excess of what is available to them by way of taxes and borrowings from public in order to enable them to undertake a more rapid economic development of the country's idle resources. These created resources may be used on schemes which become quickly productive like minor irrigation works, or they may be used for capital investment

in major works such as heavy industries, roads, houses, river valley projects etc. which would yield return in the long run. It is, of course, highly desirable that deficit financing should as for as possible be undertaken only for the sake of production schemes which would give quick results.

As has been mentioned in the previous chapter, the Government of India resorted to deficit financing on a very large scale during the second world war. The notes in circulation increased from Rs. 182.13 crores on 1st September, 1939 to Rs. 1,159.35 crores on the 19th October, 1945 representing an increase of Rs. 977.22 crores. There was also an increase in bank deposits, which in the case of scheduled banks amounted to Rs. 460 crores from 1st September, 1939, to 31st March, 1945. The Government resorted to this currency expansion with a view to purchasing various kinds of war materials on behalf of His Majesty's Government and other Allied powers. One of the immediate effects of this step was an enormous rise in the price level. After the war deficit financing continued on very much reduced scale. The adoption of deficit financing for accelerating planned development of the country has given it an altogether new complexion.

The Central and State Governments incurred an overall deficit of Rs. 446.2 crores in the course of the First Plan period from 1951 to 1956, as shown below:—

(*In crores of Rupees*)

	1951–52	1952–53	1953–54	1954–55	1955–56	*Total* 1951–52 *to* 1955–56
Central Government ..	+33.1	—46.4	—80.8	—142.3	—159.9	—396.3
State Governments ..	—39.4	—14.8	+18.9	+42.4	—57.0	—49.9
Surplus+ .. Deficits— ..	— 6.3	—61.2	—61.9	—99.9	—216.9	—446.2

Allowing for the actual increase in the floating debt of the Central Government and for certain other adjustments, however, the combined overall deficit of the Central and State Governments is likely to be lower at about Rs. 100 crores. The combined estimated deficit for 1955–56 was placed at a much higher level *viz.* Rs. 395 crores. A point of interest which emerges from a comparison of the trend in disbnrsements and current revenues during the past five years

is that while the combined disbursements of Central and State Governments on both revenue and capital accounts have risen steeply by nearly Rs. 600 crores between 1951–52 and 1955-56 to over Rs. 1600 crores, the combind current revenues during the same period have increased only by Rs. 25 crores to about Rs. 900 crores. The estimated current revenues for 1954-55 formed about 8 per cent of the estimated level of national income, a proportion which has not varied significantly since the pre-war period. Both these facts also indicate the urgent necessity to increase the budgetary resources.

India's second five year plan envisaged deficit financing of the order of Rs. 1,200 crores in a period of five years between 1956–57 and 1960–61. The Central Budget for 1956–57, after allowing for revenue from additional taxation, showed an overall deficit of Rs. 355.4 crores. The outstanding feature of budgets in subsequent years has been the rising tempo of outlay under the Plan, which was placed at Rs. 861 crores in 1957–58 (revised) as compared to the actual outlay of Rs. 635 crores in 1956–57. The whole of the estimated increase in outlay was reflected in an increase in the combined budgetary deficit of the Centre and the States from about Rs. 250 crores in 1956–57 to about Rs. 500 crores. Increased tax receipts were offset by a fall in loan receipts. For 1958–59 Plan outlay is placed at Rs. 960 crores, while the budgetary deficit is placed at a greatly reduced figure of Rs. 220 crores, because of anticipations of improvement in loan receipts including small savings as well as in foreign aid. Recent appraisal of the Plan has led to a scaling down of the target of expenditure from Rs. 4,800 crores to Rs. 4,500 crores owing to the inadequacy of resourses. The appraisal is in keeping with the flexible character of the Plan. The revised picture of the Plan is as follows:—

(In Crores of Rupees)
Likely actuals for first three years of the Plan

	1956–57	1957–58	1958–59	*Total for 3 years*	*Total* 1956–61	*Total as in the Plan*
1. Plan Outlay ..	635	861	960	2456	4500	4800
2. Resources:						
(*a*) Domestic Budgetary resources ..	359	297	445	1101	2262	2800
(*b*) External assistance	38	100	300	438	1038	800
(*c*) Deficit Financing ..	238	464	215	917	1200	1200

RESOURCES FOR THE SECOND FIVE YEAR PLAN

(In crores of rupees)

	Estimates for the first three years (1956–59)			*Estimates for the last two years* (1959–61)			*Total for the five years* (1956–61)		
	Centre	*State*	*Total*	*Centre*	*State*	*Total*	*Centre*	*State*	*Total*
Domestic budgetary resources									
Balance from current revenue	250	178	428	140	182	322	390	360	750
Railways' contribution ..	126	..	126	124	..	124	250	..	250
Loans from the public (net)	328	113	441	170	107	277	498	220	718
Small savings ..	96	115	211	59	114	173	155	229	384
Unfunded debt and Misc. capital receipts ..	—64	—16	—80	25	—19	6	—39	—35	—74
Total of domestic resources	736	390	1,126	518	384	902	1,254	774	2,028
External assistance ..	458	..	458	642	..	642	1,100	..	1,100
Total of budgetary resources and external assistance	1,194	390	1,584	1,160	384	1,544	2,354	774	3,128
Central assistance ..	—568	568	..	—470	470	..	—1,038	1,038	..
Resources after adjusting for Central assistance ..	626	958	1,584	690	854	1,544	1,316	1,812	3,128
Deficit financing ..	798	84	882	200	10	210	998	94	1,092
Total resources—Plan outlay	1,424	1,042	2,466	890	864	1,754	2,314	1,906	4,220

On present expectations the Centre and the States are likely to be able to provide in the next two years resources of the order of Rs. 1,754 crores, whereas the requirements for reaching a total of Rs. 4,500 crores over the two years amount to Rs. 2,034 crores. There is thus a short-fall of Rs. 280 crores—Rs. 198 crores at the Centre and Rs. 82 crores in the States.

After considering the question of the gap in resources in relation to wider issues affecting the economy, the National Development Council decided in November 1958 that (*i*) the State should take over the wholesale trade in foodgrains; (*ii*) emphasis should be placed on the organisation of village co-operatives in all States to shoulder the task of rebuilding the rural economy; (*ii*) determined efforts should be made both at the Centre and in the States to achieve economies in construction costs and to raise additional resources; and, finally, (*iv*) the conclusion reached in May 1958 to work up to a level of outlay of Rs. 4,500 crores during the Second Plan period should be maintained.

Recent developments pose the central issue of resources for planned economic development. While the immediate stepping up of the rate of foreign assistance is imperative for preventing a serious set-back in the progress of the Second Five Year Plan and a substantial degree of such assistance would appear necessary for some years for further development plans, the problem of resources must be considered in its fundamental aspect of increasing the rate of savings in the community to match the higher rate of investment. From such studies, as have been made, it appears that the rate of domestic savings has failed to show a perceptible increase and the great challenge in the near future is to increase decisively the elasticity of domestic resources. The recent improved performance of small savings and Government borrowing indicates a possible direction of increasing the savings through an improvement in organisation and administrative machinery.

The Union Finance Minister has given the assurance that the effect of the deficit financing will be kept under constant watch and appropriate measures will be taken to counteract any unhealthy development. In the present conditions it would seem that a measure of deficit financing is more or less inevitable for the implementation of the plan and it would be more beneficial to accept a small dose of

deficit financing rather than abandon or jeopardise the plan. In the above estimate of resources, the limit for deficit financing for the next two years has been taken at Rs. 100 crores a year. With prices at the present level and with the growing pressure for increases in wages and salaries to compensate for the rise in cost of living, there is not much scope for further deficit financing. Hitherto, the inflationary impact of deficit financing has been offset by the large balance of payments deficits financed by a draft on foreign exchange resources. Since that 'cushion' is no longer available, it is now felt that the less deficit financing there is, the better. It is only when food production increases substantially and food prices register a distinctly downward trend that deficit financing on any significant scale could be contemplated.

The balance of payments deficit over the Plan period was expected to be of the order of Rs. 2,000 crores. Roughly, one-half of this deficit has been incurred so far. With sterling balances held by the Reserve Bank at less than Rs. 180 crores, it is necessary to avoid drawing them down any further. For bridging the estimated foreign exchange gap for the period October to March, 1959, external assistance totalling $350 million was promised. Further assistance required for the rest of the Plan period is estimated at $650 million. By the end of the Second Plan period, the country will also have substantial debt liabilities abroad. In estimating the aforesaid foreign exchange gap it was assumed that no food imports over and above the 'normal' purchases and existing commitments would be undertaken unless covered by separate aid programmes.

Deficit financing provides no easy substitute for sustained and substantial efforts to mobilise resources for development. It is a double-edged weapon which may be employed within limits to help development but may hinder it if used to excess. It is, therefore, desirable to set our targets of development on a realistic assessment of available resources, while making the fullest effort to maximize such resources. The Government have initiated vigorous measures in the field of taxation, borrowing and credit control to keep inflationary pressures under check. There is little doubt that recent experience has highlighted the fact that greater mobilization of resources and larger production, particularly of foodgrains, are prerequisites for sustaining the pace of development effort. It needs to be emphasized, however, that stresses and strains in the economy are

bound to arise during the initial stages of development. It is really a question of adopting from time to time suitable corrective measures-fiscal, monetary and others—which in the given circumstances, will yield adequate results. In short, if India wants to increase her already too low standard of economic life, if famine, pestilence, ignorance and filth are to be avoided and if her dependent economy is to be changed into a self-sufficient one, planned economic development even with recourse to deficit financing, is of paramount importance.

§5. Currency Circulation and Price Trends

Price movements between September, 1949 and March, 1957 have exhibited five distinct trends: first, during the period from Sep. 17, 1949 to April 14, 1951, prices rose almost continuously; second, from April 14, 1951 to March 15, 1952 prices showed a declining trend; this was followed by a phase of rising prices from March 15, 1952 to August 13, 1953; in the next period until June 14, 1955 prices declined considerably; and this has been followed by a phase of rising prices, which has continued for a long time. The tables given below show the index numbers of wholesale prices on the old base of August 1939=100.

TABLE 1 : *Wholesale prices index (weekly)*

June 24, 1950 (*Pre-Korea*)	*Mid April* 1951 (*Korean Peak*)	*Mid March* 1952	*Mid August* 1953	*Sept.* 25 1954	*June* 4 1955	*March* 31 1956	*March* 31 1957
397.0	462.0	365.0	412.0	384.0	341.0	390.0	421.0

TABLE 2 : *Index number of wholesale prices.*

Year	*Food articles*	*Industrial raw materials*	*Semi-manufactures*	*Manufactured articles*	*Miscellaneous*	*General index*
1949–50	391.3	471.7	331.6	347.2	570.7	385.4
1950–51	416.4	523.1	348.9	354.2	707.4	409.9
1951–52	398.6	591.9	374.4	401.5	721.6	434.6
1952–53	357.8	436.9	343.8	371.2	614.1	380.6
1953–54	384.4	467.7	359.2	367.4	686.6	397.5
1954–55	339.8	436.2	350.3	377.4	612.4	377.5
1955–56	313.2	419.7	338.2	372.9	546.4	360.3
1956–57	389.0	502.0	402.0	385.0	559.0	414.0

I Period: September, 1949—*April*, 1951

In the first period, starting from September 17, 1949 to April 14, 1951, prices increased on the whole by about 19.4 per cent in about 19 months. The rate of increase was at first comparatively slow until the outbreak of the Korean episode, after which there took place a precipitate rise in prices. This was due primarily to the impact of the Korean War and the adoption of stock-piling programmes in essential raw materials. The price index of industrial raw materials rose from 494.2 in June 24, 1950 to 699.8 in mid-April, 1951.

II Period: April, 1951—*March*, 1952

The second phase began with the decline in prices from April, 1951. The rate of decline was at first slow and hesitant but by January, 1951, the decline gathered momentum and in the next two months the index number fell by 52.8 points. Compared with the height of the boom in mid-April, 1951, the total fall was 21 per cent. This decline in price was due to the combination of certain international factors with a number of domestic elements. Among the main factors was the modification of the U.S. stock-piling programme which curtailed the demand for the essential materials. The world supply position in regard to a number of commodities such as wool, coal, rubber, cotton etc. improved considerably as a result of large production. Both these factors exercised a downward pull on the prices of important commodities. At home, large domestic production of a number of commodities, the raising of the Bank Rate and the adoption of other measures of monetary control from mid-November, 1951, were also responsible for bringing about this fall in prices. Industrial production during this period rose by 12 per cent and the increase was especially marked in textiles iron and steel etc. Agricultural production also improved to some extent.

III Period: March, 1952—*August*, 1953

During this period of about 17 months the general price level rose by about 12 per cent but the boom was on the whole of a mild nature. The upward rise was assisted by abolition or reduction of export duties and relaxation of domestic controls on certain commodities.

IV Period: August, 1953- -*June*, 1955

From August 1953 prices again started declining and by June, 1955, the index number fell by about 16 per cent. In certain sectors the decline was so large as to carry prices almost to the levels prevail-

ing in the early years of the war. In this recession the agricultural prices declined by about 30 per cent due to the occurrence of bumper crops in two successive seasons on account of favourable weather conditions.

V Period: June, 1955—March, 1957

After June 1955 the prices started rising again. The rise in prices was, in the first instance in the nature of a correction of the sharp decline which occurred during the preceding one year or so and was assisted to some extent by Governmental measures, including limited price support, to achieve a reasonable degree of price stability. However, the almost continuous uptrend, particularly during the latter half of the year, suggested the operation of certain basic factors at work concerning supply and demand—in brief, a somewhat larger demand against a somewhat smaller supply. These were the lower output of cereals during 1954–55 and the rising exports of some industrial raw materials during 1955–56 season, due to floods or drought in parts of the country. It is not improbable that there was also some inventory build-up, in view of the accelerated pace of industrial development. Consumption demand must also have been rising, consequent on the rising incomes, following higher levels of investment expenditure.

Recent trends

The upward trend of prices, which began in June, 1955 continued upto early August, 1957, the General Index reaching 113.1 for the week ended August 3—the highest level for 1957–58 —after which the trend was reversed. The index declined steadily to 104.1 for the week ended February 8, 1958 and stood at 106.1 at the end of March 1958. It rose again to 111.4 and 112.3 by the end of December, 1958 and March 1959 respectively. The table on next page shows price movements with the new base 1952-53-100.

With base 1952–53=100 the prices of food articles, industrial raw materials, manufactured articles and semi-manufactures rose to 113.8, 116.2, 108.9 and 109.4 respectively by the end of March, 1959. It will be noticed that the rise was more in the prices of food articles and industrial raw materials than in those of semi-manufactures. manufactures showed a practically stable price level.

According to the provisional estimates, agricultural production in 1957–58, showed a decline in cereals and jute, the output of rice being placed at 24.8 million tons which was lower by 3.5 million tons than in 1956–57. After a phase of sustained expansion for some

Recent trends in price level (April 1957-March, 1959) :
(Base : 1952-53=100)

Year	*Food Articles*	*Liquor & Tobacco*	*Fuel, Power Light and lubricants*	*Industrial raw materials*	*Manufactures*			*General Index*
					Inter-mediate products	*Finished Products*	*Combined*	
1955-56 (End of March)	86.6	81.0	95.2	99.0	100.1	99.6	99.7	92.5
1956	94.6	78.4	97.1	110.6	110.8	101.6	102.9	99.2
1956-57 (End of March)	102.3	84.3	104.2	116.0	110.9	105.6	106.3	105.3
1957	101.7	87.8	106.5	116.8	108.7	105.4	105.8	105.1
1957-58 (End of March)	106.4	94.0	113.6	116.5	107.3	108.2	108.1	108.4
1958 December	103.4	94.4	114.5	112.9	107.1	107.4	107.3	106.1
1958 March	113.3	96.4	115.1	112.5	110.3	108.0	108.3	111.4
1959	113.8	100.3	115.6*	116.2	109.4	108.9	108.2	112.3

*Revised.

years, industrial production was characterised by a slowing down in the rate of increase. Thus the general index of industrial production (base 1951=100) advanced only by 3.5 per cent to 137.2 during 1957 as compared to over 8 per cent in each of the previous two years. The unadjusted average of the index for January-April 1958 at 141.7 was, in fact, 0.5 per cent lower than the average for the corresponding period of 1957. The Union Finance Minister in a speech in the Parliament on May 15, 1957 observed as follows: "The rising price trend is due in part to the insufficiency of food production in relation to the demand, and in part it is attributable to certain external factors. There are, however, clear signs of demands in the economy tending to outstrip the supplies available."

As a consequence of the rise in prices during the period the all-India working class consumer price index rose by 5.3 per cent between December, 1957 and December, 1958. The following table shows the working class consumer price indices between 1951 and March, 1959:—

(Year 1949=100)

Year	1951	1952	1953	1954	1955	1956	1957	1958	*Jan.* 1959	*Feb.* 1959	*March* 1959
All India Index	144	141	145	138	145	152	161	152	*157	*163	*161

*Provisional

Factors underlying recent price trends

An important factor underlying the rise in food prices during 1955–57 was the increased money incomes consequent on a larger development expenditure in the country. The last year of the First Five Year Plan saw a considerable speeding up of the scale of development expenditure and the Second Five Year Plan was drawn up on an ambitious scale with great reliance on deficit financing. All this expenditure led to a rise in the demand for food articles. The demand for food crops, therefore, outstripped supply in spite of rising output. During the two years 1955–1957, agricultural production increased to some extent but it still lagged behind the levels reached in the previous bumper seasons.

The year 1957–58 witnessed three phases, namely, a rise in prices till August, 1957, a continuous fall till February, 1958 and a rise again thereafter. The average index for 1957–58 was higher than the average index for 1956–57 by 1.2 per cent. The declining trend in prices during August, 1957—February, 1958 was largely due to the higher output of foodgrains in 1956–57 as well as the corrective measures taken by the Government such as food imports, conferment on State Governments of powers to requisition stocks at average prices and restrictions on the movement of grains, besides the credit restriction measures of the Reserve Bank.

The rising trend of prices almost throughout 1958–59 is largely accounted for by the rise in prices of cereals, particularly rice, mainly on account of the estimated decline in output in the year 1957–58. In the background is the continuous and persistent increase in money supply impinging on the price level. The variations in money supply shown in the table on next page are very significant.

The period from July, 1950 to December, 1955 was one of intensive economic activity and included a major economic boom during the Korean War. In this period money supply with the public increased by 30 per cent and bank credit by 10 per cent, and yet the general index fell by 7 per cent. The only possible inference, therefore, was that the increased money supply was used for legitimate expansion which helped to keep supply in tune with the demand. Between May and December, 1955 the supply of money increased by Rs. 200 crores and yet the effect of this on prices was negligible.

MONEY SUPPLY WITH THE PUBLIC

(*Lakhs of rupees*)

Last Friday	*Money supply with the public*	*Total currency with the public*	*DEPOSIT MONEY WITH THE PUBLIC*			*Total variations in money supply*
			Total	*Demand liabilities of banks*	*Other Deposits with reserve Bank*	
(1)	(2)-(3)† (4)	(3)	(4)	(5)	(6)	(7)
1953–54	1,793,97	1,229,43	564,54	549,83	14,71	+29,26
1954–55	1,920,63	1,311,77	608,86	599,16	9,71	+126,65
1955–56	2,184,32	1,505,09	679,23	667,22	12,01	+263,69
1956–57	2,312,89	1,556,50	756,39	744,74	11,65	+128,57
1957–58	2,389,49	1,607,27	782,22	762,36	19,87	+76,60
March 1958	2,388,83	1,606,60	782,22	762,36	19,87	+60,24
January 1959	2,389,82	1,644,68	745,14	729,21	15,92	+39,97
February 1959	2,437,68*	1,678,68*	759,00*	743,16*	15,84	+47,86*
March 1959	2,497,63*	1,724,88*	722,74*	753,50*	19,25	+59,95*

*Excluding balances held on I.M.F. Account No. 1

Variations in money supply with the public during the First Plan period 1951–52 to 1955–56 amounted to Rs. 206 crores made up of Rs. 174 crores in currency and Rs. 32 crores in deposit money.

In 1956–57 money supply with the public increased by Rs. 129 crores or 5.9 per cent as compared to Rs. 264 crores or 13.7 per cent, in 1955–56 and Rs. 127 crores or 7.1 per cent in 1954–55. The slower rate of growth in money supply during 1956–57 resulted not from any slowing down of the tempo of development—which in fact showed a rise—but from increased investment expenditure abroad on imports which tended to reduce internal money supply.

In 1957–58, money supply with the public expanded by Rs. 75 crores. As in the previous year, the chief expansionist factor was the budgetary deficit in the public sector, but its effect on money supply was substantially neutralised not only by the continuing balance of payments deficit but also by a phenomenal rise in time deposits. Besides, credit extension to the private sector by banks slowed down during this year.

In the financial year 1958–59 (upto December 26, 1958), money supply with the public declined by Rs. 36.7 crores as compared to Rs. 38 crores in the corresponding period of 1957–58.

§6. Balance of Payments and Sterling Balances

Developments in balance of payments position during the eleven years from 1948–49 to 1958–59 can be conveniently divided into four periods. The first from 1948–49 to 1951–52 was characterised by inflationary pressures and shortages; the second covering 1952–53 and 1953–54 was a period of mild recession in economic activity; the third covering 1954–55 and 1955–56 was marked by accelerated economic development at home and boom conditions abroad, and the fourth period 1956–57 to 1958–59 was conspicuous for high and continuing deficit throughout. The table given on next page shows the variations from year to year:

India's Overall Balance of Payments on Current Account 1948-49—1958-59

(*In crores of rupees*)

	1948–49	1949–50	1950–51	1951–52	1952–53	1953–54	1954–55	1955–56	1956–57	1957–58	1958–59
Exports (F.O.B.)	482.5	514.0	646.8	730.1	601.9	539.7	596.6	641.1	573	583	592
Imports (C.I.F.)	766.3	603.9	650.3	962.9	633.0	591.8	683.8	750.6	783	886	990
Trade balance	—283.8	— 89.9	— 3.5	—232.8	—31.1	—52.1	—87.2	—109.5	—210	—303	—398
Invisible (net)	+31.7	+42.8	+42.4	+70.2	+91.3	+99.5	+93.2	+129.4	+62	+55	+51
Total current transactions (net)											
Current Account	—252.1	—47.1	+38.9	—162.6	+60.2	+47.4	+6.0	+19.9	—148	—248	—347

First Plan Period

For the five years of the First Plan period, it was estimated that the overall deficit in the balance of payment would amount to about Rs. 667 crores, and that our sterling balances would be reduced by Rs. 290 crores. The actual trends were on the whole more hopeful during these five years. The first year, 1951–52, was one of food shortage and inflationary pressures generated by the Korean War boom. The result was of course a high level of imports and a substantial deficit as a consequence of which the net foreign exchange reserves were down by some Rs. 180 crores. The next two years witnessed a mild recession and lower levels of domestic investment. The level of our trade declined, but the fall in imports was larger than that of exports, partly as a result of a decline in food imports and the intensification of import control. As a result , the current balance showed considerable surplus. In the fourth year, however, the development effort increased at home, and India's trade expanded. Imports, however, increased faster than exports, as a result of which the surplus on current account declined but did not disappear altogether. In 1956 there was a still further rise in the total value of foreign trade, imports rising more than exports, partly as a result of increased imports of capital goods and relaxation of import controls. The deficit on the trade balance increased further. This was offset by larger receipts under official donations.

The net result in those five years was that the current account deficit, excluding official donations, turned out to be much smaller (Rs. 123.1 crores) than anticipated. Official donations and loans also rose substantially to Rs. 196.5 crores so that the surplus on current account amounted to Rs. 73.4 crores. The foreign exchange reserves declined by a much smaller amount *i.e.* by only Rs. 121.3 crores, largely due to certain capital transactions, especially an outflow of capital.

A survey of the balance of payments position during those years pointed to the comparative inelasticity of Indian exports. Only on two occasions our exports exhibited a rising tendency; first, in the six months following the devaluation of the rupee, and then in the period after the outbreak of Korean War and the consequent rearmament drive with stockpiling. In other periods exports were sagging both in volume and prices or in one of these two. Thus in

1953, though exports increased by volume, the decline in export prices more than neutralised this advantage.

Second Plan Period

The marked pressure on balance of payments noticed since April, 1956 continued throughout 1957. The current account deficit for 1956–57 aggregated to Rs. 293 crores and the deficit for the first half of 1957–58 amounted to Rs. 298 crores.

During the year, withdrawal from foreign exchange reserves amounted to Rs. 232 crores as against the planned draft of only Rs. 200 crores during the entire Plan period. The reserves fell from Rs. 746 crores at the beginning of the plan to Rs. 534 crores in December, 1956 and further came down to Rs. 302 crores in December, 1957.

The major factor in the sharp deterioration in the balance of payments has, of course, been increase in imports. This shows that at this point the impact of the growing tempo of development has been felt most. In 1956–57, imports went up from Rs. 230 crores in the first quarter to Rs. 306 crores in the fourth. There was further acceleration in the first quarter of 1957–58, the imports for April-June going up to Rs. 323 crores. The second quarter recorded a decrease. the imports receding to Rs. 299 crores. Over the first six months of 1957–58, imports amounted to Rs. 622 crores. There has been no advance in exports. The amount for the first two quarters of 1957-58 works out to the lower figure of Rs. 267 crores as compared to Rs. 288 crores for the corresponding period of 1956–57.

The high and continuing deficit in the balance of payments was the most conspicuous feature of the economy during 1957. Sterling assets of the Bank declined over the year by Rs. 227 crores to Rs. 457 crores. In addition, the country obtained a credit of Rs. 95 crores from the I.M.F. and grants and loans amounting to Rs. 82 crores (during the nine month period July 1956–March, 1957) mainly under the Indo-American Technical Co-operation Programme and under P.L. 480. During July, 1956 to March, 1957, India's over-all balance of payments showed a deficit on current account of Rs. 248 crores, being the result of the deficit of Rs. 363 crores on visible trade and a surplus of Rs. 115 crores on invisible account (including Governmental grants). For the last quarter of the year (April-June

1957) the deficit appears to have increased partly as a result of the seasonal decline in exports. Region-wise, the deficit was distributed over all the principal areas, but its incidence was heaviest in transactions with the O.E.E.C. countries. The deficit was largely the result of an unprecedentedly high level of imports (amounting to Rs. 846 crores during July-March 1957) by both the public and private sectors, arising out of high level of industrial production together with the need to import large quantities of foodgrains. The value of exports remained practically unchanged, there being a decline of Rs. 4 crores to Rs. 483.5 crores during July-March 1957. The level of exports was largely sustained by the record exports of tea partly for stockpiling purposes consequent to the Suez hostilities, while exports of a number of commodities, particularly in the raw material group, declined indicating higher domestic consumption.

Since the beginning of 1957, the incurring of new foreign exchange commitments in the public and private sectors on any uncommitted projects was banned and various remedial measures were adopted such as reduction of import quotas, withdrawal of the basic allowance of foreign exchange for purposes of travel abroad for pleasure and further restrictions in respect of foreign travel for business, education and health. An Export Promotion Committee was appointed to make recommendations for the stepping up of exports. Government also set up a Foreign Trade Board to coordinate export promotion policies.

During 1958, a number of steps were taken to stimulate exports, of which the more important were the reduction or abolition of export duties on a number of commodities, continuance of the free licensing of cotton piecegoods and castor and linseed oils, release of quotas for groundnut oil which was hitherto to a banned item of export and simplification of procedure relating to refund of customs and excise in respect of imported components of a number of exports items. An Export Risks Insurance Corporation was also set up. On the other hand, some measures, taken in the sphere of labour welfare exercised an upward pressure on the cost structure. On the whole, there was no improvement in export earnings owing partly to the emergence of recessionary conditions in Europe and partly to the fall in the export incomes of several South East Asian Countries.

The foreign assets of the Reserve Bank declined by Rs. 221 crores during 1956–57 and Rs. 260 crores during 1957–58. The strain

on balance of payments was considerably relieved in 1958–59, owing to larger inflow of external assistance and a severe curtailment of private imports. The rate of drawal on these reserves declined considerably in the first half of 1958–59, whereas in the following quarter there was a small increase. The total draft on the foreign exchange reserves in 1958–59 was reduced to Rs. 47 crores. Between April, 1956 and February, 1959 the reserves dropped by Rs. 535 crores in all, from Rs. 746 crores to Rs. 211 crores.

Plan Estimates

It will be recalled that the second plan estimated that there would, over the plan period, be a foreign exchange deficit of Rs. 1,100 crores and that the worst year from the point of view of foreign exchange would be 1958–59. It was hoped to meet this gap by drawing on the sterling balances, to the extent of Rs. 200 crores, through the net foreign private investment to the extent of Rs. 100 crores, while the remaining Rs. 800 crores were to be met by the raising of external finance through various means. Balance of payments estimates are notoriously difficult to make and it is well-known that because of the number and nature of the uncertainties involved, the best forecasts of this kind have, even in the most advanced countries, proved wide of the mark. Our own forecast has proved to be no exception to the rule; we have discovered that through our export earnings have exceeded the figures assumed by the planners, our expenditure on imports has been very much in excess of what they thought it would be. The reasons for this excess are: firstly, the foreign exchange costs of the projects included in the plan have proved to be under-estimates, partly because the original estimates were over-optimistic and partly because there has been an appreciable rise in the cost of capital goods; secondly, the planners under-estimated the extent of imports of raw materials, components and other industrial goods necessary to maintain the economy at an increasing tempo of industrialisation; thirdly, the plan, whether, in the private sector or in the public sector, was not phased and too many orders for goods abroad were placed simultaneously; fourthly, the need for strengthening the defence of the country was accentuated after the plan was framed; and finally, we did not in the years immediately preceding the commencement of the plan control imports sufficiently—though the quantitative effect of this factor is very much less than the critics of the Government often tend to assume.

Sterling balances

The changes in the balance of payments position during the last eight years are reflected in the variations in sterling balances, as shown below:

(*in Crores of Rupees*)

Average of Fridays	*Foreign securities*	*Balances held abroad*	*Sterling balances*
1951–52 ..	625.27	187.14	812.41
1952–53 ..	564.40	133.56	697.96
1953–54 ..	594.02	123.31	717.33
1954–55 ..	648.81	87.53	736.34
1955–56 ..	656.52	66.96	723.48
1956–57 ..	545.61	64.77	610.38
1957–58 ..	329.65	40.47	320.12
1958–59 ..	182.04	25.57	207.61

§7. Working of the Reserve Bank of India

The Reserve Bank started working from April 1, 1935 and over the last twenty four years it has consistently tried to serve as the guardian of the country's monetary system. It had to fight a mild recession almost at the very beginning of its career, to finance a first class war and to cope with the ensuing inflation; it had to neutralise the adverse effects of the partition of the country, and carry through a devaluation. It is now closely associated with the financing of the Five Year Plans. From its status as a private shareholders' bank it has now been transformed into a nationalised institution.

The nationalisation of the Reserve Bank of India which was referred to earlier in Chapter X was criticised mainly on three grounds, namely: (*i*) it was inconsistent with the general policy of the Government of India which allowed the private sector to continue and to play a predominant role; (*ii*) wisdom and guidance of experienced businessmen in the running of the Bank was lost in this way; and (*iii*) the independent stand which the Bank took in the past helped in correcting many mistakes of the Finance Ministry. The arguments in favour of nationalisation were, however, so strong that the decision to nationalise was taken. As a result of this decision all the shares of the Reserve Bank were deemed to be transferred to the Government of India on 1st January, 1949, but the process of taking over the shares from private persons who possessed them and paying for them inevitably took some time. Compensation was paid to the shareholders partly in Promissory Notes bearing 3

per cent interest and partly in cash at the rate of Rs. 118.10 per share of Rs. 100 paid up. This rate of compensation was based on the average monthly market quotation of shares during the period March, 1947 to February, 1948. No change was, however, made in the general superintendence and direction of the Bank which continued to be entrusted to a Central Board consisting of a Governor and two Deputy Governors and 10 Directors (instead of 12 Directors previously, of whom 8 were elected and 2 nominated) and one Government official, all nominated by the Central Government. The Directors now hold office for 2 years instead of 5 years. As was the case before nationalisation a local Board was constituted in each of the four areas, consisting of 6 nominated members (in place of 8 previously, of whom 5 were elected and 3 nominated) to represent territorial and economic interests as well as the interests of co-operative and indigenous banks).

Bank Rate Policy

After the impact of the Korean war and the drive for rearmament and stockpiling caused a large rise in the price level, certain disquieting developments also took place in the banking system. The combined volume of advances and discounts touched the unprecedented peak of Rs. 586 crores on May 11, 1951. The total expansion during the busy season of 1950–51 was of the order of Rs. 180 crores but in the slack season advances of the scheduled banks contracted only to Rs. 86 crores on October 26, 1951, leaving the remainder of Rs. 100 crores in circulation. Notwithstanding the declining trend in prices which set in from April, 1951 traders continued to take a bullish view of the international situation and so continued to overstock and hold back supplies from the market. Faced with these symptoms of inflationary pressure the Reserve Bank decided to raise the Bank rate from 3 per cent (the rate prevalent from its inception) to 3½ per cent in November 1951, at which level it remained till May, 1957 when it was raised to 4 per cent. This led to similar movements in all other money rates in the organised sector of the money market.

The raising of the bank rate had the immediate effect of making credit dearer, as all other banks also raised their rates on loans and advances. They adopted a cautious lending policy and showed some unwillingness to advance credit to borrowers who were likely to utilise it for hoarding purposes. The general index of prices, which

had started falling slowly from April, 1951 declined by large per centages from February, 1952, the fall no doubt being precipitated by changed international situation and cessation of stockpiling. There was no doubt that the stringent monetary conditions forced many traders to unload their stocks on the market, bringing about the steep decline in prices from 430.3 in January, 1952 to 415.8 in February, 377.5 in March and to 367.1 in May, 1952. There was also a sharp decline in the prices of Government securities. The policy of restricting the rate of creation of credit was on the whole effective.

Bill Market Scheme

In order to ensure that the policy of credit restriction would not hamper the flow of credit to finance essential transactions, and to provide some elasticity to the money market, the Reserve Bank announced the introduction of the Bill Market Scheme from January 16, 1952. Under that scheme, the Reserve Bank undertook to grant loans to banks against their demand promissory notes, supported by approved usance bills of their constituents. The banks were permitted to convert a part of their borrowings into usance promissory notes for 90 days which could be lodged with the Reserve Bank as collateral for advances. In order to popularise the drawing of bills, the Reserve Bank agreed firstly to make advances against these bills at ½ per cent below the Bank rate, and secondly to bear one half of the cost of the stamp duty to be paid at the time of converting demand bills into time bills. The scheme was provisionally restricted to scheduled banks whose deposits were not less than Rs. 10 crores on December 30, 1951. The minimum value of individual bills tendered was fixed at Rs. 11 lakh each, while a bank was to take a minimum advance of Rs. 25 lakhs at a time.

Although the scheduled banks took some time to grow familiar with the scheme, they could obtain advances from the Reserve Bank under it in 1952, for a total amount of Rs. 81.45 crores. In 1953 the amount of advances made by the Reserve Bank to the scheduled Banks under the Bill Market Scheme declined to Rs. 65.84 crores. The scheme did not prove popular because of its costliness and its limited scope. The Reserve Bank, had, therefore, to make certain adjustments to extend the scheme. The scheme thereafter became more attractive and the scheduled banks borrowed Rs.147.52 crores and Rs. 225.44 crores in 1954 and 1955 respectively

under it. In 1955, exchange banks also showed considerable interest in the scheme. In 1956 and 1957, the Reserve Bank's advances to the scheduled banks amounted to Rs. 436.82 crores and 414.81 crores respectively. This rise in advances had taken place owing to the keenness on the part of the banks to keep their investments in Government and other approved securities unencumbered to the extent possible as a matter of business prudence besides the necessity for complying with the statutory obligations pertaining to the minimum liquid assets. The Committee on Finance for the Private Sector (the Shroff Committee) recommended that the facilities available under the scheme should be extended to scheduled banks having deposits of Rs. 1 crore, instead of Rs. 5 crores, which was the original provision, and that the minimum amount of each individual bill should be lowered to Rs. 50,000 instead of one lakh, and the minimum limit of advances to one bank at a time should also be lowered from Rs. 25 lakhs to Rs. 10 lakhs. The Reserve Bank accepted these recommendations and the facilities of borrowing under the scheme were extended to all scheduled banks, irrespective of the size of their deposits, and the minimum limits was lowered as recommended.

The bill market scheme was temporarily liberalised in 1957. The minimum amount that could be borrowed at a time under the bill market scheme was further reduced from Rs. 10 lakhs to Rs. 5 lakhs. The average of the outstanding loans for the year recorded a substantial rise from Rs. 21 crores in 1955–56 to Rs. 49 crores.

Banking Companies (Amendment) Act, 1956

The Banking Companies (Amendment) Act, 1956 which came into force from January 14, 1957, provides, among other things, for the grant of powers to the Reserve Bank to give directions to banks in respect of matters of policy or administration affecting the public interest or in the interests of the institutions themselves. It requires the prior approval of the Reserve Bank for appointment, as well as the terms of appointment, of managing directors and chief executive officers of banks. It also empowers the Bank to depute its officers to watch the proceedings of any meeting of the Board of Directors of a bank or any other committee or body constituted by it and to appoint observers for purposes of observing and reporting on the affairs of a banking company. These powers would enable the Bank to have wider and more comprehensive control on banks so as to ensure an improvement in their operational methods.

The Reserve Bank of India (Amendment) Act, 1956 and 1957

Th Reserve Bank of India (Amendment) Act, 1956 came into force from October 6, 1956. It changed the proportional reserve system to one of a fixed minimum, namely a minimum holding of foreign securities of Rs. 400 crores and gold coin and bullion of Rs. 115 crores or a total of Rs. 515 crores. On account of the continued large drain on the foreign securities of the Bank, further amendment of these provisions was called for. Accordingly, on October 31, 1957 the Reserve Bank of India (Amendment) Ordinance 1957 was promulgated, this being replaced later by the Reserve Bank of India (Second Amendment) Act, 1957. The amendment modified Sections 33 and 37 relating to the currency reserve requirements. Under the revised arrangements, the aggregate value of gold coin, gold bullion and foreign securities held in the Issue Department of the Bank should not at any time be less than Rs. 200 crores, of which the value of gold coin and gold bullion should at no time be less than Rs. 115 crores. The proviso to Section 37 stipulating a floor limit on the value of foreign securities to be held in the Issue Department at Rs. 300 crores was deleted. This amendment is in keeping with the general trend of Central banking legislation in recent times to delink foreign reserves from the note-issue.

Besides this the amending Act also enables the Reserve Bank to vary the reserve ratios of the scheduled banks within certain limits. Under the previous Act, the scheduled banks had to keep at the Reserve Bank balances equal to at least 5 per cent of their demand deposit and 2 per cent of their time deposits. These ratios may now be raised by the Reserve Bank to 20 per cent in the case of demand deposits and 8 per cent in respect of time deposits. Further, the Reserve Bank may require scheduled banks to maintain with it additional cash reserves in relation to the excess of demand and time deposits over their level on a particular date, subject to the condition that the overall cash reserve ratios do not exceed 20 per cent and 8 per cent respectively. Provision has also been made to enable the Reserve Bank to pay at its discretion, interest at rates to be determined, to the scheduled banks on the amount of reserves they are asked to maintain in excess of 5 per cent of the demand deposits and 2 per cent of the time deposits. The Act thus introduced the system of variable reserve ratios, which has been regarded as an important instrument of credit control. A

large number of central banks, belonging to both developed and under-developed countries, have already been armed with this instrument of controlling the operations of the banking system. In countries like India, where the money market is comparatively under-developed, the orthodox methods of credit control (bank rate and open market operations) might not always be fully effective. and the system of variable reserve ratios is in some respects a more effective instrument than these orthodox weapons.

The Reserve Bank can also control the lending operations of the banks under the Banking Act by asking them to control particular types of loans. Their power has been used, for example, for the control of bank advances for speculative purposes in the share market, or against the speculative holding of foodgrains. It has, however, been suggested that it may be desirable to authorise the Reserve Bank to utilise the different types of selective credit control that have proved effective in other countries.

A Review

At the time of the establishment of the Reserve Bank some critics were doubtful about the smooth and proper functioning of the Reserve Bank of India because the money market in India at that time was in a loose and unorganised state. However, during the years that have passed the Reserve Bank has made its influence felt over the money market in many directions. First of all, it has helped to lessen the seasonal fluctuations in the short term rates in the money market. Before the Bank came into being, the call money rates rose sometimes to 7 or 8 per cent in the busy season and fell as low as 1 per cent or even ½ per cent in the slack season. The fluctuations now range between 3 per cent to ½ per cent. Secondly, the Reserve Bank has rationalised and cheapened the system of remittance of funds between different parts of the country. The money rates have almost been equalised all over. Thirdly, through judicious open market operations, orderly conditions have been brought about in the market for Government securities. Fourthly, the Bank rate has been effective not only in the organised sector but also in the unorganised sector of the money market. Banks rely a good deal on the rediscounting and borrowing facilities which the Reserve Bank provides to them during the busy season. This indicates that a vast majority of banks have come within its fold. The commercial banks

also have accepted its authority and the Bank now regularly inspects their books, or guides their lending policy, cautions the unwary and pro- prohibits the erring banks from taking wrong steps. The banking organisation is looked after by a separate Banking Division of the Reserve Bank which has to carry out its responsibilities under the Banking Companies Act.

Further in a true spirit, the Reserve Bank has become a friend, guide and philosopher of the agriculturist. Rural finance is made cheap and very easy. Loans have also been made by the Bank to the Industrial Finance Corporation and many of its regulations have been liberalised for facilitating an increasing flow of funds to the private sector. The Bank started the Bill market scheme and liberalised its provisions in order to impart some elasticity to the market for finance for the private sector.

Two criticisms have frequently been urged against the Reserve Bank. One was in relation to its functioning vis-a-vis the commercial banks and the other in relation to its functioning vis-a-vis the indigenous bankers. But the force of the criticism has abated, as the banking system, under the direction of the Reserve Bank of India, has gained strength and the Indian money market is becoming a more compact organisation. In the years to come the Reserve Bank will have to play a more positive role in widening and liberalising credit not only for organised private sector but also for the less organised sectors of agriculture and cottage and small scale industries.

§8. Working of International Monetary Institutions

The constitution and functions of the two institutions set up by the Brettonwoods monetary agreements, *viz.*, the International Monetary Fund and the International Bank for Reconstruction and Development have been explained in the previous chapter (XI section 2). Both the institutions have now come of age. It has been recognised that if they are to fulfil adequately, in the changing conditions of the times, the purposes for which they were set up twelve years ago, their resources must be expanded and their functions enlarged. With the problems of the underdeveloped countries coming to the fore, the two institutions will also have to do some rethinking—which in some measure they are doing already—about the suitability of the criteria hitherto followed for assisting these

countries in their balance of payments difficulties and in their programmes of long-term development.

Working of the Fund

When the Fund was set up on December 27, 1945 it had only 39 members. Not only did the Soviet Union keep out from it but several other countries which accepted the Funds basic ideals of maintenance of freer world trade and international equilibrium also held aloof, *e.g.*, Sweden, Switzerland and New Zealand. However, the membership steadily increased to 68. The regional distribution of the countries which are members of the Fund is as follows:—

Europe excluding Turkey	18
Latin America	20
Afro-Asia	27
North America	2
Oceania	1

After a short initial burst of activity, following its inception, the Fund almost went into quiescence from 1949 to 1955 when Marshall aid was in operation and accummulated war balances of creditor countries were being reduced. These processes helped serve some of the purposes the late J.M. Keynes had in mind for his International Credit Union, though it necessarily involved, 'personal' relationship between lenders and borrowers and continuance of fairly severe exchange restrictions. It is only since the latter half of 1956 that the Fund has really become active.

The Fund began its lending activity in March, 1947. Since then, upto the end of 1956, more than 1,900 million dollars have been lent to thirty different countries; of this more than 1,060 million dollars have been paid back. The lending activity has fluctuated considerably. In 1947–48, it amounted to 675 million dollars; no loans were made in 1950, but in 1956 over 690 million dollars were drawn. Upto the end of 1956, standby credits had been granted to eleven countries, amounting to almost 1,200 million dollars.

The Fund's total resources, consisting of members' subscription amounted to 9,086 million dollars on April 30, 1958 and 9510 million dollars on September 30, 1958. Since the commencement of operations, drawings by member countries have aggregated to $ 3,016 million and repurchases to $ 1,123 million.

The Fund has sometimes been criticised for its lack of activity. Such critics have usually forgotten the following facts. The world in which we live after the second world war is not the world that was hoped for at Brettonwoods. There have been wars in Korea, Indo-China and the Middle-East, and, besides these, we have had the cold war with all its undesirable political and economic effects.

Shortly after the war it became clear that the countries needed not only short term credits from the Fund but also loans for a longer period and of a magnitude that was beyond the resources of the World Bank. Then there came first the large American and Canadian loans to Great Britain and in 1948 the Marshall Aid. This has been followed by American aid in various forms to countries in different parts of the world. All this has, of course, considerably diminished the demand for assistance from the Fund and the World Bank.

The currency situation in most countries has improved in recent years mainly as a consequence of the increased world trade and American Aid. The members have been able to enlarge their currency reserves and to pay back most of what they had previously borrowed from the Fund. After the Suez crisis at the end of 1956 a new situation arose characterised, inter alia, by the standby credits to France and Great Britain, totalling 1,000 million dollars. The Fund has often in co-operation with O.E.E.C. contributed towards a gradual reduction of exchange restrictions and bilateral agreements, diminished discrimination in payments and increased transferability of many currencies. As already mentioned it has assisted in important stabilization measures, not only in the Latin American countries and Asia but also in Europe. One reason why the European members have not made more use of the Fund is that they have preferred to use their automatic credit in the European payments union.

Some countries have also entertained fears that a purchase of currency from the Fund would be regarded as a proof of a serious crisis and could thus set off a wave of speculation. Such fears would become less frequent, if the members used the Fund more regularly when a country's currency reserves are sinking. At present the tendency seems to be in this direction.

It is obvious that the Fund cannot by its own efforts abolish currency restrictions or carry through stabilization measures. This depends entirely on whether the governments of the member countries are willing to pursue such economic and monetary policies as would make these measures possible. The Fund can only analyse the situation, make clear what has to be done to bring about internal and external balance, try to convince the persons concerned of the necessity of taking these measures, and place foreign currency at their disposal to bridge over temporary payments difficulties. Sometimes, it is only after repeated discussions that the country is willing to take one or another step in the right direction. In such cases monetary measures such as raising the rate of interest or restricting credit are as a rule not sufficient. The budget deficits of Governmental and local authorities may, as a rule, have to be cut sometimes by an increase in income and in most cases by a reduction in expenditure. It is also necessary to refrain from financing these budget deficits except for short periods through the central bank. Wage increases exceeding the rise in production have to be avoided and if consumption has risen too rapidly, the increase in consumption may have to be slowed down. In some contries expenditure on social services may have risen more than economic resources permitted. In order to be able to maintain a reasonably stable value of the currency, it is essential, until a better balance has been restored by increased production, that new expenditure of governmental and local authorities is avoided except where absolutely necessary.

International Bank for Reeonstruction and Development

The Bank's first loans made in 1947 were for European post-war reconstruction; a total of $ 500 million was lent by the Bank for this purpose. In 1948, the Bank turned to lending for development, an increasing proportion of its funds being directed to the less developed areas of the world. By July, 1958 the Bank had made some 200 loans totalling over $ 3700 million to finance more than 600 projects in 46 countries or territories. The distribution of Bank lending between the various regions of the world was as follows: Africa, $ 479 million, Asia, $ 948 million; Australia, $ 318 million; Europe, $ 1,186 million; Western Hemisphere, $ 798 million.

Three-fifths of the loans sanctioned have been for such basic social overheads as transportation, electric power and

communications; the proportion goes upto 88 per cent in the case of Latin America and to 92 per cent in the case of Africa. Only in the case of Europe which is already richly endowed with these facilities is the proportion as low as 24 per cent. This financing of the expansion of social overheads shows among other things how the Bank has distinguished its criteria of creditworthiness from those applied in the case of direct private investments.

The regional distribution of loans continues to show the dominant position still held by the countries of Europe and Australia as borrowers. Asia and Africa with their large masses of population get together only 39 per cent of the total loans sanctioned while Latin America gets as much as 21 per cent. This maldistribution inrelation to needs, as judged by size of population, has become progressively less unfavourable to Asia and Africa with the passage of time but it still remains.

Not only have European and Latin American countries received large amounts of loans per capita but larger countries, on the whole, seem to have received comparatively less assistance than smaller ones. The Bank cannot be blamed for this maldistribution for it is concerned with projects rather than with size of countries, but the distribution of voting power and the proximity of Latin America, perhaps do exercise some influence on its lending policy.

Against total loans sanctioned through 1958 of $ 3,729 million principal repayments to the Bank have aggregated to $ 219 million giving a net outstanding figure of $ 3,510 million. This is to be compared with the capital subscriptions freely available for lending which total $ 1,362 million only. Reserves provide another $ 350 million making an aggregate of $ 1,712 million of owned funds or 46 per cent of total loans sanctioned. Debt obligations (Bank's own bonds) and sales of loans, thus provide the greater part of the Bank's working capital. The increasing magnitude of its operations—its loans in 1957–58 were nearly double of those of the previous year—and the inexhaustible needs of under-developed countries, therefore, urgently necessitate an increase in its freely lendable capital subscriptions.

The lending operations of World Bank are conducted on the basis of three main principles, first, that the borrowing country will

be in a position to repay the loan, second, that the project or programme to be financed will be of such benefit to the economy as to justify the borrowing of foreign exchange; and third, that the project is itself well designed and feasible of execution. The Bank usually finances only the cost of imported goods and services for development projects, and does not lend for expenditures that are going to be made locally. The expenditures, made in domestic currency, are arranged by the borrower, and they commonly equal or surpass the amount lent by the Bank. While the Bank has lent nearly $ 4,000 million, the total investment in the projects it is helping to finance is about $ 12,000 million.

One of the basic purposes of the International Bank for Reconstruction and Development as stated in its articles of agreement is "the encouragement of the development of productive facilities and resources in less developed countries". The World Bank may not have spent up all its capital in the first ten years of its life, but it has been by far the more active of the Brettonwoods twins. When it started, its immediate pre-occupation was reconstruction in Europe and then for some years while it surveyed a wide enough field and steadily expended its activities, it was still not having an adequate impact on the under-developed world. From Europe it turned its attention to the Latin American countries, Australia and then Asia. Its activities can no longer be criticised for being in any way limited to any particular region of the world nor has it lacked drive, imagination and enterprise in its operations. Though concentrating largely on and helping to finance construction of social over-heads—power and transport—which initiate and sustain development it has also gone into financing of industry both directly and through its affiliate, the International Finance Corporation.

The main contribution of the World Bank has been as much in providing the capital where it is needed most as in developing techniques by which it has been able to act more and more as a catalytic agent to channel the savings in surplus countries into such uses in the under-developed areas where it would be potentially the most productive, though such uses may not be able to satisfy the criterion of ordinary commercial or investment banking.

Loans are made only for productive purposes to finance the foreign exchange requirements of specific projects. These projects

have to be technically and economically sound and if initiated by non-governmental borrowers should be guaranteed by the Government of the territory. Loans are not tied in the sense of requiring their proceeds to be spent in particular territories. The Bank simply makes sure that the borrower is unable to obtain the loan from private sources on reasonable conditions.

India in relation to I.M.F. and I.B.R.D.

The International Monetary Fund and the World Bank have made a distinct contribution in promoting the stability of India's economic development. Indeed without their assistance major foreign exchange crises would have been inevitable. It is not only through the loans and advances she has received that India has benefited from their operations but also from the general influence they have exerted on member countries.

The membership of I.M.F. has been of great value to India. She actively participates in international monetary discussions and can safeguard her monetary interests. Apart from the benefits that accrue to her, she is also instrumental in promoting international monetary co-operation. The Fund's contribution to international monetary co-operation may not be spectacular; nevertheless, it is not inconsiderable. The Fund offers a valuable forum for the discussion of economic policies and methods followed by the members, as well as for the international exchange of idea. The Fund provides invaluable information in its regular publications on financial, trade and balance of payments, statistics and developments. The Fund has also provided useful technical advice to many countries in solving their monetary and trade problems. India has gained in all these directions.

From the World Bank India has received substantial loans for financing important projects included in the two Five Year Plans. It was really after the Second Plan was under way that India began to emerge as a large borrower from the Bank. Nine loans of the aggregate value of $385 million were compressed within a period of a little more than two and a half years. A major part of these loans has gone towards strengthening the railway transport and extending the capacity of ports but industry—both in the public and private sector—has also received appreciable assistance.

APPENDICES

Appendix A

Automatism and Elasticity in Indian Currency System

A sound currency is required, in general terms, to be simple and certain and to secure stability, automatism and elasticity. Stability means here stability in the external and internal purchasing power of the currency unit. The external and internal stabilities are, under normal conditions, closely interrelated and not incompatible but in times of exceptional economic disturbance, emphasis may have to be shifted on to internal stability. The proper criterion of the adequacy of a currency system lies in the capacity to secure balanced economic development by maintaining 'continuity of values'. The indices of this development are not merely price-cost levels but also figures about trade, employment, prices of shares and movements of capital. In the working of the Indian currency system too much importance was attached in the past to exchange stability (*i.e.*, stability of external purchasing power) and not enough to internal stability.

Automatism

There can be no automatism in any absolute sense. Some currency systems may be more automatic than others. Automatism in currency system cannot mean entire absence of control and management. No system has been discovered which would relieve the monetary authority of all responsibility as to its working. Even in so-called automatic systems, there is an element of control. The pre-1915 gold standard is sometimes called an automatic standard because under it gold movements freely took place and by producing their effect on prices corrected disequilibria. But the successful working of this system depended on the observance of some rules (rules of the gold standard game) and the presence of a certain kind of economic environment. "The preservation of the system

clearly depended upon the policies of Central Banks reflecting such variations as would have occurred under an automatic system of purely metallic currencies with no other types of money". An export or import of gold was allowed by the policies of central banks to produce its full effect through contraction or expansion of currency. If some central banks had adopted the policy of 'sterlizing' imported gold the automatism of the standard could be defeated, as was actually done by several countries in post-war years. Nor would the system work automatically if the exchange parities chosen by the countries did not reflect internal prices and costs and consequently imposed a severe strain on their economic structure.

Control and management in currency matters, as in other spheres of economic life, now meet general approbation. Opinions, may, however, differ about the objectives of such control and the methods thereof.

The Indian currency system has not been automatic even in the qualified sense except between 1835 and 1893. The element of government control was definitely introduced from the time mints were closed to the free coinage of silver in 1893. Since then the system has been deliberately controlled and managed and as no monetary authority, least of all a government, can be infallible, serious mistakes were sometimes made. The currency authority has been until recently the Government of India and it was under no obligation to expand and contract currency to the full amount of the sale or purchase of sterling. As the Hilton Young Commission observed in 1926, "there is no provision as to any organic relation between the total volume of token currency and the amount of reserves. So far as the note issue is concerned, the statutes provide for no minimum percentage of gold or sterling securities being held in the reserve as cover against the notes. Nor is there any such fixed relation in regard to the other form of token currency—the silver rupees. The amount of the Gold Standard Reserve and the time and manner of its use are wholly within the discretion of the Government. The automatic working of the standard is thus not adequately provided for in India and never has been. . . . Under the Indian system, contraction is not, and never has been, automatic. On occasions, the obligation to buy sterling exchange has been discharged by the Government without any corresponding expansion of domestic currency." The Commission recommended gold bullion standard

because, among other things, it would be automatic (*i.e.*, more automatic than the pre-war exchange standard).

The management of currency and credit has been transferred to the Reserve Bank of India since 1935. In so far as the Bank was under a statutory obligation to maintain 1. 6d. sterling rate, it had to operate the currency system with a definite objective in view.

Elasticity

Elasticity may be defined as the capacity of the currrency system to meet the varying requirements of trade and exceptional demands of a crisis. It is an important requisite for the Indian currency system because of the seasonal demand for currency to finance crop movements.

The Indian currency system was based, until recently, on the principal of fixed fiduciary issue, *i.e.* beyond a certain amount of currency issued against securities, expansion or contraction could take place at a rate exactly corresponding to the increase or decrease of the amount of metal or coins kept in the reserves. The disadvantage of such a system is that currency cannot be expanded at a rapid rate owing to statutory requirement of 100 per cent reserve against additional note-issue and in times of emergency the system may break down. Moreover, there was no arrangement by which additional currency could be provided for the requirements of internal trade.

The Paper Currency Act of 1861 provided for a fiduciary issue (*i.e.* issue against securities or invested portion of the reserve) to a maximum of Rs. 4 crores. The amount was increased to Rs. 14 crores by 1911. During the War years (1914-1918) it was increased several times and stood at the end of War at Rs. 120 crores. In 1923 and 1925, provision was made to issue currency notes upto a maximum of Rs. 12 crores against hundis or internal bills of exchange. The remarks of the Hilton Young Commission about this provision explain also the difficulty of introducing elasticity in Indian currency system. 'This provision has had beneficial effect in practice, but it is not in our opinion capable of development and improvement in connection with a re-organisation of the basis of Indian currency. Any such provision depends for its proper operation on a plentiful

supply of genuine trade bills. But in India, for a variety of reasons, most of the internal trade is financed by a system of cash credits or by the advance of money against demand promissory notes. It has therefore been found difficult to secure an adequate volume of bills as cover against the seasonal increase. As a result, the currency authority has on occasions been forced to provide for the needed elasticity by regulating its holding of sterling securities in the Reserve'.

The Commission recommended the adoption of the proportional reserve system under which the reserve bears a certain proportion to the note-issue, 40 : 100. If 40 units are added to the reserve, note-issue can be increased by 100 units and if 40 units are taken out, note-issue has to be contracted by 100 units. The range of expansion and contraction is, therefore, much wider than under the fixed fiduciary system. The system has been incorporated in the constitution of the Reserve Bank of India which has to hold 40 per cent reserve of gold bullion, gold coin or sterling securities, the amount of gold coin and bullion being not less than 40 crores of rupees in value. To secure an emergent issue of currency, there is a provision for a reduction in the reserve ratio below 40 per cent with the sanction of the Governor General-in-Council and on payment of a graduated tax.

These provisions were of value but to lend the much needed elasticity to the currency system it was necessary to encourage the habit of using cheques as the media of payment and to develop a bill market. The Reserve Bank has already done a good deal in tempering the seasonal stringency and in keeping the rise in interest rates in the Indian money market under control. It has recently taken steps in the direction of the development of a bill market.

Appendix B

Dearness Allowance, Inflation and Consumers' Subsidies

The Government of India and most of the State Governments have granted dearness allowances to some classes of their employees. Similarly the Railway administration and private employers have given dearness allowance to the workers. But the issue has been raised in certain quarters that the grant of dearness allowance to low-paid Government employees sets into motion an inflationary spiral of rising wages (or salaries) and prices. The issue may be briefly examined here.

Three or four questions that atonce arise are:—

(*a*) Is there any causal nexus at all between the grant of dearness allowance and rise in prices?

(*b*) If dearness allowance does eventually result in raising prices, to what extent will it do so?

(*c*) What is the magnitude or force of dearness allowance as a factor in the price situation relatively to other factors at work?

(*d*) Is there any implication that if dearness allowance raises prices to some extent, therefore its payment is undesirable?

As regards (*a*), it may be admitted that under certain conditions the payment of dearness allowance will cause prices to rise. If the amount paid as dearness allowance swells the existing quantity of monetary circulation or money incomes and the quantity of goods remains the same, that is, if it represents the creation of additional spending power against a constant supply of goods, it will certainly force prices upwards. This will happen if money for the payment of the allowance comes out of either the idle balances of the Government or funds which otherwise would have been invested in quickly maturing development projects or from the proceeds of taxes paid out of the savings of the richer classes lying idlle in banks or such other

savings which, if not drawn upon by taxes, would have been invested in quick-yielding development projects. (In parenthesis, it may be observed that the spending of, say, one crore of rupees by Government on the purchase of grain or Government stores is quite a different affair from the spending of the same amount by the Government employees; for the very essence of a planned economy is that the Government must spend more on development needs and obtain command of large real resources and persons, in, what may be called, the consumption of sector of economy spend less and have smaller command over real resources.) If the funds for the payment of dearness allowance are obtained merely by the process of appropriation of spending power from one class of persons to transfer it to another class, then the Government discharges its purely normal function which has no inflationary significance.

Reference may be made here to the evidence of theory and experience that in the 'vicious spiral' it is wages that chase prices. The spiral almost invariably begins with an uncontrolled rise in prices generated by inflationary methods of finance. In the earlier stages and even in later stages, therefore, price rise continues to occur independently of stimulation by wage increases and in fact wage increases play a subordinate part. Payment of dearness allowance to some classes of Government employees will obviously be an even less significant factor in the total situation.

As regards (*b*) it is difficult to define in the absence of accurate data about the total number of low paid Government employees or their total salary bill the extent to which dearness allowance will raise prices (that is, if it raises them at all). It would, however, be hardly wide of the mark to reckon the total amount of dearness allowance as a few crores in a year, for the Central and State Governments together. Dearness allowance may, of course, have to be adjusted to changes in prices and cost of living and this may well mean its amount will increase in a cumulative manner. But considering that the additional purchasing power in the form of note circulation has already expanded in India by a substantial amount, dearness allowance will, in any case, be a relatively small affair.

This necessarily leads to an inquiry into the forces at work behind the rise in prices in India. For if these forces are really amenable to control, introduction of an exciting factor in the shape of dearness

allowance will be undesirable. The position in a way is the same as during the last war when the leaders of working classes in England said to the Government. 'Stop the rise in prices and we will the stop rise in wages'.

Coming now to (*d*), as the expansion of currency continues and prices continue to rise, it becomes difficult to maintain any case against the payment of dearness allowance even if it may be admitted that dearness allowance is a price exciting factor. Expansion of currency, as is well known, must take the form of an increase in money incomes of some persons or classes before it exerts its influence on prices of consumers' goods. If dearness allowance is not paid, it will only mean that the money incomes of one class of persons are prevented from increasing while large scale Government spending is inflating the incomes of other classes. Relatively to other classes, therefore, and also absolutely, the real incomes of this particular class are being reduced. In an absolute sense there must, of course, be a curb on the consumption of all the classes, if development plans are to be effectively implemented. But there must be at the time an equitable distribution of the burdens thus imposed. The real incomes of employees getting fixed and low money incomes have, in fact, already been reduced a little too much relatively to the incomes of other classes, though in a number of cases, employment opportunities have also become available to a larger number of members of the families and there have also been rapid promotions to higher posts.

Is there any alternative to the payment of dearness allowance which will serve the same purpose and yet be not open to the objections that can be urged against the latter? The alternative, obviously, is a guarantee that for these employees essential commodities of consumption will be available at fixed and low prices. The employees themselves may prefer this because dearness allowance usually tends to lag behind rising prices. But the Government must place themselves in a position to give such a guarantee.

Whether or not dearness allowance is given, there is no escape for the Government from the time-worn and well-tested remedies of price control and rationing if all the consumers with fixed or low incomes are to be assured an adequate minimum of the essential

articles of consumption. Price control and rationing have their separate functions but serve a common purpose. Rationing secures a minimum of necessities for all and price control ensures that minimum is available at a fair or reasonable price. Taken together they go far but perhaps not far enough. For the price that is fair for producers and some classes of consumers may still be unfair or unreasonably high for large bodies of consumers with low incomes. Here is a lacuna which the Government can remove by purchasing commodities at the fair prices and selling them to low income consumers at a price which they can afford to pay, the difference between the two prices representing the financial cost of the transaction to the Government. It will be seen that this subsidisation of consumption—or consumers' subsidies—will benefit the needy few just as price control and rationing benefit all. This need not, however, be the general rule and consumers' subsidies can be given and have been given in countries like U.K., U.S.A. and Canada in order to reduce prices of certain essential goods for the consumers in general.[1] For apart from the fact that all can be needy when it comes to the possibility of paying a lower price, there is the vital consideration that lower prices for all mean a lower cost of living and the stabilization of cost of living at a low level is a useful check to the prices feeding on themselves by raising wages and cost of production and starting what Pigou has called 'wage-induced inflation.'[2] In this sense—and in this sense alone—consumers' subsidies can be said to be anti-inflationary. For otherwise the cost of subsidies itself must be met and if it is met by inflationary finance, a lot of superfluous purchasing power will go into the economic system creating an inflationary situation and imperilling price control itslef.

1. In England food subsidies amounted to over £ 102 millions in 1942, (I.L.O.: Food Control) in Great Britain, pp. 48-48). In U.S.A. food subsidies formed an important part of the anti-inflation programme but the effect of the Anti-Subsidy Bill passed by the House of Representatives was to make subsidies illegal after December, 1943.

2. *Economic Journal*, 1941, pp. 440-42. It is necessary to note that subsidies, if they are to accomplish their purpose, should be heavy enough to bring the price within the reach of the lower income groups, otherwise subsidy is a "waste of public funds—better to double the subsidy if necessary or drop it entirely." (*Food Control in Great Britain*, p. 9).

Appendix C

Demonetisation Ordinance

The Government of India as a part of its effort to mop up funds which had gone into the black market promulgated on January 12, 1946 the High Denomination Bank Note (Demonetisation) Ordinance. The holders of currency notes of Rs. 500, Rs. 1,000 and Rs. 10,000 denomination were asked to get their notes cashed at Reserve Bank, a scheduled bank or a Government treasury within 15 days on giving a declaration on a prescribed form. Thereafter the Governor and Deputy Governor of Reserve Bank were allowed to exchange such notes upto 26th April, 1946. By another extension of time limit the notes of *bona fide* holders were exchanged by the Government of India upto 28th February, 1947. The bulk of these notes were cashed upto 26th January, 1946. The number of notes outstanding on 31st December, 1947 were Rs. 3 lakhs in the case of Rs. 500 denomination, Rs. 112 lakhs in the case of Rs. 1,000 denomination and Rs. 21 lakhs in the case of Rs. 10,000 denomination as against Rs. 26 lakhs of the denomination of Rs. 500, Rs. 11,327 lakhs of the denomination of Rs. 1,000 and Rs. 1,846 lakhs of the denomination of Rs. 10,000 on 31st December, 1946. Under the Demonetisation Ordinance, high denomination notes ceased to be legal tenders and therefore notes of these denominations outstanding on 31st December, 1947 may be regarded to have been lost to the public. But apart from this loss suffered by the holders of these notes and the panic that the suddenness of the Ordinance created, the Government failed to achieve its object. The Ordinance was more dramatic than effective and the Indian economists in the course of their second manifesto issued in 1946 observed: "The Demonetisation ordinances cannot bear any important consequences as long as currency continues to be issued in large amounts, week by week. It cannot check either speculative pressure on prices or the operation of black marketeers. The ordinances do not directly reduce the volume of currency. They merely change the form in which it is held. They will put those notes

of high denomination out of circulation the holders of which do not present them for exchange within the prescribed time-limit. The declaration made by holders of high denomination notes will lead to an increase in the receipts from taxation of incomes and profits and this might also have some deflationary effect. The total results in this direction cannot be expected to be large in relation to the total value of notes in circulation. On the other hand the ordinances might lead to making active monetary hoards that were previously dormant. The Ordinance may result in visiting some malefactors with loss or taxation but they cannot be taken to indicate even a beginning with the tackling of the real problems that lie ahead." The issue of the Ordinance showed that the Government was conscious of the rising spiral of prices and wanted to check it. But demonetization of high denomination notes, as was stated by the Indian economists, was not an adequate measure to achieve that object.

Appendix D

Establishment of the State Bank of India

The establishment of the State Bank of India on July 1, 1955 marked an important development in the banking system of India. It was set up by the State Bank of India Act passed on May 8, 1955.

The State Bank of India was established by a statutory amalgamation of the Imperial Bank of India and the major State-associated Banks—Banks of Saurashtra, Bank of Patiala, Bank of Bikaner, Bank of Jaipur, Bank of Rajasthan, Bank of Indore, Bank of Baroda, Bank of Mysore, the Hyderabad State Bank and the Travancore Bank. It took over from the Imperial Bank of India on this date the entire undertaking of the Imperial Bank within the country.

Among the main functions which the State Bank of India has to perform is the provision of facilities in the rural areas for the easy and cheap remittance of money, which is essential for the easy development of rural and co-operative banking. The commercial banks have not penetrated into the villages and they play only a minor part in rural finance. The Government treasuries and sub-treasuries can not serve the purpose of banks in providing remittance and other facilities. The Imperial Bank of India and other State Banks also have not been able to establish a sufficient network of branches to meet the needs of the rural sector. It is estimated that about 400 branches will have to be established to provide the minimum facilities in this sector. This was too big a gap to be filled by the Imperial Bank or other banks because of the essentially unprofitable nature of rural branches and required financial participation of the State.

A state-partnered, State-sponsored commercial banking institution like the State Bank of India with an effective machinery of branches spread over the whole country by further expansion can be put in a position to take over cash work from non-banking

tresuries and sub-treasuries and can provide vastly extended remittance facilities for the co-operative and other banks. It can also provide special facilities for the training of the personnel in co-operative principles and banking and act as an agency responsive to the needs of the co-operative institutions connected with the rural credit and especially marketing and processing. Already in collaboration with the Reserve Bank the State Bank has undertaken a larger programme of branch extension in rural areas.

The majority of the Directors of the Central Board are nominated by the Government of India and the Reserve Bank. The Chairman is appointed by the Government of India and the Managing Director and Deputy Managing Director are appointed by the Board in consultation with the Government of India. There is an Integration and Development Fund with an initial investment of Rs. 50 lakhs to meet the additional loss that may be incurred in the intitial stages. A portion of the dividend earned by the Government and Reserve Bank on their shares would be diverted to this fund.

Freed from its pre-occupations with initial problems of an administrative and organisational character, the State Bank has been able to devote increasing attention to its developmental role. During the year 1957–58, the State Bank opened more branches (115) than had been opened during the previous two years put together (102). Since its inception in 1955, the State Bank has completed 217 out of the five year target of 400 new branches set for it in its statute. At its present rate of expansion which is almost 10 branches a month the State Bank should be able to fulfil the target in the remaining two years. Out of the 217 branches so far opened, 46 are from the 51 centres left over form the Imperial Bank's programme of branch expansion and 171 from the list of 272 centres approved by Government under Section 16 (5) of the State Bank of India Act.

Appendix E

Second Finance Commission 1956

The Second Finance Commission appointed in 1956 submitted its report to Government in 1957. The Commission had to determine the distribution of four different taxes, *viz.*, income tax, excise duties, estate duty and the tax on Railway passengers. In addition, it had to decide the principles and the amount of grants-in-aid to the States from the Centre. As regards income-tax, it recommended that 60 per cent of the proceeds of the personal income-tax (excluding the surcharges) should be distributed among the States. The Commission adopted population as the basis of distribution. With regard to the estate duty, it recommended that 1 per cent of the net proceeds of this duty should be retained by the Centre as proceeds attributable to the Union Territories. The balance was to be divided into two parts, the proceeds attributable to immovable property and to other property. This has to be done on the basis of the gross value of all such properties brought into assessment in any year. The part of the duty attributable to immovable property was to be paid to the States in proportion to the gross value of the immovable property. located in each State. The second part *i.e.* proceeds of the duty of other properties was to be distributed among the States in proportion to their population.

As regards Union excise duties, while the first Finance Commission provided for the distribution of 40 per cent of the net proceeds of such duties on tobacco, matches and vegetable ghee among the States, the Second Commission lowered the ratio to 25 per cent but recommended the inclusion of the proceeds of more excise duties in the divisible pool. As a result, it was expected that a larger share of such duties than at present would be available for distribution. As distribution on the basis of population only would place a few States into a favourable position, the Commission decided that while 90 per cent of the States' share of the divisible Union excise duties should

be distributed on the basis of population, the remaining 10 per cent should be used for making suitable adjustments. Population was also the main factor for the distribution of the proceeds of the tax on railway fares levied in the budget of 1957–58.

The last question to be considered was the distribution of grants-in-aid to the States. Under the present constitution, the grants-in-aid in lieu of the jute export duty paid to the jute growing states are to cease at the end of 1959–60. The West Bengal Government asked that this should be made permanent. This was not accepted by the Commission who recommended that these grants should continue for the next 3 years only. Regarding general grants-in-aid the Commission examined the peculiar needs and problems of every State. Bombay, Madras and U.P. did not have deficit budgets, and were not to be given any grants-in-aid. The special problems of West Bengal, caused by the influx of refugees were recognised and the Commission recommended a grant of Rs. 3.25 crores. The amount was to be raised to Rs. 4.75 crores in 1960–61 and 1961–62 to compensate that State temporarily for the cessation of the grants-in-aid in lieu of jute export duty from 1959–60. Similarly, Bihar which would normally receive a grants-in-aid of Rs. 3.50 crores was to be paid Rs. 3.25 crores in these two years. Assam's grant-in-aid of Rs. 3.75 crores was also to be raised to Rs. 4.50 crores and that of Orissa from Rs. 3.25 crores to Rs. 3.50 crores for these two years.

The Commission also made a number of recommendations for securing the repayment of all Central Government loans to the States.

Appendix F

Decimalisation of Coinage

The feasibility of adopting the decimal system was examined in India as early as in 1867 when it was decided to introduce the system in gradual stages. Accordingly, an Act was passed in 1871, but for a variety of reasons it remained inoperative. In recent years, the subject has been very closely examined by many expert bodies and institutions. In 1946, the Indian Science Congress Association issued a statement in support of the system. In the same year, a Bill was introduced in the legislative assembly. The Bill could not, however, be passed owing to the impending political changes.

The volume of opinion in favour of decimal currency had since increased, and in 1955 the Government of India introduced a Bill in the Lok Sabha on the subject. The Bill became an Act in September 1955 under the name of the Indian Coinage (Amendment) Act, 1955. It authorised the Government of India to introduce decimal coinage in India.

According to the new Act the weight and value of the existing Indian rupee is to remain unaltered, while the basic unit has been changed from a pie (equal to 1/192th part of a rupee) to a pice, designated as "Naya Paisa" (which will be equivalent to 1/100th of a rupee). This nomenclature 'Naya Paisa' was adopted at the instance of the Prime Minister, Shri Jawahar Lal Nehru because the term 'Paisa' was familiar to the Indian masses, and the old word 'Cent' was dropped. After the transitional period is over (when old coins are totally withdrawn) the prefix 'Naya' in the 'Naya Paisa' will be dropped. The following seven new coins have been issued:

New Coins	*Exact value in Current coins.*
1 Naya Paisa	1.92 Pies
2 Naya Paisa	3.84 Pies
5 Naya Paisa	9.6 Pies.
10 Naya Paisa	1 Anna 7.2 Pies
25 Naya Paisa	¼ Rupee.
50 Naya Paisa	½ Rupee.
100 Naya Paisa	1 Rupee.

The exact Naya Paisa equivalent of the total amount to be converted is rounded off by ignoring fractions of ½ Naya Paisa and below, and treating more than ½ Naya Paisa as one Naya Paisa.

The design and the composition of the new currency units is as follows: The obverse sides of all the new coins have the design of the Lion Capital of the Ashoka Pillar with terms 'Bharat' in Hindi and 'India' in English inscribed on them. The reverse sides of all the new coins indicate the year in which the coins are produced and their value in Naya Paisa specified in international numericals. In order to enable the public to understand rightly the relationship of each new coin to the rupee it has been decided to indicate on the coins themselves the number of such coins required to make one rupee. Thus the coin representing one Naya Paisa has a legend (*Rupaya Ka Sovan Bhag*) (1/100th) embodied on it. Similarly two, five, ten, 25 and 50 Naya Paisa units indicate that they represent 1/50th, 1/20th, 1/10th, 1/4th and one half parts respectively of the rupee. The metallic contents of the new coins are as follows: The 100 Naya Paise, 50 Naya Paise and 25 Naya Paise are of pure nickel while ten, five and two Naya Paise coins are of copper-nickel alloy (75 per cent copper and 25 per cent nickel). The one Naya Paisa coin is of bronze.

The process of change-over commenced from April 1, 1957 and will be completed gradually depending on the speed with which the new coins come into circulation. The complete withdrawal of the old coins will take a period of at least three years. This period may be extended a little more if need is so felt. The Government is, however, working on the basis of complete withdrawal by April, 1960.

The Government is giving extensive publicity through all available media to the new coins. The Central Ministry of Education is thinking of introducing decimal coinage system in the school text-books and the State Governments might do the same. Pamphlets in regional languages are being distributed in all the educational institutions. In addition, because of the rather small percentage of literacy in the country, a direct approach to the people is being made.

Arrangements have been made by the Posts and Telegraphs Department to replace the existing series of stamps by the new series of stamps with decimal values.

The Ministry of Railways has changed the basis of passenger fares over to the new coinage from April 1, 1957. But the basis of freight rates is expected to continue on the old coinage for sometime more. Some difficulty may be felt in respect of the calculating machines in use on the basis of the existing system. The Government is in touch with the manufacturers and will be in a position to tender expert and useful advice to the users.

The Government has prepared a conversion table to act as a ready recknor to change the old currency into the new. This table is widely publicised. Apart from this, the Government is considering the question of nominating certain key personnel at various places who give ready advice to the public in regard to any difficulties arising in connection with decimal coinage. The village level workers in the Community Project areas and National Extension Service Blocks are in a key position in so far as the rural areas are concerned and as the whole of rural India is to be covered by the National Extension Service in the second plan period, it is hoped that this service will be able to carry knowledge of the currency reform to the remotest parts of rural India.

There is no doubt that decimal system of coinage is a more modern, simple and convenient measure than the one inherited by us from the Britishers. However, crucial reforms like decimalisation of Indian currency presuppose public co-operation which must be forthcoming from all quarters in order to make it a success.

Appendix G

Union Government Budget

Revenue Account: The revenue and expenditure accounts of the Central Government are given below to give an idea as to their trends.

(Crores of Rupees)

	1953–54	1954–55	1955–56	1956–57	1957–58	1958–59 *Revised*	1959–60 *(Budget)*
Revenue ..	394.3	434.8	481.2	563.2	673.4	639.5	690.8
Expenditure ..	385.8	401.2	440.7	473.8	631.3	699.5	749.1
Surplus (+) or Deficit(—) ..	+8.5	+33.6	+40.5	+89.4	+42.1	—60.0	—58.3

The revised estimates for 1958–59 disclose a larger deficit at Rs. 60 crores as compared to the budgeted amount of Rs. 28 crores. Revenue receipts recorded a fall of Rs. 44 crores from Rs. 684 crores to Rs. 640 crores while the decline in expenditure was relatively small. The fall in revenue was mainly the result of a drop of Rs. 34 crores under 'customs', particularly in respect of imports. On the expenditure side, the bulk of the decline was under defence.

The budget estimates for 1959–60 place revenue (at existing level of taxation) at Rs. 617 crores as compared to the revised estimate of Rs. 639 crores for 1958–59 *i.e.* Rs. 28 crores higher and expenditure at Rs. 749 crores which is Rs. 50 crores higher than in 1958–59, leaving a larger deficit of Rs. 82 crores. The bulk of the increase in expenditure is under development services (Rs. 30 crores) and debt services (Rs. 16 crores). Expenditure on defence services is lower by Rs. 24 crores).

Capital Account

The capital account for 1959–60 shows a deficit of Rs. 164 crores as compared to a deficit of Rs. 198 crores in 1958–59 (R.E.). Capital receipts (excluding the adjusting item in respect of the U.S.

aid and also Treasury bills except those sold to the public) are estimated at Rs. 891 crores as compared to Rs. 657 crores in 1958–59 (R.E.). External loans are placed higher by Rs. 62 crores at Rs. 300 crores comprising Rs. 41 crores of Sterling loans, Rs. 143 crores from the U.S.A., Rs. 29 crores from the I.B.R.D., Rs. 26 crores from the U.S.S.R., Rs. 29 crores from West Germany, Rs. 12 crores from Japan and Rs. 20 crores from other foreign sources. Gross receipts from market loans are estimated at Rs. 225 crores as compared to Rs. 202 crores in 1958–59 (R.E.), the corresponding net receipts being Rs. 108 crores and Rs. 181 crores. Small savings receipts (net) at Rs. 85 crores show a rise of Rs. 10 crores over 1958–59 (R.E.). Excluding the adjustment for the transfer of capital assistance from the U.S. to the Specil Development Fund, which is technically treated as an expenditure., the budget provides for a total capital outlay of Rs. 420 crores as compared to the outlay of Rs. 395 crores in 1958–59 (R.E.) and Rs. 434 crores in 1957–58. The outlay for 1959–60, however, includes a sum of Rs. 95.24 crores for the payment of the additional subscription to the International Monetary Fund; this is to be met out of the creation of special ad hoc securities of the same amount in favour of the Reserve Bank. Capital outlay under 'Industrial Development' records a sharp decline from Rs. 189 crores to Rs. 54 crores mainly due to the absence of further investment in Hindustan Steel Ltd. As it is proposed to meet the entire requirements of this company by loans, 'other loans and advances' show a sharp rise of Rs. 91 crores. Loans (net) to States, however, would be lower by Rs. 30 crores at Rs. 217 crores;

The budgetary position of the Government of India is summed up in the statement given below.

BUDGETARY POSITION OF THE GOVERNMENT OF INDIA

	1957–58	1958–59	1959–60	
	(*Accounts*)	(*Budget*)	(*Revised*)	(*Budget*)
I. Revenue Account:				
A. Revenue (*a*)	673.38	684.02	639.53	690.77(*b*)
B. Expenditure (*c*) ..	631.33	712.04	699.48	749.09
C. Surplus(+) or Deficit (—)	+ 42.05	— 28.02	— 59.95	— 58.32
II. Capital Account :				
A. Receipts (*d*)	290.00	679.34	675.92(*f*)	947.52(*g*)
B. Disbursements ..	835.45	850.54	873.47	1111.53
C. Surplus (+) or Deficit (—)	—545.45	—171.19	—197.55	—164.01

	1957-58 (Accounts)	1958-59 (Budgets)	1958-59 (Revised)	1959-60 (Budget)
III. Miscellaneous (Net) (*e*)	..	+ 44.82	1.13	0.81 + c.89
IV. Overall Surplus (+) or Deficit(—) : (IC+IIC+III) ..	..	—458.58	—200.34	—256.69 — 221 44
Financed by :				
A. Treasury bills (*h*) increase (—)		—459.43	—205.00	—255.00 —222.00
B. Cash balance decrease (—)		+ 0.85	+ 4.66	— 1.69 +0.56
(*i*) Opening balance	..	50.96	50.55	51.81 50.12
(*ii*) Closing balance	..	51.81	55.21	50.12 50.68

NOTE—Accounts are provisional, budget estimates for 1959-60 relate to those presented to the Lok Sabha. (*a*) Excluding States' share of excise duties and other taxes; (*b*) Including the effect of budget proposals; (*c*) Excluding States' shares of excise duties and additional excise duties; (*d*) Excluding Treasury bill receipts; (*e*) Remittances and transfer of cash between England and India; (*f*) Excludes the conversion of ad hoc Treasury bills of Rs. 300 crores into 4 per cent Loan 1973 which was taken over by the Reserve Bank in July 1958 and is not intended to be placed on the market; (*g*) Includes sales of Treasury bills through public auction of Rs. 15 crores; (*h*) mostly sold to the Reserve Bank.

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