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HISTORY AND PROBLEMS OF INDIAN CURRENCY

1835—1949

AN INTRODUCTORY STUDY

By

D. K. MALHOTRA M.A., Ph. D.

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PREFACE TO THE 1944 EDITION

The 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 one hundred years and its first edition came out a few months after the outbreak of the war. The war has given rise to some very important developments in the sphere of Indian currency and these have been covered in the present edition. The shape of the material incorporated in the first edition has also been changed a little by addition, modification and amplification. It is very difficult to write about any aspect of Indian war economy without quickly getting out of date. For the scene changes even as one is looking at it and the latest information has to be pursued like will-o'-the-wisp.

The following words occurring in the last chapter of the previous edition embody the conclusions than reached about the future of Indian currency:

"It may take a long time yet for the international monetary position to become clear and stable, with war in the offing it may get more confused and unstable. An independent monetary policy alone can safeguard Indian interests in such an emergency. The past record of currency management in this country is not such as to inspire public confidence. The excessive dependence of her monetary system on currency and credit changes in England has been serious disadvantage for India. This dependence must be ended and a monetary system suited to Indian needs and managed to promote Indian interests evolved."

The war has brought a wealth of experience and wisdom but has in no way necessitated the retraction or revision of that conclusion.

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INTRODUCTION.

A general acquaintance with 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 begining 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 directives under conditions of control. Conditions of free competition will have to 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.

I 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

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

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 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 extended 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 extended 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 26 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 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 containd in a £ is, let us say, 1/4 franc.

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 franc.

As soon as the rate of exchange in the market falls below 1 £=24¾ francs, a Britsh importer will find it cheaper to export gold containd 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 13¾ : 1 and 15¼ : 1 but after 1870 this ratio was disturbed.[1]

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

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 60½*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. Natuarlly 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 aries because in one or both of the countries the currency is not convertible into bullion or coin.

Here 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 our causes but will *centre round this purchasing power parity.*

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 discribed 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, than 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 assentially 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 correncies 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 equillbrium rate:

$£ = 25 \times \frac{500}{300}$ francs

or £=41·7 fancs.

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 criticims of the theory it is needless to enter here. The theory has been accepted in

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

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 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 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 thier 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 purchases more 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, dicate 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 delibrate 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 abnormal 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 stabilished 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 last 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 present war it was introduced in countries where it did not already exist and was intensified in others. It would be wholly unrealistic now to speak of a free market in foreign exchange.

Inflation, Deflation, Reflation:

The three terms above do not refer to the state of the foreign exehange market but to the condition 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 scientifie 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, including notes and bank credit. And when this much has been agreed upon, further discsusion 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 requirments of economic activity and from this interaction of money-supply and money-work, there results a certain general level of prices. It is diffcult to say what relationship between money-supply and economic activity[2] is the optimum or the best and how it can to identified (if it ever exists) but some such optimum relationship will have to be visualised in order to hit upon 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 nowthiseq uilibrium is disturbed by an expansion of the total effective supply of money, inflation will be said to have occured. 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

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

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

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 prouctivity but the monetary authority of a country may, by puting increasing quantities of money 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 is, however, such an uncommon phenomenon that it may safely be taken to furnish a fairly strong evidence of inflation.

It is necessary now to know why the equilibrium relation-ship 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 execptional 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 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

[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 Institue's *What will inflation and devaluation mean to you*, 1941.

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 extremly indiscriminate, haphazard and inequitable in effects, inasmuch as it places the heaviest burden on the weakest shoulders and effects arbitary 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 of aftermath of an inflation. The motive behind it is the raising of the value

[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.

of currency to its previous level, in terms of gold or in terms of other currencies.

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—: The period of the post-war aftermath during which adjustments required by the post-war conditions were hurriedly made.

It would be helpful to know that running like two threads through the history of Indian currency 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 recent war has thrown 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 is steadily emerging a new pattern of international monetary relations.

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

[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.

fine) was made the standard coin throughout British India[1] 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 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 payments 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

[1] The weight and fineness of the rupee remained unaltered upto 1940.

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 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

[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.

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.* 3*d.* 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.

(*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.

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

(*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 Herschell 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 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.[3]

[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.

[3] This notification was later on withdrawn in 1906.

(*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.[1] 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.[2]

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.[3]

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 1*s.* 1*d.* in 1894[4] but recovered later and was 15·9*d.* in 1898. The Government of India

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

[2] 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.

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

[4] 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.

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 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 stan-

dard *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. 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[1]. The profits on the coinage were credited to the Gold Reserve. 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. The conclusion was wrong because both the time and manner of putting gold coins into circulation were ill-

[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).

chosen. Famine conditions prevailed about this time and rupees were needed for small payments. The method of forcing sovereigns 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 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

[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.

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, 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. 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.[1] More than £8 millions were withdrawn out of the London branch of gold Standard Reserve.

All these 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

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

1 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.

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

it was the result of a series of administrative acts. It was not adopted as a consistent whole; for it was never consciously designed.

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 is in its most perfect state when it consists of a cheap material which has an equal value with the gold it represents. 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

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

avoids the use of a costly gold currency but has gold at its command to make foreign payments.

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 might 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

[1] Before the 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.

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, 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

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

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

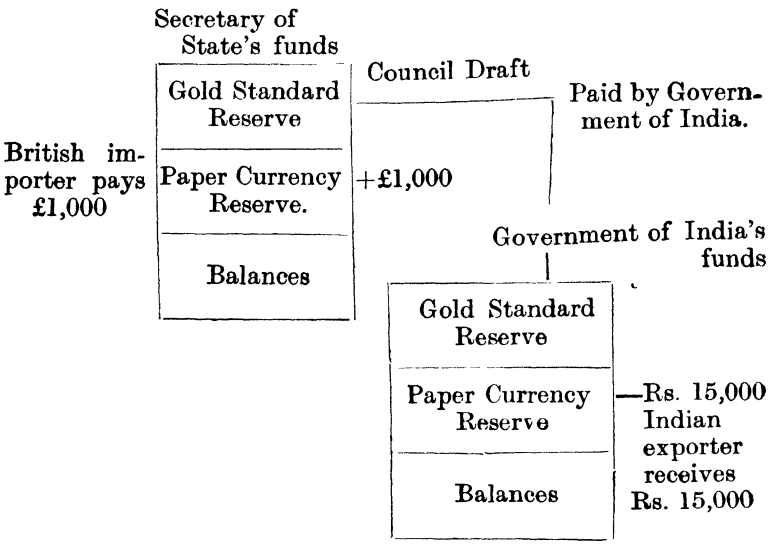
of State released from his funds sterling. The demand for Reverse Councils, unlike that for Councils, arose rarely, for Reverse Councils would be demanded only when the payments to be made abroad were larger than those made by foreigners to this country and this could happen only when imports were larger than exports. Reverse Councils were not sold below the rate of Re.: 1*s.* $3\frac{29}{32}$*d.*

By the scale of Councils 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.

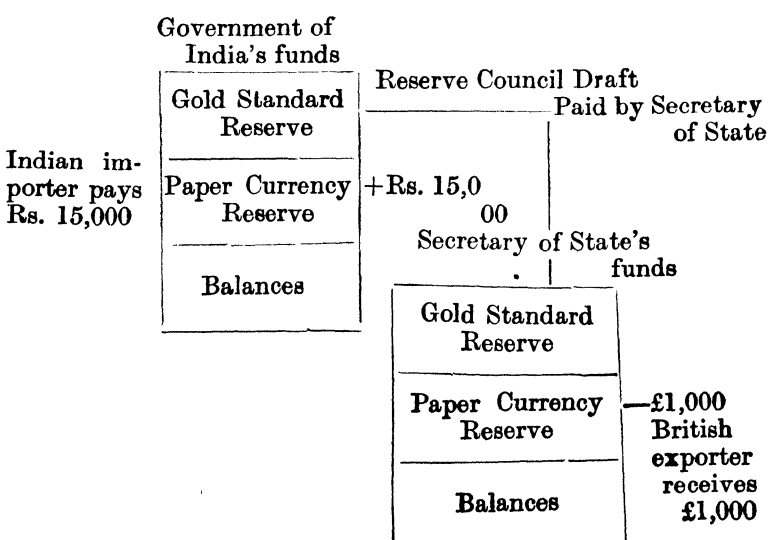
To complete the explanation, a few words may be added about the funds out of which the Councils and Reverse Councils were paid out. The proceeds of the sale of Councils were credited partly to the Secretary of State's balances, partly to Paper Currency Reserve held in gold in London[1], and partly to 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.

[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 Council Draft of £1,000=(Rs. 15,000)



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 Government should renew the notification withdrawn in 1906[2] 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.[3] 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

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

[2] See page 23, footnote 3.

[3] 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.

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,[1] 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 in dealing with them.[2] 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

[1] This always happens due to capital being withdrawn from the country in panic and a loss of confidence in the currency.

[2] 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).

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 from other countries, led to a rise in the price of silver. From 27½*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 mirage evaporated, the soap bubble burst and the chariot of Cinderella relapsed into its original pumpkins and mice !'

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*.

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

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]

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. 2½ and one-rupee notes were issued[2] 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[3] 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.

[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.

[2] The issue of these notes was stopped from 1st January 1926.

[3] The portion of note-issue not backed by metallic reserve but by securities.

§ 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.[1] Two points about this recommendation deserve notice : 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.[2] The Committee favoured a high rate of exchange on other grounds also. A high rate of exchange would secure imports

[1] At this rate one Rupee=11.30016 grains of fine gold.

[2] 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.

of goods at lower prices or at least check the rise of prices and thus reduce social and economic discontent.[1] 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 an 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 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 exchanges 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 stabilization of the Rupee

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

[1] 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.

(*ii*) The exchange value of the rupees should be fixed in terms of gold rather than sterling and stabilized 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 sovereigns 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

POST-WAR DEVELOPMENTS (1920—1927)

§ 1. Failure of the Government Attempt to Restore Stability

V Period : February 1920—September 1920

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 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.[2]

(*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.

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

[2] The British Government had begun to deflate currency with a view eventually to making sterling equivalent to gold.

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 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

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

[2] *Report*. para. 51.

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.[1]

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 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[2]. 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.* $2\frac{3}{4}$*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

[1] *Ibid.*, para. 58.

[2] *Cf.* Sir W. M. Hailey's Budget Speech for 1921-22.

more or less stable round 1*s.* 3*d.* (the limits being about 1*s.* 3 $\frac{31}{32}$*d.* and 1*s.* 3$\frac{1}{2}$*d.*[1] 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 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 the 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 has gradually displaced since 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 provisions 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; (*iii*) the Governor-General-in-Council was empowered

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

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. 1000 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.

CHAPTER VII

THE HILTON YOUNG COMMISSION.

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

§ 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,

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

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

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

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 stabilized 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 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 emphasized 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

[1] See p. 39, footnote 2.

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 stabilized 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 may be 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 had, 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 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

[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.

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 moved, there arises an increased demand for currency but under the pre-War system this could not be properly satisfied.[1] Not was there any provision for an emergent issue of currency.

(*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,

[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.).

the Reserves 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 objections they raised against it are the main objections that might be 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]

(*ii*) The amount of gold that would be required for

[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.

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 affect 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 has 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.

It is however, difficult to say if the standard would work automatically in India. If the imported gold is hoarded by the people and thus 'sterilised', prices may not rise and if gold does not come out of circulation for being exported when the balance of trade is against India, prices may not fall.[2] The natural correctives to exchange will not then operate. This is, however, on the assumption that the hoarding habit of the people will 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.

[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.*

The Hilton Young Commission differed from this view and held that "the mere act of putting gold into circulation would not.....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 do want gold in circulation, as is evident from the large absorption of imported sovereigns from 1900 to 1914.[1] Besides, the 'weight of good academic opinion' is in favour of gold currency and this is '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 will 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

[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.

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,[1] but the rupee was to continue to be full legal tender.

(*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

[1]They were made legal tender by the Act No. XXII of 1899 (see p. 25). 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.

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.

[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.

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.

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 bankers' 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]

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

1. At the existing (1*s*. 6*d*.) ratio,[2] 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 have adjusted themselves to the prices at the existing exchange rate of 1*s*. 6*d*. Though there is depression in jute industry and cotton mill industry, it is due to causes which the manipulation of exchange rate cannot remedy.

3. As regards contracts, least injury will be caused by adhering to 1*s*. 6*d*. ratio. It is true that land revenue and other long term contracts were settled when the ratio was

[1] One gold pound contains 113,0016 grains of fine gold. 8·74512 grs, =3/40 of gold pound =1*s*. 6*d*. (gold).

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

1*s.* 4*d.*, but owing to the rise of prices since 1914, the incidence of land revenue as calculated in terms of commodities has 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 has been called the 'natural' rate, it is difficult to understand in what sense it can 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 has been argued by its supporters.[1] If the reserves are adequate as they would be, 1*s.* 6*d.* ratio can be made as effective as 1*s.* 4*d.* ratio.

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

4. It is argued that if world prices fall in future, 1*s.* 4*d.* rate will cause less rapid fall in Indian prices than 1*s.* 6*d.* rate. But any abnormal price fall in future is not expected and any prolonged fall in prices will 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 cannot be contended that there has been an adjustment of prices and wages to that ratio. As there has been no such adjustment to 1*s.* 4*d.* rate, the fixing of this rate will lead to profound disturbance in economic conditions. It will lead to a rise in prices, causing hardship to consumers

[1]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.

and wage-earners. It may also by raising cost of living lead to a demand for higher wages and salaries.

6. The reversion to 1*s*. 4*d*. ratio will upset the finances of the Government of India. Increased taxation may become necessary to meet the sterling obligations of the Government. If the budgetary equilibrium is upset, the credit of India as regards borrowing may 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* have been 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 fall lower as is 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 will hit Indian producers very hard.

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

4. Until wages get adjusted to 1*s*. 6*d*. rate—which will involve a long and painful process—the foreign manu-

facturers will enjoy a bounty of 12½ per cent.[1] This indirect help to the foreign manufacturers will intensify competition with Indian industries.

5. It has been argued that 1*s.* 6*d.* rate has had no adverse influence on Indian trade. In respect of exports, the absence of adverse influence is 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 has been slackness in the demand for imports—an indication of lower purchasing power of the masses—and it is due to 1*s.* 6*d.* rate.

6. The adoption of 1*s.* 6*d.* rate will be injurious to the debtor class. There is 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 is absolutely unmaintainable or unattainable.

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

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

4. The adoption of 1*s.* 4*d.* rate will 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, has 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.

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

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

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

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[1] 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] See page 58, footnote 1.

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
Exports	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 stabilization 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.

[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 exports and imports on the basis of declared values in 1913-14
(In crores of Rs.)

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

July 1914=100

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

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 munufactured 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 the Civil Disobedience movement started in 1930 weakened it further by paralysing trade and industrial production and causing a flight of capital from India.

[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 only 17 per cent.

The Government issued Treasury Bills in large amounts and contracted currency by selling sterling[1] 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[2] and accentuated the fall in prices. Strong protests against them were made by Indian commercial interests.

§ 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 will be convenient 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

[1] 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.

[2] 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).

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 Paper Currency Act, 1923, the common purpose of the two Bills being the fixation of the rate at 1*s.* 4*d.* gold.[3] 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

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

[2] *Leg. Ass. Debates*, 1924, Vol. 4, pp. 3808-12.

[3] *Leg. Ass. Debates*, 1925, Vol. 5, Pt. 1, pp. 715 and 719.

a *fait accompli*.[1] 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 ".[2]

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 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

[1] 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.

[2] Sir Basil Blackett's speech at Delhi University on November 23 1926.

the Government that a reversion to 1*s.* 6*d.* ratio would cause at Rs. 5·26 crores.[1]

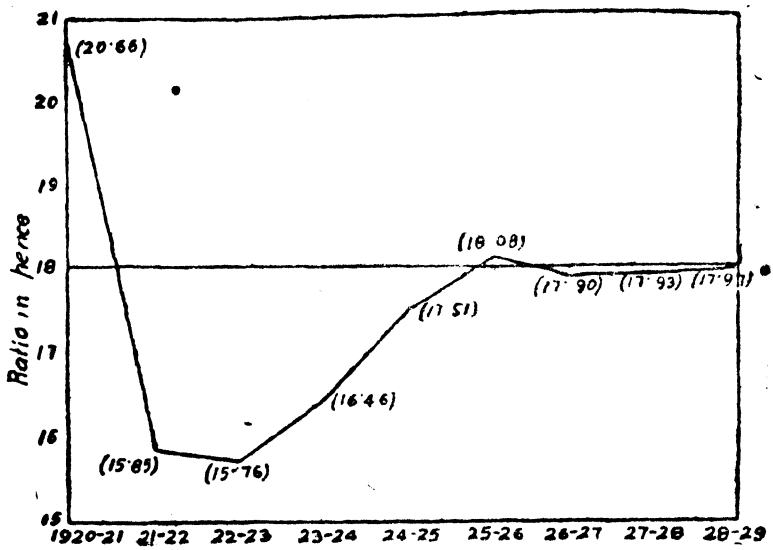
Though the comparative merits of stability of exchange and stability of internal prices were never made a prominent issue in the ratio discussions, it is interesting to find that a choice between the two was implicit in whatever position was taken by the participants. Those who began to urge on the government 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 1s. 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 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

[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.)

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 very 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

[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 and 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 Act of 1927 came into force again.

object underlying all these restrictions was to maintain the sterling value 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 another 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

[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 George Schuster's reply ; Legislative Assembly Debates,* 1931.

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

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 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

[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. 13-5-4 (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.

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 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 take this view and took no action and have taken none so far. 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 has continued ever since 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.

[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.

	Net amount of exported gold (millions of fine oz)	Value (crores of rupees)	Average price of gold per tola (in rupees)*
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

The issues raised by gold exports may be discussed under the following heading :–

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

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

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 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.[3]

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.[4] 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

[1] M. L. Darling: *Wisdom and Waste in the Punjab villager*, pp. 320-21.

[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.

[3] ..... 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 reserves and ... . our actual gold reserves stand at about £ 7 millions sterling higher than they did an year ago, owing to the receipts of gold from up-country"—*Sir George Schuster, Legislative Assembly Debates, September, 1931.*

[4] 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 1¼ 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.

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 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. 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 enable 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.

[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.*

These arguments in favour of gold exports could be reinforced further by others 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 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.[2] 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 retain-

[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.

[2] Resolution of the Federation of Indian Chamber of Commerce, dated, 26th March, 1932.

ing 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 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 independant 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.

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

Leaving side for the present the question of the monetary standard of the future,[1] 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 stabilized 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.

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 aid 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.[2] It was, however, small compared to the large quantities sold by the Government of India from 1927 onwards. The silver

[1] See Chapter XII.

[2] Report of the Controller of Currency, 1931-32, para 25.

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.'[1]

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 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.[2] The silver sales depressed the price of silver and also resulted in deflation of currency.

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.

[1] Report of the Hilton Young Commission, paras 78 and 80.

[2] " 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.*

§ 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. Of these the Governor and two Deputy 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 February 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 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

[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.

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$\frac{1}{32}$*d.* for a rupee and selling sterling for immediate delivery in London at a rate not lower than 1*s.* 5$\frac{31}{32}$*d.* for a rupee. The amount of the sterling bought of 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 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

[1] The most notable change in the composition of the assets brought about by the war is 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 of 8.47512 grains of gold per rupee or Rs. 21-3-10 per tola giving at the present value of gold (March 1946) a hidden reserve of over Rs. 120 crores.

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—	
Notes in circulation ...	12,18,77,42,000	(*a*) Held in India ...	44,41,45,000
		(*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 bankers' 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 have had ample resources of their own to lend and have rarely sought accommodation from the Bank. The bank rate has remained unchanged at 3 per cent since 28th November, 1935.

The greatest difficulty in controlling the monetary system in India arises from the existence of a vast mass of indgienous 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 has 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 contacts 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 have been 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 regulating 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

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

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 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 are 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 to 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 has 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 keeps 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 which was placed under the charge of a Director of Research in May 1940 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 is possible 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 now on an appraisal of eleven years' record of the Bank's working it may be said that it has endeavoured to serve India well and has 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 is 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 inspires confidence that India's interests will 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 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

[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.

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 began 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 restorted 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 on the next page shows the position in respect of exports and imports since 1931.

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

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 ...	161·29	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.

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 institution. 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 decline as compared to 1937-38, the balance of trade being *plus* Rs. 66 crores against *plus* Rs. 59 crores for 1937-38.[2]

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*. $6\frac{1}{8}$*d*. and 1*s*. $6\frac{3}{32}$ *d*.[3] From April 1938, however, the effect of falling exports and increasing imports began to be visible

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

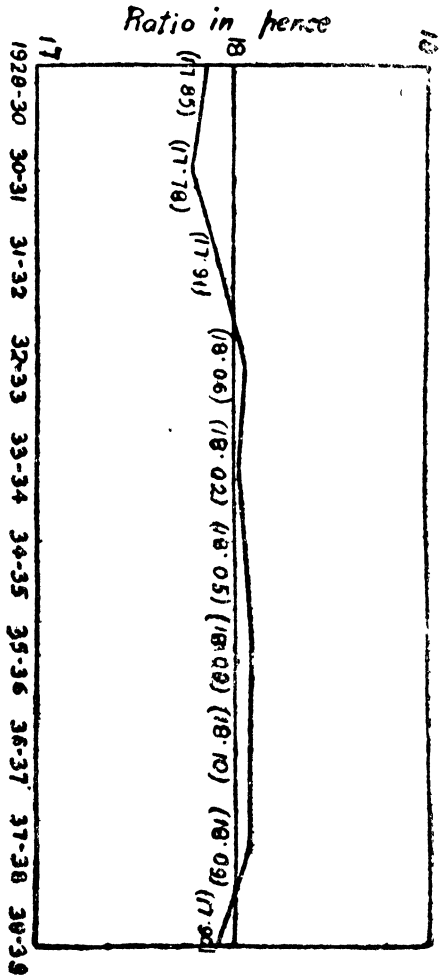
[2] There was a comparatively greater fall in the values of goods imported after the beginning of 1938-39 which was attributable partly to the reduction in the volume of imports and partly to the fall in prices.

[3] *Reserve Bank Report on Currency and Finance*, 1937-38, p.

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 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 co-operation 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 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

[1] It was feared among other things that a devaluation of the guilder might reduce the protective value of the sugar tariff and facilitate imports from Java and that of dollar might encourage the import of American cotton into India.

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

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 1s. 4*d*. and

[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,

a lower ratio and though the majority recommended 1*s*. 4*d*. ratio, a minority 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 measure of another kind)

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.

[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.

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?

There will be general agreement that the objective of currency policy in India should be determined with reference to her economic position. India has 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 could clung to 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

[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.

Schuster as a consequence of slackness in trade.[1] 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 certain 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 are neither very accurate nor very reliable. The information about changes in price level is based on Calcutta or Bombay index numbers of prices, the method of construction of which can be greatly improved. There are no statistics directly relating to costs of production and use is, 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	65·1	64·5	64·5	72·3	76·6

[1] Address to the Conference of Finance Secretaries, October 1930.

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 would, however, have to 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 a case 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 worth while 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 enonomic 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 argument 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, 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."[2] If this be the proof of a well-chosen ratio, 1*s.* 6*d.* ratio could hardly be said to have furnished it.

[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 over-valued 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.

[2] J. C. Coyajee in *The Asiatic Review*, Vol. XXV, p. 412.

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,[1] 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 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

[1] 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.

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 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 price of agricultural commodities and given 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 price 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 to-day, 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 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 open questions 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 present 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. 1*s.* 6*d.* 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 1*s.* 6*d.* gold rate into 1*s.* 6*d.* 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 has 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 have 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 has 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

Since the beginning of the war, the rates of Telegraphic Transfers from Bombay on London have remained in the neighbourhood of 1*s*. 6*d*. and the amount of sterling purchased by the Reserve Bank has 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 have 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 has been conducive to a large rise in prices in India. The balance of exports over imports has 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 last war[1] and a fixed exchange during the present war is of considerable interest.

§ 3. Exchange Control

The institution of the system of exchange control is 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,

(*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.[2] 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.

[1] *Vide* page 36.

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

Although the exchange control has been 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 are now 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.

(*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]

[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 con-

Under a system of import restrictions introduced from 20th May 1940, the sales of foreign currencies, especially those of 'hard currency' countries,[1] were severely restricted to payments for licensed imports and a few private remittances.[2] 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 balafices 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.

(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.

trolled 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.

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

2 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.

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

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

(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 since 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 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 have been 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. The general efficacy and effects of exchange control in India, as elsewhere, can be properly appraised only after some more time has passed but 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—has to be listed 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 overshadowed 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

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

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, 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 has 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 picked to pieces 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 constitute 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 from 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** (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

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 has been 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 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

*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 1943-44 and the *Monthly Statistical Summary* of the Reserve Bank. Figures from 1942-43 onward exclude Burma notes.

Magnitude of increase		*Period*	*No. of months*
7th	50 crores	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 form only a negligible fraction of the note circulation and consist 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 has been considerably restricted during the war, the whole of the note-issue may 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 has also been a large

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

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†
1943—44	23·14†
1944—45	10·05†

No less striking is 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* (in crores of rupees)
September 1939—March 1940	2·64
1940—41	4·28
1941—42	5·06*
1942—43	11·64†
1943—44	18·46†
1944—45	19·20†

Finally, the bank deposits, too, which form a significant part of the media of payment, have recorded considerable increase. The only deposits relevant in 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.

* Excluding Burma for February and March 1942.

† Excluding Burma.

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

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

* Burma figures have been excluded since February 1942.

[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.

Period	Average demand deposits	(*In crores of rupees*) 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 is the strongpropensity towards hoarding of rupee and small coin engendered by the uncertain conditions of war. To this has been 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 has been another contibutory factor.

Currency Circulation and prices :

Contemporaneously with the heavy expansion in currency circulation, tempered as it has been by a somewhat diminished velocity, there has 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 below, the

index numbers of prices, note circulation and demand deposits have been shown in juxtaposition.

Year	Month	Note Circulation (in crores of rupees)	Demand deposits	PRICES Calcutta (August 1939=100)	Bombay (July 1939=100)	Economic Advisor's (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.

Inflation—character and development

It was this simultaneous occurrence of the expansion of currency and the rise in prices that flung into focus the

†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.

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 existence of inflation but when a casual 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 wartime currency developments which fails to give it a prominent place can be really complete.

Any discussion of the inflation issue in India gets down, sooner or later, to four basic questions: *first*, what is inflation? *second*, what evidence is there that it exists in India? *third*, to what extent is it serious in magnitude and grievous in consequences? *fourth*, how can 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

[1] A short explanation of the phenomenon of inflation has already been given in the Introduction (pp. 11-14).

bottlenecks, impediments and frictions which hamper the mobility of resources. War usually leads to the stimulation, 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 a 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 has developed in India 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 has gone beyond the requirements of economic activity or has been merely evoked by the latter and on the other, to find out if the government has been pursuing a lenient or wrong budgetary policy is 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 war-time 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 can be said to exist in India only in the expansion of currency has outpaced the demand for it for sustaining economic activity at a higher war-time level. It is well known that in 1933 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

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

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 will to draw up and execute with public cooperation a comprehensive and co-ordinated plan to deal with the new forces. The net effect of all these forces at work has been an expansion of economic activity which falls far short of both the needs of the country and of the opportunities opened up by the war. Statistics of agricultural and industrial production available at present (and 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*	*1941-42*	*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

Indices of Agricultural Production—Cont.)

	1938-39	*1939-40*	*1940-41*	*1941-42*	*1942-43*	*1943-44*
Caster seed	100	87·4	94·6	82·0	132·4	126·1
Sesemum	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**	100	108·3	117·1	97·1	111·6	111·4

Indices of Industrial Production[1]

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)
Steelingots	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	103·5	121·0	117·7	128·9
Cotton piecegoods	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.

"Capital" Index of Industrial Activity [2]

Items	1938-38	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	154·4†	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†	88·7†	90·2†
Cheque clearences	100	99 3	89·1	91·8†	69·0†	70·2
General Index	100	102·4	105·6	110·4†	97·9†	98·5†

† Provincial. (*e*) Estimated

* Simple arithmetic average.

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

[2] Based on the table in *Capital*, May 1945.

Some more data which unfortunately are not available, particularly of employment and internal trade are necessary for correlating expansion of currency with economic activity [1] But even with such data of production and prices as are available it is hard to escape the conclusion that the supply of currency has far outrun 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 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

[1] It has been pointed out by Mr. G. D. Birla that the volume of transactions which are done in cash has increased a good deal during the war. Moreover the number of stages through which commodities have to pass has 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 currency was required* had greatly expanded.

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

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

treatment of the system of war finance which is 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 has to bear is 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 is 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.[1] The expenditure on defence measures undertaken by India and debitable to Indian revenues has been reduced to a formula and it consists 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 are 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

[1] 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.

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 will be determined by negotiation at the end of war.

Any expenditure in addition to the sum total of these five items, though it may be immediately borne by India, will 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, stands, though a new interpretation of some of its provisions has 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 has 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*
Provincial expenditure directly attributable to war	275·68*

By far the most important item in the expenditure arising out of the war which is not included in the central budget but without which no computation of the money cost of war to India would be complete is the expenditure incurred in India on behalf of British and other Allied Governments. No figures about this expenditure have been furnished by the Government but some measure of it can 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.[1] War expenditure recoverable from the British Government has been estimated at Rs. 439 crores for 1944-45 and has been placed for the whole of the war period upto March 1945 at nearly 1394 crores of rupees.

*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.

[1] *Report on Currency and Finance, 1944-45.* p. 38.

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. 2500 crores may be taken as the direct financial burden *of* the war.

How has the money cost of war been 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 have enabled the Central Government to balance their budgets, they have not sufficed 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) has been 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 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 9ps. for parcels
	Surcharge on telegrams	levied	-/1/- on ordinary and -/2/- on express.
	Surcharge on telephone calls	levied	10 per cent

Period	Tax	Levied for the first time or increased	Rate
1941-42	Excess profits tax	increased	From 50 to 66 2/3 per cent
	Surcharge on income tax	increased	From 25 to 33 1/3 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 *ad-valorem*
1942-43	Income-tax	increased	Exemption limit lowered to Rs. 1,500
	Corporation tax	increased	To $1\frac{1}{2}$ a. in the rupee
	Surcharge on income-tax and super-tax	increased	From 33 1/3 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. $7\frac{1}{5}$ ps. per oz. (silver)
			To 0-3-9 per imperial gallon.
	Postal letter rate	increased	From 1 $\frac{1}{4}$ to $1\frac{1}{2}$ as.
	Rates for telegrams	increased	From -/10/- to -/12/- for ordinary and Re. 1-4-0 to Re. 1-8-0 for express
	Surcharge on trunk telephone calls	increased	From 10 to 20 per cent
	Telephone rentals	increased	By 16 3/8 per cent
1943-44	Income-tax—surcharge and super-tax	increased	On incomes above Rs. 5,000
	Excise duty on tobacco produced and manufactured in India	levied	Ranging between 1a. and Rs. 1-12 per lb for unmanufactured and 2as. and Rs. 6 for manufactured.
	Excise duty on *Vanaspati*	levied	Rs. 5 per cwt.

Period	Tax	Levied for the first time or increased	Rate
	Postal and telephone rental rates	increased	Letter rate to 1a. for each tola after the first. Parcel rate to 6as. for first 40 tolas. Telephone surcharge from 1/6to 1/3
1944-45	Income tax	...	Taxable minimum raised to Rs. 2,000
	Surcharge on Income-tax	raised on incomes 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 2as. to 3as.
	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	2as. 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 has been reckoned at Rs. 827 crores of which direct taxes account for Rs. 443 crores and the main indirect taxes at Rs. 384 crores.[1]

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

There are two other measures that 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 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 moratoriun 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 has been as follows :-

	(In crores of rupees)
1939-40	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 (B.E.)	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

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

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 was 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 are repayable not on demand but one year after the end of war, the rate of interest carried by them being 2-1/2 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 is the sale of the rupee counterparts of those sterling loans which were repatriated under the voluntary and compulsory repatriation schemes.[1]

[1] *Vide* § 6.

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[1]:—

	(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
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 (net 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 secu-

[1] *Report on the Currency and Finance*, 1944-45, P. 63

rities 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 has 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 has been 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 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 1·1/4 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 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 would contribute an amount *upto* 10 per cent of the

[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.

net excess profits tax (the rate of which stood at 66·2/3 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.* 13·1/3 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 is not now deducted at the source, such as income from property, business, profession or vocation. The assessee has 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 are not treated as revenue but as deposits to be taken to revenue when the regular assessments are 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.

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

[1] *Budget*, 1945-46, Finance Member's Speech, para 14.

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

(In crores of rupees)[1]

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.

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, as 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 was tending 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 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

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

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 that was 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 full disquietude for the future. For lower velocity of circulation represents a reserve of immobilised purchasing power which, whenever it comes into operation, will be a factor of serious magnitude.

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 dis-

[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,

temper.[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 does not seem to have been sufficient appreciation of the social and distributional implications of war finance. The burdens imposed by the war (and the gains accruing from it) cannot be claimed to have been aquitably distributed among the different sections of population. There are some groups who have been able to secure most of the gains and escape many of the burdens ; these include, broadly speaking, the bigger landlords, war contractors, profiteers and speculators. There are others who have not borne their proper share of the burden and these cover all persons with large incomes including industrialists, bigger traders and highly skilled personnel in war employment. Then there are also groups about whom it cannot be said that their gains in

[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 has been very effective; for while the total Central Government expenditure rose from £2,340 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, Finanee,* 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 indeed 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.)

the form of fresh or more lucrative employment have not been outweighed by heavier burdens imposed by scarcity, high prices etc. ; these include small landholders, tenants, small artisans and traders, domestic servants and the organised industrial workers.[1] And finally, there are 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 have been called upon to bear a disproportionately heavy share of the burden. Broadly and roughly, it may be said that the proportion 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 had been diminishing while the proportion commanded by the big supplier and middleman, the war profiteer and speculator, the large investor and producer had been 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

[1] One gain generally recognized to have accrued to landowners in some parts of the country is the reduction or the complete repayment of past debts.

[2] For the general effects of the rise in prices during the last war, see *Babington Smith Committees Report*, Para.47.

the Punjab which is 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 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 have been 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, has gained on balance, *i.e.* even after allowing for the rise in the prices of goods such as cloth etc., which he consumes. He has purchased more land or house property wherever he could or made investments in gold and ornaments. He has also been hoarding cash or alternatively, increasing his deposits with the post office or co-operative societies. He has also cleared off or considerably reduced his debts and redeemed mortgages. In real terms his position is much better than before the war. The middle landowner has 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

[1]The percentage of the bigger, the middle and the smaller owners in the Punjab is roughly 2·5, 10 and 38. The proportion of those below 3 acres is about 50 per cent. As regards area held, the corresponding figures for the four classes are roughly 38·0, 28·0, 28·0 and 6·0 respectively

has both gained and lost and it is difficult to strike the balance. Whenever he had a surplus to sell, his money income has gone up and he has utilized it to pay off his old debts.[1] Whenever he could get the necessary materials, he has 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 has also been able to pay up the government demand by parting with a smaller amount of his produce and to that extent has been enabled to retain and/or consume more. The supplementary occupations pursued by him have also fetched more and when a member or two of a family have joined the army, a small stream of money has flowed into the family from that direction. There has been a noticeable rise in the material standard of living in such cases, inasmuch as the newly-acquired money has been 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 has been 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.,—have gone up, though it would be wrong to think that they have 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—has become more costly and the price of gold and silver which were used both for personal adornment and investment has increased. On the whole, it cannot be said that the small landowner has made any definite real gain during the war, though he has been able to extricate himself from a substantial part of his encumberances. Where he has had the misfortune to lose any of his cattle (whose prices have risen tremendously), his position has remained almost the same as before the war.

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

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 is held by batai tenants (or share cropper). Moreover the cash rents have risen along with a rise in prices. As for the share-cropper, his position is in many respects similar to that of the small landowner, though it is weaker and less satisfactory. The crown tenant in the canal colonies appears, however, to have improved his position by acquiring proprietory rights over the land cultivated by him.

The landless agricultural labourer has 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 has exposed him more than before to hunger and want. In the Punjab, however, he does 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 has 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 appear to be no signs of the cusom 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 has 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 has suffered both on account of the agrarian legislation and the war and has been drifting to the cities.[1] The village trader (where he was not a moneylender) has suffered a small loss through scarcity of supplies of goods he used to sell and a smaller turnover of foodgrains due to hoarding or direct sales to the buyer but he has 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 is a little worse off.

[1] The situation is 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'.

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

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. In place of them there was a series of ill-conceived, irresolute and sporadic measures emanating from the varied conflicting views and opinions jostling one and 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 that "although most of the recognised elements of inflation 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 analyses 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

[1] Speech of the Governor of the Reserve Bank, August 1912.

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.[1] 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 that existence of inflation in India and attributed the rise in prices to the scarcity of commodities.[2] 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 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 casual relation between expansion of currency and rise in prices and recommended a comprehensive series of measure for

[1] *Budget Speech*, 1943-44, paras 50 -55.

[2] 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).

checking inflation and bringing prices under control.[1] 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 superadded to the basic monetary and economic facts operated towards creating a highly unsatisfactory and stable situation, although it is not possible with any degree of accuracy to assess the relative singificance 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."[2] 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] Manifesto reproduced in Appendix B.

[2] 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, 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 noninclusion 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 may be 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, 'sealing 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 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 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]

[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

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 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 rupes 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

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 author sed 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.

[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 deficiate . (*Cf* B. K. Madan; *This Inflation Problem Commerce* ; January, 1944). There are 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 would be about the most efficacious way. But short of it, there are a few devices like the Price Bond issue whice may help to draw off the purchasing power The issue which was announced in December. 1943, is a limit d 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 is drawn for each series of bonds for a warding prizes. The issue introduces the principle of state lottery and is open to the objection that it panders to the less noble—the speculative and the gambling—instincts of men.

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.[1] 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 successfuly 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 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 has not been on the whole very encouraging (although since 1943-44 the borrowing operations of the Government of India have been on an ampler scale and have 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

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

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 is 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 obtainin finance should have been suspended and replaced by some more satisfactory and acceptable method.

Measures placed 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 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 Indin 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

[1] See p. 73.

removal of shipping difficulties, larger supplies of goods of certain varieties were being 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 had been 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 has been deliberately thrown over the amounts of gold and silver sold, the profits made on the sales and the basis of distribution of profits have been 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 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 may to some extent check currency expansion at the source but mainly they are to be valued for their effect in forcing excess

[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 utlilized 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 place the estimated value of gold and silver sales upto the end of April 1945 at Rs. 148 crores and Rs. 14 crores respectively.

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 had been 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 '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

[1] Hardy ; *Wartime Control of Prices*, 1940, pp. 43-44.

[2] Refer for further discussion of this question to Appendix C.

had been given them. Direct limitation of dividends and profits had not been 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 countries 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 may be 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 control 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 wartime 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 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

[1] *Cf.* 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.)

following table shows the magnitude and direction of price changes in each :

Period	Duration	Index numbers in the first and last month of the period		Maximum variation during the period in points
I (4 months)	September 1939— December 1939	Calcutta (August 1939=100)	114-137	+ 23
		Economic Adviser's (Week ended 19th August=100)	108-138	+ 30
II (7 months)	January 1940 — July 1940	Calcutta	130-114	— 16
		Economic Adviser's	137-111	— 26
III (10 months)	August 1940— May 1941	Calcutta	115-130	+ 15
		Economic Adviser's	110-119	+ 9
IV (11 months)	June 1941— April 1942	Calcutta	137-157	+ 20
		Economic Adviser's	126-146	+ 20
V (16 months)	May 1942— August 1943	Calcutta	169-345	+ 176
		Economic Adviser's	148-238	+ 90
VI (9 months)	September 1943 — April 1943	Calcutta	349-297	— 52
		Economic Adviser's	241-236	— 5
VII (10 months)	May 1944— March 1945	Calcutta	292-306	+ 14
		Economic Adviser's	239-249	+ 10

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 and assisted by the more determined regulation of prices by the Government. The low tempo of the war upto April 1940 had as 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 prices during this recent war furnish a striking and instructive contrast with those during the last war. (See table below). Price rise was on a smaller scale and was spread more evenly during the last 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=Aug. 1939=100

Months	1st war year		2nd war year		3rd war year		4th war yea		5th war year	
	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	153	177	272		300
VIII	108	121	123	127	143	157	176	293		297
IX	108	117	122	130	137	159	170	325		292
X	110	114	128	137	145	182	173	319		300
XI	111	14	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 have not shown any uniformity of movement. Some items have shown larger rise than others. In view of the present acute food situation in the country, the course of food prices is 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 1939=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 goods imposed 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 and 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 recommendation and conclusions embodied in it were been 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 determind 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 of 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 middleman profiteer was recognized 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 transfrontier 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

[1] Towards the last quarter of 1943, however, there was a significant reversal of policy and the Central Government was by bold self-assertion able to make the Provincial Governments agree to a uniform policy in the matter of price control and rationing.

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, 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 is 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 in the past 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 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

[1] *Report of the Foodgrains Policy Committee*, 1943, p. 85.

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 amenable 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 operation 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 econmic control is no doubt itself an anti-inflationary factor but without monetary control no control over prices can be sustained for long. 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 provides no

1 The Foodgrains Policy Committee recommended the appointment of a small Staning 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 wartime 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 be comparatively a very small factor in the total situation.

effective check.[2] 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 largerst andpoint which makes measures of governmental controllers of an unwanted imposition and more of an acceptable war time necessity.

§ 5 Public Confidence and the Currency System

The outbreak of the present 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 last 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.

[2] 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.

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 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 rupee 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-rupees 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 station 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 rupee and half-rupees 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 has been 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-annas pieces was 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 a 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 Novembet 1942, which caused great inconvenience to the public in making small payments. Ever since the war broke out, the absorption of samll coin had gone 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 outbreak of war upto the end of 1942-43 was Rs. 15.6 crores of

[1] The total amount of silver coin including half-rupees, qurter-rupees and one-eight rupees withdrawn from circulation during 1939-46 aggregated nearly 94 crores of rupees.

which Rs. 3¼ crores were absorbed in the first 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 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 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 prompted 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 was. however, declined since then and stood at 199 million in March 1945. Since October 1943, the mint at Lahore has commented operations and has made a sustantial contribution to the expansion of small coin output.

The small coin position is now much better and though shortages of a local character have not completely disappeared, they a reeven 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 not only effects vitally the present but holds far reaching possibilities for the future is the large accumulation of sterling balances as a credit item in India's balance of payments. A part of the accumulated sterling has already been utilized for effecting repatriation of India's sterling debt and the disposal of the remainder is at the moment a subject of acute discussion and anxious speculation. These two aspects of the disposal of accumulated sterling—the solved past and the unsolved future—will have to be kept distinct for purposes of study.

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 repatirated were voluntary in character. 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

[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 untilised for repatriation schemes.

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 stering 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 Railway 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 has been carried out by three methods: (*i*) open market purchases of sterling (*ii*) the license scheme and (*iii*) compulsory schemes. Under the open market purchases which commenced in 1937-38, were suspended in 1038-39 but resumed the next year, £53·49 million of debt was repatriated. The Reserve Bank was authorised under this system to purchase Indian sterling non-terminable securities in the open market out of its purplus 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 license 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 war 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 terminable sterling 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, payment 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 March 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 maner 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 have also heen used to fund the sterling obligations in respect of Railway Annuities and to repatriate Railway Debenture Stocks.

Repatriation of sterling has had a very marked effect on the composition of India's public debt, the sterling portion of the debt having been 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	1936-39	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	1781·32	2142·98
In England :—				
Loans ...	400 96	396·50	13·48	13·42
War Contribution ...	22·29	20·62	20 52	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 Repartriation 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 have been 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 has been 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 forms of existing loans. For the balance rupee resources have been 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. A natural consequence of the operations has been 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 had been 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. A little less than Rs. 142 crores of debt was cancelled on repatriation and Rs. 50 crores of rupee counterparts

[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 securites. The provision in Section 33 (3) of the Act, that the amount of such securities cannot exceed one-fourth of the total amount of assests 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.

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 has been a well-timed and successful operation and has brought solid gains both to the United Kingdom and India. The gain to United Kingdom consists in the release of sterling resources which can be mobilised by the British Government for investment in British war loans. The gain to India lies, 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 has also been 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 accrues by the heavy reduction in, what are known as, the Home Charges. The virtual disappearance of these charges removes one of the complicating factors in the Indian currency system. Furthermore the Government of India will now have to raise large rupee funds in India and this should impart the much needed strength to the Indian gilt-edged market which has suffered in the past from a plenitude of resources and inadequate demand. Above all, the repatriation of sterling has 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 may 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 may have had in the past, they have none now that the Bank's assets are groaning under the weight of superabundant sterling. A more pertinent criticism of repatriation

operations has been 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

INTERNATIONAL BACKGROUND

§1. Monetary Stability and the Economic System

The role of monetary policy in the management of the economic system which was emphasized by the Great Depression of 1929-33 has been heavily underlined by the recent war. There is no doubt that during war money functions more as a measure of costs and as an instrument for the required transfer of resources to war uses than as a governor of the economic system or an independent propelling force. Every effort is made to control it and make it subserve the general purpose of the war economy, for the imperative reason that the penalty entailed by failure to do so would be very heavy. But this apparently subordinate role of money during war does not in any way detract from the overpowering sway it normally exercises over the economic system in regulating the direction as well as the speed of its expansion and contraction. It would indeed be difficult to think of a smoothly functioning international economic system or of a balanced economic advance for the world as a whole or for any individual country without properly managed money.

Now that the possibility of financing a large scale total war involving tremendous financial costs without running into any major financial crisis or dislocation has been demonstrated during the last few years, there can be some reasonable ground for the belief that the management of money on an international scale—or what is the same thing, the setting up of a satisfactory international monetary system—would not by beyond the grasp of statesmen and monetary experts. The money costs of the present war—

leave alone the costs not measurable in money—will be found, when the final computation is made, to have been staggering. They will certainly be far heavier than those of the last war which themselves amounted, according to some calculations, to over £70,000 millions. A good part of these costs was met by bringing into existence fresh stock of wealth through larger and more efficient production but a substantial part of them represented curtailment of consumption and private investment and depreciation and depletion of the existing capital equipment. Taken by themselves, they would point to smaller real income and lower standards of living as the lot of large sections of the world's population after the war. The prospect is, however, not so depressing as it might appear and it was not an unduly optimistic note which the late Lord (then Mr.) J. M. Keynes struck when he said to the British people in November, 1940: "Stop thinking that after the war we shall have to lower our standards of life. I see no likelihood of that. On the contrary I hope that we shall have learnt some things about the conduct of currency and foreign trade, about central controls, and about the capacity of the country to produce, which will prevent us from ever relapsing into our pre-war economic morass."[1] It must be obvious, however, that to achieve any large advance in the living standards after the war, a clearer insight into the working of *national* economic systems combined with a rational operation of state controls alone would not suffice; the whole of the machinery of *international* trade, exchange and investment would have to be restored and made to function more satisfactorily than before. Schemes of post-war economic reconstruction will, therefore, defeat their own end if they are not firmly broadbased on the widest international economic co-operation and goodwill

The foremost place in any agenda for the post-war world must, therefore, rightly be given to the institution of a sound international monetary arrangement. Proposals

[1]Full text of a Broadcast reproduced in *The Statesman*, Nov. 21, 1940.

for such an arrangement were put forward by the monetary experts of Great Britain, U. S. A. and Canada and remained for more than one year under discussion. The proposals were not an expression of a sudden yearning of war-weary people for a better monetary system; they marked, on the other hand, a further step in the intellectual process of groping that has gone on during the whole of the inter-war period (1919-39) for a sound international monetary stucture. It may be helpful to review briefly the events of these twenty years as a preliminary to the statement and examination of the proposals for international currency.

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 may 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 prepetual 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 dimension bringing in its wake serious economic and social consequences. The period from 1919 to 1925 was, therefore, one of confusion, uncertainly and instability accompanied, of course, by international conferences (at Brussels in 1920 and Genao 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. The late 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 retuned 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 the use of gold in various was: 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 diseqilibrated balances of payment by altering the relatives price levels but under the restored gold standard gold exports were offset' and gold imports 'sterilized' so that the discquilibium was not speedily

[1]But in spite of these economies, the view was held that reserve ratios of centralbanks 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.

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.[1] 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 countries in general in other countres. Whenever confidece 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 cradit. 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 payment. Moreover, the dominating position which London held before 1914 as the financial centre of the world was undermined after the war so that the excess and deficit balances on international account of different countries could no longer de cleared with the 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 obligatons. 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 governmentral expenditure; for it demands a fair measure of flexibility in the matter of the 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

[1] 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 no more than 4½ per cent.

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 Creat Depression which started in 1929 not released forces which hastenep its downfall. The heavy fall in prices, particularly of agri cultural commodities, put a heavy strain on the balance of payment of debtor countries and led to the intensificatian of trade and exchage restrictions culminating in defaults, moratoria, depreciation of currencies and abandonment of gold. These measures taken by the deb tor 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-rerm 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, Neiherlands, 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 reltioans 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 preduction was evident from the attempts that were made at intervals to find a basis for international monetary stabilisation.[2] Though

[1] Ropke gives a succinct analysis of this trend and its effects (*Cf.* his *Inteanational Economic Disintegration, 1942, pp. 191-97*).

[2] For example, the World Monetary and Economie Conferece held in London in June, 1933 had curreney stabilisation as the ehief item on its agenda and in 1936 the Tripartitc Currency Agreemets signed by U. S. A., France and England established *de facto* dollar-franc-pound exchange stability.

no international agreement could be reached in this regard, monetary stability was attained over limited areas by setting up currency blocs (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.[1] 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 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 harmonized with the fixed exchange rates of the gold standard was indeed considered one of the primary

1 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.

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 useless. 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 must belong to any institutional arrangement that may be set up to take the place of the old gold standard. But there are a few more norms in terms of which such an arrangement may be judged. For instance, it will be expected to carry through smoothly the transition from war to peace. And when that has been accomplished, it will have 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 must be neutral between creditors, and debtors, must not be linked too closely to gold and must not hamper, by imposing uniform rates of economic advance, rapid economic progress of the less developed areas of the world.

From these general observations one may pass on to sketch short outlines of the three currency plans which were put forward by the British, American and Canadian monetary experts respectively in the earlier months of 1944.

§2. The three Currency Plans: An Outline

The three post war currency plans separately drawn up by the British, American and Canadian experts were an earnest of their desire to protect the peace from currency chaos and muddle and place it on an enduring foundation.

[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 falling prices, shrinking money incomes and growing unemployment by going off gold.

They were declared to be tentative and provisional and subject to modification and the American plan was reissued twice in a revised form. All of them present in clear outline the administrative arrangements for operating an international monetary system. Combining broad feautures with fairly profuse detail and representing, as they do, a new venture of thought into the field of economic internationalism, they provide somewhat taxing reading. To bring out the distinctive features of each plan, only the barest outline need be given here.

The British Plan

The British plan[1] which bears the stamp of the genius of the eminent British economist, the late Lord Keynes, sets before itself the object of providing a *mechanism* of international currency, which is non-political, elastic and equilibrating in character. It seeks to create a *substance* of international currency which is not subject like gold to the unpredictable fluctuations arising from changes in world production of gold and the gold reserve polices of different countries. The concrete mechanism proposed in the plan is an International Clearing Union and the unit of international currency, *Bancor*.

The (proposed) International Clearing Union will be an international organisation with the United Nations as its original members, the other states. iucluding the ex-enemy States, being invited to join subsequenty. The direction of the affairs of the Union will vest in a Governing Board appointed by the Governments or the member States. The responsibility of each member in the management of the Union will depend on the *quota* assigned to it, this *quota* being a kind of numerical measure fixed with reference to the sum of each contry's pre-war exports and imports.

The (proposed) international currency will be *Bancor*, the value of which will be fixed in terms of gold by the

[1] Proposals for an Intentrnational Clearing Union, 1943.

Governing board of the Union and which will be accepted by all the members of Union as the equivalent of gold for the purpose of settling international balances. The initial values of the currencies of member States in terms of bancor will be settled by arrangement and subsequent alteration will be allowed without the permision of the Governing Board of the Union. No member state will purchase or acquire gold at a price which does not correspond to the value of its currency in terms of bancor and the value of bancor in terms of gold. A member state will be entiled to obtain a credit balance with the Union in terms of bancor by paying in gold but will not be entitled to demand gold against a balance of bancor.

The centre of interest in the plan is, of course, the method of operation, the procedure by which the debit and credit balance on international account will be cleared off by the member states of the Union. The essential idea underlying the Union is to extend the principle of banking as exhibited within an isolated single nation to the wider international field. The credits and debits, by this principle, will necessarily be equalised because both the creditor and the debtor will receive and make payment within the orbit of an international monetary institution, namely the Union. A creditor State will accept payment of currency balance due to it from other States in the form of a credit balance of bancor in the books of the Union. A debtor State can like wise borrow bancor from the credit balance of any other member State.

The American Plan.

The preliminary draft of the U.S. Plan[1] worked out by Mr. Harry White, Monetary Adviser to the U S. Treasury Department, was put forward in April 1943, a rervised draft in July 1943 and a second revised draft in August, 1943. The provisions of the plan in its first draft may be briefly stated before noticing the changes made in the revised versions

The plan is drawn up with reference to three objectives

[1] *United States Proposals for a United and Associated Nations Stabilisation Fund*, 1943

viz, to prevent the disruption of foreign exchanges to avoid the collapse of monetary systems in the post-war period and to facilitate the restoration and balanced grouth of international trade. It proposes, like the British Plan, the establishment of an organisation called the United and Associated Nations Stabilization Fund and the creation of an internationally acceptable unit of currency called 'Unitas'.

The Fund will be constituted of gold, currencies of member countries and securities of member governments. Each member country will subscribe to its 'quota' which will be a certain amount of gold, its own currency and its government securities. The quata will be determined by a country's holding of gold and foreign exchange, the extent of fluctuations in its balance of payments and its national income. The aggregate of all the quatas will be equivalent to at least 5 billion dollars. The Fund will be administered by a Board of Directors to which each Govenment will appoint a director and and alternate. The Board of Directors will select a Managing Director and one or more assistants. Voting power in the Board will be closely, though not proportionately, related to the quotas of member countries but no country can have more than one-fourth of the total votes.

The unit of account of the Fund will be the 'Unitas' which will be equivalent to 137$\frac{1}{7}$ grains of fine gold, or 10 U. S. dollars. In terms of this 'Unitas' or gold, the value of the currency of each member country will be fixed by the Fund and no member country may alter it without a four-fifths majority of member votes. This provision, it will be noticed, is intended to secure the stabilization of exchange rates between currencies of member countries and to prevent competitive depreciation.

Closely akin to this provison is the one by which each member country will undertake to abandon, as soon as conditions permit, all restrictions and controls over foreign exchange transactions. Each member will also undertake not to alter exchange rates fixed by the Fund except with the consent of the Fund and only to the extent and in the direction approved by the Fund. Further, each member

country will undertake not to enter into any new blateral foreign exchange clearing arrangements or multiple currency practices except with the approval of the Fund. Each member country will also co-operate effectively with other member countries for purposes of regulating international movements of capital in accordance with the Fund's recommendations.

First Revised Draft—The first revised draft of the American Plan introduces some important modifications in the original proposals. Among these, one that provoked the sharpest criticism in the British press is the change in the composition of quotas subscribed by member countries from 12½ per cent in gold to 50 per pent in gold. Another modification is to the effect that the rates at which the Fund will buy or sell members' currencies will be fixed at the value of the curreucies concerned in terms of the U. S. dollar on 1st. July 1943. A further modification provides that exchange rates in the first three post-war years can be changed by a simple (instead of 4/5 ths) majority vote and that any country can during this period change its rate by 10 per cent either way after consultation with, but not necessarily with the approval of, the Directors of the Fund.

Second Revised Draft—The second revised draft provides that only those countries whose gold and free exchange reserves exceed thrice their quota will have to pay 50 per cent in gold, others paying between 30 per cent and 50 per cent according to their holdings in gold and foreign exchange Some calculations regarding the distribution of voting power under this draft place the share of the British Empire at 20 per cent (Great Britain alone at 10 per cent).; United States 20 per cent, Russia, 6 per cent ; China, 3 per cent and India, 2·6 per cent.

The Canadian Plan

Canadian Plan for an International Exchange Union has emerged from a critical examination of the British and American Plan and claims to incorporate important features

of both along with the addition of certain new elements.[1] In the general observations made on the two Plans which precede the outline of the Canadian proposals, considerable stress is laid on the view that international monetary organisation, though a logical and convenient starting place for joint international action, cannot by itself provide a solution for several vital problems such as commercial policy international investment and prices of primary products. Such an organization, it is further held, should not be called upon to finance measures for post-war relief and rehabilitation. It should be 'international rather than supernational', based on agreement for common purposes and advantages permitting quick withdrawal to any member choosing to do so and allowing the greatest scope for the pursuit of national economic policies in the interest of national welfare. Above all, it must make effective provision for the extension of credits to countries so that they may get time to make the necessary adjustments in their balances of payment without having to take recourse to bilaterally balancing trade and credit agreements, That inevitably means that its resources must be ample, though these resources should not be used to cover up-deep-seated and chronic maladjustments.

The resources of the International Exchange Union proposed in the Plan aggregating 18,000 million dollars will be subscribed by the member countries by way of quotas, the amount of quota of each country depending on such factors as international trade, national income, and holdings of gold and foreign exchange convertible into gold. At least 15 per cent of quota will payble in gold and the balance in national currency. To countries having less than $300 million in gold or foreign exchange convertible into gold, time may be given to pay up their gold contribution. Quotas of particular countries may be charged from time to time, through no increase in the quota of any country will be made without the consent of its repeasentative. The Union will have the right to bortow domistic currency from member countries in amouts upto 50 per cent of their quotas. All gold and foreign exchange which

[1] *Tentative Draft Proposals of Canadian Experts for an International Exchange Union*, 1943.

a member country acquires in excess of the amount held immediately after joining the Union will be sold to the Union, on its request, in exchange for local currency or foreign currencies.

The monetary unit of the Union will be an international unit (called provisionally the Unit) consisting of 137¦ grains of fine gold. Member countres will fix in agreement with the Union the intial values of their currencies in terms of gold or the Unit and will undertake not to alter these values without the approval of the Union except in cases when they are considerable net purchasers of foreign exchange and are entitled on that account to depreciate their currencies by 5 per cent (or even more with the approval of the Union). Deposits in terms of the Unit may be accepted by the Union against delivery of gold. They will be transferable to other countries, will be redeemable in gold and have a 100 per cent gold backing.

The Union will be administered by a Governing Board to which each government will appoint a representative and an alternate. The Governing Board will select a Governor and one or more assistants. In the Union, each country will have 100 votes plus one vote for the equivalent of each 100,000 Units of its quotas

An Appraraisal of the Currency Plans

The monetary arrangement proposed in the three currency plans outlined above are now of more or less historical interest, for they have been superseded by the propsals formulated by the United Nations Monetary and Financial Conference held at Bretton Woods in July 1944. The proposals of the Conference will be examined in §4 (below) but as they were preceded by and arose out of the three currency plans. it will not perhaps be redundant to attempt a comparative and critical examination of the main features of the plans. Moreover the plans do retain

[1] In the previous edition of this book when the Bretton Woods Conference was yet nowhere in sight it was regarded as not unlikely that the currency plans might fade off like the Cheshire cat leaving behind only a grin!

some value in so far as they reveal the distinctive lines of thought and approach among the monetary experts in different countries.

A comparative appraisal of the three plans may be made with reference to the following ten items: (1) aims and objectives of the Plans, (2) nature of the proposed International monetary orgnisation, (3) condition of membership and management, (4) the mechanism for correcting disquilibrium, (5) the position of creditor and debtor countries, (6) the position of gold, (7) the provision for fixation of exchange rates and for exchage depreciation. (8) control of exchange and capital movemets and adoption of protective device, (9) finance of post-war reconstruction, and (10) transfer af abnormal war balances.

It may be pointed out at the outset that the Canadian Plan is very largely an elucidated version of the American plan, though it incorporates some features of the British Plan beside some of its own. All three plans have a fundamental similarity in their aims and odjectives in that they seek to establish an international monetary mechanism which will 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. In matters of organisation and procedure, however, they eonsiderably differ. The Clearing Union of the British Plan will not have any resources of its own to start with unlike the American Stabilisation Found or the Canadian Exchange Union both of which will have ample resources of their own derived from the contributions of members. This does not mean that the British Union will be organisationally less secure; for the manner of its operation will be quite different from that of the American Fund. It may, however, be admitted that the possession of resources does inspire a greater sense of security and in this respect the American Plan may well appear more attractive. As regards membership rights, share in management and benefits extended by the monetary institution, the British Plan has the merit (from the standpoint of a large number of countries) of not putting a

premium on the possession of large quantities of gold. But it does tilt the balance of advantages in favour of certain countries—for example, Great Britain herself—by basing rights and privileges on figures of foreign trade. The American Plan does not offer a similar simple formula for determination of rights but is all the same less than fair to countries not possessing large stocks of gold. When a number of countries have to be brought into the international monetary institution, it will, of course, be difficult to devise a basis for membershipe rights which will satisfy all or will not weight the scales in favaur of some and for quite a considerable time the Governing Board of the institucion will be on trail for its impartiality and disinterestedness. All three plans envisage a division of the countries into member and non-members but do not make clear the extent of membership that will be necessary to make them workable This recognition of non-members coupled with the facilities for members to withdraw frome the monetary organisation seems to open the door to a disastrous breakdown as in the cese of the League of Nations.

The central features of plans are those relating to correction of disequilibrium in the balance of payment and the position of craditor and debtor countries The emergence of a position of disequilibrium—of surpluses and deficits on current account—is inseparable frome a dynamic international economy and all the currency plans provide for its correction in a manner weich does not overstrain the economies of countries or disrupt the international monetary arrangements. The British plan allows a debtor on interna tional account to run into deficits upto a specified limit—up to the full amount of its quota, though it will bring into operation various correctives much before that limit is reached The American Plan similarly allows a debtor to go into deficit —*i. e.*, by foregin currencies by paying up gold or its own currency—up to a maximum of 200 per cent of its quota and provides for the application of checks before that limit is reached. As regrds craditors on international account the

[1]The limit can be exceeded on approval by four-fifths member vote provided some specified conditions are satisfied.

British Plan sets no limit to the accumulation of credits (except that it provides for a small charge of 1-2 per cent annum on bancor balances exceeding a certain amount). Advice will, however, be tendered by the Union as soon as the credit balance of a country exceeds half of its quota as to what measures it should take to reduce export surplus or increase its long term lending. Under the American Plan (where the mechanism is such that the accumulation of credits in foreign currencies by a country is accompanied by the depletion of the Fund's holding of that country's gold and currency) the accumulation of credits is limited to the intial contribution to the Fund. But the Fund can replenish its holding of a country's currency by borrowing with the consent of the Goverment concerned, *i.e.* the limit to the accumulation of credits can be extended. If. however, the Fund finds its holding of a currency running out, it can resort to a rationing of that currency, that is, it can (indirectly) restrict the right of other countries to make purchases in that country[1]. The American Plan, therefore, provides for a more limited accumulation of credit balance by a country or, what amounts to the thing, a more limited accumulation of debit balances by other countries to it. There is some justification in this sense for describing it as a 'creditor's plan'. Similarly, the British Plan which does not restrict *in the same manner* the accumulation of credit balances of a country (*i.e*,. debit balances by other countries against it) may with some truth be called a 'debtor's plan.' The point is of very great practical importance because after the war a number of countries would be anxious. to make large purchases in the United States and would like to avail themselves of a method of payment which does not impose deflationary pressure on their economies. This would be possible only if the United States makes it possible for other countries to obtain dollars by either selling

[1]The Candian Plan, which also provides for rationing of scarce currencies, goes a step further in making it clear that restrictions imposed by member countries on the imports of goods from a countrs whose currency is rationed will not be regarded as constituting an infaction of the most favoured nation obligations of commercial treaties (except under certain conditions).

goods to her or borrowing from her or by paying up their own currencies will accumulate as a credit balance in favour of United States in an international monetary institution. Another point to note is that under the American Plan, the ability of a creditor country to make purchases from another creditor country is much less than under the British Plan. A bancor balance with the Union can be used to make purchases in any country but the Fund will provide freely only those foreign currencies of which it will has a goodly amount (*i.e.*, of debtor countries).

Gold is assigned a place of honour under all the three plant but perhaps more so under the American and the Canadian than the British Plan. Under the British Plan there is oneway convertiblity of gold; for while *bancor* can be had freely in exchange for gold, gold will be given out only to creditor countries (at the discretion of the Union) in extinction of their surpluses. Under the American Plan, a part of the intial contributions to the Fund will be made in gold and the Fund can buy and sell gold and accept deposits in gold. It is not clear, however, whether the Fund *must* accept gold in exchange for unitas deposits and thus ensure two-way convertibility of gold. The international currency unit will be equivalent to a defined quantity of gold under all the plans but while the gold equivalent of *unitas* and *unt* is specified in the Plans, that of *bancor* will be fixed by the Union. Under all the schemes the gold equivalent is alterable—a necessary and admirable provision for insulating the world price and credit structure from fluctuations in world gold production[1] As all the Plans provide for the fixation of the intial exchange rates of member currencies in terms of the international currency unit, exchange rates of currencies in terms of one another and in terms of gold will be settled simultaneously. The fixation of intial exchange rates of currencies will, of course, demand the greatest care and in this respect the British Plan and the revised American Plan allow scope for adjustment in the

[1]To regulate the purchasing power generated by the system itself, the British Plan provides for reduction and resorbation of the quotas of member countries The American Plan also provides for changes in quotas but is less elastic on the whole in respect of this provision.

first few years of the operation of the Plan. The American Plan will, however, fix them to begin with at the level ruling in July 1943. In the matter of the depreciation or appreciation of exchange, the original American Plan is more rigid than the British or the Canadian Plan both of which provide for appreciation as well as depreciation, the extant of depreciation being 5 per cent. for a debtor country without consulting the monetary authority and more in consultation with it. The first revised version of the American Plan, however, does tone down the rigidity by providing for a 10 per cent change either way in exchange rates. In appraising this provision of the Plans. it may be borne in mind that some amount of latitude in the matter of exchange depreciation (or apprecition) will have to be allowed if countries in different stages of economic development and having different rates of economic advance are to be brought together with in the framework an international monetary organisation. It is, of course, true that the wider and more general this latitude, the less is its utility to countries who need it most.

In respect of exchange control, the plans show considerable divergence. The American and the Canadian plans envisage an early abandonment of all restrictions and controls over foreign exchange transactions (other then those involving capital movements) and also prohibit new bilateral exchange clearing and multiple currency practices while the British plan considers further extension of exchange control "consonant with the general purposes of the clearing Union" and envisages the continuance of currency blocs of counteries like, for example, the sterling area. As regards the control of capital movements by the national governments, the British Plan affirms its necessity but does not consider it essential to the operation of the Union while the American and Canadian plans make definite provision for it. As regards protective devices such as import duties, barter trade agreement etc., the British Plan contemplates their adoption under certain circumstances but expects coutries not to have them as a general rule. The American and the Canadian plans do not make any mention of them.

The plans also differ as regards the extent to which the proposed international monetary organisation will be called upon to assist in the task of post-war relief and reconstruction. The British Plan provides for grant of overdraft facilities by the union as a substitute for or as a supplement to any alterntive provision for relife finance. The American plan envisages a separate agency for the purpose while the Canadian plan is definate that any monetary organization which is set up should not be called upon to finance relife and rehabilitation. Obviously the American and Canadian Plans are in this respect more sensible. The Plans, however, agree in recognising that seprate agencies will be necessary to provide long-term fiinance and stabilise the prices of primary commodities.[1]

The problem of liquidating post-war blances has engaged attention in all the plans but the American and Canadian plans are more dfinite in their proposals in this regaid than the British. The British Plan mentions the need of some provision by which the Union could help in coverting these balances into bancor without imposing an evcessive strain on the bancor resources of the debtor country. The American and the Canadian plans, on the other hand, lay down a detaild procedure by which the monetary authority might purchase a portion of these balances from the country to which they belong and thereafter the country where they are held as well as the country transferring them might repurchase them from the monetary authority over a number of years.

The general impression one is left with after a persual of the plans is that the British plan has a larger element of flexibility than the American and demands in some respects a smaller restriction of the area for national economic polices and national discretion. The American plan, on the other hand appears to have a solid structure and faces up to some issues with greater directness. Both are necessarily coloured by the general outlook of the framers regarding

[1] An agreement to set up a separate relief organisation called the United Nations Relief and Rehabilitation Administration was signed on November 9 1943. The resources of the Administration are derived from the contributions of the member governments which have been fixed at one per cent of the national income of each country

currency problems. Both embody long-term proposals and do not address themselves to the problems and conditions of the confused transitional period of the early post-war years.

§3. International Monetary Fund Scheme

The proposals embodied in the three currency plans were discussed at a high technical leval by the experts of thrity-four nations in the United States and as an out come of these discussions a new scheme—called the International Monetary Fund scheme—was put forward in April 1944. This scheme represented in some ways an enormous advance over the Keynes and White plans and was generally more acceptable in principale to the experts of the united Nations.

The purposes and objectives of the Fund were to be virtually identical with those of the Keynes and white plans; *viz*, the promotion of international monetary cooperation, facilitating the expansion and balanced growth of international trade and contributing in this way to the maintenance of a high leval of employment and real income, the promotion of exchange stability and the avoidance of competitive exchange deprecation. The subscriptions to the Fund which were to be in the form of quotas assigned to United and Associated Nations totalled up to about §8 billion (or $10 billion for the world as a whole). Twenty-five percent of the quota of each member was to be in the form of gold. On specified and well-defined conditions being fulfilled, a member country was to be entitled to buy another member's currencey from the Fund. One of these conditions was to be that the Fund's total holdings of the offered currency should not increase by more than 25 per cent of the member quota during the previous twelve months and should not exceed 200 per cent of the quota. Another condition was that the Fund's holdings of the currency demanded should not have become scarce.

The par value of a member's currency was to be fixed in agreement with the Fund and was to be expressed in terms of gold. Changes in the par value could be made only in consultation with the Fund and to correct a fundamental

disequilibrium. The Fund was not to reject a requested change because of the domestic, social or political policies of the country applying for a change. A change upto 10 per cent could be made by a member country after consulting the Fund but a further change was to be subject to examination and consideration by the Fund.

A member country was not to use the Fund resources to meet a large or sustained outflow of capital, though capital transaction of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking and other business were allowed.

In the event of Fund's holding of a particular curreney getting scarce, the fund was to apprise member countries of the situation and to propose and adopt an equitable method of apportioning the scarce currency.. Any member country could, after consultation with the Fund, adopt whatever measures it considerd suitable to restrict exchange operations in the scarce currency or to limit the demand for it.

The Fund was to be governed by a Board on which each member was to be represented and by an Executive Committee. The Committee was to consist of at least nine members including representatives of the five countries with the largest quotas The distribution of voting power on the Board and the Executive Committee was to be closely related to the quotas.

The members of the Fund were to accept, among other obligations, the obligation not to impose restrictions on payments for current international transactions with other member countries and not to engage in any discriminatory currency arrangements or multiple currency practices without the approval of the Fund.

The Fund was not intended to provide facilities for relief or reconstruction or to deal with international indebtedness arising out of the war.

During the early post-war transition period, the member countries were to be allowed to maintain exchange regulations of the character which had been in operation during

the war but were to undertake to withdraw, as soon as possible, any restrictions which impeded multilateral clearing on current account. Not later than three years from the coming into operation of the Fund, any member country retaining exchange restrictions or discriminatory currency practices was to consult the Fund as to their further retention. No member country was to be required to assume obligations of the Fund until it could make satisfactory arrangements to facilitate a settlement of its balance of payment difficulties arising out of the war.

In several respects the scheme of the International Monetary Fund was recognised to be an improvement on the British and American currency plans. In the first place, it placed part of the responsibility for adjustments on the shoulders of surplus instead of deficit countries by permitting member countries to curtail imports from a country whose currency had become scarce. Secondly, it allowed greater latitude to countries in the matter of effecting changes in exchange parities. Beyond an initial variation of 10 per cent which could be made unilaterally, any further change was to require the approval of a simple majority of the member countries. Thirdly, it was made clear that the Fund must accept the domestic, social or political policies of a member country as facts of the situation to be accepted and not criticized. Fourthly, it made a definite provision for transitional arrangements in the post-war period by allowing the member countries to assume the obligations of the Fund only when their balances of payment were sufficiently free from uncertainties and difficulties.

§ 4. Bretton Woods Monetary Agreements

These proposals for the International Monetary Fund were in no way binding on the countries whose technical experts participated in the discussions leading up to them. They were to be placed before and approved by the delegates of the United and Associated Nations in a formal conference. This was the genius of the United Nations

Monetary and Financial Conference which met at Bretton Woods in New Hampshire, on the borders of Canada, from July 1 to July 22, 1944. 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 cover the agreements relating to the International Monetary Fund and the International Bank for Reconstruction and Development. The provisions of the two agreements may be taken up separately.

1 The International Monetary Fund

The Agreement to set up the International Monetary Fund will come into force when it has been signed on behalf of governments having sixty-five per cent of the total quotas but in no event before May 1, 1945.

Objectives and Purposes

The purposes of the Fund are to promote international monetary co-operation, facilitate rhe 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 payments and to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. The Fund is not intended to provide facilities for relief or reconstuction or to deal with international indebtedness arising out of the war.

Membership, Quotas and Management.

The original members of the Fund are to be those of

the forty-four nations represented at the Bretton Woods Conference whose governments accept membership before 31st December, 1945. Governments of other countries will be admitted to membership on such terms as the Fund may prescribe. Any member may withdraw from the Fund at any time by giving a notice in writing and any member who persistently fails to fulfil his obligations may be asked to withdraw.

The each member country will be assigned a quota which will be subject to review and readjustment at intervals of five years and, with the consent of a member, even earlier. The subscription of each member will be equal to its quota and will be 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-fiive 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 vary from 2750 million (United States) dollars for U. S. A. to 5 million dollars for Panama and Siberia. The first six countries come 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 will vest in a Board of Governors, Executive Directors, a Managing Director and a staff. The Board of Governors which will be the custodian of all the powers of the Fund will consist of one governor and one alternate appointed by each member. Except in specified cases, the decisions of the Fund will be made by a majority of the votes cast. The Executive Directors to whom powers will be delegated by the Board will conduct the general operations of the Fund and will not be less than twelve of whom five will be appointed, one by each of the five members having the largest quotas and seven elected. The Managing Director who is not to be a governor or an executive director will be selected by the Executive Directors and will be the chairman of the Directors with no right to vote except in case of an equal division. In appointing the staff, the Manging Director

will, consistently with the maintenance of efficiency, have due regard to geographical distribution.

Determination and Variation of Exchange Parities

When the Fund is in a position to start operations, it will request the members to communicate the par values of their currencies and if such values are considered unsatisfactory, the Fund will in consultation with each member determine the par value its currency. The par value of the currency of each member will be 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 will be based on the par values and each member will undertake to promote exchange stability and to avoid competitive exchange alterations,

Changes in par values will be allowed only on a proposal made by a member and in consultation with the Fund. The Fund will not object to a proposed change if it does not exceed ten per cent of the initial par value. It may agree or object to a further change of 10 per cent or more of the initial par value but will make its attitude known to the member concerned with in a definite period. No proposed change will be allowed unless it is necessary to correct a fundamental disequilibrium and no such change will be 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 may be made by the Fund by a majority vote.

Obligations in Respect of Restrictive Exchange Practices

Except under certain specified conditions, no member will impose restrictions on current payments without the approval of the Fund nor engage in any discriminatory currency arrangements or multiple currency practices. The specified conditions under which exchange restrictions may 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 are to be relaxed and removed as rapidly as conditions permit. Members are allowed to exercise such controls as are necessary to regulate international capital movements. They may also impose restrictions on exchange transactions with non-members unless such restrictions are contrary to the purposes of the Fund.

Operations of the Fund.

In entering into transactions with the Fund, each member will act through its Treasury, central bank, stabilization fund or other similar agency. The Fund will sell the currency of a member country in exchange for another member currency or gold, subject however, to certain specified conditions which may be waived in particular cases. Of these conditions, the first relates to scarce currencies. In this case, *i.e.*, when the Fund's holdings of a currency become scarce,the Fund will make a formal declaration to that effect and proceed to apportion the supply of scarce currency according to the relative needs of members. The second condition is that the Fund's holdings of the purchasing member's currency should not exceed two hundered 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 is that the resources of the Fund should not be used in a member country 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 repurchase 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 will use a specified part of its monetary reserves to repurchase from the Fund the Fund's holdings of its own currency.

The Fund will levy a graduated and steadily increasing charge on the average daily balances of a member's currency when these exceed the quota. All charges will generally be payable in gold.

The resources of the Fund will not be allowed to be used for meeting a large or sustained outflow of capital. Capital transactions of a reasonable amount will, however, be allowed when they are for ordinary commercial purposes or 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 will inform the members and issue a report on the causes of scarcity and the measures necessary to that end. It will also take 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 may maintain and adapt to changing circumstances restrictions on payments and transfers for current international transactions but they will withdraw them as soon as this balance of payments gets properly adjusted. Within three years of the commencement of its operations, the Fund will report on restrictions still in force and five years after the commencement of operations, any member still retaining any restrictions will consult the Fund as to their further retention. The Fund may also represent to any member that conditions are favourable for the withdrawal of any particular restriction or for the general abandonment of restrictions. If it finds that any member persists in maintaining restrictions which are inconsistent with its purposes, it may declare such member ineligible to use the resources of the Fund

2. *The International Bank for Reconstruction and Development.*

The Agreement to bring the International Bank for Reconstruction and Development into existence will come into

force when governments with minimum subscriptions of not less than 65 per cent of the total subscriptions decide to come in but in no event before May 1, 1945.

Objectives and purposes.

The purposes of the Bank are 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 will be those members of the International Monetary Fund which accept membership before December 31, 1945. Other members of the Fund will be admitted to membership on such terms as the Bank may prescribe. Any member may withdraw from the Bank by giving a notice in writing and a member who fails to fulfil its obligations may be suspended. A member who ceases to be a member of the International Monetary Fund will (unless retained by three-fourth majority vote) automatically cease after three months to be a member of the Bank.

The authorized capital stock of the Bank will be $10,000,000,000, divided into 100,000 shares of $100,000 each which will be available for subscription only by members. The capital stock can be increased by three-fourths majority vote. The subscriptions prescribed for the original members vary 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 come 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 will be paid and the remaining eighty per cent will be subject to call by the Bank. Of the paid up capital, two per cent will be payable in gold or United States dollars and the remaining eighteen per cent in the currency of the member. The capital subject to call may be paid either in gold, United States dollars or in the currency required for the purpose for which call is made. Shares of the Bank will have to be kept unencumbered by the Bank and will be transferable only to the Bank.

The management of the Bank will vest in a Board of Governors, Executive Directors, a President and staff. The Board of Governors which will have all the powers of the Bank will consist of one governor and one alternate appointed by each member. Except in specified cases, the decisions of the Bank will be taken by a majority vote. The Executive Directors to whom powers will be delegated by the Board will conduct the general operations of the Bank. Of the twelve Directors, five will be appointed, one by each of the five members having the largest number of shares and seven will be elected. The President who is not to be a Governor or an Executive Director or an alternate will be selected by the Executive Directors and will be the chairman of the Directors with no right to vote except in case of an equal division. He will conduct under the direction of the Executive Directors the ordinary business of the Bank and in appointing the staff will pay due regard to the importance of recruiting personnel on as wide a geographical basis as possible.

An Advisory Council of not less then seven persons selected by the Board of Governors including representatives of banking, commercial, industrial, labour and agricultural interests will be set up to advise the Bank on matters of general policy. There will also be appointed Loan Committees to study and report to the Bank on the suitability of particular projects for purposes of loans.

Loans and guarantees

The Bank may guarantee, participate in or make loans to any member, to any political sub-division of a member and to any business, industrail and agricultural enterprise in the territories of a member. Loans made or guarantee will be for the purposes of specific project of reconstruction or development. The Bank will satisfy itself that the borrower is unable to obtain the loan in the market at reasonable conditions and that the borrower or the guarantor will be in a position to meet its obligations under the loan. It will also make arrangements to ensure that the proceeds of any loan are 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 have suffered great devastation from enemy occupation or hostilities, the Bank will pay special regard to lightening the financial burden and expediting the completion of such restoration and reconstruction.

Operations of the Bank,

The Bank will make or facilitate loans of three kinds: (1) direct loans out of its own funds (2) direct loans out of funds raised in the market of a member or otherwise borrowed by the Bank and (3) wholly or partly guaranteed loans made by private investors through the usual investment channels. Free-est possible conversion of currencies into one another will be ensured for purposes of loans and in the case of direct loans-*i.e.*, category (1) and (2) above-made by the Bank, it will furnish, 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 amortization payments, maturity and dates of payment or direct loans will be determined by the Bank. In the case of guaranteed loans, the Bank will charge a guarantee commission at a rate which the Bank will determine and which during the first ten years of the Bank's operations will not be less than one per cent per annum or 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 will be set aside as a special reserve which will be used to meet the liabilities of the Bank in cases of default on loans. The reserve will furnish the first line of defence in cases of default ; other reserves, the surplus and the unpaid capital will provide the second.

The Bank will have 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 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 will be guided only by economic considerations. They will not be influenced by the political character of the members nor will they interfere in the political affairs of any member.

3. *An examination of the Agreements.*

The Bretton Woods Agreements have the most unexceptionable objective of providing both an international code of monetary conduct and the machinery for consulation and adjustment of monetary relations among nations. They not only offer a way out of the chaos created by the norrow autarchistic policies which the nations adopted especially during and after the Great Depression of 1929—33 but provide something of a substitute for the gold standard which was found so unworkable in the inter-way years. Unless the nations wish to revert to the utterly unsatisfactory arrangements instituted during the thirties, they must accept an essential international framework of the type embodied in the Agreements. A measure of monetary integration on the international scale is the only alternative to complete monetary disintegration.

In the present temper of nations, even the ensuring of a certain guaranteed minimum of international monetary co-operation will be a definite achievement For there is a str ong 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 seem to restrict unduly the area of national freedom. Each nation wishes 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 will help the nations in tiding over temporary deficits in the balance of payments by extending to them short-term credits, the Bank will assist in the more permanent tasks of reconstruction and longrange development by granting or assisting in raising longterm credits. The Fund will, by ensuring stability of exchanges and abandonment of restrictive exchange practices, help in opening up the channels of international investment and the Bank will by stimulating the economic development of nations and the expansion of international trade reduce 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 will be 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 will certainly call for the highest degree of impartiality and fairness on the part of the management. The two institutions will be judged by their actual working and if they fail to inspire the confidence of smaller nations, they will fall in their main objective of making a contribution to the task of international monetary and financial collaboration.

In discussion on the Fund, the important point has been raised whether the monetary system embodied in the Fund is not after all a slightly modified version of the gold standard and whether it will not be on that account beset with the same kind of dangers and pitfalls.[1] Now 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 will be expressed in terms of the United States dollar and transactions in gold will be 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 except that it would be. But it is far from the truth to say that the Fund pushes out gold standard from the front door and brings 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 will provide convertibility of its currency into gold or regulate the volume of internal currency or credit in some proportion to the amount its gold reserves. Exports and imports of gold will not, therefore, have the same

[1] See particulary *The Banker* (Sept. to Nov., 1945). Also *Econoca* (November, 1944).

significance as they had under the gold standard. An adverse balance of payments will be 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 have 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, restores the gold standard—standard, it is a very flexible type of gold standard—sans mechanism, sans rigidity, sans dominance.

The Fund excludes from its purview international indebtedness arising out of the war. The liquidation of large war balances built up in foreign currencies, particularly sterling will, therefore, have to be dealt with by bilateral negotiation between the countries concerned. This will obviously militate against the multilateral flow of trade which the Fund is actually intended to promote. At the same time it is difficult to see how the Fund with its limited resources of $8800 millon can undertake the unlimited obligation of converting balances of very much bigger magnitude. *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 nation participating in the Bretton Woods Conference. This exclusion of war balances from the scope of Fund has naturally caused the greatest disappointment and dissatisfaction in countries like India which have accumulated large balances abroad.

CHAPTER XII

X Period

POST-WAR PERIOD

§ 1. 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 Bretton Woods 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.

It is somewhat melancholy to reflect that there is so little in common between the post-war world that people talked about and dreamt of a few years back and the world as it is and perhaps for sometime is going to be. In all serious discussion on post-war economic problems, one word which occurred a little more frequently than others

was 'transition'. It stood for the stage that would inevitably follow the end of hostilities and precede the establishment of 'normalcy' (whatever that might mean). It carried with it some associations of hope and comfort, for transition was looked upon by many persons as a kind of bridge, so to speak, by which a war-worn and war-weary world would cross over to the safety and happiness of an established peace. The actual experience was much less pleasant than the dream. More than 4 years have passed since the end of hostilities with Japan and there are yet no signs visible on the horizon of a definite advance towards those arrangements which will bring about economic stability and progress for the world. We do not seem to have entered the transitional stage at all and are witnessing just the aftermath of war.

§ 2 The International Background

In any appraisal of the situation in India as it developed after the war, it will be better to begin with the study of economic conditions of the countries abroad. The war had left agriculture and industry of the European countries completely devastated and the recovery in these countries, despite the Marshall Aid from the United States of America, was painfully slow. Recovery was rendered all the more difficult by the emergence of two distinct political blocs 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 inspiration 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 authorized by the United States Congress on 2nd April, 1948 for the year ending 31st March, 1949. The Marshall Aid is scheduled to come to an end by 1951, but recovery in Europe as indeed in many other countries, like India is so slow that it is difficult to imagine that even by that year, the world will return to normal conditions.

One of the greatest problems of the world after the war has been inflation. The soaring price level coupled with

rising costs without a proportionate increase in production is 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 was at 184 in March 1949. In the United Kingdom also the rise was continuous from 155 in 1945 to 161 in 1946, 176 in 1947, 202 in 1948 and 203 in March, 1949. In Canada the index jumped up from 122 at the end of the war to 181 in 1948 and 187 in 1949. One of the worst sufferers was France where the price index rose from 421 in 1945 to 1920 in 1948 and 2100 in March, 1949. The worst year in the matter of inflation 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 consumers 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 marked in the value of notes in circulation in some important countries like Australia, United States and United Kingdom in the latter part of 1947 but on the whole the amount of notes in circulation

has been very high as will be shown by the following table :—

NOTES IN CIRCULATIONS

	End of 1945.	End of 1946.	End of 1947.	In Millions Percentage Increase (+) or decrease(−) over 1946.
United Kingdom £	1380	1422	1350	−5·1
Australia £ A	200	207	205	−1·0
Canada $ C	992	1031	1046	+1·5
Newzealand £ 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

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 continues to experience one of the worst periods of inflation ever recorded in history.

But inflation is not the only headache of the world at the present time. There is a serious disequilibrium in the world trade relations. Countries of Europe, United Kingdom and other countries in the sterling area have found it impossible to balance their balance of payment 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 E.R.P. aid from the United States. But the economies of these countries have failed to stage sufficient recovery and the aid that is being received by them from America has not proved enough to bridge the gap between imports and exports. These countries have been 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 was £552 millions. They fell to £406 millions in June 1949. The net deficit of Great Britain on dollar account

*In 1000 millions

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 will 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 has not been taken seriously by any one and such leading journals as the London *"Economist"* have suggested that despite her best efforts, Britain will not be able to maintain the present value of the pound.* The fact of the matter is that while the world continues to suffer from shortages of consumers goods, machinery and raw materials, prices in the United States have shown a downward trend in the last few months. On the other hand on account of the existence of inflationary conditions in other countries, prices and costs have remained high. At present the prices of British manufactures are much higher than those of American goods with the result that the British goods are being priced out of the American market. The productive efficiency of the United States in almost all lines today stands much higher than that in any other country of the world. While the productive efficiency in other countries remains lower, their costs remain 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 are trying to meet the present shortage of dollars by cutting down drastically their imports from dollar area and increasing their exports to it. But this will accentuate inflationary conditions still further. Another suggestion that is being put forward is a general devaluation of currencies *vis-a-vis* dollar in order to encourage exports to dollar areas and discourage imports. But this step will be of dubious value for achieving the objectives in view. At present a conference is being held at Washington to evolve a plan to resolve the "dollar crisis" of the sterling area. The conference may result in further cuts in imports from the United States by these countries and in an increased aid from America to these countries. Devaluation of pound may also be agreed*. But these steps will not restore the equilibrium nor will they resolve the crisis. What is needed is an increase in productivity in these countries and reduction in costs in

* Pound was devalued on 18th September, 1949.

order to enable the goods of these countries to compete freely with the American goods. On the American side, it must be clearly understood that America must discharge the obligations of international creditor more efficiently At a time when it is striving for restoration of multilateral trade and when her productive efficiency stands highest in the world, it does not behave her to continue with high tariff walls against foreign goods nor can the measures like subsidized shipping be justified on any ground today. United States Government has failed to realize the immense change that has taken place as the result of the war in the position of that country. It has refused to see the logic of events and so long as it keeps up its present attitude, the dollar will remain a permanent problem.

There is only one way to resolve the present difficulties of the world World must be made safe for peace. The political squabbles between the power blocs must stop and expenditure on defence and armament must be 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 are the measures which are necessary to restore the world to its economic health. But chances of these steps being taken are remote. Conditions may not improve for a long time to come.

§ 3 Expectations and their Failure.

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 has shown the same trends that have been observed in the countries directly affected by the war. Rising prices, mounting costs, budget deficits and trade gaps are the most outstanding problems of the country at the present 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 are the basic factor in price level in India, there would be a general fall in prices: The continuance of controls was assumed and but for few economists in the country, none thought of 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 practice however, events 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 came to be 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 of 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 continued to be felt inspite 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 govern-

ment employees also got several upward revisions of their salaries in the form of enhanced dearness allowances, etc. The impact of the rise in wages in the government offices was felt in private offices as well. The alround 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.

§ 4 Inflationary Trends

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 is still at 388·3. Prices have been stabilized but they have not been brought down. As a matter of fact, they are showing a tendency to rise again as the index number after going down to 370 has come up to 388 again. The greatiest increase has 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 has shown a great increase in prices is the industrial raw materials Prices of manufactured goods have not risen as high as the prices of agricultural commodities and raw materials. Several causes have contributed to this rise of prices. Expansion of currency, deficit budgets, decontrol, fall of production and critical food situation in the country are some of the most important among them.

Expansion of Currency

The process of financing H. M. G. 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 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 Issue	Notes in Circulation	Sterling Securities with Reserve Bank
September 1945	1162·74	1141·84	1042·33
1946—47			
April	1245·95	1235·12	1124·7
May	1249·93	1237·05	1129·32
June	1254·33	1241·97	1135·32
July	1254·39	1225·17	1135·32
August	1255·88	1214·41	1135·32
September	1257·32	1198·35	1135·32
October	1258·26	1197·09	1135·32
November	1258·89	1201·29	1135·32
December	1258·59	1218·78	1135·32
January	1258·19	1230·80	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
May	1263·50	1234·87	1135·32
June	1264·26	1229·11	1135·32
July	1266·12	1209·61	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 H. M. G. expenditure in India was concerned, it came to an end in that month. Thereafter inflation was resorted to finance the deficit of the Indian Govern-

ment 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. 1,31,668 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 remained the same. The object was different. In their second Manifesto* issued in the first week of Fabruary 1946 the Indian Economist warned the Government that by continuing to finance the purchases of His Majesty's Government of 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 financing of His Majesty's Government purchases in India was stopped three months after. 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 already seems to have driven the economy of the country to the brink of disaster.

Deficit Budgets.

Despite the sharp fall in the defence expenditure in the Central Government and civil security expenditure in the provinces, the budgets of both Central and Provincial Governments remained grossly unbalanced.

The following table shows the dificit 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)
Revenue	360.67	336.19	178.77	338.32	322.98
Expenditure	484.57	381.48	185.29	339.87	322.53
Deficit	123.90	45.29	6.52	1.55	

*See Appendix B.

Figures are for the period, 15-8-47 to 31-3-48

IN CRORES OF RUPEES

	All Provinces (*) 1946-47 (Accounts)	(†) 1947-48 (Revised)	1948-49 (Budgets)	(‡) 1949-50 (Budgets)
Revenue	169·78	207·04	242·77	254·83
Expenditure	162·17	211·08	258·27	264·15
Surplus (+) or Deficit (—)	+7·61	—4·04	—15·50	—9·32

The budget estimates for 1949-50 for the Central Government disclosed a small surplus of Rs. 45 Lakhs after a series of deficit budgets. But this surplus is not going to be realized in actual practice. On the other hand in the revised estimate a deficit as big as Rs. 30 crores may be disclosed. Moreover the above figures do not take into account the deficit on the capital account. The capital budget for the interim period of 1947-48 disclosed a deficit of Rs. 134·34 crores. In 1948-49, the deficit on this account was budgeted at Rs. 112·50 crores and for 1949—50 at Rs. 134 crores. The same trend was visible in the provinces. Except for 1947-48, the provincial budgets showed deficit from year to year. And even in 1947-48, if we include the figures of East Punjab and West Punjab, the two big deficit provinces, the surplus of Rs. 7·61 crores 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 on this head was as high in 1948-49 as in 1946-47. So long as the relations between the two dominions remain what they are, expenditure under this head cannot be reduced. But it is not only military expenditure that is responsible for the deficit. Civil expenditure has shown a tendency to rise beyond all proportions. In 1945-46 for the undivided India, total civil expenditure was Rs. 124·34 crores. For

*. Excludes figures for East Punjab and West Bengal.

†. Includes figures of Budget estimates of West Bengal.

‡. Excludes Assam.

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 has now turned to balances with Reserve Bank. The balances which stood at Rs. 236 crores on 1st April 1949 came down to Rs. 105·75 crores on 19th August 1949—a decline of Rs. 131 crores in a period of four months.

Decontrol.

Another factor that 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 Food Grain Policy Committee. It was contended that controls were creating artificial scarcity in the country and once they go, goods will appear on the market which will automatically bring down prices. Mahatama Gandhi advocated decontrol of food grains, Sugar and Cloth on the ground that controls breed immorality, black markets and corruption. Many people* opposed the policy of decontrol but the Government unmindfull of the consequences announced the decontrol of food grains 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 as has been shown above 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 have been held stable since then, but the present conditions once again make for further rise unless appropriate steps are taken to check it.

Fall in Production.

Goods continued to be in short supply even after the war when there was an alround increase in demand on

* Cf. Pt. Kunzru's speech in the Parliament on 10th December 1947.

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, the production in the country both in the agricultural and the industrial field began to fall due to variety of causes. Thus the Eastern Economist's index number of industrial production which stood at 126·8 in 1943-44 fell to 105 in 1946-47 and 105·3 in 1947-48. There was an improvement of 8 points in 1948-49 but welcome as this improvement is, it still falls much short of the requirements of the case. In agricultural production, things have been even worse. The production index, (taking 1936-37 to 1937-38 average production as the base =100,) declined to 94 in 1945-46 and was at 96 and 97 respectively in 1946-47 and 1947-48.

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 has consistently followed a policy of encouraging industrial production in the last two years but the results have been none too satisfactory

Critical Food Situation.

An important factor which contributed greately 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 grains was announced by the government greatest pressure was brought to bear on the Allied Food Board for the allotment of more food grains 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. Dr. Rajendra Prasad, the then Food Member stated on 15th January 1947, "During the past year large portions of our population have been on the brink of starvation. The situation is somewhat easier now on account of the arrival or expectations of arrival of the rice crop but not free from

anxiety on account of the distance and dangers due to uncertainties of the weather between now and the time when the wheat and Rabi crop would be ready".

The situation grew worse after the partition and the Indian dominion found itself in the grip of a chronic shortage of food grains. Out of the total all-India annual production of 7·9 million tons of wheat and 22·9 million tons of rice, Pakistan got 2·8 million tons of wheat and 6·4 million tons of rice. Considering that she got only one-fifth of the total population of India, 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 crore. The shortage for 1949 is estimated at 4 million while for 1950 the estimate is 3 million tons.

The imports of foodstuffs from abroad at a heavy cost not only made the balance of payment 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 the rise in the general price level.

§ 4 Inflation And The People

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 industrialists community that had benefited from the rise of prices. Profits increased enormously partly as a result of rise of prices and partly because of stoppage of imports and increase in demand for the goods. Wages of industrial labour rose but not to the extent of prices so that in real wages labour was sufferer. The agriculturists also gained as a result of rise in prices but the gain was not much. In any way, 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 increase in employment.

After the war as result of general labour 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. That explains why at a time when commodity prices are high, the stock Exchange quotations have been very low. The greatest sufferers in the post-war inflation are the middle class people. The poor and rich have gained ; the middle class is on the verge of elimination. Savings in the country have disappeared. On the other hand there is a net dissaving. The reason is obvious. The middle classes who were in habit of saving have no capacity to save. The poor who have got additional income have no banking and investment habits.

§ 4 Anti-Inflationary Policy.

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 advise tendered by these representatives, 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 food grains and other essential commodities, bridging up the budgetary gap, by economizing public expenditure and 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 Dividend Act, the dividends that can be declared by Joint Stock companies were limited to defined limits. Ordinarily it was not to exceed 6 per cent. Nothing was done to increase savings in the country and they continued to decline. One method of encouraging saving was an increase in the rates of interest. It is doubtful whether an increase in the interest rates would have made a perceptible influence on the volume of savings Savings are low in the country because those who have the power

to save at present do not possess banking and investment habits while those who have banking and investment habits have no capacity to save at the present time. The Government rightly did not succumb to the temptation of raising rates of interest. But if savings are to increase it will have to approach rural classes in the country to get back the funds that have gone there on account of high agricultural prices. The Government has striven hard to give all conceivable help and assurances about future to the industrialists 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. According to the figures compiled by the Eastern Economist, the index number of industrial production rose by 8 points in 1948-49 over the figure for the previous year. This however cannot be said about agricultural production. 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 crore uncovered in the capital budget. However the press reports suggest that the budgeted surplus of Rs. 45 lakhs will be turned into a deficit of Rs. 30 crores at the present rate of expenditure. The Government is already alarmed at the prospect and is planning to scale down expenditure.

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 food grains. It was announced that complete control over production, procurement, distribution and prices of food grains would be reached in October 1949. Meanwhile all provinces were asked to set up machinery for procurement and rationing. Except in Madras and Bombay, rationing had been completely abolished. The Government has reverted to it now and has been able to effect substantial reduction in prices of food-grains which is of the order of 40 to 50 per cent. Thus wheat, which was selling at Rs. 26 to Rs. 30 per maund before the recontrol is being distributed through ration shop now at Rs. 15 to Rs. 16 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 effeciency in its execution with the result that it failed to be effective permanently. Inflationary tendencies once again began to 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 the Sugar racket in August 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. It did not however touch the trade fearing that stocks might go under-ground. The result is that price of sugar has not been brought down and the government itself has agreed to Rs. 35/- per maund as the fair wholesale price of Sugar as compared with Rs. 27/8/- before the racket. The cancellation of Open General Licence No. XI, XV and XVI with a view to resolving the balance of payment difficulties has also resulted in the rise in the prices of manufactured and imported goods.

The situation is under control at present but it does not permit any complacency. The shortage of consumers goods continues in the country. Savings have almost disappeared and production in industry or agriculture, is not increasing. Our balance of payment position is critical. We are still spending huge amounts on the imports of foodgrains to feed our vast population. The government is finding it difficult to balance its budget. Labour and salaried classes are resisting stoutly any reduction in wages and salaries or any attempt at retrenchment. Productivity is very low in the country. All these factors create anxiety about the future of Indian economy. The situation is full of dangerous possibilities and requires skilful handling on the part of the government. It appears that we will not be able to dispense with controls for another 3 or 4 years and the government as wall as the people will have to take to austerity for a number of years to come. Our development plans will have to wait execution until the economic situation in the country improves.

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CHAPTER XIII

POST-WAR PERIOD (*Continued*).

PRESENT DEBATE IN INDIAN CURRENCY

We have noticed in the last chapter only one development in the field of Indian currency after the war namely post-war inflation. But that is not the only or even the most important development. Many other changes have taken place. Events have moved both in India and in other countries with such rapidity and the working of numerous forces in the economic sphere has been so complex during the last five years that even to present a bare sketch of the Indian currency developments and problems requires a full volume to itself. It would be impossible to examine all the problems as they present themselves at present and to predict their future course within the compass of a short chapter. It is proposed therefore to suggest the lines along which their solution may be sought.

Among the many developments and problems of Indian currency in the post-war period, the following stand out to be the most important:—

1. Sterling Balances and their releases
2. India's membership of International Monetary Fund and the Bank
3. India and Empire Dollar Pool
4. Par value of Rupee
5. Link with sterling
6. Currency Policy and Price Stability
7. Nationalization of Reserve Bank
8. Decimal System of Coinage
9. Demonetisation of High Denomination notes

§ 1. Disposal of Sterling Balances.

The manner of the disposal of sterling balances during the last six 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 the 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 sufferd 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. 6d. 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 re-interpretation 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

[1] 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 has 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. In this matter it is difficult to arrive at any conclusion on economic considerations alone. India's capacity to pay for the defence measures undertaken by her may be measurable in economic terms—and it is well known that it is none too large—but no one can seriously suggest that India should be called upon to pay to the utmost limit of her capacity except on the strict assumption that every defence measure for which she has to pay was also undertaken solely in her own interest. That assumption, however will be widely questioned in this country.

way as a deadweight 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, 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 were released for realization might be very slow and the purposes for which they could be utilized might be severely restricted in practice.

It is not difficult to detect in these 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) are episodes that belong to the dead past and cannot 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 is fortunate that Britain in spite of unofficial suggestions did not officially ask for her. 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 free-est utilization of sterling balances were to be subscribed to. Fourthly, no

[1] This line of attack on the integrity of sterling balances was adopted by some of the British economic and financial journals but has been effectively countered by the Selected Committee on British Expenditure in India which has report that taking all the circumstances into consideration fair prices have on the whole been secured for war stores and for food bought on account of His Majesty's Government in this country.

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 in such countries as she decided upon in her own interest[1]. Fifthly, any loss to India from depreciation of sterling must be made good by the British Government as part of a bargain in which the debtor pays 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 has 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 war-time 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 largess but an amply deserved measure of economic restitution on the part of United Kingdom. In fact, the use of the term 'reparation' would not be inappropriate—but for its odious associations—in this context.

[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 a 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).

The fears regarding scaling down of sterling credit or revision of Indo-British Financial Agreement to the detriment of India fortunately proved unfounded. England has stood by its pledged words and is committed to pay the whole amount. Already the balances standing at the credit of India have come down to Rs. 635 crores (September 1949) as compared with Rs. 1,600 crores in October 1946 and Rs. 1,093 crores in July 1948. We have spent most of this money in payment of pensions, etc. to British Officers in Britain, and purchase of goods and food stuffs from abroad. The balances have not been utilized for purchase of capital goods or increase in the productive capacity of the country. We have utilized them for meeting current deficit on trade account.

One fear however has been realized. Sterling has been devalued in terms of dollar by 30·5 per cent. The value of our balances has been decreased by 30 per cent. This is a heavy loss for a poor country like India which she may not be able to stand easily. We have been pressing in the past for an assurance from Britain that she would compensate us for any devaluation of pound sterling that she decides upon. This assurance has not been given. It is only in the fitness of things that England should compensate this country for a loss which has been forced upon us. We did not keep balances in England willingly. They are there because they are blocked and England has not found herself in a position to pay them except small releases.

Sterling Releases.

On 14th August 1947 was signed in London an interine 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 tobe 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 payment account for the period from 15th July to 31st December 1947. In addition to this amount of £35 millions, another sum of £30 millions

was released 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 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 to 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 (Rs. 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 millions 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 of payments and rapid depletion of sterling available in Account No. 1. By January 1949, we had spent £43 millions more than what had been provided for and we asked the United kingdom for release of this amount. The United kingdom refused to do it and by April our position in respect of balance of payment became precarious.

Negotiations were 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 provides for drawing of £50 millions per annum for each of the two years 1949-50 and 1950-51 when last year a limit of £40 millions was let for further drawings from Account No 2. India had agreed to draw £160 millions in 3 years. It drew that amount in one year only in actual practice. The agreement provides for the release of £50 millions in each of the two next years. The British Government also agreed to release sterling to cover the orders placed for foods by India before July, 1949. This is expected to amount to another £50 millions.

The agreement was hailed as very liberal to India and City Editors of London papers criticized it on the ground of overgenerosity on the part of England to India. But when we study the agreement in the context of devaluation of pound sterling that took place two months later, the generosity is easily explained. The value of sterling releases as also the sterling lying blocked in London to India's credit has been reduced by 30·5 per cent in terms of gold and dollars and India will be able to buy much less with the amount released than she could have bought if sterling had not been devalued.

If India does not draw more than what has been agreed only £360 millions will be left to the credit of India at the end of 1951. We have spent our balances more rapidly than any one expected them to be spent. And almost whole of the amount has been spent on financing the purchase of food and consumers goods which were so badly needed. The balances have not helped India in building up new industries or financing agricultural plans that was thought at a time to be the most important object for which balances might be used. Nor has the problem of deflation arisen in the country as a result of their use as was feared at one time. The country is still faced with the problem of inflation though we have used up huge part of these balances already.

§ 2. India's Membership Of International Monetary Fund And The Bank.

The Central Assembly in a resolution passed on the 29th October, 1946 approved of India's continued membership of the International Monetary Fund and the International Bank for Reconstruction and Development. The whole question had been examined earlier by a committee of the Assembley on the Bretton Woods Agreements and three Interim reports had been submitted. In their first report dated February 26, 1946, the Committee expressed the view that 'the final decision whether it would be to India's advantage to remain a member of the Bretton Woods institutions may be determined to a very considerable extent by the outcome of the negotiations which His Majesty's Government are committed to undertake with the Government of India on the subject of liquidation of sterling credits'. If these negotiations are unduly delayed or are not satisfactory, it may be necessary for India to withdraw from the Fund and the Bank. In the second report presented on April 17, 1946, the Committee reiterated the views expressed in the first report and recommended that the Government of India should take advantage of every possible provision in the Articles (i.e. of Bretton Woods Agreements) to postpone payment of the subscriptions due to the Fund and the Bank till the last moment. In the third report, a majority of the Committee recommended that the Government should pay a portion of the subscription to the Bank so that India may not default in her obligations and a session of the Legislative Assembley should be called on or about November 10, 1946 in order to allow the Assembley to make up its mind whether it wishes to continue India's membership of the Bank or whether it wishes India to withdraw from that institution. In a separate report, Mr. Manu Subedar, disagreeing with the majority, recommended that India should withdraw from the membership of the Bank because of the delay in negotiations regarding sterling balances. He

was of the view that by joining the Bank, India would be called upon to undertake commitments which she would be unable to shoulder in the absence of a satisfactory solution of sterling credits. As for the membership of the Fund, he said that its position was different and some of the considerations stated by him did not apply to the Fund.

The question of the liquidation of sterling balances got unnecessarily intertwined with that of India's membership of the Fund and the Bank. The Indian delegation at the Bretton Woods Conference in 1944 took up the stand that the liquidation of War debts should be included as among the legitimate duties of the Fund.

India was represented at the conference by a delegation headed by Sir Jeremy Raisman, the Finance Member of the Government of India.[1] In presenting India's case and trying to secure suitable provision inserted in the Agreements, the members of the delegation acted with commendable unanimity and zeal. India's interest in the discussions at Bretton Woods was two-fold: as one of the United and Associated Nations she wished to assist in establishing a suitable machinery for international monetary and financial collaboration and as a country intent on developing her resources to the full, partly by utilizing her war balances, she wanted not only to secure a satisfactory solution of the problem of the liquidation of her war balances but also to have in the management of the Fund and the Bank a share which would be commensurate with her economic position and requirments. While, therefore, the delegation participated in the discussions with a view to securing a general improvement in the proposals, their specific interest centred round two matters, viz. the sterling balances and the position in the executive directorate of the Fund and the Bank.

In the matter of sterling blances, the delegation succeeded only to the extent that this subject was included in the agenda of the Conference. In the Conference itself, however, they could not obtain any support for the inclusion of the abnormal war balances in the Fund. Not only the U. S. and the United Kingdom delgations but also some of

[1]It is of melancholy interest to note that this was the only delegation which was not headed by a national of the country.

the delegations of the exiled Governments of Europe stoutly opposed them. In the matter of a suitable quota and a permanent seat on the Board of Executive Directors, the delegation fared little better ; for the validity of their claim to a permanent seat was not conceded, though the Indian quota was fixed at a sufficiently high figure to ensure a seat for India in every election. Nor were they successful in their effort to get a clause included to the effect that the development of economically backward countries should be one of the main principles of the Fund's operations. They succeeded, however, in getting included in a modified form in the scheme of the Fund and Bank a minor provision that in recruiting staff for these institutions regard should be had to geographical distribution consistently with efficiency[1].

While in the Conference the Delegation could not receive any recognition of their major claim, they were able to obtain an assurance from Lord Keynes, Chairman of the British delegation, that "when the end is reached and we can see our way into the daylight, we shall take it without any delay to settle honourably what was honourably and generously given."

Though the Assembley decided in favour of India's joining the Fund and the Bank, doubts were expressed in some quarters whether India was not accepting too big a liability as compared to the advantages to be obtained. As far as the Fund is concerned, India can withdraw without any continuous liability but in regard to the Bank, a reserve liability of about 105 crores of rupees was to be accepted which was to be met on call in gold or in dollars or in any other currency required by the Bank. The substantial gains to be obtained are : firstly, that India will have an appointed as distinct from an elected director and would thus have a more effective voice in the counsels

[1]The report of the Delegation has not been published but a succinct and very helpful account of the proceedings is given in the joint statement of Sir R. K. S. Chetty and Mr. A. D. Shroff (*Times of India*, Bombay, August. 24, 1944) and the Bombay Rotary address of Sir C. D. Deshmukh (October, 1944.)

of these institutions and, secondly that the Bank will be an important source for India of long term credits which will be multilaterally convertible into other currencies and thus available for purchase of machinery and capital goods from countries other than the United States. The working of these institutions has already amply proved the wisdom and foresight of those who decided in favour of joining the Fund and the International Bank. A loan of $34 millions has already been granted by the Bank to India for purchase of locomotives boilers and other railway equipment. Another loan of $ 75 millions may be expected for agricultural development in the near future. We also borrowed $ 100 millions from I. M. F. to meet current deficit in dollars in balance of payment account.

§ 3. INDIA AND THE EMPIRE DOLLAR POOL

The Empire Dollar Pool is realy an old arrangement, continued with modifications necessitiated 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	1½	2	4½	453
Used by India ...	237	83	13½	2¾	2½	339
Balance	+168	—43	—12	—¾	+2	+114

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

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 any where. 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 has also experienced in the last 4 years a perpetual deficit on the Dollar Account. India's decision to remain in the British

[1] Extracted from Manu Subedar's report dated 29th July 1946, *Vide* Indian Information, Volume 19, No. 196, page 324.

Common Wealth of Nations as a free partner made her association with Great Britain in the economic field as well inevitable. The economic difficulties of the United Kingdom and the "Dollar Crisis" of the Sterling Area led to the creation, 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 has been admitted to all rights and duties of full membership of the sterling area Dollar Pool. At a time when the country is in difficulties in getting dollars, the arrangement is 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 has many implications, two of which must be clearly understood. The first is that while we are entitled to a share in the Central Dollar Pool, our fortunes are linked up with those of the pool. Should there be any shrinkage in the dollar resources of sterling area, India would be affected in the same way as any other country of the sterling bloc. Already it has been stipulated that sterling area countries should cut down their imports by 25 per cent from U. S. At present this may not seem a hardship in view of our own prevailing balance of payment position but before long such a condition may become unbearable in view of our needs for machinery and other capital goods. Of course a clause has been inserted in the agreement which lays down that the cut in the dollar expenditure when necessary, will be distributed among various members in accordance with their economic conditions and standard of living of their people. That is to say, a rich country may be asked to cut down expenditure more than a poor country. But this is still on paper. Much depends on how this clause is worked. Secondly it must also be made clear that the Dollar Pool arrangements create bilateralism and blocs in the world trade which will reduce the volume of world trade. This is a bad omen for the world and India which believes in internationalism, by joining the Dollar Pool, is creating difficulties in the way of the establishment of free multilateral international trade. This is true but so long the major portion of India's foreign exchange resources remains in sterling, as a matter of self-interest she must toe the line of sterling and keep it strong. Any depreciation of sterling will hit India hard.

The Government of India communicated the par value of the rupee as 1*s*—6*d* (*i.e.* 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 interest which were clamourous of a change in exchange rate before the war were now insistent on no change being made.

The Constitution of the I. M. F. however allows a country to make a change of 10 percent in the par value of its currency without permission of the Fund and another change of 10 percent with the permission of the Fund. Should a contingency arise for devaluation of the rupee, it would not be difficult for us to reduce the exchange value of the rupee upto 20 percent.

Of late voices have once again begun to be heard that rupee is over-valued and a 20 percent cut in its value will restore the much needed equilibrium between the value of rupee and foreign currencies. Secondly it is also argued that pound sterling is in a very difficult position and in-spite of the long protestations of the British Chancellor of Exchequer it will have to be devalued sooner or later. Even such well informed journals as the London "Economist" have expressed doubts on the ability of Great Britain to stick to the present value of £ sterling with reference to dollar. If sterling is going to be devalued, why should rupee be not devalued before hand? Should we be caught napping when devaluation of pound comes? Thirdly it is pointed out that India has developed huge deficit on the balance of payment account and with the present exchange rate it would be impossible for her to bridge the gap. A devaluation of rupee is therefore very necessary to encourage exports from India and to enable her products to compete in foreign markets. Lastly even

such competent authorities as International Bank are suggesting a revaluation of European and other currencies to get out of the "dollar crisis". Why should India not follow this advice ?

It must be admitted immediately that price level in India is much higher than in the United States, United Kingdom, Canada and Australia. With this price level, rupee is over valued. But it must also be clearly understood that a devaluation of rupee under the present circumstances will raise the price level still further. We are dependent for our food grains on foreign countries, A fall in the rate of exchange will increase the price of imported food. The consumer will suffer and so will the Government of India which is spending about Rs. 40 crores at present in subsidijing food imports. Secondly if we devalue the rupee and Pakistan does not do it, the cost of imported jute and cotton will rise. It will become more difficult for us to market jute manufactures and cotton textile in foreign markets than it is at present. Exports instead of increasing may fall. Thirdly the cost of imported machinery will rise. As the major portion of industry in India stands sorely in need of replacement and renewal of plant, the industrial cost will go up which will not only raise price level in the country still further but will also reduce export. Fourthly, any further raising of prices of imported goods will react on the general price level and cause further inflation in the country.

These are weighty arguments. It may be necessary to change the exchange rates before long on international level but the present is not the time for India to take any unilateral action. If any revaluation of currencies comes about as a result of an international agreement, India should become a party to it. Or if devaluation is deemed necessary as a part of some bigger comprehensive economic plan in the country, it may be advisable to take the step. But in the absence of any such thing, it will be better to continue with the present rate until international conditions become more stabilized.

5. Link With Sterling

A corollary of India's membership of the International Monetary Fund was the weakening of link between the rupee and sterling. As soon as India undertook the obligation 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 exist 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 requires the Reserve Bank to buy and sell foreign exchange at such rates and on such terms and conditions as the Central Government may determine from time to time in conformity with their obligations as a member of the Inter National 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 Common Wealth of Nations, it was actually strengthened. India is a full-fledged member of the sterling area and in view of her major portions of her foreign exhange resources being in sterling. She is interested in keeping pound sterling in a strong position.

As has been explained before, 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 closer 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 is no doubt that the link with sterling has not been wholly beneficial to India during the past and during the war, it contributed a great deal towards the development of an inflationary situation. But the political decisions of a

country have far reaching effects on her economic situation. We have decided to continue our association with Great Britain even after the independence. That association involves economic obligations as well. Further, on account of the balance of payment difficulties, we have decided to be a member of sterling area. We have the assurance now that the rupee sterling link is not the result of political pressure but is an economic necessity.

§ 6. Currency Policy And Price Stability

India is in the throes of inflation at present but after this inflationary phase is over, she will be confronted with the problem of stabilization of prices, particularly of agricultural prices. The objectives of monetary policy in India have been conceived in a rather narrow way in the past and the promotion of stability of prices, trade and employment has not been given its due place among them In the unsettled conditions of the transitional period and in the succeeding period of long range reconstruction and planning, a much wider conception of the aims of currency policy will be necessary. Not only must the internal price and economic structure be protected against wide economic fluctuations orginating abroad but the currency policy must also be so shaped that highest possible level of employment and producion is reached. With the government of the country in our own hands and with the nationalization of the Reserve Bank of India, the pursuit of this wider monetary policy had become comparatively easier. The monetary policy must be related to the economic conditions in the country and should aim at stability of employment, incomes and prices and avoid the destructive fluctuations in the economic life. Even today when the country is faced with the gigantic problem of inflation, a monetary and financial approach to the problem is likely to bear better results than the approach from the side of production on which the government seems to be banking at present for the solution of its difficulties.

In the past the monetary policy has centred round the stability of rate of exchange. We tried to keep the exchange rate stable at the uneconomic level of 2S gold in 1921-22 though we lost Rs. 35 crores in the bargain. We refused to change rate of exchange in the last thirties inspite of the fact that our price level was very low and our exports were being driven out of the world markets. Devaluation was very much needed to stop export of gold from the country, raise price level and improve economic conditions of the agriculturists. Exchange stability should no more be a criterion of a sound currency policy. If the Reserve Bank were to initiate a policy of credit control together with encouragement of savings in the country and mopping up of surplus purchasing power, prices could be brought down to economic levels. There is only one way to bring down the prices at the present time. This is surplus budgets accompanied by an effective control over currency and credit.

But this is the immediate problem. When the present transitional stage is over and prices begin to fall, the currency policy will have to be directed towards price stabilization especially of agricultural prices. We will have to guard against a slump which may land us in more difficulties than even the last depression did.

The Prices Sub-Committee of the Policy Committee on Agriculture, Forestry and Fisheries under the chairmanship of Sir V. T. Krishanamachari has recommended the fixation of a fair price for the farmer. A 'fair price' has been defined as a price which after meeting the costs of production would leave a representative producer an income sufficient to maintain him and his family at a standard of life equivalent to that enjoyed by comparable classes of the population. Pending the collection of the data of costs of production and family budgets, the Committee has

recommended, as a rough and ready test of 'fairness', the parity between agricultural and industrial prices existing in the quinquennium of 1924-25 to 1929-30 which is generally accepted as a period during which conditions in this respect were most satisfactory. The parity shall be between agricultural prices on the one side and the prices of commodities that enter into the cost of production and prices of articles that enter into the cost of living, on the other. During the period of control it is proposed that parity prices should be fixed on the basis described above. During a short period of about 3 years after controls are removed, the parity prices shall be subject to a rock-bottom minimum and also a maximum. It is stated that the only effective manner in which the Government can support prices is by freely entering the market when necessity arises. For this purpose the Committee has suggested the setting up of a Commodity Corporation financed by the participating Governments on an agreed basis.

It is obvious that a Commodity Corporation can stabilise prices only within limits ; it can smooth out price fluctuations arising from temoprary causes but cannot offset basic price trends due to fundamental reasons. If world prices begin to decline due to structural changes in agriculture, Indian prices can to some extent be prevented from falling by large-scale market operations by the Corporation. But the efficacy of such operations will not extend beyond a certain limit. Commodity pools and reserves are not effective antidote against the overpowering influence of basic factors.

It is under conditions of this kind that currency policy supplemented by drastic measures like export and import prohibitions and quotas can preserve the internal price structure against the onslaught of external forces. These

measures may, of course, lead ultimately to a 'closed economy'. Without closing its economy, no country can, in times of trouble and turmoil, escape the impact of world forces.

§ 7. Nationalisation of the Reserve Bank

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 the 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 shareholders.

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 may be pleaded that it does tender advice, whenever occasion demands it to the government and it seeks to act in the best interests of the country. The public is, however prone to judge the record of the Bank by results visible to the naked eye and these sometimes show that either the Bank gave wrong advice or the Government did not listen to it. It has not always been able to decide whether to accuse the Bank of collaboration or to excuse it for its helplessness.

With the independence of the country there was no danger of the policies of the bank being directed to serve extra territorial interest if it was completely subordinated to the Central Government by a decree of nationalization. More over the Government is committed to the policy of

Economic planning which cannot be carried out without a 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 which raised very little Controversy or even debate. The only comment was that Imperial Bank of India and other banks should also be nationalised.

§8. Decimal System of Coinage

A scheme for the decimalisation of the Indian coinage system was prepared and circulated for opinion by the Government of India in 1946. It was proposed to replace the present system of coinage, consisting of the rupee, the half-rupee and so on down to the pie and based on the scale of notation of 4 or 2, by the decimal system under which the rupee would be divided into 100 cents and not into 192 pies. The rupee would be equivalent to 100 cents, half-rupee to 50 cents, and four-anna to 25 cents. New coins of lower denominations equivalent to 10, 5, 2 and 1 cents and even ½ cent would be minted to replace the existing two-anna, one anna pieces, etc.

It need hardly be emphasized that the system would represent a sharp break from the present, traditional centuries-old system and should be introduced only if the present system is utterly outmoded and inconvenient. It will be desirable,therefore, to describe briefly the present small coin system and to examine the merits and drawbacks of the proposed system.

The small coins in circulation in India are the half-rupee, quarter-rupee, two-anna piece, one-anna piece, double piece single pice, half-pice and pie. Of these, the half-rupee and quarter rupee were issued in the past as both standard silver and nickel coins but the nickel coins were

withdrawn from circulation with effect from the 1st October 1924 and the standard silver coins from the 31 May 1942. Now only the quarternary half-rupee is being minted and issued. The standard silver four-anna and two-anna pieces are no longer coined, though coins previously issued continue to be legal tender. The copper double pice are also being withdrawn from circulation. A new series of two-anna, one-anna and half-anna pieces in nickle-brass alloy was introduced in 1942 as a war time measure. As regards the copper half-pice and pie pieces, their coinage was discontinued in 1943 and a new design of pice with a different metallic composition and a circular hole in the centre was issued.

The nickel-brass alloy used for minting the two- anna, one-anna and half-anna pieces has been found to be unsuitable not only because it involves a disproportionate waste of metal in the process of manufacture but also because the coins tarnish badly in circulation and due to the universal domestic use of brass in India, can be easily counterfeited. The new pice with the central hole has also not been a success. The Government of India have, therefore, decided that as soon as conditions permit, the nickle-brass alloy should be replaced by the pre-war cupro-nickel alloy and a pice of new design should be issued. It is in connection with this huge recoinage programme that the Government have under consideration that they want to take the opportunity of changing the system of subsidiary coinagg.

The table given below brings out the changes which the introduction of the proposed system of coinage will bring about—

Existing coinage		*Proposed coinage*	*Metallic content of coinage*
1 Rupee	= 16 annans or 192 pies		100 cents — Quarternary
½ Rupee	= 8 ,, or 96 ,,		50 ,, — ,,
¼ Rupee	= 4 ,, or 48 ,,		25 ,, — ,,
As. 2	= 2 ,, or 24 ,,	Will be replaced by	10 ,, — cupronickel
As. 1	= 1 ,, or 12 ,,		5 ,, — ,,
½ anna	=		2 ,, — ,,
1 pice	=		1 ,, — Bronze
1 pie	=		¼ ,, — ,,

§9. Demonetisation Ordinance

The Government in order to catch money operating in the black market promulgated on January 12, 1946 the High Denomination Bank Note (Demonetisation) Ordinance. The holders of currency notes of Rs. 500, Rs. 1000, 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 bonafide 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 these 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 lakh 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 the notes of these denominations outstanding on 31st December 1947 may be regarded to have been lost to the public. But besides 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[1] 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

[1] Appendix B

merely change the form in which it is held. They will put those notes of high denomination out of circulation the holders of which donot 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 dorment. 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 it wanted to check it. But demonetization of high denomination notes, as was stated by the Indian economists was not the proper measure to achieve that object.

Post Script

Devaluation of Sterling and Rupee

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 percent. The value of pound was reduced from 4·03 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.

The Government of India had three alternatives:

(*i*) It could decide to continue with the existing parity with dollars and refuse to devalue the rupee as Pakistan has done.

(*ii*) It could reduce the rate of exchange more than the fall in the value of sterling and establish a parity of 1$-4*d* which has 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 are already in a precarious condition in respect of balance of payment. If we continued with old rate of exchange, conditions would have become still worse. The condition in Pakistan are diffierent. She has favourable balance of trade. She exports cotton and jute which are demanded all over the world.

Her exports are absolutely inelastic. She has no industry worth the name which is to face the competi-

tion from countries with devalued currencies. Her decision not to devalue her currency is understandable. It will of course hit India hard. However India could not adopt this course.

As regards 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 stands at 390 (September 1949). It would have gone up tremendously.

The Government wisely adopted the third course which has been adopted by 24 other countries. This was the right thing to do.

India did not want devaluation. It was not in her interest. But it has been forced upon us by the force of circumstances.

Prices of American goods will rise in India by 30 per cent unless there is a fall in dollar prices in America. Prices of goods produced in India and Britain may rise in sympathy. Some rise in prices and cost of living is bound to occur especially when Pakistan has not devalued her rupee. We import cotton and jute from Pakistan besides foodgrains. The rise in the prices of cotton will raise the price of cloth and our jute manufactures will not get any advantage of devaluation as a result of increased cost of raw jute that is imported from Pakistan. We may not succeed in increasing our exports to United States to any considerable extent. While the disadvantages of devaluation are obvious, the advantages we will get are of doubtful character.

The value of our sterling balances has been reduced by 30 per cent. This loss has been forced upon us by Britain which blocked our balances in London. We did not keep our balances in England out of our free will. England must compensate us for this loss.

The value of loans contracted from the International Bank has increased in terms of rupees. We were indebted by $34 millions to the bank which was equal to Rs. 113 crores before devaluation. It is now equal to Rs. 168 crores.

Devaluation may make the already bad situation in respect of inflation still worse in the country. A race between prices and wages may start again. If that comes about, it will ruin our economy.

The decision of Pakistan not to devalue her rupee in terms of dollar and appreciate it in terms of sterling and Indian rupee is another big blow to Indian economy. By her action, Pakistan has neutralized the effect of fall in the value of our rupee on our exports of jute to dollar area. The cost of imported raw jute will go up by 44 %. Moreover our exports of cotton cloth to that dominion may also suffer because of high cost of cotton that we will have to pay for Pakistan cotton. The economies of the two dominions will diverge more from each as a result of situation created by devaluation.

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 its 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 has been attached 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 occured 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 'sterilizing' imported gold the automatism of the standard could be defeated, as was actually done by 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 servere strain on thei. 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 is under a statutory obligation to maintain 1*s.* 6*d.* sterling rate, it has to operate the currency system with a definite objective in view.

Elasticity

Elasticity may be defined as the capacity of the currency 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 principle 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 can not be expanded at a rapid rate owing to statutory requirement of 100 per cent reserve against additional note-issue and in times of emer-

gency 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 reorganisation 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, say, 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 are of value but to lend the much needed elasticity to the currency system it is 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 can render further assistance in the direction of the development of a bill market.

APPENDIX B

Indian Economists' First Manifesto

" The rapid rise in the general price level during the past two years and the enormous expansion of currency in India are, we feel, causally related. The unprecedented expansion of currency since the war began is due chiefly to the system adopted for financing the large British and other Allied purchases in India, under which the Government of India, accepts payment in sterling and provides rupees in exchange. For all these purchases India acquires, under present arrangements, sterling assets in London and against these there occurs an expansion of currency in India.

The provision of internal finance in India for these purchases is a necessary concomitant of the accumulation of sterling assets in London and the responsibilily for this financing falls on the Indian Government in the same manner as that for any part of the expenditure included in its regular budget. The failure of the Government of India to recognise this fundamental and essential fact has prevented it from taking the proper view of the economic and financial situation in the country.

The Government seems to act as if it is enough for it to take care of its own budget deficit while meeting the needs of the British Government by printing more notes. This is a grave misreading of the whole situation and has resulted to an ever increasing expansion of currency unrelated to the needs of internal production and trade. As a result, the inflationary spiral is already at work in India.

The net inflationary gap in India's finances, counting in the finance made on behalf of His Majesty's Government, is thus being wholly filled by the creation of more currency. The inflation in India is, therefore, a deficit induced fiat-money inflation. It is the most disastrous type of inflation. The repatriation of India's sterling obligations does not act as an anti-inflationary factor, except to the extent to which the rupee counterparts are taken up by the public; but this has so far been only small in proportion,

The increased liquidity preference of the public, which is at present tempering the rise in prices, cannot be expected to last long with a continuously rising price level. The experience of many European countries after the Great War emphasises the danger of counting on a continuance of this phenomenon. It is clearly a temporary phase and with a further rise in prices a preference for holding commodities instead of money might suddenly manifest itself.

Inflation is the most inequitable way of distributing the war burden and usually involves large transfers of wealth from the poorer and the middle classes to the richer classes. It is also undesirable because it increases the cost of war and impairs the war effort by hindering production and distribution. Its consequences to economic society are immediately felt; it, however, also holds the threat of bringing about later political consequences of an even graver nature.

We earnestly feel that immediate and drastic measures to check inflation are called for. In this connection we urge on the Government of India the primary necessity of closing the 'gap' by increased taxation and borrowing.

Taxation, in our opinion, should be raised to the highest practicable pitch, adjusted to shoulders that can best bear it. We suggest a much steeper progression in income tax rates, the laying of a maximum limit to individual consumption income and absorption of all profits above a limit, either in tax revenue or to be impounded into special loan contributions. To increase the volume of borrowings to the required level, it is necessary to institute a comprehensive scheme of compulsory savings as well as a rigid control of all investment outlets.

This programme should be brought into effect with great rapidity. However it will take some time before the inflationary gap is completely closed and the total currency in circulation is to-day already greatly redundant, even at the existing high prices. To tie up this vagrant purchasing power we propose the immediate initial steps of a blanket control of all prices followed by a strict examination of all later allowable increases.

In order to make this price control measure effective a policy of centralised supervision and direction of productive effort will be necessary. This will in its turn involve equally strict regulation of transport and distributive machinery on a national scale. A rationing of the essential necessities of life should be undertaken to as large an extent as possible. An effective control of prices will involve a wage stop but this will mean no hardship as long as the price rise is stayed. An equally strict profits stop is indicated as a corollary of this policy as well as independently on account of financial considerations.

In our opinion, only such a comprehensive view of economic policy is capable of averting the grave economic, political and social consequences of the continuance of the

present process of inflation. We would also emphasize that the total liabilities undertaken by the Government of India, whether on their own account or on account of the British and Allied Governments, should not exceed the resources that they find possible to raise in pursuance of the policy outlined by us."

Indian Economists' Second Manifesto

"The uninterrupted expansion of currency against the increase of sterling securities in the Issue Department of the Reserve Bank of India, even after the cessation of hostilities, and the prospect of its indefinite continuance revealed by Dr. Dalton's assertion, during his speech in the House of Commons on the Anglo-American Agreement, that the sterling balances within the sterling area would continue to grow, impel us once again to repeat the warning, given in a previous manifesto, (dated 12 April 1943), against the financial policy pursued by the Government of India. 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 glaring mismanagement of currency and finance and the inefficient and inept working of economic controls during the war have created a host of intractable post-war problems. Instead of trying to tackle these by an appropriate economic and financial policy the Government of India seems to be satisfied with resorting to such merely palliative measures as a the recent Demonetization Ordinances. The Demonetization 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 specified time-limit. The declarations made by holders of high denomination notes will lead to an increase in the receipts from the taxation of incomes and profits and this might also have some deflationary effect. The total result in this direction cannot, however, 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. For we must repeat the elementary economic truth, that the forces of inflation and the resulting operations of black-marketeers and profiteers cannot be brought under check while deficit-induced fiat money inflation keeps on.

"We had stressed the necessity, even during the war, of limiting the total liabilities undertaken by the Government of India on all accounts, to the resources that they were able to raise by taxation and borrowing. Whatever justification there might have been for ignoring this warning during the war period, and lending far beyond India's capacity at the cost of unprecedented hardships to the people of India, this has disappeared with the end of hostilities. Financial help, now being extended by India, is no-longer required for winning the war; it only helps in the rehabilitation and reconstruction of the borrowing country, namely Britain. The justification of loan is to found in the relative resources, current and capital, of lender and borrower and the issue needs to be raised whether India is in a position to lend at all. Considering her immediate consumption needs it is clear beyond

doubt that India has no lending capacity. During the war the standard of consumption of India's people has declined even below the precarious pre-war levels. During the current year in particular, famine, probably the worst of the past two decades, stalks Peninsular India, threatening to bring about enormous suffering. We need all the imports we can get immediately of such essentials as rice and wheat. Apart from pressing consumption needs the urgency of utilising every available resource that we can obtain for internal rehabilitation and reconstruction is demonstrably plain. In these circumstances, we feel that in continuing to lend to Britain, the Government of India, while attending to the convenience of that country, is being unjustifiably negligent of India's legitimate interests.

"Moreover, the most remarkable thing about this lending is that it is being achieved by the worst possible method, that of currency inflation. The deficits to finance which currency was inflated on such a large scale during war were not those of the Government of India but those of His Majesty's Government. During the last few months the process has continued so that from 31st August 1945 to 11th January 1946 the total currency issued increased from Rs. 11,45 crores to Rs. 12,36 crores as against the parallel rise in the value of sterling securities from Rs. 10,34 crores to Rs. 11,20 crores.

"Unbelievable as it may seem, India is to day being forced to add to her sterling balances with almost certain prospect of her being forced to give up a part of them in the near future. In this connection it must be pointed out that sterling balances built up to India's credit during war represent real resources that she had to sacrifice at the cost of suffering and starvation. The

cost cannot be just written off because it has been already borne in the past. For we would emphatically assert that this huge cost would never have been visited on the country and India would never have been deemed capable of bearing it, if the financial policy of India had been governed by the policy of contributing the utmost to the war effort consistent with the maintainence of minimum national standards, which ruled in the self-governing Dominions. All section of people in India are concerned over the grave deficiencies in our Industrial and other capital equipment and every plan of reconstruction and development made so far has depended on the sterling balances being available for the finance of its capital programme. The extent to which and the time at which they will be availabe seems uncertain to-day. But we at least insist with all the force at our command that the size of this problematic quantity should not increase. The first thing that must happen to the sterling balances is that they should cease to grow.

"The manner in which all sections of British opinion have reacted to the Anglo-American Agreement should serve as an object-lesson to us Indians. What appears to third parties as a loan unprecedented in history generous both in conception and magnitude, is being assailed on all sides in England as a hardhearted bargain. If the conditions of that agreement are hard, we are at loss to describe in appropriate terms this compulsion on a poor famine-stricken country of lending through currency inflation, large sums to a country which is among the richest in the world".

APPENDIX C

Dearness Allowance, Inflation And Consumers' Subsidies

The Government of India and some of the provincial 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.[1]

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 will be 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

[1] That the Government are anxious to limit the rates of dearness allowance is clear from the Draft Rules under the Excess Profits Tax Act, 1940 published by them in November 1943. The Rules provide limits upto which payments of dearness allowance, bonus and commission shall be admissible for purposes of the deduction of Excess profits Tax Earlier in October 1943, the Government had appointed a committee under the chairmanship of Sir Theodore Gregory to determine and report on what principles dearness allowance should be fixed.

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 Defence loans or spent on war effort or through the taxes paid out of the savings of the richer classes lying idle in banks or such other savings which, if not drawn upon by taxes, would have been invested in Defence loans. (In parenthesis, it may be observed that the spending of, say, one crore of rupees by Government on the purchase of grain for the army or on munitions, is quite a different affair from the spending of the same amount by the Government employees; for the very essence of war economy is that the Government must spend more on war needs and obtain command of large real resources and persons in, what may be called, the civil 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' is its wages that chase prices. The spiral almost invariably begins with an uncontrolled rise in prices generated by inflationary methods of war 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, say 15 or 20 crores in a year, for the central and provincial governments together. (In the Punjab the total number of Government employees in 1939-40, was reckoned at 75,534 and the total amount of pay and allowances at about Rs. 5½ crores). 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 expanded in India by about Rs. 250 crores between January 1943 and December 1943 alone, dearness allowance will, in any case, be a negligible affair.

This necessity 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 stop the rise in wages'. Unfortunately, whether by the force of circumstances or by the weakness of Government, this counsel of prefection was not followed. In India also an overpowering impersonal necessity seems to be the master, causing expansion of currency and inflation of money incomes. Even granting that there is no inflationary issue of currency ('credit inflation,' as Sir J. Raisman put it) in India and that currency is being expanded in a legitimate manner through Government purchases of commodities and services, there is no doubt that a situation

(Sir J. Raisman called it 'temporary') has arisen in which a large amount of spending power is pressing against a more or less limited supply of consumers' goods. This situation may perhaps be temporary in the sense that now when the war is over, accumulated sterling against which currency is expanded may be used to purchase and import large quantities of goods into India. But while the war was on, currency expansion was bound to continue and along with some other forces, such as speculative hoarding, could drag prices upwards-unless, of course, by extensive and heavy borrowing, control of speculation etc., rise in prices was kept under control[1]. (One may here enter a caveat against the arguments of some Indian businessmen that what we were faced with was commodity scarcity and not monetary inflation. They seemed to overlook that scarcity of consumers' goods was an inevitable outcome of war; for resources must be drawn away from the production of war goods. What they seemed to drive at was that the production of consumers' goods *as well as* the production of war goods could be increased, the tacit assumption being that there existed unutilised or unemployed resources in the country which could be used both ways. But even so there must be *some* proportion maintained between the quantity of consumers' goods and the spending power to be used against them. Actually there was a big disproportion and it required quite an amazing feat of faith to believe that this disproportion could be quickly rectified by devoting more resources to the production of consumers' commodities.)

[1] Professor Brij Narain worked out a law governing the variation of note circulation from the examination of statistics between September 1941 and December 1942. This law connecting X (time) and Y (note circulation) is given as :

$$Y = 196.4 + 59.7X$$

If this law continued to govern the increase of note circulation, the total amount of note circulation would have been as follows :

March	1943	...	614	crores	March	1944	... 853	crores
June	1943	...	674	,,	June	1944	... 913	,,
Sept.	1943	...	734	,,	Sept.	1944	... 974	,,
Dec.	1943	...	793	,,	Dec.	1944	... 1032	,,

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 cut in the consumption of all the classes, if war is to be effectively prosecuted. 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. Dearness allowance paid now can prevent further deterioration and not compensate for a past injury.

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' sudsidies can be given and have been given in countries like U. K., U. S. A. and Canada to lower 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 stabilisation 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 itself.

[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 have 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 D

The Anglo-American Financial Agreement

Following is the text of Financial Agreement between Governments of United States and United Kingdom:—

It is hereby agreed between the Government of the United States of America and the Government of United Kingdom of Great Britain and Northern Ireland as follows:

1. *Effective Date of the Agreement:*—The effective date of this agreement shall be the date on which the Government of the United States notifies the Government of the United Kingdom that the Congress of the United States has made available the funds necessary to extend to the Government of the United Kingdom the line of credit in accordance with the provisions of this agreement.

2. *Line of credit:*—The Government of the United States will extend to the Government of the United Kingdom a line of credit of dollars 3,750,000,000 which may be drawn upon at any time between the effective date of this agreement and 31st December, 1951 inclusive.

3. *Purpose of the line of credit:*—The purpose of the line of credit is to facilitate purchase by the United Kingdom of goods and services in the United States to assist the United Kingdom to meet transitional post-war deficits in its current balance of payments, to help the United Kingdom to maintain adequate reserves of gold and dollars and to assist the Government of the United Kingdom to assume the obligations of multilateral trade as defined in this and other Agreements.

4. *Amortisation and interest :*—(1) The amount of the line of credit drawn by 31st December, 1951 shall be repaid in 50 annual instalments beginning on 31st December, 1951

with interest at the rate of 2 per cent per annum. Interest for the year 1951 shall be computed on the amount outstanding on 31st December 1951 and for each year thereafter interest shall be computed on the amount outstanding on 1st January of each such year. 49 annual instalments of principal repayments and interest shall be equally calculated at the rate of dollars 31,323,000 for each dollars 1,000,000,000 of the line of credit drawn by 31st December, 1950 and the fiftieth annual instalment shall be at the rate of dollars 31,640,736 65 for each such dollars 1,000,000,000. Each instalment shall consist of the full amount of the interest due and the remainder of the instalment shall be the principal to be repaid in that year. Payments required by this section are subject to the provisions of section 5. (2) The Government of the United Kingdom may accelerate payment of the amount drawn under this line of credit.

5. *Waiver of interest payments:*—In any year in which the Government of the United Kingdom requests the Government of the United States to waive the amount of the interest due in the instalment of that year, the Government of the United States will grant the waiver if (A) The Government of the United Kingdom finds that a waiver is necessary in view of the present and prospective conditions of international exchange and the level of its gold and foreign exchange reserves and (B) the International Monetary Fund certifies that the income of the United Kingdom from home produced exports plus its net income from invisible current transactions in its balance of payments was on the average over the five preceding calendar years less than the average annual amount of United Kingdom imports during 1936-38 fixed at pounds sterling 866,000,000 as such figure may be adjusted for change in the price level of these imports. Any amount in excess of £ 43,750,000 released or paid in any year on account of

sterling balances accumulated to the credit of overseas Governments, Monetary Authorities and Banks before the effective date of Agreement shall be regarded as a capital transaction and shall not be included in the above calculation of the net income from invisible current transactions for that year. If waiver is requested for an interest payment prior to that due in 1955 the average income shall be computed for the calendar years from 1950 through the year preceding that in which the request is made.

6. *Relation of this line of credit to other obligation* :(1) It is understood that any amounts required to discharge obligations of the United Kingdom to third countries outstanding on the effective date of this Agreement will be found from resources other than this line of credit. (2) The Government of the United Kingdom will not arrange any long termloans from Governments within British Commonwealth after 6th December 1955 and before the end of 1951 on terms more favourable to the lender than the terms of this line of credit. (3) Waiver of interest will not be requested or allowed under section 5 in any year unless the aggregate of the releases or payments in that year of sterling balances accumulated to the credit of overseas Governments, Monetary Authorities and Banks (except in the case of Colonial Dependencies) before the effective date of this Agreement is reduced proportionately and unless interest payment due in that year on loans referred to in (2) above are waived. The proportionate reduction of the releases or payments of sterling balances shall be calculated in relation to the aggregate released and paid in the most recent year in which waiver of interest was not requested. (4) The application of the principles set forth in this section shall be the subject of full consultation between the two Governments as occasion may arise.

7. *Sterling area exchange arrangements* :—The Government of the United Kingdom will complete arrangements as early as practicable and in any case not later than one year after the effective date of this agreement unless in exceptional cases a later date is agreed upon after consultation under which immediately after the completion of such agreements the sterling receipts from current transactions of all sterling area countries (apart from any receipts arising out of military expenditure by the Government of the United Kingdom prior to 31st December 1948 to the extent to which they are treated by Agreement with the countries concerned on the same basis as the balances accumulated during the war), will be freely available for current transactions in any currency area without discrimination with the result that any discrimination arising from the so-called sterling area Dollar Pool will be entirely removed and that each member of the Sterling Area will have its current sterling and dollar receipts at its free disposition for current transactions anywhere.

Other exchange arrangements : (1) The Government of the United Kingdom agrees that after the effective date of this Agreement it will not apply exchange ontrols in such a manner as to restrict (A) payments or transfers in respect of product of the United States permitted to be imported into the United Kingdom or other current transactions between the two countries or (B) the use of sterling balances to the credit of residents of the United States arising out of current transactions. Nothing in this paragraph (1) shall affect the provisions of Article VII of the Articles of Agreement of the International Monetary Fund when those Articles have come into force. (2) The Governments of the United States and the United Kingdom agree that not later than one year after the effective date of this Agreement, unless in exceptional cases a later date is agreed upon after consultation, they will im-

pose no restrictions on payments and transfer for current transactions. The obligations of the paragraph (2) shall not apply (A) to balances of third countries and their nationals accumulated before this (2) becomes effective or (B) to restrictions imposed in conformity with the Articles of Agreement of the International Monetary Fund provided that the Governments of the United Kingdom and the United States will not continue to invoke the provisions of Article VII Section 2 of those Articles after this paragraph (2) becomes effective unless in exceptional cases after consultation they agree otherwise or (C) to restrictions imposed in connection with measures designed to uncover and dispose of assets of Germany and Japan. (3) This Section and Section 9 which are in anticipation of more comprehensive arrangements by Multilateral Agreement shall operate until 31st December 1951.

9. *Import Arrangements:*—If either the Government of the United States or the Government of United Kingdom imposes or maintains quantitative imports restrictions, such restrictions shall be administered on a basis which does not discriminate against imports from the other country in respect of any product provided that this undertaking shall not apply in cases in which (A) its application would have the effect of preventing the country imposing such restrictions from utilizing for the purchase of needed imports in convertible currencies accumulated up to 21st December 1946 or (B) there may be special necessity for the country imposing such restriction to assist by measures not involving a substantial departure from the general rule of nondiscrimination a country whose economy has been distrupted by war or (C) either Government imposes quantitative restrictions leaving equivalent effect to any exchange restrictions that Government is authorised to impose in conformity with Article VII of the Articles of Agreement of the International Monetary Fund. The provisions of this section shall become effective as soon as practicable but not later than 31st December, 1949.

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