

FROM  
HYPER-INFLATION  
TO ,  
DEVALUATION

BY

S. K. MURANJAN

M.A. (Bom.), B.Sc., D.Sc. (Lond.)

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In *Shadows of Hyper-Inflation* the learned author gave a picture of our precarious economic situation after decontrol. A Government which was yet groping through that situation is now suddenly confronted with a world-wide crisis of devaluation. How devaluation coming on top of hyper-inflation and decontrol complicates and aggravates our tremendous economic problem, is the theme of this publication. The author has his own solutions for these tremendous difficulties. But this publication is also a call to the people to wake up to the realities of the situation and make a supreme effort to save themselves.

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*Economics of the Cabinet Delegation's Proposals*  
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*The Budget and After* (Hind Kitabs)  
*Modern Banking in India* (Third Edition in Press,  
Hind Kitabs)

*Foreign Banking Systems* (in Marathi; Hind Kitabs)

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*Currency and Prices in India* (Longmans)

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*TO*

*MY WIFE*

Who has more cause to resent inflation being  
concerned with things outside the study-room

## P R E F A C E

The first part of this book is a mere reprint of *Shadows of Hyper-inflation* which was completed at the end of the year 1948 and published early in 1949. The economic situation analysed in it continues unaltered even today and forms necessarily the background of Part II.

The second part is a restatement of a lecture delivered at the Sydenham College on 19th September, the day of devaluation, and elaborated in another lecture to the Commerce Graduates' Association on 26th September.

Revision of exchange parities is a highly technical subject. There is much to be said for every alternative and the decision must rest on the balancing of several forces and estimates of their workings in the near and distant future. Those responsible for the destinies of a country cannot afford to overlook any aspect of the intricate situation.

Events alone must prove or disprove the wisdom of the technical decision. The people of this country would do well, however, to recognize one simple truth. It is the privilege of every one to ask and work for the maximum payment and income. But it is also the moral obligation of every one to offer in return the maximum honest work of which he is capable. Levels of investment, employment and output, the balancing of exports and imports at the maximum levels, and efficiency of public and private administration cannot be achieved on the basis of the maximum of pay and the minimum of work and character. Under a half-free and half-controlled economy, a competently framed and competently implemented economic policy is of the utmost importance. But so is also the determination of the people to face toil, sweat and tears.

S. K. MURANJAN

*Sydenham College of  
Commerce & Economics,  
Bombay, 4th October 1949*

## PREFACE TO PART I

The present booklet is a restatement of a theme first advanced in an article contributed to the Independence Number of the *Forum* of Bombay and elaborated subsequently in four lectures delivered to the Banking Association of the Podar College of Commerce, the Marathi Literary Association of the Sydenham College, the Bombay Discussion Group and the Social Contact Group.

A few months before the end of the War, I wrote in *Economics of Post-War India*, "...the danger of a further inflation superimposing itself on the inflation of war years arises from more than one quarter—the unleashing of the pent-up forces of investment, the release of hoarded currency and bank balances, the super-normal level of cash reserves and subnormal level of loans and advances of banks..... In an all-round sanguine environment like this a cheap money policy by the Reserve Bank can only aggravate the upward trend and make the ultimate crisis and collapse more certain."

In discussing the "International Background of Post-War Planning", I observed in the same book: "It is more consistent with the logic of facts that the co-operation of the future will be one of pacts, compacts and agreements and that behind this facade will operate not rational economics, but political power, pure and simple. If this analysis is correct, closed economy rather than inter-country mobility of capital and labour will be more compatible with the spirit of the future."

Immediately after the end of the War, I observed in the second edition of the aforesaid work: "It appears therefore reasonable to conclude that the volume of expenditure during war whether financed out of taxation and borrowing or by inflation need not leave behind it a legacy of adverse effects on the volume of output or employment."

Unfortunately, those who were in power and those who offered themselves to be their advisers were all haunted by fears of uncontrollable deflation and they blundered into

measures which kindled the fires of an uncontrollable inflation. Whatever chance there appeared for a short time of reaching stable conditions were more than destroyed by precipitate decontrol unaccompanied by any precautions to hold in check monetary factors.

The outcome has been described by some as an 'economic crisis'. We are certainly not in the midst of an economic crisis in the scientific sense of the term. We are at present treading the road to economic attrition and atrophy. The crisis, if it ever comes, will not be an economic crisis: it will be a crisis of social relations—between man and man, class and class, the power of Capital and the power of Labour. The voice of Economic Wisdom, if there ever was any in this country, will be as ineffective then as it has been in the past. In no country is Truth invoked more *ad nauseum*; in no country is Truth, when unpalatable, more resented or covered with genuine or calculated quackery.

I must acknowledge thanks to the Editor of the *Forum*, through whose kind courtesy the article referred to earlier has been reproduced as an Appendix in this book.

31st December 1948

S. K. M.



**P A R T I**

**SHADOWS OF HYPER-INFLATION**

## THE FINGER OF HISTORY

### *HYPERINFLATION IN AUSTRIA*

An economist who knew how to describe graphically all the phases of the inflation which spread from Austria to Germany would find it unsurpassed material for an exciting novel, for the chaos took on ever more fantastic forms. Soon nobody knew what an article was worth. Prices jumped arbitrarily; a thrifty merchant would raise the price of a box of matches to twenty times the amount charged by his upright competitor who was innocently holding to yesterday's quotation; the reward for his honesty was the sale of his stock within an hour, because the news got around quickly and everybody rushed to buy whatever was for sale whether it was something they needed or not. Even a goldfish or an old telescope was 'goods' and what people wanted was goods instead of paper. The most grotesque discrepancy developed with respect to rents, the government having forbidden any rise; thus tenants, the great majority, were protected, but property owners were the losers. Before long, a medium-sized apartment cost its tenant less for the whole year than a single dinner; during five or ten years ... the population of Austria enjoyed more or less free lodgings ... A man who had been saving for forty years and who furthermore had patriotically invested his all in war bonds became a beggar. A man who had debts became free of them. A man who respected the food rationing system starved, only one who disregarded it brazenly could eat his fill. A man schooled in bribery got ahead, if he speculated he profited. If a man sold at cost price he was robbed, if he made careful calculation he yet cheated. ... Because Austrian money melted like snow in one's hand everyone wanted Swiss francs or American dollars and foreigners in substantial numbers availed themselves of the chance to fatten on the quivering corpse of the Austrian krone ..... Every hotel in Vienna was filled with these vultures; they bought everything from tooth-brushes to landed estates, they

mopped up private collections and antique shop stocks before their owners, in their distress, woke to how they were plundered. Humble hotel clerks from Switzerland, stenographers from Holland, would put up in the *de luxe* suites of the Ringstrasse hotels. Incredible as it may seem, I can vouch for it as an eye-witness that Salzburg's Hotel de l' Europe was occupied for a period by English unemployed, who, because of Britain's generous dole, were able to live more cheaply at that distinguished hostelry than at home. Whatever was not nailed down disappeared ... greedy visitors came from Sweden, from France; more Italian, French, Turkish and Rumanian was spoken than German in Vienna's business district. Then, at the instigation of the German Government, a border control was established ... One article, however, that could not be confiscated remained free of duty: the beer in one's stomach ... and so they would come in their hordes with their wives and children ... to enjoy the luxury of gulping down as much beer as belly and stomach could hold ... The merry Bavarians did not, to be sure, suspect how terrible a revenge was in store for them. For, when ... the mark in turn plunged down in astronomic proportions, it was the Austrians who traversed the same stretch of track to get drunk cheaply ... This beer war ... was a precise reflection, in grotesque graphic miniature, of the whole insane character of those years.

### HYPERINFLATION IN GERMANY

Now the real witches' sabbath of inflation started, against which our Austrian inflation with its absurd enough ratio of 15,000 old to 1 of new currency had been shabby child's play. .... Whoever had foreign currency to exchange did so from hour to hour, because at four o'clock he would get a better rate than at three, and at five o'clock he would get much more than he had got an hour earlier.....On street cars one paid in millions, lorries carried the paper money from the Reichsbank to the other banks, and a fortnight later one found hundred-thousand-mark notes in the gutter; a beggar had thrown them away contemptuously. A pair of shoe laces cost more than a shoe had once cost—no, more than a fashionable store with

two thousand pairs of shoes had cost before; to repair a broken window more than the whole house had formerly cost, a book more than the printer's works with a hundred presses. For £ 20 one could buy rows of six-storey houses on Kurfurstendamm, and factories were to be had for the old equivalent of a wheel barrow. Some adolescent boys who had found a case of soap forgotten in the harbour disported themselves for months in cars and lived like kings, selling a cake every day, while their parents, formerly well-to-do, slunk about like beggars. Messenger boys established foreign exchange business and speculated in currencies of all lands. Towering over all of them was the gigantic figure of the super-profiteer Stinnes. Expanding his credit, and exploiting the mark, he bought whatever there was for sale, coal mines and ships, factories and stocks, castles and country estates, actually for nothing because every payment and every promise became equal to naught. Soon a quarter of Germany was in his hands. The unemployed stood around by the thousands and shook their fists at the profiteers and foreigners in their luxurious cars who bought whole rows of streets like a box of matches.....All values were changed, and not only material ones; the laws of the state were flouted, no tradition, no moral code was respected, Berlin was transformed into the Babylon of the world. Bars, amusement parks, red light houses sprang up like mushrooms. Along the entire Kurfurstendamm powdered and rouged young men sauntered and they were not all professionals; every high school boy wanted to earn some money, and in the dimly lit bars one might see government officials and men of the world of finance courting drunken sailors without any shame. Even the Rome of Suetonius had never known such orgies as the pervert balls of Berlin, where hundreds of men costumed as women and hundreds of women as men danced under the eyes of the police. In the collapse of all values a kind of madness gained hold particularly in the bourgeois circles which until then had been unshakable in their probity. Young girls bragged proudly of their perversion; to be sixteen and still under the suspicion of virginity would have been considered a disgrace in any school of Berlin at that time; every girl wanted to be able to tell of her adventures, and the more exotic the better.....Everywhere it was unmistakable

that this overexcitation was unbearable for the people, this being stretched daily on the rack of inflation.....And secretly it hated the Republic, not because it suppressed this wild freedom, but on the contrary, because it held the reins so loosely .....Around Ludendorf, more than the then still powerless Hitler, the counter-revolution was already crystallizing openly; the officers whose *epaulettes* had been torn off their shoulders organized in secret, the small tradesmen who had been cheated out of their savings silently closed ranks and aligned themselves in readiness for any slogan that promised order... Nothing ever embittered the German people so much,—it is important to remember this—nothing made them so furious with hate and so ripe for Hitler as the inflation...The inflation served to make it feel soiled, cheated, and humiliated; a whole generation never forgot or forgave the German Republic for those years and preferred to reinstate its butchers.....

—*The World Yesterday*  
(Stefan Zweig)

## Monetary Trends of War

Leaving out of account foreign loans or any investments held abroad, a country can find the means for war by withdrawing men and resources from the employments of peace, by more intensified exploitation of resources hitherto used or unused and finally by postponing replacement of equipment built up during years of peace. The ordinary financial or monetary equivalents of these sources of the sinews of war are the consumption-expenditure, ordinary savings and depreciation reserves of the community in the aggregate. The most straightforward means to finance a war is therefore to levy the maximum taxation on individual and corporate incomes and/or to compel or prevail on all classes of people to subscribe the excess over the minimum of consumption to public loans. It is not found feasible, however, in every country to employ taxation in such a manner as to reach every income-receiver or to equalize incomes and yet retain the economic incentive required to reinforce the urge of patriotism. Unequal incomes create two difficulties. Firstly, they mean unequal consumption out of a strictly limited stock of things to prevent which rationing and price-controls have to be invoked. Secondly, combined with rationing and price-control, unequal incomes mean unequal savings which might run into idle hoards or undesirable forms of investment unless they are intercepted at the source or forms of investment are strictly controlled.

Taxation and loans were the principal means by which the United Kingdom and the United States met the bill of World War II. Profiting from the experience of World War I, both countries had formulated their financial policies with the utmost care and completeness and lost no time in putting them into effect. In India, forethought had no place in the policies of the British Government and haphazard measures, improvisation, conflict of policies, etc. fell to the lot of the bewildered and unorganized people.

**RUPEE FINANCE DURING THE WAR (Figures in Crores)**

Year	Visible Balance of Trade in Merchandise of British India (excl. of re-exports, private) *	Sterling payment by H. M. Govt. (against War Expenditures Recoverable from Br. Govt. shown in brackets)	Defence Capital Expenditure	Revenue Surplus (+) or Deficit (-)	Total Rupee Finance to be met (Columns 1+2+3+4)	Rupee Finance met from loans †	Rupee Finance met by issue of currency, i.e. Absorption of Notes & Rupee coin **
	1	2	3	4	5	6	7
1940-1	+29.93	43 (53)	...	- 6.5	79.4	+124	56
1941-2	+64.31	199 (194)	...	- 12.6	275.9	+ 37	164
1942-3	+77.18	310 (325)	52	-112.1	551.2	+137	318
1943-4	+80.35	365 (377)	37	-189.7	672.0	+252	282
1944-5	+53.08	457 (410)	62	-161.0	733.0	+206	231
<b>Total</b>	301.80	1374	151	-481.9	2311.0	756	1001
1945-6	+24.11	342(Re)(347)	14	-123.0	524.0	+277	162.2
1946-7	+28.65	...	...	- 55.7(Re)	...	...	31.1
				- 6.0(Re)	...	...	53.9

  

	*Sterling amounts utilized for Repatriation	Total Govt. outlay on account of Defence & exp., Defence capital exp., Exp. recoverable from Br. Govt.	†Treasury Bills (Average amounts outstanding with public)	** Increase in sterling holdings of Reserve Bank (i.e. total sterling purchased & sterling payments by H.M. Govt. minus Repatriation of Debt and other Sterling commitments)	Defence Loans
1940-1	89	...	26	2	85
1941-2	110	297.9	...	140	64
1942-3	160	592.6	...	227	100
1943-4	16	973.7	122	434	341
1944-5	14	896.2(Re)	...	418	266
<b>Total</b>	389	...	...	1221	856
1945-6	...	900.7(Bud)	...	361	376

## Financial and Economic Policies

The financial and economic policies of war years must be judged against the avowals or confessions of the Finance Member from time to time about economic conditions in the country. When he presented his three budgets for the years 1940-41 to 1942-43, he found no cause for any serious concern. The budget of 1940-41 found the prices of chief articles of export 40 per cent higher than at the outbreak of the war and ~~there was no marked difference in the trend of prices of raw materials, industrial commodities, food, etc.~~ "The different branches of the national economy", averred the Finance Member, "are moving forward in fair unison and there is no need to fear, for the present at any rate, a lop-sided development with serious cleavages in interest." The downfall of France and the loss of continental markets caused some deterioration in prices but at the time of the budget of 1941-42, they were still 15 per cent higher than in September 1939. The general indices of progress like railway and postal traffic still showed improvement and the value of exports still ran at the old level. The Roger Mission on output of munitions, the Eastern Group Supply Council and the programme of placing supply orders two years ahead were described by the Finance Member as tremendous developments in the supply field which "must necessarily give a great stimulus to Indian industries." In presenting the next budget, he assured the legislature that "on the whole this country has been fortunate; the balance has so far been to her advantage."

It was when presenting his budget of 1943-44, two and a half months after Japan's attack on Pearl Harbour, that for the first time the Finance Member admitted some cause for uneasiness. "It would be idle to pretend", he said, "that in the last twelve months unfavourable factors have not gained relatively to the favourable ... Prices have risen and, as in other parts of the world, an increased money income is being expended on a smaller stream of immediately available goods." But with this admission in the earlier part of his speech, he devoted subsequent parts of it to disprove the existence of any inflation. In the light of what happened later, his arguments can now be regarded only as historical curiosities. The ceiling of the maximum utilization of available man-power and resources was not yet



reached and increase of currency was apparently the means, in the opinion of the Finance Member, to reach it! The impossibility of increasing the volume of commercial imports and the futility of any upward movement of exchange rate were held as another valid excuse for adding to the note circulation. Sterling balances in India's favour could not have any bearing on the internal problem which was to make disbursements in Indian currency. Since the only inflation which the Finance Member was willing to recognize was the inflation in the countries "which suffered utter defeat in the last war", the assured victory of the United Nations itself gave us guarantee against inflation! Indebtedness of the U. K. had been kept low while there were sterling debts to be repatriated and pure credit inflation had been avoided by making cash payment against "a block of investment waiting to be taken up by the nation". Finally, the rate of turnover of money was falling and in any case, high prices must require more currency to support them!

Yet in his budget speech of 1941-42, there had occurred this curious passage: "No one would wish to see repeated the period of hectically inflated prices which ruled towards the end of the last war, but we can rely upon steadily increasing industrial effort during the present one, with consequences which seem likely permanently to affect India's position among the industrial nations of the world." So, the Finance Member was aware of other degrees of "hectically inflated prices". But this was at a time when prospects of any inflation appeared remote. Nor was he altogether unaware of the duty which such inflation casts on the Government. When he presented his budget of 1942-43 amidst "favourable conditions", he stated the problem in the following words: "Nevertheless, it is beyond dispute that a stage has been reached at which in addition to the ordinary process of taxation, it is the clear duty of the Government to make a beginning with measures of a kind which will assist in relieving the pressure of enhanced volume of purchasing power on the inevitably limited supplies of goods and services which are available for private consumption at the present time."

In the budget of 1944-45, the Finance Member casts off any pretence. "Whether we approach the matter from the viewpoint of building the new India of our hopes, or from

mitigating the hardships of the immediate present, it is clearly our paramount duty to deal first with the menace of inflation." So ran his new revelation. Among the "resolute measures of a two-fold character launched by the Government in the monetary field and in the sphere of control of commodities", he listed all-India statutory price control of foodstuffs, cloth control, release of woollen clothing from defence requirements and the Hoarding and Profiteering Ordinance. For the rest, his fiscal measures were devised to close the gap estimated at 250 crores between the total of our taxation and borrowing on the one hand and the total of rupee outgoings on the other.

### Inflation or Loans ?

The annual visible monetary savings and investment of India progressed at a rate of approximately Rs. 100 crores during the decade 1921-1930. During the five years 1939-1945 the accumulation rate appears to have exceeded Rs. 250 crores. While during the earlier years, precious metals claimed more than a third and the permanent public debt about a quarter of the annual savings, the War has enabled bank deposits and public loans to oust almost every other visible form of holding savings like precious metals, post office savings and certificates, scrips of joint-stock companies, insurance, etc. The public debt of India absorbed more than half of the visible investment funds and bank deposits a little less than a half.

The story of how this growth in the volume of monetary savings took place and how public debt and banks appropriated five-sixths of those savings is very simple and may be told in non-technical language in the following manner. Between 1940 and 1945, England and her Allies purchased goods for use in or outside India to the monetary value of about Rs. 1400 crores. During the same period, India also financed her War expenditure which was in excess of her revenues by about Rs. 500 crores. To facilitate the acquisition of sterling, the currency law was suitably amended so as to remove the existing restrictions on the volume of sterling assets the Reserve Bank was permitted to hold against note issue. Unable or unwilling to offer in return any goods or capital assets, the Allies could have paid for their purchases from individuals only by means of loans raised in India. Similarly, having exceeded its income

resources, the Government of India could finance itself only by loans in the same manner. It would now be futile to discuss why the British Government did not assemble and offer British investments in India as in the United States or why the Indian Government did not adopt more drastic measures of taxation including a war-time capital levy. Actually against the aggregate liability of about Rs. 2200 crores, the Government of India on whom fell the responsibility to find domestic finance for both the expenditures, could not raise public loans of more than Rs. 800 crores. Of course, these figures of Rs. 2200 crores and Rs. 800 crores must not be taken in the absolute sense because they are what they are only on account of the inflationary means adopted to fill the gap. What is important and relevant is the proportion between expenditure requirements and available means which they roughly indicate. The Indian authorities met the disproportion by accepting the mere paper promises of England called the sterling holdings of the Reserve Bank of India to the extent of about Rs. 1220 crores and issuing currency notes against them to the extent of Rs. 1000 crores. Over and above this direct expenditure, the net purchases of foreign countries through the regular channels of trade amounted to more than Rs. 300 crores. As notes were issued from week to week and month to month, the rise of prices caused a simultaneous growth both in the value of Allied purchases and the need to issue more currency notes. The goods supplied to the Allies came ultimately out of the consumption of those people whose incomes fell in purchasing power on account of rise of prices. It was a forced loan from classes who could least afford it.

The rise of prices approximately in the proportion of 100:250 raised money incomes, which in the ordinary course of things should have raised monetary savings in about the same proportion. But the rationing and price control of certain goods as they came into force for one commodity after another no less than the non-availability of certain other goods curtailed ordinary opportunities of expenditure and thus reinforced the normal influences which create savings. The volume of savings tended thus to swell still further. At the same time, legal or administrative restrictions or prohibitions altered materially the normal channels into which the community directed its savings.

New capital issues were licensed and house-building and imports of precious metals came practically to a standstill. The way was thus apparently cleared for canalization of all savings into bank deposits or public loans but for the fact that there were still pre-existing assets like land and the operation of heavy taxation, excess profits duty and above all black markets had already created a new rival to bank deposits and public loans, namely, currency hoards. The size of these hoards must have in the aggregate, reached impressive dimensions because as against a rise in the note issue from less than Rs. 200 crores to about Rs. 1000 crores (i.e., a five-fold increase), the prices of both controlled and uncontrolled commodities and capital assets did not rise by more than  $2\frac{1}{2}$  to 3 times the pre-War level.

### Failure of Loan Finance

This inflationary procedure of war finance raises the question whether the failure to raise sufficient loans was unavoidable. During the more normal years, 1921-1930, when prices on the whole were sagging and there were no prohibitions on capital issues and no cessation of imports of precious metals or house-building, the public debt was growing at an average annual rate of about Rs. 25 crores. Precious metals and paid-up capital of joint-stock companies were absorbing on the average about Rs. 50 crores annually. In other words, at a much lower price level and without taking into account the much enlarged real national income during the thirties, these sources alone could have furnished Rs. 75 crores annually or Rs. 375 crores in five years. It is difficult to estimate the savings which were releasable from house-building which was then passing through a great boom. It is reasonable to suppose that investment in housing could not be much short of our annual consumption of precious metals. Thus against the price-inflated requirements of Rs. 2200 crores in five years of War, there is to be set our normal capacity to furnish without curtailment of ordinary consumption an output of Rs. 400 to Rs. 500 crores which at war prices has to be valued at not less than Rs. 1000 crores.

Apart from the identification of the public mind with a cause, the most powerful inducement to attract savings into public loans is undoubtedly the interest rate offered. It appears

that it was decided from the very first that the era of low interest rates amidst which the War started should be continued into the War itself, presumably in the interests of public borrowing. The decision by itself is not to be blamed, provided the implications of it were fully realized and translated into action. A particular level of interest rates for public borrowing is, however, appropriate and effective only when it is properly related to the returns on alternative investments. In England for example, the War was made a successful 2 or 2½ per cent war only because wholesale rationing and price controls created a volume of enforced savings, and over-all and drastic controls of profits and civilian output made alternative investments sufficiently unattractive. In India, rationing and price control arrived in a tardy and haphazard manner and could cover only a few commodities and, what is more important, only in a few bigger places. High income-tax, super-tax and excess profits duty introduced at a fairly early stage of the War appeared to hold down the profit level of trade and industry but, with output uncontrolled and low rates for loans and advances, profit margins were, as a matter of fact, twice and thrice as large as in peace times. When at length the Government awoke in the budget of 1944 to the need of more drastic steps, capital values had already doubled and trebled themselves. Moreover, land, the main outlet for investment in the rural areas, although growing more attractive to the investor because of the rise in prices of agricultural produce, remained altogether outside the range of the Central Government's power. While alternative investments acted in this manner as a magnet for public savings, low interest rates for public borrowings invited their own frustration by reducing the cost of liquidity and encouraging people to hoard resources in the form of currency notes and bank balances. It may, therefore, be truly said that the essential prerequisites of low interest rates were not adequately grasped and certainly were never fulfilled to the required degree in India. Whether the cause of the ultimate financial impasse is to be ascribed to the choice of a wrong financial policy or to administrative failure must depend on our judgement about the scope and potentialities of legal and administrative action in this country. In the abstract, the choice lay between over-all and effective controls and effective levels of interest rates for borrowing. In

actual practice, since large sectors of the economic system were bound in any circumstances to lie outside the range of Government's power, the proper policy for financing the War should have been on the one hand to raise moderately the rates of interest and on the other to take whatever measures were available to restrict and curtail returns on alternative investment. As the present writer observed on the outbreak of the War: "With a rigidly controlled foreign exchange market and a scale of relative demands furnished by a definite objective like the prosecution of War, interest rates in England have only a formal significance. With a largely uncontrolled economy like that of India, interest rates are a real and active force of regulation."

Indeed, India seems destined to pass through a quixotic phase of financial experience. During the years of War when higher interest rates could have moderated the degree of necessary inflation by inducing the public to subscribe to public loans and investment (such as was possible) required no stimulus of this kind, the country got the blessing of low rates. When the requirements of full employment and rapid growth should make in post-war years low rates very imperative, it is more than probable that higher rates will prevail in a struggle to hold in check the potential inflation implicit in hoarded currency and bank balances and, in the absence of a proper exchange policy, the trend to adverse-trade balance implicit in an inflated price level. The pennies gained on the interest charge of public debt will have as their nemesis the pounds lost on the actual inflation of War years and the probable deflation of post-war years.

## II

On the conclusion of the war in the West in May 1945 and in the East in August of the same year, the situation was bound to change materially. The actual course of events was, however, such as to falsify most prophecies.

Post-war economic trends fall into three distinct periods. From March 1945 to March 1946, prices continued to rise steadily and inexorably. The wholesale index number moved up from 247 to 293. From thence onwards till November 1947,

the level was on the whole stable between a narrow range of 293 and 302. Then arrived an anxious period of a few months when the index number began to mount in an alarming manner. From 302 it mounted to 383 in the following May-August.\*

### March 1945—March 1946

The continuation of inflationary conditions during these months of 1945-46 is hardly a cause for surprise. The favourable trade balance on private account was falling but still aggregated to Rs. 24 crores; inclusive of government and treasure accounts however, it was unfavourable. The sterling payments by the Allies for war expenditure in India ran into Rs. 342 crores. The Government of India's own expenditure exceeded its revenues by Rs. 123 crores, while its defence capital expenditure amounted to Rs. 35 crores. Against this total liability of Rs. 524 crores, the Indian Government could muster not more than Rs. 376

	( In Crores of Rupees )					Wholesale Prices 1939 = 100
	Demand Deposits	Note Circulation	Cash of Banks	Reserve Bank Deposits		
				Central Govt.	Other Govts.	
1940 March	145	238	6.0	20	—	—
1945 „	604	1084	28.8	242	27	247.8
1946 „	703	1218	36.2	512	32	292.7
1947 „	690	1242	39.0	417	33	293.2
1948 „	670 (81)+	1304	36.8	257	20	340.7
1947 Nov.	651 (73)+	1199	35.5 (4.6)	369	17	302.0
1948 August	692 (20)+	1215	38.2	226	15	383.1

+ Demand deposits of Pakistan

crores in loans with a net increase in permanent indebtedness of about Rs. 334 crores.

The remaining gap between incomings and outgoings was covered by the issue of paper money which raised the note circulation by Rs. 134 crores. The addition to the volume of purchasing power in the hands of the public was much more as this further issue of legal tender raised the demand deposits of scheduled banks by Rs. 100 crores more.

The rise in the price level was moderate in relation to the volume of purchasing power in the hands of the public. If the latter did not exert its full pressure on prices of goods, it was due to certain favourable factors called into action by the termination of the war. From the day of the close of the war in Europe, an unbridled optimism seized hold of the investment market of India. It is difficult to estimate the funds which were thus diverted into speculation or investment. Judging from the giddy heights at which investment scrips were changing hands, the volume must have been unprecedented. The general public also appears to have preferred a precautionary shift into liquidity. The time-deposits of scheduled banks which showed small progress during the war recorded an upward rebound of almost Rs. 75 crores. The small savings of the country which moved but at a slow pace during the war now increased by Rs. 62 crores—a rate of growth three times as high as during the six years of war. The close of the war caused unavoidably a fall in the rate of expenditure of the Central Government though not very quickly.

The general public and even experts feared a sudden deflation and counselled cautious dismantling of the apparatus of war. Even then, the deposits of the Central Government with the Reserve Bank rose by Rs. 270 crores.

### March 1946—November 1947

The stability of prices during the next twenty months was the outcome of the receding causes of war expenditure and the gradual assertion of the forces of peace. The year 1946-47 had to record no expenditure to be financed on behalf of the Allies or defence on capital account. The trade balance inclusive of government and treasure accounts which was unfavourable to us in the previous two years continued unfavourable to the



extent of Rs. 40 crores and the Central Government revised deficit amounted to Rs. 55 crores.

The earlier part of the year 1946-47, was distinguished by a plentitude of funds in the markets. The Government took the opportunity to carry out a great conversion operation and, during the whole year, was able to raise its public debt by about Rs. 160 crores. The rise in the note circulation was only Rs. 24 crores from March to March which was probably accounted for by the difference between the two successive seasons. It is remarkable that the demand deposits of scheduled banks actually disclosed a fall.

It was during August 1946 that the investment market received the first check on the outbreak of riots and murders in Calcutta. But those who were encouraged by the premature abolition of E. P. T. and large-conversion operations or allowed to indulge in the orgies of optimism by the criminal inactivity of the market authorities were not inclined to take much heed. They continued to feed and be fed by the prevailing fervour. In contrast with the demand deposits of scheduled banks, time deposits recorded a rise of Rs. 50 crores for the year 1946-47 and small savings were only a little behind with an increase of Rs. 47 crores. The volume of consumption expenditure was thus under fair restraint.

This general picture of falling war expenditure and growing volume of public savings, is somewhat marred by a tendency which began to disclose itself about the October of 1946. The new all-Indian Government at the Centre was besieged with demands for additional expenditure from all sides. For the whole period of twenty months, there took place a fall of Rs. 143 crores in the deposits of the Central Government with the Reserve Bank. But other favourable factors just described served to mask what was happening.

### November 1947 onwards

Causes were, however, already at work to undermine the basis of this stability. Industry found itself between two fires—the mounting demands and strikes of Labour and the mounting fervour of the Government in proclaiming radical economic plans and policies. Strikes cost the country 12.7 m. man-days in 1946 and 16.5 m. man-days in 1947. The war years' average

was only 4.3 millions. Starting with the budget of the Interim Government, which should have entitled trade and industry to a respite of a few years, the investment market was subjected to a series of shocks like Nationalization Plans, Congress Economic Committee's Plan, Profit-sharing Plan, Limitation of Profits Plan, etc. Practical measures of immediate usefulness had no chance before distant, vaguely conceived ideals. The investor was filled with terror which was intensified by a creeping doubt from about August 1946 about the ability of the Government to maintain the uneasy low rates of interest. The already deteriorating situation was aggravated a thousand-fold by the events of the Partition which brought about huge losses of wealth, considerable unemployment and great unproductive expenditure out of public funds.

Even before the Partition, savings showed a tendency to evaporate. The year 1947-48 recorded an actual fall in the time deposits of scheduled banks. Small savings increased during the same time by Rs. 11 crores only. The evil effects of this tendency to save less were much intensified later when the uprooted people had to liquidate such wealth as they rescued to maintain themselves.

But for the new demands on revenues which were yet to disclose themselves the financial position of the Government was not uncomfortable.\* The budget of 1947-48 foresaw a deficit of Rs. 6 crores only. It is true that the fall in the rate of savings and the changed psychology of the investment market were making borrowing extremely difficult. The yield on Government Security was steadily falling from March 1942 and for the 3 per cent loan, reached its lowest level of 2.84 in July 1946—the month of the cheapest loan ever floated in this country. With the August events in Calcutta, the yield began to mount and the yield of 3.03-3.05 for April-August 1948 reflected truly the change which had come over the capital market. But the liabilities of the Government were limited and

\* *The improved budget position reveals itself on closer analysis to be more apparent than real. The distinction between ordinary budget and capital budget appears to have been availed of to smuggle inconvenient items from one category into the other. Started with good intentions it should not be surprising if financial jugglers abuse this practice with the same disastrous effects as in France.*

it met the situation by drawing heavily on the balances with the Reserve Bank. While repayment caused a fall in the Public Debt of Rs. 19 crores for 1947-48, the deposits with the Reserve Bank fell by Rs. 191 crores between March 1947 and July 1948.

The rate of withdrawal from Government balances with the Reserve Bank was on a somewhat bigger scale for the twelve months 1947-48 than for 1946-47. The main difference, however, lay in the fact that the previous withdrawal coincided with an improving rate of savings on the part of the public while the latter reinforced the effects of a deteriorating outlook on the future and a proclivity to save less and spend more on the part of all classes of people.

### Significance of Government Expenditure

In order to appreciate properly the significance of government expenditure, it is necessary to bear in mind the vast change which has taken place in the volume of public spending relatively to the volume of national income and expenditure.\* In the pre-war year 1938-39, the total revenues at the disposal of the Central and Provincial Governments aggregated to about Rs. 168 crores. Although it is difficult to say what proportion this figure bore to the total national income or expenditure of that year it is unlikely that it was much above 5 per cent. According to the budget estimates for 1948-49 which exclude the Pakistan areas in the East and West, the Central and provincial governments shared as before almost equally in a total revenue pool of almost Rs. 500 crores. Looking to the changes in the level of wages of factory labour, or salaries or business incomes of individuals and joint families assessed to income-tax it appears unlikely that most of the money incomes in the

\* *National Income & Expenditure in Crores of Rupees*

	1938-39	1939-40	1944-45	1945-46	1946-47	1948-49
Central Govt.						
Revenues	84.5	94.5	335.5	360.5	—	255(bud)
Tax-Revenues	76.0	—	—	—	300(Rev)	266 „
Provincial Govts.						
Revenues	84	90	208	229	—	242 „
Central Govt.						
Deficits(—)		—482		—123	—55	

country are today much more than twice as high. The profits of companies assessed to income-tax reached a peak level of Rs. 168 crores in 1944-45 as compared with Rs. 47 crores in 1940-41, but profits are about a third of the total income assessed and are shared among a small fraction of the population. The expenditure of Rs. 500 crores by the governments of partitioned India exceeds by a large measure, perhaps by a quarter, the gross profits of businesses and companies assessed to income-tax in undivided India. If we take account of the deficits of recent years, the great importance of government expenditure is obvious. If the withdrawal from accumulated balances proves to be expenditure in addition to the disbursements from ordinary revenues, the pull of governments on the whole economy is bound to be very decisive.

The alarming rise of prices from November 1947 to June 1948 coincided with two significant occurrences. From about the middle of 1947, it was clear that controls on food and cloth were on the road to be lifted more or less completely. Secondly, November is the usual starting point of the busy season and not less than Rs. 100 crores were added to the note circulation till May and subsequently withdrawn during the slack season.

Decontrol by itself need not have caused a rising spiral of prices. Unless speculative funds receive a durable addition or the consumers' income and outlay are replenished, an initial rise of prices cannot sustain itself very long, or indefinitely. The seasonal expansion of currency might have aggravated the severity of the price rise but with the withdrawal of the seasonal issue this aggravating cause must have lost much of its force. During those fateful eight months from November 1947 to August 1948, the note-issue increased by Rs. 16 crores. This was a trivial amount compared with the total note-issue and was more of a reflex consequence of the release of government balances impounded in the Reserve Bank.

Apart from the vast resources released from ordinary savings, liquidation of accumulated investment and the release of government balances impounded till now in the Reserve Bank, the only other sources of funds must be banks or hoarded currency. It appears unlikely that hoards of currency continued in any appreciable volume after the demonetization ordinance of January 1946 and the frequent rumours of further demoneti-

zation. It is rather significant that the amount of 1000-rupee notes increased by a hundred crores between the outbreak of the War and the issue of the demonetization ordinance and that during the subsequent year the amount of 10-rupee notes rose by an equivalent amount. But these 10-rupee notes were more likely to be in circulation than out of it and the place of currency was filled very conveniently by gold and silver. The unwillingness of the war-rich to hold the precarious notes is no small element in the continuous spiral of prices of the precious metals.

From the end of the War till the end of 1947, banks were liquidating slowly their government security portfolios and replenishing their cash in the vaults. This was perhaps a precautionary measure against possible changes in the long term rate of interest. When prices began to rise in November 1947, banks seem to have found use for their accumulated cash. It is significant that while the note-issue shows a rise of only Rs. 16 crores, demand deposits of scheduled banks record an upward movement of Rs. 47 crores. The loans and advances of scheduled banks which began to recover from the end of the War improved further by about Rs. 75 crores. In those eight months, therefore, the Government and the banks between them made an initial addition of about Rs. 200 crores to the purchasing power of the public. Before it spends its force, an initial addition diffuses itself into a much bigger volume of purchasing power.

The time chosen for decontrol coincided therefore with: (i) the busy season when expansion of currency could not be avoided, (ii) a spate of central and provincial government expenditure which was largely unproductive or at best offered only delayed fruitfulness and (iii) a severe fall in the rate of savings investment and even actual disinvestment.

### Fall in Savings

A substantial fall in the rate of savings or even actual disinvestment appears to have added materially to the fires of inflation. It is difficult to estimate the size of our annual savings and therefore the potentialities of expenditure from this source. It would be useful nevertheless to have even the roughest estimates on this head to enable us to assess the comparative importance of different forces at work.



little inflation during the first two or three years and there was actually a fall in savings of certain kinds during these years. For the two years 1945-47, this volume of savings was much larger and may be placed at more than Rs. 400 crores annually. The estimates for war and post-war years are much more definite than those for pre-war years when house-building absorbed large amounts which could not be traced and recorded. The war and post-war years exclude an important item—the augmentation of the paid-up capital of public companies and what must be a much more important item, their aggregate contributions to reserves and depreciation reserves. Making allowances for these untraced items, it would not do much violence to human credulity to place the annual savings of post-war years at Rs. 450-500 crores per annum at the maximum. This estimate may be compared with the estimated pre-war savings of Rs. 200 crores.

There are two ways in which this part of the national income may be drawn upon for consumption expenditure. Those who normally save may decide to refrain from saving and use their income for ordinary expenditure or those who hold investments out of past savings can unload at prices which are attractive to those who have present savings and use the proceeds for consumption. The important point to be noted is that whether people decide to save less or to disinvest, the finance must come out of the current estimated savings of Rs. 500 crores and from no other source.

It is pointed out above that the year 1947-48 has no improvement to record in time deposits as against the additions of Rs. 50 crores and Rs. 76 crores in the previous two years. Similarly, it recorded an improvement in small savings of Rs. 11 crores only as against Rs. 47 and Rs. 62 crores for the two earlier years. Again, the public debt showed a fall of Rs. 19 crores as against additions of Rs. 169 and Rs. 303 crores in the same earlier years. The aggregate fall under these three heads alone may be equal to Rs. 250-300 crores. This fall cannot be explained by suggesting a fall in our national money-income during that year. Our money-income is probably on the increase—even after allowing for the fall in output which had undoubtedly taken place after 1945-46. It is also not possible to account for this fall by pointing out to any

increase under other possible heads of visible savings or investment. House-building has hardly received any impetus. In a time of rapidly rising prices, hoarding of currency does not offer even a plausible explanation.†

We thus arrive at the following picture of the sources of inflationary expenditure at the present time.

Source	(in crores of rupees)
(i) Central and Provincial Government expenditure out of Revenues	500
(ii) Central expenditure out of Balances	150
(iii) Volume of Savings	400
(iv) Sale of Assets and Investments	100
(v) Creation of bank Deposits and bank Loans and Advances	50-75
Total	1200 approximately

### III

#### The Situation today

The situation before us today is briefly this: (1) The volume of savings has fallen appreciably. This is not due to fall in †

	Time Deposits	Small Savings	Public Debt (minus small savings)
	(in crores of rupees)		
1940 March	109	135.3	592
1945 „	220	159.8	1412
1946 „	296	221.4	1715
1947 „	346	268.4	1874
1948 „	319	—	1855
1947 November	312	—	—
	(30)*		
1948 August	312	—	—
	(0.8)*		

\* Time deposits of Pakistan



income levels. It has been caused by increased tendency to consume or even to be extravagant. (2) The volume of private investment has been negligible since the outbreak of the War. This is very largely due to our dependence on foreign supplies for capital goods. (3) The intensified propensity to consume and the arrest of progress in our productive capacity,† if not an actual fall, has raised the cost of living for several important sections of our community very much above their income levels. The distress caused by this disparity and the anger at the riotous living of the top “traders and business men” have undermined general willingness to work and made men look for remedy out of sheer despair to drastic economic and social changes.

### Possible Alternative Policies

What are the possible alternative policies which we could now adopt?

(i) *Measures to stimulate private savings*: According to a recent estimate, the volume of our national income was about Rs. 4000 crores in 1945-46. We have estimated above our annual national savings at about Rs. 400-500 crores at present. The serious fall in our savings in 1947-48 and thereafter has been already indicated above.

*Firstly*, the present high level of taxation is too recent to permit sufficient time for the necessary psychological adjustment. New taxation—particularly at high levels—creates doubts about the virtues of saving and fears about still further depredations. Those who can save take time to be convinced that the ground under their feet is stable and that they can plan safely for the future. The obvious remedy for such a state of things is that the Government should adhere rigidly to the pattern of taxation they have announced and refrain from repeated changes or experiments in any direction.

*Secondly*, saving could be offered special inducement as against consumption. In order to frame proper inducements, it is necessary to have some rough idea at least about the exact sources of our national savings.

From the stand-point of these sources, our people fall into two large groups: (i) those who pay income-tax and super-tax

† A competent estimate places the need for renewal of our machinery and capital equipment at 40 per cent of our present productive power.

and (ii) those others who do not pay, either because they fall below the exemption level or because their incomes are derived from agriculture.

(i) What is the total income and therefore the capacity of the first group of people to save? Their total assessable gross income was Rs. 224 crores in 1932-33 and their number was estimated at 553 thousand. In 1940-41, their aggregate gross income was only slightly more and rose to about Rs. 480 crores by 1944-45, the latest year for which statistics are available. Our total national savings are estimated above at about Rs. 200 to 300 crores before the War and Rs. 400 to 500 crores after the War. If these estimates are not too wide of the mark, it is clear that our volume of visible savings is equal to the whole gross income of this group. In estimating the contribution of this group to our savings, we must make allowance for certain special facts. It is clear that the group consists of a very small number of persons with individual incomes far above the levels true of the rest of their countrymen. Qualitatively, their contribution is vital because investors in all modern trades and industries are largely drawn from this group.\* The proportion of the income this group saves must be somewhat less because about one-third of its income consists of salaries which at the present cost of living cannot have a margin of saving above 10 to 20 per cent. Even if the rest saved 50 per cent of their gross income out of sheer incapacity to spend, the total volume of savings of this group in 1944-45 could not reach Rs. 200 crores and was probably round about Rs. 150 crores. Actually, a good fraction of this income now goes into payment of taxes.

The annual increase in the paid-up capital of companies and firms, fixed deposits of banks, buildings in highly urbanized areas, etc. is largely the objective expression of the savings of this group.

It appears from our estimates that the bulk of our savings is derived from the other group of our countrymen. Their savings run perhaps into Rs. 250 to 350 crores at present and are spread in small amounts over a very large number of people. The

<sup>10</sup> In a recent analysis of shareholders of 8 companies—Tata Iron & Steel, Ajol'o, A. C. C., Balaipur, Scindia, Central Bank, New India Assurance, Tata Hydro—it was found that 8 per cent of the shareholders held 60 per cent of shares. The analysis excludes holdings of blank shares.

objective expression of their savings is to be found very largely in small savings, Government Securities, houses in medium-sized and non-industrialized towns, gold and silver, etc.

The causes which have led the first group of people generally to prefer spending to saving are diverse. (a) In order to evade high taxation, trade and business have chosen to increase their expenditure in all manner of ways. If an inquiry were made into increase of salaries recently granted to certain employees and the caste, social or communal relationship of these highly paid employees to directors, managing agents, etc., the extent of this evil will become quite clear. (b) The income recorded in the income-tax returns is only a part of the real income of traders and business men. Controls and government regulations have created opportunities for and placed a premium on all kinds of illegal profits and incomes. Where these profits and incomes cannot be concealed, they are spent on extravagant living. This evil may have a counter-balancing effect. If expenditure out of illegal sources makes such persons show less expenditure and more saving in their income-tax returns, a certain mitigation of extravagance must be allowed for. (c) The existence of the Income-tax Tribunal and the consequent risk of exposure and punishment must be having curious effects on the disposal of concealed profits. Successful concealment must have immobilized quite a large spending and investment power. But it is also likely that fear of perpetual immobilization on account of an efficient Income-tax Department may induce gradual spending away of these reserves. The recent provision for compounding war-time evasion of taxes by agreed payments is unlikely to achieve much except in marginal cases.

The inducements to saving announced till now by the Government apply very largely to this group. These measures are special depreciation allowances, lower corporation tax on profits carried to reserves, special tax exemptions and depreciation allowances on new buildings, etc. The effectiveness of these inducements is somewhat marred by certain undecided points and measures running counter to them. It is not yet clear whether the ownership of reserves lies with the shareholders or is held in common by them and labour. The existence of Capital Gains Tax must tend to encroach to some extent on the profit

accruing to the shareholders on account of the improved financial strength of a concern. The practical value of depreciation allowances must depend on the basis on which depreciation is to be calculated. The prospects of heavy death duties or inheritance taxes is another factor which must tend to weaken the motive to save—particularly at the higher income levels.

It is clear that the inducements devised till now do not touch the problem as explained above. The inhibition of a high level of taxation raises several important points. As suggested above, the inhibition may be only a temporary phase pending the needed psychological adjustment. Even if reduction in taxation increased the volume of savings by more than the reduction—itself a very doubtful proposition—we shall have yet to answer the question whether funds in private hands will in the present circumstances be invested to better purpose than funds in the hands of the Government. As for extravagant expenditure to avoid taxes, the auditors and Income-tax Department should be in a position to report such cases to a special branch of the Industries and Supply Department of the Government. The prevalence of illegal incomes and profits is a part of the much bigger question of controls and cannot be judged apart from it. The Income-tax Tribunal relates to a specific period and therefore to the specific profits already made and unless it becomes a permanent feature of our tax system, its inhibitive effect must vanish with itself.

(ii) We must now turn to the other group which supplies probably the bulk of our annual savings. This group is very miscellaneous, the only common point among the classes of persons being the low or moderate level of their incomes. It consists of salary-earners below Rs. 2500-3000 per annum, labour in factories, urban and rural artisans, the peasant and agricultural labourer, money-lenders, etc. It would be impossible and probably futile to try to isolate those among them who can save and to estimate their saving capacity. Their volume of savings rests simply on the foundation of their large number.

We may take for illustration the only compact class among them, labour in recognized factories—organized labour, as it is sometimes described. The numerical strength of this class was about 17 lakhs at the outbreak of the War and it now stands at about 24 lakhs. In 1946, the total wages bill for 20 lakhs among

them stood at Rs. 112 crores and on that basis, a labour force of 24 lakhs should have a wages bill of Rs. 134 crores. Since 1946, labour has achieved certain further improvements and it is probable that the wages bill of this class lies today near Rs. 175 crores.\* Even with all members of the family in gainful employment and with their habits as they are, their saving is not likely to exceed 10 per cent of income. The urban and rural artisans, agricultural labour and the bulk of the actual tillers of the soil are certainly not better placed than these factory labourers. It appears reasonable therefore to infer that the bulk of the savings of this miscellaneous group ensues from salary-earners, money-lenders, more well-to-do farmers, land-owners, and professional persons.

Till some relief was given in 1947 and thereafter, the salaried classes were ruthlessly squeezed between rigid incomes and soaring cost of living. Even in the case of those above the income-tax limit, the total income assessed was about Rs. 70 crores in 1940-41 and only 92 crores in 1944-45, the increase being largely due to expansion of employment. The condition of those below the income-tax limit is unenviable even now. More than any psychological inducement, what they need most is restoration of their saving capacity by a fall in the cost of living. Passive victims of their soaring cost of living, they have contributed nothing to the inflation except for any disinvestment due to the same cause.

Among the middle-classes, the numerically small professional section has risen to be the "New Rich". They must be classed, with traders and business men, among the beneficiaries of war and post-war inflation. They are covered by the income-tax returns of income and assessment.

It is difficult to speak of farmers and peasants—the bulk of the country's population. Those among them who cultivate food-grains or even commercial crops on a subsistence scale have hardly improved their economic status. Others, who form a small fraction of their class, have probably repaid the bulk of their debts—which means a flow of liquid capital into the hands of rural traders and money-lenders and explains partly

\* On the basis of Bombay Province statistics for 1947, the all-India average yearly earning of factory labour should be 271 per cent of the average yearly earning for 1939, that is, about Rs. 813.

rural hoarding of goods and commodities. The volume of savings of these classes must be considerable in the aggregate and may be very sensitive to psychological inducements.

*Interest Rates:* An advance in interest rates may be suggested as a remedy for this fall in savings. Such an advance must be judged from different angles.

(a) It is probable that the present returns on savings fall short of the required level for inducement to save. This would be particularly true if the return on government securities, fixed deposits or savings deposits is discouragingly lower as compared with returns on other forms of investments. So long as controls prevent the necessary adjustment between the volume of purchasing power in the hands of the public and the price-level, an artificial plentitude of funds ensues and enables purely money rates to be kept low. But when purchasing power and price-levels move towards adjustment, the surplus funds are no longer surplus and real rates of interest assert themselves. In this case, an advance of interest rates means nothing more than conformity to the supply and demand conditions of capital and is a prerequisite to the proper functioning of the economic system.

We must therefore answer the following questions. Will an advance of interest rates induce all classes of people and particularly the second group of people to save more? Is there at present a wide disparity between returns on forms of investment preferred by the second group as compared with other forms? If the returns on other forms of investment are appreciably higher, how is this fact to be reconciled with falling values of such investments? Finally, with the index number of prices at the level of 380-390, could it be said that the volume of purchasing power and prices are adjusted to each other?

(b) An advance of interest rates may be desirable not only as an inducement to save. By making money dearer, it may initiate deflation and a fall of prices. We shall consider in its proper place whether a fall of prices brought about by this means is appropriate and desirable in the present situation.

The figures tabulated overleaf indicate the following trends: The yield on Government Security has been steadily rising since July 1946. As for returns on industrial investments, it must be remembered that most individual dividends clustered round the lower figure during 1926-36 and the higher figure during 1937-47:

	1939	1940	1941	1942	1943	1944	1945	1946	1947	1948
<i>Net Rates of Interest accruing to Insurance Companies</i>										
<i>Indian</i>	4.68	4.37	4.17	3.94	3.88	3.64	3.48	-	-	-
<i>Non-Indian</i>	-	-	3.68	3.50	2.79	3.35	3.22	-	-	-
<i>* Government Security</i>										
3.5 per cent	-	-	3.68-3.65	4.01 (March)	-	-	3.39 (Nov.)	-	-	-
3 per cent	-	-	-	-	-	-	3.08	2.84 (July)	-	3.05-3.03 (Aug.)
<i>Fixed deposit Rates</i>										
<i>Imperial Bank</i>	1.5	-	-	1.5						
<i>Punjab National Bank</i>	2.875	-	-	2.5						
<i>Average Dividends per cent.</i>										
<i>Highest &amp; Lowest :-</i>	1926-36	1937-47								
<i>Cotton Industry</i>	24.6 7.6	40.3 8.6								
<i>Jute Industry</i>	72.0 15.7	21.6 7.3								
<i>Sugar</i>	21.3 11.0	17.0 9.0								

\* In this case, the interval between two dates represents continuous rising or falling movements

The yield at present prices works out for most of them between 4 and 8 per cent. The fall in the values of these investments must be ascribed to doubts firstly, whether industry could maintain its profits at the present level, the present trend being distinctly lower year after year, and secondly, whether the Government could maintain interest rates at their present levels, the trend being towards greater scarcity of money year after year and greater adjustment of prices to the volume of purchasing power.

### Fall in Volume of Investment

It is difficult to say whether there has taken place any measurable fall in the volume of investment. During the War, all surplus funds went into government loans for purposes of war. Even after the War the obstacles to the acquisition of capital goods and basic raw materials have continued to the same extent. The applications for capital issues and the consents given are an index only to plans of investment and not to investment itself. We have no statistics of capital paid-in and even if they were available, they could indicate only the liquid funds seeking investment. So long as capital goods do not flow in and basic raw materials are not available freely, willingness to invest or absence of it has little effect on actual investment.

The collapse of investment values is sometimes suggested as a deterrent not only to investment but also to saving. It is not clear why depreciation of equities, etc. should affect the volume of savings itself. If investment becomes risky, savings will tend to be kept in a liquid form—in fixed deposits, short-term government securities, current-balances, etc. Unless people are persuaded that no investment is possible today or in the future, there is no reason why the volume of savings itself should fall off on this account.

If the volume of investment shrinks and funds are kept in liquid forms, this should act as a deflationary force. Fall in the volume of investment means fall in incomes and ultimately a downward pressure on employment and on prices. There is certainly no evidence of such a trend.

A depressed outlook on the prospects of investment has a significance for the future when investment starts in earnest. So long as that day is far off, this depressed outlook can affect the value of only existing scrips. It matters little for the present



functioning of the economic system whether these values are high or low. A fall may even be salutary because it automatically reduces the temptation or the power to liquidate and spend. The only precaution about which the authorities have to be careful is that this depressed outlook should not persist or deepen till the day of resumption of investment. If the authorities adhere to the pattern of a fixed policy, the present gloom is sure to work itself out in due course of time.

The fall in equity values might even prove salutary and a much-needed initial preparation for healthy investment. The present bear phase of the investment market is the outcome of two forces. Firstly, the unbridled speculation which started at the end of the War was not in any manner checked or counteracted by the market authorities. This speculation was reinforced but was certainly not caused by the imprudent abolition of excess profits duty, and cheap money policy and conversion operations. No one in his senses will believe that the absurd equity values which prevailed before August 1946 could have ended in anything but disaster. If the market authorities had during the tremendous boom taken measures similar to those which the Bombay Stock Exchange introduced after the Liaquat Budget, the boom and the collapse might have been much less severe. The second factor which is responsible for the debacle in the investment market is a series of events—strikes of labour and public utility employees, the Calcutta riots, the Liaquat Budget, awards of industrial courts, Partition outbreaks, organized bear raid in January 1948, publication of the Congress Economic Committee's Policy Plan, another organized bear raid following the Shanmukham Chetty Budget, ministerial unauthorized and quite unnecessary utterances from time to time—to mention the most outstanding in a roughly chronological way. This record of events, it will be observed, centres largely on government policy which was never devised or presented as a consistent, well-defined whole but was thrown out at trade and industry in haphazard ejaculations.

The Government must accept a large share of the blame for the present plight of the investor. But, whatever the excuses or provocations for the landslides of the stock-markets, the revision of equity values to conform to post-war costs and profits was an absolute prerequisite of healthy investment. The mistakes

of the Government could at the most have hastened prematurely this inevitable and necessary adjustment. The Government has now before it a valuable interval of time before private investment starts with any appreciable earnestness. It will be wisdom on its part to make use of this respite to devise proper, permanent reforms for the investment market and joint-stock enterprise so as to avoid the scandals of the last few years. The fiasco of the Stock Market inquiry instituted in 1944 which culminated in an astounding document has a lesson for the Government not confined exclusively to this sphere as such. It is yet to be proved that the Government has even an awareness of the lesson.

Although in general there is an enforced limited scope for private investment, there is one possible exception. House-building should evoke no little eagerness in all areas—urban or rural—if it were not held up by the obstructions implied in all controls. If Government retired from this field and allowed raw materials to be obtained freely, the pent-up investment enthusiasm might find a healthy outlet. But controls and transport bottlenecks must be cleared out of the way first.

### Public Taxation, Expenditure and Investment

In a phase of falling savings, increasing consumption and limited private investment, what function could public expenditure and investment assume?

It is indeed obvious that the Government must reduce or bring to a halt all unproductive expenditure. "Unproductive expenditure" means in this context expenditure which adds to the demand for consumption goods without much prospect of adding to their output. The Government must also curtail all long-term investment which leads to immediate disbursements of incomes but much delayed fruit in the shape of commodities.

With the trend of private expenditure to increase and limited private investment, reduction in taxation or borrowing appears to be out of question. There appears, indeed, to be a strong case for increase but for certain obstacles. The present level of taxation of certain classes of incomes seems to have reached its maximum and is perhaps already affecting adversely the incentive to produce. For further increase in taxation we must seek out other classes of people. Income-tax on agriculture

or duties on inheritance offer a certain scope. Taxation of luxury-consumption already introduced by the Government has but little scope as the use of luxuries is confined to an insignificant fraction of the population.

Borrowing or alternatively a compulsory levy in return for Government bonds is suggested as another remedy. A compulsory levy has some justification only if it could be proved that people prefer to keep their cash liquid, rather than offer it to the Government. Even liquid cash is to be encouraged if it tends to reduce private expenditure. The main question to be answered is whether borrowing or compulsory levy will in any manner touch the funds which people are inclined to devote to expenditure. Unless the incentive to lend is very high or compulsory levies reach impracticably high levels, it seems highly improbable that the volume of expenditure will fall. The only usefulness of such measures should be that the Government is likely to use these funds to better purposes than private persons are now doing.

With such new taxes as are feasible, the present volume of taxation of Rs. 500 crores should be maintained and by curtailing expenditure, a growing surplus should ensue. With this surplus and the sterling at the disposal of the country under the Sterling Agreement, the Government should have quite a large margin for investment. If the sterling were used for acquiring the needed materials abroad, this should relieve to an extent the present pressure on local supplies. If the Government acquired all the iron and steel it requires from abroad, the decontrol of these goods to stimulate house-building could be expedited.

### Disparity between Incomes and Cost of Living

We have two alternative choices before us. The first choice would be to accept the present price-level and cost of living as established facts and to allow incomes to rise to their level. Such a policy would still mean a grave injustice and hardship to all those who hold accumulations of the past. This is a very serious consideration in a country composed of such a large element of persons with moderate incomes, especially the middle-class. All insurance policies, provident funds, etc. created before and during the War must in this case fall to less than half their expected value. Besides, although the principle of a

*Prices and Cost of Living (August 1939 = 100)*

	Wholesale Prices				Cost of Living				Average Earnings of Factory Labour	
	Food	Raw Materials	Miscellaneous	General	Bombay	Sholapur	Kanpur	Jalgaon	All India Rs.	Bombay Province Rs.
1946-7	270	352	—	—	252	303	338	—	619	—
Nov. 1947	294	377	460	302	273	362	413	—	813	1013 (271% of pre-war)
Aug. 1948	—	—	—	397	321	306	—	434	—	—
Sept. 1948	396	435	531	382	323	309	—	437	—	—

particular average increase is accepted, the adjustment of relative wage-rates, etc. will not be less difficult than the achievement of the average itself. For the Government, it will mean a very serious reshaping of the whole structure of taxation and expenditure.

The other choice is to reduce the price-level and cost of living to somewhere near their post-war mark. A controlled fall in the index number from about 400 to about 250 is not an easy task. Whether such a fall will settle the issue of class relations must depend on the means employed to bring about this fall. The fall by itself does not assure justice on this point though it means relief of immediate distress.

(a) The immediate removal of the causes of the recent inflation is only a first step. The accustomed rate of saving may be restored. The Government may halt its present unproductive expenditure and even create a surplus. In an expanding economy, this might have been sufficient by itself to cause not only a halt to rising prices but even a reversal of the trend. In a stagnant economy where productive power is hardly even maintained, the chances of any appreciable fall are very limited.

(b) Another means which suggests itself naturally is increase of output. With 1939 equal to 100 for the output of our industry, the highest level reached was 126.8 for 1943-44. Today the index number stands at about 107. It appears therefore, on paper at least, that there is some margin for raising industrial output. But the scope for increase is not as large as these figures indicate since we have to allow for special war effort, subsequent wear and tear of equipment, etc. If we recall that agricultural output must also be reckoned, the aggregate war-time improvement will be much smaller and the possibilities of present increase much more slender. It is difficult indeed and hardly feasible even to estimate the increase in output which could bring down prices from 383 to 250. It is important to remember, however, that in 1943-44 when the industrial output index number was the maximum at 126.8 and the price-index number was at 236, the note circulation was Rs. 882 crores for the whole of India. Today the note circulation for India minus Pakistan is Rs. 1254 crores. If the price-index number were sensitive to industrial output as such, the present note circulation alone would justify a price-level of much more than 335. Apart from over-simplification which such calculations unavoidably in-

	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46	1946-47	1947-48
National Income (in crores of rupees)	1,934	2,058	2,336	3,373	4,233	4,270	4,238	—	—
Index Number of Industrial output ( <i>Eastern Economist</i> )	110.3	114.2	123.2	125.5	126.8	121.7	120.0	105.0	107.6
Labour in Factories—Perennial (in lakhs for calendar year)	14.5	15.4	18.4	19.8	22.4	28.1	26.4 (24.8)*	23.1*	

\* Excluding Punjab & N.W.F.P.

volve we have to allow for the fact that in 1943-44, the demand for war requirements was at its greatest while now the whole of this output is available for civilian consumption. We must not overlook also the reduction in the hours of labour, number of shifts, the transition from war to peace psychology, etc. The increase of output should lower the price-level somewhat below what such calculations indicate.

From the standpoint of output what we are up against is not a mere economic deadlock but a far more serious psychological deadlock also.

Labour resents advice to increase output as a device very largely to increase profits. The answer of the Government is a succession of ill-examined or half-examined proposals—profit-sharing schemes, a dividend limitation measure, share in industrial administration, promises of nationalization in the future, etc. The advanced sections of labour feel that to increase output is to give a fresh lease of life to the old system and that the world-wide trend in economic ideology will not be recognized by the other parties except under compulsion and obstruction.

The initiative of the "Capitalists" ended with the publication of the Bombay Plan. They are now paralysed by uncertainty—uncertainty about profits, taxation, ownership of industry, control and management of industry and, perhaps in some instances, the fate of profits from tax-evasion and law-evasion. The uncertainty is caused only partly by confused counsels in the Government. It originates much more in their psychological inability to accept a new economic order as an inevitable, even if unpleasant, fact and to take initiative accordingly. The answer of the Government to these fears is tax-exemptions, tax-reliefs, depreciation allowances, stabilization of profits, vain attempts at joint and agreed decisions on disputed points, compulsory arbitration, more vagueness about nationalization, etc.

When a psychological deadlock of this kind is reached, it means two things—either capitalism must be given up as a working system or Government, Labour and Business must reach an agreement on all heads which the State will enforce with all the power of law at its disposal. It is worse than futile to deal with the situation in a piecemeal manner. It is much more dangerous to announce intentions in advance of detailed examination and positive adoption of plans—particularly when the

intentions relate to dates as distant as five or ten years. When one party to the economic system refuses to recognize that its basic presumptions are breaking down fast, another party is bent on destroying it by sabotage and the Government cannot rise above the level of amateurish ideas, it is only a question of time when all will be involved in a common ruin.

### Effects of Advance in Interest Rates

The classic weapon for deflation and fall of prices is an advance in the interest rates and other supplementary or reinforcing measures. Could an advance in interest rates be trusted to bring about the desired fall in prices and cost of living? To answer this question, we must bear in mind how exactly advancing interest rates bring about their expected effects. Advancing rates (i) reduce the volume of credit offered—particularly by banks; (ii) increase the expenses of production, particularly in those lines which employ much capital relatively to labour and thus force a contraction of business; and, most of all, (iii) by deterring further investment, bring about a fall of incomes and therefore of prices as well.

(i) As for the effect of advance of lending rates on supply of money and particularly credit, the issue is not without serious doubts. It is true that a substantial deflation of the large volume of notes and deposits holds out greater assurance of fall of prices than any other means. But bank credit is a relatively smaller source of funds in this country. It is not improbable that in case of a squeeze on bank loans, funds will be drawn out of other sources. It is possible to support advancing rates by sale of Reserve Bank investments and withdrawal of funds from the market. But a prolonged period of inflation is hardly favourable for accumulation of investments by the Central Bank and the ammunition might well run out before the first phase of the battle is over.\*

(ii) As for increase of expenses on account of higher rates,

\* *Reserve Bank of India Investments (in Crores of Rupees)*

1949	March	9	1947	March	58
1945	„	17	1948	„	73
1946	„	31	1947	November	96
			1948	August	55



the scope for action is limited only to stocks of manufactured goods. The main stocks to be held in this country consist of agricultural produce and the output of these commodities is hardly sensitive to expenses of holding stocks. Higher rates will be passed on in smaller prices to the producer once and for all. The fall of prices is not likely to be appreciable and it is not even certain that with the present obstinate scarcities, increased expenses may not be passed on to the unfortunate consumer in higher prices.

(iii) The main effect of advancing interest rates should be felt on the volume of investment and income. On an economy which has capacity for expansion, the inhibitive effect is large and instantaneous. Unfortunately, we have to deal not with an economy in which investment is active but with a stagnant economy. Advance of interest rates will cause depreciation of existing investments. Such depreciation means no change in output capacity. Beyond that, it will achieve very little by way of increase of output.

Resistance to advance of interest rates springs sometimes from a cause different from those discussed till now. It looks like a breach of faith with those who subscribed to loans during the War at continuously falling rates. If necessary the objection could be met by revising simultaneously the rates allowed on all such war loans till now. The burden on the Public Exchequer should not exceed one per cent on the average or one crore of rupees on a total indebtedness of 100 crores. In a total budget of about Rs. 250 crores, it should not be difficult to find Rs. 5 crores for this purpose. A good part of the increase in interest will probably flow back into the Exchequer *via* income-tax and super-tax.

As made clear earlier, an advance in the interest rates has to be assessed both as an inducement to save and as a means of restraining prices. The foregoing discussion makes it clear that its capacity for deflation is, in the present circumstances, very little. A fall or a rise has little relation today to our productive capacity. But as an inducement to save and refrain from consumption, an advance in rates may have quite notable results.

### Start to Investment

From our discussion till now, one fact stands out very

prominently. Normal correctives to our economic difficulties are not appropriate because our economic system is not functioning in a normal manner. Neither in our trade relations with the rest of the world nor in our trade relations among ourselves, does a higher price for a commodity bring forth its proper supply. We have reached a state of economic deadlock. In this deadlock, the most significant factor is the standstill nature of investment. Savings have to be encouraged not merely to draw away purchasing power from consumption but also in order that they should augment our productive capacity. Efforts have to be made to raise the output of existing equipment but the margin for raising the output is not large unless we invest and add to the equipment. Changes in interest rates have ceased to function because the volume of investment has ceased to be elastic. The investment market has ceased to have a positive function because though savings may be forthcoming for new enterprises, they must remain in liquid forms for want of the necessary goods and equipment. Some effective measures must be taken to start the normal processes of investment.

In the altered circumstances and ideology of the times, private investment and public investment have both to play important roles. Whatever the actual decisions on the points of dispute about them, care must be taken that the aggregate volume of investment remains at the desired level and progresses at the desired rate. Until the investment mechanism starts to function it is idle to raise paper controversies about our ultimate ideals.

What are the causes which have brought to a halt private investment? (i) There is first the inability or unwillingness of the highly industrialized countries to supply capital goods. Offer of a higher price is today not sufficient to attract the needed goods. Most countries have imposed physical controls to assure priority for their own rehabilitation. Trade-agreements and currency practices fix arbitrarily the channels of trade. It is clear that we must exert all our bargaining power to secure the satisfaction of our immediate pressing needs, not only of equipment but also of personnel.

(ii) A factor which repels investment is high prices of capital goods and high labour costs. Capital goods are reported to be three times as costly as they were before the War. Measures have to be devised to counteract this obstacle. Trade

and industry must be enabled and encouraged to provide for depreciation on a scale which protects them against this dead weight. Mere allowances in taxation are not enough. The basis on which depreciation is to be calculated on invested capital is important. If capital goods are three times as high, the basis should be at least  $2\frac{1}{2}$ -3 times the pre-war book value. On new capital goods installed, some depreciation fund must be created before taxation is levied on gross profits. The other obstacle is largely psychological. If capital avoids investment because of high prices, it must be due to an expectation that present prices are abnormal and will not last. This psychology is incapable of direct treatment except by creating some insurance along the lines just now suggested.

(iii) It is to be feared that controls on basic industrial raw materials are not a little responsible for the stalemate even in lines in which scope for immediate investment does exist. Housing is the most important issue at stake here. Before the War half, perhaps even more than half, our savings went into this form of investment every year. According to the location of the place, the raw materials of house-building are very varied and capable of very wide substitution. But so long as controls exist, iron and steel, cement, timber, etc. cannot reach the right places and the right hands. Some of these materials are in short supply but it is better that they should be freely available than that they should have to pass through a series of parasites before *bona fide* persons can obtain any supply at all. Certain suggestions will be made presently to relieve the pressure on these supplies.

If private investment does not show signs of life and savings accumulate or are enforced, the case for public investment is very strong. While the resumption of the normal rate of saving will exert a downward pressure on prices, public investment will reinforce it by adding to the output of those goods which are deemed vital in our present situation. As public investment is hardly likely to encroach on or run along competitive lines, the risk of depreciation of investment does not exist. It is true that the public will have to pay for the high construction costs but against it must be set the fact that a planned investment over some years might put heart into private investment by assuring demand for certain goods for a period.

The Government would do well to secure from abroad supplies of goods of which there is shortage here. Such a policy will achieve two things. The local shortages will not be aggravated. Secondly, the balances which are allotted by the United Kingdom for the next few years would be fully used without the necessity of parallel monetary measures here. Even if the cost of foreign materials is relatively higher, compensation will be reaped on the cheapness of domestic investment in the private sector.

#### IV

### Immobilization of Purchasing Power

We have examined now several means to deflate present high levels of prices and cost of living. In every case—halt in public expenditure, further taxation and creation of surplus, increase of output, advance in interest rates, impetus to private and public investment—we encountered stiff obstacles. A moderate but steady and determined application of every one of these remedies should in course of time bring about some mitigation of present conditions. But will such non-spectacular exhibition of economic common sense be sufficient to the needs of the situation? According to certain persons, direct immobilization of purchasing power and perhaps its gradual release offers a drastic and immediate solution of the problem.

Before stating and examining the wisdom of possible measures in this direction, it is well to bear in mind one crucial warning. A mere fall in prices and cost of living is not the sole object we should aim at. An equally urgent and, from the standpoint of our permanent progress and welfare, much more important need is to assure increase of output and a proper functioning of the economic system both in the public and private sectors. Measures which offer immediate prospects of fall in prices but at the same time deepen and complicate our present economic deadlock are not to be adopted light-heartedly.

### Possible Remedies

The measures likely to achieve immobilization of purchasing power are stated below in the order of increasing severity.

Every one of these measures requires very careful con-

sideration and scrutiny. It would be of little use to embark on a full discussion here when the question of remedies is still on a hypothetical plane. The difficulties to be faced are grave and enormous. The best wisdom in a complicated economic structure like ours would lie in avoiding dependence on any particular remedy or set of remedies, and putting into effect simultaneously all possible measures for relieving the situation. A few general observations are all that is sought to be recorded here.

(i) *Enforced margin for bank loans generally and against particular commodities:* This remedy presupposes a much closer contact between the Reserve Bank and the commercial banks than exists at present. There is possibility of evasion by collusion between the banks and their clients as to valuation or ultimate destination of a loan. It may create a black market in loans. Some banks will be adversely affected in their profits.

(ii) *A variable proportion of deposits of scheduled banks to be compulsorily deposited with the Reserve Bank:* This remedy is already in operation in the U. S. A. The actual arrangement links this proportion not only to the volume of deposits but also to the turnover of deposits. The limitations of this arrangement should, however, be borne in mind. The volume of checkable deposits is only about a third of the purchasing power in this country. Secondly, business is able to raise a very large volume of funds from outside the banks and at rates which are more favourable than the lending rate of banks. If the profits of banks fall it might cause some harm to the position and status of certain banks.

Alternatively, it is possible to empower the Reserve Bank to issue its own debentures or in other words to increase its volume of investments at will and unload it on the market. The procedure has this advantage over Government loans—there arises no question of the employment of these funds. The Reserve Bank whose income is inflated by issue of notes has to bear automatically the burden and penalty of deflation. This remedy has not yet been adopted anywhere.

(iii) *Full freedom of imports and withdrawal of all notes to the extent of any adverse trade balance against payment of sterling abroad:* This would mean abandonment of the idea of curtailment of unnecessary consumption and of creation of enforced

savings. It must be remembered that in the absence of investment, such enforced savings mean hoarded currency or purchase of existing investments and durable goods at continuously inflated prices or expansion of working capital, which in the absence of increase in labour or raw materials, adds to the general inflation. It is to be feared that most of the war savings have been wasted in this manner.

This remedy is limited by the sterling, soft currencies and hard currencies available within the respective areas in addition to our exports to them.

(iv) *A controlled but higher exchange rate to stimulate imports and cause a check on and fall of prices of export goods:* The use of the weapon is limited by the degree of fall in our essential exports and the availability of foreign currencies which might be aggravated by the fall in exports. It conflicts with our obligations towards the I.M.F. and in the present circumstances might provoke export controls and other retaliations.

For 1946-47, on private and Government account, our imports stood at Rs. 330 crores and exports at Rs. 320 crores. The total visible balance of trade inclusive of treasure was Rs. 40 crores against us. For the previous two years, the adverse balance amounted to Rs. 26 crores and Rs. 33 crores respectively. Even after March 1947 the trade balance is against us on the whole, though the figures are not comparable on account first of the exclusion of Pakistan altogether since August 1947 and later its inclusion among foreign countries after July 1948.

A controlled high rate is at best a temporary expedient. The higher it is, compared with domestic and foreign price levels, the more difficult and tardy must be the return to free commerce and equilibrium rates. It is more than probable however that the day of normal conditions is very distant and the freedom which was permitted to France might be claimed with equal justification by India.

(v) *Surrender of all or selected British assets in this country and their sale against accumulated sterling balances:* In the prevailing circumstances, the release of sterling and the acquisition of British assets must be treated as alternatives. This step might facilitate the nationalization or part nationalization of certain industries. But the main object should be to offer an outlet to

savings wasted at present. If the offer of these investments stimulates savings, to that extent inflation will be counteracted.

(vi) *Acquisition of gold and silver against sterling balances and sale in this country*: This is primarily a question of sterling releasable by the United Kingdom or available dollars. The effect on inflation depends on the extent to which it stimulates savings. Offer of British investments is a better alternative than the sale of gold and silver.

(vii) *Special graded levy on incomes*: This has been already considered earlier.

(viii) *Nationalization of gold and silver stocks in the country and their use for financing imports from hard currency areas*: This would be the best means of creating unlimited foreign exchange. If conscription of life and blood for defence is justifiable, conscription for our material advancement is a comparatively mild measure. Two per cent bonds would not be an ungenerous compensation for the conscripted gold and silver. Its success depends on the administrative capacity and moral authority of our Government. The seizure of safe-deposit vaults, freezing of alternative possible stores of value like precious stones, a complete prohibition of loans against or exchange of notes for bullion by banks, abolition of the prohibition of imports in order to lower the value of bullion to a more natural level—these and other ancillary steps will have to be promulgated to ensure the success of the policy. If bullion disappears underground in the process, it will be a desirable end of a potential inflationary threat.

(ix) *Blocking of bank deposits and their gradual release according to the behaviour of the price-index*: The extent of this remedy is limited by the relative unimportance of deposits in our purchasing power—particularly the purchasing power in rural areas. It might give a blow to our banking habit and to less well situated banks. It was tried with success in Belgium—a small country emerging out of the complete dislocation caused by the War and with a highly developed banking habit.

(x) *Withdrawal of 100-rupee notes in exchange for two per cent Government Bonds*: The restraining consideration is the exposure of the character of our people and of the administrative efficiency of our Government and the Reserve Bank which occurred when 1000-rupee notes were demonetized. An offer

of two per cent non-transferable bonds in exchange for the notes on a regressive scale might prove less of a strain on the honesty of our people. The non-transferability could be limited to ten years in the first instance and transfer allowed thereafter only by registration. The measure will have greater chance of success if stocks of precious metals, etc. are first-frozen or, better still, they are nationalized with a deferred payment on a regressive scale after ten years.

(xi) *Stop on wages, salaries and profits*: This has very little meaning unless the output expands or prices are brought down by other means. With an inflating price-level, stop on wages and salaries means increase of gross profits; and stop on dividends means either appreciation of investments or increased revenues for Government. Unless the cost of living is brought within the reach of most incomes, a stage is bound to be reached, sooner or later, when the stop will be no longer enforceable.

### Controls as a possible Remedy

In our search for remedies for present inflationary conditions we have found no place for re-imposition of controls. The fact is that controls are not a remedy for inflation but only a palliative. A palliative is perhaps unavoidable in the present circumstances; but it would be a grave error to mistake it for a remedy. It is very vital that the distinction should be clearly understood and grasped.

Controls as a palliative for inflation are to a certain extent different from war-time controls. The War, by the obstacles it put in the way of normal supplies and by the demand it made on available stocks, created acute shortages of consumption and other goods. There was of course inflation but the main evil to be dealt with was shortages. Today war as a cause of shortages has ceased to exist and although shortages persist, the main evil to be coped with is inflation.

Controls tend to place a premium on a form of investment which locks up the capital resources of the community and intensifies shortages. In ordinary circumstances, stocks of goods are built up to the level sufficient to ensure an uninterrupted flow of supplies from the producer to the consumer. Controls create a host of parasites between the producer and consumer whose sole object is to hold up supplies till they extract their



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### Controls as a possible Remedy

In our search for remedies for present inflationary conditions we have found no place for re-imposition of controls. The fact is that controls are not a remedy for inflation but only a palliative. A palliative is perhaps unavoidable in the present circumstances; but it would be a grave error to mistake it for a remedy. It is very vital that the distinction should be clearly understood and grasped.

Controls as a palliative for inflation are to a certain extent different from war-time controls. The War, by the obstacles it put in the way of normal supplies and by the demand it made on available stocks, created acute shortages of consumption and other goods. There was of course inflation but the main evil to be dealt with was shortages. Today war as a cause of shortages has ceased to exist and although shortages persist, the main evil to be coped with is inflation.

Controls tend to place a premium on a form of investment which locks up the capital resources of the community and intensifies shortages. In ordinary circumstances, stocks of goods are built up to the level sufficient to ensure an uninterrupted flow of supplies from the producer to the consumer. Controls create a host of parasites between the producer and consumer whose sole object is to hold up supplies till they extract their

price or their premium. If in the ordinary course one quarter of the total goods needed by the community is held in stocks, under controls as much as one half may be found at any time in the possession of these authorized or unauthorized traders. No small part of the trading capital of this country finds its outlet at present into this anti-social activity.

The proper function of controls in times of peace is to prevent costs and wages from racing after prices and thus to offer a temporary respite during which spiralling prices could be checked and lowered to a reasonable level.

Controls cannot hold in check inflation. They merely offer a breathing space during which inflation can be checked and prices brought down in alignment with costs and incomes. If inflation continues, a stage must arrive when controls themselves will be disrupted. The additional purchasing power which inflation brings into play must either remain idle as hoards or have its impact on uncontrolled lines of production. In the latter case, wages will rise in those lines and labour will move away from the control-affected commodities or insist on and obtain a parity of remuneration between the different lines. This is probably what is happening to rural labour which is slowly drifting to the towns. The fall in the produce of land is, therefore, not merely a coincidence of natural forces. It is very likely that land is not attracting labour today in as high a proportion as our backward technique of cultivation requires. It is also significant that in the case of organized factory labour, employment has been falling since 1945 under almost every important head except 'food, drink and tobacco' and the wages of cooks and domestic servants are rising fast. These are the lines in which prices are uncontrolled. If, to remedy the disparities of wage-levels, wages in the controlled lines are brought into alignment with those in the uncontrolled lines, higher wages will soon cause an upward revision of prices and thus frustrate the controls themselves. In short, controlled prices in certain lines cannot be maintained indefinitely, while inflation continues unchecked; and while they last, they create a most serious problem of wage-adjustments in different trades and industries.

It would be prudent to consider whether the steady inflationary trend is not an expression of basic economic facts. When the income of an individual falls he has two alternatives

before him. He can borrow from others or liquidate his investments and maintain his accustomed standard of life. The other alternative would be to revise his standard of life to suit his present income. When the output of a country falls, the situation is not materially different. If the fall is expected to be temporary, it may be defensible to live on loans from abroad or accumulated past investments. In the case of India, these sources hardly exist. The only alternative possible for us, therefore, is a general reduction in the standard of life. The question arises whether our present controls fix our standard of life at the level of our output or whether they fix it above that level and thus aggravate shortages.

Controls—the twin devices of rationing and price-fixation—are an effective means for redistribution of national income. Ordinarily, government taxation and expenditure are employed to achieve this object. But when it is not feasible to transfer incomes in this manner from one class to another, the same object can be achieved by means of controls. Instead of raising small incomes, controls simply bring commodities and services within the reach of these incomes. The ordinary law of Economics is that the producer must not receive in excess of what he contributes to the output. It is possible that controls may operate in such a way that the worker is enabled to consume more than what he produces. Such a rise in standards of life is not to be always deprecated for, in certain circumstances, it may be followed by immediate improvement in efficiency. But except for this likelihood, it would certainly not be prudent for a country to try to live beyond its means in this manner. This is so not merely because one class of workers consumes more than its output and other classes have to forgo their share of the output for their sake. The ultimate outcome of such a situation might well be that other classes will cease to produce as much as they could and thus aggravate shortages and inflationary conditions.

It is probable that we are trying to maintain a level of consumption in food and cloth much above what the country can afford. There appears to be a vague realization of this fact in that exports of cloth of certain varieties are now to be freely allowed. This is nothing but an invitation to consume less cloth and to use the balance for paying for our imports of food. This

food is then to be placed within the reach of the mass of people by subsidizing it out of taxation levied on the more well-to-do classes of people, that is, by curtailing their superfluous consumption or their savings.

Could not the same adjustment take place in a free market for food-grains and cloth? If people on the whole prefer more food and less cloth the prices of food will rise much and the prices of cloth will also rise but to a lower level corresponding to the decreased expenditure on cloth. If stocks of food built out of the subsidy funds were released in a discriminating manner, it should relieve the food situation from time to time. Such a course of action has certain advantages. It leaves to the people themselves the choice whether to have more of food or more of cloth and how much to have of each. It dispenses with controls which have an inhibiting effect on the investment and production mechanism. But a free market in the present conditions presumes that monetary factors are kept under strict check and control and not allowed to play again the havoc of the few months of decontrol the country has enjoyed.

## APPENDIX

### INFLATION\*

#### Probable Factors in Recent Price-rise

Prices do not rise unless consumers, including investors, increase their outlay on goods. A strange and therefore suggestive feature of the present situation is that while raw materials and consumption goods have experienced a steep rise of prices, investment values are at a low ebb. An ominous feature of the rise of prices is that the short period from November 1947 to July 1948 has witnessed an upsurge greater than in the preceding two years, 1947 and 1946. It is all the more ominous because during these few months production has on the whole recorded an improvement.

Decontrol of food, cloth, sugar, etc. by itself need not raise prices. It raises prices only when what income-holders were forced to save on account of rationed consumption and fixed prices is now spent on these decontrolled goods. Of how many income receivers in this country, however, could it be said that their expenditure during the controlled era left them with a surplus?

Prices of consumption goods may also rise because people on the whole are inclined to save less and spend more. This might happen in three conceivable ways. Firstly, individuals as such may lose faith in the virtue of saving. There is as yet no direct evidence of this loss of faith, although the recent stability of Post Office savings and cash certificates and of fixed deposits in the commercial banks deserves to be watched. Secondly, what people saved and invested formerly is perhaps being seized now by the Government by way of heavy taxation and disbursed largely on unproductive purposes. Our recent budgets certainly deserve closer scrutiny from this angle. Thirdly, the pattern of income-distribution in the community is perhaps changing in such wise that a large share of the national

\*Reproduced from the Freedom Number of the FOKUM, Bombay, 15th August 1948.



income now falls to the lot of the mainly consuming classes. During the War, traders and business classes had their heyday of exploitation. Has the decontrol of agricultural commodities altered the ratio of exchange between agricultural and non-agricultural goods in favour of the consuming peasant? If the flow of new savings is slowly drying up, this fits in well with the fact of the moribund state of investment markets.

### Investment disburses Incomes

Every act of investment disburses incomes immediately. But the fruit of investment is delayed for a short time or a long time according to the character of the investment. Damodar Valley may mean a waiting period of 20 years; Konya Valley, perhaps of 10 years; education, of 30 years but health and medicine, perhaps not more than 3 years. In the mean while, disbursement of incomes means inflation, of shorter or longer duration according as we prefer one kind of investment or the other. In the schemes of development and reconstruction at present in hand, which predominate?

Prices sometimes rise because money-incomes of people have risen. Money incomes do not rise unless the volume of money is raised or the volume of bank-credit expands. From November till now, the note circulation has mounted by about Rs. 100 crores and demand deposits by about Rs. 50 crores. Is this rise purely seasonal? Or, is the Government financing itself by ways and means advances first, to be covered by issue of notes later? If the Government is depleting its accumulated balances—they are estimated to have fallen by about Rs. 175 crores over the last two years—the effect is the same as when an individual sells his investment—present savings are consumed. How far have these three factors been at work? Have they been particularly at work during the last six months?

Expansion of money and credit could occur within the monetary system itself. If the market rates of interest are maintained much below the current rate of profit and what the level of savings justifies, a pressure on loanable funds must develop. There is nothing in the world like "discriminating support" to the security market. The prevailing level of market rates is either correct or it is not. Meaningless words are not a good cover for scientific ignorance.

The volume of expenditure could rise because people have begun to throw away money. It could also rise because people have taken into their heads to throw away their past investments and make the best of life while life lasts. Fortunately, except in the case of the uprooted people and refugees, there is as yet no trace of these tendencies. But wise statesmanship should remember that in certain situations people's temper and patience are apt to be short, much shorter than we many times imagine.

### **International rise, threat to domestic price-level**

In certain contexts, rising prices in the outside world mean a threat to the domestic price-level. Contrary to the expectations aroused in last February and March, prices in the U. S. A. have staged a most ominous upward movement during the last few months. Fortunately, their immediate effects on our prices are limited. By severe restrictions on or prohibition of exports, we have prevented our prices of raw cotton, cotton goods, steel, and food-grains from rising to the level of the war-devastated world outside. As the benefit of high export prices are confined only to tea, jute, oilseeds, etc. we have to limit our imports within the range, firstly of the barest essentials, and secondly, of those goods which we are prepared to subsidize, as in the case of food or goods whose prices are essentially non-competitive, as in the case of machinery.

There are two possible dangers in this situation. If such imports do not equal exports, unrequired exports, accumulation of foreign exchange and finally inflation must ensue. Secondly, high-priced machinery may prove as much a burden as high-priced final goods—the products of the former may prove as unsalable as the goods themselves at the prevailing level of domestic prices. Then must ensue an economic deadlock—industrial expansion halts because capital goods are too high priced, capital goods are too high-priced because prices of their products are kept at a lower level than the world-level, prices of their products are kept low because industrial capacity is not expanding sufficiently! Could both these dangers be met by raising our exchange rate to the highest level compatible with our present volume of exports?

**PART II**  
**DEVALUATION**

When on 19th September, 1949, the United Kingdom announced the devaluation of the pound sterling from \$4.03 to \$2.80, India was confronted with six alternatives. (i) India could have devalued her rupee both against the pound and the dollar. (ii) India could have left her rupee free to find its own level which in our circumstances means general devaluation. In concrete terms, this means that our rupee today should be equal to something less than 1s. 6d. and in relation to the dollar, the parity should stand at much more than Rs. 476 for \$100. (iii) The next alternative was to devalue the rupee against the dollar to the same extent as the devaluation of the pound sterling. We chose this course and this is why our rupee continues today at its pre-devaluation parity of 1s. 6d., but in terms of the dollar it has depreciated from Rs. 332-33 to Rs. 476 for \$100. (iv) The fourth course open to us was to devalue the rupee against the dollar but to a smaller extent than the pound sterling. In actual figures, this would have given us a dollar-rupee parity of less than Rs. 476 and a rupee-sterling parity of more than 1s. 6d. (v) In the fifth place, India like Pakistan could have refused to follow the sterling either full way or half way, allowed the sterling rate to rise to 2s. 2d. and the rupee-dollar parity to remain unaltered. (vi) The last choice before us was to try to reconcile the benefits or diminish the evils of both devaluation and appreciation. It is possible to achieve this by introducing multiple exchange rates both for imports and exports.

The first four choices have one point in common. They all involve devaluation against both the pound and the dollar or against one of them. The fourth and the fifth alternatives imply some appreciation against the pound sterling. It is therefore necessary to inquire whether in the present circumstances of our country a change in external parities is at all to be desired and, if desired, whether it should be in the upward or downward direction.

### First Condition of the Problem

We are suffering at present from three great economic evils not unrelated to each other.

(i) From the end of the war till today, our price level and cost of living have risen from somewhere in the neighbourhood of 250 to somewhere near 380, when the pre-war year is taken to be equal to 100. Although these levels have now persisted over nearly two years, it is not yet definite whether we desire to stabilize them at the points which they have reached or to lower them in a smaller or greater measure.

(ii) In spite of import restrictions, relaxed or intensified by fits and starts, the country is running an adverse trade balance of more than Rs. 150 and 190 crores for the last two years respectively, taking into account imports across our land frontiers and on Government account. This adverse trade balance may be traceable in a smaller or greater measure both to lack of adequate exports and to causes which act as stimuli to imports.

(a) The present inadequacy of exports must be distinguished according to the causes at work. One cause which suggests itself is the separation of the Pakistan area which carried with it 80 per cent of our raw jute and a good fraction of our raw cotton, hides and skins, tea, etc. Two important points deserve to be noted in this connexion. Mere separation of the area by itself does not and need not mean loss of these exports. The loss becomes effective only to the extent that we are not able to sell in this area our usual goods like iron and steel, sugar, textile goods, manufactured jute, etc. Even if we are not able to sell these goods in Pakistan, there is still the alternative of selling them in other foreign countries. If, however, because of the prevailing scarcities we decide to consume these commodities at home or because of the required changes in qualities, etc., we are not able to market them abroad, then we must reduce our imports to that extent. Otherwise we shall be living beyond our productive and output capacity. The second point which deserves to be stressed is this. If Pakistan has taken with her our export

assets, it must not be overlooked that she has also relieved us of our import liabilities. The question to be determined in this connexion is whether the export assets exceed these import liabilities. The high probability that Western Pakistan was our source for a good deal of our annual savings which financed a good part of our capital goods imports and investment at home seems to indicate such an excess. The important point of which we must seize hold firmly is this. Whether we want to maintain our rate of investment or our volume of imports on the pre-Partition scale, we must either consume less or produce much more.

Loss of our normal markets or accustomed volume of investment funds cannot account for more than a small part of our export inadequacy. Reports from certain lines of trade indicate that our present prices for certain commodities are too high for world markets. This is where high prices and cost of living are linked with our exports inadequacy. It is but an obvious point that a country suffering from high inflation is not the country from which foreigners will purchase willingly.

The real analytical difficulty about the present position of our exports is that it is not easy to allocate even approximately the share of purely physical shortages and of high prices in our exports inadequacies. If physical shortages are the main cause of our fall in exports, as has happened in the past in days of famines, lowering of prices becomes relatively a less important question.

(b) Our adverse trade balance may be due to an inflated volume of imports. Ordinarily, except when he chooses to borrow, an individual can buy or consume only to the extent of what he sells or produces. A country should not be able to import more than the fraction of its domestic output which it finds it profitable to export. How does it happen then that in spite of import restrictions and over and above what other countries give us by way of loans, we are importing very much in excess of what we are able to export? If our output has fallen and is falling, we should export less and also import less.

If our expenditure on imported goods is persistently more than the foreign exchange we earn by our exports, the disparity must be due to two causes. Firstly, imported goods including investment goods must be more attractive in price, quality or prospective returns than comparable things this country has to offer. Secondly, although high prices mean correspondingly high incomes in the hands of consumers, the expenditure of the community on goods out of domestic output must be less than in proportion to the rise of prices. Otherwise, there will be no balance in the hands of the income-receivers to spend on surplus imports.

The first condition of the greater attractiveness of imported goods is more than satisfied by a country which is passing through a severe inflation and whose exchange rate is not only not falling in proportion to the falling value of its monetary unit but is actually pegged at a point.

It is the second factor of which the meaning and operation seem to have escaped attention entirely. When prices of food, cloth, sugar, housing, etc. are controlled and maintained below the level of money-incomes, the consumer is left with a large balance of his income. With rationing, he cannot spend more on these goods except in the black markets. Even when he spends his surplus income on investment, he finds that he cannot dispose of all his savings because many vital investment goods like iron and steel, cement, etc. are controlled in price and limited in quantity. Hence, there arises the enormous pressure of these vast funds for conversion into imported goods, gold and silver, etc. either for direct use or to be held as stocks.

It is clear that our high incomes are being disseminated through the production of commodities other than food, cloth, cotton, etc., which are controlled in price. Those other commodities are very largely export commodities like jute, oil-seeds, pepper, hides and skins, gums and resins, tea, tobacco, etc. Under ordinary circumstances, high price evokes its own remedy in increased output. Unfortunately for this country, these are commodities the supply of which is limited severely by purely physical conditions. And so far as physical

conditions do not operate to limit the supply, restrictions on acreages, etc. imposed in favour of food, raw cotton, etc. tend to aggravate the same tendency. Herein lies the tragedy of our present economic situation. Stabilization of prices at a high level means price-control over necessities and high prices of our export goods. High prices of export goods mean low exports and high incomes the surplus part of which must attract larger imports. So long as our high price-level and controls continue, this cumulative process of low exports and high imports must continue till all our external exchange resources to finance the adverse trade balance are exhausted. Once more, we see how our inflated price-level is linked with our adverse trade balance both through our exports and imports.

To say this is not to suggest that price-controls and creation of artificial savings are wrong steps in an era of mounting inflation. The mistake lies in not taking appropriate measures when the era of inflation comes to an end. These appropriate measures consist in canalizing these artificial savings into production and investment to the full measure of available external finance and when the limit of external finance is reached, in restoring the parity of prices between export goods and domestic goods.

(iii) Our third great economic evil is the fall in output or its failure to recover to its best levels. The causes of this malady are not above dispute. In agriculture, the tendency is to place the blame on weather. Actually, shortage of labour due to diversion of population into towns and trades in towns is likely to be an equally important cause. In industry, shortened hours of work and slack work have proved great obstacles second only to standstill of investment and bad management.

Rationed food and cloth and the gap between the wages of uncontrolled and controlled trades offer some explanation of the bloated population of the towns and the shortage of labour in the countryside. High construction costs and high price of capital goods, much more than the shortage of investment funds, account to an extent for the standstill of invest-



ment. The deterioration in the level of skill and character of business is only a reflex consequence of opportunities for illegal gains, inefficient tax-collection, large profits due to lack of competition inside and outside the country, etc. Once more, high prices and high cost of living emerge as the main villain of the piece.

The conclusion to which this discussion leads is that a revision of the rupee parity must be judged in the light of, firstly, our objective about the future level of prices in general and the cost of living; secondly, its likely effects on the marketability of our export goods abroad and the expansion of their output at home; thirdly, the prospects of expediting the supply of urgent imports from abroad and the restoration thereafter of parity of prices between export goods and domestic goods; and, finally, the over-all necessity of flow of greater effort and funds into investment and enlarged output.

### **Second Condition of the Problem**

Revision of external parities, when not retaliated against by foreign countries, operates through imports and exports, inflow or outflow of capital, expansion or contraction of credit and revision of interest-rates; and, as the objective expression of all these forces, the rise or fall of price-levels and cost of living.

This logic of the revision of parities is not fully or even to a large extent applicable to our present economic situation. In three broad respects the conditions today are materially different from what they were in 1931 when a world-wide revision of parities took place.

1. Firstly, the world had then suffered an unprecedented fall of prices. In particular, the fall of prices had created a grave disparity between prices of agricultural produce and other commodities which made the trade-balance position of agricultural countries pretty desperate. The object of the world-wide devaluation then was to remedy this disparity, to raise the price-level if possible and to restore foreign trade equilibrium.

Our price-level stands today in the neighbourhood of

380 as compared with the pre-war year. In the United Kingdom and the U.S.A., it is in the neighbourhood of 220 and 170 respectively. The cost of living has risen in these countries in about the same proportion.

Measurement and comparison of price-levels being subject to so many pitfalls, exact quantitative inferences are to be always avoided. But it is clear that devaluation as a measure to raise prices is ruled out on the facts of the situation. It could be employed either to stabilize the price-level at the point which it has already reached or to eliminate the gap between our price-level and the price-level next below us. In the latter case, it would be justifiable to accept the degree of devaluation adopted by the sterling and to make efforts to lower our price-level somewhat so as to bring it into alignment with the United Kingdom price-level. If prices in the U. K. rise as a result of the 30 per cent devaluation, the required fall in our price-level will be less to that extent. The required fall is also likely to be much less for the reason that the devaluation of the sterling is believed to be much more than is warranted by the concrete facts of the British situation. But this means alignment with a much higher British price-level.

The conclusion therefore emerges that devaluation is proper only on the basis that this country is prepared to abandon the objective of lowering its price-level to any material extent.

2. The second great contrast which the situations in 1931 and 1949 present is that we lived in 1931 under more or less free economies in which revision of parities could operate in the normal manner while today we have controlled and restricted economies in which ordinary economic forces are more or less suspended. The prices of several important commodities are fixed by executive authority and can be altered only with the consent of the authority. The prices of several others, particularly several export goods, are subject to excise or export duties which are changed from time to time to stimulate or discourage exports or consumption. Still other commodities are left more or less free of control or restrictions.

With fixed prices of food-grains, raw and manufactured cotton, iron and steel, cement, etc., the incomes of persons engaged in their production are also controlled. Except in so far as the Government claims a share by excise or export duties, revision of parities can exert influence only on the prices and incomes received from the production of other commodities. If devaluation stabilizes the price-level, the disparity between the incomes of producers subject to or free from controls must persist and the pressure of demand for imports in excess of our exports must also continue. If devaluation raises the price-level still further, the disparity must widen still further and with it, the intensity of the demand for excessive imports. The only force which can keep the prices of these two classes of commodities together is the tendency of equalization of wages and the movement of labour from one line of employment into others. But equalization of wages and movements of labour are tardy processes particularly in a country like ours and, if complete and successful, must end in torpedoing all price-controls.

On the import side, revision of parities is equally ineffectual. The kind and qualities of allowed imports are fixed by executive authority and revised from time to time. Appreciation of the rupee will not widen the range of imports although it may cheapen prices and increase their quantities. Depreciation of the rupee again will raise the prices of and have a discouraging effect on imports which are deemed necessary and may even make the adverse balance still worse, under the pressure for imports described above.

3. The third great difference between 1931 and 1949 relates to credit conditions now and then. In 1931, rates were high but capital came out freely. Official rates now and for several years past have been so low that they cannot fall lower. At the same time, there is the curious phenomenon of the clogging up of the channels of investment or misdirection of capital into stocks of imported or domestic goods. It is obvious that cheap credit is no remedy for this state of things and devaluation will serve no purpose at present.

### **Third Condition of the Problem**

No country is entirely free to make a choice of devaluation or appreciation by itself. The United Kingdom is more free than many other countries because she has the assurance of an automatic line-up of a large sterling area of the world and because as their largest market, she can force a number of countries like Holland, Denmark, etc., to follow her. It cannot be said that India is in a comparable position in this regard. As the exporter of tea, she has a vital interest in taking Ceylon, the other great producer, with her. As the exporter of jute and cotton goods, she has a great stake in Pakistan as the source of her raw materials. This common interest extends to several other commodities like hides and skins, etc. In more happy circumstances, Indonesia, Siam, Burma and Malaya are other countries with whom monetary alignment should be of incalculable significance to us and to them. With a common line-up, appreciation can have fewer terrors for our export trade and devaluation fewer attractions. Without such a line-up, the very same decisions must expose us to serious economic perils. On the other side, the United Kingdom is the self-appointed custodian of a large part of our currency reserves and accumulated savings and both the United Kingdom and the U.S.A. are the main source of capital or capital goods. It is obvious that there is a strong case for the formation of a rupee bloc and a great need for a careful balancing of the relative merits of dollar and sterling alignments.

### **Revision of Parities and Trade-Balance**

The first four choices catalogued above involve devaluation against both the pound and the dollar or against one of them. An immediate object of devaluation is to improve the trade-balance of the devaluing country. From this standpoint the volume and character of our trade with the U.K. and U.S.A. deserve the closest attention.

U.K.'s TRADE WITH INDIA  
(In millions of pounds)

	Exports.			Imports.	
	1948	1949 (Jan.- June)		1948	1949 (Jan.- June)
Total	96.6	73.0		96.2	46.1
Machinery	34.0	20.9	Tea	35.1	18.8
Vehicles	12.8	9.6	Jute Mfgs.	15.8	5.1
Chemicals (Drugs & Dyes)	9.8	7.3	Seeds & Nuts	9.6	2.5
Electric goods, etc.	6.0	5.8	Leather Mfgs.	7.2	4.8
Cotton Yarn & Mfgs.	7.0	8.5	Raw Jute	5.9	3.5

INDIA'S TRADE WITH U.S.A.  
(In millions of dollars)

	Exports.			Imports.	
	1948	1949* (Jan.- June).		1948	1949† (Jan.- June).
Total	253.9	126.4		272.7	148.5
Jute Mfgs.	152.6	65.0	Machinery	59.6	42.3
Beverage	14.8	8.4	Grain & prepa- rations	63.5	33.0
Gums & Resins, etc.	18.6	8.2	Vehicles	38.8	15.0
Nonmetallic Min- erals Mfgs.	13.0	6.6	Petroleum products	20.6	15.3
Spices	8.2	4.7	Metals Mfgs.	29.6	15.2
Raw Wool	8.2	4.0	Paints, Varnishes, etc.	19.4	1.5

\* based on three months' figures.

† based on two months' figures.

1. In 1948, our exports to the U.S.A. amounted to about two-thirds of the exports to the United Kingdom. Among the more important articles of exports, it is difficult to single out any, the supply of which can possibly be raised in case of an improved market in the U.S.A. A 30 per cent depreciation

means a 30 per cent loss of dollars on the present volume of exports. Even in ordinary circumstances, it would be idle to expect a rise in output of more than 5 to 10 per cent, and it is likely to materialize mostly in marginal and miscellaneous commodities. The loss, therefore, will be made good very largely by a rise of export prices under the pressure of keener demand.

The same holds good of our exports to the U.K. Except perhaps for seeds and nuts, it is difficult to envisage an expansion in the output of others.

The proportion of imports from the U.S.A. and the U.K. is about the same as in the case of exports, which is of course to be expected from the prevailing trends of trade policies. The important point to note is that under our import restrictions, our purchases both in the U.S.A. and the U.K. are confined to articles of the greatest urgency. Devaluation must therefore either raise the value of our imports or result in the curtailment of supplies of vital goods. In the case of the U.S.A., grains and preparations and in the case of the U.K., cotton yarn and mfgs. are the only important items which could be further pruned.

It appears reasonable to conclude therefore that devaluation, whether against the pound or the dollar, must in the context of present circumstances reduce our foreign exchange from our exports. The relief to be expected in our import liabilities appears very doubtful and may turn out to be illusory. We have seen above the special causes which are operating at present in our economy to maintain the pressure for more and more imports.

If the choice before us was devaluation against the dollar or devaluation both against the dollar and the pound, it is true that the former alternative is to be preferred. It is then simply a choice between disequilibrium of the trade balance on the smaller volume of trade as against the larger volume. It must not be overlooked, however, that quality of imports is not less important than quantity and past trends may not be equally significant for the future. If dollars are the scarce currency while our sterling resources are relatively

abundant, equilibrium of our sterling trade may not prove an entire blessing.

It should not be overlooked that our present trade relations with the U.K. are of a special kind. India is at present running a deficit on her current trade with both the U.K. and the U.S.A. The U.K. on the other hand has her main deficit only with the U.S.A. Our deficit is being financed largely out of releases from the sterling balances and partly from loans from the I.M.F.

According to a previous agreement, the U.K. had undertaken to release £.81 million and also £.15 million convertible into dollars for this purpose till the end of 1951. To this the I.M.F. was expected to add \$100 million. As India relaxed her restrictions on imports in 1947-48 these resources were exhausted even before the end of 1948. The agreement was revised and the U.K. undertook to allot exchange of \$140 million and to release two instalments of £.50 million each for 1950 and 1951, apart from an undefined liability for orders placed by Indian traders before the latest revision of import restrictions. The assistance from the I.M.F. was, however, scaled down from the previous figure of \$100 million to \$56 million. In other words, we had a provision for an adverse trade balance of \$196 million before devaluation was announced.

Why was the U.K. prepared to release sterling balances and even revise the releases when our circumstances required revision? The central fact of the situation before devaluation was that the U.K. was unable to make much headway in the dollar markets. This was largely because her costs and prices were much higher. To maintain her volume of employment, she had to seek countries in which prices and money-incomes were inflated just as in her own case. India was one of those countries suffering from a similarly high costs and prices structure. If sterling balances were not released, India should have had to take measures to cut down her U.K. imports as much as dollar imports. The release of sterling, therefore, was no charity but an instrument of maintaining the U.K. level of employment. The sterling area was really a camp

of countries which were suffering from high costs and prices and were unable to scale them down.

How does devaluation alter the situation? If the trade of the U.K. in the U.S.A. markets improves, her present dependence on the Indian market must diminish. Devaluation is meant to close the gap between the prices and costs of the U.K. and the U.S.A. If this means any appreciable diversion of goods from India to the U.S.A. or, what amounts to the same thing, appreciable diversion of resources from production for the Indian market into production for the U.S.A. markets, the need for release of sterling balances must diminish in the same proportion. We have of course to allow for the general increase of the U.K. output which is expected to result from devaluation. But a fall in our imports from the U.K. would not be a favourable development for India in the sense that the volume of goods available to us and the recovery of our balances must both fall off. If at the same time our trade balance with the U.S.A. deteriorates or can be improved only by further curtailment of vital imports, the effects must be equally unpleasant. The U.K. will no doubt meet her obligation of convertible pounds already agreed to. But what about the future? Sterling balances will be convertible into dollars but at a rate which will reduce their value by 30 per cent.

The effects of revision of parities on the trade balance of a country must not be judged without taking into account the reactions of other countries which share in the same exports or which are the source of raw materials for the revising country. Ceylon is today the only important rival to India in exports of tea. Ceylon is, however, a small country whose exports and domestic economy depend on one or two staples of production. It was therefore inevitable that it should line up with the country of its main export market—the United Kingdom. The position of Pakistan is different. Devaluation as a stimulus to exports and a deterrent to imports holds good only when the exports and imports are not mutually interdependent. The case of the United Kingdom is the most outstanding example. It was always recognized as a strong argu-



ment against devaluation that the United Kingdom imports substantial quantities of food and raw materials from the dollar areas and that the advantage of devaluation to exports may be largely nullified by more expensive raw materials and higher wages. Pakistan is to India what some dollar countries are to the United Kingdom and very much in the same way. It is the source of jute and raw cotton for our great textile industries and may become the main source of wheat in our food supplies. If Pakistan joins the dollar countries, as she has in effect done, much of the advantage, if any, in our jute exports to dollar areas and cotton goods exports to other countries is wiped out, while our jute exports to the U.K. are saddled with a handicap. Without a common alignment in currency, exchange and trade, unilateral action, howsoever politically correct, borders economically on imprudence.

The fourth and fifth choices indicated above mean appreciation against sterling with or without devaluation against the dollar. It is necessary therefore to examine the possibilities of appreciation in relation to our trade balance.

From our discussion of devaluation, it may appear that appreciation offers an actual advantage. Our exports to the U.K. must add to our sterling resources. On the other hand, the closely pruned imports will be cheaper and will have a margin for expansion. This would be true if our exports were in a comfortable position. As a matter of fact, the general experience is that our present prices are too high and our pre-devaluation parity was causing difficulties. Jute manufactures, oilseeds, vegetable oils, tea and sugar in particular are all reported as too high-priced for foreign markets. The main question just before devaluation was whether we are to stabilize these high prices at the expense to some extent of our parity or to lower our price-level and postpone the question of parity to more favourable times.

We reach therefore the disturbing conclusion that appreciation is impracticable unless we desire a drastic fall in our prices and devaluation may well result in further unbalancing of our foreign trade.

### Revision of Parities and the Price-Level

The effect of devaluation on the level of prices must depend on the actual disparity in the prices of the countries concerned and the degree of devaluation adopted. Every situation must be judged in the light of its own facts in which prevailing prices do not by any means hold the first place of importance.

As compared with the pre-war year, the price-level in the U.K. is in the vicinity of 220 and that in the U.S.A. somewhere near 170. The actual devaluation adopted is 30 per cent. The degree of devaluation is distinctly higher than what mere price disparity will warrant. It was certainly not suggested by any special attention to other relevant factors like terms of trade, changes in productivity, tariffs or costs of transport. What weighed with the authorities in the choice of the degree was the desire to avoid the danger of a further revision of the parity. It is also likely that the choice was inspired by the memory of the 10 per cent over-valuation of 1925 and the havoc which it is alleged to have played with output and employment till the devaluation of 1931. Half-hearted measures were probably regarded as too risky. Whether the degree of devaluation is exact or excessive, it is arguable in the case of the U.K. that it is just what should enable the country to stabilize prices at the prevailing level and hold its own in the world markets. It means in practice that the 30 per cent expensiveness of food and raw materials, unless lightened by further fall in dollar prices will be countered by some sacrifice of wages and profits, i.e. the standard of life of the country.

The Indian price-level is in the neighbourhood of 380. With a very much higher price-level, it is tempting to argue that the devaluation against the dollar is far too moderate and that it still leaves a big margin for lowering our prices; that the continuation of the rupee-sterling parity still leaves untouched the problem of the alignment of rupee prices and sterling prices.

Unhappily, the course of events in India will be very different. No feature of the Indian economy is more baffling

than the movements of her price-level. The reasons are not always properly appreciated. Certain export commodities like jute, shellac, tea, etc. have no substitutes in foreign markets except at prices which may be left out of account. Her domestic food-grains, etc. and even some of her other articles of export are so inferior in quality that even trebling or quadrupling of prices leaves them still cheaper than the next best world substitutes. In a general rise of prices therefore and particularly in the event of a domestic inflationary situation, prices can rise very high without inviting a flood of foreign substitutes. If the pressure of imports attracted by diffusion of higher incomes is held in check by physical controls, inflated prices can continue almost indefinitely.

With devaluation, the demand for our exports to dollar countries should improve. If devaluation improves the trade and industry of the U.K. and sterling countries, the same trend will be further reinforced. Our previous analysis has made it clear, however, that expansion of output under stimulus of keener demand is hardly feasible for most of our key exports. The ill-advised insistence on cultivation of food-grains on any and every kind of land makes such expansion still more unlikely. The improvement of our foreign markets must therefore be absorbed in higher prices of export goods. In other words, the evil gap between incomes of producers for domestic consumption and producers for export must widen still further, the intensity of the pressure for more imports grow still worse and, if labour and other resources move on any appreciable scale into production for exports, local shortages tend to become more serious.

The connexion between expensiveness of imports and prices is not as direct in the case of India as of the U.K. Those industries which use raw materials from the dollar area must raise their prices or find the materials in the sterling area. It is more likely that they will have to curtail their output for lack of these materials. The situation will be even worse in the case of capital goods. Dollar capital goods will have to be avoided because of their expensiveness. Sterling capital goods will not be found in required quantities. If sterling

prices rise as they must for those goods which use dollar raw materials, the position is bound to deteriorate further.

An upward pressure of prices presupposes predisposing conditions of currency and credit. In ordinary circumstances, devaluation creates such conditions by relaxing the pressure of adverse trade balances, inflating the value of exchange reserves, stimulating borrowing by export industries and trades. Positive measures on the part of the Government and the Central Bank to lower interest-rates tend in the same direction. It may be asked whether it would not be possible to check the rise by appropriate monetary measures. One great danger of such steps would be to perpetuate the adverse trade balance on account of the loss of foreign exchange earned on exports and to cause still further curtailment of vital imports. Secondly, such steps presuppose that the monetary factor is still operating in the normal manner in our economy and that the currency authority has got a firm grip on monetary conditions in the country. Both these conditions are absent at present. With fixed prices for several important commodities, restrictions on cultivation of crops, physical controls on exports and imports, individual prices are quite out of alignment. Monetary measures even if feasible might impinge on individual commodities in unexpected ways and aggravate existing mal-alignment. But the plain fact is that our currency authority lost its grip over the monetary situation long ago. The official rates have no touch with the rates of the modern money markets and the modern money markets have still less touch with the bulk of trade and industry. Even if it sought to re-establish touch, its resources might prove to be very limited for the purpose. Its currency reserve contains but little gold to benefit appreciably from devaluation while the dollar value of the currency reserve part of the sterling balances has fallen very heavily. If sterling prices rise in the U.K., even the sterling reserve must shrink in its effectiveness. Sale of securities by the Reserve Bank or the Government is the alternative measure, but this means the final abandonment of cheap money.

What are the possibilities of appreciation of the rupee

against the pound?

Appreciation of the sterling-rupee parity with or without devaluation against the dollar should mean an immediate revision of our bloated export prices in the larger export market, i.e. the sterling area. Whether the aggregate sterling exchange reaped on our exports would be more or less than at present must depend on the elasticity of demand for those commodities. It is not improbable that the demand is more on the inelastic side than the elastic. Even if it were not so, there would be some compensation by expansion of demand in the dollar markets. Internally, the narrowing of the gap between incomes and prices of producers for export and for domestic consumption should allay the intensity of demand for imports.

If Pakistan must array itself on the side of dollar countries, the choice for non-devaluation or better still for a moderate devaluation against the dollar and a moderate appreciation against the pound has much to be said in its favour. Our imports of wheat, raw cotton and raw jute from Pakistan would be less expensive to us in that case and prices of our cotton and jute textiles should remain stable between the upward pressure of the dollar markets and the downward pressure of the sterling markets.

In regard to our price-level, our conclusion therefore is that devaluation must tend to stabilize or even to raise it, to perpetuate the evil gap between export and domestic prices and in general to keep alive uneasiness and discontent among large and vital sections of the population. Partial devaluation and appreciation appear to offer just the corrective that our present predicament calls for.

### **Revision of Parities and Output and Investment**

When devaluation is expected to raise output and increase the activity of trade and business, it is assumed that export prices and therefore costs will not rise to the full extent of devaluation. If prices and costs, particularly labour costs, march with the rise of prices, devaluation ends as a costly failure. Devaluation is thus an alternative to reduction of

wages and other fixed costs.

To justify devaluation for this purpose, it is necessary to prove not only that export prices are too high but that costs, particularly wages costs, are so high that the margin of profits has diminished to the point of expulsion or repulsion of capital. If profits are adequate, there is a case not for devaluation but for lowering of prices. Over the greater part of our economy, i.e. agriculture, what matters is neither high prices nor low prices but a proper alignment of prices of agricultural and non-agricultural produce and a reasonable degree of stability compatible with technical progress and efficiency. According to our previous analysis, such an alignment does not exist. There exists as a matter of fact a double mal-alignment between controlled and uncontrolled agricultural produce and between controlled and non-controlled trades and industry. Such mal-alignment cannot but become a cause of misdirection of effort and capital.

As for profit margins outside the agricultural sector, the existence of a profit limitation law tells its own tale.

Investment is clogged because of these mal-alignments among individual lines of production and because mal-alignments, controls, unsteady public policies have created opportunities for much quicker and larger profits mostly of an illegal and anti-social character. It is clogged even more by high costs of capital goods particularly when these costs are not expected to last long.

In 1948, the U. K. supplied us machinery and vehicles worth £46 million. The supplies from the U.S.A. amounted during the same year to about £24-25 million or a little less than \$99 million. Devaluation against the dollar must raise the prices, already prohibitive, of a third of our supply of capital goods. It is not likely that the U. K. with her pre-occupation with her dollar balance will make good more than a part, perhaps a very small part, of the U.S.A. supply.

In goods which need for their manufacture not one staple raw material but a large number of raw materials, sterling prices are not likely to escape a rise. Devaluation whether against sterling or dollar must result in slowing down of our

industrial recovery. Appreciation whether against the one or the other would bring improvement to a most vital sector of our economy.

The question is largely one of proper estimate of our immediate priorities. Are improvement of our present export markets and increase in the output of export commodities the first priority, granting that devaluation is likely to achieve these objects? Or, is investment in industry, public development projects, housing, etc. the first priority? From this standpoint again, partial devaluation and appreciation offer a compromise much more suitable for our immediate predicament.

#### **Devaluation for the U. K. and India**

To put the whole question in its proper perspective, it would be wise to compare how devaluation will operate in the U. K. and in India.

For the last four years, the U. K. has put her greatest effort into the rehabilitation of her economy. In 1948, her level of output was 30 per cent higher than in the pre-war year. The physical volume of exports was still higher at 51 per cent. The disparity between output and exports is of course a measure of her concentration on the balance of trade and her austerity in consumption at home. According to her Chancellor of the Exchequer, the United Kingdom has in the post-war years invested capital in the renovation of her productive apparatus on a scale unprecedented in her history. The United Kingdom is therefore well poised to enter foreign markets on a competitive basis. Compared with this, our record is almost dismal. The depreciation of our industrial apparatus is estimated at 40 per cent of the pre-war capacity. Investment funds and investment have been most inadequate even to restore our pre-war efficiency. Agriculture is ordinarily incapable of quick expansion and the dissolution of big farms or estates is unlikely to improve efficiency in the near future. A policy of bribing labour today and the capitalists tomorrow, and that many times under pressure of propaganda, bullying and blackmail, does not make for sober settling down to effort and reorganization.

Secondly, interest-rates have been rising in the United Kingdom. The consols are almost on a four per cent basis. This was the outcome partly of a heavy fall in the currency reserves of the country and some speculation on the probable fall of the sterling. There was therefore some case for removing the growing upward pressure of interest-rates. In India, rates continue low in our official markets. They are hardly likely to fall further. As a matter of fact, we are not able to make up our minds whether we shall maintain them at their present levels or allow them to rise so as to reach parity with private rates. The official rates are hanging round their low levels only because of the standstill of private investment and public loans and investment.

The British wholesale price-level is only 50 points higher than that of the U.S.A. when compared on the basis of the pre-war year. The control of the British Government over costs and wages is hardly to be compared with ours. To absorb 50 points in devaluation is relatively an innocuous and moderate measure. To try to absorb 150 or 200 points by a proportionate devaluation would be to devalue all cash savings investment in public loans by one-half to one-third and create an uncontrollable stress and strain for readjustment of wages and incomes throughout the economic structure.

### **Revision of Parities and the U.S.A. Economy**

In our exposition of the situation till now, we have almost assumed that there will be no reactions from the non-devaluing countries. This is hardly warranted. The economic trends in the dollar countries must always operate so powerfully throughout the world that the ultimate outcome must depend as much on them as on the devaluing countries.

As the first step, it is necessary to understand the powerful pressure which, beyond question, emanated from the U.S.A. for the devaluation of the sterling. Till the middle of 1947 and even later, the trend of prices in the U.S.A. was upwards. Indeed, at one stage, responsible opinion in the United Kingdom was speculating whether there was not a good case for a revalorization of the sterling, i.e. an upward revision of the



cross rate. There was a dramatic change during 1948 when prices of food-grains, raw materials, etc., began to collapse. It was difficult to make out whether it was a mere recession or the starting point of a depression.

With a prosperity supported largely by foreign loans or investments abroad and a corresponding export surplus of astonishing magnitude, it is hardly wise or feasible to maintain incomes or employment at home by concentration on domestic markets and rearrangement of productive resources accordingly. Recession could be halted and upward trend resumed only by continuation of public or private loans abroad. But who would invest in foreign countries when prices were out of alignment, revision of parities was expected at some stage and there was therefore the risk of loss of capital by such revision? If revision of parities must come some day, why not in time for halting the growing recession and unemployment and fall of incomes in the U.S.A.?

Devaluation has its thorns for the U.S.A. On the one hand, there is the danger of British and sterling goods generally competing severely with the U.S.A. goods in their home markets. This is likely to happen particularly because at \$2.80, the pound is definitely undervalued, and such undervaluation if persistent must cause not a little difficulty to all her competitors. To retain the devaluing markets, it would also be necessary for the U.S.A. to prune her dollar prices. A fall of prices in dollar countries is therefore a risk not to be underestimated. On the other hand, loans and investments abroad could so raise the demand for U.S.A. goods abroad and also incomes abroad that the fall of prices might prove the lesser danger. But loans and investments abroad mean revision of tariffs at home, sober and unprejudiced decisions on the political plane, tolerance of other people's economic beliefs and creeds, for all of which the political animal in the U.S.A. is not particularly well-suited. This is therefore a race between further fall of prices and loans and investments abroad. If the U.S.A. loses the race, she will involve herself and the world in a depression for which the low prices of devaluing and non-devaluing countries will be hardly a compensation.

The outcry for devaluation must now be followed by an outcry for the next logical step of which we must take careful note. To offer loans and capital to a particular country, say the U.K., and to expect the country to produce exactly the goods in which the U.S.A. would like to receive repayment of loans and capital are of course impracticable and even absurd ideas. The maximum use of loans and capital and the maximum opportunities of recovering loans and capital are to be sought only in specialization in production by every country and free and unrestricted exchange of goods by all countries. But this means multilateral convertibility, all-round reduction and moderation of tariffs, abolition of import and export controls, scaling-down of one-sided transfers and unrequited exports, dismantling of the apparatus of internal controls and, finally, the restoration of money as the regulating force of the non-Communist world.

What will happen if loans and investments fall short of the requirements and the U.S.A. finds itself in a depression? Revision of the dollar price of gold and a corresponding revision of the gold equivalents of all world currencies appear to be the next possibility. This will mean an expansion of the resources of the I.M.F. and the stage will be set for another bout of inflation disguised as reflation. How far the depression will be permitted to deepen and at what point reflation will be initiated are of course crucial points. It would then look as if the world had turned a full circle and was back virtually on the gold standard.

And so must end the episode of plans and planners, created money and created savings, priorities and controls and what not. But then the Capitalist and the Communist world will squarely be confronted with each other for the weal or woe of mankind!

The results of our discussion till now are epitomized in the following broad statement. (See overleaf.)

With imports controlled and a large element of inelasticity in the foreign demand for our goods, an upward revision rather than devaluation is more consistent with our immediate needs and circumstances. But it is risky to postulate

## SUMMARY

Effects of → on ↓	Devaluation against £ & \$	Devaluation against \$ but not £	Devaluation against \$ & appreciation against £	Appreciation against £
1. Trade-Balance Exports	Loss in exchange earnings hardly counterbalanced by high prices being raised higher & small increase in output; with Pakistan not joining high price benefit lost partly to Pakistan.	30 p.c. loss on \$ exchange compensated by higher prices & diversion to \$ area; higher prices for £ area on smaller purchases; with Pakistan not joining, little price fall in \$ area & higher prices in £ area. Little benefit.	15 p.c. loss on \$ exchange compensated by higher prices & diversion; sterling earnings not seriously affected; with Pakistan not joining, some loss of export benefit.	\$ earnings maintained or extended £ earnings of appreciation counterbalanced by fall in rupee prices.
2. Controlled Imports	Rise in prices much more than fall in quantities.	Increased liability on \$ imports; and some on £ imports, if they rise in price.	Increased liability on \$ imports outweighed by cheapness of larger sterling imports.	Total liability appreciably reduced.
3. Net Outcome of 1 & 2	Continued adverse balance.	Adverse balance reduced; without Pakistan, much greater.	Trade balance likely to improve.	Further improvement in trade balance possible.
4. Price-Level (General)	Inflationary rise possible.	Inflationary rise only to the extent of diversion to \$ area and rise in sterling prices.	Inflationary rise of diversion counteracted by fall in demand of £ area; price-fall possible.	Fall in export prices and prices in general.
5. Gap between Local Prices & Export Prices	Widens still further.	Widens but to a less extent.	Gap must narrow.	Gap narrows further.
6. Output & Investment	Little rise in export lines; greater strain on internal controls. Retardation of Capital goods imports.	Little improvement in export lines. Retardation of \$ Capital goods imports.	Export lines little affected. Retardation of \$ Capital goods imports more than made good by sterling goods imports.	Export lines little affected. General stimulus to investment & capital goods imports.

the continuation of these conditions beyond a limited transitional period. A high parity without a drastic fall of prices is necessarily an unstable parity. The higher the parity, greater must be the crisis when the moment for multilateral convertibility and free exchange of goods arrives. The central conclusion to which our discussion points is that for the transitional period a middle way between devaluation and upward revision is by far to be preferred.

### The Middle Way or Multiple Exchange Rates

It is not impossible to perfect this middle way so as to serve as an easy and convenient bridge across the difficult transitional period. With our economy as it exists at this moment, the basic conditions of our problem could be stated thus: Certain imports we need very urgently and at prices not only within the reach of but positively attractive to the purchasers. Machinery and industrial raw materials may be cited as illustrations. At the other extreme are imports which should be either prohibited or severely discouraged. Between the two extremes must fall many commodities the significance of which probably rises and falls with the state of our national income. The logical and administratively simplest procedure to achieve these diverse objects would be to prescribe three different exchange rates for these three categories of imports. The midway rate, as for example 1s. and 3d., should be chosen carefully with reference to the more permanent price-level we have in view for the next few years. The prevailing prices of the other two categories of goods should furnish the clue then as to how much higher should be the rate for the necessary category and how much lower should be the rate for the category to be discouraged. 1s. 9d. for the former and 1s. for the latter may be given as illustrations.

To pay for these imports, we must export and earn the necessary foreign exchange. Some of our commodities like jute manufacturings, tea, shellac, perhaps hides and skins, etc. meet with a fairly inelastic demand in the outside markets. With the optimum prices in view, the exchange rate for them should be fixed as high as the markets will bear. At the other

extreme are commodities which are already too high priced to make headway against the competition of rivals. The foreign exchange raised from their export should be at rates which strengthens their competitive position. The balance of commodities should have a middle rate applicable to them. If the rates are chosen with care, it should not be difficult to have the same series of three rates for both exports and imports but applied in the reverse order.

Just as now, all foreign exchange earned will be surrendered to and all foreign exchange required will be issued by the Central Bank. A system of multiple exchange rates like this offers certain special advantages. All controls will be now concentrated in the few embarking and disembarking points in the country. In the place of the welter of bilateral agreements, etc., the rest of the world will constitute a uniform market to buy from or to sell to. Except for the strict inspections at the port, foreign trade will be much simplified. The categories could be revised and items removed from one to another according to the changing economic situation.

Rationing and price control should be confined to the minimum of essential commodities like major food-grains, cloth, cement and iron and steel. For the rest, fiscal and monetary controls are much to be preferred.

What will be the effects of this system of foreign trade on our internal economy?

Multiple exchange rates are compatible with any level of prices we may desire to fix for export goods and therefore prices in general. If the top rate is fixed sufficiently high, prices of those goods must fall but at the same time it is possible to moderate the fall of prices of other goods by fixing the bottom rate sufficiently low. Similarly, the prices of individual import goods can be lowered without causing a flood of others which are not wanted in the context of our prevailing circumstances. In this way, the evil gap could also be closed by moving goods from category to category according to circumstances.

There will of course be reactions on production. Among export goods, those whose rupee prices will be high because

they can be marketed abroad at the lower rate might gain at the expense of others for which the rate is fixed high. But this need not cause concern unless the alignment of prices and classification of goods is not properly worked out and the rate fixed is unduly low. Among import goods, care must be taken to make only unnecessary goods sufficiently expensive to the consumer.

On whom falls the burden of payment for the stimulus we offer to certain exports and certain imports? Among exporters, those who produce or market goods exportable at the higher rates and therefore smaller prices really pay for those others who send their goods abroad at the lower rates. Among importers, importers of capital goods, etc. are subsidized by those who are prepared to pay the high prices for imports allowed at the lower rates. If there are excess gains and profits in any lines, an efficiently administered income-tax, super-tax and profits-tax should be able to intercept them.

This scheme has the supreme advantage of being adaptable to a situation like that created by Pakistan. If raw jute and particular qualities of cotton are placed among goods importable at the highest rate, the hurdle created by Pakistan's non-devaluation is avoided. If the raw materials are obtained at the same rupee expenditure as before, the export of such goods can be placed among the best exchange earning class of goods according to circumstances.

Of course, there will have to be an exchange budget as now. The total expenditure on imports must not be allowed to exceed our total earnings of foreign exchange. For this purpose, it would be necessary to reach an agreement with the U. K. and obtain final disposal over our foreign assets. Whether we devalue or not, the dollar value of our sterling balances has fallen very heavily. If sterling prices rise—as they must—the sterling value also depreciates. We never had a choice about the form in which we should hold our foreign assets and we have little now. But if the dollar as well as other currencies are to be devalued in terms of gold at any future date, it would be well to keep what assets we can in gold. The present depreciation of our foreign assets and

their future likely depreciation would be another argument why we should try to compensate ourselves by obtaining as much of foreign currencies as we can through a system of multiple exchange rates.\*

The main obstacle to this scheme is likely to be political rather than economic. It may be deemed inconsistent with our obligations under the I.M.F. It is possible to meet this objection quite effectively. Firstly, with physical controls over imports and consumption, it is idle to pretend that foreign trade is not already subject to discrimination. Secondly, France devalued in the face of the I.M.F. and later put into operation a scheme of official and free exchange rates. France has not been expelled although aid from the I.M.F. has ceased. Thirdly, the situation is not of our creation but has been forced on us despite ourselves. Finally, we could ask for permission only for a limited period, e.g. five years, to enable us to put our internal price-level and economy in a position to face unrestricted foreign trade and multilateral convertibility.

### **Government Decision and Remedial Measures**

It is possible though not plausible that the decision of the Government of India is irrevokable. Our freedom to make a particular choice is perhaps limited by our international obligations and difficulties. In this case, it would be prudent to think of remedial measures. The objects of such measures are clear. They should check rise of prices, narrow the gap between export prices and prices of internal goods, balance exports and imports at the highest possible level and generally increase investment and output.

To check the rise of prices, it is possible to impose a general export duty of 30 per cent, just equal to counteract the devaluation of 30 per cent. This will mean some rise in sterling prices of our goods and some curtailment of their cheapness in the dollar areas. The diversion from sterling to

\* Our sterling balances are estimated at present at £650 million. Of these £150 million will be released by the end of 1950. Of the balance of £500 million, at least £300 million must be regarded as the necessary currency reserve against a note circulation of Rs. 1133 crores (July 1949).

dollar areas will be much more with such a duty than without it. At what level sterling and dollar prices will meet must depend on the general elasticity of foreign demand for our goods. There is, however, no doubt that there will be some fall in the total off-take which must cause a fall in our prices at home.

The great difficulty of such an export duty would be its different incidence on different commodities. It would be better to aim at an average level of an export duty but to levy it at different rates on different commodities according to their position in the foreign markets. Three or four rates levied on a threefold or fourfold classification of goods are much to be preferred to a welter of rates. In placing commodities in categories, attention should be given to their proper alignment to domestic prices.

If the cheapness of our goods in the dollar areas and their diversion to them do not balance the probable fall in the off-take by the sterling areas, the fall in exports will have to be countered by some curtailment of imports. The expensiveness of dollar goods must itself act as a check on imports. A rise in sterling prices which must ensue on devaluation is a further check. With physical controls over imports, our real problem is to ensure the maximum inflow of essential and vital goods. This could be best achieved by placing the proceeds of the aforesaid export duty in a special fund and using them to subsidize essential imports like machinery. This does mean subsidizing the relatively well-to-do investing classes at the expense of the small producers and tillers of land. But if sterling areas are not able to offer these goods, and they must be purchased in the U.S.A., there is no other way of maintaining or expediting industrial progress.

In one sense, duties on exports and subsidies on imports are really substitutes for multiple exchange rates. The more the rates of levy or subsidy are varied, the more do these duties approximate to multiple exchange rates. One great difference between them is that duties are seen and felt while the operation of multiple exchange rates is somewhat shrouded from ordinary eyes. To allow export and import duties



or physical restrictions on imports and exports, and to prohibit multiple exchange rates is hardly a logical procedure.

In our recent imports, food has loomed very large. The deficit is estimated at less than 10 per cent—in the neighbourhood of 6 to 7 per cent. The import and subsidizing of food have been favoured because of the fear that otherwise this shortage may be concentrated on the poorest sections of the people with deaths from starvation. The fear is not well-founded and arises from a confusion between a famine situation and our actual situation today. In a famine, both the food-grains and the incomes with which food could be bought from elsewhere disappear. This is not our situation today when employment is nearly full. If imports of food cease immediately, the question before us will be whether the shortage should be distributed over all classes of people by decontrol and rise of prices or by reduced rations in the controlled areas. It is indeed very doubtful whether prices could be much higher than they are at present, in case of decontrol of food-grains. If private imports of food-grains are allowed on a cautious scale, the situation could not be much worse than it is today.

Till the food situation becomes clear it would be necessary to continue controls on cloth, sugar, cement and iron and steel, etc. At a time when food prices are likely to rise, it would be imprudent to raise the prices of these goods also. With export duties on certain agricultural produce and rise in food-grain prices, there should take place redistribution of cultivated acreage in favour of the more expensive food-grains.

Subsidizing of imported machinery and capital goods merely prevents the aggravation of the investment standstill. Positive measures will still be required to stimulate investment. It is implicit in the clamour of the U.S.A. for devaluation that dollar loans and capital should now flow in growing volume into sterling areas. The decision about the use of foreign capital and still more foreign technicians is more a political and even military decision than an economic one. On the economic side, if borrowed sterling and dollar re-

sources are used in the countries of their origin, no immediate difficulties are involved. But it must not be overlooked that with prices already too high in this country and with likelihood of fall in the future, the burden of repayment must be enormously enhanced. A much larger produce than before devaluation and before the expected fall of prices will have to be offered to make the same repayment.

The large-scale use of foreign capital to meet investment expenditure at home is not exactly consistent with check on expansion of currency and credit. It would be well if all the domestic expenditure parallel to foreign loans and capital were raised out of domestic savings. This factor as well as the general desirability of lowering prices point to a revision of our borrowing and interest-rates policy. With private investment not very active, it is difficult to discover any virtue in a policy of depressing interest-rates by mere avoidance of public borrowing and public investment. As a matter of fact, a rise of prices unless accompanied by further inflationary policies will expose still more the shortage of savings and capital and raise rates in the unofficial markets.

Apart from public borrowing and a rise in the rate of interest, no steps should be deemed too drastic to keep profits at just the reasonable levels and purchasing power at the higher income rungs as immobilized as possible. Until the machinery of income-tax, super-tax, profit-tax and death duties reaches its maximum efficiency, the search for immobilized purchasing power should wait. The answer to standstill of private investment is public investment and not further bribes at public expense.

## APPENDIX I

While the manuscript was in the press, the Minister of Finance gave the Indian Parliament on 5th October 1949 a full account of the course of events and the reasons for devaluation. Important extracts from his speech are given below to enable the reader to judge the case for devaluation and the logic of the proposed programme:

In view of the very short time between the time the decision of the U.K. was communicated to India and its announcement next morning, the Government of India had no opportunity for arranging a "sort of leisurely consultation" which the Ceylon Government had in mind. As soon as the Government of India reached the decision to devalue the rupee on Saturday Dr. Matthai tried to get in touch with the Ceylon High Commissioner, but he was away from Delhi.

Making full allowances to the difficulties of the United Kingdom Government, he nevertheless felt that it was possible, if arrangements had been made in time, for the U.K. Government to take the Commonwealth Ministers more fully into their confidence than they apparently did. He made this statement because he felt that not only had India been placed in an inconvenient position, but it had caused inconvenience to "our neighbours, Ceylon and Pakistan." He would always make every effort to avoid inconveniences to others.

"I feel that in this matter I have had to act not on conviction necessarily born of logic but, so to speak, by the compulsion of events.

"I am not happy that I have had to make a decision in these circumstances. Nevertheless, since the pound sterling was devalued, I felt—and my colleagues entirely agreed with me—that there was no other course open to us."

Dr. Matthai reminded the House that nearly 75 per cent of the export trade of this country was with the countries included in soft currency areas. Indian piecegoods would have had to compete with Lancashire piecegoods in the markets of the sterling area.

The same applied to Indian competition with Ceylon tea, groundnut and manganese from East and South Africa and Dundee jute goods. Because of our dependence on the sterling area for exports, because of our unfavourable balance of trade, because of our high level of prices, everybody who understood finance and business in any country would have presumed that a high rate for the rupee would be unmaintainable.

With regard to the balance of trade with the United States, India's main exports were jute goods and tea. In respect of these two commodities neither the demand for these articles in the United States nor the supply in India admitted of any substantial variation in response to the changes in prices.

One way in which this could be obviated was by a system of customs duty on exported articles consistently with the maintenance of our position in the export market. On the import side India's dollar expenditure would increase. The remedial measures that they would have to take were to stop imports of food grains as far as possible and reduce imports such as motor vehicles and divert our machinery imports to soft currency areas.

As far as the United Kingdom was concerned, he thought the position would be left unaffected except for two factors, namely, the prices of goods exported to India by the U.K. using materials produced in the United States would necessarily increase. Due to increased demands on soft currency areas because of the higher dollar prices of goods, prices of goods in soft currency areas might increase to some extent.

He claimed that the movement of capital from India to other countries would now diminish and similarly investments in India for hard currency areas would be more attractive.

"We are a member of what is called the sterling area. So long as we are a member of the sterling area, it is an obligation which is placed upon us, and which we must be prepared to honour fully, that whatever we do must be in keeping with the general objective of that area."

"The essence of the sterling area is that all the hard currency resources earned by the members of the sterling area are pooled. All the members of the sterling area have the

right to draw upon this central reserve for meeting their deficits in respect of dollar resources.

"It so happens today that next to the United Kingdom, we are the country which makes the biggest demand upon these central reserves. That was not so till a few years ago."

Dr. Matthai explained that the rupee today was not linked to sterling any more than to any other currency. There was a par value between the rupee and sterling in the same way as there was between the rupee and other currencies.

He said that if, as the result of the devaluation of the pound sterling and other measures which the United Kingdom Government had taken, there was no improvement in the dollar position of the United Kingdom and other countries of the sterling area and the dollar reserves of the sterling area continued to diminish, "it is not inconceivable that we should be faced with the position that the sterling area would be dissolved."

"All the agreements that we have made with Pakistan regarding payments for commodities are based on the parity of the Indian rupee with the Pakistan rupee. They are based also on this consideration that all settlements should be made in sterling."

On the ratio now proposed by the Pakistan Government, Indian manufacturers would be compelled in their own interest as a matter of sheer self-preservation to refuse to buy raw jute and raw cotton from Pakistan to the extent they had done in the past. This was not a matter of retaliation at all but simply the play of economic forces.

The Pakistan Government were understood to have a fairly big industrialization programme. The moment that programme came into operation, imports of capital goods would begin to increase. That again would be a factor on the other side. "It seems to me, therefore, that forces are likely to work in a direction which will diminish and eliminate this favourable balance."

Referring to the question of price level in the country, he said, he would leave out speculative increases. From the purely economic point of view, the cost of living index should

not increase as all the items on which the cost of living index was based were of indigenous origin.

As regards food, imports from the United States for the current year had already been completed and there would be no additional expenditure on that account.

As regards cloth, the medium and coarse varieties were produced out of short staple cotton of indigenous origin.

Concluding, the Finance Minister said that this devaluation should be looked upon as a "timely warning." "For many years now, we have been living beyond our means both internally and externally. I say this is a timely warning because we have yet time to put things together and to remedy the situation before it becomes too bad to mend."

The Finance Minister announced some of the steps which the Government of India had taken or proposed to take to meet the situation created by devaluation. The measures are:

(1) Formulation of the future pattern of trade which in the new situation with which we are faced should reduce our expenditure of foreign exchange to the minimum, having regard to the essential requirements of the country.

(2) Employment of such purchasing power as we have for the purpose of bringing down to reasonable minimum prices of industrial material imported from countries whose currencies have appreciated in relation to Indian currency.

(3) Prevention of speculative prices by legislative and administrative measures and by regulation of credit facilities.

(4) The imposition of customs duties consistently with the principle of non-discrimination on articles exported to hard currency areas so as to ensure maximum amount of foreign exchange and at the same time to secure advantages resulting from devaluation, distributed among the foreign importer, Indian manufacturer and Indian exchequer.

(5) To further stimulation for investment which devaluation generally provides and thereby assist production and promote development by an intensified savings drive by propaganda and, failing this, by compulsion and provision of suitable Government assistance for the extension of banking facilities in rural areas.

(6) With the same object in view to extend facilities for voluntary settlement of taxes payable in respect of war profits of assesseees whose cases have not been referred to the Income-Tax Investigation Commission.

(7) Introduction of economy measures for securing a reduction of approximately Rs. 40 crores in revenue and capital expenditure for the current year and not less than twice that sum next year as compared to the Budget estimates of 1949-50. It is, however, expected that if the scheme for stimulating investment makes satisfactory progress, further sums would be made available for development expenditure next year.

(8) To take steps in co-operation with the Provincial and State Governments to bring about a reduction of ten per cent in the retail prices of essential commodities, manufactured goods as well as food grains by a reduction of ex-farm and ex-factory prices or by reduction of distribution costs and incidental charges or by both.

## APPENDIX II EXCHANGE RATES

LONDON on:	Old Rate	New Rate	Percentage change
New York (\$)	4.03	2.80	—30.5
Brussels (Fcs.)	176	140	—20.4
Montreal (Can. \$)	4.03	3.08	—23.6
Paris (Fcs.)	1097	980	—10.6
Tokyo (Yen)	1450	1008	—30.5
Moscow (Roubles)	10.38	14.84	+30
Zurich (Fcs.)	17.35	12.12	—30.14
Milan (Lira)	575	617	+ 6.8
Karachi (d)	18	25.9	—30.5

## INDIA'S FOREIGN TRADE (In Crores of Rupees)

Twelve months ended March:	Exports	Imports	Balance of Trade
1948	395.31 (7.88)*	398.62	— 4.57
1949	415.53 (7.29)*	518.00	—95.18

\* Re-exports.

PRINCIPAL EXPORTS AND IMPORTS

(In Crores of Rupees)

EXPORTS (including re-exports)				IMPORTS			
Twelve months ending :				Twelve months ending :			
March				March			
1948				1948			
March				March			
1949				1949			
Jute Yarn and Mfgs.	..	127.82	146.31	Machinery	..	59.14	80.87
Raw Jute & Waste	..	25.86	23.89	Grain, pulse, flour	..	23.00	66.51
Cotton Yarn & Mfgs.	..	20.53	41.13	Cotton Yarn & Mfgs.	..	9.51	17.06
Cotton Raw & Waste	..	39.87	19.15	Cotton Raw & Waste	..	31.20	64.23
Tea	..	54.90	63.69	Metals	..	23.03	32.89
Hides & Skins	..	14.49	12.69	Vehicles	..	26.64	32.68
Gums, resins & Lac	..	9.87	9.49	Chemicals, drugs & medicines	..	20.04	28.89
Tobacco	..	6.65	8.36	Electrical goods & appliances	..	9.72	11.40
Spices	..	6.42	5.53	Oils	..	36.97	37.66
				Cutlery & hardware	..	21.83	16.44
				Paper, pasteboard	..	14.21	15.08



## COUNTRY-WISE IMPORTS AND EXPORTS OF MERCHANDISE OF INDIA

(In Crores of Rupees)

Twelve Months ended March 1949

<i>Devaluing Countries</i>				<i>Non-devaluing Countries</i>			
	Exports	Imports	Balance of Trade		Exports	Imports	Balance of Trade
U. K.	97.26	152.04	-54.78	U. S. A.	70.64	104.24	-33.60
Australia	20.52	20.93	- 0.41	Pakistan	46.12	22.37	+23.75
Egypt	6.72	31.89	-25.17	Canada	8.39	7.91	+ 0.48
Sweden	2.12	6.05	- 3.93	Belgium & Belgian Congo	6.87	7.62	- 0.75
Burma	10.56	18.77	- 8.21	Argentina**	16.76	6.60	+10.16
Portugal & Portuguese Africa	2.32	2.65	- 0.33	Switzerland	1.22	8.66	- 7.44
Total	139.50	232.33	-92.83	Japan*	4.59	6.37	- 1.78
Other countries	126.14	119.57	+ 6.57	Germany*	2.60	2.25	+ 0.35
				Total	157.19	166.02	- 8.83

\*\*Multiple exchange rates.

\*Controlled economy and foreign trade and arbitrary rates.

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