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HISTORY OF INDIAN CURRENCY AND EXCHANGE



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HISTORY
OF
INDIAN CURRENCY
AND EXCHANGE

BY

B. E. DADACHANJI, M. A.

*Assistant Professor of Economics,
Morris College, Nagpur, and late Fellow,
Baroda College (Bombay University),
Author of*

"A Reserve Bank for India and the Money Market"

SECOND REVISED AND ENLARGED EDITION

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TO
THE MORRIS COLLEGE STUDENTS
THIS BOOK
IS DEDICATED

92-88

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EXPLANATION OF FIGURES

As a guide to the reading of the figures it may be mentioned that:—

100,000 rupees=1 *Lakh* rupees=£ 7,500.
(at the present rate of exchange.)

100 lakhs (10 million rupees)=1 *Crore* rupees=£ 750,000.
(at the present rate of exchange.)

PREFACE TO THE SECOND EDITION

The author is largely indebted to the many Professors of Commerce and Arts' Colleges of Indian and some Foreign Universities for the warm welcome accorded by them to the first publication. Indeed, he is under a particular obligation to them for having offered many excellent suggestions and criticisms which were calculated to improve the book. For instance, the Professors of many American Universities have suggested the inclusion of a preliminary explanation on the peculiarities of the Indian Foreign Exchange as a basis for a clear understanding of the evolution of the Indian currency mechanism. With much pleasure their suggestion has been carried out. Requests have also been made to embody the subject of the Indian Banking System in this book. But as the subject is exhaustively dealt with in the Author's recent publication—“*A Reserve Bank for India and the Money Market*”, an apology from the Author for disappointing these friends will, it is hoped, be kindly accepted by them. All other minor suggestions from other friends have been included and thus the wishes of these too have been complied with. Happily, the book has a wide share of its use in Japan, and to bring it within the scope of the Universities teaching purely in the Japanese language, a Japanese translation has been mooted.

In this second edition the plan of the book remains unchanged. Some chapters have been added to bring the history up-to-date; some have been divided and modified, while in others the subject-matter has been rearranged. Commentaries, too, have been added to clear certain points. Hence, if its indulgent readers overlook its deficiencies, as

they have done previously, the author will consider himself greatly rewarded.

It only remains to say that in the preparation of the second edition, the writer takes pleasure in acknowledging his great indebtedness to his colleague, Professor A. C. Sen Gupta, M. A., I. E. S., for his very scholarly comments and suggestions. The writer's special thanks are due to the Rev. Father A. J. S. Monteiro of St. Francis de Sales' High School, Nagpur, for his advice and invaluable help given in various ways. Finally he is also grateful to his former pupil, Mr. V. V. Prayagi, B. A., for preparing the diagrams and rendering general assistance in preparing the manuscript.

August 17, 1931.

B. E. D.

PREFACE TO THE FIRST EDITION

This book on the *History of Indian Currency and Exchange* has been specially written with the object of meeting the requirements of students preparing for the *B. A. and B. Com. examinations* of Indian Universities. It, therefore, presupposes the knowledge of the general principles of Currency and Exchange. The plan adopted of treating the subject is very simple and is designed to elucidate the different phases of the Indian Currency System. Its chief aim is not to stuff the students' minds with facts and figures, but to create in them a genuine taste which would lead them to a methodical study of the chaotic history of Indian Currency.

My debt to various authorities on the subject and to the Blue books mentioned in the Bibliography cannot but be acknowledged by me. In the case of the latter, which form the real basis of the work, their original language has been adhered to, wherever necessary, to indicate the source of information.

I am indebted to my colleague, Professor A. C. Sen Gupta, M. A., I. E. S., for his very valuable suggestions, and to Professors Chordia and Ghose for the help they gave in correcting the proof-sheets.

Despite its imperfections, it is sincerely hoped that the book will prove useful to students and form the foundation for further study.

Morris College,
Nagpur: June 25, 1927. }

B. E. D.

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12. The Problem of the Rupee „ B. R. Ambedkar.
13. India's Exchange Problem „ B. F. Madon.
14. A Reserve Bank for India and the Money Market „ B. E. Dadachanji.
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INTRODUCTION

Special peculiarities of Indian Foreign Exchange.

For a clear understanding of the development of the Indian Currency System some knowledge of the peculiarities of the Indian Foreign Exchange is necessary. These peculiarities arise from factors which are almost unique and give to the Indian Foreign Exchange a character which at once distinguishes it from that of any other important trading country in the world. The one predominant characteristic that pervades these factors is the direct part which the Government of India plays in the currency and exchange system of India. In what way these transactions of the Government of India influence the Indian Foreign Exchange will now be shown.

I. Chief imperfections of the standard of currency.

In the first place, the Indian Currency System has been since 1813 what is commonly, although mistakably called the "Gold Exchange Standard". Indian currency consists of two kinds of *token*; (1) paper money and (2) silver coins, which are mutually convertible. Unlike other Governments, the Government of India issues *its own paper currency* and is the *sole supplier and direct controller* of both notes and silver rupees.

For keeping the value of the token currency (near a fixed par in relation to gold) the Government holds *two Reserves*: (a) the Paper Currency Reserve and (b) the Gold Standard Reserve. The former is composed of the proceeds of the note issue and is held as a backing against the notes in circulation; whereas the latter has been built

out of the profits of the coinage of the silver rupees and has for its purpose the maintenance of the sterling (*i. e.* the exchange) value of the rupee. It is kept in England with the Secretary of State for India. As regards the Paper Currency Reserve, some part of it is kept in India in silver and securities and the larger part of it is kept in England in gold and securities.

It is an established practice of the Gold Exchange Standard that, in order to keep the local token currency near the gold parity with other countries, the *control of the foreign exchanges by the Government or a Central Bank* is necessary. All that is necessary is the power and ability of the authority to sell foreign exchange at a fixed price. *In India it is the Government that controls the foreign exchange.*

But the fact that needs the greatest emphasis is that up to 1927 India had *never* had the 'Gold Exchange Standard' except in name. The currency system in operation in India up to the outbreak of the Great War was not in fact more than a 'Sterling Exchange Standard'. Besides, during the War the rupee broke loose from its moorings and an unsuccessful attempt was made to stabilize it in 1920. Since then the fact remains true that India had no currency standard at all. In criticizing this feature the Royal Commission on Indian Currency and Finance, 1926, wrote, "The stability of gold value of the rupee is thus based upon nothing more substantial than a policy of the Government and at present that policy can be found defined under no notification or undertaking by the Government. It has to be implied from the acts of the Government in relating to the currency and those acts are subject to no statutory regulation or control." This deficiency the Currency Act of 1927 made good.

It enforced a statutory obligation upon the Government to maintain the rupee at the ratio to gold so fixed by *pur-
chasing gold bullion* tendered for sale and by *selling gold
or sterling* at the fixed parity of exchange. But even this
Act has *not* established the Gold Exchange Standard in
its perfect form.¹ However perfected this standard may
be the danger inherent in it, that is, the danger of the
rupee going out of circulation if the price of silver rose
above a certain point, will always remain. Besides, the
system does not secure the automatic expansion and con-
traction of currency. "Such movements", wrote the
Royal Commissioners, "are too wholly dependent on the
will of the currency authority".

In the absence of a Reserve Bank, with intimate and
thorough knowledge of the day-to-day requirements of
the money market of managing the currency and the re-
serve of the country, it is natural that expansion and
contraction of currency cannot take place adequately. This
therefore brings in a disturbing element in the foreign
exchanges of India.²

II. No co-ordination of credit and currency.

The second peculiar feature of the Indian foreign ex-
changes arises from the first. In other important trading
countries a Central Bank is instituted which is given the
monopoly of note issue, so that the banking and currency
reserves are at once concentrated in a single institution
and that harmony of relation which ought to exist be-
tween currency and credit is obtained. It is the single
controlling hand of a Central Bank which gauges con-
stantly and accurately the demand for money in the

¹ For other defects of the Act see chapter VI, Period V.

² For other defects of the standard read chapter VI, Period IV.

country from time to time and is able to adjust its supply accordingly. When the supply of money and credit is adequately adjusted to the demand for them, that disturbing element in foreign exchanges resulting from their maladjustment does not exist. But in India the case is different. It is the Government that exercises direct control over currency both metallic and paper, and the very meagre control which exists over the credit organization of India is in the hands of the Imperial Bank of India, a joint stock bank which works as bankers to the Government. With divided control the equilibrium between demand for and supply of money is not obtained and the foundation for the establishment of a credit policy so essentially necessary for foreign exchanges does not exist.¹

III. Government is the largest dealer in foreign exchange.

The third and the most important peculiarity of the Indian Foreign Exchange arises from the remittance operations of the Government of India. They have to remit *annually* nearly £35 millions from India to London to the Secretary of State to pay for what are commonly known as the *Home Charges*, which are payments for loans contracted in England for the Indian railways and irrigation, the purchase of bar silver for Indian silver currency, stores purchased, pensions and furlough allowances, expenses of the High Commissioner's office etc. In this respect the Government is the *largest dealer* in the *Indian* foreign exchange.

(1) THE SYSTEM OF MAKING REMITTANCES EXISTING BEFORE 1923 :—Since India has had no gold currency or gold standard and the payment

¹ This subject is developed in chapter VI. But for a fuller account of this subject read the Author's: *A Reserve Bank for India and the Money Market*, Chapter II.

for the Home Charges had to be made in *gold* in London, a system was evolved in order that this annual payment to the Secretary of State might not necessitate the actual buying of gold in India to be remitted to London. This system which existed *before 1923*, consisted in the *sales of "Council Bills" and Telegraphic Transfers by the Secretary of State for India in London*. The mechanism had the same effect as the sale of an ordinary bill of exchange. A simple example would make this clear.

Suppose X in England had bought goods worth £10,000 from Y in India. In the ordinary course X would either buy a bill of exchange through a broker or a bank and send it to his creditor Y or send actual gold to him. In either case, Y would have to get the Bill or gold exchanged *for Rupees*, the current coins of India.

At the same time, suppose the Secretary of State for India had to receive £10,000 from the Government of India towards the payment of the Home Charges. The Secretary of State for India (the creditor) drew a bill (called a "Council Bill" because it was drawn by the Secretary of State in Council) for £10,000 on the Government of India (his debtors) and sold it to X the debtor of Y, and like an ordinary banker or bill broker charged for cost and commission from X.

The Bill was an order asking the Government of India to pay to Y not £10,000 but the value of £10,000 *in terms of rupees at the then existing rate of exchange*. When the Government of India paid Y in so many Rupees it was equivalent to paying its debt of £10,000 to the Secretary of State. In this manner the Government of India discharged its obligation and also helped the foreign importers of Indian commodities to make remittance to their creditors here. Diagram A illustrates the mechanism :

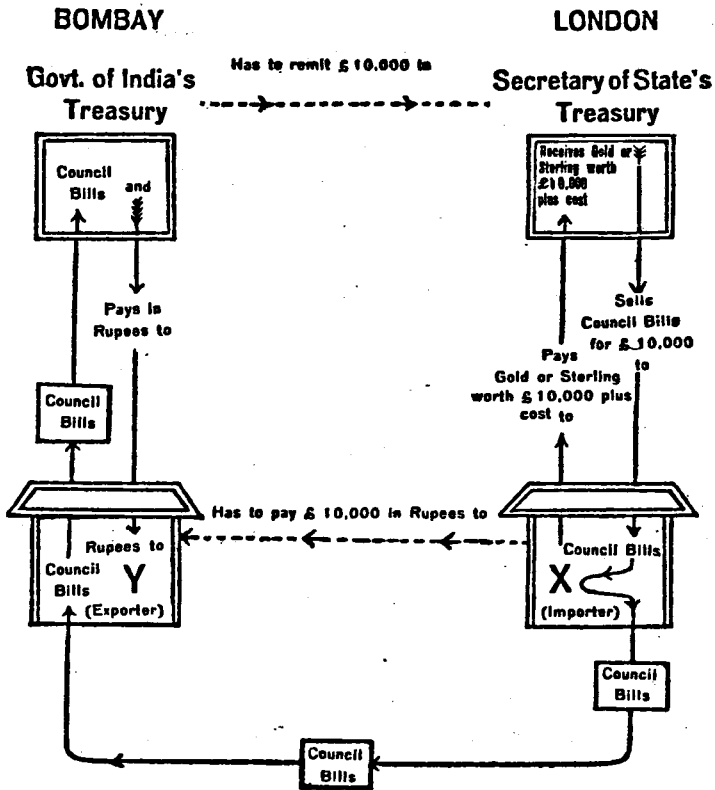


Diagram A—Illustration showing the working of Council Bills

If, however, as in the above example, X the debtor had to make *immediate* payment to Y, he would buy a *Telegraphic Transfer*, which was a Council Bill in a telegraphic form. Ordinarily it took a Council Bill fifteen days and more to reach India, so that the interest on the amount remitted for this period was thereby lost. If X wanted to save this loss, he bought a Telegraphic Transfer which empowered his agent in India to obtain his rupees from the Government of India Treasury within a few hours after the payment of the Sterling into the Secretary of State's Treasury. Thus a Telegraphic Transfer cost more than a Council Bill.

The allotment for Council Bills and Telegraphic Transfers was made to the highest bidder on Tuesday every week. But if they were demanded on other days of the week, "intermediate bills and transfers" were sold by the Secretary of State at a higher rate than that existing on the previous Tuesday.¹

This system of the sale of Council Bills and Telegraphic Transfers was primarily adopted as a substitute for actual remittance of gold by the Government of India to pay for the Home Charges to London. But in course of time their use was extended and more Council Bills (than representing the total value of the Home Charges) were sold to afford facilities for payment to importers in England of Indian commodities. What other part these Bills played in the Indian Foreign Exchange will be shown shortly.

(2) THE NEW SYSTEM OF MAKING GOVERNMENTAL REMITTANCES SINCE 1923 :—
However, since 1923 this method of the sale of Council

¹ For simplicity of exposition the details of the sales of the Bills and Transfers are omitted here.

Bills (and Telegraphic Transfers) by the Secretary of State has been more or less abandoned and is substituted by the system of *purchase of sterling in India*, sometimes by public tenders and at other times by private purchase.¹ This important change has been introduced because it is possible to do so owing to the existence of the Imperial Bank of India which works as bankers to the Government, although the Government has not ceased directly to operate in the exchange market. It is through the agency of this Bank that Sterling is purchased from the Exchange Banks (or foreign banks in India) and recognized firms.

The old method of sale of Council Bills was superseded for various reasons : (1) In the first place, in this method the Exchange Banks first used to purchase Sterling Bills in India and had them rediscounted in the London Money Market by their Head Offices, and with the amount so obtained they used to buy Council Bills and Telegraphic Transfers for their clients. This system was in practice found cumbrous and inconvenient to businessmen. (2) Secondly, it will be shown in the course of this volume that on many occasions the Secretary of State sold Council Bills at such times and at such rates that the Indian Money Market was adversely affected. (3) Thirdly, it always gave the Secretary of State undue power in the exchange market, which sometimes in practice subordinated the interests of the Indian Money Market to his own requirements.²

The new method of purchase of sterling in India is better than its predecessor for various reasons :

¹ Since 1925 this new method has completely superseded the old.

² For a fuller discussion of this subject read the Author's : *A Reserve Bank for India and the Money Market*, Chapter VII.

(1) It is in India that the export bills originate and it is in the same country that the liability of the Government of India to remit money also arises. It is, therefore, natural that the sellers and buyers of bills can best meet each other in the same country. (2) Then, the factors which influence the immediate course of exchange can be judged more accurately and more promptly than in the old method. Besides, the purchases can be regulated according to the varying conditions of the Indian exchange market and the remittance operations can be conducted so as to avoid violent fluctuations in rates, and the consequent disturbances to the Money Market. (3) Further, by this method the initiative in making remittances and thereby fulfilling their liabilities is rightly given to the Government of India who ought, in principle, to be able to remit the Home Charges smoothly and economically.

As long as India has a favourable trade balance and there are enough surplus Bills for sale to pay for the Home Charges, both the old method of the sale of Council Bills (and Telegraphic Transfers) and the present one of the purchase of sterling in the open market prove successful. But in case there are some unfavourable circumstances existing, such as a failure of the monsoon, and exports fall off considerably and the balance of indebtedness goes against India, both these methods of remittance fail because in the case of the Council Bills (and Telegraphic Transfers) there would not be sufficient debtors to sell to, and in the case of the other method it would not be possible to purchase an adequate amount of sterling bills in India.

IV. Government's Control of the rate of exchange.

In the system of Government remittance by "Council Bills" and their counterpart, the "Reverse Councils"

(which will be explained shortly) the Government found in course of years the best method of controlling the rate of exchange and thereby the standard of Indian Currency. By regulating the amount of the sale of these Council Bills (and Telegraphic Transfers) and the *Reverse Councils* as occasion required it was in a position to control the rate of exchange.

(a) HOW THE UPPER LIMIT OF EXCHANGE WAS CONTROLLED? (THE SALE OF COUNCIL BILLS):—When normal conditions prevailed, Council Bills were sold by the Secretary of State up to the limit of the Home Charges. But *if the supply of sterling in India was greater than its demand*, its price was prevented from falling *i. e. the rate of exchange was not allowed to rise above a certain point*. This was done by selling *extra* Council Bills in London. The effect was obvious. When the *extra* Bills were encashed at the Government of India Treasury, so many more rupees were made to enter into circulation. That is, *expansion of currency* took place. *More rupees than before were forced into circulation with the same number of commodities as before*, with the result that *the exchange value of the rupee was artificially brought down*.

Suppose for instance, at a given time Rs. 150 crores were in circulation in India and it was found that the excess of supply of sterling in India over its demand was Rs. 1 crore. Then, the extra sale of Rs. 1 crore of Council Bills would increase the circulation to Rs. 151 crores and to that extent the rate of exchange was lowered. Diagram B illustrates this result.

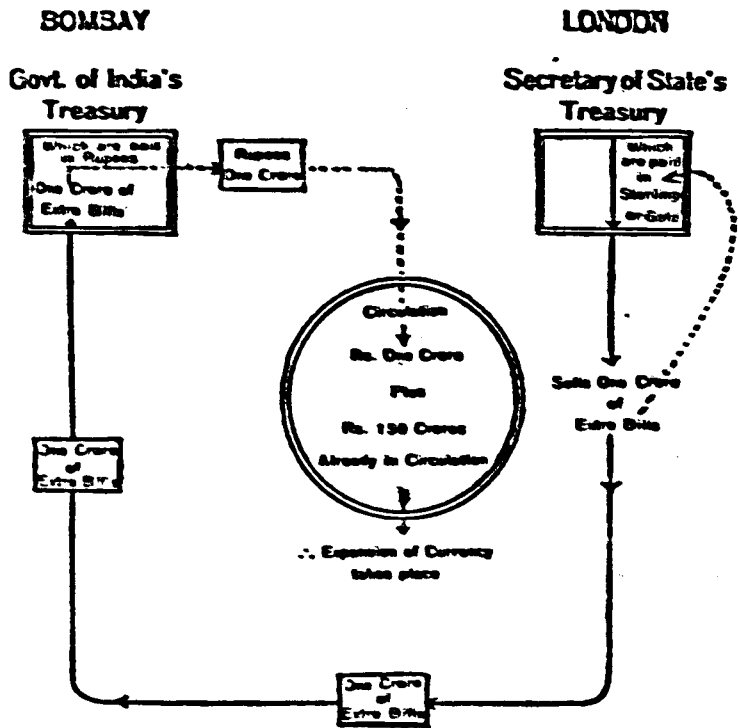


Diagram B—Illustration showing Expansion of Currency resulting from extra sales of Council Bills

This sale of extra Council Bills tended to produce another effect. It *prevented* Rs. 1 crore of *gold* from entering India and thereby helped the Government in bringing down the rate of exchange. Because, if this gold were permitted to enter the country, more gold than before would have exchanged with the same amount of rupees and the rate of exchange would have consequently gone up.

Another means was also resorted to by the Government of India at the same time. They began to *buy* the gold imported into India at a fixed price in rupees. This had the same effect of expansion of rupee currency and contraction of gold in circulation.

This, therefore, was the two-fold mechanism adopted in case *the exchange tended to rise above the specie-point.* *less rupees for £1*

But the present method of purchase of sterling in India by the Government of India results in the expansion of currency *directly* because, when sterling bills are bought by the Government, they are paid for in rupees. These rupees are added to those already in circulation and all these exchange with the same number of commodities as before and thereby tend to keep the exchange value of the rupee *lower* than it would otherwise be.

(b) HOW THE LOWER LIMIT OF EXCHANGE WAS CONTROLLED? (THE SALE OF "REVERSE! COUNCILS") :—On the other hand, when owing to the failure of the monsoon or some other adverse cause Indian exports fell off considerably and the balance of indebtedness went *against* India, the *demand for sterling would be greater than its supply* in India. In this case, the price of sterling was not allowed to rise i. e. *the exchange value of the rupee was not per-*

mitted to fall below the lower specie-point. This was achieved by the sale, in India, of Sterling Bills or "Reverse Councils". These are Bills sold in the reverse direction to "Council Bills", i. e. they are drawn by the Government of India on the Secretary of State.

Suppose X in India had to remit £10,000 to Y in London and at the same time the Secretary of State wanted to transfer £10,000 to India. If in the ordinary course X could not buy bills on London in the open market, he would purchase "Reverse Councils" worth £10,000 from the Government of India drawn in favour of his creditor Y and send it on to him. Y, on his part would present it to the Secretary of State's Treasury and would receive sterling worth £10,000. Thus, by the purchase of "Reverse Councils" the buyers in India pay in Rupees and make remittances in Sterling to London, and by their sale the Secretary of State is able to remit £10,000 to India. Diagram C explains this in a simple form,

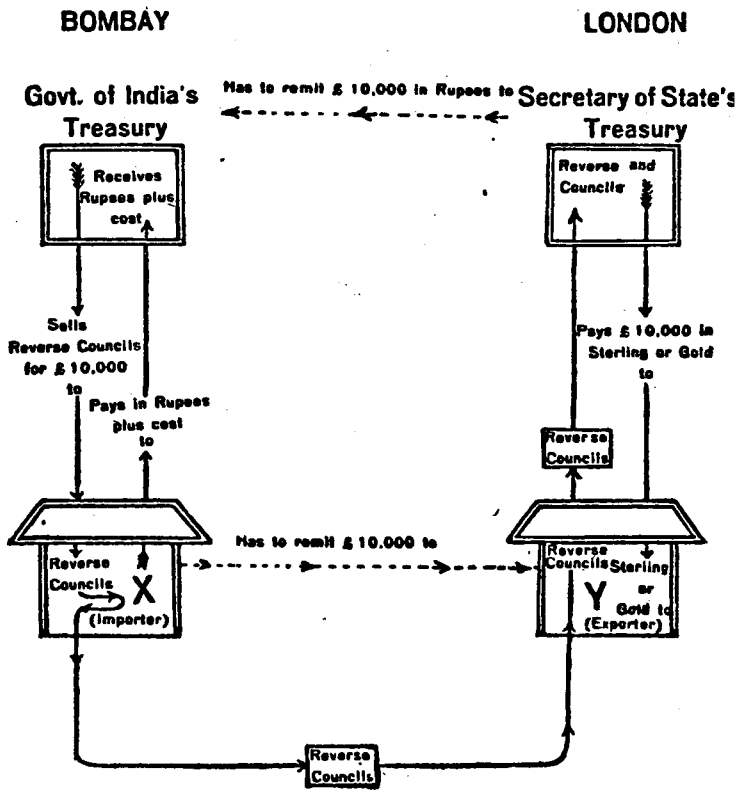


Diagram C — Illustration showing the working of Reverse Councils

But when the Government of India sells "Reverse Councils", they are paid for by the buyers *in rupees*. In this way rupees are withdrawn from circulation and *contraction of currency* is effected and *the exchange value of the rupee is accordingly raised.* *less rupees for £1*

Suppose, as in the above example, there are Rs. 150 crores in circulation, when the exchange value of the rupee tends to fall below the specie-point and it is found necessary to reduce the amount by Rs. 1 crore by the sale of Reverse Councils. The result would be to leave Rs. 149 crores to circulate with the same number of commodities as before, tending to raise the exchange value of the rupee. This is explained in Diagram D.

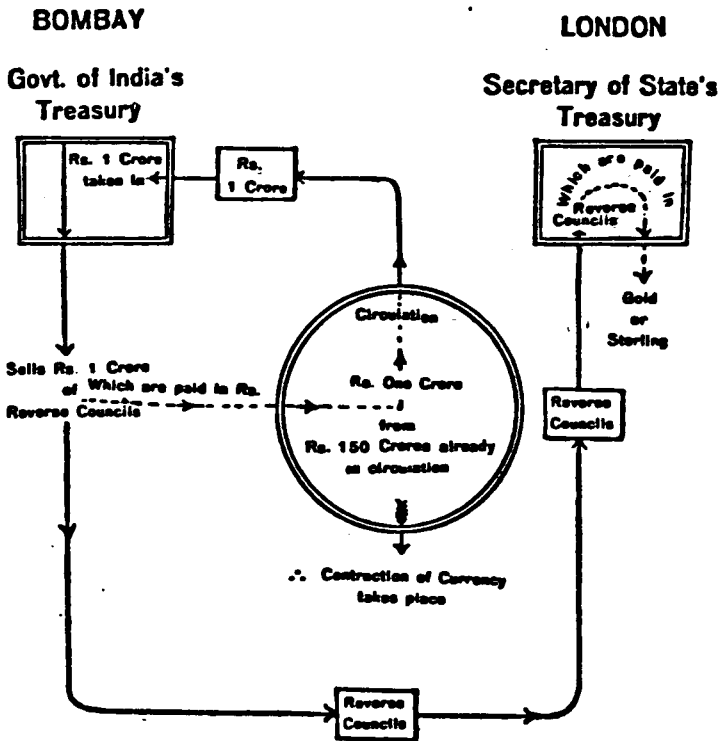


Diagram D—Illustration showing Contraction of Currency resulting from sales of Reverse Councils

Besides, in order to prevent the exchange from falling below the specie-point the Government of India adopted another measure. Before Gold sovereigns were demonetized by the Currency Act of 1927, they were sold by the Government of India in exchange for rupees at fixed rates. The effect of such sales was to withdraw rupees from circulation and put more gold coins into it, so that more gold coins would circulate with less rupees than before, thereby raising the exchange value of the rupee.

In short, the Government of India has endeavoured to fix the upper and lower limits of exchange by directly operating on the exchange market whenever the exchange value of the Rupee rose above or fell below specie-point.