

# OUR STERLING BALANCES

by

M. V. BHATAWDEKAR.

In this considerably enlarged and revised edition, diagnosis of the present Indian attitude is made and its dangers are pointed out. For the first time 'Sterling Balances' are treated as a Transfer Problem and with the analysis of Britain's capacity to export, it has been convincingly argued that British writers on the subject have unduly exaggerated their difficulties.



POPULAR BOOK DEPOT, BOMBAY 7.

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## PREFACE TO THE FIRST EDITION

This little book needs no apology. While the subject is of the greatest importance, the available literature on it is dispersed in various journals and periodicals. Even a systematic presentation of the subject in one place would be of great help to the common reader.

But the object of this essay is not limited to a merely systematic presentation of the subject. I have tried to examine, as far as I could, the present Indian attitude towards the problem. It is for the reader and the critic to judge how far I am correct, and any suggestions as regards correction are welcome.

The subject of sterling balances cannot be discussed without reference to the kindred subject of inflation. I have condensed my views on the subject, in Chapter Two. But for a fuller exposition of the subject I would request the reader to refer to the last Chapter of my book, *A History of Indian Currency*.

The subject is too technical and in spite of my efforts to simplify it, some passages might appear obscure to the general reader. I shall be grateful if such passages are pointed out and such suggestions made, which will enable me to bring the subject within the reach of the intelligent layman.

In the preparation of this essay I have received help from many persons. I owe special thanks to Mr. P. M. Shah, M. A., of the Indian Merchants' Chamber for providing certain information, Principal L. N. Welingkar has taken interest in this writing and I am grateful to him for his criticism. My thanks are due to Prof. M. R. Palande who has been kind enough to read the manuscript and to make a number of valuable suggestions. My thanks are also due to three of my friends Mr. P. K. Garde, Mr. N. M. Ketkar, and Mr. G. P. Palekar who have helped me in various ways.

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of  
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M. V. BHATAWDEKAR.

October, 8, 1944.

## PREFACE TO THE SECOND EDITION

This essay was published ten months back by the Padma Publications, Limited. For the quick sale of the book the selling organisation of the publishers and the growing interest which people are taking in matters economic are responsible. My thanks are due as much to the public as to the publishers.

But in spite of the quick sale of the book it is very difficult for me to say that the book has been well received. None of the leading financial weeklies to whom the copies were sent reviewed the book, and those that reviewed it, I am sorry to write, failed to see the purpose of the book. There was only one exception to the general reviews that appeared in the press. The Marathi newspaper 'Lokmanya' not only recognised the fact that the book had to throw new light on the problem but the reviewer suggested that I must supplement my argument by pointing out how the present attitude is inimical to the interests of the common man.

Similar suggestions were made by some readers and it was definitely pointed out by my friends that without a supplementary chapter describing the evils of the present attitude, the book gave an impression of an attempt to employ the scientific reasoning in support of Government action.

I am not concerned at all with the charge of taking a pro-government attitude as long as it is not combined with another charge of perverting the truth. No reader, as far as I am aware, has made that charge. I am, therefore, guilty of not having given full realisation of the truth about the sterling balances as I wanted to give. I must, therefore, take this opportunity to bring home to every common man how he is vitally concerned with the problem of 'sterling balances'.

### II

It is generally believed that economic phenomena are too complex for the comprehension of the common man. Many times the writings on such subjects are so obscure that a clear view of the problem is rendered impossible, and the belief that economic matters are the concern of the experts only gains strength. The problem of 'sterling balances' is believed to be not only economic but also technical. Naturally, the common reader does not think that he is in any way concerned with the solution of the problem and so the attitude he accepts towards it is one of blank indifference.

For this state of affairs the writings on this subject are mainly spon- sible. The obscurity that prevails in the discussion of this subject emanates from wrong representation of the subject. The discussion of India's sterling balances was preceded by the discussion of inflation. The increase in the amount of money that was taking place due to the favourable balance of trade was wrongly described as 'inflation'. It was confused with inflationary methods that are adopted to finance the war when the government cannot raise sufficient funds and the usual attacks on inflation followed. Going a step further it was pointed out that the issue of notes was backed by sterling securities which are nothing but paper. These sterling securities, so was the argument, are under the control of the Reserve Bank and since the Reserve Bank of India was a State controlled institution, the 'sterling balances' was a problem between the Government of India and the British Government. Once this line of reasoning was adopted it was only a next step to suggest that since sterling balances represent a sum which the master country owes to the slave country, there was every chance of repudiation; And if not repudiation, there was every fear that the pound would depreciate. Much of the writing on this problem thus centred round two points only: viz (i) raising fears of repudiation and if not of repudiation, (ii) of a loss of value on account of the depreciation of the pound.

Because of the pseudo-nationalistic character alone the argument was bound to be popular. But since it was likely to be beneficial to certain classes of the community it was accepted and widely propagated.

However, since the problem of sterling balances will be soon pressing, this faulty reasoning should be thoroughly examined and abandoned once and for all.

To have a clear understanding of the problem, the point should be firmly grasped that sterling balances are not a problem between the British Government and the Indian Government. It is essentially a problem between the Indian people and the Government of India. When His Majesty's Government were in need of goods and services the Government of India undertook the responsibility to make purchases on behalf of the British Government. In order to secure goods from the Indian producers, the Government of India were required to pay hard cash in rupees. It was not necessary for the Government to tax

the Indian people to raise the rupee sums. After all the goods which would be sent to England were paid for by the British Government. But the payment was to be made in sterling. The problem before the Government was, therefore, to secure rupees for the sterling which they were receiving. Since the problem was that of conversion of sterling into rupees, the Government had to resort to the usual procedure. All the sterling sums were offered to the Reserve Bank and it was required to pay in rupees. It was a statutory obligation on the Reserve Bank of India, to give rupees in exchange of sterling and even though many such demands on private accounts could be ruled out, the Government demand could always satisfy the requirements of the exchange control. The Reserve Bank, therefore, using its power to issue notes against sterling, could satisfy this demand on the part of the Government.

Once this mechanism of issuing additional currency is carefully understood many points become at once clear. Since the Government of India are required to pay sterling to the Reserve Bank of India they had to see that the amounts were secured from the British Government. Thus for all purchases not only were the Indian producers adequately paid, but the Government of India also were paid. The sterling balances thus do not represent a sum which British Government owe to Indian Government. If the sums are thus paid out, it should be clear that it is no longer a problem between the two governments.

Similarly, because the Government of India have paid the Indian producers, these sterling balances no longer remain on their account; they have, therefore, no ownership rights over these balances. The major part of these sterling balances is held by the Reserve Bank in the form of sterling assets, and these assets will be utilised only in fulfilling the obligation to pay back in sterling whenever rupees are offered.

Now, it should become at once evident that all those people who can afford to offer rupees to the Reserve Bank will be able to acquire these sterling balances. The industrialists and the traders knew very well that, they alone had the rupee amounts and they alone would be able to acquire sterling balances whenever they will be released.

But an early release was in the interest of moneyed classes. There was every possibility that national government might be established.



Such a government at least to a certain extent was bound to pursue a policy that would not allow these people to utilise these balances for expanding their own private concerns but might use these sums for establishing such industries as would be government-owned and government-controlled. If the sterling balances had been released immediately it was certain that this class would have acquired those sums and succeeded in turning this national property into private property.

The writings on the problem were directly helpful to this class to achieve this objective. There were possibly two difficulties. Since people were made to suffer in order to accumulate these balances they would oppose this policy of releasing sterling and making it available to one class only. Raising the fear of total repudiation was useful to prevent such opposition to immediate settlement. No Indian could have objection to the gain of this class if it averted the possible loss to the country.

But the second difficulty could not have been overcome by this argument. It was not possible to bring pressure on the Government to relax the exchange control by saying that there was possibility of repudiation. To induce the Government for immediate release it was pointed out that the pound may depreciate in future and it would involve loss in value. It was, therefore, necessary to release these balances as early as possible.

Since the attitude taken by the writers on the problem was thus favourable to the capitalist class it should be no surprise that it was accepted and popularised by such a financial weekly as the 'Eastern Economist'.

In spite of all this propaganda, however, the conditions of the Exchange Control were not relaxed and as yet these sterling balances have not been converted into 'private property'. It is not late, therefore, for the common man to realise his position even now and establish his own claim.

Once the truth is known that there is no possibility of repudiation and that it is not a problem between two governments the entire attitude towards the problem changes. In order to accumulate these sterling balances expansion of currency was necessary. This continuous expansion caused enormous profits and the incomes of the richer

classes were increasing day by day almost beyond measure. Hence in spite of rising prices the richer classes did not suffer at all. In fact, they gained all the advantages of the so-called inflation while all the losses had to be suffered by the masses. Because of the rising prices it was not possible for lower classes to keep up their ordinary consumption and they were even required to sacrifice the bare necessities of life. The creation of sterling balances thus owes its origin to the vast sacrifices which were imposed on the masses. And it is only natural that those alone who have suffered should gain the advantage of the accumulation.

Any move on the part of the Government whereby sterling would be made freely available to the richer classes should be strongly opposed by those who have suffered because of 'inflation'. The problem of sterling balances can be said to be 'satisfactorily solved' only when these balances are used for the amelioration of the masses. With this view in mind only I have suggested means whereby it would be possible for the Government to acquire Rs. 500 crores worth sterling without any withdrawal of currency. The Government should proceed to spend such money on developing hydro-electric power, irrigation schemes, building dams, and building railways, etc. They will be of far greater help in stimulating the general economic development in the country and the resulting increase in the employment and the income level will be much greater.

Apparently the suggestion does not bring out any striking difference in the solution of the problem of sterling balances. After all, it might be argued, the private individual who will get the sterling will utilise it for expanding the existing plants or establishing new industries. Such a procedure also is bound to result in increasing income-level and employment. There is thus no reason to decry the demand for removing the exchange control and releasing the sterling balances freely to all the individuals.

There are two important reasons which should gain support for the policy outlined in this essay. In the first instance, the new nation building industries will ever remain the property of the nation and the dangers of capital accumulating in the hands of the few will be averted. Secondly development of these industries will give a stimulus to general economic development. Many new industries will be started

and our trade and commerce will flourish. The increase in employment and income-level is bound to be far greater than what private industries such as automobile industry or machine tool industry can provide.

### III

Having made it sufficiently clear why the book was written for the common man, for the remaining part of the preface I can indulge in the academics of the problem.

For my own part, I have only succeeded in proving that there is no budgetary problem in connection with our sterling balances. Normally, there are two distinct problems connected with such payments as are to be made by one country to the other. Usually such transactions take place between two governments and the debtor government is reduced to that position mainly because of two reasons. A government might raise loans abroad and thus may place itself under the obligations of making payments to the other country or countries, or it might be required to make such payments because of war indemnities imposed upon it. Whether it is war indemnity or loan of capital from one government to another, the government, which owes the sum and has therefore to pay the annual instalments, is required to raise the sum by way of taxation or public borrowing. Thus the government must succeed in making provision in its annual budget of a sum equal to the value of the instalment to be paid to the creditor government. Now it may not be always possible for the debtor government to raise the necessary sum. There are limitations to taxation and borrowing, and as it is likely to happen in case of war indemnities, the government will be unable to manage its huge budget and pay the necessary instalments. Again, even if the magnitude of the instalment may not be exceeding the limits of the budget, due to extraordinary circumstances, e. g. long and severe depression, the revenue of the government might suffer and the same result will follow. When the budgetary problem thus becomes unsurmountable the only course open to the debtor government is to default. Precisely such a course was followed by England with respect to America when His Majesty's Government declared their inability to pay owing to the severe economic depression.

In the case of India the problem does not arise at all. For all the purchases of goods and services which they have made His Majesty's

Government have paid the sums and will not be required to have recourse to taxation and borrowing. The Government have already taxed the people so as to enable themselves to make these purchases. They are free from all payments and have not to face any budgetary problem. Hence there is no possibility of budgetary problem.

This indeed is an advantage of the peculiar mechanism that was adopted to secure goods and services for His Majesty's Government. This advantage was never seen by the Indian Economists and they made suggestions which would have added to our difficulties. It was suggested in the manifesto issued by twenty-one Economists that in order to check and prevent inflation, Government of India should tax the people and increase public borrowing to find out the necessary rupee amounts. It was further suggested that a loan should be given to His Majesty's Government. In all these cases, the payments, because of the sub-ordinate position of the Government of India, would have been postponed, and we would have added one more problem viz., budgetary problem, to many others which already exist. It is indeed gratifying that these suggestions which amounted to creating problems for the country were not accepted by the Government. Because of the fact that the same arrangements were continued today we find that at least one of the two problems is already non-existent.

The second problem is often referred to as "Transfer Problem." This term was used by Lord Keynes while discussing the problems of German reparations. In his article 'The German Transfer Problem' in the Economic Journal he pointed out that even though the debtor government succeeds in raising the required monetary sums it may not succeed in discharging the debts. Ultimately international payments are made in terms of goods and in order to achieve it the country shall have to create surplus export trade. It will be possible to create such surplus export, only if the production of export industries is increased and for increase in production it will be necessary to transfer some of the labour and resources from home industries to export industries. In a capitalist economy such transfer can be brought about only by reducing the wages in home industry. Lord Keynes wanted to contend that even if the budgetary problem is solved there are certain circumstances in which reduction in wages becomes difficult and even impossible and since increase in production of export industries becomes impossible the country cannot succeed in making the payment

in terms of goods. He gives the circumstances in which wage-reduction may become impossible. He writes, "Such a reduction becomes difficult and may be even impossible in the following cases, †

"(i) Where the output e. g. personal services or buildings cannot be exported anyhow:

"(ii) Where the world's demand for England's goods has an elasticity less than unity i. e. where a reduction in price stimulates demand less than in proportion so that the greater quantity sells for a less aggregate sum:

"(iii) Where England's foreign competitors fight to retain their present connection by reducing their own rates of wages *pari-passu*:

"(iv) Where England's foreign customers, reluctant to allow intensive competition with their own producers, meet it by raising their tariffs."

In order to find out whether the transfer problem with respect to our sterling balances presents difficulties which cannot be surmounted it must carefully be examined whether any of the above-mentioned conditions are present. The problem would be difficult or even unsurmountable if one or more of these conditions are in existence. On the other hand, if on the application of these principles, it is revealed that none of these conditions is present it must be said that there exists no Transfer Problem in the sense that the necessary changes in the production in export industry can easily be accomplished

(i) I am not quite clear as to what is suggested by the first condition. But it seems to me that the condition only indicates that the exports of these two items are incapable of contributing substantially towards creating a surplus to the desired magnitude and consequently they will ever remain items on which a country cannot depend to create a surplus.

Lord Keynes was writing with special reference to Germany and there it was natural to think in this way. However, it should be made very clear that the export of personal services is not as unimportant in case of India as it would be in other cases.

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† Economic Journal-March 1929 - page 5.

I have substituted England for Germany so as to make the quotation more suitable for the discussion of Sterling Balances.

At present there are 72,000 English men in the services of the Government of India. † The number of such people employed in private services e. g. in factories, banks etc. is not known. Further in years to come there will be rapid economic development in the country and for that India will be required to import 'skilled labour' along with many other items. Taking into consideration this additional 'export of personal services' in future, it may be said that it will turn out to be of considerable importance.

There might arise one difficulty in the repayment of sterling balances in the case of 'export of personal services'. If all the income which the foreigners receive is spent in this country it will only have an effect of not creating demand for sterling balances. It will not reduce the volume of the sterling balances and the interest payment shall have to be continued.

To get over such a difficulty a definite plan shall have to be followed to reduce the volume of the sterling balances and consequently the burden of interest payment. His Majesty's Government will have to compell these people to subscribe to the national debt. They will be required to surrender to the Reserve Bank a definite percentage of their income and the Reserve Bank will transfer sterling securities of equal amount to them. Thus in course of time the balances will be reduced and the problem will be solved to that extent.

ii) No elaborate argument is necessary to prove that the elasticity of demand for English exports is not less than unity. Almost all of England's exports consist of manufactured goods and such goods do not have inelastic demand.

It must be remembered that substitubility is not the only factor which is responsible for elasticity of demand. Among other factors changes in income and the distribution of it are far more important. The demand for a commodity might be increased more than proportionately by slight reduction in the price if by that reduction the commodity is brought within the reach of classes having lower income. Similarly the demand for a commodity might increase even if the price remains the same provided that the income of the lower classes is raised. The same result will follow even though the distribution of income remains the same but the income of the community increases.

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† 'Imperialism in action' by Margaret Pope.

The last two are likely to be the possibilities in India. The distribution of income may slightly change in favour of the lower classes. But more certainly the income of the community will rise. Due to development of industries in post-war years employment and income in general, are bound to increase and this increase will result in greater demand for English goods, even at the prevailing prices. There is thus no difficulty in the way of creating surplus export trade because of the nature of demand. On the contrary the nature of Indian demand is such that it would make it very easy for Great Britain to create a surplus export trade.

iii) For want of sufficient statistical data and other information it is very difficult to say whether the competition of other countries would prevent Great Britain from increasing her exports to India. But some of the factors which indicate that there will be no great difficulty of this sort might be stated.

The only powerful rivals to England are Russia and America. Both these countries are less interested in India and their keen competition will be felt in Central and Western Europe rather than in India. No doubt the percentage of these two countries in our foreign trade will increase. But that means nothing. In the first instance, India's foreign trade is not in a static condition, so that a gain by these two countries must necessarily mean loss to Great Britain. On the contrary India's foreign trade will be growing rapidly. In these circumstances to draw a conclusion that England will not be able to increase her export trade with India it must be assumed that (1) England will not be able to capture even a per cent of our additional imports and (2) that even those supplies which India secured from Germany and Japan and which it is impossible for her to secure from these two countries in near future, will be provided by Russia and America. When these factors are taken into consideration it seems almost inevitable that India's imports from Great Britain are bound to increase by a considerable amount.

In spite of all these factors if the costs are lower in Russia and America, no doubt it will be difficult for England to increase her export trade to the extent to which she can do so otherwise. No information regarding the price-structure and cost-structure of Russia is available. The economic structure of that country is entirely different.

In a planned economy as that of Russia the whole system is concentrated on home industries rather than on export industries. Normally the planning authorities develop such export trade only as is necessary for internal development. At present the country seems to be more busy with the internal problems and it seems very difficult that the planning authorities would change the internal structure in order to secure foreign markets on which the country does not depend to any significant extent.

The economies of U. S. A. and Great Britain are alike and the New World has increased its productive capacity so much that development of foreign markets is essential. It does not, however, seem likely that America will be required to lower the cost structure in order to capture the Indian market or other foreign markets. For, in the first instance there are many other Asiatic markets which America can develop without any competition from Great Britain. Recourse to the markets where English goods have already penetrated will be necessary only if other markets turn out to be insufficient for the increased exports of America. Again it should be remembered that Great Britain has succeeded in keeping her cost-structure on a low level by adopting various controls. The White Paper to which a reference has been made in chapter four, indicates that Britain's costs are actually lower than that of America. If this report is true, a reduction in American costs would only mean, in the first instance, enabling that country to achieve parity with Great Britain. In any case it might be safely concluded that England's competitors do not create difficulties which would make it absolutely impossible for England to repay her debt.

(iv) The last factor deserves a more careful consideration because it is generally feared that by using the political power such goods alone would be forced on India as would kill the existing Indian industries. If one takes into consideration the composition of our imports in pre-war days this belief gathers strength. The major part of our imports consisted of consumers' goods such as cloth, pastes, powders, drugs etc. Almost all these goods are now produced in the country and hence if additional goods of these types are imported it is likely that demand for home industries would suffer. Would not the repayment of sterling balances, it might legitimately be asked, be detrimental to our industries ?



It is not possible to find out a final answer to such a question unless the way in which the repayment of sterling balances will be effected is fully understood.

At present almost all our sterling balances now worth about Rs. 1,300 crores are invested in the sterling securities. They will be released only when rupees are withdrawn, not otherwise. The actual total amount which England will be required to pay will be determined by the amount of currency which Indian people will be prepared to withdraw. There seem to be two different methods of working out the magnitude of the probable withdrawal. The simplest and the easiest to follow is the one which is employed in making the calculations in Chapter four.† Assuming that the people are inclined towards the pre-war price-level the quantity of money needed for increased production will be in the neighbourhood of Rs. 300 crores. At present notes in circulation are over Rs. 1,100 crores, which means that almost Rs. 800 crores might be presented to the Reserve Bank in exchange for sterling. But this method cannot be relied upon as the safest method because it rests on the crude form of the quantity theory, ignores the possible increase in production in the next few years which might increase the demand for money, does not take into consideration hoards, and attaches too great importance to psychological factors.

Another method to work out the magnitude of currency withdrawal is to work out the surplus demand for foreign goods. There will be a greater demand for imports in post-war years because both the firms and the individuals had to live on capital during the years of war. The probable demand on the part of industries is worked out at Rs. 150-225 crores.× The various assumptions that have to be made are explicitly stated in chapter four. Here it is necessary to mention two more points. It ignores the machinery that has been imported during war-years, and the probable additional demand that might exist due to various schemes of expansion of industries. Due to want of information about the new schemes it is very difficult to calculate such demand. However, from the news that are published every day it might be said that the additional demand on account of new schemes would more than compensate the ignored imports of machinery during the period of war. Taking these two together it might be estimated

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† See page 20

× See page 21

without much error that the demand on behalf of industries would be varying between Rs. 300 and 350 crores.

In the case of individuals it is very difficult to calculate such demand. In big concerns and factories regular procedure has to be followed in replacing the old machinery. Such regularity is not maintained by the individuals. No doubt men had to go without houses, vehicles and many other durable commodities. But there are no regular depreciation funds set apart and it cannot be said that there will be additional demand equal to five times the average annual demand. However if 50% of this demand that has gone unsatisfied is regarded as likely to arise from the replacement of individual capital goods, the figure need not be considered erroneous.

The average post-war demand ( 1918-39 ) for vehicles, instruments apparatus and appliances, hardware, building and engineering materials was Rs. 17,63,92,000. So that the additional demand which is likely to exist in immediate future may be somewhere Rs. 44 crores. Following the method adopted in case of industries, it cannot be said that because of higher price-level the total demand would be Rs. 132 crores. However, it may safely be said that individuals would be prepared to purchase goods at double the pre-war prices. So that the total demand for what might be termed as capital goods might be estimated round about Rs. 400 crores.

According to the first method the probable withdrawal would be about Rs. 800 crores while according to the second one it would be Rs. 400 crores. The difference is indeed too great and while considering the dangers of repayment to our existing industries this fact must always be borne in mind.

Before proceeding further one important point must be stated, As long as the whole payment is not completed India would be receiving from England payments on two different counts. Since all our sterling balances are invested in securities we shall be receiving payment by way of interest; and when the balances are released we shall be receiving the sums as the payment of principal. Even at one per cent rate of interest the interest charges would be over £ 11,00,000. So that we shall be importing goods in payment of this sum and in addition to that goods equal to the value of instalment which would depend upon how quickly the debt is repaid. Reasonably speaking it might vary between

£ 50 million and £ 100 million. Of course as the principal is repaid gradually the interest payments would be scaled down.

When the position as regards the different payments due from England is clearly understood it becomes obvious that we have to decide two different questions. First we must try to find out how far England will go in forcing consumers' goods in payment of these sums.

Clearly so far the demand for capital goods is concerned England should have no objection to give capital goods which are needed for replacement. Before this war these goods were supplied by England and since replacement of capital is essential and it does not mean expansion of Indian industries, there will be no restriction on such imports. But if the demand begins to exceed Rs. 400 crores it means that it is for further Industrial development and such imports may not be allowed.

There is no reason to suppose that any rigid restrictions of this type will be found in practice. After all it has been realised that development of Indian industries is in the interest of Great Britain. But for the sake of argument assuming that the old policy of checking India's industrial development is pursued, a policy might be adopted whereby sterling will not be released if it is likely to be conducive to the industrial development of India.

In such a case the calculations made with regard to withdrawal of currency according to the first method must be remembered. If the demand is just equal to Rs. 400 crores there is no problem. But if it begins to exceed that limit it is likely that the political power might be used and there would be danger to the existing industries.

To determine whether such a course would be seriously dangerous the way in which these repayments will be realised must be understood. The interest payments will be received by the Reserve Bank of India. It means that the profits of the Reserve Bank will increase, as all the profits, after due deductions (the dividend is only 4% or it might be increased to 5%) are taken over by the Government. In effect, therefore, payments on account of interest charges will go to increase the revenue of the Government and it will depend upon the government action whether they would create any trouble to Indian industries. If the government decide to give relief to the tax-payer by way of reducing indirect taxes, the income of the lower classes

will increase and since consumption will increase *Pari passu*, even if consumers' goods are given it will not affect the Indian industries. Again if the government decide not to give relief to the tax-payer but use such sums for public works programme the same result will follow.

As against this if the government decide to give relief by reducing taxes such as supertax or if a policy of reducing the public debt by the same amount is followed, the income of the richer classes only would be increased. It will only mean that there will be a greater propensity to save and it may create some trouble. Since it is assumed that only consumers' goods can be had from England there will be a tendency on the part of these classes to shift their demand from Indian industries to English industries. But, after all such a loss will not be of a serious nature because such demand shall be confined to articles of luxury only. England cannot supply foodstuffs and the other demands of these classes were never largely supplied by Indian industries.

More probably, however, it will lead to hoardings. With higher incomes consumption does not increase in the same proportion as the income and there will be a greater tendency to invest the increased savings. But since by the assumption import of capital goods is prohibited it will mean sterilisation of our savings or increased speculative activity on the stock exchange.

Similar effects would follow in case of additional payments of principal. Finding that nothing but consumers' goods can be had there will be a tendency not to import these goods beyond a certain limit. The magnitude of the balances will continue to be more or less the same and interest charges also will be the same. How long such blocking will be continued is not the point at issue. It has been partly discussed in Chapter Four. From whatever has been said it is clear that repayment of these balances does not mean a great harm to our existing industry. Therefore, there will be no need of raising the tariffs to protect our industries and from that source there will not be any difficulty of a serious nature.

Reviewing the whole discussion of the four factors we find that the first three are almost non-existent. So far the fourth is concerned there will be some difficulties but they cannot be regarded as rendering the whole transfer problem impossible of solution.

## IV

Uptill now the argument with respect to the Budgetary Problem and Transfer Problem was developed with a view to pointing out how extremely difficult it is for England to effect repudiation of our sterling balances. It was necessary to develop argument in this fashion because of the common belief that England is sure to repudiate these sterling balances. As it has been already pointed out, the writings and utterances of officials and non-officials in England were largely responsible for such a belief. As a matter of fact English writers have always exaggerated difficulties of England and given rise to undue fears. Hence to complete the argument it is necessary to study the post-war position of Great Britain and find out whether the difficulties imagined by the British writers are really serious and whether it is in any real sense a hard task for Great Britain to repay these sterling balances.

First of all it is essential to have a correct idea about the Sacrifices which Great Britain will have to make in order to pay off these sterling balances. The national income of that country is estimated to be over £ 7000 million. The external debt of England amounts to £ 3000 million. Supposing that England is required to liquidate all her sterling balances within ten years, the sacrifice which the country shall have to make comes to 4 per cent and a little more. If the calculation is confined to India only, it may be said that Britain will be required to pay over £ 600 million. On the supposition that the payment is spread over a period of ten years, Britain will be required to sacrifice hardly 1 per cent of her national income. When the actual sacrifice involved in the repayment of sterling balances is so little, any argument attempting to give an impression that it is not possible for England to pay off these balances and hence they ought to be scaled down, must be regarded as almost meaningless.

To give further support to this conclusion it is necessary to point out the additions to her national income which Britain is sure to make in years to come. In working out the magnitude of Sacrifice which Britain shall have to undergo it was assumed that the external debt would be paid out of her own national income earned by internal production and external trade and investments. The enormous gain which England has secured by way of reparations from Germany in this war was not taken into consideration.

The actual amount in terms of pounds is not known. But from the principles of Potsdam Agreement it is clear that it is found to be in millions of pounds. Even if Britain decides to pay off sterling balances out of these reparations a large portion of her external debt would be paid off.

In all these considerations the real national income has not been taken account of. Before the war the national income of Great Britain was about £ 5000 million. It might be questioned whether there is any increase in the real national income of Britain or whether the rise is due only to higher prices. If it is due to higher price-level then the whole argument loses its force. For, ultimately England can pay off her external debt only by increasing her export trade and thus creating a wide margin between her exports and imports, and the capacity of England to create a surplus export trade finally depends upon the increase in the productive capacity of England. The true importance of having an idea of an increase in the productive capacity of England can be realised only when the peculiar position of England is taken into consideration. It is a well known fact that Britain has to import almost all the raw materials which she requires for her exports. If exports are to be increased it follows that imports must be increased. If, therefore, England decides to pay £ 300 million annually she will have to increase her export trade by a greater margin. The probable productive capacity of England is, therefore, the most important question which must be answered satisfactorily.

Unfortunately it is not possible to secure the necessary statistical data. However, from the information that has been made available it seems beyond any shadow of doubt that the productive capacity of England has greatly increased. Even agricultural production which could not be removed under ground was increased by 70%. With respect to industrial production World Economic Survey † for 1941-42 states, "In the United Kingdom the unemployment was down to under 150,000 persons in march 1942, having been about 1½ million in the same month of 1939.....The number of industrial women workers has been increased by 4,000,000..... As a result of all these measures, war production was doubled in the year from June 1941 to June 1942."

Recently the London Times has published, 'A Record of British War Production.' In this supplement Rt. Hon. Oliver Littleton writes, "Of all the munitions used by the armed forces of the British Commonwealth and Empire (8½ million men in all) since the beginning of war no less than 70% was produced in the United Kingdom itself."

To have a further idea as to how this increase in industrial production was achieved, use of the official division of industries might be made. The first group represented engineering and allied (munitions) industries. The second group included the basic essentials such as public utilities, transport, shipping and food. The third group comprised the civilian industries such as building, textiles, clothing, distribution and professional services.

The number of workers in the first group increased from 3,100,000 in 1939 to 5,200,000 in 1944, that in the second group remained same while in the third group it decreased from 9,300,000 to 6,000,000. It need not be supposed that increase in employment in the first group was secured at the cost of the third group. For, "the number of men and women employed in the forces, whole time Civil Defence and the women's auxiliary services rose from 550,000 in 1939 to 5,250,000 in 1944"

To sum up, taking into consideration increase in the agricultural production and gains from German reparations there is no room for any doubt concerning the productive capacity of England. It is absolutely easy for England to increase her exports so as to create a surplus export trade to the desired extent, and the policy advocated by the Labour party of increasing exports is in the right direction.

The conditions of international trade also seem to favour Great Britain in making it easier for her to pay off these sterling balances. During the Great Depression and the years that followed it the agricultural production increased more than proportionately in comparison with the industrial production of the world. This tendency is likely to be strengthened in the post-war years. Eventhough it is a fact that industrial production in U. K. and U. S. A. has increased it must also be remembered that agricultural production has increased almost by the same percentage in these countries. In addition to that while the agricultural production in Canada, South America and Australia has increased by a large percentage two important industrial countries

Germany and Japan have been defeated and plans are being prepared to turn Germany into an agricultural country and to kill Japanese industries. Generally speaking while the agricultural countries of the world have not been directly affected by war almost all the industrial countries were adversely affected by the war. The result is inevitable. The increase in agricultural production is bound to exceed the increase in industrial production and the terms of trade will go against the primary producer. In such circumstances it will be possible for England to secure greater amount of raw materials and food stuffs for the same quantity of exports. Thus it will be possible for England to create the necessary surplus export trade without increasing her exports to any great extent. When this fact is taken into consideration it becomes obvious that the difficulties of England are a product of the imagination of the British writers on the subject.

Lastly, one more factor which has some bearing on the problem might be mentioned. Any one who has read the famous reports of London Chamber of Commerce and Federation of British Industries will be convinced about the revolutionary change that is overcoming the British industrialists. They have not only realised the fact that industrialisation of the Eastern countries is essential and inevitable but they are prepared to help such a process by supplying capital goods. Two reasons are responsible for this changed out-look. Firstly it is realised by them that to ensure increased demand for their greater productivity the purchasing power of the Eastern countries must be increased. Secondly for technological reasons, it is easier to carry out a change from war production to the production of capital goods. It is only natural that British industrialists should now be prepared to supply capital goods when conditions are almost forcing them to do so.

Reviewing the whole discussion it appears that it is extremely easy for England to repay these sterling balances and any attempt to scale down these balances is without any basis. We should not allow ourselves to be carried away by the systematic propoganda of the financial press in England and America. On the other hand we must be on our guard to defend our position and turn down any demand on the part of England to reduce these sterling balances under one plea or the other.



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The preface has been too long. But in view of the fact that the original essay was of a controversial nature, it would have been contrary to tradition to introduce changes in the body of the essay. Without, therefore, an apology for the monstrous length of the preface, it would be more appropriate to thank various gentlemen who have helped me in bringing out this second edition with the addition of this preface.

Dr. S. K. Muranjan of Sydenham College and Prof. N. A. Mawalankar of Fergusson College were kind enough to spare considerable time for discussion and I am grateful to them for their criticism and valuable suggestions. Mr. P. M. Shah, B. Com. of Indian Merchants' Chamber supplied information whenever I sought it and my indebtedness to him cannot be adequately expressed. Mr. G. V. Mahashabde, B. Com. has given considerable help in correcting proofs and getting the book ready in a short time. I record my thanks for his unsparing efforts.

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# OUR STERLING BALANCES

## CHAPTER ONE

### INTRODUCTION

Not only the views expressed in this essay but even the title and the choice of the subject are likely to provoke some criticism; many other subjects, such as inflation, the methods of war finance, etc., will be discussed in the body of the booklet even though they may not be directly suggested by the title of this little book. The choice of the subject is likely to come in for criticism for to many readers the subject has become quite out-worn and they believe that no substantial addition can be made to what has already been said and written. In a sense it is true that this subject (and especially the allied subject of inflation) has been discussed so often that it has lost—if not its significance, at least its novelty. In spite of these facts a keen interest has been aroused in this subject recently and once more articles are pouring in, in various economic journals and periodicals.

The cause of this sudden interest is to be found in the recent events. The international monetary conference was held at Bretton Woods and news flashed in the daily papers that India's demands in respect of sterling balances were turned down. Soon after the Conference, when questioned in the House of Commons, the Government of Britain chose to remain silent on this issue. Besides, the speech made by Lord Keynes in the House of Lords and the general trend of articles and notes that appeared in the *Economist* have brought about a complete change in the Indian outlook on the question of sterling balances. The recent articles on the subject are an expression of the changed attitude.

It would not be far from the truth if it is said that Indian opinion on the subject has always been a reflection of and a reaction to the British attitude towards the war debts of England. The sterling balances began to attract attention of the British people when the accumulation reached a figure that decidedly changed the position of Great-

Britain from a creditor country to a debtor country. In June 1943 a leading article appeared in the *Economist* boasting of the generosity of the financial settlement between India and England. There was a reaction in this country against this attitude because the losses which the Indian people had to suffer due to inflation, not being very perceptible, were not taken into account at all. There was a general feeling in the country that the cost which India has to bear had already reached the maximum of her capacity and this feeling is to be found embodied in the scientific and convincing book *Financial Burden of War on India* by Prof. C. N. Vakil.

The inflationary method of financing war in India was continued and sterling balances went on increasing in magnitude. The total accumulation was in the neighbourhood of £ 2,000,000,000 of which £ 1,000,000,000 were credited to the Indian account by June 1944. This figure did not fail to create anxiety in Great Britain about the mounting war debts and instead of a feeling of generosity, there was now a feeling of nervousness and worry and the general attitude of the British politicians and the press underwent a change. There was a general demand for the revision of the financial settlement between Great Britain and India and it was further argued that since a part of the expenditure for defending India from Japanese invasion was incurred by His Majesty's Government, India should bear the cost of defence on this account. The city editor of the *Manchester Guardian* said, "On balance India has become a creditor of England not through normal process of trade and investment but through negotiated division of defence cost. The Indian Government drove a very hard bargain with the British Treasury only justifiable by regarding India as a semi-neutral"† Complaining about the agreement the *Economist* wrote, "India only pays for the cost of air-fields constructed in India if they are regarded as necessary for the local defence of the country. The Asia Command and those which are used by British forces are not provided for in the Indian budget estimates. This repatriation of financial costs—the true costs are in any case borne currently by India—was agreed upon before Japan entered the war and before the scale of military operations in and around India could possibly have been foreseen. The financial agreements can hardly have contemplated a situation whereby the expenditure of the British Government alone in

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† *Eastern Economist*— 3-7-43, page 213.

India would very considerably exceed the total Indian Government Budget." ×

These articles did not fail to create suspicion in the minds of the Indian people as to the genuine desire of Britain to pay those war balances. One of the monthly notes of the *Journal of the Indian Merchants' Chamber* was entitled 'Repudiation?' in which the writer says, "The speech of Lord Keynes in the House of Lords has created and rightly--a sort of righteous indignation in the Indian Commercial World over the question of our sterling balance . . . It would seem from the above observations of the *Economist* that the repudiation ball was set rolling before Lord Keynes openly said it in the House of Lords." † The *Eastern Economist* in its leading article comments, "Further in recent weeks, the danger of these balances being frittered away under one plea or another and under one arrangement or another, which had been somewhat remote is threatening to be imminent." =

A general feeling of suspicion and distrust with regard to sterling balances is only natural, considering the fact that India is a subject nation that has not been given a fair treatment on many occasions. But this is only one aspect of the Indian attitude towards this question. The other is more positive. It is generally believed that though Britain may not repudiate the debt she will yet give such goods in repayment of it as are not wanted by Indian people. After all these balances have been created by sacrifice and therefore, India must be able to use these forced savings in any manner she chooses. For the economic development of the country India needs capital goods which she should be able to secure with the help of these sterling balances from Great Britain; and if England cannot supply these goods at competitive prices, India must be free to change her sterling resources into any foreign currency and purchase goods in any part of the world. In short it is considered that these sterling balances are the private property of the Indian nation and the country must be free to use it in any way that she thinks best. Voicing these feelings the *Eastern Economist* in its leading article writes, "The second problem to which however greater attention has been given is how to ensure that the sterling balances are

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× *Economist*—25-3-44.

† *Journal of the Indian Merchants' Chamber*, June 1944.

= *Eastern Economist*, 2-7-43, page 218.

available when we want and in the manner in which we want them and how to ensure against their depreciation in value" 8

The purpose of this essay is to examine critically the correctness of this attitude and to see whether it requires any further modification. In order to arrive at the right conclusion it is necessary to examine in detail (i) whether it is possible for the British Government to repudiate all the sterling balances, (ii) whether even if there is no attempt at total repudiation—there is any likelihood of loss by way of depreciation of these balances in value or through enforced sales of goods which we do not want and (iii) whether there should be any restrictions on the use of our sterling balances or whether we should be quite free to use them in any way we like and at any time we choose. However, before any direct consideration of these points is undertaken, it is absolutely essential to sketch in brief the origin and the nature of our sterling balances.

## CHAPTER TWO

### ORIGIN AND NATURE OF OUR STERLING BALANCES

On the 3rd September 1939 England declared war on Germany and without the consent of the Indian people India found herself involved as a partisan in this war. Participation in the war on the side of the master country meant without doubt that all co-operation would be offered by the Government of India to the Allied powers. India was not directly threatened, and therefore the help which she could give, was naturally confined to the provision of supplies and men for the purposes of war. India was an important market for His Majesty's Government for the purchase of goods from Indian manufacturers and agriculturists and for the services of recruits. But to make these purchases in India it was essential for the foreign government to pay in terms of rupees to the producers of goods and to the men who were ready to serve. The British Government, however, had no rupees. Normally, in peace time, purchases of goods alone were made and they could find the necessary rupees because there were at the same time

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8 Eastern Economist, 2-7-43, page 219.

Indian importers who were ready to pay rupees in exchange for pounds sterling, which they needed to pay to the English merchants from whom they purchased the commodities. It was essentially a two-sided bargain in which, in the first instance, rupees were exchanged for sterling and finally Indian exports were paid for by English exports. But this mechanism could not work during the war because English producers being engaged in the production of war goods, the Indian people were unable to find the goods which they wanted. As there were no exports from England, exports from India also stopped; the Indian exporter would not have parted with the goods unless he was paid in rupees, annas and pies. The English importers would not have been able to find the necessary rupee amounts because there were no imports into India and there was no supply of rupees against the pounds sterling. It would have been impossible for the English importers to secure the necessary commodities from India. But this contingency was avoided by the Government of India by their undertaking to provide the necessary rupee amounts. The Government of India now act as agent for the British Government and make all the purchases on their behalf from the Indian producers paying them in cash in Indian currency. But when the Government of India, so to say, re-sell these goods without profit to His Majesty's Government, they are not paid in rupees but in pounds sterling at the rate of 1s. 6d. for every rupee.

When the Government of India receive pounds sterling from the British Government they deposit the whole sum with their bankers, viz., the Reserve Bank of India. The pounds sterling, therefore, first appear in the Banking Department of the Reserve Bank as 'Balances held abroad.' If these balances are held in liquid cash they do not yield any income and therefore they are constantly invested in Treasury Bills issued in England or in securities of the British Government. The sums which are thus invested figure in the accounts of the Banking Department as Investment. At the same time the Government of India have to pay to the Indian manufacturers from whom they have purchased the goods. These payments are made by cheques on the Reserve Bank of India. When the cheques are presented to the Reserve Bank of India through the banks it has to pay out of its own till. If the sums which are paid thus are pretty large there is a drain on the cash portfolio of the bank which is required to hold at least 10 crores of

rupees. When it tends to decline below that level some of the securities, needed to replenish the till, are transferred over from the Banking Department to the Issue Department as sterling securities against which new notes are issued. By a continuous repetition of such transactions sterling securities are increasing simultaneously causing expansion of the Indian currency.

One point must be made clear before proceeding further. It cannot be said that against every pound which the Government of India receive, there is a corresponding expansion of currency in India. Suppose the Government of India make purchases on behalf of His Majesty's Government of goods worth Rs. 1,333-1/3 for which at the current rate of exchange they will be paid £ 100. Now it is not at all necessary for the Reserve Bank to expand the Indian Currency by Rs. 1,333-1/3 the moment it receives a deposit of £ 100 from the Government of India if it has a surplus sum over and above the 10 crores which it must hold as minimum cash; in such a case even though the payment will be made in rupees, there will be no addition to the existing notes. Notes are not therefore issued against all the sterling balances which the Bank holds, but against only a part of them. This part of our sterling balances against which notes are issued ceases to be liquid and in a sense is frozen because it will be released only when free individuals in India will tender notes asking for exchange and even then the released sterling amounts cannot be commanded by the Reserve Bank or by the Government of India because the Reserve Bank shall have to pay these amounts to the holders of the rupee notes and they will therefore be the owners of these sterling amounts. This part of our sterling balances is therefore quite important because it is of an entirely different nature from the rest. It is held as an asset against the notes issued and is therefore described as sterling assets as distinguished from sterling balances. The Reserve Bank has no right of ownership over these assets and it cannot tamper with them. They are owned by those who hold notes issued against them and who will be in a position to tender notes asking for exchange. The major part of our sterling holdings is sterling assets. Out of the estimated £ 1,000 million approximately £ 800 million are held as sterling assets and £ 200 million as balances and investments.

Just as the Government are required to find the rupees first and are paid afterwards in the English currency for all the purchases they

make in India, similarly in the case of services, the expenditure is first made by the Government of India and then they are paid by His Majesty's Government in pounds sterling. But calculations are not so easy in this case. Very often soldiers are trained and equipped by the Government of India for their own requirements but have to be sent abroad whenever necessary. It is thus impossible to distinguish the expenditure incurred on behalf of the British Government. A settlement has been arrived at between the two governments whereby that portion of this expenditure which is to be reimbursed from the British Government to the Indian Government was determined. This settlement lays down principles according to which the sum to be debited to the Indian account is to be determined. According to this settlement India has to bear (1) a fixed annual sum, representing the normal net effective costs of the army in India under peace conditions, plus (2) an addition to allow for rise in prices, plus (3) the cost of such war measures as can be regarded as purely Indian liabilities by reason of their having been undertaken by India in her own interests and (4) a lump sum payment of 1 crore of rupees towards the extra cost of maintaining India's external Defence Troops overseas. It is quite plain that these clauses are capable of being interpreted in a way that is more favourable to England. It is this settlement that has provoked the British people to complain against its supposed generosity and to clamour for its revision. In the summer of 1943, the Finance Member paid a visit to England but finally it was decided that the settlement should not be disturbed and that new items of expenditure should be adjusted by an elastic interpretation of the principles of the settlement. It is in accordance with this agreement that the cost of aerodromes and other defence costs are met by the Indian Government because these measures are necessary for defending India against Japanese aggression. Because of this new interpretation the military expenditure of the Government of India has increased from Rs. 50 crores in 1939-40 to Rs. 182-81 crores in 1943-44. The point to be emphasised is that the sterling balances accruing on account are flexible and their size can be controlled or changed by changing the financial settlement, while the amount which accrues on this account of purchases of goods is determined by the prices of goods produced in India and have to be paid in full by His Majesty's Government. They cannot escape it. In fact every time purchases were made in India, Indian



producers were paid in hard cash, and the Government of India also have been paid in cash, and therefore at present there is no payment which is to be made in future by His Majesty's Government. All transactions have been cash transactions.

This mechanism which made goods and services available to His Majesty's Government without any trouble has its bright side inasmuch as payments are made in cash and are not postponed without any security. The inevitable increase in the Indian currency to which it gives rise is the dark side of it. It was only natural that the dark side has become a target of criticism in this country. But it should not be forgotten that the weakness of the Government in raising funds here alone, has led to accumulation of our sterling balances. If there had been no inflation our sterling balances would not have existed in the form in which we see and have them today.

This brighter side of the picture has never received due attention and to have a clear idea of the advantages which it has to confer on us, it is necessary to contrast it with the alternative suggestions for meeting war finance in this country. Since it is well known that inflation has had its evil effects, nobody can deny that it is a bad way of financing war. But what were the other methods available whereby this huge expenditure could have been met ?

Various methods have been suggested.† But taking a most realistic view of the situation it must be said that few of them were practicable. The most popular suggestion was that India should have been paid in gold rather than in sterling. This is objectionable on the ground that it forgets the subordinate position of India. But even then did gold have any advantage except by way of providing a better cover for our

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† The other methods suggested are (i) asking the British Government to find the rupee finance for themselves in the Indian market (ii) payment to India in durable assets (iii) rupee loans to U. K. and (iv) liquidation of British assets in India. Except the last one, none of the measures need be considered because it would have meant asking the British Government to do something which would have directly interfered with the prosecution of the war. The last one of course was a right suggestion because it should have avoided inflation both in England and India. However it must be remembered that this was not a permanent cure. The British assets in India are valued at 300 million pounds which comes to 400 crores of rupees. Their liquidation would have postponed inflation for 400 days. But this was a considerable period during which Indian people would have suffered less and British people would have secured goods at lower prices.

currency? If we were paid in gold at the rate of 1s. 6d. per rupee, that would not have altered the situation in any fundamental respect. The Government of India would have received gold instead of pound sterling and currency would have been issued against addition of gold instead of against the addition of sterling. That would not have avoided inflation at all. If we had not been paid at this rate but at the market price of gold, there would have been less inflation but there would have been the danger of gold depreciating in value; for war-time price of gold is bound to be higher than its normal value. There was a third course open. Gold should have been imported and sold to the Indian people, so that there would have been no possibility of inflation. But it is a very moot question whether the people would have reduced their consumption and bought gold worth 1 crore of rupees every day. In any case this was not possible because England had no gold to pay and India had no independence to ask for it.

Realising the impracticability of receiving gold it was suggested that the necessary sums should be raised in India by taxation and borrowing and that purchases should be made with the sums thus raised. ↓ Even this would have meant suffering for the people because sacrifices would have been imposed upon them through reduction of their incomes while at present it is imposed by keeping the incomes more or less fixed but by increasing the prices. (Of course it will be said that if proper methods had been followed, there would have been an equity and a justice which inflation lacks. Whether proper methods of direct taxation would have been followed by the Government which had to placate the Indian capitalists is very doubtful. That nothing of the sort could have happened is plain enough when one notes that the Government are not even prepared to raise excess profit tax to cent per cent.)

But the change which such a mechanism would have caused in the very nature of the sterling balances is of fundamental importance. Let us suppose that instead of the present inflationary mechanism, the Government of India had raised funds by taxation and borrowing. In that case there would have been no necessity for the Government of India to ask for cash payment in pounds sterling from the British Government. In such circumstances the British Government, anxious to avoid strain on their reserves, would have postponed the payment and the Government of India could not have taken any objection to such a course. In the normal sense of the word Britain would have

↓ Manifesto issued by Indian Economists (Published on 12-4-1943).

been indebted to India. Goods would have been delivered to Britain without receipt of any immediate payment and there would have been a mere pledge that Britain would pay these sums at the end of the war—a pledge without any security from a master country to a subject nation! In that case it would have been very easy—if past history is any guidance to future events then it would have been a dead certainty—for the British Government to repudiate the whole debt by observing complete silence over the issue.

To illustrate still more clearly the fundamental distinction in the very nature of our sterling balances in the two cases, an analogy might be useful. Let us suppose that there is a tenant occupying a flat in Bombay, that he is not on good terms with the owner of the house and that there is no Rent Act. Let us further suppose that in these days when rationing is in force the landlord with some genuine excuse comes and asks for rice. The tenant cannot refuse because he is in a subordinate position and therefore gives up the little quantity which he has secured on his own ration card. That he has to sacrifice his desire to eat rice is plain enough and that the owner is indebted to him is equally evident. Now the transaction may be effected in two ways. When the owner takes the rice he may offer the tenant the cash price or give him an oral or written promise that he will pay at some future date. Now in the first case the tenant suffers loss and has to sacrifice something due to his own subordinate position but he can use the cash obtained to purchase any other goods he needs. There is thus no chance, once the price is paid, of repudiation. But in the second case if the owner just keeps mum or does not pay, what course can the poor tenant follow? His debt is completely repudiated for he receives nothing in return for his rice.

The transactions between the Government of India and His Majesty's Government are of the first type. The Government of India have been paid in cash and in their own turn they have paid the Indian producers in cash. So that even if there is sacrifice and loss involved in it there is no possibility of complete repudiation. If the Government of India had sold the goods to His Majesty's Government without any immediate payment they would not have been able to recover the money from them at a future date. It is, therefore, a decided advantage—to see the best in the present mechanism—that Britain cannot repudiate our sterling balances.

Under normal conditions, when the war ends and England is free to sell goods which India normally imports, the Indian importers will go to the Reserve Bank to demand sterling in exchange for rupees. It is a statutory obligation—suspended at present because of war conditions—on the Reserve Bank to pay sterling in certain amounts, if rupees are offered, at a fixed rate of 1s. 6d. So that those people who possess surplus Indian currency can acquire English currency which is legal tender money in England and can purchase any goods they require subject to the limitations of the market. If they do not receive the goods they demand they can exchange sterling into dollars or any other currency available in the foreign exchange market and purchase goods in any part of the world they desire.

The peculiar characteristic of the sterling balances is that they do not represent a sum which His Majesty's Government owe to the Government of India, for they have paid it. Neither do they represent a sum which the Government of India owe to the Indian public because the latter have been paid in cash. What remains to be done is not payment but conversion of sterling into goods; and to this, at least under normal conditions, there should be no obstacle. There seems to be no loss because the goods which will be purchased by these importers will be the goods, which they feel, will sell in India because they are desired by the Indian people. But how is it that there is such glib talk of repudiation and loss and imposition of goods which India does not want? This is because, behind all the argument elaborated here there is an assumption that as soon as war is over the normal mechanism will be restored. But it may be argued that if the present restrictions continue and the Indian note-holders are not allowed to convert notes into sterling there is a likelihood of repudiation and loss. What are those extraordinary circumstances that can be created and what will be the possibility of repudiation or loss on account of such changes?

### CHAPTER THREE

#### POSSIBILITIES OF TOTAL OR PARTIAL REPUDIATION

The strangest characteristic of Britain's war debt to India is that it has been paid in terms of money. It differs from the ordinary loan in that even the monetary payment is deferred in common loans. As long as, therefore, the pound continues to have some purchasing power

in Great Britain India will be able to acquire some goods. There is thus a possibility of some loss because the second step in the International debt, viz., conversion of money into goods is yet to take place. But the first step, that of making payment in currency, is over and hence there is no possibility of repudiation!

The typical Indian mind revolts against such a conclusion which seems so strange and which it is never prepared to accept. It immediately raises the question! 'Is it impossible for the master country to repudiate the whole debt?' The answer to such a question can be one. 'No; it is not impossible for Great Britain to effect complete repudiation.' In the realm of possibilities everything has a place by itself. But why repudiation alone? Everything is possible under the Sun. The British Isles may sink in the sea due to an earthquake and we may come to grief. It is also possible, provided there are 400 million bullets and a few machine-gun operators to kill the entire population of India and we shall lose our sterling balances since we ourselves will be lost. There are possibilities which ought to be accepted for the sake of argument and yet everyone knows that nothing of the sort will ever happen. While considering total repudiation, therefore, such possibilities alone must be considered as have earthly chance of occurrence. And unfortunately such possibilities do exist even though they may be quite remote and need not be expected at all to be realised.

All the sterling which the Reserve Bank receives is invested mostly in the securities of the United Kingdom. This practice is followed because liquid cash earns no income while the securities yield some income. All the money which is received by India is thus a part of the public debt of Great Britain which is well over £19,592 million at present. This is indeed a huge debt which they cannot pay. Even the interest charges to be borne by the treasury would be too heavy. Especially if there is any socialistic revolution in England, the Government may repudiate the whole debt and along with the other holders of £18,000 million securities India will come to grief. But there is no likelihood of such events occurring.

There is also another possibility. If His Majesty's Government succeed in imposing on the Government of India a forced gift equal to £1,000 million to be paid, out of taxation, as contribution to war it will mean virtual repudiation, because Great Britain will be paying to India

a sum which they have already managed to secure from this country. It would really mean a payment of £2,000 million by India of which £1,000 will be returned. It means nothing short of total repudiation of the existing debt.

To support this it is generally pointed out that during the last war a gift of £ 100 million was presented to the foreign power. But are the circumstances unchanged after 24 years? And will they continue to remain unchanged? What happened 24 years before is not likely to be repeated because even the present members of the Viceroy's Council may not acquiesce in it. The sum also is so big that such taxation shall have to continue for years together during which the Indian Legislature and Government will not remain so weak as they are now presumed to be. Even during the war the revision of the financial settlement was opposed by the Finance Member because it was thought that the maximum possible taxation has been reached in India. Taking into consideration these factors and especially the political advance of India after the last war, it is not likely that the Government will succeed in any such attempt of total repudiation. Undoubtedly, however, a partial repudiation is possible if this country is forced into making a gift.†

There are other ways also through which partial repudiation might be attempted. At present, according to the Reserve Bank of India Act, the Bank is required to maintain 40% gold equivalent as assets against the notes issued. The existing gold is valued at 8.47512 grains of fine gold per rupee, which comes approximately to Rs. 20 per tola. The total value of gold is 44 crores of rupees. If by changing the Act, this gold is revalued at a higher price, say Rs. 40 (allowing for the probable fall

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† It is desirable that an estimate of the time required for such repudiation should be given. The Budget of 1944-45 estimates the central revenue to be over Rs. 370 crores. The pre-war expenditure of the Government of India was Rs. 130 crores. The plans of demobilisation that are published indicate that the Government are bent on reducing their expenditure. If they succeed in maintaining the taxation at the same high level and reducing the expenditure to the pre-war level it is possible to make a gift of Rs. 1100 crores within five years. However it should not be forgotten that in post-war years when the trade-activity would be slack revenue cannot stand at this high level. Nor will it be possible for the Government to reduce their expenditure to the pre-war level. And yet the fact remains that recently Government have made it clear that there will be no relaxation in taxation and that is sufficient to arouse suspicion unless statement is issued making it clear that the surplus thus created will not be utilised for making a gift to His Majesty's Government.

in the price of gold), the same gold can act as cover for additional Rs. 44 crores of notes. There will be thus a surplus of sterling securities worth Rs. 44 crores which the Government might give up as a gift to the British Government! But fundamentally this surplus, thus created, is under the ownership of the Reserve Bank and if the Central Board stoutly opposes such a course of misusing power, it is not possible for the Government to dissolve the Central Board and utilise the surplus for giving the gift. Of course the Reserve Bank of India Act does make a provision whereby the Governor-General in Council may set aside the decision of the Central Board. But if the Central Board is dissolved it will shake the faith of the people in the Indian Currency and the whole monetary machine will come to a standstill. A crisis of this sort is as ruinous to the British Government as it would be to the Indian people.

The same conclusion emerges even if we consider the other way of releasing sterling balances with a view to making gift. According to the Reserve Bank of India Act, the proportion of gold and sterling together must be 40% of the total notes issued. At present this percentage is far above the minimum. It is over 93%. It is possible for the Reserve Bank to replace sterling securities by Government of India securities because the original limit of Rs. 50 crores in the act has been removed by a special ordinance. But such a course though possible is not feasible because the proportion of sterling is not to be determined by legal requirements only. The stocks of sterling securities must be sufficient to enable the bank to fulfill its obligation to pay back sterling. If sterling securities are replaced by Government of India securities it is likely to lead to such demand for conversion of rupees into sterling that the reduced stocks of sterling would turn out to be inadequate to meet the demand and confidence in Indian currency would be shaken.

It is again feared that by manipulating the exchange rate at least a partial repudiation will be effected. Clearly there are three courses open for the Government : (1) The exchange rate might be maintained at the existing level of 1s. 6d., (2) The exchange rate might be lowered to 1s. 5d.-4d.-3d., etc., or (3) The exchange rate might be raised to 1s. 7d.-8d. etc.

Very often it is asked whether the Reserve Bank will maintain the existing exchange rate or not. It is difficult to give any definite answer

to such a question but what is likely to happen is evident when we examine how far it will be possible for the Government to repudiate debt through manipulation of the exchange rate. Before that, another question which troubles the Indian people must be settled. It is doubted whether it will be possible for the Reserve Bank to maintain the existing exchange rate. The inability to maintain the prevailing exchange rate during the years that followed the last world-war is largely responsible for this suspicion. But there is no possibility of this kind in future because the management of currency and exchange has undergone a great deal of change.

Even in the most unsettled conditions of sudden rush the total demand for conversion of rupees into sterling will be Rs. 9,45,58,00,000. Notes in circulation † + Rs. 128,01,00,000 absorption of rupees † Rs. 42,08,00,000 absorption of small coin † = Rs. 11,15,67,00,000. As against this issue of currency the Reserve Bank possesses sterling securities worth Rs. 995,93,00,000 + Rs. 44,42,00,000 gold coin and bullion = Rs. 1,04,35,00,000. The gold which the Reserve Bank holds as asset is valued at a low rate of Rs. 20 per tola and hence in times of danger like the present sterling securities and gold at market value would be quite sufficient to enable the Reserve Bank to maintain the exchange rate at 1s. 6d. Normally there will not be any such demand because the demand for sterling which will exist on account of imports will be more or less balanced by the supply of sterling on account of imports from India. The supply of and the demand for sterling will not be exactly balanced and there will be a greater demand for sterling because of the capital consumption during the past five years. Enough funds have been set aside for the replacement of capital. With the help of these funds orders for machinery will be placed. An estimate of the depreciation that has taken place is extremely difficult. But supposing that it is 50% of the total capital invested in this country, the demand on this account should not exceed Rs. 500 crores. Again all the orders will not be placed simultaneously. Hence it would be quite possible for the Reserve Bank to maintain the exchange rate at 1s. 6d.

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† Reserve Bank of India Statistical Summary—August 1944.

‡ Report on Currency and Finance for the year 1943-44, page 53. This figure takes into consideration absorption during war years only. It won't be unreasonable to think that more than this amount may be withdrawn in the extreme circumstances for the figures of previous absorption have not been taken into consideration.



But whether it will do so or not is quite a different matter. For lowering the exchange rate will help the Government to enable them to make a gift to the foreign government. If the exchange rate is lowered to 1s. 3d. or even more the necessary cover for the notes will be much less in amount and once more there will be a surplus sterling with the Reserve Bank. At present the sterling securities which the Bank holds are worth Rs. 828,32,00,000. At 1s. 3d., 16-2/3% of these securities could be released and the necessary cover at that ratio will be provided. A total of rupees 138 crores worth sterling securities could be thus released. Of course once more the Reserve Bank possesses the right of ownership over these surplus securities and how far partial repudiation could be effected depends on the ability of the Central Board to take up a bold stand. If the Board does not take up a bold stand then we must have only ourselves to blame.

Thus while the lowering of the exchange rate is profitable for the Government the raising of the rate is not. Besides if the rate is raised and if it is to be maintained it will need additional sterling resources and how is the Reserve Bank to command these resources? Clearly there can be no direct gain in raising the exchange rate as there is in lowering it.

But raising the exchange rate means depreciation of the pound and a higher rate is more favourable for imports into India. Besides it means that since the pound is depreciated our sterling balances also suffer a loss in value. In terms of real goods England shall have to give less and therefore it is often believed that the exchange rate after the war will be at higher level. We will discuss later the grounds on which this belief is based. But clearly raising the rate does not enable partial or total repudiation. For, the word has been used throughout this booklet in the sense of refusal to pay either in part or in full. If Mr. A gives Mr. B Rs. 100 and, say after 3 years when prices have risen he recovers the sum back, we do not say Mr. B has repudiated the debt because Mr. A is getting less in terms of real goods. The co-operative societies are to-day recovering their dues from their members because they receive better prices. These loans were given in pre-war days and yet this transaction cannot be described as repudiation because the co-operative societies happen to receive less in value.

There is still one source from which sterling assets can be released. In February 1943 the maximum limit for Government of India's

securities to act as cover for currency was removed by an Ordinance. The Reserve Bank may be forced to increase the proportion of Indian securities and lower that of sterling securities. At least at present that does not seem to be the intention of the Government of India or the Reserve Bank because the percentage of gold and sterling to the total notes issued is 92.35. Such a high proportion is kept only because the Government of India are only too sure of the fact that if the proportion of the Government of India's securities is increased, the currency system in India will be in danger.

The possibilities of repudiation are thus not many and therefore they need not cause us any anxiety about sterling balances.

But what matters to India, whether through repudiation or loss in value, is the loss incurred on this account and therefore maximum attention must be directed to the possibilities of the various means that might be devised to give India the least possible in the forms of goods.

#### CHAPTER FOUR

#### POSSIBILITIES OF LOSS

It has been made sufficiently clear that if the normal procedure is followed and if any extreme course of action which will bring the monetary machine to a stand-still is not postulated, then there is no possibility of repudiation or even of a loss to any great extent. If, therefore, any attempt is going to be made at repudiation or at giving less in terms of real goods, it must necessarily assume either exchange control or political control, manipulation of monetary policy of England with objectives which will not be in the interests of India, interference with the monetary policy of India and such other things. No definite answer can be given as to which of these devices will be employed to effect indirect repudiation or inflict loss in value of our sterling balances. Provided there is a definite gain for Great Britain, any one of these devices or even all of them might be employed. It is necessary to examine carefully the possible loss on account of our sterling balances, which will result from the adoption of such controls.

Inasmuch as payment in terms of money has been made, there is no possibility of repudiation. But no international payment is finally completed unless goods actually leave the boundaries of the country. The conversion of sterling into goods is yet to take place and by making

conversion difficult it would be possible for England (i) to make it compulsory for India to confine all her purchases to England only, (ii) to compel this country to purchase only such goods as England would be willing to part with, and (iii) to manipulate prices in England in such a way that the real sacrifice which England would be required to make would be reduced to the minimum. There will be thus qualitative as well as quantitative loss.

The last should be taken up first. It is generally believed that the pound will depreciate and it will mean a loss in the value of our sterling balances. When it is said that the pound will depreciate two things are hinted at. In the first instance it may be argued that the sum which we command is fixed while the purchasing power of that sum is liable to fluctuations. If the prices in England rise in future, we shall be able to secure only a small amount of goods. The value of sterling balances is thus bound up with the value of the pound sterling and that being inconvertible paper currency its value is liable to wide fluctuations.

There is no doubt that keeping our balances in sterling may involve some loss. But a disadvantage of this sort is bound to exist in any circumstances. The only alternative to holding balances in sterling is to convert it into goods immediately by an agreement. Since it is not possible to purchase and import goods at the present moment, to avoid loss due to fluctuations in the value of the pound, an agreement might be made today with Great Britain fixing the total quantity of goods which England should give us in future. But such an agreement is not a simple matter and may turn out to be disadvantageous to India. Supposing the quantity of goods is fixed today and that the pound appreciates tomorrow, we shall be getting much less in terms of goods because of the agreement. Again such an agreement will mean giving a promise to England to make all purchases out of these balances from herself alone. This is highly undesirable. A future opportunity to change sterling into foreign currency would be completely lost by such an agreement.‡

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‡ The Bombay Chronicle of 27th September publishes the news that 'A mission to London to discuss the issue of sterling balances is expected to leave India as soon as arrangements for discussions are completed both in London and New Delhi. *It is emphasised here that the issue is largely of goods and not so much of money.* The mission is expected to consist mostly of officials with non-official advisers'. Whether the sentence in italics means an agreement of the sort that we have been discussing is not clear. But there need not be any surprise if it means the same thing. When there is a question of holding such balances our preference undoubtedly must be for the most liquid assets and not goods!

Secondly the argument hints that the monetary policy will be so controlled by the British Government that there will be a deliberate devaluation of the pound. To lend support to this argument it is further added that Great Britain shall have to create a surplus export trade to pay off these war debts; and for creating such a surplus a lowering of the exchange rate would be the most desirable objective.

This argument is not as sound as it appears. The payment of these war debts will be a slow process. Reasonably speaking it will extend over a period of 25 to 30 years. The advantages of a lower exchange rate are short-term advantages and to maintain the surplus export trade England shall have to manipulate her monetary policy in such a way that the exchange rate will be continuously falling for the period of 25 to 30 years. There is hardly any likelihood of this happening because the stability of the exchange rate is an essential condition for England's monetary and economic system. Besides, if the price levels of different countries are compared,† it will be at once noticed that there is no likelihood of the depreciation of the pound; and when the price-level in England is so low (in many cases by 100 points) there is no necessity of lowering the exchange rate in order to create surplus export trade.

There are two possibilities with regard to the depreciation of the pound. The rupee-sterling exchange rate might be raised from 1s. 6d. to 1s. 7d., 8d., 9d., etc. which will mean depreciation of the pound in terms of rupees. Or there is another possibility. The rupee sterling ratio might be maintained at the same level but the cross-rate will go against the pound. In such a case the pound will depreciate in terms of all other currencies though it will not depreciate in terms of rupees. But clearly there will be some loss even if the pound depreciates in terms of dollars only. Because in that case with the same amount of sterling we shall be securing fewer dollars.

To say that the exchange rate will be at a higher level is tantamount to predicting the future exchange rate. It is very difficult to anticipate such things. Both the currencies are paper currencies and the exchange

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† On the basis of I—VI 1939—100 the wholesale price index numbers for different countries for November 1943 were reported as follows: Iraq 692; Iran 495; Palestine 325; Egypt 291; India 318; U. K. 167; Canada 140; Australia 138; South Africa 154; U. S. A. 135. These figures are taken from the *Eastern Economist*, 18th August 1944. For the comparison of U. S. A. and U. K. price levels and the dollar-sterling parity an extract from *Commerce* is quoted elsewhere which is more reliable.

rate must express the purchasing power parity of the two currencies. Due to war restrictions even though the old rate is maintained it bears no relation to the purchasing power parity of the two currencies at the present time. Whether future circumstances will justify this ratio or not depends on the relative changes in the price levels that will take place after the war. As compared with the pre-war six months, the index number in England was 167 for November 1943 and in India it was 318. The exchange rate must be below 9d. to have some relevance to the purchasing power parity. But it is erroneous to work out the proper exchange rate on the basis of war-time inflated currencies. To get some indication as to the future exchange rate some attempt must be made to calculate the probable changes in the two price-levels. Taking into consideration the small increase in the price-level and the difficulties and dangers of a deflationary course which she has learnt during 1922-31, it is unlikely that any fall in the price-level will be allowed in England. While in India, unless some positive action is taken to counteract the effects, there will inevitably be a tendency for deflation. Assuming that the present rise in prices is solely due to the addition to the quantity of money, the probable fall in the price level might be estimated by the probable withdrawal of currency. There are two pointers. Assuming that people are accustomed to the pre-war price-level and would like to return to it, the quantity of money which will be withdrawn will be determined by taking into consideration the quantity of money in circulation before the war and the additional quantity necessary for the increase in production. The second method would be to estimate the demand that will exist on account of the depreciation of the machinery during the past five years. The total number of notes in circulation for the three years preceding this war was 208, 214 and 207 crores respectively. Taking 210 crores as the base, the index number of notes in circulation is 347 for June 1944. The index number of prices was 300 for June 1944. The increase in production is estimated at 60% by the end of June. Assuming that the people are inclined to reach the pre-war price-level, the total notes that would be required for the current production would be 350 crores. On this basis there would be a fall of 177 points. There will be a heavy fall in the price-level but it will not be a proportionate one. The rise in the price-level has not been proportionate to the increase in notes. Besides the velocity of circulation will increase in post-war days. Hence

there would not be a corresponding fall in the price-level. Depending on pure guess with the support of commonsense only, it may be said that the price-level may fall by 100-125 points. But with this much fall, the price-level in India remains at a higher level and there should not be any inducement for Great Britain to raise the exchange rate. If there is a proportionate fall in the price-level then alone will there be a price-level that will necessitate a manipulation of the ratio to create a favourable balance of trade. Otherwise, there is no ground to expect a deliberate depreciation of the pound.

The same conclusion emerges, and with greater force, if the probable withdrawal of currency is estimated by measuring the extra demand that will exist on account of depreciation of machinery. If the prewar import of machinery (this includes machinery imported for starting new industries, but to argue on the safe side no such distinction is made) is taken as the index to depreciation, normally, machinery worth Rs. 10 to 15 crores was imported every year. Taking imports of machinery to be zero for the duration of the war the total depreciation comes to 50-75 crores of rupees and calculating it at the present high price level the total demand comes to Rs. 150-225 crores. The fall in the price level, in this case, will be much less than is anticipated and there will be no necessity for raising the exchange rate.

Similarly there seems to be no possibility of a fall in the value of the pound in terms of dollars.† In one of the articles published in the *Commerce* of 12th February 1944, the writer says: "For some time past, there has been considerable speculation in London about the sterling-dollar parity in the post-war period. The conclusions arrived at by some of the foreign exchange specialists in Britain on the basis of index numbers should be somewhat startling to those who believed that, after the war, sterling was bound to depreciate in terms of dollars. Foreign exchange experts in Britain have been contending that prices in U.S.A. have gone up to such an extent that the purchasing power of the dollar has suffered heavily and that in consequence, at the present rate of 4.02½ dollars per pound sterling is undervalued. The White Paper published by the British Government on reciprocal lend-lease disclosed that the cost of war material was 50% higher in U. S. A. than in Britain. On the basis of calculations made on this statement in the White Paper, some of the foreign exchange pandits, not excluding the *Economist* have been stating that the correct parity today is \$6 per £."

† See footnote on page 19.

It should now be examined how far it will be possible for the British Government to compel India to purchase all goods from England alone. There are many points that need clarification. Why will there be any desire to enforce a bilateral transaction on India? The only relevant argument that could be advanced is that if multilateral clearing is allowed India may not purchase goods in England but may convert her sterling balances into dollars and import goods from America. But what will America do with the pounds which she thus acquires? Pounds are useful to Americans only because they give command over English goods; and if America uses these pounds for importing goods, England should have no cause to complain. But Americans can use the pounds for other purposes than imports. They may use the sterling which they acquire from Indians for investment in England! American investment in England is an extremely intolerable prospect, especially to a country that is accustomed to send capital abroad!!

The best way to restrict India's trade to England only would be to block the sterling balances. Nobody would be allowed to convert his currency into sterling without licence and special permission. A list of various goods and commodities would be prepared and if the applicant is going to import goods and commodities from those in the approved list then he would be allowed to convert his rupees into sterling, otherwise not. If such blocking takes place the opportunity to convert rupees into dollars would be denied to India and the danger of American investment in England will be avoided.

What would such an exchange control of the type that was instituted by Hitler in Germany, mean to India? Apparently this would enable England to force any goods on India. In this way alone it would be possible for England to give all consumers' goods to India and not capital goods. The second point is thus bound up with the first but its consideration must be postponed.

Does such blocking render India quite helpless? If the Indians are not allowed to utilise their sterling balances for imports they can retaliate against such a measure by getting sterling for investment purposes. Rupees will be tendered here to the Reserve Bank and with the sterling amounts that will be received from the bank shares of English companies will be purchased or property will be secured or if there is enough enterprise new Indian concerns will be started in England! To prevent all this, even if it is supposed that sterling would not be released for

such purposes, it would only mean that all our sterling balances are invested in U.K. securities. Even at 1% rate of interest England will have to pay £ 10 million annually as interest charges to India. A figure which well compares with our "Home charges" in the years that are now past!

Avoidance of American investment is not the only objective for such an exchange control. After the war our import trade from England will consist of goods imported as a payment for goods exported from India to England and of goods which will be given as a payment of a part of our sterling balances. If England finds herself incapable of delivering the goods which India needs, there will be a change in the direction of our foreign trade. Before the last war our trade with England formed a major part of our total export trade. After the war, in spite of all the attempts of Imperial Preference and commercial agreements, our trade was diverted to U.S.A., Germany, and Japan. After this war we can get goods worth £50 million or over from England without sending any goods to that country. If England proves herself incapable of providing the goods which India needs, India will export goods to U.S.A. and import most urgently needed goods from that country. If England is at all concerned with maintaining her trade with India the only way open for her is to give those goods which India needs and to give them at competitive prices.

Great Britain may not be able to achieve this in the first years after the war. Much destruction has been caused by bombing and much capital has been consumed. As soon as war is over England will be anxious to put her house in order and will be unable to spare production for foreign markets. For the duration of such a transition period England will block the foreign trade of India to retain it in her own hands. During such a period the accumulation of sterling will be continued and simultaneously expansion of Indian currency will also be continued. But the process cannot go on indefinitely for if the inflation is carried on to dangerous limits, it will mean that the monetary machine will come to a stand-still. And British Government is not prepared for this because such a crisis may mean not merely the ruin of British trade but that of the British Empire in India!

A complete blocking of all of our sterling balances is thus a remote possibility almost next to an impossibility. A more logical step would be to achieve partial blocking by distinguishing war debts as a separate



category. The normal export and import trade will not be interfered with, but so far as conversion of the war balances is concerned an exchange control of the above mentioned type will be instituted. The list of goods and commodities which England can spare will be drawn up; and such a list may contain items of consumers' goods only. They might be goods such as Bata shoes, Valet blades, Maclean tooth paste, etc. It is a natural desire that these balances should be used for purchasing machinery that will enable India to manufacture machines here. If, therefore, the dominating power is going to adopt such controls as would permanently retard the fulfilment of such a desire it may be legitimately complained that we are going to incur loss on this account.

The point needs serious consideration. Is it really a fact that we do not need consumers' goods at all? Before the war there was no compulsion on India to purchase any goods in England and still we imported so many consumers' goods from that country. It can never be seriously maintained that no consumers' goods should be imported from England. If all our imports are to consist of machinery, are we in the meanwhile to go without consumers' goods? As Sir Ramaswami Mudaliar recently suggested, in the first few years when we shall be concerned with building up of capital goods, there will not be enough production of consumers' goods and there is nothing we should complain about or be sorry for if a *part* of the goods which we will import are not capital goods.

It shall at once be agreed that nobody seriously wants to maintain that all the goods in the list will be of the type of shoes and pastes. The list might as well include tractors and fertilizers. No objection can be raised for such goods. For they are goods which India needs at present. And after all where is the line to be drawn between consumers' goods and capital goods? If mill-machinery is imported it might be said that we want such machinery as would enable us to manufacture that machinery and for such reasoning there is no end. The truth is that there is no hard and fast line between consumers' goods and capital goods. But granting that such an attempt is made what would be the loss which India shall have to suffer?

In the post-war years our import trade will consist of two items. We shall be importing goods which constitute payment for the goods that will be exported and secondly we shall be importing goods on account of the payment of sterling balances. If the latter part (which

alone can be regulated) is so regulated by exchange control that we cannot import anything except consumers' goods, we shall import consumers' goods on this account and cent per cent capital goods on account of normal exports. In the past since there was no such surplus due to India our total exports used to pay for consumers' goods and capital goods. Now all our exports can be used to pay for capital goods. Thus by regulating imports of goods on account of sterling balances it will not be possible for the British people to impose consumers' goods at the cost of capital goods. There is one difficulty in such a procedure. If the annual instalment of the payment of sterling balances is, say, £ 50 million while the country needs consumers' goods worth only £ 40 million will it mean loss to the country or not? Of course in such a case the rest £ 10 million would be turned into investment and either England will have to tolerate Indian investment or modify exchange control. If England chooses investment inasmuch as it involves refusal to allow India to import capital goods it is certainly a loss to India.

It is worth considering whether England will be able to export goods equal to the normal Indian exports and a certain amount of goods as a payment on account of war debt. While considering the capacity of England, in the absence of knowledge of conditions prevailing there, it is very difficult to say anything positive either way. However, it may be pointed out that a country that could not only maintain but increase her production even when bombing was going on with a view to causing total destruction, will certainly be able to increase her production in peace time and pay off her debt. If it is supposed that the payment of sterling balances is spread over a period of 20 years, every year Britain shall have to export goods worth £ 50 million on Indian account and another £ 50 million for other countries. A country having a national income of £ 7,384,000,000† should not find it difficult to pay £ 100 million.

It may be argued in case of sterling balances, as it was argued by Lord Keynes in respect of German reparations, that to create a surplus to this tune, wages in England must be lowered and there is a limit to the reduction in cost. It is said, in recent years, that wages are sticky and the price structure is growing more and more rigid. Without

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† An Atlas History of the Second War p. 97.

entering into the details of the Keynes-Ohlin controversy over the German Reparations, it may be said at once that it has been now acknowledged that Keynes was taking into consideration only the supply side and even if the other extreme cannot be reached by saying that all the adjustments are brought about by a shift in the demand schedule, the truth lies half way. Cost reduction, therefore, need not be necessarily undertaken to a very great extent and to a certain extent costs can be reduced. When it is, therefore, known that not all the adjustments will be brought about by reducing the cost in England, it will be very difficult to demonstrate the inability of England to pay off the debt.

The financial settlement between England and India has been the subject of displeasure for the British people. Even though it has not been disturbed till today it does not follow that it may not be revised at the end of the war when the need to appease Indians will be less urgent. The revision will be so managed that not only will there be greater burden thrust over India but the arrangements will be applicable with retrospective effect. To the extent to which this burden will be accepted by the Government of India, our sterling balances will be reduced. The Government of India shall have to pay back this sum to His Majesty's Government which was paid through mistake committed in the original settlement. If any such revision is agreed upon it will be a clear loss. For, it is only another way of compelling the Government of India to make a gift to the British Government. It is only a partial repudiation disguised in the form of revision of the settlement. If any such trick is played, India is absolutely helpless. What will be maximum possible loss which she will suffer through such revision?

In the second chapter a distinction was drawn between the sterling accumulating on account of goods purchased by His Majesty's Government and the sterling accumulating by way of payments for services of troops. The financial settlement is applicable only to the latter part. If, therefore, the surplus of exports during the war time is known it would be possible to find out the magnitude of sterling balances that cannot be affected by the revision. The value of total surplus export trade by the end of February 1943, was 329 crores and the increase in notes by the end of that period was 657 crores. This indicates that

about 50% accumulation of sterling is on the account of services.‡ The percentage need not have undergone any fundamental change in the past five months. If, therefore, the revision is brought about and even if all the burden is thrown over to Indian Government, the maximum possible loss would be £ 500,000,000/-. It is impossible that the revision will be such as to transfer all the cost to India and the actual loss will be much less than is contemplated here. But in any case the probability of loss has to be reckoned with and if such an attempt is made there does not seem to be anything in the power of India to retaliate against such a measure. Since this seems to be the only way in which the debt can be repudiated, let us hope that Britain will honour the pledge of her newly created Lord of Tilton and shall not attempt repudiation in this mean way.

## CHAPTER FIVE

### DISPOSAL OF STERLING BALANCES

In spite of what is said by the British news-papers, the impartial reviewer of our sterling balances must come to one conclusion only. They have been created by an immense sacrifice by the Indian masses, of the bare necessities of life such as food and clothing. After all, the richer classes had not to undergo much suffering because they had enough money to be able to live luxuriously even at higher prices. And if they have suffered any loss it has been fully compensated for by the huge addition they have made to the quantity of money of which they already had had sufficient stocks. It is therefore, quite natural to feel that these sterling balances should be used to effect a permanent improvement in the lot of the masses.

It is undoubtedly the property of the nation and the country must be free to use it as she chooses. But this freedom to use the sterling balances need not lead us to believe that we are free to use them at any time we like and in any manner we choose. First of all, the way in which these balances will be utilised will be determined by the above

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‡ The calculation is based on the increase in notes in circulation only because it is not far away from the truth. The correct calculation must be based on sterling holdings of the Reserve Bank.

mentioned objective, that of improving the lot of the masses. But apart from this desirable limitation, we shall not be free to use these balances at our own sweet will. It must be our concern to see that we get maximum possible goods for the sterling amounts. If the maximum amount in terms of real goods is to be secured the desired freedom (i) to use as much of these balances as we like at any time and (ii) to purchase goods outside England, will necessarily be limited.

Suppose that India is given full freedom to use her sterling balances in any way she likes. If India rushes to use big sums by way of registering demands for machinery since the supply of it cannot be increased suddenly, the prices will be forced up and we shall receive less amounts of goods. Instead of Great Britain raising prices by devaluing the pound we shall raise the prices by a shift in the demand curve. Of course it must be admitted that inasmuch as the adjustment in international trade is brought about by a shift in the demand curve, to some extent the natural factors will force us to pay higher prices. But we need not aggravate it by our own folly. If, therefore, any attempt is made to spread the payment of sterling balances over a period of 15 or 20 years there is nothing in it to which India should object. The extent of the period shall have to be determined by the capacity of England to lower the prices and the need of additional capital which can find profitable employment in India. The above mentioned figure is only illustrative.

Similarly it is incorrect to believe that if Britain cannot give us goods in sufficient quantities we should change our sterling into dollars and purchase goods in America. The exchange rate between the pound and the dollar is determined in the London foreign exchange market. If therefore India will begin to supply pounds over and above the normal needs of the market, due to an over supply, the value of the pound will fall in terms of dollars and with the same amount of sterling we shall be getting less amount of dollars. There are thus natural restrictions on our power to utilise these balances and if in addition to spreading the payment over a period of time there is a bilateral agreement for the payment of a part of our sterling balances, not much loss will be involved. Our sterling balances, because they are the property of the Nation, cannot be used in any way we like and we shall have to impose on ourselves two restrictions while using them. The first one would be of not raising prices to any appreciable extent. The second

one would be of converting only such amounts of these balances into dollars or into any other foreign currency as would not entail loss on account of changes in the exchange rate.

Starting from what the British Government will do the argument has come down to what we should do. While advancing the argument it has always been presupposed that the political position of India is going to remain unchanged and that provided there is some gain for the British people, any mechanism or controls will be resorted to, to secure that gain. It is now necessary to change this assumption even though it is not suggested that this change is going to come definitely. But events are fast developing in a manner which does not make us appear foolhardy for making assumption of Independence—at least in the matter of dealing with monetary policy and sterling balances. Japan is yet to be defeated and as India is the only base for the offensive America is very much concerned in gaining Indian support and it may not be quite possible for the British Government to ignore the American demand. Recently we received news that for the first time that there has been a clear majority in England in favour of reopening talks with Indian Leaders, in the ballot that was conducted by the British Institute of Public Opinion. It is for these reasons that although it may turn out to be a dream it is necessary for us to assume the independence of India and outline a policy as to how we should proceed to utilise these sterling balances.

It is impossible to give the outline of a policy for using the sterling balances without saying something about the post-war monetary policy to be pursued in India. The first issue with which India will be faced as soon as she is left free to determine her monetary policy, will be whether the existing sterling link should be continued or not. This is not the place to discuss the disadvantages of the dependent standard and the advantages of the independent standard. India has suffered so greatly owing to the dependent standard that she would no more like to continue the rupee-sterling link. Even the London *Economist* remarked that India would like to support her currency by gold rather than by sterling. This change might be desirable but it must not be forgotten that a hasty step will not be without its adverse effects. For the time being at least it should not be the objective of our monetary policy to discontinue the rupee-sterling link altogether. There will not be any serious disad-

vantages in adopting the link because it is to be adopted for a short while only and during the first years at least, after the war, the predominant part of our foreign trade will be with Great Britain for which reason sterling-link will be advantageous. It will also facilitate the process of the conversion of sterling balances. Since we shall require sterling to act as cover for our currency there will not be a sudden demand for conversion of sterling into goods.

The other objective of the monetary policy to be decided in the immediate future, is about the quantity of money in circulation. At present there is a good deal of surplus currency. Should the monetary authority adopt a deflationary policy? Whatever the disadvantages of inflation may be, deflation is hardly a cure for them. During the years of the war, people have been suffering as a result of inflation. In postwar years they need not be made to suffer by deflation. Deflation produces its own evil effects. It means low prices, less production, reduction in incomes and unemployment. Many countries tried to deflate, after the last world war, and they did not succeed in putting back the clock of history. Those attempts only created a monetary chaos and the great depression, the effects of which are still not defaced. It would, therefore be a mistake to adopt a deflationary policy.

If a definite policy of keeping the same quantity of money in circulation is to be followed how is the release of sterling to be brought about? We can get the cue from the previous analysis given in Chapter Three.

First of all the gold that is being held by the Reserve Bank as an asset should be revalued. At present it is valued at about Rs. 20 per tola and the total value is over 44 crores of rupees. If it is once declared as an avowed policy of the Reserve Bank to maintain the existing quantity of money in circulation the price of gold will be almost as high as it is to-day. So gold may be revalued at Rs. 50 and the total value will be 110 crores of rupees. There will be now the same gold acting as cover for an additional sum of 66 crores of rupees. and sterling to that extent can be released.

Again if the present quantity of money is maintained the price level also will continue to be high and therefore there will be a great disparity between the internal value of the rupee and its external value, at the present rate of exchange. But keeping the rupee sterling-link

does not mean keeping it at this rate only. The present exchange rate, therefore, might be lowered almost to 1 shilling for a rupee. The lowering of the rate has got one important advantage. For every rupee the Reserve Bank shall have to keep only one shilling as reserve and not 1 s. and 6d. as at present. For every rupee, therefore 6d. will be released. The total amount which can be thus released will be about Rs. 280 crores.

The lowering of the exchange rate has far reaching consequences and it must be considered more fully. Since the existence of a National Government is assumed and since the entire sterling debt has been wiped out, the Government cannot have any objection to such a course of action. Normally it is presumed that at least in the short run lowering of the exchange rate has a favourable effect on the exports of the country while raising the exchange rate increases imports and diminishes exports. Such practices are generally criticised because the advantages are only temporary and an attempt to thrust your own commodities on the other nation is bound to result in retaliation. But, in spite of these short-lived advantages, this means has been tried by advanced countries when the short term advantage which it gives can be utilised to capture the market. When goods are once introduced in the market people begin to buy them and they continue to sell even when the advantages of the lower exchange are no longer continued. India is not an economically advanced country and therefore lowering the exchange rate for simply getting first into the market would not be justifiable. But the short term advantages cannot be denied and that one cannot be a gainer in the long run is no argument for his not being a gainer in the short run.

To this it might be objected that in the immediate future, especially in the first years after the war, such lowering of the rate is of no use at all. "For some years after hostilities cease, there will be a world shortage in almost all those goods which India will be in a position to export and as such there will be a good demand for Indian Goods."† India can export only food articles and raw materials and since Europe will be willing to purchase it at higher prices, there is no necessity for India to induce Europe by offering lower prices. Further there will be certain other disadvantages also. The writer from whom the above quotation

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† Commerce 12 February 1944 Page 209.



has been taken has enumerated all of them. He argues that lowering the exchange rate means that the cost of imports will increase and this is not at all desirable because India needs huge imports of capital goods in the immediate future. It will also increase the cost of replacement. A reduction in the imports will mean a fall in the revenue of the Central Government. Weighing these disadvantages against the advantages the writer draws the conclusion that "A careful consideration of what has been stated above will show that depreciation of the rupee in the early post-war period, as suggested by Mr. Bal Burcau, may not be quite advantageous to this country."

It is indeed very strange that after having clamoured for almost a century and a half for a lower ratio, today when there seems to be no opposition from the Government, we should come to the conclusion that the lower exchange ratio is not desirable! One is almost tempted to ask what are those revolutionary changes effected by this war so as to suddenly reverse a conclusion that was applicable for such a long time? Surely there is a fundamental change in the respective position of the countries. Shortage of raw-materials will give rise to a higher demand and India will not be in the same position as she was, in so far as she will not be required to cater for foreign markets by using artificial methods. Further, it also seems that India need not think of exports in order to increase imports because there is now the accumulated credit on which she can legitimately draw. Besides, since there is no need to rely on exports only, the present exports may be used for feeding the Indian population that is starving and famine-stricken today. Again, rapid industrialisation will create an internal market for raw materials and India need not depend upon the foreign markets. All these considerations strengthen the conclusion that India needs no lowering of the exchange rate in the immediate post-war years.

Maintaining the existing ratio without any deflation is an impossibility and it has been shown that this course is not advisable. But the new ratio of 1 shilling that has been suggested is not strictly speaking lowering the exchange rate. It will be a rate that will only be nearer purchasing power-parity of the two currencies. On the general price level the ratio will be somewhere 9d. Even if the other index numbers are taken into consideration the ratio shows a range between 9d.-12d. There is no sanctity about the prewar exchange rate and there is no

sense in making attempts to reach 1s. 6d. once more by heavy withdrawal of currency. Again the proposed ratio will be slightly higher than the purchasing power parity ratio and India should rest content with whatever advantages this margin has to confer. Variation in the exchange rate has its advantages but for that reason an extreme variation of such a margin of 6d. for 1s. 6d., almost 33%, cannot be advocated. There seems to be no cause to fear any serious loss on account of the lowering of the exchange rate to 1s. from 1s. 6d.

The National Government whose existence is assumed will differ in one important respect from the present Government. It will command the confidence of the Indian people. The present Government in defining the assets, had originally to limit the issue of paper currency against Government securities to 50 crores only. Even though by an Ordinance in February 1943 this restriction has been removed the percentage of gold and sterling to the total notes is 92.35. Such a high percentage has to be kept because if currency is issued against Government of India securities only, a complete collapse of the monetary machine in this country will be within sight. The National Government need not fear any such contingency. There will be a third source for releasing sterling securities. It will be possible for the National Government to increase the backing of the govt. securities without any adverse effects. The necessary high percentage need not be maintained. It is very difficult to guess with any precision how much sterling the Government will be in a position to release, in this particular manner. But considering the obligation to maintain the rupee-sterling link at 1s. it may be safely inferred that at least Rs. 150 crores worth sterling could be thus released.

Government will thus be able to command almost Rs. 500 crores worth sterling without any withdrawal of currency. It will thus be a sum which Government can proceed to utilise for the amelioration of the masses by importing those goods which are of real use to India. It is not suggested that the entire sum should be immediately spent. It shall have to be used continuously with a view to getting the maximum good out of it.

Such a policy has one important advantage. Since the Government will have it in their power to import any goods they choose, there will be no necessity of instituting an exchange control to see that the Indian

capitalists import only capital goods and nothing else. Even granting greater freedom to the Indian importers to import any goods it would be possible for the country to import capital goods.

If there is thus a National Government not only will the loss be avoided but the sterling balances will turn out to be a real boon to the country and she can soon afford to forget the sacrifices she had previously to make. It must, therefore, be the sincere desire of every man that our Great leader should succeed in his endeavour to solve the present deadlock and win independence for the country.

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