CHAPTER XII

CURRENCY AND PRICES

A. CURRENCY

I. Historical Review Of Currency

The currency history of India since the early part of the nineteenth century is of unusual interest and significance in monetary annals. During this period, India successively passed through a variety of phases with regard to monetary standards. Starting with a silver standard in the middle thirties of the nineteenth century, the country had a 'managed' inconvertible silver currency (1893-1898), gold exchange standard (1899-1916), a mixed standard (1917-1926), gold bullion standard (1927-1931), sterling exchange standard (1931-1947), and finally, after independence, a managed rupee standard. The crux of the monetary controversy during the last century or so has consisted in the twin issues of the choice, firstly, of a workable monetary standard based on silver, gold or sterling and, secondly, of an appropriate rate of exchange between the domestic currency, *viz.*, the rupee, and the prevailing standard. Likewise, India's currency experience embodies the working of both the Fixed Fiduciary System and the Proportional Reserve System for the issue of currency. Under a Fixed Fiduciary System, the volume of currency that can be issued against domestic Government securities cannot exceed a stipulated statutory maximam whereas, a Proportional Reserve System lays down the minimum proportion of currency which has to be covered by metallic reserves in the form of bullion or coin and foreign securities.

The origin of the modern Indian monetary system may be traced to the Gold and Silver Coinage Act of 1835 whereby the East India Company established the silver rupee (180 grams in weight and 11/12 fine) as the sole legal tender currency for payment throughout its territories. The face value of the rupee was equal to its intrinsic value and the mints were opened to its free coinage. This was a form of monometallic silver standard to replace the variety of bimetallic standards prevailing in the Company's territories. However, the Act of 1835 also authorized the coinage of gold *mohurs* and specified gold coins at market value, if required by the public. Although the Presidency Banks of Bengal, Bombay and Madras were authorized to issue notes payable to bearer on demand, their circulation was practically confined to the Presidency towns. Even after the enactment of the Paper Currency Act of 1861, while notes were issued to the public without limit in exchange for rupees or British gold coins, they were declared unlimited legal tender only within their respective circles of issue. The Act of 1861 provided

for a fixed maximum fiduciary issue of notes against Government of India securities upto Rs. 4 crores, a limit which ws successively raised by special Acts to Rs. 6 crores (in 1871), Rs. 8 crores (in 1890), Rs. 10 crores (in 1897) and Rs. 12 crores (in 1905). The remainder of the paper currency circulation was fully backed by bullion and coin. Government securities, gold and silver coin and bullion, against which notes were issued, were kept in a reserve called the Paper Currency Reserve.

The efficient working of the silver standard was rendered increasingly difficult with the depreciation of silver that accompanied its rising production as well as falling demand consequent upon the demonetisation of silver by several countries. The corresponding appreciation of gold with its smaller output and enhanced demand from countries adopting the gold standard further complicated the situation. The depreciation in the value of the rupee also created a difficult budgetary problem for the Government of India which had to mobilize larger rupee reources, mostly through higher taxation, to meet the Home Charges in England on account of interest on sterling debt, payments for Government stores, pensions and other items. Likewise, the fluctuations of the exchange rate affected not only foreign trade but also the inflow of foreign capital, enterprise and personnel.

Recognizing the need for monetary reform, the Government of India appointed in 1892 the Herschell Committee and, in pursuance of its recommendations, passed the Act of 1893. Under this Act, the mints were closed to the free coinage of both silver and gold, although the Government retained the power to coin rupees on their own account. The Act also provided for receipt of gold at the mints at the rate of 16d. to the rupee and the issue of notes in exchange for gold. Government also decided that there should be a transitional period before an attempt was made to coin gold in India and establish a full-fledged gold standard as recommended by the Herschell Committee.

Instead, following a period of transition, there came to be established, under the Act of 1899, in the light of the recommendations of the Fowler Committee (appointed a year earlier) and as administratively modified, a gold exchange standard. The main features of the currency system which thus came to be established and which remained in operation till 1916, were: (a) the sovereign was unlimited legal tender, at 1s. 4d. to the rupee; the authorities also issued sovereigns and half sovereigns to a limited extent but undertook no obligation to give them in exchange for notes or rupees; (b) the rupee was unlimited but inconvertible legal tender; (c) the rupee was maintained at 1s. 4d. by purchases and sales of sterling at fixed rates, largely through the system of Council Drafts and Reverse Council Drafts whereby the demand for rupees/sterling was met by payments of sterling/rupees into the Paper Currency Reserve, the Gold Standard Reserve or the Secretary of State's Balances.

In accordance with the recommendations of the Committee a reserve — called the Gold Standard Reserve — was created out of the profits of the coinage of silver rupees; this was designed to maintain the external value of the rupee. A change was also made in the composition of the Paper Currency Reserve. Since 1905 a part of the invested portion (upto Rs. 2 crores) of the Paper Currency Reserve was also authorized to be held in sterling securities, the remaining portion being invested in Government of India securities.

The outbreak of World War I made it difficult to maintain the exchange value of the rupee; there was a phenomenal rise in the price of silver leading to the intrinsic value of the rupee exceeding its face value. The price of silver rose from 27¼d. per standard ounce in 1915 to above 43d. in August 1917. At this price (43d.) the exchange value of the rupee was equivalent to its bullion value and, with every rise in the price of silver above 43d., the exchange value of the rupee also had to be raised *pari passu*. The Gold Exchange Standard which depended, among other things, on the rupee remaining a token coin thus virtually broke down. Accordingly, several corrective measures were taken apart from allowing the exchange rate to rise, such as the purchase by Government of 200 million fine ounces of U.S. silver, a ban on import of silver on private account, prohibition of melting of gold and silver coins in India, and the issue of an Ordinance (June 1917) requiring all imported gold to be sold to the Government. The fiduciary note issue limit was also increased from Rs. 14 crores in 1911 to Rs. 120 crores in 1919.

In 1919 the Babington Smith Committee was appointed to examine the effects of the war on the Indian exchange and currency system and to make recommendations to ensure a stable exchange. The committee's main recommendations, which were accepted by the Government in 1920, were to fix the exchange value of the rupee in terms of gold at 2 s. (*i.e.* one rupee for 11.30016 grams of fine gold) and to prescribe a minimum of 40 per cent metallic backing for the paper currency with a maximum fiduciary issue of Rs. 120 crores for a limited period. Besides, provision was to be made to issue notes upto Rs. 5 crores against export bills over and above the fiduciary issue to meet seasonal demands. The attempt to stabilize the exchange rate of the rupee at 2 s. (gold) failed because of an unfavourable balance of trade and the rapid fall in sterling relatively to rupee prices. The adjustment took the form of a fall in the exchange rate rather than in internal prices. After May 1925, the rupee ratio was maintained around 1s. 6d. and the Government introduced the system of purchase of sterling in India through the Imperial Bank from exchange banks and recognized firms in order to replace gradually the sale of Council Drafts in London, *i.e.* the system whereby sterling used to be tendered in London for credit to the Secretary of State

against rupee paid in India.

Following the return of England to the gold standard in April 1925, the Government of India appointed the Hilton Young Commission in August, 1925 to examine and report whether any modifications were desirable in the Indian currency system. Its report and recommendations were the most far-reaching of those of all he Currency Commissions appointed in India till that time. The commission rejected the gold exchange standard chiefly on the ground that it was too complicated to secure the confidence of the general public since the backing which the system supplied for the currency was too abstract to be readily intelligible to the majority. The commission, therefore, recommended the establishment of a gold bullion standard (without internal circulation of gold coins) and an exchange rate (fixed in terms of gold) of 1 s. 6 d. for the rupee. It also proposed that the control and management of currency be entrusted to a Central bank to be called the Reserve Bank of India and that the Paper Currency Reserve and the Gold Standard Reserve should be amalgamated; it also recommended that not less than 40 per cent of the combined reserve should consist of gold and gold securities. The recommendations of the commission were followed by acute controversy which centred for the most part on the choice of the 1s. 6d. ratio and, to a lesser extent, on the organization and powers of the proposed Reserve Bank.

The Currency Act of 1927 established the 1s. 6d. (gold) ratio by imposing statutory obligations on the Government to purchase gold in bars (containing not less than 40 tolas or 15 ozs. or 466.55 grams) at Rs. 21-3-10 per tola and to sell gold for delivery at Bombay or sterling for delivery in London in amounts of not less than 1065 tolas (400 ozs. or 12421.95 grams) of gold or the sterling equivalent thereof. The retention by the Government of the option of selling sterling against rupees meant that the standard adopted was not a gold bullion standard but a gold exchange standard so long as sterling was convertible into gold as it was upto September 21, 1931, and a sterling exchange standard thereafter.

The proposal for the creation of the Reserve Bank, which was referred to a Select Committee of the Indian Legislature, was dropped in February 1928 owing to differences between the Government and the Opposition on the organization of the bank, particularly regarding the composition of the directorate and its creation as a shareholders' bank.

With the delinking of sterling from gold on September 21, 1931 when England went off the gold standard, the rupee was linked to sterling at 1s. 6d. The Government of India assumed the statutory obligation to sell and buy sterling against rupees at this rate. Thus in law and practice India adopted a formal sterling exchange standard which was retained even after the creation of the Reserve Bank of India in 1935

and continued to be in operation until the cretion of a new international monetary system under the auspices of the International Monetary Fund.

The establishment of the Reserve Bank of India is a landmark in the monetary history of India not only because it set up for the first time a unified monetary authority to control both currency and credit but also introduced a basic change in the currency system by replacing the Fixed Fiduciary System by a Proportional Reserve System comprising a minimum cover of gold (in coin and bullion) or sterling securities of 40 per cent and of not less than Rs. 40 crores in value. The Reserve Bank assumed the liability of the currency notes of the Government of India and the corresponding assets in the Gold Standard Reserve and the Paper Currency Reserve, which were maintained separately heretofore.

Although the Proportional Reserve System imparted the necessary flexibility, particularly for expanding the note issue, a construction in foreign exchange reserves below the minimum level necessary to maintain a given note circulation necessitated a contraction of note issue to a larger extent than the fall in reserves. Consequently, the Bank kept a larger proportion of gold and sterling reserve, around 52-58 per cent during the years 1935-39, than the minimum of 40 pr cent.

But, in keeping with the general trend of central banking legislation to delink foreign reserves from the note issue consequent upon a growing recognition that the main purpose of foreign exchange reserves is to meet deficits in the balance of payment, the Proportional Reserve System was again modified by the Reserve Bank of India (Amendment) Act, 1956. This provided for a minimum of foreign reserves in absolute amount of Rs. 400 crores in foreign securities and Rs. 115 crores in gold coin and bullion (valued at 2.88 grains of fine gold per rupee or Rs. 53.58 per 10 grams in terms of the official parity price agreed to by the International Monetary Fund). A further change made by the Reserve Bank of India (Second Amendment) Act, 1957 reduced the aggregate value of gold and foreign securities to be held in the Issue Department at any time to not less than Rs. 200 crores, of which the value of gold should not be less than Rs. 115 crores. The Act also empowers the Reserve Bank, with the previous sanction of the Central Government, to suspend the requirement of holding foreign securities, though not the provision for a minimum gold holding of Rs. 115 crores.

The backing for the rest of the note circulation can, under Section 33 of the Reserve Bank Act, comprise rupee coin, rupee securities of the Government of India and such bills of exchange and promissory notes payable in India as are eligible for purchase by the bank. But in practice the major part of the cover consists of Government of India rupee securities including *ad hoc* Treasury bills because commercial bills and promissory notes have not figured as assets owing to lack of a proper bill market.

India's assumption of membership of the International Monetary Fund in 1946 and its political independence since August 15, 1947 have brought about further important changes in the statutory basis as well as the operation of the currency system. This may now be described as a fully autonomous as well as a managed monetary system which provides for the requisite elasticity of money supply. This system is described later in the section on 'External Value of the Rupee'.

II. Changes in the Volume and Composition of Currency

The volume of currency, although it is the most important means of payment, does not encompass the total monetary media in the community, which included bank deposits besides currency. It is therefore more meaningful to study the changes in the supply of money (*i.e.* legal tender currency with the public and bank deposits) as a whole rather than of currency alone. In the absence of a consistent time-series of money supply in India this section attempts to explain the mechanism and causes of variations in money supply since 1951. Apart from the convenience of availability of data for this period, it has the added advantage of being a period of active monetary management which fully exemplifies the working of the principal determinants of money supply.

Before analysing the variations in the supply of money, the concepts as used here may be briefly elucidated, particularly as these are operational definitions which vary with the purpose and scope of the analysis and do not have a universally accepted connotation. The most widely used concept of money supply is the one which refers to the magnitude of money supply with the public (*i.e.*, entities other than the Government and the banking system) comprising both legal tender curency (*i.e.*, notes and coin) and bank deposits.

Currency with the public comprises currency notes and coins in circulation excluding the balances of Central and State Governments held at treasuries and cash on hand of banks. Cash balances of Government are excluded because variations in them can be used as instruments for influencing the liquidity of the rest of the economy *i.e.*, off-setting any excess or deficiency of money supply with the private sector. The cash on hand of banks, including their balances with the Reserve Bank, is excluded because it constitutes the reserve against deposits and cannot therefore be used for purposes of transactions.

The deposit component of money supply consists of (a) demand deposits of banks, *i.e.*, those deposits which are withdrawable without notice such as deposits in current account and overdue fixed deposits, and (b) 'other deposits' with the Reserve Bank, which include items such as deposits of quasi-Government institutions and of foreign Central Banks as well as those balances of the International Monetary Fund (held in Account No. 2), which consist of working balances to meet the

Fund's administrative expenditure in India. Time deposits of banks and post-office savings deposits are excluded from money supply because these are essentially instruments of savings and are not ordinarily used as media of exchange. In the case of savings deposits with commercial banks, only that part which is withdrawable readily and consitutes the demand liability portion of such deposits is included. Recently the rules regarding withdrawal of savings deposits have been liberalized by many commercial banks, as a result of which the demand liability portion of such deposits has increased considerably.

Of the total currency with the public, one-rupee notes and small coins are the liability of the Government and form only a small portion of total currency. All other currency notes and 'other deposits' with the Reserve Bank are the liability of the Reserve Bank. Demand deposits are the liability of commercial banks. Thus money supply is largely the liability of the Banking System to the public and to a small extent that of the Government. However, there are other liabilities of the banking system, apart from demand deposits, *e.g.*, time deposits and items like capital and reserves of the banks as well as of the Reserve Bank which constitute the non-monetary liabilities of the banking system.

It will be clear from the above definitions that any transactions which increase either currency or deposit money (*i.e.* demand deposits) with the public will increase money supply; on the other hand, any transactions which increase time deposits, balances of the Government, cash on hand of the banks or non-monetary liabilities of the banking system, will decrease money supply. Since liabilities and assets of the banking system (including the Reserve Bank) must always be equal, changes in money supply, *viz.*, monetary liabilities of the banking system can be explained in terms of changes in (financial) assets, on the one hand, and changes in non-monetary liabilities of the banking system, on the other. Factors which account for such changes would thus explai n variations in money supply, as indicated in the following equation:

Increase in money supply (Currency plus bank deposits).	Increase in financial assets of banking system minus increase in non-monetary liabilities.

and *vice versa* for a decrease in money supply.

There are five major factors which affect money supply with the public *i.e.* (1) net bank credit by the banking system to Government which is the net result of banks' and Reserve Bank's investments in Government securities and loans and advances to Governments, Central and State*, offset by Government deposits with the Reserve Bank, (ii) net bank credit to the private sector comprising Reserve Bank of India

*Since 1943-44, however, there have been no loans and advances by the Reserve Bank of India to the Central Government and therefore this item thereafter pertains only to State Governments.

Credit to the private sector and banks' net credit to the private sector which, in turn, is the result net of banks' loans and advances to the private sector offset by banks' time deposits; (iii) net foreign exchange assets of the Reserve Bank and other banks, *viz.* the excess of foreign exchange assets over liabilities. Changes in foreign exchange assets of the Reserve Bank affect money supply since a rise in these as sets will be balanced by an increase in currency or deposit liabilities of the banking system to the public; a surplus in the balance of payments will therefore increase money supply and a deficit will reduce it; (iv) Government's net currency liability to the public, which indicates the changes in the public's holdings of one-rupee notes and small coins, and (v) net non-monetary liabilities of the banking system, which also include some errors and omissions. An increase in the first four factors will increase money supply, whereas an increase in the last one will decrease it. It may be pointed out that all the factors affecting money supply cannot be completely identified for want of adequate data. For instance, it is not possible to isolate the effect on money supply of the transactions of the foreign sector (comprising foreign companies, institutions and non-resident individuals) with the banking system.

The following Table presents a broad analysis of trends in money supply during the period 1951-52 to 1969-70 and factors affecting the variations:

TABLE I

(in Rs. crores)

	First Plan Period 1951-52 *to* 1955-56	*Second Plan Period* 1956-57 *to* 1960-61	*Third Plan Period* 1961-62 *to* 1965-66	1966-67 *to* 1969-70
A. Money supply with the public	**+196**	**+704**	**+1,661**	**+1,850**
1. Currency with the public	**+166**	**+527**	**+936**	**+972**
2. Other deposits with the Reserve Bank of India	**—15**	**+4**	**+3**	**+41**
3. Bank Money (Demand deposits of commercial and co-operative banks)	**+45**	**+173**	**+722**	**+837**
B. Factors affecting money supply				
1. Net Bank Credit to Government	+297	+1,384	+1,321	+917
2. Net Bank Credit to Private Sector	+105	+23	+642	+738
3. Net Foreign Exchange Assets of the Banking Sector	—96	—664	—107	+439*
4. Government's net currency liabilities to the public	—52	+17	+81	+68
5. Net non-monetary liabilities of the Banking Sector (including errors and omissions)	—58	—56	—276	—312*

*Excluding the charges due to revaluation of gold held in the Issue Department of the Reserve Bank from February 1, 1969.

It is evident that net bank credit to Govrenment has been the most important factor accounting for increase in money supply over the larger part of this period, though in some years such as 1966-67 (+Rs. 225 crores) and 1969-70 (+Rs. 249 crores) net bank credit to the private sector has been the major source of monetary expansion. On the other hand, the factor which tended to moderate the increase in money supply during this period, particularly during the Second Plan years, was a decline in foreign exchange assets.

Of the total money supply with the public, notes in circulation are the most widely-used medium of exchange, as the following figures show:

TABLE II

As on Last Friday of March 1970

(Rs. crores)

(1) Money supply with the public	6,379	
(2) Currency with the public	4,006	
(2) as % of (1)		62.8
(a) Notes in circulation	3,799	
(a) as percentage of (2)		94.8
(b) Estimated circulation of rupee coins	233	
(b) as percentage of (2)		5.8
(c) Estimated circulation of small coins	123	
(c) as percentage of (2)		3.1
(d) Less cash on hand with banks	149	
(d) as percentage of (2)		3.7
(3) Deposit money with the public	2,373	
(3) as percentage of (1)		37.2
(e) Net demand deposit of banks	2,315	
(e) as percentage of (3)		97.5
(f) Other deposits with Reserve Bank	58	
(f) as percentage of (3)		2.5

It is also interesting to note that, although currency (notes and coins) has been the predominant component of money supply in India, the (crude) ratio of deposit money to total money supply was as high as 43-46 per cent in the thirties and early forties of the present century.

TABLE III

(in crores of Rs.)

End of March	*Money supply with public A*	*Currency B*	*Deposits C*	*% of C to A*
1936	281	160	121	43.1
1941	456	246	210	46.0
1946	2,120	1,334	786	37.1
1951	2,016	1,406	610	30.3
1956	2,217	1,571	646	29.1
1961	2,869	2,098	771	26.9
1966	4,529	3,034	1,495	33.0
1970	6,353	4,009	2,344	36.9

Although the money supply data are not strictly comparable over these years, it would appear that, while both currency and deposit money

have been increasing, currency has risen at a more rapid rate than deposits over the period as a whole. This is partly due to the fact that the initial impact of absorption of the non-monetized sector into the monetary economy is reflected in a greater demand for currency than for deposits. However, with the banks opening branches in rural and semi-urban areas, rising interest rates offered on time deposits and liberalization of facilities to holders of these deposits, the increase in bank deposits has been greater in time than in demand deposits. More recently, the proportion of deposit money to total money supply has shown a rise indicating, among other factors, greater resort to bank money for mediating transactions.

III. Monetary Policy Before Independence

The policy of the period before independence may, broadly, be divided into the period before and after the creation of the Reserve Bank of India in 1935 as the country's Central bank. In the pre-1935 phase there was, strictly speaking, no monetary policy in the sense of a purposive regulation of the quantity and price of money *i.e.*, the structure and level of interest rates, to sub-serve objectives of general economic policy. This was not only because of the absence of a Central bank acting as a unified monetary authority but even more because of India being a dependency which meant that the maintenance of a stable relationship with the currency of the metropolitan power was, as indicated in an earlier section, a prime criterion of monetary policy irrespective of its effects on internal economic activity. Consequently, most issues of currency policy revolved round the choice of the monetary standard and the maintenance of an appropriate rate of exchange. These issues were forced to a head when India, following the United Kingdom, left the international gold standard in September 1931, and the rupee was linked to the pound sterling at 1s. 6d. Even then the really significant question was not the choice of the standard since it was not practicable at the time to link the rupee either to gold or to establish it as an independent currency. The former alternative was ruled out not only because of the inadequacy of India's monetary gold reserves and the shrivelling up of the international gold bloc but also because the retention of the gold standard would have aggravated the economic depression in the country. Likewise, an autonomous rupee, apart from being not practical politics for a non-self-governing country, would not have been feasible in the absence of a central ban. Consequently, the effective choice of a monetary standard was limited to some variant of the sterling standard which was not unjustified because the major portion of India's external transactions was with the sterling area apart from the close financial links with Britain.

The really controversial issue was, therefore, whether the maintenance of the rate of exchange unchanged at 1 s. 6 d. was justified. Although

the linking of the rupee with sterling amounted to a depreciation of the rupee in terms of gold to the extent of about 30 per cent, the competitive advantage to Indian exports was offset by the larger depreciation of the currencies of India's competitors, notably Japan, Argentina and Australia. Generally, Indian public opinion favoured a moderate devaluation of the rupee in terms of sterling as an anti-depression measure; the currency controversy was limited mainly to this question of an adjustment in the exchange ratio to 1 s. 4 d. as against maintenance of the *status quo*. The official justification of the existing ratio was based on the ground that India as a debtor country on external account benefited by the *status quo* as devaluation would have necessitated raising of larger amounts in domestic currency to meet the Home Charges of the order of about £30 million due every year to the United Kingdom.

As measured by the relative price levels in India and the U.K., it appears that the rupee was for a time undervalued in terms of sterling. This undervaluation of the rupee in terms of sterling (placed by different authorities within a range of 10 to 31 per cent) meant a rise in the rupee price of gold which therefore was one of the contributory factors to the large-scale export of gold from India estimated at about Rs. 300 crores over the period 1931-37. This reversal of the historical role of India as a habitual net importer of gold could not, however, be wholly or largely attributed to the under valuation of the rupee. The extensive dishaording of privately held gold reflected the distress sales by agriculturists who were unable to meet their monetary commitments like tax and interest payments, or even to maintain their customary standards of living, due to the fall in agricultural prices. In effect, these gold exports meant a monetization of a sterile asset although some sections of public opinion advanced official purchases to strengthen currency reserves. But in view of the prevailing uncertainty about the future of the international gold standard and the commitment to the sterling exchange standard, currency policy did not reflect a definitive position on gold exports.

The maintenance of a fixed rate of exchange naturally precluded an expansionist monetary policy aimed at stimulation of the economy through finance of public works, etc. Even the creation of the Reserve Bank in 1935 did not make any material difference to this aspect of currency policy as the bank was statutorily committed to buy and sell sterling within the limits of 1 s. 6-3/16 d. and 1. s 5-49/64 d. subject to minimum transaction of £10,000 or its evalvalent.

The Reserve Bank was given powers to regulate credit through the bank rate and open market operations, but it did no exercise them to any appreciable extent during its early years because of the general slackness of demand for credit, the comfortable reserves position of banks which could always be supplemented by borrowings from the Imperial Bank of India or from their overseas head office in the case of

Exchange Banks. The first official bank rate at 3½ per cent was announced on July 4, 1935. The rate was subsequently reduced to 3 per cent with effect from November 28, 1935, at which level it remained steady for nearly sixteen years. Open market operations were also of a very modest character and, apart from supporting public borrowing operations and the gilt-edged market, they were used to relieve seasonal stringency in the money market through purchase and sale of Government securities and sterling bills.

Although the Reserve Bank could not exert much influence over the credit situation, judging purely by the magnitude of its advances to banks and open market operations, its capacity to meet seasonal monetary stringency was a distinct improvement over the pre-1935 system when such stringency could be relieved only by borrowing additional currency from Government at high rates of interest.

Monetary policy during the war years (1939-45) was comparatively passive in the face of the huge inflationary increase in money supply originating as a cumulative result of budgetary deficits, military expenditure of the British and the Allied forces in India and the favourable balance of trade. Given the current requirements of war expenditure in rupees, the Reserve Bank had to issue large amounts of rupee currency against sterling and *ad hoc* Treasury bills of the Government of India as provided in its Act. But the mere fact that the additional currency had adequate foreign cover in the form of sterling did not alleviate the inflationary impact of the expansion of money. The war-time inflation reflected the gap between a comparatively inelastic supply of essential goods, a large portion of which was being increasingly appropriated for defence requirements, and the rise in effective demand due to rising employment and incomes. Besides, the decision to finance the war on the basis of cheap and stable money meant relinquishing the use of the interest rate as a weapon of monetary policy though it is doubtful whether the excessive liquidity of the banking system or even of the economy as a whole could have been absorbed merely by stepping up yields on Government securities.

IV. Monetary Policy Since Independence

Despite the essential similarity of the basic economic framework for its operation in the two periods, Indian monetary policy since independence presents some significant contrasts to its role in the pre-independence period. The general identity of the economic environment for monetary policy in the period before and after independence lies in the largely unaltered character of the broad structural features of the economy bearing upon the conduct of monetary policy like the considerable extent of the non-monetized sector, the predominance of currency in money supply, the extent of seasonality in currency circulation and credit and the

dichotomy of the organized and unorganized sectors in the money market. However, there has been a considerable change both in respect of the institutional framework of monetary policy and its more active use to influence the tempo and tenor of economic development. Thus, for one thing, there has occurred an enlargement of the scope, effectiveness and range of employment of the instruments of quantitative and qualitative credit control vested in the Reserve Bank under its own Statute as progressively amended as well as in terms of the Banking Companies Act, 1949, and its successive amendments.

In the period immediately after independence, the role of monetary policy continued to be largely subsidiary to sustaining the cheap money policy which was more or less an inheritance of the phase of war finance. Consequently, the bank rate remained constant at 3 per cent and the open market operations of the Reserve Bank which were aimed at a general support of the gilt-edged market resulted in large net purchases from the banking system. The maintenance of a fixed pattern of yields meant monetization of the bank-held Government debt through large-scale purchases by the Reserve Bank. In the context of the ample cash reserve position of commercial banks, it enabled the banking system to be virtually independent of Central bank credit.

It was the inflationary conditions generated in the wake of the Korean War boom in 1951 that led to the emergence of credit control as a purposive instrument of economic policy. To begin with, the bank rate which was unchanged at 3 per cent ever since 1935 was raised to 3½ per cent in November 1951. In itself this measure would not have been of much consequence considering that in India, in the absence of a developed bill market, the bank rate had not functioned as a rediscount rate. Rather, its customary significance as an advances rate against approved collateral was enhanced by a simultaneous change in open market policy. To make the rise in the bank rate effective, the Resesve Bank also announced that it would not buy Government secrities from banks as a matter of course to meet their requirements of seasonal expansion of credit, save in exceptional circumstances, but make advances against the collateral of Government securities. Soon after this a Bill Market Scheme was formulated under which banks could convert advances to their clients into usance bills and borrow against them from the Reserve Bank. This provided a convenient mechanism for controlling the flow of Central bank credit to commercial banks while enabling them to meet their legitimate credit requirements. The scheme was initially subsidized by offering a rate lower by ½ per cent than that on Government securities. Subsequently, in 1956, this rate was raised in two stages to 3½ per cent.

But even more than the Korean War boom phase, the commencement of the Second Five Year Plan witnessed the progressively growing im-

portance of monetary policy. The pressure of investment expenditure of the Second Five Year Plan witnessed the progressively growing importance of monetary policy. The pressure of investment expenditure under the Plan led to a gradual upward rise in market rates of interest; the bank rate too was raised to 4 per cent in May 1957. Likewise, the effective rate of borrowing under the Bill Market Scheme was increased to 4.2 per cent with an increase in the stamp duty on usance bills. The introduction, in October 1960, of a system of borrowing quotas for banks under graded lending rates by the bank was yet another landmark in the gradual sophistication of monetary policy. Since then this system has been retained with appropriate variations and modifications in keeping with changing requirements. It is a system which aims to reconcile the obligations of the Reserve Bank as a lender of last resort as well as the controller of credit with its role as promoter, through preferential rates of lending, of special sectors or purposes like agriculture, small-scale industries, co-operatives, exports, etc. Its mechanism consists of fixation of quotas, based on statutory reserves, for borrowing by banks from the Reserve Bank whether against Government securities or under the Bill Market Scheme at graded slab rates, with provision for borrowings above the quota at higher rates; lending for special preferential purposes is charged at the lowest slab rate, *viz.*, the bank rate. Since the need for borrowing by banks is specially acute during the busy season, the increase in the Reserve Bank's average lending rate and ceilings on banks' borrowings help to regulate the expansion of credit. Initially, there were three slabs with quotas fixed for the first two slabs, for which the prescribed rates were the bank rate and one per cent above the bank rate, respectively, whereas there was no limit to borrowing for the third slab at 2 per cent above bank rate. The number of slabs and the rates of interest applicable thereto have changed from time to time. A change of some importance in the system was, however, introduced from November, 1962 when lending above the quotas became restrictive, being subject to a detailed assessment of individual cases by the Reserve Bank. Till September 1964, there were two slabs of lending rates within the quotas, at 4½ and 6 per cent, respectively and a third slab for special accommodation of a discretionary nature at 6½ per cent.

Effective September 25, 1964 the slab system of lending rates was replaced by the differential rates scheme and concurrently the Resesve Bank evolved the concept of net liquidity ratio with a view to preventing banks from circumventing the requirements of the statutory liquidity ratio by borrowing against eligible paper. The net liquidity ratio is defined as total of bank's cash balances with the Reserve Bank and other banks in current account and all investments in approved securities less its total borrowing from the Reserve Bank, the State Bank and the Industrial Development Bank of India (I.D.B.I.).

Under the differential rate scheme, as long as the net liquidity ratio was at or above 28 per cent, the Reserve bank's accommodation was made available to banks at the bank rate. For every percentage drop in the ratio, the cost of borrowing on the entire amount moved up by ½ per cent. In September 1964, the bank rate was raised from 4½ per cent to 5 per cent. Simultaneously, the Reserve bank fixed the maximum rate of lending for bigger banks at 9 per cent, which was raised to 10 per cent in February 1965, when the bank rate was also stepped up to 6 per cent.

The system as thus envisaged had a self-correcting element in as much as, with every increase in borrowing from the Reserve Bank, the rate at which a bank could make further borrowing rose progressively, while, at the other end, it was constrained by the ceiling rate on its own advances to customers. This, in effect, established the principle of differential rates on borrowings from the Reserve Bank, depending on the individual bank's liquidity position.

Broadly, the system has continued to-date with certain modifications from time to time. Thus, in February 1965, the minimum liquidity ratio required to qualify for bank rate accommodation was raised from 28 per cent to 30 per cent. In November 1965, the rate of escalation for lending was also raised from ½ per cent to 1 per cent for every drop of 1 percentage point or fraction thereof from the minimum liquidity ratio of 30 per cent. Certain concessions have also been granted from time to time in respect of the net liquidity ratio. Thus, refinance to priority sectors such as food procurement, defence supplies and export packing credit was provided at bank rate irrespective of net liquidity ratio. For the 1966-67 busy season banks were given additional refinance facilities at bank rate for an amount equivalent to 10 per cent of the actual net liquidity ratio as at the end of 1966 slack season. Provision was also made for the Reserve Bank to charge a penal rate of 10 per cent for any borrowings in excess of the borrowings at the bank rate.

In view of the recessionary trends in certain sections of the industry, the Reserve Bank's refinance policy was selectively liberalized since August 1967. Thus a preferential rate of 4½ per cent was applied for export packing credit for engineering and metallurgical products. With a view to stimulate the economy, concurrently with certain fiscal measures announced in the budget for 1968-69, the Reserve bank also initiated certain monetary measures. The Bank rate was reduced from 6 per cent to 5 per cent in March 1968, and the maximum rate on bank's advances to customers was lowered to 9.5 per cent from 10 per cent.

Since October 1968, a uniform rate of 4½ per cent was charged, irrespective of the net liquidity ratio for the total short-term advances to agriculture and small-scale industries and not merely the increments over the base periods as before. In February 1970, certain concessions

granted with respect to priority sectors were withdrawn as credit had expanded at a faster rate than warranted by the real trends in the economy. Thus, although changes were made from time to time in the differential rate system of lending based on the net liquidity ratio, the basic element of this policy, namely, the application of a penal rate in the event of a fall in the liquidity ratio below 30 per cent, continued to be in operation.

The fact that banks have had frequent resort to borrowings from the Reserve Bank against Government securities and under the Bill Market Scheme is a significant index of the effectiveness of the bank rate-cum-borrowing quota technique of Central banking in India.

TABLE IV

Reserve Bank Credit to Scheduled Banks

(In crores of Rs.)

Outstanding as on last Friday of March	*Against usance bills and/or promissory notes*	*Other Advances*	*Total*
1951	—	12	12
1956	29	35	64
1961	45	50	95
1966	53	23	76
1970	78	160	238

However, the effectiveness of the bank rate technique is still limited by the lack of integration and cohesion in the money market. Similarly, the use of open market operations has been subject to varying limitations since the inception of the bank. In the early years the statutory restrictions on the volume and maturity of rupee securities which the bank could hold in its portfolio as well as the comparatively under-developed state of the security market inhibited recourse to open market operations. The pursuit of cheap money in the war and post-war years necessitated virtually unlimited purchase of securities from the banking system. It was only when 'cheap money' was replaced by 'regulated money' following the rise in the bank rate in 1951 that it was possible to regard open market operations, as observed above, as a purposive instrument of policy through the extension of discriminating support to the gilt-edged market. This was reflected in the emergence of moderate net sales in contrast to net purchases in the earlier years. Open market operations have been used increasingly as an adjunct to Government borrowing operations, primarily in the maintenance of orderly conditions in the gilt-edged market rather than to influence the cost or availability of credit. However, their use for meeting the seasonal need of banks for reserves illustrates their potential significance in the Indian context as a flexible instrument to regulate the monetary climate.

TABLE V

Open Market Operations of the Reserve Bank of India

(In crores of Rs.)

Financial Years	*Net Purchases* (—) *Net Sales* (+)
1945 to 1951	— 281.06
1951 to 1956	+ 55.47
1956 to 1961	+ 72.26
1961 to 1966	+ 55.43
1966 to 1970	+ 218.93

Although there is at present no statutory restriction on either the volume or maturity of Government securities which can be held by the Reserve Bank in its portfolio, in practice open market operations have been confined to medium and long-dated securities in the absence of a developed market for Treasury bills.

The inherent limitations of the bank rate and open market operations as instruments of monetary policy in India underline the importance of other weapons, notably the variation of reserve requirements, selective credit controls and moral suasion. The power to vary the statutory reserve, and hence the cash base of commercial banks,is peculiarly suited to Central banks in under-developed money markets where the classical weapons of bank rate and open market operations have comparatively less scope. It was not until October 1956 that the Reserve Bank acquired the necessary powers to vary (a) the reserve ratios of banks between 5 and 20 per cent of demand liabilities and 2 and 8 per cent of time liabilities and (b) the proportion to be maintained as reserves of the increase in deposits after a certain date upto 100 per cent of the increase in deposits subject to the aforesaid overall maximum. It was, however, not until March 1960, that the Reserve Bank had occasion to employ these new powers when banks were called upon to maintain with the bank 25 per cent of the increase in deposit liabilities over and above the minimum statutory reserves. The requirement was raised to 50 per cent of the additions to deposit liabilities after that date. The impounded deposits were subsequently released in two instalments (March 1960 and January 1961) as part of the changed credit policy of the bank consequent upon the introduction of the three tiers of lending rates. As from September 1962, the minimum statutory reserve requirements were unified at 3 per cent for both demand and time liabilities taken together and made variable upto 15 per cent. The merger of the differential ratios for demand and time deposits is indicative of the growth in volume of time deposits and even more of the fact that, in practice, these deposits tend to have a maturity shorter than their formal period of deposit.

But the distinctive feature of Indian monetary policy has been the extensive resort since 1956 to qualitative controls, as distinct from the

foregoing quantitative weapons, notably the flexible use of selective holding of commodities in short supply or else to restrain excessive borrowing from banks in the form of clean advances (*i.e.*, without formal security or collateral) or against the security of assets such as stocks and shares. These selective credit controls have mainly taken the form of stipulation of margin requirements and directives to maintain aggregate credit against particular commodities (mostly foodgrains, oil-seeds, sugar, cotton and jute) within specified limits. The implementation of these controls has its problems in a banking system with a very wide branch network and regional diversities. But, on the whole, there has been responsive co-operation on the part of the banks and selective controls have played a salutary role in maintaining orderly conditions in commodity markets.

Formal credit controls, whether quantitative or qualitative, have often been supplemented by recourse to moral suasion through informal consultation with and exhortation of the banking community by the Governor of the Reserve Bank. This technique has a certain efficacy in view of the concentration of the major part of the resources of the banking system in a comparatively small number of banks but it also has its limits. It has worked particularly well where the climate for its use with regard to the interests of the banking system is propitious.

In retrospect it may be said that the period since independence has, on the whole, been notable for the gradual emergence of an articulate and flexible monetary policy aimed at reconciling the requirements of an expanding volume of money to finance the expansion of output while restraining the use of credit for unproductive and non-essential purposes. While the onus of maintaining general economic stability does not rest exclusively or even largely on monetary policy, it can be said with some justification that monetary policy has been operated with a view to ensuring a reasonable degree of stability consistent with the needs of economic development.

V. External Value of the Rupee

The preceding paragraphs have dealt with the evolution of the rupee primarily in the context of internal economic developments. But the role and significance of a currency unit is no less important in terms of its use in international transactions; in this context, it is the external value of the currency, *i.e.*, its relation with other currencies, that is of interest. As indicated earlier, for many decades the internal aspects of currency policy in India were largely subordinated to its external aspects. This was a logical corollary to the statutory link of the rupee with sterling. During the heyday of the

international gold standard, the rupee was, through its link with sterling, on a gold exchange standard. With the realization of the importance of internal monetary management and a rejection of the automaticity implied in the gold standard arrangements, there was virtually a world-wide abandonment of the gold standard. In September 1931, the movement was sparked when the U.K. went off the gold standard. For India, however, the gold exchange standard was replaced by a sterling exchange standard which continued to detract from the full freedom of monetary management. Thus, the rupee sterling rate set, as mentioned earlier, after much controversy at 1 s. 6 d. per rupee in April 1927 (in terms of the Currency Act) remained unchanged through the maelstrom into which currencies were thrown following the Great Depression of 1929-31 and was the ratio that was also formally adopted in the Reserve Bank legislation (Sections 40 and 41). This rate continued to be in force until June 6, 1966, when the rupee was devalued in terms of all currencies including the sterling.

Meanwhile, however, a major change has occurred in the theoretical and legal basis of the ratio in the wake of independence as well as India's membership of the International Monetary Fund (I.M.F.). The par value of the rupee is now set in terms of gold as required by the I.M.F. Articles of Agreement. The Reserve Bank of India Act was accordingly amended in 1947 without specifying any particular rate of exchange but making it subject to determination by the Central Government having regard to its obligations to the I.M.F. On India joining the I.M.F., the rate was initially fixed at 4.145 grains of fine gold per rupee corresponding to the 1 s. 6 d. rate to sterling. When the pound sterling was devalued by 30.5 per cent in September 1949, the rupee, like the currency of most sterling area members, was also devalued to a similar extent and the par value was fixed at 2.880 grains of fine gold per rupee. Thus, while in terms of gold the rupee was devalued from Rs. 3.31 to Rs. 4.76 per dollar, the rupee-sterling ratio was unchanged at 1 s. 6 d.

The rupee was again devalued by 36.5 per cent on June 6, 1966, so as to bring domestic prices into alignment with external prices. In terms of the U.S. dollar, the rupee was devalued from Rs. 4.76 per dollar to Rs. 7.50 per dollar. The new par value of rupee works out to 1.828 grains of fine gold as against 2.880 grains of fine gold heretofore. The value of the rupee in terms of sterling was also accordingly changed from 1 s. 6 d. to 11-3/7 d. Unlike the previous devaluation in 1949, which was only in terms of non-sterling currencies, the devaluation in 1966 was in terms of all currencies.

Though the rupee is now formally linked to gold in terms of the I.M.F. Articles, in practice, the link with sterling continues to be important for historical reasons as also because the larger portion of India's external transactions has been and is financed in sterling. The major portion of

India's reserves is maintained in London. India is a member of the Sterling Area group of countries, which involves a pooling of exchange reserves of the members in London and the financing of the bulk of their foreign trade in sterling; further, while each country has the right to determine its rate of exchange, the exchange parity is maintained through operations in spot and forward sterling.

The considerations which guide a country in the choice of an appropriate par value are, briefly, that it should enable the currency unit to perform adequately its functions as a medium of international payments, *viz.*, financing the stream of imports of goods and services needed by the economy through an adequate flow of exports, visible and invisible. This would have to take into account the pattern of relative costs, incomes and prices between the country and the outside world and, more particularly, the pattern and structure of its external trade. Obviously, no country can afford to support an exchange rate which is clearly out of alignment with international costs, incomes and prices and which makes it difficult to achieve external equilibrium over time. Implicit in the above is the assumption that a country's demand for and supply of foreign exchange would be decided by the free play of market forces. In practice, however, official intervention in the market process is widespread whether by tariffs, subsidies or import and other controls and it is, therefore, difficult to assert that any particular rate is the appropriate one for maintaining equilibrium, allowing for short-term variations, in the exchange market. Further, the experience of the nineteen thirties showed that countries, in their pursuit of policies designed to adjust their internal economies free from the constraints of exchange rate rigidities in automatic standards, often allowed exchange rate variations to be used as a protective device. This was a period of competitive exchange depreciation and international currency disorder. The I.M.F., set up after the war, with India as a founder member, seeks to bring about order in international monetary affairs and, for this purpose, aims at preventing unilateral actions like competitive exchange depreciation. The objectives of the Fund are not only to bring about stable exchange rates but fixed rates (as against floating rates) and also unitary exchange rates (as against multiple rates). The rupee rate is in conformity with these objectives. The Fund arrangements, however, by no means imply a reversion to the rigidities in exchange rate structure of earlier monetary standards. In fact, while its Articles provide for the liberalization of trade and payments, they also provide for a change in a country's exchange rate in consultation with the Fund to correct fundamental disequilibrium.

In terms of the Fund agreement, member countries have to maintain the par value within limits of 1 per cent on either side of parity. In keeping with the sterling area practice, in India this takes the form of the

Reserve Bank's readiness to buy and sell spot and forward sterling within narrow limits. The bank buys both spot and forward sterling (upto 6 months) from authorized dealers (scheduled banks authorized to deal in foreign exchange) at 1 s. 6 d. per rupee. The selling rate for spot sterling is 1 s. 5-63/64 d., the rate for forward sterling being slightly lower at 1 s. 5-31/32 d. After devaluation, the buying rate for delivery within six months was changed to £4.7619 per Rs. 100 and the selling rate for ready delivery to £4.7467 per Rs. 100. Forward sales by the Reserve Bank of India were discontinued from June 10, 1966. Following the change in the per value of the pound sterling on November 18, 1967, the actual rates at which the Reserve Bank of India bought and sold sterling were also revised. The buying rate for delivery within six months (including spot) was changed to £5·556 per Rs. 100 and the selling rate for ready delivery to £5.538 per Rs. 100.

The narrow spread between the Reserve Bank's buying and selling rates for spot sterling and its provision of forward cover affords a convenient arrangement for authorized dealers to convert rupees into sterling and *vice versa* and helps them in turn to meet the requirements of the public at fine rates thereby ensuring that the rupee-sterling rates move well within the terms set by the Fund Agreement. This has also enabled the authorized dealers to buy sterling at rates fixed by the Foreign Exchange Dealers Association (comprising the banks authorized to deal in foreign exchange); these rates are fixed in consultation with the Reserve Bank. Exchange rates in India for non-sterling currencies are governed by the prevailing rates in the London Exchange market for those currencies *vis-a-vis* sterling.

One of the primary objectives of the I.M.F. is to free international payments on current account from control and to assure full convertibility for currencies earned in current transaction. The Fund's Articles recognize that restrictions on capital transfers would be necessary, but they also provide for the transitional provisions (Article XIV) whereby countries can maintain restrictions even on current transactons. While the primary purpose of this Article was to enable countries to adjust their economies during the post-war transition, its provisions have also been helpful to countries like India experiencing balance of payments difficulties during a period of growth. In terms of the Fund Agreement (Article XIV), countries are required to consult with the Fund each year on the nature and extent of exchange restrictions and the progress achieved in regard to removing discriminatory restrictions.

While the exchange restrictions now in force in India are thus permitted by the I.M.F., the restrictions themselves date back to the outbreak of World War II in 1939 when exchange control was introduced under the Defence of India Rules both as an instrument of economic warfare and to conserve and restrict the use of scarce foreign (non-

sterling) currencies for essential purposes.

In the post-war years with large deficits in India's balance of payments, it has been necessary to extend the war-time exchange controls on a permanent basis. Accordingly, the Foreign Exchange Regulation Act of 1947 was enacted in terms of which the Government and the Reserve Bank of India are empowered to control all transactions involving foreign exchange, including foreign securities and, among other things, prohibit dealings in foreign exchange by other than authorized dealers at rates other than those fixed by the Reserve Bank. This Act is administered by the Reserve Bank in accordance with the general policy laid down by the Government in consultation with it. With the general shortage of foreign exchange, including sterling, it became necessary to extend in 1947 the control to sterling area countries also. With mounting imports under the successive plans for economic development, it remains necessary to ration foreign exchange so as to distribute current earnings of foreign exchange among competing demands so as to be of the maximum advantage to the nation.

B. PRICES

This section presents a historical review of the broad movements of prices in India since the middle of 19th century, their more important causal factors and economic consequences. Apart from the limitations imposed by the difficulty of constructing accurate price indices, the absence of adequate and consistent time series of price data precludes meaningful comparisons of prices over a long period of time. The emphasis is, therefore, on themore salient aspects of price fluctuations.

The history of prices in India may be conveniently divided into six well-marked phases, namely:

(a) 1860s until early 1890s;
(b) 1890s until World War I;
(c) World War I and early post-war period (1915-20);
(d) Inter-war period (1920-1939);
(e) World War II, post-war transitional period and post-independence period (1939-1951), and
(f) The period of planned economic development (1951 onward).

(a) **1860-1893:** The 1860's are a convenient starting point. Not only does the earliest available general index relate to 1861 but the three decades following are also roughly the period when the Indian economy and its domestic price and income structure, which had hitherto been comparatively insulated, were increasingly exposed to external influences. The earlier part of this period was marked by cyclical movements with

phases of rising prices alternating with those of price declines. This was especially so until 1880; the Indian price level was influenced not only by domestic and natural causes such as the vagaries of the monsoons but by external factors such as the American Civil War, the opening of the Suez canal and fluctuations in world prices of the precious metals.

TABLE VI

Weighted Index Number (100 Articles)

Base: 1873 = 100

Year		*Year*	
1861	93	1880	109
1865	109	1885	116
1870	107	1890	117
1875	96	1893	129

The initial phase (1861-66) witnessed a steep rise in Indian prices. The American Civil War and the consequent diversion of demand for cotton to exports of this commodity from India set off a boom in cotton prices in India which led to a large influx of precious metals to the country and a considerable volume of silver coinage. A general rise in the price level was the result, the index increasing by over 17 per cent to 109 in the 4 years upto 1865. A down-trend in world prices followed the end of the Civil War in the States and the expansion in world trade (helped also by a fall in the freight rates). Between 1865 and 1875 prices receded by 12 per cent, the index falling to 96. But for a brief spell between 1876-79, when prices rose by about 34 per cent, almost exclusively in respect of food articles following famine conditions over vast areas in India, prices on the whole continued their decline until the early 1880s. While the fall in Indian prices was to a large extent the counterpart of a world-wide trend, the downward movement in India was halted earlier than abroad as a result of a fall in the value of the rupee; the depreciation of the rupee was associated with a sharp fall in the price of silver following a large increase in its production. The fall in the value of silver had commenced even in the mid-seventies but after 1883 the rate of depreciation in the value of silver was accelerated. By 1893 the price index had risen once again to 129.

(b) **1893-1914:** The closure of the mints in India after 1893 following the Report of Herschell Committee, referred to in an earlier section, brought in another interlude of decline in prices till about 1899 when the index touched 121; the exchange rate was stabilized at 1 s. 4 d. per rupee in that year.

TABLE VII

Weighted Index Number (110 Articles)

Base: 1873 = 100

1893	129	1910	150
1899	121	1914	187
1900	143		
1905	135		

From about the turn of the century until the outbreak of World War I, prices were once again generally on the increase and especially so after 1905. The position was considered sufficiently serious to warrant the appointment by the Government of India in 1910 of the Prices Enquiry Committee under the chairmanship of K. L. Datta to examine the causes for the price rise in India. The committee noted that prices in India during the quinquennium 1907-11 were 40 per cent higher than in 1894-98. This rate of increase, the committee pointed out, was higher than in several countries including the U.K. and the U.S.A. where the price increase was 21 per cent and 38 per cent, respectively. The rise in Indian prices was over a wide commodity range and covered both export staples and consumer goods. Foodgrain prices rose by 30 per cent, raw cotton and jute by 58 per cent, metals by 22 per cent. The committee cited both internal and external factors as being responsible for the rise in the price level. The rise in world prices during this period due mainly to the wider use of gold as monetary metal and the pressure of demand arising from military expenditure in several countries was communicated to India through the fixed exchange rate. Internally, although production was increasing, it was not large enough to match the rising demand due to expansion of population and the increasing purchasing power. The excessive coinage of rupees inconvertible into gold was a major factor making for higher prices. Thus, the volume of currency rose between 1898-1913 by nearly 99 per cent and prices by 58 per cent.

(c) **World War I and Early Post-War Period (1914-1920):** With the outbreak of World War I the pace of price increase accelerated sharply. In the initial period of the war, however, the rise in prices in India was slower than in the belligerent countries due to war-time restrictions on export of goods and import of the precious metals. The rise in the domestic price of silver and the fixed rupee sterling exchange rate were once again the principal factors in bringing about the steep rise in prices. The expansion of money circulation was particularly sharp after 1917; by 1920, the Calcutta index of prices had risen by over 100 per cent compared to the level of 1914.

(d) **The Inter-War Period (1920-39):** While the purchasing power of the rupee was thus declining internally, its external value was, however, rising as sterling depreciated at a faster rate; consequently, at the end of 1919 and early in 1920, the rupee value was about 2s. 4d. The adoption of the 2s. rate for the rupee in accordance with the Babington-Smith Committee's recommendations and the deflationary currency policy following the maintenance of rigid exchange ratio were super-imposed on the post-war decline of prices abroad which was communicated to India. By 1929 Indian prices had moved down by nearly 30 per cent

compared to 1920. With the onset of the Great Depression (1929-32), Indian prices declined further sharply and by 1932 prices had dropped by another 35 per cent; this was a rate of decline much more severe than in many other countries.

TABLE VIII

Index of Wholesale Prices (1929=100)

Average for the year	*India (Calcutta)*	*United Kingdom*	*U.S.A.*	*Australia*
1930	82.3	87.5	90.7	88.4
1931	68.0	77.0	77.0	79.2
1932	64.5	74.9	68.0	78.3
1934	63.1	77.1	78.7	81.6
1936	64.5	82.7	84.8	85.6
1937	72.3	95.2	90.6	91.9
1938	67.6	88.8	82.5	92.2

External influences were aggravated by an orthodox exchange policy; nor was domestic monetary and fiscal policy geared for reviving economic activity. India also felt the adverse impact of a worsening of the terms of trade; agricultural commodities (which constituted the bulk of her exports) suffered larger price declines than did industrial products (her major imports).

The trough of the Depression had been reached in 1932 and from then on there was a steady recovery in prices with the revival of production and trade. The rearmament programmes in several countries abroad provided a further stimulus. By 1937, the Calcutta index had risen by 12 per cent compared to 1932. The middle of 1937 witnessed a recession once again in business activity in the United States and other countries; though this recession proved short-lived, Indian prices continued to decline and, by 1938, the index (base: 1929 = 100) had once again dropped to 68 around which point it hovered until the summer of 1939.

(e) **World War II and Early Post-war and Post-Independence period (1939-1951):** The outbreak of the Second World War in September, 1939 marked the commencement of yet another phase of price increase. With the progressive mobilization of resources for the war, prices tended to rise; the super-imposition of high and rising demand on a relatively inelastic supply of essential goods and the diversion of commodities from civil to military uses exerted a steady pressure on wholesale prices and the cost of living. Especially after 1941, with India becoming a base of operations and the larger expenditure incurred here on behalf of Allied forces and with the use of inflationary methods to finance war expenditure, the general price level took a sharp upturn, despite the imposition of rationing and of price controls on a wide range of commodities. Over the war period as a whole, the general price level rose by 143 per

cent, the increase being more pronounced in the case of food articles, export commodities and agricultural products in general.

TABLE IX

Index Numbers of Wholesale Prices

(Base: Week ending August 19, 1939 = 100)

	General Index	*Food and Tobacco*	*Other Agricultural Commodities*	*Raw Materials*	*Manufactured Articles*	*Chief Articles of Export*
Last week of						
August 1939	100.3	100.3	100.7	100.2	100.0	100.6
„ 1940	108.4	103.2	98.2	118.9	109.3	106.3
March 1941	118.8	108.1	112.4	125.9	131.7	116.7
Average 1942	144.2	130.5	116.8	162.4	162.5	138.7
„ 1943	213.5	247.8	215.3	172.0	227.0	210.4
August 1945	244.1	239.4	268.0	210.8	243.5	248.4
%variation August 1945 over August 1939	143.4	138.7	166.1	110.4	143.5	195.8

This order of increase in the general index was, however, much below the rate of monetary expansion; this was partly due to the price controls which made the inflation 'latent' rather than 'open'. This monetary expansion was, indeed, backed by sterling assets but this afforded no relief from inflationary pressures as these foreign assets could not be transformed into real resources by enlarging the import of commodities owing to war-time shortages of shipping space, diversion of resources to defence uses and the loss of Burmese rice following the Japanese occupation of Burma.

TABLE X

Money Supply and Prices — 1939-51

	Money Supply (Rs. crores)	*Wholesale Prices Annual Averages (Base: Week ending August 19, 1939=100)*	*Working Class Cost of Living Index, Bombay (Base: August 1939=100)*
1939	322.8	125.6 (Sept.-March)	103 (Aug.-Dec.)
1940	398.5	114.8	107
1941	455.6	137.0	118
1942	616.4	171.0	150
1943	1,035.8	236.5	219
1944	1,575.7	244.2	226
1945	1,875.7	244.9	224
1947	2,128.7	308.2*	268
1949	1,928.7	385.4*	291
1951	1,965.9	434.6*	314

Note: Data on money supply relate to last Friday of March. Data on wholesale prices and working class cost of living relate to financial year averages with 1939 relating to 1939-40 and so on.

*Base August 1939=100.

The cessation of the war did not alleviate the price situation. The continuance of heavy governmental expenditure and the maintenance of cheap money led to the persistence of inflationary conditions which was aggravated by crop failures. Between September 1945 and August 1947 wholesale prices rose by over 20 per cent and the cost of living index (Bombay) by 18 per cent. The dismantling of war-time controls over several essential consumer goods as well as the upward revision of controlled prices in respect of others apparently aggravated a basically untenable price situation through activizing the latent inflation.

The economic consequences of country's partition accentuated the pressure on prices; the Indian Union became a net importer of foodgrins, jute and cotton. The increase in expenditure on defence and rehabilitation and the experiment of food decontrol (between November 1947 and July 1948) further pushed up prices; from August 1947 to July 1948 prices increased by 29.3 per cent. There was a temporary recession in prices in the second half of 1948 and the early part of 1949 though the decline only partly offset the increase that occurred during the phase of decontrol. With the devaluation of the rupee, along with sterling in September 1949, prices again started to rise, the outbreak of the Korean War in 1950 providing a further powerful stimulus to his trend. Once again, the rise in commodity prices all over the world was communicated to India, though the degree of price increase here was somewhat less. The peak was reached in April 1951 when the index of wholesale prices touched 462.0 — a rise of 16.3 per cent compared to the pre-Korean War level and of 18.8 per cent compared to the pre-devaluation level. Food articles and industrial raw materials prices in particular rose to inordinately high levels.

At the commencement of the First Plan, the Indian price level was thus 55.7 per cent higher than at the time of independence, and 90.6 per cent higher than at the end of World War II.

(f) **Period Of Planned Economic Development (1951-1969):** Given the objective of development with stability, price policy in a planned economy has to ensure that absolute and relative movements of prices accord with Plan priorities. In particular, given the pattern of consumption, it is necessary to avoid any excessive increase in the prices of essential items of consumption, in particular, of foodgrains. The role of price policy is crucial in that stepping up the rate of development inevitably sets in train pressure on prices. The behaviour of prices in the First and Second Plans must, therefore, be viewed against this perspective.

As mentioned above, the price level in India at the commencement of the First Plan represented the peak of the post-Korean price increase. With the collapse of the post-Korean commodity boom as well as with the implementation internally of corrective fiscal and monetary policies,

prices fell sharply in the early months of 1952. The decline in Indian prices in this period was sharper than in sveral countries abroad, and by March 1952, the wholesale index had moved down by 18.5 per cent from the April 1951 level. After remaining generally steady around this level for about two years, prices fell sharply in 1954-55 following the bumper harvests of 1953 and 1954. Between March 1953 and March 1955 the overall index declined by 8 per cent and food prices in particular fell by about 19 per cent necessitating price support operations by Government. Whereas the decline in prices in 1952 was partly the result of a contractionist monetary policy, the decline in 1954-55 occurred at a time when money supply increased and indicated that the expansion of aggregate monetary demand was not sufficient to absorb the increase in overall supplies, especially of the agricultural commodities. By July 1955, the decline was arrested and in fact reversed, marking the recommencement of a phase of price rise, and over the whole of the last year of the First Plan prices increased by 18 per cent. The level in 1956 was, however, still 22 per cent below that at the beginning of the Plan. The all india cost of living index (1949 = 100) also varied considerably over the period of the First Plan but at the end was only 3 per cent below that at its beginning (Table XI).

The Second Five Year Plan thus started, as did the First Plan, against the background of rising prices; unlike the earlier period, the primary impetus to the rise in prices in 1956 was internal. Lower agricultural output, combined with rising investment expenditures, reflected in a sharp monetary expansion in the last year of the First Plan, exerted pressure on prices and policy was accordingly geared to bring about relief from a situation of rising prices, especially of foodgrains; imports of grains were stepped up and selective credit controls on foodgrains advances were initiated. Prices were on the whole steadily rising over the whole of the Second Plan and by March 1961 the general index of wholesale prices was higher by 30 per cent compared to the level at the beginning of the Plan. The price increase was shared by all the major groups. Food articles (+27 per cent) and manufactures (+26 per cent) rose by somewhat below the average but industrial raw materials (+45 per cent) showed a much sharper rise. Reflecting the trends in the general wholesale price index, the all-India cost of living index increased by 24 per cent over the Second Plan.

The underlying factor behind the Second Plan price experience had been the rising pressure of aggregate monetary demand as reflected in the sharp monetary expansion, which was nearly three-and-a-half times that recorded in the First Plan. The impact of the rising investment expenditure, reflected in a steep increase in the level of Government indebtedness to the banking system, was moderated initially by a draft on external reserves but subsequently exerted considerable stress on the domestic

TABLE XI

Wholesale Prices — 1951-1969

(*Bases* 1952-53=100)

March (Average)	1951	1956	1961	1966	1969	*Percentage changes* 1956 *over* 1951	1961 *over* 1956	1966 *over* 1961
1. Food Articles	112.4	92.8	117.5	172.9	220.1	— 17.4	+ 26.7	+ 47.1
2. Liquor and Tobacco	112.9	78.7	113.4	128.8	258.8	— 30.3	+ 44.0	+ 13.5
3. Fuel and Power, Light and Lubricants	97.5	96.8	122.7	159.9	196.8	— 0.7	+ 26.7	+ 30.3
4. Industrial Raw Materials	153.7	109.4	159.1	207.0	245.5	— 28.8	+ 45.4	+ 30.1
5. Manufactures	118.7	102.9	129.4	157.3	173.1	— 13.3	+ 25.7	+ 21.5
6. All Commodities	120.2	98.1	127.5	172.3	210.5	— 18.4	+ 30.0	+ 35.1

price situaton. The expansion of demand coincided with shortfalls in agricultural production, especially of foodgrains, particularly in 1957-58. The situation was alleviated by larger import of foodgrins, the bulk of it under P.L. 480 agreements. Towards the end of the Plan, with a spurt in agricultural production, an element of relative stability was imparted to foodgrains prices, and with their weight in the overall index, to the general price level.

This element of relative stability marked the price experience of the first two years of the Third Plan. With the bumper harvests of 1960-61 and 1961-62, and the continued availability of supplies of P.L. 480 foodgrains, an acceleration of the investment level was possible without any untoward effects on prices. The Chinese aggression in late 1962 and the super-imposition of larger defence expenditure on growing development outlays exerted strong demand pressures in 1963-64. The increase in aggregate demand coincided with comparative stagnation of agricultural production so far during the Third Plan. Over the greater part of 1963-64, prices were consequently on the uptrend and recorded the highest rate of rise during any year in the Third Plan period. Over the Third Plan period, prices rose by 35 per cent on top of a rise of 30 per cent during the Second Plan period. The largest rise during the Third Plan took place under the Food Articles group (47.1%), followed by Fuel and Power (30.3%) and Industrial Raw Materials (30.1%). Manufactures rose by 21.5 per cent and Liquor and Tobacco by 13.5 per cent. Reflecting these trends in the wholesale prices, cost of living also rose by about 40 per cent. Measures to arrest prices, especially of essential commodities, so as to protect the more vulnerable section of the people have included the continuance and, where indicated, the tightening of credit controls, both general and selective, and steps to enlarge the availability of essential goods.

A noteworthy feature of the record of Indian prices in the period of planned economic development as a whole is that they have not risen more than have prices in other countries similarly situated.

Admittedly, it is difficult to generalize about the effects of price changes on the Indian economy over the period of an entire century from 1861 to 1961. Historically, periods of rising prices seem to have been more frequent and prolonged than those of depression and falling prices. For a country like India, with the large mass of the people being net debtors, a gradual rise in prices should in part alleviate the burden of debt. Given the structure of production and marketing, however, only a small proportion of the benefit of higher prices accrues to the agriculturist or artisan owing to interception by middlemen and money-lenders. Likewise, the extent of stimulus to output as a result of high prices is limited by structural and institutional constraints, such as the shortage of capital, skills and enterprise and the largely self-sufficient

character of Indian agriculture. On the other hand, although the proportion of fixed income groups (salary and wage-earners) in the total population is comparatively negligible, the effects of rising prices on general consumption standards are usually serious enough for fixed income groups, including the large class of landless agricultural labourers who are remunerated in cash, to warrant special measures. Also, the bulk of the population, although nominally self-employed, has such small and fluctuating money incomes that its capacity to bear price changes is very limited. Thus, apart from acute famines like those of the nineteenth century and the Bengal famine of World War II, even minor increases in prices, particularly of food articles, impinge harshly on the more vlunerable sections of the community like the salaried middle class, landless and certain other classes of labour and the smaller cultivatcors and artisans. In the result, the structure of the Indian economy makes it basically more sensitive to the less desirable socio-economic consequences of rising prices.

With the rising tempo of investment expenditure in the phase of intensive economic development ahead, continued pressure on prices is only to be expected. The task of price policy, and indeed of economic policy, in the coming years will be to organize the financing of defence, development and rehabilitation with the minimum disturbance to financial and price stability so as to ensure substantial growth on a sound and orderly basis. Withal, cyclical, temporal and seasonal variations in agricultural prices have to be progressively reduced so as to conform to their economic function of orderly marketing and distribution of supplies. The objective of policy in respect of non-agricultual as of agricultural prices remains to assure a reasonable return to the producer and to safeguard his incentive to sustain a steady flow of output and suppleis at a level of prices which, all the same, is fair to the average consumer and to the industrial user of commodities and products.