MONEY, CURRENCY AND EXCHANGE

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PREFACE

The patronage extended to my *Banking—Principles : In India* both by the teachers and the students has encouraged me to bring out this book.

It is hoped that the two volumes will be of considerable assistance to those who are reading for the Examinations of the various Boards and Universities in India.

A study of the pages of this book will reveal that I differ in certain cases with the views expressed by most of the Indian writers. For instance, while they seem to suggest that money was invented, I hold that it was discovered. Of course, I do not claim to be original; my views are based upon those of the best foreign writers I have also gone in certain places in a greater detail, specially in the case of Monetary Standards and Foreign Exchanges, than has been done by other authors. The chapter on Managed Currency will be found an additional feature and is meant only for those who wish to make a higher study of the subject.

I will consider my efforts amply rewarded if the students derive the real benefit of acquiring the knowledge of various subjects discussed in this book and an insight into the currency problems of India which demand immediate solution.

In the end, I feel that in spite of the great care taken in correcting the proofs, the book may contain some errors. I would, therefore, feel obliged for any mistakes that may be brought to my notice.

June 15, 1943. K. N. GARG.

PREFACE TO THE SECOND EDITION

The first edition of this book was well received by students and teachers. In this edition, I have tried to bring the material as up-to-date as possible.

The book has been out of print for more than one year, and hence I owe apology to the students and teachers. It was, however, due to unavoidable reasons.

I hope that it will be found more useful in its present form.

January 14, 1947. K. N. GARG.

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CHAPTER I

INTRODUCTION

Money—the subject matter of our study is something we are all familiar with. It has its attractions for every one of us. A child needs it for purchasing sweets and *chatpata*, a student for buying books and paying up his school or college dues, and a grown up man for satisfying his wants and those of the other members of his family. But this does not mean that we understand all about it. If we think that, we are wrong. The prices of all the commodities we need, rise and fall because of the actions of money, and the cause of most of our troubles is that we fail to understand its behaviour, and hence exercise a control over it. The course of money as that of love has never run smoothly. Various governments have tried many strange and round-about methods in ancient and modern periods to supply their nationals with a satisfactory medium of exchange but without any lasting success.

1.1 Money was discovered and not invented

There was a time when there was no money of any kind in this world. It is usual, of course, to say that idea of money originated with barter ; and its obvious difficulties, *e.g* , the want of coincidence, the want of a measure of value and the want of means of sub-division, gave rise to the commodity money system. This obviously means that money was actually introduced with a view to alleviate certain difficulties. But this is far from truth. As Spalding says, there were certain commodities even at the earliest times of man's social development which were eagerly coveted by men for their 'magic properties.' The cowrie shell is a striking example. The more one possessed of it, the more abundant were the prospects of present and future life. For this reason, skins, animals, and every kind of domestic articles, were exchanged for cowrie shells, until, in course of time, the reverse action took place, and men exchanged cowrie shells for food and implements. The point of interest is that they were not seeking for a medium of exchange, but it was quite unconsciously used without any realization of that significant property. So it would appear that money was discovered, not invented. It was not actively sought after ; the earliest people, just *tumbled* upon it and, gradu-

ally, began to use it as a medium of exchange. As time went on, however, other functions began to be performed by it, and these, as we shall see subsequently, have assumed more importance than the original one, so much so that we have now begun to feel that some of them must be performed if the work of society is to go on smoothly.[1]

2. Meaning and inconvenience of barter

Barter is the exchanging of 'the comparatively surplus for the comparatively necessary.' The answer to the question, 'How did bartering begin ?' is purely a matter of conjecture. May be that a particular person who had a surplus of skins found that a neighbour had a surplus of grains ; and in case each one of them was desirous of having the surplus of the other because he regarded it of necessity to him, bartering could take place. Some of the writers believe, however, that the earliest bartering was between groups and not between individuals. Whatever it be, the trouble inherent in all forms of barter is *the lack of coincidence* which means finding at precise moment any two parties whose surplus is the necessity of each other. Is it necessary that Ram should have surplus of horses and necessity of cows, if Shyam has surplus of cows and necessity of horses ? It is possible that he may have one or none of them. Even if he has, there is another difficulty, *viz., that of the rate at which exchange should be made.* Different people generally have different utility of different commodities, and assign different values to them. Supposing Ram assigns the value of one horse as one cow, but Shyam the value of one cow as two horses, bartering would be impossible. There is, in this case, obviously no common measure of value. Finally, supposing Ram assigns the same value to the horses and cows as Shyam, there may be the *difficulty of subdivision.* If Ram has a surplus of one horse and Shyam of one cow, the transaction cannot take place as the cow cannot be halved lest it should lose its value.

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1. Spalding says, we can understand this by looking to certain things which have been discovered in more recent times and he takes, for instance, steam power. Wind, water and hand mills had been employed for all needs for centuries, and transportation was quite effective for the requirements of the population and its activities. There was no conscious need of the steam power for driving the mill and carriages. It was its discovery which created the need for its use. Of course, once a thing is discovered, the need rapidly develops until we begin to depend wholly upon it. This is the case with money as well. First of all, an article was exchanged for, as people had a desire to have it and, gradually, it began to be used as a medium of exchange and acquired other functions and in course of time became indispensable.

3. Importance of money

Whether money was actively sought after or the earliest people just tumbled upon it, the fact is that it has removed all the inconveniences of barter. This does not, however, mean that it has, for this reason, removed completely the system itself. Even in our own country, besides being prevalent in the villages, it is often resorted to by the womenfolk in the towns while exchanging their worn-out clothes with the glass and stone-wares and other sundry articles of use. But it may be pointed out that this is a very rare instance. Let us, then, take up the external trade. It is commonly said that in foreign trade, exports pay for imports, which means, if something of equal value is bought from foreigners, something of equal value has got to be sold to them. Though this has been for ever, it is more true of the present day. After the war of 1914-18, there being little or no gold (which had for long been the only means of payment between foreigners) left with most of the European countries, imports were restricted to the amount of exports. If there was any excess, it could not be paid in gold. Even countries having gold with them built high tariffs against imports. It was, in fact, the United States of America, the largest holder of the world stock of gold that swung the world finally in the pernicious path of ever higher and wider tariffs by passing the Howley-Smoot Tariff of 1930. Within a short time more and yet more drastic measure of stopping imports, *e.g.*, their prohibition except under the license or a definite limitation to a specified quota, had been introduced in almost every country. By the spring of 1933, France had quotas applying to over 12,000 tariff items. Many countries introduced exchange control whereby importers were unable to offer money for foreign goods. As a result of all this, the hindrance to trade became so serious that eventually a considerable number of clearing arrangements had to be developed. We shall, however, look to them elsewhere. The long and short of it is that there is, at present, in international trade, nothing but barter - refined barter. We may call it—a barter where money without intervening directly is always behind and effecting the exchanges. This is true of many of our internal exchanges as well. In advanced countries of the world, money (when used only for legal tender money) does not actually pass hands in connection with most of the purchases and sales. They are only measured and recorded in the terms of money, and in the end are cancelled by counter-claims.

4. We live under a money economy

In spite of all that has been said in connection with the continuance of barter in the present age, it may be pointed out that we live these days essentially under a money economy Whether commodities or services—all are measured in terms of money. We satisfy our wants indirectly. Every one of us is a specialist, and renders a particular service, the value of which is reckoned in money. And this, in its turn, is used to procure the necessaries sustaining life and comforts and luxuries making it pleasant. In short, it enables our specialised efforts to be turned into generalised enjoyment, and places the whole world at our command, though only to a limited extent.

SUMMARY

1. There was a time when there was no money. It was, however, discovered later on. In fact, an article was first exchanged for, because of its qualities. But, gradually, it began to be used as a medium of exchange. In course of time, it developed other functions as well.

2. Money has done away with the difficulties of barter, i.e., the want of coincidence, the want of a measure of value, and the want of means of subdivision.

3. It has, however, for that reason, not done away with barter itself, whose traces are found in rural and urban areas even to this day. As regards foreign trade, it may be said, it is barter, pure and simple. In internal exchanges as well, the use of money as a medium of exchange has been declining. Notwithstanding this, we live under a money economy. All commodities and services are measured in terms of money which turns our specialised efforts into generalised efforts, and places the whole world at our command.

TEST QUESTIONS

1. Comment on the statement: Money was discovered and not invented.

2. What do you understand by barter? Point out the difficulties experienced under this system of exchange.

3. Has money replaced barter altogether? If not what is the position of the latter at present?

CHAPTER II

DEFINITION, NATURE AND FUNCTIONS

Whenever we begin the study of a subject, it is usual to define it. In fact, we cannot proceed further unless we understand what we mean by it. "The word 'money' is derived from the Latin word *moneta*, which was originally the name of the goddess Juno, in whose temple at Rome money was coined. Juno in Italian mythology was regarded as the Queen of Heaven and of heavenly delight, and there seems to be truth in the statement that it was from the name of this goddess that money derived its designation, moneta, for it was coined in the temple of Juno Moneta. Hence, the term 'mint', the place where money is made. The Latin word *moneta*, which signifies coin, is from *moneo*, to advice, or to admonish, and is a monition of value by an inscription or stamp. Some authorities consider the word money to have emanated from the ancient pecuniary fines which the Romans exacted in the shape of cattle. The Latin word *pecunia*, now translated as money, was originally a 'property in cattle', and is derived from *pecus* meaning cattle or herd, or a single head of cattle, which, in a sense did money's work. It was a form of property that was originally the medium of exchange both in Rome and Greece." This much about the derivation of the word *money*. Regarding its precise meaning, it may be said that there is no very general agreement. But as with other economic terms, it does not matter much what meaning we adopt so long as we stick to it. For this purpose, we shall have to look to its definitions as given by the writers representing different schools of thought, and choose one of them.

1. Definition of the term money

As far as the definition of the term money is concerned, there are three schools of thought. The one holds that it should be such as to include only metallic coins, the other as to include all media of exchange—metallic money, paper notes, cheques, bills of exchange and drafts, etc., and the third as to include only metallic money and legal tender notes. The following definitions illustrate the point.

Money is a commodity which is used to denote anything which is widely accepted in payment for goods or in discharge of other kinds of business obligation.—*Robertson.*

As only metallic money is widely accepted, this is a definition representing *the first school of thought.*

Money is purchasing power—something which buys things.—*Cole.*

As metallic money, notes and credit instruments, *e. g.*, cheques, bills of exchange, and drafts, all have purchasing power and buy things, this is a definition representing *the second school of thought.*

Money is anything that passes freely from hand to hand as a medium of exchange and is generally received in final discharge of debts.—*Ely.*

Money includes all those things which are (at any time and place) generally current without doubt or special enquiry as a means of purchasing commodities and services and of defraying expenses.—*Marshall.*

As metallic money and legal tender notes are the only forms of money which are generally acceptable (at any time and place), these are the definitions representing *the third school of thought.*

2. Meaning of the term currency

There is another term, *viz.*, *currency* which is usually regarded to be a synonym of the word *money.* But it is not always so. The word currency comes *from* the Latin word *currere*, which means to flow or to run ; and as only metallic money and legal tender notes run current, it may be taken to include these and nothing more. It is obvious, then, that currency is a synonym of money only in one sense, *i e.*, when we accept some such definitions of the latter as represent the third school of thought. If, however, money is taken to mean all media of exchange, in order to find out currency, we shall have to exclude all forms of credit from it. On the other hand, if money is taken to mean only mettalic money, we shall have to add to it legal tender notes.

Throughout this book money must be taken to mean all media of exchange and the readers will do well to remember the following formulas :

Money = Metallic money + legal tender notes + credit instruments.

Currency = Metallic money + legal tender notes = Money—credit instruments.

3. Nature of Money

As regards the nature of money, it may be said, it is a means by which we exchange our commodities and services for those of others. *It is not an end in itself but a means to an end.* Nobody except a miser wants it for the sake of possession but because it has a general purchasing power ; it gives to its holder a command over all goods and services. According to Weston, money allows the consumer to take his real income at the time and in the manner that suits him the best. It is a certificate that the claims a man has upon the stocks of goods, will be honoured by the community whenever he wants it to do so. Besides being a means, *it is also a measure* which enables us to compare the value of different things. In fact, it is as a measure that money is more important these days. In many cases, we sell commodities and services without getting actual money in exchange They are only measured in terms of money, and a book entry is made. This in its turn, is cancelled by another entry at a later date. Money also helps us in several other ways.

4. Function of Money

At this stage, we must look up to the functions of money ; for we cannot obtain *a clear idea of it* unless we examine them.

It has already been observed that even in the modern age, services or commodities are ultimately exchanged for services or commodities. But in most of the cases money intervenes. Truly speaking, it cuts an exchange into two ; and a sale is necessarily followed by a purchase and *vice versa.* Money is accepted ultimately to be given up for something else.

This shows that money is the *means* whereby exchanges are effected. But it does this work because it *measures the comparative values of the goods exchanged.* In fact, the question as to how much of one commodity should be given for another is not capable of solution unless there is a third commodity to act as a denominator of value of both, and this is where money steps in. This function of money is truly speaking, much more important than any other. It is as necessary for exchanges, as numbers are for calculations ; feet and inches, etc., for measure ; pounds and seers, etc., for weight, and language for expression. As has been said elsewhere, money may not act as a means in a direct exchange or in an exchange through book entries ; but it acts as a measure of value

in all the cases of exchange. Each party to it more or less consciously measures its articles in monetary units. Each uses money, though it may not be handled actually.

The above are the *primary functions* of money, but there are certain secondary and contingent functions as well.

The secondary functions are the services (*i*) a store of value, (*ii*) a transfer of value, and (*iii*) a standard for deferred payments. These functions are dependent upon the primary functions.

We find that we can *store* value much more easily in the form of money than in the form of other commodities. Labour or services cannot be stored at all ; for if we do not work for a moment that much of labour or service is lost for ever. Ordinary articles of consumption cannot last for long—some perish by lapse of time, others are lost in other ways.

We can also *transfer value* in terms of money with sufficient ease. This helps us a good deal. Transportation of commodities, as we know, is costly and involves good deal of inconveniences. In the absence of money, all of our education, sport and pleasure-giving trips would become impossible.

Money serves as a *standard for deferred payments* as well. These involve a period of time before they are fulfilled. If the prices of commodities between this interval rise or fall, the debtor or creditor, as the case may be, stands to lose. But if these are expressed in terms of money, its value being more stable than that of any other single commodity, the chances of loss are appreciably reduced.

This brings us to *contingent functions* which have assumed importance only in the present economic stage. We know that our productive system is very complex ; goods are produced in bulk and the labour used is extremely specialised. Money serves in the first instance, as a *distributor of joint* product. Division of labour to its utmost limit has been made possible only because of this unique quality of money. Nobody would co-operate, if he is not assured of the apportionment of the joint product. Next, *money enables a consumer to spend his income on various items of expenses in such a way as to derive equal marginal utility from each of them.* Thirdly, it may be said that *the vast superstructure of credit has been raised on the basis of money*, and this, as we know, is the lifeblood of commerce. Gigantic works have been established and large scale enterprises are being

carried on. These would not have emerged without the development of the system of credit. Finally, *it enables capital to get a generic value*, as it can be kept in the most liquid form and thus help production.

The following lines sum up the primary and secondary functions of money :

"Money's a matter of functions four,
A medium, a measure, a standard, a store.
But as this does not complete the picture
We may add transferability more."

SUMMARY

1. The word money has different meanings and hence different definitions. According to one definition, it includes only metallic money, according to the second, metallic money, and legal tender notes , and according to the third, metallic money, legal tender notes and credit instruments.

2. Currency means to run, and hence it includes only metallic money and legal tender notes.

3. Money is not an end in itself but a means to an end. Besides, it is also a measure which enables us to compare the value of different things.

4. The functions of money are primary, secondary and contingent. The Primary functions are (1) medium of exchange, and (2) measure of value. The secondary include (1) store of value, (2) transfer of value, and (3) standard for deferred payments ; and the contingent functions comprise of (1) distribution of joint product, (2) equalisation of marginal utilities, (3) acting as basis for the superstructure of credit, and (4) giving a generic form to capital, etc.

TEST QUESTIONS

1. Define money and consider its nature and functions in the economic organisation of a community.

2. Show clearly the difference between money and currency so as to make the two terms intelligible to an average man.

3. Define money carefully. Discuss its functions. Why is it that barter is becoming more and more popular in modern times ?

CHAPTER III

EVOLUTION

Nowhere is the present monetary system claimed to be perfect. *It has been under evolution since ages and shall remain so always.* The stages in the evolution so far may be roughly divided into (1) commodity, (2) metallic, and (3) paper.

1. Commodity money

Different communities have at different times, used different articles as money. 'The old testament story shows that in the primitive society, depicted by it, a man's wealth was gauged by the size of flocks and herds and the number of his changes of raiment, and in the Homeric poems fine suits of armour are valued by the number of kine that they would fetch. Other instances of the use of articles of common consumption as currency include tobacco, hides, shells, bullets and nails.' It may be said, that hunting communities have adopted the skin of a beast; the pastoral a herd of cattle, *e. g.*, ox; and the agricultural a common product of the soil. In the world of today as well, there are places where some such articles are used as money. W. I Weston in his book 'Banking and Currency' gives a letter written by W. B. Harris, a traveller, to the editor of "The Times" in which there is an account of the currency in the Yap Island, somewhere in the Caroline Archipelago which bears a testimony to this. It has been pointed out therein that the natives of this part of the world use stones as currency. In the words of the author of the letter 'so retrograde are these islanders that even the Japanese government, under whose mandate Yap passed at the termination of the War, has failed, in spite of admirable and preserving effort, to raise to any appreciable degree their social status.' For small changes, as the account given discloses, they use shells which pass at a fixed value. Amongst the tribes living in the north west frontier of our own country, rifles pass current as money. Other instances can also be given very easily.

2. Metallic money

With the advancement of civilisation commodity

money began to prove inconvenient. Man's nomadic instincts soon led him further to exchange his surplus, and it was at this stage that he discovered the defects in his commodity money. As his exchanges increased in volume, and boundaries of inhabitance were crossed, and his relations with the world beyond his began to be established, the troubles commenced. The money that satisfied his own people, would not satisfy others far removed from him. This led man to discover something that would satisfy people all over the world. Gradually, he tumbled upon the metals for use as money, and very often he had to take long journeys to obtain them. As to the question, how and when they were discovered, no definite answer can be given. It is said that the ages were divided into four : the gold, the silver, the copper, and the iron ; and that the metals with which ages are associated were also discovered in this very order. But the saner view seems to be that the order in which the metals were discovered was not the same everywhere. *The value of gold as a commodity had been long realised.* Its lustre and beauty appealed to mankind at a very early stage. Added to these is the quality or durability for which reason people have always shown a tendency to hoard it. 'Gold was utilized as *a store of value*, long before its general acceptance as a medium of exchange or measure of value and it was the same with other metals, silver in particular.'

They were not only hoarded, but also turned into ornaments which were worn by both the sexes, specially fair one.

The Indians, the Egyptians, the Assyrians, the Babylonians and other ancient nations—there are traces—had resorted to metals as money. They used them, in the beginning, in the shape of *ingots*, more usually of gold and silver. Later on, *strips* were used *from which pieces according to the value of the exchange to be effected could be cut off.* At first, these pieces were of no uniform weight, but gradually the idea of uniformity as to weight must have dawned on them. Once the weight had been fixed upon, inscription of the denominational value on the face of the piece was a natural process and this was, of course, done by the merchant bankers. Specimens of such crude coins have been unearthed at many places, in the course of excavations. *The advance in the production of early coinage went on from one stage to another.* The coins made in the early and mediæval periods, however, appear to be more or less of the same kind ; and from this we can conclude that for a long time no improvement could be made in the art of their production. It may be remarked in the end that such coins were strikingly

uniform in weight, though they varied in size and thickness.

The next step in the art of coinage was taken in the sixteenth century. The enormous quantities of precious metals, more particularly silver which had been discovered in America and was being poured into Europe, necessitated the finding out of an improved method of coinage and this led to further researches and experiments. It is said that the credit of inventing a rolling mill and a screw press for this purpose goes to the Italians. The Spaniards, the French and the English all learnt it from them. *The first mill of this type introduced in England was installed in London Tower in 1561* during the reign of Queen Elizabeth. This was driven by horses. The invention of the steam coining press in the eighteenth century completed the task ; and this with the addition of the knee joint press and several other machines for cutting the dices, milling the edges and stamping the inscriptions has raised the art of coinage to a high pitch of perfection.

The introduction of coinage was undoubtedly due to private enterprise ; but the privilege was soon usurped by the state. Each king tried to introduce his own coins. Sovereignty and independent coinage, so to say, went together. As one of the writers remarks, 'The right of coinage became inherent in the bones of the king.'

3. Paper money

Though it cannot be said with any certainty when paper money was introduced at first, *there are records of its existence in China in 807 A. D.* Hian-tsung of the Thang dynasty is said to have compelled, in or about this year, the people under his rule to deposit their valuables in Public Treasuries and take, instead receipts which were current throughout his kingdom under the name of 'Fey-thsian' or voluntary money. These were made to represent different provinces and were redeemable only at their respective provincial capitals. They became very popular, as the merchants found that they could travel with them in connection with their trade with greater ease, and did not usually return them to the Treasuries. The Government of the day, being very scrupulous began to be anxious for their metallic money, and, fearing that the notes would displace the coins, took steps to suppress them.

In Europe, the notes were first issued by the State banks of Italy, and in England by the goldsmith bankers

immediately preceding the Commonwealth.[1] At present they form the bulk of the currency all over the world and are usually irredeemable, their value being governed by the supply in relation to the demand for them as a medium of exchange in the country in which they circulate. The greatest defect of the irredeemable paper money is its *overissue* ; and there is a temptation for the governments of the various countries to have recourse to it, specially under the exigencies of war. In Russia there was a note circulation of 1633 million roubles in 1914 with a gold cover against redemption of 92 per cent. Immediately on the outbreak of the war, they were declared irredeemable, and gradually the circulation reached the stupendous figure of 176,505,500,000 million roubles by 1923. The result was that they became practically worthless, and towards the end of October of that year the quotation was 5,040,000,000 to a pound. In Austria, note circulation rose from 2300 million kronen in 1913 to 7,125,755 million kronen in 1923, and this led to a fantastic depreciation in the value of currency so much so that the index number of wholesale prices for food alone had risen to 16,216. In Germany, it rose from 2 billion marks in August, 1914 to a little less than a million of billion marks in November, 1923. The resulting depreciation may be gauged from the fact that an article worth 1 mark in 1913 became worth 5,000 million marks in 1923. These in brief are a few examples of the overissue of irredeemable paper money.[2] Writers in the past always viewed it with misgiving. In the drama of Faust, written by Goethe, a German poet, Mephistopheles, the devil is supposed to have invented the inconvertible paper money.

It may be pointed out in conclusion that paper money alone cannot form the total currency of any country at any time. It must be accompanied by metallic coins of one sort or another at least for effecting the transactions of considerably small values. The term 'paper money' can also be applied to instruments of credit.[3]

4. Qualities of a good money material

At this stage arises a question, *viz.*, 'What are the qualities of a good money material ?' Professor Stanley

[1] Please see the author's book "Banking : Principles in India."

[2] Other examples can be cited from its increase during the war of 1939-1945.

[3] For a detailed study please see the author's book 'Banking : Principles, in India' published by Kitab Mahal, Allahabad.

Jevons mentions them in his book *Money and the Mechanism of Exchange* in the order : (1) Utility or value, (2) portability, (3) homogeneity, (4) divisibility, (5) stability of value, and (6) cognisability. Some writers have added to these indestructibility as well. The first letter of the above terms make CUPDISH through the help of which these attributes can be easily remembered. Now, let us take them one by one and see what they imply

(1) *Cognisability* Cognisability means the capability of being easily recognised and distinguished. As a medium of exchange, money has to be continually passed, and it will cause great inconvenience if every person receiving it were to use his skill in recognising it. Jewels have, because of the lack of this quality, never served as a good money material : only experts can distinguish them. On the other hand, gold and silver, due to their distinctive colour, require no special skill for being recognised from other substances.

(2) *Utility or value* In fact, utility or value was the prime quality which made man realise that a particular commodity could well serve as money and not any other else He began to understand that some articles were more wanted than others, they were, so to say, acceptable generally. An article can be acceptable generally only if it has some intrinsic utility independent of its value for monetary purposes. Gold and silver have without doubt this intrinsic utility Paper, on the other hand, lacks it ; and hence is not accepted when it loses value for monetary purposes.

(3) *Portability* Portability is an essential quality of a money material inasmuch as it needs to be passed from one hand to another in payment of goods and discharge of debts. As the area of man's activity widens, this quality becomes more pronounced. Transactions involving large payments require the money material to possess high value in small bulk Gold and silver have this quality, and paper obviously to the largest extent. Truly speaking, it is because of this quality in the paper money that the people like it the most.

(4) *Divisibility.* Indivisibility is one of the inconveniences of barter ; and as money has removed them, the material of which it is made must necessarily be divisible which means that the aggregate value of the pieces should be exactly equal to that of the mass. Gold and silver possess this quality immensely ; their portions can be melted and remelted without any loss. But this cannot be said of other commodities as well.

(5) *Indestructibility.* Indestructibility and durabi-

lity mean almost the same thing. And it is this quality in a money material which is of the very essence for its functions as a store of value and a standard for deferred payments. All metals are, in general, ideal from this standpoint.

(6) *Stability of value.* Stability of value is a quality essential to a standard for deferred payments. It was surely not possessed by the articles chosen for money in earlier days. Fluctuating standard of value is just like a changing yard or seer. Contracts are often entered into in advance, and if money could not purchase as much at the time of their completion as at the time of entering into, there will certainly be a loss to the party receiving it. This quality is also of considerable importance to the performance of the function of the store of value. In its absence, savings cannot be very much encouraged.

'*Gold prices and stable prices used to be considered as one. Yet gold is not absolutely stable.* An ounce of gold has not throughout the ages been valued at an unvarying amount of wheat or oil or wine. Changes great enough to be called revolutions have taken place in the value of gold relative to the value of other commodities. One such change came as a result of the extraordinary conditions following the outbreak of the European War in 1914. A single country, the United States, maintained an effective gold standard. Gold ceased to be the foundation of the monetary standards of the world. As such its value had to be determined by circumstances other than economic.'

But gold is less liable to fluctuations in value than most of the things, the reasons wherefor are its indestructibility, portability and high cost of production. On account of the indestructibility of gold, its stock is comparatively larger than any addition by production in a particular year or period consisting of several years. Besides, the production itself cannot be very huge due to its process being very laborious and tedious. In consequence, it may be said that additions to the existing stock do not affect the supply to the extent of affecting its value. '*If gold were a crop, one year bountiful, another year niggardly, we should have no steadiness of supply.* But gold is a stock of such a metal as is carefully preserved by men, and does not perish through natural forces. The annual increment makes only the slightest impression upon the total amount.'

There is demand side as well. For some time past, gold is not being used as money. May be in future man's mind would change, and it would lose all attractions for him; in that case, of course, it is bound to depreciate.

But this is a distant possibility, and most of us cannot envisage it.

Finally, *comparative value of gold has not changed so much in reality as it appears to have done at the first sight*. The fact is that we consider it in terms of money and not in that of commodities as a whole. Money has, (to tell the truth), itself much depreciated in value, obviously because, it has been overissued and bears no relation to anything real. In terms of commodities in general, it may be said without any fear of contradiction, that gold has not changed its value to any appreciable extent.

(7) *Homogeneity*. This means all portions or specimen of any substance should be of the same nature or kind. In order that a commodity may be used as measure of value, it is essential that its units be similar in all respects Metals are of the same nature throughout.

(8) *Malleability*. Malleability is a quality whose importance grew with the beginning of coinage This requires that the money material should be capable of being melted, beaten and formed into coins.

5. Ideal money material

No material is ideal money material. Man yet has to find something which possesses the qualities enumerated above to their perfection. Gold, to the exclusion of all other metals, possesses all these qualities to the best. It is possible that any one of these qualities may be found in a large degree in any other commodity. But all of them will not be found together in an equivalent degree in any other commodity.

SUMMARY

1. The first stage in the evolution of money was commodity. This is, however, prevalent in many parts of the world at present as well.

2. The second was metallic. Gold was utilized as a store of value long before its general acceptance as money. The ancient nations, all used it. Coinage has passed through various stages from pieces cut off a strip to that of building out of the most up-to-date modern machines.

3. The third stage is paper. This form of money existed in China in 807 A. D. In Europe, it was introduced in Italy in twelfth century, and in England by the goldsmiths in the seventeenth century. At present they form the bulk of the currency all over the world and are irredeemable. The greatest defect of the irredeemable paper money is its overissue as is evident from the currency history of various countries. Paper money must be supplemented at all times with the metallic money, at least for small transactions.

4. The qualities of a good money material are (1) cognisability,

(2) utility or value, (3) portability, (4) divisibility, (5) indestructibility, (6) stability of value, (7) homogeneity, and (8) malleability. Gold prices and stable prices used to be considered as one. In spite of all that is said, gold is the most stable commodity even to this day. If its money value changes so often, it is the fault of money and not of gold.

5. An ideal money material has yet to be found out. Gold, however, possesses different qualities to a greater extent than any other material.

TEST QUESTIONS

1. Comment on the statement : Money has been under evolution, and shall remain so ever.

2. Trace the various stages through which metallic money has passed. What has brought it to the present stage ?

3. Give a short history of the development of paper money. What is the most striking defect in it ?

4. Consider the merits and demerits of gold as money and show how far it is superior to silver.

CHAPTER IV

METALLIC MONEY

Money made up of metals takes the form of coins which may be *defined* as pieces of metal whose standard weight and fineness are certified by the stamp of the government impressed upon them. It has already been observed that they have passed through various stages, from pieces cut off a strip to those turned out by the most up-to-date modern machines. The present-day coins are difficult to counterfeit and pillage of any of their metal. 'The various devices of the mint—the indenting and raising of the edges, the beauty and fullness of the designs—are not solely or mainly to produce a handsome coin. They are largely so that successful imitation may be laborious and costly.' Their sizes, shapes and weights are convenient for handling and for carrying in the pockets.

1. Kinds of Metallic money

Coins may be (*i*) natural or full-bodied, and (*ii* token.

A natural or full-bodied coin

A natural or full-bodied coin is known to be a standard coin as well. It is, where it exists, the principal or ultimate means of payment. The following are the essentials of a standard coin.

(1) The mint should be open to the public for *free coinage*. The word 'free', it may be pointed out, does not suggest that no charge should be made by the authorities for rendering the service. The charge may or may not be made. It means only this much that anyone can have his metal turned into coins.

(2) *The exchange value of the coin is equal to its metallic value.* If there is any difference, it is limited to the charge made by the mint authorities.

(3) It is *unlimited legal tender* which means it can be offered in payment or discharge of all debts and is compulsorily acceptable. If the creditor wants the payment in any other form, the debtor may refuse it.

A token coin

A token coin is a subsidiary coin, and being of smaller denomination forms a fraction of the principal coin. It is a representative of a particular value assigned to it. The following are its essentials :

(1) The mint is not open to the public for its free coinage. It has a *limited or restricted coinage*, which means that it is only the government which issues it whenever it thinks it necessary.

(2) *The exchange value of the coin is higher than its metallic value.* It is a metal token, marked by the government, serving as a representative of the value allotted to it.

(3) Its *legal tender is limited* which means it can be offered in payment or discharge of a limited amount of debt. Beyond a certain limit, it is not compulsorily acceptable, and the creditor may refuse.

Illustrations. Though Indian currency does not afford any illustration of a standard coin as at present, it affords many of token coins. We have got a pie, a half-pice, a pice, a half anna, an anna, a two anna, and a four anna pieces—and each one of these is a token coin. *The Indian rupee and half-rupee have got an anomalous position.* They are neither standard nor token. As standard (1) mints should be thrown open to the public for their free coinage, and (2) their exchange value should be equal to their metallic value; and as token their legal tender should be limited. But they were undoubtedly standard coins prior to the year 1893, as we shall see later on.

2. Various kinds of coinage and terms relating to it:

Free coinage may be *gratuitous or non-gratuitous.* In the former case, no charge is made for turning the bullion into coins; while in the latter case, a charge is made, and this may be equal to the expenses actually incurred in coinage or more.

Brassage and Seigniorage. In case a mint is open to the public for free coinage but a charge is made by the mint authorities for rendering this service which is exactly equal to the expenses incurred in coining, it is called *brassage.* If, however, it is more, the difference between the amount charge for and the expenses actually incurred in coining is called *seigniorage.*[1] It represents, in fact, a toll, *i.e.*, a profit to the Government.

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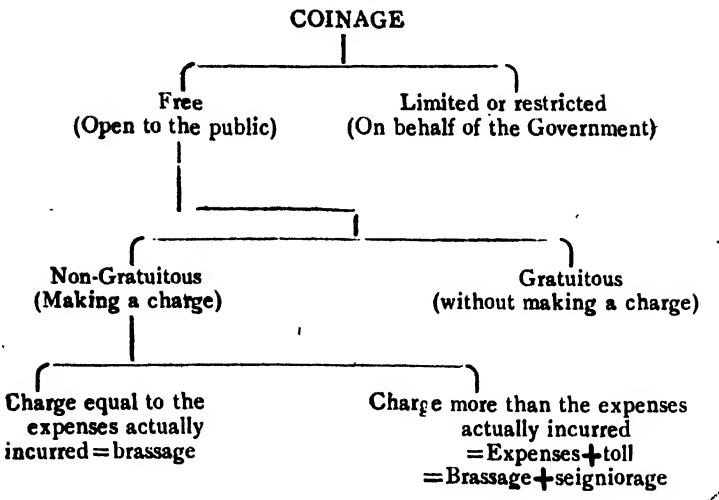
[1]Seigniorage is often used to cover both brassage and toll —Sykes



The charge made by the minting authorities may be required to be paid separately or deducted from the bullion tendered. In the latter case, it is usually made good by mixing alloy which hardens the metal and renders it more suitable for coinage.

Is free and gratuitous coinage desirable? Free coinage is desirable because *it affords an automatic corrective to the volume of currency* at all times. We shall look to the way in which this is done elsewhere. The question before us is, then, whether it should be gratuitous as well. The following are the arguments advanced by those in its favour.

(1) Maintenance of good currency is *a primary function* like the maintenance of law and order; and should on that account, be administered by the state without any charge in the same way as the latter.

(2) *The cost of minting being very little*, it can be easily defrayed out of the general revenue of the state.

(3) When minting is both free and gratuitous, the parity between the bullion and coin provides *a greater automatic corrective* to the volume of currency than when it is only free and not gratuitous. The reason is obvious; the cost of minting not being required to be paid by the public, coins are melted or exported immediately an excessive issue causes any divergence from the parity and *vice-versa*

(4) In case cost of minting is deducted from the coins, they have one value in the country and another outside it, and hence *the difficulty in exchange*,

(5) When coinage is non-gratuitous, *importers as a whole lose* value while exporting the coins in discharge of

payments, and raise the prices to counter-balance the loss thus caused to them.

Gratuitous coinage may prove injurious in the long run if people begin to melt the coins unnecessarily. But the state can check the mischief by declaring it to be illegal.

Debasement. When currency contains less than the declared amount of precious metal *the difference is called debasement.* It may be due to (1) the dishonesty of the minting authority or (2) that of the people who take out a portion of the metal from the coin by means of various devices, or (3) natural wear and tear in the course of circulation.

Illustrations. An illustration of the debasement of currency due to the dishonesty of the minting authority is provided in the English history. We know that Henry the Eighth was an unscrupulous king. He directed the mint to debase thecoins and used the gains for his personal ends.

As regards the debasement by the people, it may be said that this goes on at all times and in all the countries. In the beginning when alloy was not mixed with the bullion, the crude coins used to be debased by wearing them down through friction. They were gathered together and rattled by which device small particles of bullion dropped off leaving the coins debased. This act was called *abrasion.* This is not possible now, as the coins made out of the mixture of bullion and alloy are too hard to be worn by friction. Debasement could also be effected by scratching bullion out of the coins, the action being generally known by the term *clipping.* As a safeguard against this malpractice came the device of stamping both sides of the coin, and milling the edges. In the modern times, debasement is effected by the device of *sweating* which means putting the coins into chemicals. This process results in the spoiling of the designs on the coins and can be detected by observation.

Coins wear down in the course of circulation as well. Jevons estimated in 1869 that 31½% of the sovereigns and 50% of the half-sovereigns were below the legal limit in weight. This was bound to happen, as the onus of paying for the wear of the coinage lay upon the public. The Bank of England always charged for light coins tendered to it and as a consequence other bankers sorted out the heavy coins by means of a weighing machine, and returned the lighter ones for circulation. About 1884, the bankers of the Kingdom took the matter up and eventually the Government so far receded from the position it had always maintained, that in 1889 a new coinage Act was passed, providing for the calling in of pre-Victorian

gold coins at the expense of the state. Exception was made in the case of coins which appeared to have been illegally or unfairly tampered with, the evidence of such ill-usage being loss in weight of more than four grains. Such coins would be bought as bullion, but all other pre-Victorian sovereigns and half-sovereigns were to be exchanged by the Mint, through the Bank of England at their full nominal value. By a Royal proclamation, pre-Victorian gold coins were declared to be no longer current after Feb. 28, 1891. In 1891, this Act was extended to all the gold coins in circulation, the evidence of ill-usage being altered to three grains' loss in weight. Since then, the practice of calling very old coins and declaring them to be no longer current after a particular date has been followed several times. In our own country we find the same thing. The Victoria and Edward rupee and half-rupee coins are no longer current,[2] they having been called up by the Government very recently.

Remedy. Remedy was the term applied to *the deviation allowed to the mints in the weight and fineness of the coins* when they could not be absolutely accurate due to the use of the primitive type of machines for turning them out. There is no need of this sort of allowance these days as the perfect machinery now in use is capable of working without causing even the slightest error.

Trial of the Pyx. The pyx was the box at the English Mint in which specimen coins were deposited for being tested once a year by a jury selected from freemen of the Goldsmiths' Company and the process was known as the *'Trial of the Pyx'*. There is no need of the ceremony at present.

Devaluation of a standard coin. Devaluation of a standard coin should be distinguished from its debasement inasmuch as *it is a reduction in the metallic contents of the standard coins sanctioned by law*, and not merely made by the mint with a view to illegitimately depriving the people of what is lawfully due to them.[3]

Monometallism. Monometallism, strictly speaking, is the term which can be applied to a system of currency wherein the different coins in circulation in a country are made up of a single metal, whether it be gold or silver ; but as this is never the case anywhere, it is the term which is usually applied to *a system of currency wherein the principal coin is made up of a single metal.* An example of this is

[2]Other coins have also been withdrawn but for a different reason discussed later on in this book.

[3]For a fuller definition of devaluation, please refer to Section 7, Chapter XII.

available from the currency system of the United Kingdom prior to the war of 1914-18. In order to distinguish it from the monometallism of the first type, people called it by the name of the *composite legal tender system.* Different writers have used different names for these two systems of monometallism. We can distinguish the first from the second by calling them *orthodox monometallism* and *modified monometallism* respectively.

Monometallism or composite legal tender system of U. K. Under monometallism or composite legal tender system of the United Kingdom, gold coins, *viz.*, five-pound, two-pound, one-pound (sovereign), and half-pound (half-sovereign) were principal coins. and silver and bronze coins, *viz.*, crown, double-florin, half crown, florin, shilling, six-pence, groat or four-pence, three pence, two-pence, penny (all silver pieces). and penny, half-penny and farthing (all bronze pieces) were subsidiary coins. Principal coins satisfied all the essentials of the standard coins, and subsidiary coins were token coins—the tender of the silver coins being limited to forty shillings and that of the bronze coins to one shilling.

Bimetallism. Bimetallism is the term applied to a system of currency wherein there are two principal coins —one of gold and another of silver. Its essentials are :

(1) Free coinage of both.

(2) Unlimited legal tender characteristic of both, and

(3) A fixed legal ratio between them.

The system could not be prevalent for any considerable period in any country due to the impossiblity of the maintenance of a fixed legal ratio between them for any length of time because of the market variation in their relative value as bullion. We shall, however, turn to it in a subsequent chapter in connection with the Gresham's law.

Limping standard. It is an imperfect form of bimetallism. Under a limping standard, two metals are unlimited legal tender and circulate at a fixed legal ratio, *but the mint is open to the free coinage of only one.* It existed in France and U. S. A. before the war of 1914-18. In these countries both gold and silver coins were unlimited legal tender, but only gold coins had a free coinage.

Parallel standard. It has already been observed that bimetallism labours under the difficulty of maintaining a fixed legal ratio between the two coins. Hence, if both the gold and silver coins are declared to be unlimited legal tender and allowed to be minted freely *regardless of maintaining a fixed legal ratio between them,* we have what is known as a parallel standard.

Under the circumstances, they circulate at rates determined according to the market conditions.

Symetallism. **This is a system under which the principal coin is made up of *two metals mixed into one*. It has, however, been never adopted by any country in practice. The system was originally suggested by Alfred Marshall. It does not, however, possess the necessary quality of being readily intelligible by the ordinary person.**

SUMMARY

1. Metallic money may be (1) natural or full-bodied, and (2) token. The first is also known as standard. It is a principal coin, and ultimate means of payment. Its essentials are free coinage, equality of the face value and the intrinsic value, and unlimited legal tender characteristic. A token coin is a subsidiary coin, and forms a fraction of the principal coin. It is representative of a particular value assigned to it. Its essentials are limited coinage, difference in the exchange value and intrinsic value, and limited legal tender characteristic.

2. Free coinage may be gratuitous or nongratuitous. Gratuitous means free of charge. In the case of non-gratuitous, the charge may be equal to the cost of minting, i. e., brassage, or more than this, in which case the excess is known as seigniorage. Free and gratuitous coinage has a number of advantages. Then a coin may be debased. Worn out coins should, however, be withdrawn by Government. Remedy was the deviation allowed to the mint in the weight and fineness of the coins. Trial of the Pyx was the trial of some of the coins minted which were deposited in a box known as pyx. Devaluation is a reduction in the metallic contents of a standard coin sanctioned by law. Monometallism these days means a system of currency wherein the principal coin is made up of a single metal. In the case of bimetallism, there are two principal coins whose exchange value with each other is fixed. They have got the characteristics of the standard coins. Under limping standard, though there are two principal coins, the coinage of one of them is restricted. Under paralle l standard, the relation between the principal coins made up of two metals is not fixed. They circulate according to market value. Symetallism is a system under which there is only one principal coin which is made up of two metals. This has, however, not been tried in any part of the world.

TEST QUESTIONS

1. What do you understand by the terms (1) a natural coin, and (2) a token coin ? Mention the essential characteristics of each.

2. (a) Explain the following terms :—

Free and Gratuitous Coinage, Brassage and Seigniorage.

(b) Is free and gratuitous coinage desirable ?

Give your arguments for and against it.

3. What do you understand by the following

Remedy, Trial of the Pyx, Monometallism, Bimetallism, Composite Legal Tender System, Limping Standard, Parallel Standard and Symetallism ? Point out in this connection the difference between a Bimetallism, Limping Standard, and Parallel Standard.

4. What do you understand by debasement and devaluation ? Give examples of the former.

CHAPTER V

PAPER MONEY

Paper money, though introduced long long ago, has come into prominence only during the present century. As already observed the term applies to notes and credit instruments both. We have, however, to take up only notes here.

1. Kinds of paper money—notes

Notes may be :—

(1) Representative
(2) Convertible.
(3) Inconvertible.

Representative notes. The earliest notes issued were representative notes. They were, so to say, the delegates of the standard coins and bullion held in the chests of the issuing authority *Their volume never exceeded the amount of the reserve.* The gold assignates of the United States of America, and the gold bullion certificates recommended by the Royal Commission on Indian Currency and Finance in 1927 are good examples.

Convertible notes. Convertible notes are also known by the term fiduciary money. They are issued, in fact, *with a partial backing of standard coins and bullion.* We know that all the notes cannot be ordinarily presented for conversion at the same time. Hence, the amount of standard coins and bullion needed in the reserve is also small. The balance is invested and held in security. This is known *as fiduciary or invested portion.*

(1) It enables the issuing authority to *earn something by way of interest.*

(2) In this case. *quantity of money need not be unnecessarily limited to that of the bullion.*

(3) There is, in this form of issue, *some economy of metal.* Gold is scarce and the blessings of the gold standard can be enjoyed by the whole world only if this form of issue is encouraged and adopted everywhere.

Inconvertible notes. Inconvertible notes, contrary to representative and convertible notes, *confer a claim to nothing. They circulate only because law enforces them.*

Such notes were issued in almost every country when their respective governments were hard pressed for money. The earliest instances are the greenbacks issued by the American Government during the Civil War, the French assignates issued by the Revolutionary Government of France, and the Bank of England notes issued during the Napoleonic Wars. During the War of 1914-18, most of the governments issued this kind of notes.[1]

2. Issuing authority

The notes may be issued either by the *banks* or by the *governments* of the country. Bank notes are, however, better. It is, in fact, not the function of the government to issue and redeem notes, which partakes of the nature of banking. Government notes, it has been observed, do not possess the quality of elasticity which is so very essential to a good system of currency. They also suffer from several other defects.

Defects of the government issue of notes. (1) *Lack of elasticity.* Lack of elasticity is the first defect of the government issue of notes. It means that they do not possess the *capacity of expanding and contracting* automatically in pursuance of the requirements. The business need for money is not the same at all times. At one time business is slack, at another it is brisk. When business is brisk, there is need for more money, and when business is slack, there is need for less money. If the quantity of money were not changing with the changing needs, the prices of commodities, as we shall see later on, will be *widely fluctuating* and will thus introduce the element of speculation and uncertainty in business. It is an open secret that even the best informed governments cannot be trusted to judge wisely the quantity of money required for business purposes at any time. They are usually *out of direct touch* with trade and industry. But even supposing that they can estimate the requirements, *they are not readily responsive* to sudden changes. Government mechanism, as we know, is always slow and suffers from red-tapism.

(2) *Defective control.* The state being supreme in all matters, government issue of notes cannot be subjected to control in the same way as the bank issue. There is a possibility of *infringement of the rules* relating to it at all times. A monarch may do so to find out money for his

[1] The Rs. 2½ and Re. 1 notes, which were issued by the Government of India, during this period were not the notes of this kind, though some of the writers assert this.

own luxuries. Under a democratic system, the party in power may do it just to serve its own ends.

(3) *Value precarious.* There is a tendency for the modern states to finance various development and social schemes and deadly wars by issuing notes, which are backed by government securities. This leads to *a fall in the value of currency.*

Advantages of the bank issue of notes. Bank note issue is free from all the defects of the state note issue.

(1) *It has the necessary elasticity.* Most commonly, bank notes are issued against discounted bills. When business is brisk, more commercial bills are discounted, and the banks issue more notes and thus expand currency. But when business becomes slack and there is less need for currency, on the one hand less bills come for being discounted and on the other, people return the surplus money to the banks in meeting their bills ; and thus there is a contraction of currency.

(2) Bank issue is subjected to the control of the government which may be depended upon to look after it. There is, in this case, thus *no possibility of any infringement of the rules.*

(3) As bank's power to grant loans to the state or hold government securities is limited to a fixed amount or percentage of the total assets, *there is no room left for the financing of the various development and social schemes and deadly wars by means of issuing notes.*

Single versus multiple banks' note issue. In most of the countries, notes were at first issued by more than one bank. But in course of time, it was found necessary to grant one bank either a complete monopoly or a residuary[2] monopoly. The causes leading to this change were as follows :

(1) When notes were issued by a number of banks, *it was not possible for the total note-currency to correspond exactly to the need.*

(2) A single bank issue has the advantage of *uniformity in size, shape and denomination.*

(3) When notes are issued by one bank, there is a greater convenience for the government to *exercise its control* than when they are issued by a number of banks. Besides, it becomes easier for the state *to share in the profits* arising out of the note issue business.

[2]Please see "Banking—Principles ; in India."

3. Method of control

There are at least seven methods of control of note-issue by the state.

(1) The first method of control of note-issue business is what is known by the term *fixed fiduciary issue method*. It was adopted first of all in England in 1844. Under this method, notes worth a fixed amount are required to be covered only by government securities, while all those issued in excess must be covered by metallic reserve. It has certain defects : (1) It is deficient in elasticity because whenever there is an appreciable internal or external drain of the metal, an undue contraction of currency and credit is rendered necessary. (2) It is not sufficiently adaptable to heavy demands for currency, as an expansion becomes impossible in case there is a shortage of the metal. But as against this, it may be said that it acts to a certain extent as a brake on undue expansion of currency and credit in times of prosperity. An element of elasticity was, however, introduced in the English system in 1928 when it was provided that the Treasury could authorise the fiduciary issue above £260 million to a special amount for not more than two years altogether from the date on which the authority was finally given.

(2) The second method is that of *a fixed legal maximum of note issue*. It was followed by France from 1870 to 1928. 'The system was altogether too rigid and incapable of sufficient adjustments to the requirements of the present-day money markets.' It also provided no guarantee against inflation as the Parliament could raise the limit at any time without any sufficient reason whatsoever.

(3) The third method is that where notes are required to be *fully covered by government securities, and in addition limited* to the paid-up capital and reserves of the issuing bank. It was formerly employed in the United States in the case of the national bank notes. Its shortcoming is that it does not provide for elasticity.

(4) The fourth method is that where *a small percentage of the total issue is to be kept in metallic reserve and the remainder is to be maintained in trade bills and government securities* with the further provision that subject to certain conditions and penalties the metallic reserve percentage may be allowed to fall below the statutory minimum. It was adopted in Germany in 1875 and with certain modifications in U. S. A. in 1913 with the introduction of the Federal Reserve system, and in various other countries after the War of 1914-18. A

great advantage of this method is that while it provides sufficient elasticity there is also a considerable guarantee against an undue expansion of currency.

(5) The fifth method is that where just like the fourth method a small percentage of the total issue is required to be covered by metallic reserve but *for the remainder there is no specification of the particular kinds of assets* which may be used as such. There is, however, a further provision under this method which makes the notes a first charge on all the assets of the issuing bank. It gives the bank greater freedom of action than is possible under the fourth method.

(6) The sixth method is the *proportional deposit method.* Under this system, the issuing banks are required to deposit a fixed percentage of the amounts of the issues with the premier bank in gold or government securities. This system prevails in United States, where member banks are required to invest a fixed percentage in securities and lodge them with the Federal Reserve Board.

(7) The seventh method is a variation of the fixed percentage, wherein *a fixed amount is to be kept in the form of securities of some foreign government or the balances of the bank of foreign country.* As we shall see later on an example of this is found in the Indian system of note-issue.

Currency and banking theories. There were, in fact, only two theories of note issue in the beginning and all the methods discussed above are the modifications of one or the other. They are known by the term currency and banking theories. *The advocates of the currency theory held that the amount of notes in circulation should always be the same as the amount of gold would be, provided the notes did not exist.* In some cases, however, and the Bank of England Charter Act of 1844 is an instance, *notes worth a fixed amount were allowed to be issued on the basis of the government securities as well.* Pushed to its logical conclusion the upholders of currency theory regarded notes merely bullion certificates. The upholders of the banking theory, on the other hand, urged that *the only consideration to be borne in mind in the regulation of the issues of notes was whether they were made in pursuance of legitimate needs* as opposed to speculative needs. Dr. J. W. Gilbart, once the general manager of the London Westminster Bank who was one of the chief exponents of the banking theory ridiculed the idea of the regulation of the issues of notes by the amount of the bullion available. He said that it could be depended upon to take its own course ; if the amount of notes issued in the legitimate manner were to be greater

than that needed, the excess would inevitably be presented for payment. The circulation was bound to increase or decrease, according to local conditions, the state of the harvest and of local trade. But this is good only in theory, as experience has shown that issues are not always sound and careful. Credit is, at times, allowed by banks to finance doubtful business ventures. This, therefore, necessitates some control or regulation. It does not, however, suggest that all the notes issued or those issued beyond a fixed fiduciary issue must be backed by bullion. It justifies only measures which may safeguard against expansion to meet illegitimate needs and which may leave issues free for all legitimate business requirements.

4. Defects of inconvertible paper money

Inconvertible paper money is *not defective in itself*. But it becomes so, because it has necessary *tendency to be overissued*. The value of money or its purchasing power is determined by the interaction of the forces of supply and demand in the same way as the value of any other commodity, and as such tends to decrease with an increase in the circulation of its quantity. If the issue of inconvertible paper money, in a country, is according to the needs, its value remains steady. But if it is more than the requirement, *i.e.*, over-issued, it loses its value. This also happens under convertible paper money and metallic money. Any unnecessary increase under all systems of currency, surely brings about a *fall in the value*.

An over-issue of inconvertible paper money affects the value of the currency of a country in terms of everything, whether gold or goods or foreign currencies.

An inconvertible paper money has no relation with gold. Value of the currency of a country with this type of money falls in its term due to the loss of confidence as more and more of it is over-issued. *The amount of the premium on gold represents the extent of its depreciation.*

Similarly, the value of the currency of a country having inconvertible paper money falls in terms of goods, *prices in general rise*. On account of a premium on gold, importers have to pay more for their imports. The result is that they raise the prices of the goods in order to recoup their loss. The raising of prices by the importers leads to the raising of the prices by others as well. Experience has shown that prices under a depreciating paper money regime rise faster than is warranted by the increase in the quantity of paper money issued, perhaps because of the loss of confidence. The value of inconver-

tible paper money is dependent upon confidence, and once this confidence is lost fall in the value of currency is abrupt.

If foreign currencies are convertible into gold, the currency of a country wherein we have got inconvertible paper money *falls in value in their terms* to the same extent as the premium on gold. In cases where foreign currencies are also inconvertible fall in value in their term depends upon the relative depreciation of each currency in terms of gold and goods.

5. Advantages of paper money

Paper money is very advantageous.

(1) *It replaces metallic currency and makes it available for use in other productive channels.* "The gold and silver money, which circulates in any country may be very properly compared to a highway, which while it circulates and carries to market all the grass and corn of the country, produces itself not a single piece of either. The judicious operations of banking and substituting paper money in the place of a great part of gold and silver, by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air, enable the country to convert, as it were, great number of its highways into good pastures and corn-fields and thereby to increase very considerably, the annual produce of its land and labour.

(2) *It is very economical. The cost of making it is almost negligible* in comparison with the cost of making the metallic money. It *saves loss through wear and tear as well,* which must take place if we were to have metallic currency in its stead.

(3) *It is very light and handy* and this quality of paper money makes it easily transportable. This advantage is of great value when large payments are involved and specially between places far off from each other.

(4) *It has a fiscal advantage* inasmuch as in times of national emergency, such as war, the government need not find itself handicapped for want of money. It can set the printing press to work and thus carry on.

6. Disadvantages of paper money

Paper money has certain disadvantages as well.

(1) First of all, and specially when it is inconvertible, there is a *natural tendency towards its over-issue,* and as

has already been noted this tells upon its value. But there are different ways of control and any one of them may be relied upon.

(2) *It is limited in circulation.* Paper money, strictly speaking, is national money. It circulates within the boundary of a country or under the authority of one and the same government. Beyond it, metal is indispensable. In these days, when movements of gold are controlled by the governments of all the countries a good deal of inconvenience is experienced in the natural flow of our international trade.

SUMMARY

1. Paper money notes may be (1) Representative, (2) Convertible, and (3) Inconvertible. The volume of the first never exceeded the amount of the reserve, standard coins and bullion. In the case of the second, however, there is only a partial backing. The remainder is invested. Inconvertible notes confer a claim to nothing.

2. The note-issuing authority may be the banks or the government of the country. Government issue of notes suffers from lack of elasticity, defective control and precariousness of value. Bank notes have all these advantages. A single bank note issue is better than a multiple bank note issue for various reasons.

3. There are seven methods of control. But they are modifications of either the banking or currency principles. Banking principle has the advantage of elasticity.

4. Inconvertible paper money is defective only because of its tendency to be overissued which invariably results in the fall of its value in terms of all, gold, goods and foreign exchanges.

5. Paper money replaces metallic money and thus leaves the metal to be used elsewhere. It is economical as well. It is transportable and finally has a fiscal advantage also.

6. The defects of paper money are its tendency to be overissued and limited circulation.

TEST QUESTIONS

1. Mention the different kinds of notes giving their characteristics. What is the main defect of the inconvertible notes and how does it affect the people ?

2. Give your arguments for and against bank and government issue of notes. Why a single bank note issue is preferable to a multiple bank note issue ?

3. What are the usual methods of note control ? Discuss the merits and demerits of each. In this connection also give your opinion about the banking and currency principles.

4. Mention the effects of an issue of inconvertible paper money. What is its chief evil and how can this be avoided ?

5. How does the issue of inconvertible paper money in a country affect the value of its currency in terms of gold, goods and foreign currencies ?

CHAPTER VI

GRESHAM'S LAW

Money has always been troublesome and it will continue to be so, as long as we remain ignorant of the general laws which govern all currency systems. These laws, it may be pointed out, are scientific and not political in their nature. They are expressions of tendencies which follow certain conditions through the action of certain causes. They are not enactments, and they are not enforced by police and magistrates One of such laws is Gresham's law, which is named after an Elizabethan knight, who is supposed to have inspired a Royal proclamation in which the law was first stated.

1. The law as contained in the royal proclamation inspired by Gresham

The law as contained in the Royal proclamation inspired by Gresham was: 'If coins of the same metal, but of varying weight and quality circulate together at the same nominal value, the worse coins will drive the better from circulation, but the better will never drive out the worse'.

Its paradoxical nature. At first, this seems paradoxical, as people in their self interest generally choose good things and reject bad ones, but in the case of coins they seem to behave differently. But this paradox is easily solved, if we look at the things rather minutely. Both the good coins and bad coins have the same value as money within the country, but their value is different as bullion. The owner, under the circumstances, naturally *puts the bad coins in circulation* for making the payment so long as it is not refused by others, and *withdraws the good ones* which are melted and sold as bullion or hoarded or used in arts or exported in payments to foreign creditors who accept them as bullion.

2. Marshall's enunciation of the law

The statement given above is applicable to only one form of currency, namely mono-metallic. Marshall has revised it in a way so as to be applicable to all forms of currency. It is that *an inferior currency, if not limited in amount, drives the superior currency out of circulation.*

Conditions under which it operates. The law operates under different forms of currency.

(1) *Under monometallism.* When old and worn out coins circulate together with newly minted full weight coins, *the old and worn out coins* (inferior currency) *drive newly minted full weight coins* (superior currency) *out of circulation.* In fact, it was the realisation of this truth by Gresham which prompted him to inspire the Royal proclamation referred to above. At that time a mill, which to a great extent superseded the human hand for shaping and striking the coins, was set up in the Tower of London. "This mill was worked by horses and would doubtless be considered by modern engineers as a crude and feeble machine". It produced the best coins of that age. The result was that both the hand-made and machine-made coins were received without distinction in money payments. The government expected that the new money, which was superior would soon displace the old money which was inferior. But this did not happen and the politicians of that age marvelled exceedingly that people could be so perverse as to use inferior currency in preference to superior. The horses in the Tower went on and numerous coins were issued, but still they vanished as fast as they appeared. Gresham could, however, understand the cause and brought the truth to light.

(2) *Under bimetallism.* When coins of two metals with a fixed legal ratio between them circulate together as standard coins, and there is divergence between their mint value and market value in terms of each other, *over-rated coins* (inferior currency) *drive under-rated coins* (superior currency) *out of circulation.* The best illustration of this can be had from the currency history of France and U. S. A. when they were on bimetallic standard. In fact, there was in these countries an alternating standard under which sometimes coins of one metal and at others coins of another metal formed the largest portion of the circulating media, according as they were over-rated or under-rated.

(3) *Under depreciated paper currency.* When depreciated paper currency and metallic currency circulate together, *paper currency* (inferior currency) *drives metallic currency* (superior currency) *out of circulation.* A very good example of this is provided in the currency history of European countries during the Great European war of 1914-18. Gold sovereigns, during this period, were driven out of circulation from United Kingdom. This also happened with the gold marks of Germany.

Qualifications or limitations. In Marshall's statement of Gresham's law as given above, there is an

important phrase, namely, 'if not limited in amount.' Others have used the phrase, 'other things being equal.' In fact, all economic laws are hypothetical laws, *i. e.*, they are true only under certain conditions. In the case of this law, they are as follows—

(1) *The supply of currency of both kinds (inferior and superior) is in excess of the demand.* In case this is not so, and the trade is so large and brisk that the whole currency, inferior and superior, is required or falls short of the requirement, inferior currency will not drive superior currency out of circulation.

(2) *The intrinsic value of the superior currency is not less than its face value.* If this is so, it is not likely to be sold as bullion or hoarded or used in arts or exported in payment to foreign creditors.

(3) *Public opinion is not opposed to the inferior currency.* It sometimes so happens that the inferior currency is so inferior that public opinion is not at all in favour of its use. During the post-war period people being opposed to the use of depreciated currencies, their respective governments had to stabilise them.

(4) *One of the currencies is not limited in its legal tender.* In case this is so, the law does not operate.

3. Withdrawal of worn-out and depreciated coins

Since the realisation of the truth of the Gresham's law the governments have taken upon their own shoulders the responsibility of the withdrawal of worn-out and depreciated currency. *They issue notifications* to the effect that the coins bearing certain effigies on the obverse should be returned to the Treasury before a particular date, after which they cease to be legal tender except at the Treasury. We know that Victoria and Edward coins have been withdrawn in our own country in this way. While withdrawing the coins, the Treasuries are instructed not to examine them for light weights, but to take care as usual to see that counterfeit coins, and coins bearing obvious signs of fraudulent defacement are not accepted.

In our own country, a rupee or half-rupee ceases to be a legal tender when it is more than two per cent below standard weight. In fact, this is regarded as depreciation in due course. Any further reduction in them is treated as a sign of fraudulent defacement.

SUMMARY

1. Gresham's law at first seems to be paradoxical, though it is not so. It is natural for the people to put the bad coins in circulation, and retain the good ones.

2. Marshall has so enunciated it as to cover all forms of currency. Under monometallism, worn-out coins drive newly minted coins out of circulation. Under bimetallism, over-rated coins drive under-rated coins out of circulation. And when depreciated paper currency is issued along with full weight metallic currency, the former drives the latter out of circulation. It holds true, only under certain conditions.

3. Since the realisation of the truth contained in the law, governments have taken upon their own shoulders the responsibility of the withdrawal of worn-out coins. A number of examples are provided from the history of our own currency system. While withdrawing the coins, care is taken to refuse counterfeit and fraudulently defaced coins.

TEST QUESTIONS

1. State briefly Gresham's law indicating the conditions and qualifications under which it operates. Give examples.

2. Comment on the statement : 'Bad money drives good money out of circulation.'

CHAPTER VII

QUANTITY THEORY OF MONEY

There is yet another law—the law governing the value of money—which must be understood to solve the monetary problems arising in these days of difficulty. The truth of the statement contained in this law had been realised much earlier than that contained in the Gresham's law. It was first noticed by Julius Paulus, who was a Roman jurist of high repute in the beginning of the third century. He said that the value of money depends on its quantity and based his arguments in support of that view on the monetary conditions of his time. Contemporary writers have since enlarged upon it and justified their findings from circumstances of their own days.

1. The theory in its bald form

We know that the value of a commodity depends upon its supply in relation to the demand for it. This is the case with money as well. Economists have, however, expounded a distinct theory about it, namely, the Quantity Theory of Money. Stated in its bald form, it is 'Other things being equal, value of money varies exactly in inverse proportion to its quantity in circulation.' This is incontestably true ; for if there are four things of equal value to be exchanged, and four pieces of money available for their purchase, the price-level for each unit bought and sold is bound to be one. Next, if the quantity of money is doubled, and the number of things available for exchange remains the same, the price is bound to be two. On the contrary, if the quantity of things is doubled, and the quantity of money remains the same, the price is bound to be one-half. In the case of commodities, however, though an increase in supply brings about a fall in their value and *vice-versa*, it does not necessarily mean that the change is bound to be in uniform proportion. But in the case of money, it does mean that.

Importance of the phrase 'other things being equal'. The phrase 'other things being equal' is very important. It comprises a number of assumptions. They are :—

(1) that the legal tender money is the only form of money in use ;

(2) that there is no change in the velocity of circulation of money ;

(3) that there is no hoarding—the whole of the money is in circulation ;

(4) that all the goods are exchanged through money ;

(5) that there is no credit system ; and

(6) that the rate of circulation of goods has also not changed.

Over and above these assumptions, it is also taken for granted that there have been no changes in production, rate of exchange and population.

But these assumptions are not in accordance with the actual facts. In the present dynamic state of society, they cannot be true.

2. Recent enunciation of the theory

Recent writers have, therefore, after making allowance for these facts enunciated it as follows.' "The general level of prices tends to vary directly in proportion with the quantity of money in circulation and its rapidity, *i. e.*, its supply and inversely with the activity of exchange, *i. e.*, the demand for money indicated by the goods to be exchanged multiplied by their prices". Here the word *tends* is very significant. In fact, all the economic laws show tendency. They are not exact. That is true of this law as well.

The term 'variation in the general level of prices. The term 'variation in the general level of prices' is certainly something very abstract ; for we know that the prices of all commodities do not rise or fall at the same time and by the same amount. But this abstraction can be made concrete by bringing forward what we call *Index Numbers*. These, though once of only academic interest, are now of practical necessity. They are called for, owing to rapid changes in the level of prices, in order to adjust long term contracts (made on a money basis) to the movement of prices. When money wages are fixed over a period during which the cost of living rises, the wages buy less of real goods at the end of the period than at the beginning. Wage disputes arise, and when no satisfactory way of measuring the rise in prices exists, these disputes are difficult to settle. When a system of measuring changes exists that commands general confidence, *wage agreements are attained with little friction*. In the United Kingdom agreements between organisations of employers and of workers provide for the regular and automatic adjustment of the wage rates of about three million workers by sliding scales in accordance with variations in the cost of living.' Next, *they*

enable the maintenance of the value of inconvertible paper money; for it can be expanded and contracted in the light of the requirements according as they rise or fall. For instance, if index numbers prepared during a given period show a rising tendency, the value of the paper money can be brought to the former level by contracting it and *vice-versa*. Managed currency depends largely upon them. We shall, however, turn to these in a greater detail in the next chapter.

Demand for and supply of money. Having understood the meaning of the term variation in the general level of prices, we must now take up the meanings of the terms demand for and supply of money.

Demand for money. Every economist knows that demand is not co-extensive with desire It is desire backed by the power to satisfy it. Obviously, then, *the services we can perform and the goods at our command*—when they come actually for sale—constitute our demand for money. In other words, they make up the price offered for money. Hence, if this price becomes greater, *i. e.*, if more goods are available for sale and more services are offered, the value of money rises It purchases more, and thush as a greater command. But it may be said here that all goods and services coming for exchange are not exchanged with money. Some of them exchange by barter, and these do not in any way constitute the demand for money.

Supply of money. The supply of money consists of *the money available for purchase.* It seeks goods and services, and goods and services seek it. It may be pointed out that the whole money does not constitute supply. Some of it lies idle and that must be taken into account while estimating the supply. Besides, we must also be clear with regard to the point as to what constitutes money. This is certainly not only gold—but gold, the representatives of gold. *e g.*, token coins and notes and credit instruments. In short, the word 'money' has been used here in the widest possible sense. Hence, it is well-nigh impossible to determine at any time the exact supply of money. Bank failures and things like political upheavals and international situation which tend to bring about depression in a nation also bring a reduction in the supply of money. As against this, anything raising public confidence and giving a buoyant feeling to the market, brings about an increase in it

Now, it is not only the quantity of money available for the purchase of goods and services that constitutes its supply. *Its efficiency also has to be taken into consideration.* A coin which is readily transferred and effects a

number of purchases is of more importance than anothe which is stored or transferred only once. This, therefore, presents another serious difficulty, *viz.*, we cannot in any way discover the rapidity of circulation of money. No doubt, it will be equal to the *total expenditure in any community divided by the average of money in circulation*, but as none of these can be estimated correctly, it is no gain saying this. The formula

$V = \frac{E}{M}$ where V = the velocity or rapidity of circulation of money, E = the total expenditure in a community, and M = the average amount of money in circulation roughly denotes the way in which it can be found out

A change in the quantity of money also brings about a change in the rapidity of its circulation as well. Hence, we can never discover its supply with any exactness.

Changes in the demand for and supply of money react upon each other. It has been often observed that an increased supply of money in itself acts as a stimulus to production and *vice-versa*. Similarly, changes in production and trade bring about a change in the volume of credit money. The world being dynamic, as already stated, static conditions can never be expected to remain.

3. Practical importance of the quantity theory of money

It has been said in the beginning that the idea contained in the quantity theory of money is only a special case of the theory of value the only difference between the two being that while in the former case there is a proportionate change, in the latter case it is not so. But bearing in mind all that has been observed in connection with the variation in the general level of prices, and the demand for and supply of money, it may be said that the truth contained in the statement can never be tested. Then, the question is whether the quantity theory of money is abstract or of any practical importance. In fact, it is of much practical importance as *it tells us at least one of the main reasons of price fluctuations.* They can surely be avoided to a very great extent by regulating the supply of money according to the demand. Hence, it may be said that *it has shown us a path which leads to more or less stability* which is most desirable in these days of complexities.

4. A mathematical expression of the quantity theory of money

There is a mathematical expression of the quantity

theory of money which shows us clearly the effects on the prices of the changes in the quantity of money or goods. It is in the form of *an equation where one side represents goods and other m ney.* Professor Irving Fisher has stated it as follows :—

$PT = MV + M^1V^1$ or $P = \frac{MV + M^1V^1}{T}$ where P means price level ; T total goods for exchange ; M quantity of legal tender money ; V velocity of the legal tender money ; M^1 quantity of credit money in circulation ; and V^1 velocity of credit money in circulation. Here, an attempt has been made to explain the meaning of the phrase 'other things being equal' by including the velocity of circulation of money, the quantity and velocity of circulation of credit money, the condition of trade and the amount of business done. A change in any of these factors affects the general level of prices.

Professor Chapman has reversed the formula by making P to stand for the purchasing power of money, *e.g.*, $P = \frac{T}{MV + M^1V^1}$. This is quite correct as *the purchasing power of money varies directly with the total number of commodities and inversely with the supply of money.*

Conclusions derived from the above. From each of the above formulae certain conclusions may be derived regarding the effects on the prices and value of money of the changes in the volume of money and goods. They may be re-stated for the sake of clarity.

Professor Irving Fisher's formula points out the effects on prices of the changes in the volume of money and goods, which is as follows :—

(1) The price-level rises with a rise in the supply of money, (total goods remaining the same).

(2) The price-level falls with a fall in the supply of money, (total goods remaining the same).

(3) The price level rises with a fall in the demand of money—total goods, (supply of money remaining the same).

(4) The price-level falls with a rise in the demand of money—total goods, (supply of money remaining the same).

Professor Chapman's formula points out the effect on the value of money of the changes in the volume of money and goods, which is as follows :—

(1) Value of money rises with a rise in the total goods (supply of money remaining the same).

(2) Value of money falls with a fall in the total goods, (supply of money remaining the same).

(3) Value of money rises with a fall in the supply of money, (total goods remaining the same).

(4) Value of money falls with a rise in the supply of money, (total goods remaining the same).

5. Terms most commonly used for expressing the changes in the value and quantity of money.

The following are the terms most commonly used for expressing the changes in the value and quantity of money.

Appreciation. Money is said to have appreciated *when its purchasing power rises.* Supposing one Rupee buys 20 units of commodities in general ; if it begins to buy 25 units it is said to have been appreciated Fall in prices means appreciation of money. It is caused by a fall in the volume of money or rise in the production and trade.

Depreciation. Money is said to have depreciated *when its purchasing power falls.* Supposing one rupee buys 20 units of commodities in general ; if it begins to buy only 10 units, it is said to have been depreciated. Rise in prices means depreciation of money or a fall in the production and trade.

Inflation. When the supply of money (including credit) relatively to the demand increases to such an extent that the prices in general rise and the purchasing power of the monetary unit decreases the currency is said to be inflated. So long as its volume remains dependent upon the quantity of bullion available, inflation can be brought about only by *natural causes*, e. g., *a sudden increase in the output of mines or heavy importation of metals.* The former was the case during the period 1896-1911 when prices rose because of the discovery of gold mines in South Africa, and the latter in Sweden, Norway, Spain and U. S. A. — specially in the last named country during and after the war of 1914 18. But more often, it is brought about *artificially* in times of war as had happened during the *period* 1914-18 and after, and is happening at present.

In this connection, we may profitably give some of the extracts from Weston's Banking and Currency of what one of the experts sent to devise plans for helping

[1]To check inflation Sweden and Norway placed an embargo upon the import of gold, Spain bought it at a discount, and U. S. A. sterilised it.

the harassed nations in their distress said about the inflation of currencies in some of the European countries. "In Austria, when the great armies came home from the war and there was nothing to do—industry was shattered—the state was confronted with millions of men who were perforce idle and without any means of livelihood. What did they do? Among other things, where there was one railway porter, they put six or eight; and these men had to be paid the rate of wages of the day; there was no money to pay them; and so the printing press was brought in and turned round so many hours day and night until bits of paper were produced to pay the men who were doing nothing on the railway but had to be kept. Very shortly, these pieces of paper became more or less valueless, and these men said, "we cannot buy tea, bacon, bread and sugar, we cannot pay our rent; we cannot feed our children; we cannot clothe our wives and ourselves with these particular number of pieces of paper? Very well. Then the printing press went on again, and double the number of pieces of paper were produced—not things—symbols, which did not mean things."

Proceeding further he said, "I had in my bank the other day one of the very latest of those who have got away from Russia. He said, 'Before I left I paid £26 pre-war price for a glass of milk; I gave £400 pre-war price for a loaf of white bread; my living expenses were £8,000 per month or £96,000 per year pre-war price in paper to enable me to live; and the Russian Government seeing that it was objectionable to have every pocket in a man's suit bulging with paper enough to pay for a loaf of bread or a cab drive, or any of the small necessaries of life, are now printing pieces of paper, bank notes of 25,000 and 50,000 denominations of roubles to save carrying notes.' "

Deflation. When the supply of money including credit relatively to the demand decreases to such an extent that the prices in general fall and the puchasing power of the monetary unit increases, it is known as deflation. This was done both in the twenties and the thirties. In the twenties, it was done by those countries which wanted to bring about a fall in their prices after their highest level had been reached in 1920. In our own country, the net withdrawal of currency during the decade under reference amounted to Rs. 86 crores. In the thirties, it was mainly the outcome of the financial crisis and was adopted for a few years in Italy and successfully in France. In the former, it was introduced twice in 1931 and 1934 by the Fascist Govern-

ments. There was ordered an all round cut in wages of all public as well as private employees. Fixed charges including rent charges and other charges arranged in advance by private contract were reduced. Finally the prices of all commodities were put under control and brought down. All opposition was crushed. It is doubtful whether such a result would ensue in a country which does not have an authoritarian system of the government as there existed in Italy. The scheme was also tried in France in 1935, but persistent opposition led it to be ultimately given up. In Holland and Belgium also there was opposition and the scheme was scotched almost before it had been adopted.

Reflation. When the supply of money (including credit) is made to increase to bring the prices to a former level, it is known as reflation. This is, correctly speaking, controlled inflation. Uncontrolled inflation is dangerous ; it may throw the whole economic structure of a country into disorder. In it was the 'evil odour about inflation' which forced the people to call this remedy as reflation This term was first used in U. S A. in 1931 when the object was to increase the pricelevel to that of 1929. But the scheme met with a strong opposition and finally had to be abandoned owing to a defect in the legislation and a decree of the Supreme Court.

6. Inflation in India during World War II

The question is whether there was any inflation in India during World War II. We know that the prices rose here unchecked. Most of the people thought that this was due to profiteering, speculation, scarcity and the lack of a strong price control policy. But this was not the fact. After a certain stage in the development of a war economy, financial and monetary events have their own effects and this was the case in India during World War II as well.

The main culprit of a rise in prices. Defence services demanded more and more with the result that less and less was left for civil consumption. Whatever increase was brought in production it was generally in favour of war production. On the other hand the purchasing power of the consumers, including those engaged in the fighting forces, grew as a result of the fresh employment of both men and women in various capacities The people as a whole (barring of course those with fixed incomes) feel richer in terms of money but not in terms of goods in any way. There was a scramble for the latter in the market. Prices rose. Profiteering and speculation no doubt, in-

tensified the tendency. *But the main culprit was expansion of purchasing power and not the profiteering and speculation.* They surely conspired with it, but in the absence of a continued support could not have sustained for long. It may be said without any fear of contradiction that it was rather by arresting the growth of purchasing power or actually reducing it that the collapse of profiteering and speculation would have been brought about and the rise of prices checked or reversed.

Actual increase in the volume of currency The active note-circulation increased in India from Rs. 172 crores on September 1, 1939 to Rs. 1,218 crores at the end of the year 1945 46—an increase of over Rs. 1,046 crores There was an increase of rupees and small coins as well in circulation by Rs 149 crores and Rs. 70 crores respectively during the same period. It will not be out of place to mention here that an increase in the volume of cash currency brings about in its turn a corresponding increase in the credit currency also. Bank deposits as well during this period grew enormously.

Causes of inflation. Inflation is usually the result of the *Government's policy of balancing the deficit budgets* by manufacturing purchasing power for its overuse. The same when spent re-appears as income in the hands of the people, and the portion not withdrawn in the form of increased taxation and loans comes to the market against a given or probably a diminishing supply of goods available for civil consumption.

The Government of India over and above this had to make *heavy purchases* in this country *on behalf of the British Government*, and naturally paid up the suppliers in home currency which was issued against the sterling securities of the latter. It is clear that in the absence of British purchases, or under a different method of financing them, the expansion of currency would not have been so huge as it had been under the circumstances. No doubt, the backing against it was good, but its immediate effects were distressing for the country

Remedies for avoiding inflation. Various remedies were, however, suggested but their actual appliance was out of question under the then relationship of the British Government with the Indian people. One of them was to finance British purchases by the *sale of* the *British assets in the country* in the open market. This was the method adopted in U. S. A. before the passage of the Lease and Lend Act. It was, however, not acceptable to the British people so far as India was concerned. They wanted to keep their assets in this country intact. Later

on, the expediency of the adoption of this method seemed to have lost all importance because the cost of the British purchases had grown far heavier than the value of such assets. Next, the Government of India could finance them by the acquisition of more and more of national savings. This they did though not very successfully. Public opinion was not in favour of any co operation. Hence force had to be resorted to. During the latter years of the war the Reserve Bank of India sold gold and silver on behalf of foreign Governments. This, it was said, it did with a view to withdraw currency from circulation But a close observation of the policy followed in this respect reveals that the sales of gold were more with a view to earn profits for foreigners than for withdrawing currency. The Bank sold only at high prices. When there was a tendency for them to go down, it withdrew itself from the market.

7. Consequences of inflation or effects of a rise in prices

The following are the consequences of inflation or effects of a rise in prices :—

(1) *The creditors as a whole lose while the debtors as a whole gain.* This is because the money borrowed at a time when it bought more, is paid back at a time when it buys less. The interest payments on it also become of less value than before.

(2) *The agriculturists, manufacturers, wholesalers and retailers obtain large prices simply by holding their stocks* which rapidly increase in value. It also *stimulates production* and hence *increases employment.*

(3) *The labourers and other persons with fixed incomes stand to lose.* It has always been observed that wages and salaries do not rise at such times if they rise at all in the same proportion as the rise in prices. They lag considerably behind.

(4) As a consequence of the above, there arise *social unrest and labour troubles* Strikes are very common during such period.

(5) *Consumers as a whole suffer,* as they are required to spend more and more of their money to maintain the same standard of living as had been maintained by them previously.

(6) *Producers find it difficult to compete in the markets of the world* as the cost of production which they are required to incur as a result of the rise in the prices of the raw materials and other articles and services used by them during the process increases appallingly.

(7) Because of the rise in the money income, people think themselves better off and disregard for a time at least the rise in expenses. *This misleading prosperity felt by them undermines the economic life of the country and usually leads to thoughtless extravagance.* This is, in itself, deplorable.

8. Consequences of deflation or effects of a fall in prices

Like inflation deflation is also very disturbing. When prices fall, the economic effects are, so to say, the reverse of what they are when there is a rise.

(1) *The creditors as a whole gain while the debtors as a whole lose.* This is because the money borrowed at a time when it bought less, is paid at a time when it buys more. The interest payments on it also rise in value.

(2) *The agriculturists, manufacturers, wholesalers and retailors obtain less prices and hence production and business activities suffer seriously.* This, in its turn, brings about *unemployment* and results in *disaster*. It may also be pointed out that of all the classes mentioned above *the first suffers the most.* The reasons for it are not far to seek. We know that (1) *agricultural commodities tend to decline in prices much more rapidly than other commodities*, (2) as the time taken, in the process of their production is considerably longer, *the expenses incurred at the commencement at one price-level are not made good by the income yielded at the end at another* and lower price level.

(3) *Those with fixed incomes benefit* as their money incomes purchase a larger share of goods and services. It may, however, be said that the rates of remuneration in certain case are reduced as well but here again the fall is usually less than that in the prices.

(4) *Consumers as a whole gain*, but difficulty is sometimes felt when increase in un-employment leaves a good many of them without any income.

(5) *Exports do increase*, if there is no corresponding fall in the prices in foreign countries. But more usually what happens is that trade barriers are built to check the imports.

(6) *The position of the country as a whole is jeopardised* as the national progress is checked. Falling prices deaden the desire to venture and thus lead to human retrogression.

9. Stability is desirable

'Short weight cheats the buyer; long weight cheats the seller. In like manner a unit of money changing in

its power to buy upsets contracts. If general prices rise, then creditors and the recipients of fixed incomes are penalised; if general prices fall, the debtors—who must now transfer more of real stuff to cancel their obligation—are penalised.' The drawbacks attendant upon violent and capricious changes in the purchasing power of money have been given above in detail. It has been seen that the rising and falling prices have each their characteristic disadvantages. In short, while the former leads to the *over-stimulation of industrial activity* and is unjust, the latter leads to *retrogression* and is inexpedient. This means that in the interest of social justice and harmony steady prices are the best. They lead to the stability of production, trade, employment, and general economic conditions. It has already been pointed out that this is made possible by a clear understanding of the quantity theory of money, and regulation of the supply of currency and credit according to the demand in that light. No doubt, this regulation will take sometime to be fully effective; and in the meantime there will be fluctuations; but such fluctuations are desirable as without them, there will be no activity and no need for the use of human brains. As a writer has remarked, movement of prices is necessary but it should be like the ripples in a river and not like the waves in the sea.

SUMMARY

1. Quantity Theory of Money is incontestably true. It holds good only under certain assumptions.

2. A recent enunciation of the theory is applicable to all conditions. The general level of prices is measured by index numbers which are very useful. Demand for money is represented by the services offered and commodities brought in the market for sale. The supply of money consists of the money available for purchase. It is also determined by its velocity. Finally, supply and demand re-act upon each other.

3. Though the truth contained in the statement cannot be tested, it tells us at least one of the main causes of the changes in the prices; and hence is of great practical importance.

4. Professors Irving Fisher and Chapman have expressed the theory mathematically and the formulae given by them tell us the effects on prices and the value of money respectively of the changes in the volume of money and goods.

5. While an appreciation of money denotes a rise in the purchasing power, a depreciation denotes an increase in its supply relatively to the demand for it, a deflation denotes a fall in the former relatively to the latter. Reflation is controlled inflation.

6. There was certainly an inflation of money in India during world war II, and this was truly speaking, the main culprit of the day to day rise in prices. No doubt, profiteering and speculation also had their effects, but in the absence of a continued support they could not have sustained for long, in fact, we have got figures which go to prove that there was real increase in the volume of money of all sorts during this period. More usually an

inflation is brought about by the policy of the Government's balancing the deficit budgets by manufacturing purchasing power for its own use. In India, it was also due to the heavy purchases made by the Government on behalf of Great Britain and other allies and making their payments in home currency. It could surely be avoided by the sale of the British assets in the country in the open market, and acquisition of more and more of national savings. But this was impossible under the then relation of the people in both the countries. The Reserve Bank also pretended to sell gold with this end in view.

7. & 8. The effects of a rise or fall in prices are far-reaching. They bring about maladjustment in the position of the different classes of the people living in a country, and hence must be avoided.

9. Prices must be stable, as a rise in them leads to the overstimulation of industrial activity which is unjust, and a fall in them leads to retrogression which is inexpedient. But they cannot be so even if we understand fully the quantity theory of money and regulate the supply of circulating media according to the demand for it. It may be said that fluctuations are desirable although they should be only to a very limited extent.

TEST QUESTIONS

1. State and explain fully the Quantity Theory of Money. Illustrate your answer with suitable examples.

2. Explain the Quantity Theory of Money and indicate its limitations.

3. Write short notes on :- inflation, deflation, reflation, appreciation and depreciation.

4. Do you think that there was inflation in India during world war II ? If so give your reasons and suggest remedies.

5. What are the usual effects of a rise in prices ? Do you consider it essential for stimulating business activity ?

6. The quantity theory of money has been on the one hand elevated to the rank of a great discovery and on the other hand denounced as a pernicious falsehood. Discuss the statement. (B. Com. Part I, Alld.)

CHAPTER VIII

INDEX NUMBERS

It was pointed out in the last chapter that variation in the general level of prices are measured by index numbers. We now proceed to make their detailed study.

1. Meaning and construction

As regards the *meaning* of the term index numbers, it may be said that they are *the numbers which represent the prices of a chosen commodity or group of commodities at selected dates*, and are prepared *to compare the prices* of the same articles or group consisting of certain articles over a given period.

Construction. In the construction of index numbers, we start with a *base year*. This must be normal. Then, the price of the commodity chosen is taken to be equal to 100. In case, there is a group of certain commodities, the prices of each of the commodities are taken to be equal to 100. The average, then, comes to 100. For example, if there are four commodities : wheat, rice, sugar and pulse, and their prices are Rs. 3, Rs. 5, Rs. 8, and Rs. 4 per maund respectively, they will be tabulated as follows :—

Articles		*Price*		*Index numbers*
Wheat	...	Rs. 3	...	= 100
Rice	...	Rs. 5	...	= 100
Sugar	...	Rs. 8	...	= 100
Pulse	...	Rs. 4	...	= 100
				4,400 = 100
				Average

Next, the prices of these particular commodities are taken in *other years* and changed in numbers which are reduced or increased in the same proportion as the prices. Pursuing the above example, let us suppose that the prices of the commodities under reference are in the following year in order of mention Rs. 4, Rs. 4, Rs. 5, and Rs. 3, per maund,

The revised figures will in that case be as follows :—

Articles	Base year		Next year	
	Price	Old Index Number	Price	New Index Number
Wheat ..	Rs. 3 a md.	100	Rs. 4 a md.	$133\frac{1}{3}$
Rice ...	Rs. 5 ,,	100	Rs. 4 a md	80
Sugar ...	Rs. 8 ,,	100	Rs. 5 ,,	$62\frac{1}{2}$
Pulse ...	Rs. 4 ,,	100	Rs. 3 ,,	75
Index Numbers	4)400(100		4)350$\frac{5}{8}$($87\frac{17}{24}$	

The Index number in the base year is 100 ; next year it is $87\frac{17}{24}$. This shows that prices have fallen or say the value of money has risen.

Necessary precautions while preparing them. Certain precautions must be taken while preparing the index numbers.

(1) First of all, *the base year must be carefully selected.* It should be a normal year, and not abnormal. By a normal year, we mean a year in which the prices are neither uncommonly high nor low. If that be the case, it would tend to mislead the average readers regarding the rate of increase or decrease of other years. For most of the comparisons, we generally take the year 1913 or 1939 as the base year obviously because these were the last years before the Great Wars when the prices were more or less stable all over the world. The official base year in India is 1873. As will be noticed later on, the succeeding years were the years of comparatively high prices, and thus abnormal. There are some who hold that no one year can be taken to be normal. For this purpose, they take a number of consecutive years, and regard the average of the prices in these years equal to 100.

(2) Secondly, *a fairly large number of representative commodities should be selected.* They should not be taken off and on.

(3) Thirdly, *the qualities of these commodities should not change in the different years* relating to which numbers are being prepared.

(4) Another point to be taken into consideration is

that *the figures of prices must be selected carefully*. If wholesale prices have been once taken into account only wholesale prices should be taken into account in other years as well. It may, however, be added that it is not always possible to obtain reliable figures of retail prices, and our official index numbers are, for this very reason, prepared only on the basis of the wholesale prices.

(5) *Difficulties arise also due to the constant shifting of human wants.* It has been observed that the articles of great importance in one period lose their importance in another period and sometimes cease to be consumed at all.

(6) Finally, *all articles are not necessarily wanted by everybody and perhaps in the same proportion*, and hence all index numbers prepared do not hold good for all purposes. They must be prepared with a definite object in view and should take into consideration the points affecting it the most.

2. Weighted index numbers

While preparing the index numbers, some statisticians also take into consideration the importance of the commodities selected, and as they do it by giving to each *proper weight*, the index numbers so prepared are called weighted index numbers. Supposing wheat, rice, sugar and pulse are consumed in the ratio of 8, 2, 1 and 1, the weighted index number table from the previous data will be as follows :—

Articles		*Base year*		*Next year*
Wheat	...	$8\times100=800$	...	$8\times133\frac{1}{3}=1\ 66\frac{2}{3}$
Rice	...	$2\times100=200$	...	$2\times80\ =160$
Sugar	...	$1\times100=100$	...	$1\times62\frac{1}{2}\ =62\frac{1}{2}$
Pulse	...	$1\times100=100$	....	$1\times75\ =75$
		12)1200(100		12)1364½(113$\frac{42}{72}$

The weighted index number is, therefore, $113\frac{42}{72}$, and it gives *a more correct view* of the changes in the prices than the ordinary index number which is $87\frac{17}{24}$. As is evident while the ordinary index number shows a fall in the general level of prices, the weighted index number shows a rise in this case, and thus conclusion is reversed.

But most of our index numbers are unweighted, firstly because there is the difficulty in obtaining reliable statistics of total expenditure, and secondly because the relative quantities of different commodities change considerably between one period and another.

3. Services of index numbers

Index numbers are very useful :—

(1) They enable us to measure *changes in the purchasing power of money.* If general prices double, the purchasing power of money in general is halved.

(2) Cost of living index numbers show whether *real wages are rising or falling,* money wages remaining unchanged.

(3) *The movement of prices in different countries may also be studied* with the help of index numbers, though no exact comparison can be made with regard to the changes in some or all of them, as the basis of their construction differ in different countries.

(4) They furnish *a standard to keep general prices stable.* They form the basis of the composite standard of the value.

(5) Index numbers also furnish *a basis for the equitable discharge of long-time debts.* We know that with a fluctuation in the prices, there is also a change in the debtor's position. Hence, the amount of the money debt may be so varied as to avoid it.

In conclusion, it may be pointed out that the index numbers prepared on one basis may be useful for one purpose but not for another. For instance, cost of living index numbers prepared on the basis of the expenses of the industrial labourers will show only the changes in the cost of living of the industrial labourers and not in that of the agriculturists.

Index numbers of prices and costs of living are prepared all over the world with the sole exception of the Soviet Union mainly because of the services they offer, as enumerated above.

4. Index numbers in India

Index numbers of wholesale prices in India during the years 1861-1931 are available in the publication 'Index Numbers of Indian Prices 1861-1931' and those from 1931 to August 1941 in the addenda to it. Since the last mentioned date, it has been *discontinued.* The above publication and the addenda thereto were issued by the Director-General of Commercial Intelligence and Statistics, Calcutta. They contain (1) the unweighted index numbers of 28 articles of export ; (2) the unweighted index number of 11 articles of import ; (3) the general unweighted index numbers for 39 articles of export and import and (4) the weighted index numbers of 100 articles.

The following table contains these index numbers since 1925. Price in 1873=100

Year	Exported articles 28 unweighted	Imported articles 11 unweighted	General index numbers for all 39 articles unweighted	Weighted index Nos. (100 articles)
1925	233	211	227	265
1926	225	195	216	260
1927	209	185	202	258
1928	212	171	201	261
1929	216	170	203	254
1930	177	157	171	213
1931	125	134	127	157
1932	120	139	126	149
1933	118	128	121	139
1934	117	122	119	136
1935	128	122	127	149
1936	127	122	125	150
1937	133	144	136	155
1938	128	142	132	147
1939	133	137	134	157
1940	158	183	164	Not available.
1941 Seven monthly average.	Not available	Not available	181	,,

The Economic Adviser to the Government of India now publishes in place of the above a Monthly survey containing Index Numbers for the prices of 23 commodities in one group and also in four groups of 8, 3, 7 and 5 commodities respectively. A sensitive index called the primary commodities index is also published on the basis of 18 agricultural commodities. An index for chief articles of exports is also complied on the basis of the prices of 15 raw and manufactured commodities. The base for the index is the week ended 19th August, 1939.

The above authority also publishes wholesale price

index numbers for Calcutta. The governments of Bombay and the United Provinces also compile and publish similar wholesale prices index numbers for Bombay and Cawnpore respectively. The governments of Sind and Madras also did the same. But since 1942, they have discontinued it. The following table gives these index numbers since 1925 : –

Wholesale price index numbers for Calcutta, Bombay, Karachi, Cawnpore and Madras.

Year	Calcutta (July 1914 = 100)	Bombay (July 1914 = 100)	Karachi (July 1914 = 100)	Cawnpore (1913 = 100)	Madras (week ended 21st August 1939 = 100)
1925	159	163	151	...	...
1926	148	149	140	...	...
1927	148	147	137	...	...
1928	145	146	137	...	...
1929	141	145	133	...	...
1930	116	126	108	...	...
1931	96	09	95	...	...
1932	91	109	99	...	...
1933	87	98	97	...	...
1934	89	95	96	...	...
1935	91	99	99	...	...
1936	91	96	102	117	...
1937	102	106	108	92	...
1938	95	101	104	85	...
1939	108	109	108	101	...
1940	120	118	116	100	119
1941	139	137	120	104	137
1942	185	219	×	175	192
1943	307	256* Ten monthly average		304	270* Five monthly average

The various Provincial Governments publish in their respective Gazettes fortnightly and monthly statements of retail and wholesale prices of certain important commodities. In addition to these, some Provincial Governments also publish *working class cost living index numbers.* Such index numbers are being published regularly every

*Discontinued.

month from and for the following areas : for Bombay, Ahmedabad, Sholapur by the Labour Office of the Government of Bombay ; for Nagpur and Jubbulpore by the Department of Industries, Central Provinces and Berar ; for six centres in Bihar by the Commissioner of Labour Bihar ; for Madras, by the office of the secretary to the Commissioner of Civil Supplies Board of Revenue, Madras ; for Lahore, Sialkot, Ludhiana Rohtak and Multan, by the office of the Director of Industries, Punjab and for Cuttack, by the Director of Development, Orissa. In addition to these series, working class cost of living index numbers for Jalgaon in the Bombay Province and for Bangalore in the Mysore State and cost of living numbers for low paid employees at eight places in Madras Province and for low paid Government servants at five places in the United Provinces are at present being compiled.

The inadequacy as also the general unreliability of the Indian price statistics has been subject of comment by many Committees and Commissions of Enquiry including the Indian Economic Committee of 1925, the Royal Commission on Indian Labour and also by Messrs. Bowley and Robertson who were invited by the Government of India to advise them on the question of obtaining more accurate and detailed statistics. The eleventh Industries Conference held at Mysore in December 1939 and the first Conference of the Labour Ministers held at Delhi in January 1940 recommended that the Central Government should undertake legislation to facilitate the collection of statistics relating to industries. In pursuance of this recommendation the Government of India introduced in the Legislative Assembly in 1942 a bill on the subject which has since been passed by the Central legislature and received the assent of Governor-General. This act which is called the Industries Statistics Act, 1942, empowers the Provincial Governments to arrange for the collection of statistics relating to prices of commodities as also certain other matters like wages, employment, industrial disputes, etc.

In view of the inadequacy of the existing retail price data, especially from the point of view of compiling cost of living index numbers, the Court of Enquiry constituted in August, 1940 under the Trade Disputes Act, 1929, under the Chairmanship of the Hon'ble Sir B. N. Rau to investigate the question of dearness allowance for the railway employees recommended that the Central Government should take up the work of preparation and maintenance of cost of living index numbers for three distinct classes of area in India, *viz.*, city, urban and rural. This recommendation led the Government of

India to consider the formulation of a centrally controlled scheme for the preparation and maintenance of cost of living index numbers for important places in British India and a tentative scheme has been outlined. The scope of the scheme is understood to have been limited at present to the preparation of figures for industrial labour (excluding plantation labour) as the necessity of such figures arises mainly in connection with disputes concerning Indian labour. A special post of the Director, Cost of Living Index Scheme, has been created and a Committee of experts has been appointed to assist him. Unweighted retail price index numbers for 15 selected rural centres in British India where cost of living index numbers are not available are being published by this authority.

5. Principle of Index Numbers

In the preparation of all index numbers whether in India or elsewhere and whether on the basis of weighted or unweighted averages, there is only one big principle involved, and it is that they seek to set aside the irregularity of the individual instance and replace it by the regularity of the big numbers. *The particular is eliminated and replaced by the general.* They are, so to say, averages.

SUMMARY

1. Index numbers are numbers representing prices and are prepared for the purposes of their comparison over different periods. While constructing them the price in the base year are taken to be equal to 100, and then the prices in other years are changed in numbers by reducing or increasing them in the proportion of their variation. All this, however, is to be done with great care.

2. We may have weighted index numbers as well. What is done in this case is that due weight is given to the commodities chosen in accordance with their importance.

3. Index numbers are of great use. But those prepared with one object can rarely serve another object.

4. Index numbers of wholesale prices in India were prepared upto the year 1941 by the Director-General of Commercial Intelligence and Statistics, Calcutta. They have been now discontinued. But this agency prepares index numbers for Calcutta as well. Also the Government of some provinces prepare index numbers for one of their important towns each. Finally, some cost of living index numbers are also prepared by certain Government and private agencies. The arrangement is, of course, inadequate. Recently, an important enactment has been passed in this respect.

5. The principle of index numbers in all the cases is only one, **viz.**, the elimination of the particular and its replacement by the general.

TEST QUESTIONS

1. What is index number? Explain carefully the method of constructing a simple index number. What precautions should be taken in preparing the same. (*Agra—B. A.*)

2. What do you understand by weighted index numbers? How are they prepared? Write a note on their importance.

3. What are the different services which can be rendered by index numbers? Do you think that they can be universally applied? If not why?

4. What do you know of the different index numbers prepared in India? Give your own opinion regarding their adequacy.

CHAPTER IX

MONETARY STANDARDS

"*By a standard we mean a thing with which to compare.* Our standard of length is a yard, and where we wish to express lengths we compare them with this fixed length. We can make this standard of length an invariable one; and, when men began seriously to consider what standard of value should be adopted, it seemed to be axiomatic that the selected standard should, in measuring values also, be invariable. This would imply that the monetary unit should always have the same power over the market. And, to the people, it appeared long long ago that the desired invariability in the standard could be attained by making the monetary unit equal in value to the value of a specified weight of fine gold or silver."[1] No doubt the idea has been abandoned since; and at present in almost all the important countries the monetary unit has been divorced from these metals.

1. Definition of a Monetary Standard

A monetary standard, as is obvious from what has been said above, can be *defined* as the standard or object with reference to which the value of a monetary unit is regulated. In case, it is gold, it will be called gold standard; in case it is a fixed quantity of goods and services, it will be called tabular standard as index numbers which are in the form of tables are required to be prepared in this case. It is also possible that the value of the monetary unit of a country may be regulated with reference to that of another, say sterling—the monetary unit of the United Kingdom—or dollar—the monetary unit of the United States of America. If this is the case, the standard will be called the particular exchange standard, *e.g.*, sterling exchange standard or dollar exchange standard.

2. Classification of Monetary Standards

Below is given a classification of the various monetary standards:—

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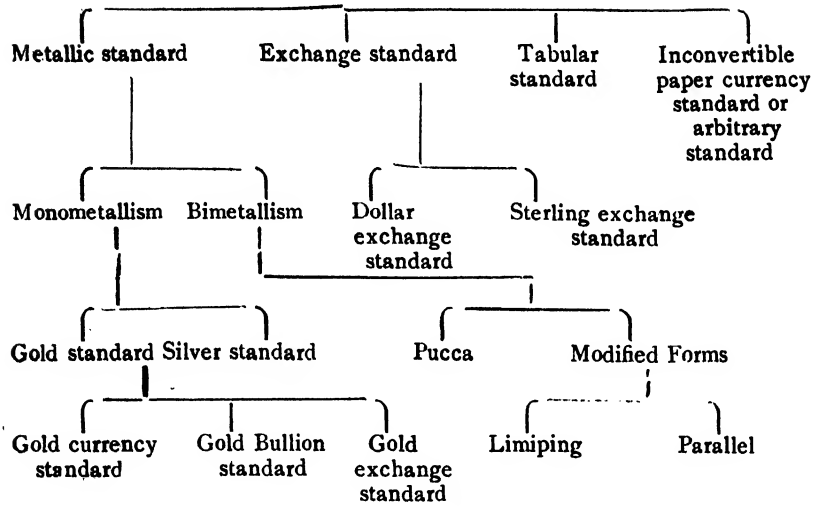
[1]The truth of this statement can be realised by looking into the beginnings of English currency system as contained in the appendix.

MONETARY STANDARDS



3. Gold Standard

Gold standard is a system of currency wherein the value of the monetary unit of a country is *regulated with reference to gold*. It may take one of the three forms, *viz.*, gold currency standard, gold bullion standard, and gold exchange standard.

Gold Currency Standard. At first, gold standard took the form of gold currency standard. For a long time the term gold standard implied gold currency standard. Under this standard, *gold acts both* as a *medium of exchange and as a measure of value*. That is, gold is coined freely and coins of gold are standard coins. They circulate. Paper money, if in circulation, is convertible with them at the option of the holder.

The essential features of a gold currency standard are that

(1) gold coins are in actual circulation,

(2) mint is open to the public for their coinage,

(3) there is no restriction on the export and import of gold, and

(4) any other currency, if in circulation, is convertible into gold currency.

This standard was first adopted by Great Britain in the year 1816. It was later on adopted by several other countries, and gradually came to be regarded as an ideal standard all over the world. It gave way, however, during and after the war of 1914-18 ; and when currencies

were restored to gold after sometimes, another form of gold standard had come in vogue.[2]

Gold Bullion Standard. Gold bullion standard is a modified form of gold standard, first adopted like gold currency standard by Great Britain in 1925. Under this system *while gold is the measure of value, it no longer circulates as coins.* It is a gold standard without a gold currency. The government, herein, does not issue gold coins, but binds itself to purchase and sell gold bullion in exchange for internal currency which may consist of paper money and coins of baser metals, at fixed rates. This provides a true link between the circulating media and gold between which the maintenance of a permanent ratio is ensured for ever. Exports and imports of gold are also allowed without any restriction whatsoever. The example of Great Britain was later on followed by several other countries.

The essential features of a gold bullion standard are also the same as those of a gold currency standard with the only difference that the currency does not consist of gold. Instead, it is exchangeable with a fixed quantity. Evidently, it does not matter much whether the currency consists of gold or of something else provided it is exchangeable with gold, as money we know is not an end in itself but a means to an end, and anything which is exchangeable with gold will serve the same purpose as gold coins. A pound note purchased as much as a sovereign (gold pound) so long as it was exchangeable with sovereign or gold contents of sovereign. Such was the condition obtaining in Great Britain during the regime of the gold bullion standard from 1926 to 1931.

Gold Exchange Standard. Gold exchange standard resembles gold bullion standard in many points. Under this standard as well, the circulating media does not consist of gold currency. It may consist of paper money, and coins of other metals than gold. *This currency is exchangeable with gold for delivery in a foreign country or it is exchangeable with a foreign gold currency.* In the latter case, some people prefer to call it *gold currency exchange standard.* The one essential difference, therefore, between this standard and the gold bullion standard is that while under the latter, currency in circulation and gold bullion are exchangeable for delivery within the country, they are exchangeable under the former only for delivery of gold outside the country. In this case

[2]Writing in 1913 Keynes said, A gold standard is the rule now in all parts of the world ; but a gold currency is the exception. England had developed the use of cheque currency. All other important countries had silver coins and notes in circulation.

gold stocks need not be maintained, maintenance of sufficient balances with banks in foreign countries having gold standard serves the purpose. This system was first adopted by Holland in 1877 and then by Russia and Austria-Hungary in 1892. India[3] and several other countries adopted it later on. This was the standard which was adopted after the war of 1914-18 by those countries of Central Europe as well whose currencies had to be entirely reconstituted due to their unlimited depreciation. It was recommended at the Genoa Conference of 1922, and its fundamental principles may be said to have affected almost all monetary systems during the last twenty-five years.

Advantages of gold bullion standard over gold currency standard and gold exchange standard. Gold bullion standard has certain advantages over both gold currency standard and gold exchange standard.

(1) *A comparison with gold currency standard,* (*1*) *'Gold coin is, in fact, an imperfect application of the gold standard,* Its use leads to uncertainty and variation in its nominal gold value through the imperfections and the wear and tear of coins.

(2) *Gold bullion standard, on the other hand, is economical,* firstly, because there *is no loss due to wear and tear,* secondly, because *the cost of minting the coins is saved* and finally, because under this system *a lesser quantity of gold is required* by each country than under gold currency standard.

(3) It is also obvious that due to the fact mentioned in (2) *a larger number of countries can adopt gold standard* of the gold bullion type than that of the gold currency type. In fact, it was only when the scarcity of gold had begun to be felt that this system was introduced.

(4) The quantity of gold saved by each nation yields an *income from investment.*

(5) Finally, it is also a decided fact that *gold in reserve is more useful for the stabilization of exchanges than gold in circulation.*

A comparison with gold exchange standard. (1) It may be said that *while gold exchange standard possesses all* the *advantages of the gold bullion standard it falls short of it in respect of confidence.*

(2) As a result of the fact mentioned in (1) *it checks the development of banking and investment habits.* All

[3] But India was the only country which adopted it in a complete from of it according to Keynes, *vide* Indian, Currency and Finance, page 33.

the savings, under the circumstances, are *hoarded* in the shape of precious metals.

(3) As a consequence of the (2) *production suffers or else the resources of the country are exploited by the foreigners.* The conditions in our own country can be cited as an illustration.

(4) *Gold exchange standard is not automatic.* Under an automatic system of currency, *e. g.*, (1) the gold currency standard, when gold in circulation is in excess of the needs of trade, excess gold in circulation is melted down or exported, and (2) the gold bullion standard, when currency in circulation is in excess of gold it is tendered to the Government and gold obtained. Under the gold exchange standard also, it may be supposed that currency in circulation would be reduced when it is tendered in exchange for the delivery of gold in a foreign country. But it depends *on the will of the government* which may reduce the currency by the full amount of the gold sold or by a smaller amount. This was the case in India, during the regime of the gold exchange standard as is evident from the Report of the Indian Currency Commission, 1925, which refers to the absence of contraction on occasions when the currency authority has had to sell sterling exchange.

(5) *Gold exchange standard is not elastic, i. e.*, it does not make a provision for an increase in currency in busy seasons and times of financial crisis When crops have been harvested and are moved, there arises an increased demand for currency which can, however, be not ordinarily met without their being exported. No doubt, a remedy lies in the increase of credit instruments and paper money on their basis.

What the golds tandard implies. From the preceding discussion, it is obvious the gold standard may exist without gold currency in actual circulation. Then, the question may well arise in the words of an eminent writer on Banking 'How can we say that a gold standard is effectively maintained?' The answer is, this is possible by finding out *whether the value of the monetary unity in circulation is regulated with reference to gold or not*, and if this is so, it is gold standard It is also possible that the currency in circulation may consist of gold, but the standard may be different. In our own country, we have silver currency in circulation, but as since 1893, its value is regulated with an object different from silver, it is not silver standard. The same may be the case with gold currency in actual circulation. What is required is that *in case of a gold currency in actual circulation mint should be open to the public for its free coinage, and in case*

of a representative currency, it must be convertible into gold at a fixed rate. The price of a standard ounce of gold is fixed under the circumstances in gold currency or the currency actually in circulation. It was in Great Britain £3. 17s. $\frac{1}{2}$10d., though Bank of England gave actually £3. 17s. 9d. Thus there was a loss in the latter case, but the mint which gave £3. 17s. 10$\frac{1}{2}$d. could keep one waiting for days which would cause loss in interest. This was known as the *mint price of gold*. So long sovereigns were in circulation, £3. 17s. 10$\frac{1}{2}$d. contained one standard ounce of gold and when they had gone out of circulation and paper currency remained linked with gold, notes worth this amount could be exchanged with this quantity of standard gold. Gold standard also implies that *there should not be any embargo on export and import of gold*, and if so, the government of the country should facilitate foreign exchanges at least.

Break down of gold standard and steps taken thereafter. Gold standard broke down at first during and after the war of 1914-18, and next during and after the slump of 1929-33. The reason which led to this step on these two occasions were, however, different.

Break-down during and after the war of 1914-18. Coming to its break down during and after the war of 1914-18, it may be said that while in some of the countries *e.g.*, France, Germany, Russia and Austria-Hungary, *this was done by their respective legislatures*, in others, as in England and U. S. A. *it ceased to work because of the obstruction on the export of gold*—in the former though not by law, partly through inevitable difficulties of transport in war-time and partly through official pressure—and in the latter, in 1917, when it entered the war, by law itself. Then, this happened *not only in belligerent but also neutral countries*, so much so, that all the thirty-two countries which had gold standard before the outbreak of the war, had lost it either during or after it—though U. S. A. had revived it in 1919 soon after the signing of the armistice.

Causes for break-down in belligerent countries. (1) The one reason for which belligerent countries relinquished gold standard at this period was the same as made gold in ordinary times the basis of currency, *viz.*, the fact that *its supply is inelastic*. It was pointed out in a previous chapter that the annual increment to it makes only the slightest impression upon its total amount. The war compelled belligerent governments to raise colossal sums of money which could not be done either by taxation or by borrowing or by both, alone. Under the circumstances, *they had to resort to the issuing of money without caring*

for any Cover against it, or for its convertibility. But inflationary finance is about as prudent as eating the seed corn, and the result was that in some of the countries it had gone by the end of the war completely beyond control.

(2) Another reason for which this was done was *to safeguard gold reserves.* Because of the inflationary finance and inconvertibility of paper money, there was depreciation of prices, or say gold had acquired premium and there was a natural tendency for its being exported to foreign countries in payment of the imports. Hence, the need for checking it was felt, and an embargo had to be placed which in itself meant the abandonment of gold standard.

The reason for break-down in neutral countries. The reason for break-down in neutral countries was *the depreciation of gold itself* in relation to commodities. Belligerent governments sold much of their gold to such countries to pay for urgently needed supplies, and the latter's demand for it was swamped by the enormous quantity thus let loose. The result was obvious: a great rise of prices in them or say a depreciation of gold itself in relation to commodities. After the revival of gold standard by the United States of America as pointed out previously, in 1919, soon after the signing of the armistice and consequent withdrawal of the prohibition on the export of gold, large amounts of it were exported to such countries as Japan and Argentina where gold standard was till then in operation. 'By May 1920 the price level in terms of gold, as measured by the American index number was 2½ times what it had been in 1913, or in other words value of gold in terms of goods was only two-fifths of what it had then been. There followed a violent contraction of credit in the United States, which reduced prices by more than 40 per cent in 12 months.' Countries which had till then preserved gold standard were unable to keep pace with this precipitate movement, and had to give it up. Hence, in course of time the United States was the only country in which gold standard remained operative, and there being no other buyer of gold for monetary purposes, all the surplus gold of the world graviated thither.

Need for the revival of gold standard after its first break-down. After the signing of the armistice and revival of gold standard by the United States of America, there arose once more an eager desire on the part of almost every country to get back to it, and this can be easily understood, for *when the currencies of the world were securely based on gold, prices and exchanges were more or*

less stable. Difficulties were felt neither in connection with the internal nor that of the external trade. But since they were not so, stability of both prices and exchanges had gone away. The drawbacks attendant upon it were felt, and people wanted to be free from them. At the Genoa Conference, in April 1922, representatives from all over Europe, and outside Europe from Japan and the British Empire meeting together to consider their economic future, laid stress on the avoidance of inflationary finance and stabilisation of currencies.[4]

Recommendation of Genoa Conference, 1922. They for the first time put forward a scheme of reconstruction which recognised *influence of each country's currency system on world demand for gold* and therefore, upon the monetary affairs of all the others. Prior to the war, each central bank maintained the value of its currency in terms of gold, and hence the value of every one of them in relation to every other was approximately fixed. But the value of all in terms of commodities varied, because the value of gold varied due to the variation in its demands of different countries themselves for monetary purposes. Hence, it was suggested at the conference referred to above that the central banks could, by co-operating between themselves, control the latter, and thus enable the former to conform to the value of currency units instead of the value of the currency units conforming to it. This was, so to say, *international gold standard.* With a view to economise gold whose shortage was envisaged, as has already been said, its *gold bullion and gold exchange forms were also recommended by it.* The fact was that the people belonging to the countries which had been the greatest users of gold coins before the war had by then, become thoroughly used to paper money, and were prepared to discard gold. Efforts in Switzerland and Holland to reintroduce gold coins into active circulation did not materialise. The advantages of gold bullion standard and gold exchange standard over gold currency standard had, in fact, by that time, begun to be realised everywhere.

Revival of gold standard after the first break-up. The United States of America was the first to revive gold standard, and soon those countries of Eastern Europe which had suffered from complete monetary collapse followed suit. It may be said that they did not attempt at this stage to accumulate metallic reserves, but were content with reserves of foreign exchanges which means that the form of gold standard adopted by them was that of the *gold exchange standard.* Then came Great Britain. It

[4] This had also been done by the first World Conference held in Brussels in 1920.

adopted the *gold bullion form* in 1925. Then, all the rest. So that by June 1931, all except Spain which had been on gold standard prior to the war had once more returned to it. But it is remarkable that almost all of them took steps to avoid any undue encroachment on the world's stock of the metal in question.

Abandonment of gold standard during and after the slump of 1929-33. The scales had begun to be turned by 1929. The second slump in prices since the end of the War of 1914-18 had set in. The period of general world prosperity which became evident about 1925 as a result of the cumulative efforts at economic reconstruction, included among which was the restoration of gold standard came to an abrupt end. On the 29th of October of 1929 there was a tremendous crash on the New York Stock Exchange and thereafter a swift recession in prices which spread throughout the world though not as a result solely but mainly of the former. It may be added here that most of the countries which had been attempting to reconstruct their economic life with borrowed capital had found themselves unable to obtain loans even before the crash because of the boom due to which the United States of America—the one of the two countries financing them—could not spare funds. But after the crash, it was still less able and the conditions in the debtor countries having greatly deteriorated, much less willing, to lend. As a result, they had to endeavour not merely to carry on without the accustomed influx of capital but also to pay the interest on the accumulated debt. This led them to place additional[5] restrictions on importation in order that they may have favourable balances of trade with the result that, *as each began to close its markets against all, the difficulties became even acuter and prices fell all over the world* The crisis developed first in agricultural and then in manufacturing countries, as prices of agricultural commodities in general tend to fall more rapidly than those of the manufacturing commodities. As a result, the Argentine and Uruguay suspended gold payment in December, 1929; Canada, in the same month, introduced restrictions on gold exports, though she was back on gold standard for a short time again by June 1930. In 1930, the exchanges of Brazil, Chile, Venezuela, Paraguay, Peru, Australia and New Zealand fell and remained below the gold export point. Next came the turn of the manufacturing countries as well. They, however, belonged mostly to Europe, and as such France which was the other financing country helped them for some time. But it was impossible for them to sustain for long. The crisis was postponed but

[5] Tariff barriers had been built everywhere prior to this as well.

could not be averted. The trouble first arose in Austria, a country which had been reduced by the Peace Treaty to an impossible economic position, a great metropolis shorn of its surrounding territory and opposed by high tariff barriers on its new restricted frontiers. For a time the Austrian Credit Anstalt, historically the most important banking institution in Central and Eastern Europe tried to pull on, but soon it collapsed. Then came the turn of the great Danat Bank of Germany. This led to a loss of confidence in other central banks as well, and as a result the funds began to be withdrawn from the Bank of England wherein almost every country kept its money. *This of course meant a drain of gold, which had ultimately to be stopped* by the abandonment of gold standard. In fact, Great Britain had been labouring hard against all odds due to its having restored the pound to the old gold parity in 1925 while others had restored their currencies at much lower parities. There was as a result of this, *a lack of adjustment between the external and the internal price-levels.* The effects of the suspension of gold standard by Great Britain were far-reaching and catastrophic. A number of other countries quickly followed suit and by the end of 1931, they included Canada, India and nearly all the British Colonies, Egypt, Norway, Sweden, Denmark, Finland and Japan. Mexico had gone off the gold standard in July of this year. A few countries notably South Africa left in 1932, and then came the abandonment by the United States in April 1933 followed by further fall in South American countries. At last there remained by the middle of 1933 a genuine gold standard only in France, and a nominal gold standard maintained by exchange control in Czechoslovkia, Poland, Switzerland and Belgium. But they too had to devaluate their currencies several times after that. An attempt of the United States to adopt gold bullion standard in 1934 was further foiled up in that very year. But this is the only country whose government has been since then always prepared to buy gold at dollars 35 for an ounce.

Reasons of the break up of gold standard a second time. From what has been said above, it is obvious that the cause of the abandonment of gold standard during and after the slump of 1929-33 was *the appreciation of gold* which in other words means *fall in prices.* Production of goods had increased during the twenties, but the quantity of money did not. There was, in fact, scarcity of gold as the United States of America where it had accumulated in a huge quantity did not allow it to move to other countries. Ordinarily there operates what is known as the *rule of gold standard* which means there is a constant

movement of gold from the countries where it is in abundance to the countries where it is scarce. When currencies are linked with gold, its increase brings about an increase in currency as well. As a result, prices rise and the balance of trade turns unfavourable. Thus gold flows out. Quite contrary to this is the position in countries where it is scarce. But this could not take place during this period. U. S A. did not allow its currency to increase with an increase in its stock of gold; the latter had been sterilised. Hence, it could not move from there. In the beginning. U. S. A. viewed the gold shipments from U. K. with much misgiving—so much so that the Washington administration, alarmed by the possibility of an unwanted credit expansion, informed the British Government that these would in future be regarded unfriendly. But soon the policy changed. The increase of the gold stock was no longer regarded to be against the interests of the country. An embargo was placed on its export! But even at this time, while admitting European gold, it emphasised the essentially temporary character of the influx, and regarded the whole merely in custody. But its sterilisation had the effect of giving it a permanent character. During the course of the next few years, the idea that it was held in trust began to be discarded. The whole increased gold stock had gradually begun to be considered as a necessary part of the country's monetary structure. But as such, it should have been used for the expansion of currency and credit. Had this been done, matters would have become all right. As it was apart from a few brief spells during which the United States lost gold, the American gold stock increased persistently until 1931. Even on rare occasions when it was lost, although the losses never amounted to more than a fraction of the unused surplus, there was evidence of uneasiness in the press, in banking circles and in government quarters as well. Admittedly from 1925 onwards, U. S. A. lent abroad, and this led from time to time to some export of gold, but to a large extent it was accompanied by an increased favourable balance of trade. After the crisis of 1931, of course, it lost large amounts of gold between October 1931 and the suspension of gold standard in March 1933. In fact, the latter step was a consequence of it. Then, for the next four months, *i. e.*, until the dollar was established, movements of gold to and from U S. A. were at a standstill. But thereafter, there began another period of gold influx which, insignificant interruptions apart, continued till 1942.[6] Finally, in spite of all that has been

[6]Since 1946 because of the cessation of lend-lease, gold has again been coming to U. S. A.

said by press, official quarters in Washington have made it quite clear in a number of statements made from time to time that they have no intention of resorting to either a limitation of gold purchases or a reduction in its price. Rather there is a possibility of an increase in it.

Yet another condition of the satisfactory working of gold standard, *viz.*, *laissaz faire* as is clear from what has been said previously, was not allowed to exist. We have seen that a system of state regulation and control had grown up everywhere before the abandonment of gold standard second time. The world market so to say had disappeared. Instead, it had broken up into more or less sufficient politico-economic blocks.

In most countries, specially Great Britain, there was also a lack of adjustment in external and internal prices. This caused a drain of gold ; and to prevent it the abandonment of gold standard was the only course.

Difference in the steps taken after the break-down on the two occasions. The steps taken on this occasion were quite different from those taken on the previous. First of all, *while in the former case there was an ultimate return to gold standard, in the latter case it was not so.* In the former case, we know that :—

(1) Some countries after a period of hyper-inflation, started a new currency on gold basis ;

(2) Other countries managed to steady the fall in the value of their currency units and then devalued, either keeping the old name as in the case of the French franc, or adopting a new one ; and

(3) A few countries fought their way back to gold by a deflationary price-level.

In the latter case,

(1) There was no hyper-inflation ;

(2) There was no return to gold by a drastic deflationary policy ; and,

(3) When the strain became too great, the usual plan followed was to allow the currency to depreciate, but when it was possible to steady the fall, the return to gold was not made : the currency merely floated at its own level without any anchorage. This was no doubt not true in the case of some of the countries, *e. g.*, Belgium and the United States which definitely devalued.

In the latter case, there was also the growth of controlled exchanges, governments making their currencies available only at official rates which were undoubtedly higher than what the uncontrolled rates would have been.

But as this resulted in a hindrance to trade, a considerable number of clearing arrangements were made.

Finally, *exchange equalisation funds to obviate undue fluctuations in the currencies were also established during the latter period.*

Merits and demerits of gold standard. When the principal nations of the world, after the signing of the armistice in 1919, were looking forward to the restoration of gold standard as the only escape from the chaos then prevailing, criticism had begun to be directed against the *imperfection of that standard itself.*

(1) *Purchasing power of gold exposed to violent fluctuations.* It was being pointed out that recent experience had shown that the purchasing power of gold was exposed to violent fluctuations specially because the market for it had, for the time being, gone under the arbitrary discretion of the United States. 'In the nineteenth century people had been content to assume that the world market in the precious metals was big enough not to be disturbed by movements originating in any one country. They took it for granted that gold or silver could be bought or sold 'abroad' much as an electric current can be directed to 'earth' and that is the end of 'it.' But there are events[7] which go to prove that they were mistaken. This was, in fact, not possible without the co operation of all the countries. It had, however, been fully realised at the Genoa Conference (1922) as is obvious from its suggestion regarding it referred to previously, *viz*, that of an international gold standard, with a view to control demands of the various countries for gold, and hence its value in terms of commodities. Evidently, they thought that both the prices and exchanges could be controlled in this way, instead of only exchanges as had been the case during the regime of the pre-war national gold standard.

(2) *Gold standard necessary for the maintenance of neither prices nor exchanges.* But there were people who held that gold standard was necessary for the maintenance of neither prices nor exchanges. Keynes particularly observed that the stabilisation of the currency unit, which is the ideal of all monetary systems, is effected quite independently.

(*a*) *The holding of a huge amount worth of gold in stock and the purchase of still more to add to it are pure waste and its use actually endangers the stability of the currency unit.* He argued that the holding of a huge amount worth of gold in stock and the purchase of still

[7] France's continunace of bimetallism for a long time, and Germany's adoption of gold standard in 1872.

more to add to it are pure waste and its use actually endangers the stability of the currency unit. Those countries which possess the redundant stocks of it may flood the market and lower its value. Or others which have hitherto been content to work a gold exchange standard with little gold may start accumulating reserves and raise its value.

(*b*) *Variations in the rates of exchange can be secured through the instrumentality of an exchange standard without any metallic medium.* In fact, the main advantage of the use of a common standard by different countries as claimed by the people is that the variations of the rates of exchange can be kept within narrow limits. But Keynes said that this advantage could be secured through the instrumentality of an exchange standard without any metallic medium Every country could keep a reserve of foreign currencies and make its currency convertible into them. And this is exactly what is being done these days.

(*c*) *Stabilisation of prices leads to the stabilisation of exchanges as well and the former could be done without any metallic medium only by the regulation of the quantity of money in relation to the demand for it.* Keynes did not insist even on a stabilisation of the foreign exchanges. He rather wanted to keep the value of the currency unit fixed in terms of commodities ; and this could, he maintained, undoubtedly be done without any metallic medium only by the regulation of the quantity of money in relation to the demand for it. But he hoped and rightly too that if each country succeeded in stabilising the value of its own currency, the values of all currencies in terms of one another would be stabilised.

This view was also held by Gustav Cassel, another economist of repute who, writing in 1928 said, the endeavours to stabilise the world's currencies after the great monetary revolution connected with the War have hitherto resulted in an universal return to gold standard. Theoretically this solution was not necessary. The world had a system of paper standard, and if each of these paper standards had been simply stabilised at a certain purchasing power against commodities, the world would have had a satisfactory monetary system. *Stabilisation did not in itself require that the separate currencies should be bound up with the value of gold : The possibility of a rationally regulated paper standard had already been demonstrated by scientific investigations.*

But as he said further, 'In spite of this, it was a practical impossibility at that time to bring the world at large to accept the programme of a scientifically regulated paper standard. The extremely discouraging experiences

of mismanaged paper standards had fostered a deep-rooted distrust of every form of paper standard. The programme in itself may have been ever so sound. The time for realizing it was, no doubt, the worst that could be imagined. Had an attempt been made to persuade the world of the advantages of a scientific paper standard, the solution of the problem of post-war stabilisation would have been infinitely delayed. This had, at all costs, to be avoided. The need for an early restoration of a system of sound currencies was paramount. There was no time to be lost'.

Notwithstanding what has been said above, *i.e.*, the demerits of gold standard, it has its merits as well. There is the real need of a currency anchored to a concrete metal rather than one based upon the general level of prices

The need of a currency ancho ed to a concrete metal rather than one based upon the general level of prices. Balfour Committee reporting in 1929 for Great Britain during the period when the gold bullion standard was in operation in that country, strongly advocated a currency anchored to concrete metal rather than one based upon the general level of prices A composite standard of value as the latter is called, they pointed out, could only be based on rough approximations, derived from records of past transactions, and hence *not fairly representative* at the outset. 'Moreover even if it were so, they continued, *its basis would, over a long period, need periodical revision* in order to conform to changed conditions. *Nothing would convince the business world that in such periodic revisions the government of the day would always be free from political pressure.* Nor would there be any confidence that the controllers of a 'managed' currency *would always possess sufficient capacity, integrity and firmness,* and would enjoy sufficient powers and independence, to enable them to carry out their delicate task, free from aberrations due either to political, or economic influence, or to imperfect appreciation of the economic situation. *The whole superstructure of modern credit depends ultimately on the confidence of the commercial community* in the basis on which it rests, and we do not think that in the present condition of the world this confidence could be ensured by any system of currency management independent of a gold basis.

Conclusion. Since the abandonment of the gold standard second time the managed system of currency has been in operation all the world over, and all that has been said above either in favour or against the gold standard has been undoubtedly proved.

Future of gold and gold standard. As the world has now become accustomed to the managed system of currency, and there seems to be no use of gold for monetary purposes excepting as a corrective to exchange fluctuations and for settlement of foreign payments through the agency of exchange equalisation and international monetary funds, people have begun to doubt the very future of gold and gold standard. Most countries of Europe had been *keeping out of gold craze* of the thirties. From some countries there were *gold exports* as well, *e.g.*, India and the principal gold producing countries, *viz*, South Africa, Australia, Russia and Canada. But as against this, it may be said that U. S. A., England and France continued to purchase it. U. S. A acquired it over and above what it produced itself.

U. S. A., England, France and Russia have the greatest stake in the future of gold ; U. S A., because it is the biggest holder of this metal ; England[8] because it has to safeguard the prosperity of the three gold producing Empire countries, South Africa, Australia and Canada ; France because her people have an undying faith in the security of gold ; and Russia because of being a big gold producer. These countries will, therefore, not allow any fall in its value. Rather there is a tendency to raise it.

Monetary management also has its limitations. The basis of credit structure must for ever remain gold. In the International Monetary Fund as well recently established fund a very important place has been assigned to this metal.

The fact that the gold scare[9] which had begun in 1935 and accentuated in 1937 could be put down so easily and rapidly also indicates how deeply rooted is the preference of the people for gold. It has emerged with its prestige unshaken from the severe test to which it was subjected. Hence, taking all these facts into consideration, we can say that we should not feel in any way pessimistic with regard to its future.

As regards the *future of gold standard*, it may be said that we shall not have it now in any of old forms, but the parities of the currencies shall be fixed with gold for external purposes. In some countries, they might also have to be fixed for internal purposes as well. This, of course, presupposes co-operation of all the governments. Recently, however, a number of schemes have been put

[8]England has lost its stock of gold during world war II.

[9]It indicates acute fears about reduction or fall in the price of gold ; of a suspension or limitation of official gold purchases at a fixed price ; or of a complete demonetisation of gold.

forward with this end in view; and out of these one is being put to use.

The scheme that is being put to use. The scheme that is being put to use was agreed to at the Bretton Woods conference and is known as that of the International Monetary Fund We give below its brief summary.

(1) The Fund is to consist of 10,000 million dollars to be subscribed by the member countries. The quotas of those attending the Conference has been fixed, U. S. A. 2,750 ; U. K. 1300 ; Soviet Russia, 1,200 ; China 550 ; France 450 ; India 400 ; Belgium 225 ; Canada 300 ; Australia 200 ; Netherlands 275 ; South Africa 100 ; Iraq 8 ; Iran 25 ; Greece 40 ; Iceland 1 ; Egypt 45 ; Ethiopia 6 ; Ireland, liberia $\frac{1}{2}$ in million dollars and amounts to the aggregate of 8806 million dollars. The balance has been left for those joining at a later date. The obligatory gold subscription of each is 25% of its quota or 10% of its holdings of gold and gold exchanges whichever is lower. The remainder is to be paid in their respective currencies. As regards the location, local currencies are to be kept at their central banks and gold portion at any place to be decided by the members in future.

(2) The par value of a member's currency shall be agreed with the Fund when it is admitted to membership, and shall be expressed in terms of gold. After consulting the Fund, a member country may also change the established parity of its currency provided the proposed change inclusive of any previous change since the establishment of the Fund does not exceed 10%. In the case of application for a further change, not covered by the above and not exceeding 10% the Fund shall give its decision within two days of receiving the application, if the applicant so requests. An agreed uniform change may also be made in the gold value of member currencies provided every member country having 10% or more of the agreement quotas approves. All transactions between the Fund and members shall be at par.

(3) Member countries shall deal with the Fund only through their Treasury, Central Bank, Stabilisation Fund, or other fiscal agencies. A member shall be able to buy another member's currency from the Fund in exchange for its own currency or gold provided that the currency demanded is needed for making current payments and the Fund's total holdings of the currency offered (after having been restored, if below that figure, to 75% of the member's quota) have not increased by more than 25% of the member's quota during the previous 12 months and do not

exceed 200% of the quota. If, however, it becomes evident to the Fund that the demand for a member country's currency may soon exhaust the Fund's holdings of that currency, the Fund shall so inform member countries and propose an equitable manner of apportioning the same currency. So long as a member country is entitled to buy another member's currency from the Fund in exchange for its own currency, it shall also be prepared to buy its own currency from that member with that member's currency or with gold.

(4) The Fund will be entitled at its option to borrow or purchase for gold a member's currency with a view to preventing it from becoming scarce.

(5) While selling foreign exchanges to a member country, the Fund may also require it, so long as its holdings of gold and gold convertible exchanges exceed its quota to submit to it gold to the extent of one half of the net purchases of such foreign exchanges during the Fund's financial years. Besides, if at the end of the Fund's financial year a member's holdings of gold and gold convertible exchanges have increased, the Fund may also require it to re-purchase part of the Fund's holdings of its currency in exchange for gold to the extent of one half of its increase of that metal. But this is to be done only if the Fund's holdings of that member's currency does not fall below 75% of its quota and if the member's holdings of gold and gold convertible exchanges do not fall below its quota.

(6) A member country may not use the Fund's resources to meet a large or sustained outflow of capital, and the Fund may require the member countries to exercise control to prevent such use of the resources of the Fund. This provision is not intended to prevent the use of the Fund's resources for capital transactions of reasonable amount required for the exports or in the ordinary course of trade, banking and other business. Nor is it intended to prevent capital movements which are met out of a member country's own resources of gold and foreign exchanges provided such capital movements are in accord ance with the purposes of the Fund.

(7) The member countries have got the obligation (*a*) not to deal in gold at prices outside the prescribed parities, (*b*) not to allow exchange transactions in its markets in the currencies of other members at rates outside a prescribed range based in the agreed parities, and (*c*) not to impose restrictions on payments for current international transactions with other member countries or to engage in any discriminatory currency arrangements or multiple currency practices without the approval of the Fund.

(8) Special relaxations have been allowed by the Fund to member countries during transitional period which may last for 3 years after the termination of the hostilities. Member countries can, during this period, continue exchange controls, and by implications impose restrictions and payments for current international transactions with other member countries and also engage in discriminatory currency arrangements or multiple currency practices. The obligation to purchase their own currencies in exchange for other currencies or gold may also not be imposed during this period.

Note. The inaugural meeting of the Board of Governors of International Monetary Fund was held at Savanah (Georgia) from the 8th to the 18th of March, 1946. India was represented on it by Sir Chintaman D. Deshmukh, C I E, the Governor of the Reserve Bank of India The representative of America, Mr. Fred Vinson, was unanimously elected Chairman and the nominee of the United Kingdom (the Late Lord Keynes now succeeded by Dr. Dalton) was assigned Deputy Chairmanship. The bye-laws have been adopted and the date for admission of those signatories of the Bretton woods Agreement who have not yet joined as original members (and Russia is one of them) has been extended from the end of 1945 to the end of 1946. The first annual meeting of the full Board of Governors was fixed for September. 1946, and pending that a procedure committee of 12 was appointed. In addition, the Executive Directors were also elected. In terms of the Agreement, in addition to the five Executive Directors appointed by nomination by the Big Five (India being one of them, Russia having not joined), seven Executive Directors from amongst the members have been elected.

4. Silver Standard

Silver standard is a system of currency wherein *the value of the monetary unit of a country is regulated with reference to silver.* Though theoretically, it can also take any of the three forms taken by gold standard, in practice it has always taken the form of the silver currency standard, under which silver acts both as a medium of exchange and as a measure of value. That is, silver is coined freely and coins of silver are standard coins. They circulate. Paper money, if in circulation, is convertible into them at the option of the holder.

This standard was in vogue in all the parts of the world before the introduction of bimetallism or gold standard. This was in vogue in India till 1893 and in China till 1935. It has, in fact, certain defects which led

the different countries of the world to give it up gradually.

Defects of silver standard. (1) Silver standard, first of all, suffers because of the fact that silver contains only *a small value in high bulk*; and as such it had to be given up by those countries which had made a good deal of progress and thus brought about a rise in their standard of living.

(2) Secondly, silver has *a capricious value.* It was, truly speaking, because of this reason that India had to give it up in 1893, following the great fall in the value of silver from 1872 onward. For the same reason China, too, had to abandon it in 1935, following the great rise in its value in that year.

(3) Thirdly, it was found *unsuitable for payment of unfavourable trade balances.* This standard could work only so long as international trade had not much developed.

(4) Fourthly and finally, when important countries of the world had taken up to gold standard, those countries which still remained on it *found it difficult to calculate the equivalents of their currencies in terms of those of the former.*

In conclusion, it may be said that the standard has no future, and will never be adopted by any country again.

5. Bimetallism

The essentials of bimetallism and its short-comings have already been pointed out in a previous chapter.[10] It is an old scheme, and may probably be traced back to the middle ages. But we need not go so far as that. Our interest centres round it only as an alternative proposal to the pre-war gold standard. Further, it was in vogue in France and U. S. A., in the nineteenth century. In the latter country, in fact, it has never disappeared as a serious proposal of a monetary reform so much so that a presidential election (1896) was fought on this issue.

France had adopted bimetallism in 1803 and the ratio fixed was 15½ ounces of silver for one ounce of gold. But as between 1811 and 1850 the average market ratio was always slightly above this mint ratio, silver was over-rated there and drove gold almost entirely from circulation. However, between 1852 and 1864 the position was exactly reversed. Hence, throughout these periods what was in theory a bimetallism became in practice an *alternating standard*, at one time the preponderating bulk of circulation being silver, and at another time of gold In fact,

[10] See Chapter III.

it was only for very short periods that they circulated together in anything like equal quantities.

In 1865, however, France along with some of the other European States, *viz.*, Belgium, Italy, Switzerland, and afterwards Greece, signed a monetary treaty called the *Latin Union* with the sole object of *putting an end to the disappearance of fractional silver.* It included[11] :—

(1) That gold coins and five franc pieces of the fineness of nine-tenths were to be coined to an unlimited extent, to be of the same weight and equally legal tender in any of the countries which became, signatories to the treaty.

(2) That the smaller silver coins were to be of proportional weight, but only '835 fine, thus reducing them to the rank of tokens and preventing them leaving the country : such coins to be limited by the population of each country, and to be legal tender to the amount of fifty francs, only in the country which coined them.

But hardly had the ink been dried on the paper when events[12] occurred which once more raised the market ratio above $15\frac{1}{2}$ to 1, and once more threatened to flood the bimetallic countries with silver. Accordingly, in 1874, a meeting of the Union was held, at which it was resolved to close the mints to the free coinage of standard five-franc pieces, and limit the amount of these to be issued. In theory they still adhered to the double standard ; in practice they had adopted a system hardly to be distinguished from the composite legal tender system.' It may, however, be said that *even with gold currency their preference for silver persisted till 1914.* In France, the cash reserves against bank notes consisted of gold and silver both, and the central bank had the option to pay in either of the metals for the purposes of export

The American standard had been nominally bimetallic with a fixed ratio of 15 : 1, and so long as the world market followed the French ratio of $15\frac{1}{2}$, no gold went to U. S. A for coinage. In 1834, however, the ratio was revised. It was put at nearly 16 : 1, and the reverse began to happen—so much so that silver dollars went out of circulation. In 1873, the Government in the Coinage Act of that year did not include silver dollar in the lists of standard coins. This led to protests after protests.

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[11] *Vide* page 44 of Banking and Currency—Sykes.

[12] They were twofold : (1) silver was discovered in apparently inexhaustible quantities in Nevada and some of the other Western States of America. (2) a violent reaction in favour of gold as a single standard set in all over Europe. Page 45, Banking and Currency by Sykes.

The silver mining interests were politically powerful in the country. They were suffering from the sudden cessation of the demand for this metal as money in Europe, and objected to their own country joining in a movement so injurious to them. As a result, a compromise was arrived at, and the silver dollars were to be coined every year up to a prescribed limit. In 1893, however, this currency became a serious embarrassment and a stop had to be put to its further coinage. The question was then brought into the political arena, and finally had to be set at rest as a result of the Presidential election of 1896 which had, as already pointed out, been fought on this very issue. The gold standard Act of 1900 placed the country unequivocally on gold standard.

With the financial depression of 1929, the advocates of bimetallism again came into power and finally succeeded in persuading President Roosevelt to declare in 1933 that *the policy of the Administration was to restor bimetallism in U. S. A.* as a permanent measure of monetary reform. Next year, a law was passed which required 25% of the total metallic reserves of the country to be held in silver. This resulted in huge purchases of the metal by the Government in the world markets, *and compulsory acquisition of the country's stock held privately.* Further, the price was fixed at a high value, not in the least justifiable on the basis of the circumstances. This naturally led to speculation which in its turn ended in slump that had to be accepted by the Government. As a consequence of all this, China the only country in the world remaining on silver standard till then had to give it up, *'U. S. A is still persisting in its continuance of bimetallism* and the experiment should prove a useful lesson to others who may think of introducing it in future.' It may be pointed out, in this connection, that very recently this (July, 1946) country has raised the price of silver from 71'11 cents to 90'50 cents per troy Oz.

International bimetallism. This brings us to international bimetallism. It has been so often pointed out that there is an automatic check to the operation of the Gresham's law in the case of a bimetallic country by the counter-operation of another law, *viz.*, the law of compensatory action. *'In international bimetallism all or most of the countries of the world will fix by law the relative value of the two coins as money. Their relative value as metal will also be fixed in the bullion market of the same world.* In this case when there is a variation, in the two values, that is as money and metal, of gold and silver there is a corrective which works automatically through the open mint. If silver as metal depreciates and gold as metal appreciates – which is the same

thing as silver appreciating and gold depreciating as money, silver coins will be minted into currency and gold coins melted into bullion. This process will go on all over the world on an extensive scale, all or most of the countries having bimetallism. But this will lead to a great increase in the demand for silver to be used as money, thus substantially reducing the supply of silver as metal. On the other hand, by the melting of the gold coins the supply of gold bullion will substantially increase. Thus the diminished supply of silver as metal and the increased supply of gold as metal will raise the value of silver in terms of gold. Therefore, the former depreciation of silver and appreciation of gold, which started the process of minting silver and melting gold, will be corrected. This process of correction will continue till the relative value of gold and silver as bullion is brought back to the same position as their relative value as coins. This is known as the *compensatory action of bimetallism*. This does not operate in national bimetallism—bimetallism referred to previously--because the additional demand of the depreciated metal for purposes of minting and the additional supply of the appreciated metal by melting, being confined to one or few countries, cannot affect the supply of the metals in the world market as much as in the case of international bimetallism where the area, over which the operation of such melting and minting goes on affecting the supply of the metals, is practically co-extensive with the area, the whole world, in which the relative value of the metals as bullion is determined.'

Advantages of bimetallism. Bimetallism, and specially international bimetallism which does away with the only disadvantage of it, *viz.*, that of the divergence in the mint and market ratios of the two metals, has certain advantages. They may be given below :—

(1) *The joint supply of both gold and silver* will enable the quantity of money based on them to be equal to its requirements.

(2) *Their annual joint production* will keep pace with the annual progress of the people and thus have a steadying effect on prices.

(3) *Their common use* will lead to the prosperity of silver producing and holding countries as well, which have, for so long, been suffering due to the undue and capricious preference given to gold by human beings for its employment in the form of money.

One more advantage was claimed for it which has, however, fallen to the ground since the abandonment of silver standard by China. It was that it will open the

markets of this important country for all those adopting this system.

Future of bimetallism. Finally, it may be mentioned that attempts were made to arrive at a decision in favour of international bimetallism towards the closing decades of the nineteenth century. Three international conferences were called up one after the other at the instance of France, or the United States at Paris in 1878, and 1881, and at Brussels in 1892 with this object in view but the efforts of every one of them proved abortive. Besides, the controversies between gold and silver are obsolete now. The question which is discussed at present is whether it is possible to dispense with a metallic standard altogether. Under the circumstances, it is futile to expect anything in this connection in near future, in spite of what may be said by theorists.

6. Modified Forms of Bimetallism

The above is pucca bimetallism. But there are also some modified forms of it. They were, in fact, devised as a countermeasure against the operation of Gresham's law in the case of national bimetallism. One of these is what is known as *the limping standard or limping or halting system of bimetallism* and the other is *the parallel standard.* An introduction to these was made in the Chapter on Metallic Money. *For an illustration of the former, we may refer to the Latin Union.* We know that the same had forbidden the free coinage of silver. *Next, for a long time before the war of 1914-18, there had been silver coins in circulation both in France and the United States of America along with gold currency.* They were unlimited legal tender and also exchanged with gold currency at fixed rates. But mint was not open to their free coinage anywhere.

Illustrations of parallel standard are also available from the currency history of various countries. Gold coins were first introduced in England in 1663, and since then they circulated along with silver coins. Mint was open to the free coinage of both, and they were also unlimited legal tender. But there was no fixed ratio at which they were exchanged. It varied according to the ratio at which the two metals as bullion were exchanged. This was, however, only till 1717 when the gold coin (guinea) was rated at 21s. But immediately Gresham's law came into operation and drove silver coins which were under-rated out of circulation. This ultimately led to the country's adoption of the composite legal tender system, under which only good coins (sovereigns) remained standard coins, silver coins becoming only token. Further before the adoption of the silver standard by the British Govern-

ment in India in 1835, both gold and silver coins circulated in this country as well. Mint had been open to the free coinage of both, and they were unlimited legal tender. There was, however, no fixed legal ratio at which they were exchanged. It depended upon the market conditions.

7. Exchange standard

Exchange standard is the name given to a system of currency which is convertible at fixed rates only in terms of some other currency. We have already dealt with gold exchange standard wherein internal currency is convertible into gold for delivery abroad. *In the case of exchange standard, it is convertible in a foreign currency*—and as in most of the cases it is either sterling (the British currency) or dollar[13] (the United States currency), it is known sterling or dollar exchange standard respectively.

Sterling exchange standard was first adopted in India during the first decade of the twentieth century. But so long as sterling was in parity with gold, there was no difference between this standard and gold exchange standard. In fact, they were regarded as synonyms. The Babington Smith Commission was the first to draw the distinction between these. It was perhaps because sterling was not in parity with gold at that time. Previous to this the contingency had, probably, not even been imagined.

This standard pre-supposes the establishment of huge reserves both at home and in Great Britain for meeting the bills drawn by the authorities in the former country or by their agents in the latter on each other at the maximum and minimum fixed rates.

In the case of India, this was done out of the gold standard and paper currency reserves, a portion of both of which was kept in India and Great Britain. The Secretary of State for India in Council sold bills, called Council Bills on India for the convenience of British traders at a price not exceeding 1s. $4\frac{1}{8}$d per rupee, and when there was a demand for foreign means of payment, the Government of India sold Reverse Councils in India, drawn on the Secretary of State for India in London, at a rate not less than 1s. $3\frac{29}{32}$d. Exchange was in this way maintained within 1s. $4\frac{1}{8}$ and 1s. $3\frac{29}{32}$d. There were no standard coins in circulation in India : rupee coins and notes which were unlimited legal tender were token, and not convertible for internal purposes

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13 During World War II the countries under the influence of Japan had Yen exchange standard and those under German domination had Mark-exchange standard.

At present, Argentine, Bolivia, Iran, Iraq, Syria, India, Free France, Iceland, Portugal, Sweden, Australia, Newzealand, Free Holland, Free Belgium, etc., have got this standard.

Dollar exchange standard is in vogue in Brazil, Chile, Columbia, Costa Rica, Ecuador, Gantemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Salvador, Venezuela etc.

This standard suffers from all the disadvantages of gold exchange standard and one more, *viz.*, that of the anchorage of the currency in circulation with the currency of another country. This binds the fate of the country having it with that of the country with whose currency it is anchored. Then, this standard is also not popular because it shows dependence and usually political dependence.

8. Tabular Standard

A tabular standard of currency is that wherein the value of the monetary unit of a country is regulated with reference to the general level of prices. It is also called, as previously pointed out, *a composite standard of value*

From all that was said by the Balfour Committee, and given out in this chapter under the heading : Need of a currency anchored to a concrete metal rather than one based upon the general level of prices, it may be concluded, that it suffers from the following defects :

(*i*) Being based on rough approximations (index numbers) derived from records of past transactions, it *cannot be fairly representative.*

(*ii*) Even if it were so, *its basis over a long period* (index numbers) *would need revision* in order to conform to changed conditions.

(*iii*) The governments making the revision referred to in the (*ii*) *cannot be expected to be always free from political and economic pressure.* They will, whenever it will be in their own interests, as distinguished from that of the nation as a whole, do it in the way desired by them.

(*iv*) *The governments have not usually got the sufficient capacity, integrity, firmness, power and independence to enable them to carry out this delicate task.*

(*v*) Under the circumstances, the business world *cannot have the desired confidence* in the currency system, and as such it cannot be called ideal.

(*vi*) When the business world will have no confidence in the currency system, it *cannot build the required credit system* which depends for its basis upon the former.

But this does not mean that it has got no admirers at present. The supporters of the scheme say that even gold standard on which the whole world had pinned its faith for long had a number of disadvantages. In fact, it is better than the paper currency standard wherein there is absolutely no object to regulate the value of the monetary unit in circulation, and may bring about stability in prices.

9. Inconvertible paper currency standard

Paper currency standard or Arbiteary standard is a system of currency without any particular object with reference to which the value of the monetary unit in circulation may be regulated. Under the circumstances, its value depends upon the forces of its demand in relation to supply. At present, we have got this system of currency in even the most important countries of the world. No doubt, the government of the various countries adopting it *have made arrangements for its convertibility at fixed rates in one or more of the currencies.* But there is so much of exchange control that it can, in no circumstances, be regarded as truly convertible in any one of them. But it is possible under paper currency standard that *there may not be any arrangement whatsoever for the conversion of the internal currency into foreign currency.* Under the circumstances, there will be either no foreign trade or foreign trade by barter. Finally, this standard may be had with a set purpose, *e.g.*, to bring about an economic development within the country, and thus do away with unemployment increased production, and lead to a steady rise in the standard of living.

It has, however, got certain disadvantages.

(1) First of all, it is *viewed with uneasiness because* of the grave apprehension of over-issue and consequent depreciation of the monetary unit in circulation with its attendant evils.

(2) Secondly, it *commands no confidence*, and hence fails in increasing production and trade. This may lead to unemployment.

(3) Thirdly, it acts as *a deterrent to savings and investment* mainly as result of (2).

(4) Lastly, *it may bring about a reduction in international trade* consequent upon the withdrawal of payment in gold.

10. An ideal standard

From a careful perusal of the various standards given above, it is obvious that none of them is regarded as per-

feotly sound. In fact, man has, yet, to devise an ideal standard. It should, however, conform to the following :

(1) It should *stabilize the currency* in circulation both in terms of goods and exchanges.

(2) It should *economise* the use of precious metals.

(3) It should be *capable of expansion and contraction* according to the needs of trade ; and

(4) It should be *simple and command* the confidence of the people in general.

SUMMARY

1. A Monetary standard is an object with reference to which the value of a monetary unit is regulated.

2. A monetary standard is classified into metallic, exchange, tabular and inconvertible paper currency. The first two can further be sub-classified into (1) Monometallism and (2) Bimetallism, and (1) Dollar Exchange standard and (2) Sterling Exchange standard respectively. Again, monometallism may be gold or silver, and bimetallism may be pucca or modified. Finally, gold standard may be gold currency or gold bullion or gold exchange standard and modified bimetallism, Limping or Parallel.

3. Under gold currency standard, gold acts both as a medium of exchange and as a measure of value. Under gold bullion standard gold acts only as a measure of value. And under gold exchange standard, currency is exchangeable with gold only for delivery in a foreign country. Gold bullion standard is, however, preferable to both the other forms of gold standard due to its advantages over them. Gold standard, in fact, implies that the value of the monetary unit in circulation should be regulated with reference to gold. If gold currency is in, actual circulation, mint should be open to the public for its coinage, and if a representative currency is in circulation, it must be convertible into gold at a fixed rate which is known as the mint price of gold. Finally, there should not be any embargo on the export and import of gold.

Gold standard broke down once during 1914-18 and after it, and again during the slump of 1929-33. It broke down on the former occasion in belligerent countries because of the inelasticity of the supply of gold and of the necessity to safeguard gold reserves, and in neutral countries because of the depreciation of gold itself in them consequent upon its huge importation as a result of the increase in the export of commodities to belligerent countries. It was, however, revived because it was felt that prices and exchanges could not remain stable without it. But the Genoa Conference of 1922 recommended an international gold standard and the gold bullion and gold exchange forms of it. On the latter occasion, it broke down because of the fall in prices or appreciation of golddue to its shortage in almost every country excepting U. S. A. which had accumulated a large portion of it and did not allow the usual rule of gold standard to operate. Then, restriction had been imposed on international trade as well. Besides, in some countries, there was also a lack of adjustment in external and internal prices, which caused a drain of gold and this had to be stopped. This time, however, gold standard was not revived—it was ultimately replaced by an inconvertible paper currency standard though with controlled exchanges.

Gold standard has lost its advantage of being a stable standard since the closure of a free world market for it. What happened during and after the War I was its acquisition in the hands of only a few countries, specially U. S. A, which could fix its value arbitrarily. The Genoa Conference of

1922 had realised it, and hence recommended an international gold standard with a view to control the demand of all the countries for gold. Further, it had begun to be argued at this time and has since also been demonstrated that gold standard was necessary for the maintenance of neither prices nor exchanges. Exchanges could be maintained and are being maintained without the medium of gold. Prices could also be maintained without its medium simply by the regulation of the quantity of money in relation to the demand for it and these in their turn can bring about the stabilisation of the exchange rates as well. But the anchorage of the currency in circulation with gold is indispensable in the absence of any other satisfactory one.

Though gold is not in much use for the purposes of currency, there is nothing to worry about its future. As regards the adoption of gold standard, it cannot be in any of its old forms, though the parities of the currencies shall be fixed with gold. This of course requires co-operation of the central banks. A new scheme of I. M. F. has been devised recently with this end in view.

4. Under silver standard, the value of the monetary unit is regulated with reference to silver. It suffers, however, from some very serious defects.

5. Bimetallism always results in an alternating standard. It had been for long in vogue in France and U. S. A. In 1865 France formed a Latin Union with a view to put an end to the disappearance of fractional silver, but this had to be dissolved soon. The possibility of an international bimetallism has also been discussed several times, and it is suggested that this can work because of the operation of the compensatory action of bimetallism. Certain advantages are claimed for bimetallism by its advocates. But there seems to be no future for it.

6. The modified forms of bimetallism are the limping standard and the parallel standard. Under the former, the mint remains closed for the coinage of the cheaper metal, usually the silver, and under the latter, no fixed legal rates exist between gold and silver coins.

7. Under exchange standard, the currency in circulation is convertible with only foreign exchanges, *viz.*, Sterling, Dollar, Marks and Yens. This standard suffers from all the disadvantages of gold exchange standard and one more, that of dependance upon another currency.

8. Under Tabular standard, the value of the currency in circulation is regulated with reference to the general level of prices. It also suffers from certain serious defects. But this standard is better than the inconvertible paper standard.

9. Under an inconvertible paper standard, the value of the monetary unit is not regulated with reference to any object whatsoever. At present, we have got this standard prevalent almost in every important country. But currencies everywhere are convertible at fixed rates in one or more currencies. There is, however, a good deal of exchange control, and hence the objection in calling them exchange standards. This standard also suffers from certain serious defects.

10. A perusal of all the monetary standards reveals that man has, as yet, to devise an ideal standard. This has, however, to ensure stability of prices and exchanges, economy in the use of precious metals, elasticity and simplicity and command confidence.

TEST QUESTIONS

1. Define a monetary standard, and classify it. Write short notes on each of your classifications.

2. Attempt a careful classification of the various monetary systems. Which of them do you consider the best and why? (B. Com. Part I, Allahabad.)

3. What do you understand by a gold bullion standard ? How does it differ from gold and gold exchange standards and what are its merits over them ?

4. Gold Bullion standard not only possesses all the essential features of gold currency standard but it has several advantages over the latter ? Explain this statement fully.

5. What are the essentials of a gold standard ? How can you say that a gold standard is effectively maintained ? Support your examples by giving illustrations.

6. Write a short note on the breakdown of gold standard and steps taken thereafter during the present century. Give reasons for all that took place in this connection.

7. Discuss the various arguments advanced in the present century for and against a gold standard. Do you think that the world must have it sooner or later ? Give reasons for your answer.

8. What in your opinion is the future of gold and gold standard ? Point out in this connection the conditions for the satisfactory working of a gold standard.

9. What do you understand by the term silver standard ? Point out the various defects from which it suffers.

10. What are the essential features of a pucca bimetal ic system ? Why did it break down in the past ? Is there any possibility of its revival even in a modified form ?

11. What is bimetallism ? Describe its chief advantages and disadvantages. Why is it possible to have an international bimetallism rather than a national bimetallism ?

12. In what different ways is it possible to combine gold and silver in the currency system of a country ? (B. A., Calcutta).

13. What do you understand by a tabular standard of money ? Give your arguments for and against this standard.

14. What do you understand by the term an arbitrary standard ? How does the system prevalent in most of the important countries of the world differ from it ?

15. 'Man has, as yet, to devise an ideal standard.' Comment. What are the essentials of an ideal standard ?

CHAPTER X

MANAGED CURRENCY*

A currency is said to be managed *when there is a deliberate adoption of some definite policy in the monetary system of a country by its Government with some definite object in view.* This is true both of currencies with and without gold standard though the erroneous idea commonly shared still prevails that it is so only in the cases of currency without gold standard. A striking example of this in the case of a currency with gold standard is provided for in the lowering and raising of the discount rate by the central banks and thus bringing about a change in the volume of the currency and credit in circulation. Later on, a number of other devices had been found with this very purpose in view, and an inquisitive reader may be referred for a study of all these to author's work entitled: '*Banking—Principles: In India.*' Next, gold exchange standard also of which we have already read so much is a system of managed currency. Then, there is a scheme recommended by that great writer on banking: *Fisher*, who is responsible for a clear elucidation of a number of theories on the subject.

1. Altering gold value of currency

According to the orthodox view, the value of currency should be kept stable both internally as well as externally, and this has been the ideal aimed at by those in charge of the monetary policy. But since 1918 this has been more and more difficult, and there is a growing volume of opinion at present which regards it impossible to secure stability in both internal and external prices. Therefore, it is proposed that a futile attempt like this should be given up, and an effort be made *to secure stability of currency either in the terms of internal prices or those of the foreign exchange through gold*, and at the same time to find out some new method to secure the stability on the other side. What was done upto 1914 and attempted after the termination of the War of 1914-18 and up to the outbreak of the slump of 1929-33 was actually to keep

*This chapter is meant for advanced study.

the value of currencies in the terms of foreign exchanges through gold. No doubt, the ideal was stability in terms of both, but this could never be secured.

The circumstances of the world have since changed, and the better course for future will be to do just as Fisher wants us to do. When he wrote, he wrote, however, for the United States, and as the gold dollar was in circulation he *spoke of a variation in the gold content of the dollar according to the variations in the internal commodity prices, i.e.*, varying in an inverse ratio to the variations in the internal purchasing power of the monetary unit. But his scheme is not on that account inapplicable to paper currencies provided that they are ultimately linked with gold as most of the currencies still are[1]. In this form his scheme will aim *not at altering the gold content of the gold currency but the gold equivalent of it*. Supposing there is a tendency to a fall in prices within the country in response to a fall in world prices, this would not be allowed to come about, or if it has already come about, it will not be allowed to continue. What will be done under the circumstances is to reduce the gold value of the currency, and hence the rates of exchanges. This will discourage imports and thus check the fall in internal prices in response to the fall in world prices. It is obvious, however, that the extent of reduction in the gold value of the currency must exactly correspond to the fall in world prices. There should not be allowed even the slightest difference, or else the result would not be satisfactory. And, for this again, the help of a carefully constructed index number of prices within the country is necessary.

Difficulties confronting the system. There are, of course, several difficulties which prevent the scheme from being successful.

(1) The foremost is that of *the construction of the index number* of prices.

(2) Besides, it is not probable that a change in the gold value of the currency will bring about a corresponding

[1]This seems to be misleading at first sight as the value of dollar in the terms of which the values of all other currencies have been kept stable either directly (of sterling and currencies based on dollar exchange standard) or indirectly through sterling (of currencies based on sterling exchange standard) is not kept equal to the value of a defined weight of gold. But this is true because the value of a fixed quantity of gold (1 oz.) is made to conform to the value of a fixed number of dollars ($35). 'In fact, U. S. A. has been deliberately trying to treat gold as a servant and not master. We are not, therefore, forced into the inconveniently paradoxical statement that U. S. A. is not on a gold standard. Nevertheless, it is arguable that a truer impression of the state of the world's monetary affairs would be given by saying that U. S. A., is on an arbitrary standard, while the rest of the world has climbed back painfully on to a dollar standard.'

change in internal prices, which will be *automatic, immediate, and uniform for* all commodities.

(3) As is obvious, the scheme contemplates frequent changes in the gold value of the currencies; and this in itself is *highly undesirable*, as it will lead to uncertainty in all business relations and hence speculative activities.

Experiments in U.S A. and Great Britain Nevertheless, it has been tried officially in U. S. A., and unofficially in Great Britain. In the former country, it was tried in 1933-34 for a very brief period at the beginning of the first term of the President Roosevelt's office. The object was, however, to raise the internal prices, though the method and procedure remained essentially the same. *But it suffered from one defect from the beginning*, and it was that the Government could not control the world value of gold; nor did it allow its own value of gold to adjust to the world value as there was no free flow of gold into and out of the country. *Then, the changes in the gold value of the dollar did not immediately and automatically affect the internal commodity prices in the desired direction.* In fact, no remedy can be prescribed for 'those strains and disharmonies whose roots lie deep in the present structure of industry, and perhaps in the very nature of man himself.' As a result, the scheme had to be given up before long.

In Great Britain, it was tried from the date of its relinquishing gold standard in 1931 to that of the stabilisation of the dollar in 1935 and hence of the sterling as well, as the latter was maintained at a fixed parity with the former. What happened actually was that the market value of gold in terms of sterling changed, and there being no ban on dealings in gold, this denoted a change in the gold value of sterling. In fact, sterling could be changed for gold at fluctuating rates in the market, though not at the Treasury all through this period. Besides, the fluctuation in gold prices was not allowed haphazard. There was official intervention through the Exchange Equalisation Account. though the object was vague, probably that of not allowing the sterling to depreciate too suddenly or too excessively in terms of gold. Every fall in the gold value of the sterling (which was the same as a rise in the prices of gold) brought about in its turn a corresponding rise in the internal prices of commodities, though this was neither automatic, nor immediate. nor uniform. The operation, however, ceased when the dollar was stabilised and hence sterling as well.

2. Schemes of managed currency without the use of gold

There are other schemes of managed currency as well without the use of gold, and these may be national or international.

Taking the national schemes first, we have got

(1) that wherein the reserves against the currency will consist of commodities other than gold;

(2) that wherein there will be one currency for short periods and another for a long-period of time, and

(3) that wherein the currency is inconvertible in terms of gold or of other currencies.

Coming to the international scheme, there are

(*i*) that wherein there is an extension of the clearing system, and

(*ii*) that wherein there will be one world currency.

National Schemes

(*i*) *A scheme with reserves in commodities other than gold.* So far reserves against currencies in various countries are maintained in gold on the basis of which the foreign exchanges are regulated. There is, however, a scheme in which gold will be scrapped altogether from this position, and reserves kept in other commodities. It is argued that *social wealth should not be locked up in an article which has little utility, and cannot be used for the purposes of general consumption, if in excess at any time.* Rather, it should be maintained in articles which are of greater utility, and may enter into consumption if need be. Besides, their production being on a much larger scale than that of gold, *all risks of a rise in their value to the same extent as that of gold by concentration in one or a few countries will be avoided.* Various commodities have been suggested for this purpose. They should, however, be of non-perishable nature, and if possible from out of staple products. Some prefer only raw materials, *e. g.*, copper, tin, iron, zinc, and lead. Surely, they are quite satisfactory from the reserve point of view.

Impracticability of the scheme. But there is one difficulty. The scheme is not practicable under the present conditions of the world. So far as there are countries on the one hand producing only raw materials, and on the other, only manufactured goods, there will be trade between them. But if there are countries on both the sides producing only raw materials or producing only manufactured goods, there cannot be any trade between them. The

most important objection to the scheme is that commodities, whatever their nature, can never have the same marketability as gold has. Under the circumstances *its partial adoption is possible.* The present gold reserves may be strengthened by the addition of the reserves of commodities. In this limited form, no doubt, the scheme will be less objectionable. But no country has, in actual practice, attempted to introduce the scheme either in its extreme form or limited form. That is perhaps because gold cannot, at present, be dislodged easily and effectively from the secure position it has built for itself by inspiring confidence amongst the people.

(*ii*) *A scheme with two currencies.* Besides the scheme referred to under gold exchange standard, *there is another scheme with two currencies and without the use of gold.* Under this scheme there will be *one currency for short periods and another for long periods* of time. *The long period currency will be stable, while the short-period currency will be depreciating* with a view to act as a stimulus to production. Further, with regard to the stability of the former. It may be in terms of gold or in terms of cost of living or of commodities. In the two latter cases, there will also be the need of index numbers.

Defects of the scheme. (1) The scheme is first of all open to the same objections as any other scheme requiring the services of index numbers.

(2) Further, this scheme will suffer from the lack of adjustment between the prices of the commodities and of other things with the changes in the former.

(3) Finally, it is defective inasmuch as if prices in terms of long period currency remain stable, and those in terms of short period currency fluctuate, there will arise unearned profits or unforeseen losses. This will, of course, instead of stimulating production, discourage it.

Experiments in U S. A. and Germany. The scheme, as it is, was adopted for sometime in U. S. A. and Germany. In U. S. A., it was after the Civil War when greenbacks had much depreciated. At that time all long-period contracts contained a clause by which payment was required to be made in gold. But soon, the dollar reached the parity, and the practical effect of the gold clause in the contracts ceased to have any operation. Next, it was adopted when dollar had begun to depreciate just after the abandonment of gold standard in U. S. A. in 1933, and gold clause began to be included in the contracts for long-period. But an objection to this was raised, and by a declaration of the Supreme Court all such clauses were held invalid in law.

In Germany, the scheme was first adopted when a transition was being made from a highly depreciated currency of paper marks to that of reichmarks by the introduction of what were known as rentenmarks, which circulated side by side with the old currency but were stable. The result was that the stability of the rentenmarks restored the confidence of the public in the money which had been rudely shaken, and thus paved the way for the introduction of a permanent currency, the reichmarks, which supplanted both the old marks and the rentenmarks. In fact, this was the method adopted by various other countries at that time to achieve this very object. Next, it re-appeared in Germany when during the last financial crisis she was granted moratorium by the creditor nations and her balances in foreign countries were blocked. Thus there arose two currencies one consisting of foreign balances, and the other of the reichmarks. The former was depreciated, and the latter stable. But soon the balances in blocked accounts were exhausted by imports, and there remained only one currency. This time also, however, the scheme was adopted in certain other countries under the same circumstances.

(*ii*) *A scheme with an inconvertible currency.* This scheme is not at all different from what is known as the paper currency standard, which as we know implies a system of currency without any particular object with reference to which the value of the monetary unit in circulation may be regulated. It may, however, be said that this should be distinguished from the paper currency standard as it is prevalent at present in almost every important country of the world. Under the latter, it has been observed, the governments of the various countries have made arrangements for the convertibility of their respective currencies in one or more of the foreign currencies Under this scheme, however, there will be no such arrangement ; the currency in circulation will, so to say, be purely national, *completely severed from the rest of the world.* There will be no foreign exchange market, and no necessity to maintain reserves in gold. The value of the currency internally will depend solely upon the forces of demand and supply. In fact, this scheme is based on the supposition that there will be a planned economy, in the interests of the country, quite free from the disturbing element of foreign rivalry.

Experiments in Russia and Germany. In practice, it has been adopted in Russia and Germany. In the former country, first of all there was a movement for the abolition of all currency, as it was considered to be the symbol of capitalism. But this appearing to be impossible, it was

thought desirable to stabilise the currency for internal exchanges, and divorce all relation between internal and world prices. There was no exchange rate between the Russian currency and other currencies. Nor was the price of gold quoted It is claimed that this has helped the country in carrying through the various five years plans successfully. In Germany, however, it was not introduced deliberately. What happened was that after the blocking of the accounts referred to in connection with the scheme with two currencies, foreign exchange transactions were rigidly controlled, and a rise in internal prices was brought about which in its turn gave stimulus to industrial expansion. This was, latter on, further increased by the rearmament scheme adopted by the Nazis as a part of their planned economy.

External trade by barter. From the above, it should not be concluded that there will be no external trade in this case. In fact, it was carried on in Russia and Germany both under the above circumstances. But this was purely by barter and under Government control. So *this scheme is not opposed to foreign trade*, but it will be without the help of currency and strictly according to the interests of the respective nations.

International schemes Coming to the international schemes, it may be said that they envisage the *co-operation of all the nations of the world*—if not all at least the important ones. But this has been so far lacking in spite of the various attempts made at different periods. We already know what was done in the last century in support of the international bimetallism, and in this century at the Genoa Conference (1922). In fact, each nation wants to be supreme in matters of its own monetary policy and there lies the difficulty. But it is possible that what has not been achieved so far might be achieved in near future and this fact, if not any other, compels us to look to some of these.

(*i*) *Extension of clearing system.* Machinery of clearing house has proved very useful in the cancellation of inter-bank debts and resulted in the economy of the use of cash The scheme under discussion, however, envisages the cancellation of international debts through the extension of the system and consequent economy or elimination of the use of gold in international payments. It will require the establishment of an international organisation ; or the Bank for International Settlements any where in the world may serve the purpose. All debts between individuals and banks in different countries will be settled at their respective banks. This means that *the existing foreign exchange*

markets will stop. Debts between different central banks will be settled through the international organisation. As regards the final adjustment which may be necessary from time to time at least to enable the institution to make the payments on behalf of a particular central bank, it may be said that there are two opinions. According to one this will be done in gold—*which is nothing but an extension of gold exchange standard.* But according to the other, *the balance will be carried forward and settled ultimately by a change in the course of trade.* In fact, this is being done through the Exchange Equalisation Funds though without the help of the international organisation as suggested.

(*ii*) *A single world currency.* There is another international scheme of managed currencies which stands for the introducti n of one single currency for all the countries of the world. *This will consist of paper, controlled and regulated by one bank with powers to direct all the central banks and hold gold reserves on behalf of them.* There will, however, not be any objection, if it does not hold gold reserves on behalf of them, but only distributes them fairly amongst them. It will a lot to each central bank the amount of notes which may be used by the people within its jurisdiction. All complications of foreign exchanges will thereby disappear and it will lead to the uniformity of prices everywhere with the only difference arising on account of the cost of transportation. In the beginning, however, the International Bank may also not issue notes but simply control the issues of all the central banks, or again there may not be established any international bank but things be controlled by international agreements.

Difficulties of the scheme. Surely there are some difficulties which may not be encountered. *First of all,* it is probable that the various countries holding the gold reserves may not be ready to surrender them to the international institution. *Secondly,* it may *dilate* decisions which should be swift and immediate.

(*iii*) *Recent Schemes of International co-operation.* Certain schemes of international co-operation have been put forward very recently. A brief summary of one of these, *viz.*, the International Monetary Fund has been given previously. This is the Anglo-American Joint Plan, and the greatest unanimity has been reached over it in the Bretton Woods Conference After its ratification by the legislatures of the countries concerned, it is being put into force. Proposals had been put forward in the beginning by Britain, U. S. A. and Canada separately. They had been

drawn on a much more ambitious scale. But as each nation is still inclined to place its own economic interests in the forefront of its policy and is unwilling to incur the sacrifice that is implicit in the creation of any international organisation, they could not satisfy the majority of nations. U. S. A. possessing the largest stock of gold and being a creditor and a Surplus nation insisted in its plan upon gold and provision of safeguards for creditors. Canada being within the orbit of the American economy and also a creditor country supported the U. S. A. plan. Britain favoured the deficit and debtor countries and argued in favour of continued existence of subordinate currency blocks. She did not lay much importance upon gold as well. India displayed acute interest in abnormal balances and demanded their free and rapid liquidation. Under these circumstances, an ideal international structure could not be built. The joint plan is modest. It goes only to a very small extent in subordinating national interests for international good. But something is better than nothing. It will pave the way for better understanding of international problems, and shall be improved gradually. The joint plan provides for freedom of domestic economic policy on th · part of member countries and concedes them the right to change their exchange rates to a certain extent to suit their national requirements. Of course, it does not provide for the development of the backward economies like those of India and China and the liquidation of war-time balances with that end in view. Had this been done, it would have been more realistic. But let us hope that the things will improve in due course.

The Anglo-American currency plan. 1 Both the British and American plans provided for the creation of an international currency unit with which all the currencies of the world could be freely exchanged In the American plan, there were *unitas* and in the British plan *bancors.*

2. The value of the *unitas* and *bancors* was to be fixed in gold That of the *unitas* was proposed at 137½ grains (equivalent to 10 dollars U. S.) and that of the *bancors* had been left to be decided by the Governing Board. Once fixed, the value of the *unitas* in terms of gold could not be changed but that of the *bancors* could be changed.

3. The member countries were to agree between themselves the initial values of their own currencies in terms of the international currency unit and hence gold. The British plan, however, permitted variation in the link more easily than the American plan.

4. Under the British plan, the *bancor* was only a unit of account, and the international authority was not to start with any assets. Its function was only to act as a clearing union. As against this, the American plan envisaged the international authority to start with independent assets, each member country subscribing a specific amount to be called its quota. The initial payment was to be 50% of this quota—12·5% in gold, 12·5% in its own currency, 25% in its government securities. In the case of the countries having a small amount of gold, some concessions were to be made with regard to the percentage deposit in that metal. Quotas were to be fixed under the British plan as well. But these were not for the purpose of receiving subscriptions from the member countries They were only for the purpose of setting a limit to their respective variations in trade balances. In the case of American plan, the quotas were for this purpose as well in addition to for the purpose of subscribing to the assets of the international organisation. In the British plan, quotas were to change annually according to the changes in the international trade, while in the American plan this was to be done only by a resolution passed with the approval of a four-fifths vote of the Governing Board.

5. In both the plans opportunities were given to deficit and surplus countries to adjust their accounts if the balances were of a temporary character instead of requiring them to clear up immediately and thus bring about unpleasant consequences on their economies. In cases where the balances persisted because of a basic disequilibrium, they proposed to give advice on the measures to be adopted with a view not to lead to economic blizzards in their respective regions and in the world outside.

6. There was, of course, no provision in any of the plans for the settlement of war-time balances.

SUMMARY

1. All currencies are managed in one way or the other. In the case of a pure gold standard as well, the central bank has to take steps to maintain it. Next, gold exchange standard is also a form of managed currency. Then, there may be a currency wherein its gold value may be allowed to fluctuate with a view to stabilise prices, which when attempted all over the world, will also result in the stabilisation of the exchanges. It suffers, however, from certain defects, though it has been tried in U. S. A. and Great Britain.

2. There are some schemes of managed currency without the use of gold. These are national as well as international.

National schemes are (1) a currency with reserves in commodities other than gold, (2) that with two currencies, and (3) that with an

inconvertible currency. International schemes are (1) extension of the clearing system and (2) a single world currency. Each of these currency schemes has its advantages and disadvantages, and all excepting the last have been tried in one or the other country at different periods.

3. Certain schemes of international co-operation were discussed very recently. Main features of one of these, *viz.*, I. M. F. have been dealt with previously. The others were the British scheme, the American scheme, and the Canadian scheme. All these schemes differed in details. There were certain special points of comparison between the British and the American schemes.

TEST QUESTIONS

1. What do you understand by a currency whose gold value may be altered with a view to avoid fluctuations in commodity prices? Discuss its merits and demerits in the light of the experiments made in U. S. A. and Great Britain.

2. Give your opinion regarding a scheme of currency against which a reserve may be kept in commodities other than gold. Do you think that its adoption is possible under any circumstances?

3. Write what you know of a currency system consisting of two currencies with and without the use of gold. Give examples of the latter's adoption by U. S. A. and Germany.

4. Discuss the merits and demerits of an inconvertible currency in the light of the experiments made in Russia.

5. Suggest some international schemes of managed currencies with or without the use of gold, and give your opinion on their practicability.

CHAPTER XI

FOREIGN EXCHANGES—I

It is a fashion with most of the writers on the subject of foreign exchanges to begin with the remark that it is dry and complicated, but it is just the reverse. It is really easy and interesting if we keep it free, as far as possible, from the technicalities which are the delight of the experts on the subject. There is no difference between foreign exchanges and domestic exchanges, of which we have read so much, excepting that when transactions between men are across the boundary lines that mark the separate countries they constitute foreign exchanges. These have been since the remotest times of which we have got any record. The Assyrians, the Phoenicians, the Egyptians, and the Babylonians had them long before their full development by the Greeks and Romans. They have, however, grown enormously now-a-days, and hence become very important, and require our special attention.

1. Meaning of the term 'foreign exchanges'

Foreign Exchanges mean *the buying and selling of the moneys of other countries*, and as such refer to (1) the bills of exchange which are very much used in foreign payments or settling international indebtedness, (2) the rate of exchange which is the price at which one currency is given for another, and (3) the institutions—Banks and stock exchanges - through which business is conducted. It is also concerned these days with the methods and machinery of exchange control which have arisen recently. Hartly Withers has defined[1] the subject as *the Art and Science of international money-changing.* On the Art side, we are concerned with the bills of exchange, the banks and the stock exchanges, the exchange equalisation funds and accounts ; on the science side we are concerned with the knowledge of the rates of exchange, and the methods of exchange control.

2. Bills of Exchange

Bills of exchange play an important part in the exchanges of the large amounts which are made payable in one place or another because of the international trade,

[1] 'Foreign Exchange is the system by which commercial nations discharge their debts to each other.' Ency. Brit.

commerce and other relations that arise these days specially as a result of the spread of civilisation. *They constitute a big class* that includes a number of instruments, *e.g.*, cheques, postal orders, bank drafts, letters of credit and such other instruments. These are also used in home trade; but there is surely some difference between the wordings of the instruments meant to be used for this purpose and for that of foreign trade.

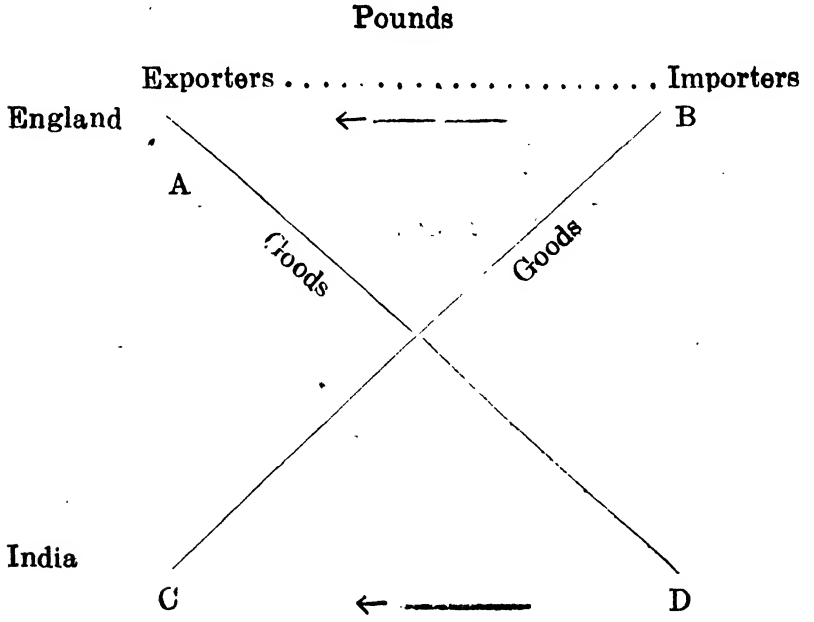
Definition. A bill of exchange is an order by one person, addressed to another, directing the payment of a certain sum of money on demand, or at a fixed future time, to a specified person, or to bearer. If payable within ten days, it is called '*short bill*', and if required to run for a longer period, it is known '*long bill*'. All bills payable after some time, whether short or long are '*usance bills*', while those payable on presentation are '*sight bills*..

Parties to a bill of exchange. Three persons may be concerned in a bill—the drawer, the drawee or acceptor, and the payee. The *drawer* is the person who draws (makes) the bill. A debt is usually due to him. The *drawee* is the person addressed to, directed to make the payment. He is also known as the *acceptor*, and sometimes denotes his acceptance on the instrument by means of a signature across it. The *payee* is a third person who is entitled to receive payment. The bill is made in his name. It is also possible that it may be made payable to the drawer himself. In that case, the drawer himself will be the payee. Next, a bill is a visible sign of a right to receive money, and this right may be transferred. The payee if he is a third person who has received the instrument from the drawer in discharge of a debt, or if he is the drawer himself, can transfer the bill in payment of his own debt by means of what is called an *endorsement*. The holder of a bill whether he is the original payee or any endorsee can get it discounted with a bank or a discounting house. *Discounting a bill* means obtaining its present worth—which is the face value of the instrument minus the discount charges.

Foreign bills are drawn in one country and payable in another.

Use of bills of exchange for payment of foreign debts. Bills of exchange were in use for the payment of foreign debts long before the birth of Jesus Christ. Cicero is said to have written a letter to Atticus of Epirus, on 1st—January, 48 B. C. wherein he says: 'I have in Asia about 2,200,000 Sesterces in local money. You can easily look after my credit by a bill for that sum.' Let us see how they actually work. Supposing, A of England

exports £100 worth of goods to D in India, and C of India exports goods of the same value to B in England, A will draw a bill of exchange upon D which B will purchase from him and send to C who will then obtain payment from D. In this way, the claims of all the parties will be adjusted. A will receive £100 from B, and C will receive equivalents of this amount in Indian currency from D.



This is a very simple case. In actual practice (*i*) there are more than one exporters and importers in every country, (*ii*) the exports and imports are rarely equal and (*iii*) the exporters and importers in the same country do not know one another, and hence cannot purchase or sell their respective claims and obligations.

This necessitates the services of certain specialised institutions, *e. g.*, exchange banks.

3. Exchange Banks

Exchange banks are institutions whose sole business is to finance foreign trade and bring about the settlement of debts between foreign countries. Their branches are spread all over the globe and specially in important trading countries or else they have their correspondents. They purchase bills from exporters and sell their proceeds to importers. In case, the bills are usance, they are purchased at lower prices than what their face value warrants, the difference representing the discount charges. The bills are

collected on maturity, and payments received by their branches or correspondents from the drawees. Thus they accumulate funds with them, and draw on their basis what are known as bank drafts which are purchased by the importers. If there is any difference left between the purchases and sales of any particular bank they are cancelled by mutual dealings. When metallic standards were in operation, final balances were settled by exports and imports of precious metals. At present, they are referred to their respective central governments or banks who make arrangements for their settlement.

Economy in the use of precious metals. The use of foreign bills brings about an economy in the use of precious metals. To turn to the illustration given previously, if the parties had no knowledge of the bills of exchange an unnecessary and uneconomical movement of gold would be necessary. B will remit £100 worth of gold to C, and D will likewise export a similar amount to A. Thus there will be a double flow of gold which is both expensive and unnecessary. Gold bullion or coins will be converted into circulating media in each country, and if the latter consists of coins, minting charges will be paid. Cost of transportation will also be borne by both the parties. A large stock of precious metals will be locked up during the course of transmission. All this would involve huge waste.

4. Calculation of what one country's money is worth when expressed in that of another country

It was observed in connection with the heading, use of bills of exchange for payment of foreign debts, that C will receive equivalents of £100 in Indian currency for D. The question is how to calculate this. It will be a pretty easy job, if both the countries have got either a gold standard or a silver standard. What will be done in such a case is to find out a relation between the amount of pure metal contained in the standard coins of the two countries. Or if standard coins do not circulate we have to find out a relation between the amount of pure metal available in exchange for the currency in circulation according to the law. For example, the exchange value of the rupee was fixed at 8·475 grains of gold in 1927 and that of the sovereign was 113 grains of fine gold. The relative value between the rupee and the sterling was, therefore,

$\frac{8{\cdot}475 \times 240}{113}$ d. = 18d. (£1 = 240d.). In banking parlance, it is

known as the mint par of exchange which expression need cause little difficulty. The word mint is the key to the

problem. The mint price of gold in a gold standard country, and of silver in a silver standard country is, as we know fixed by law, and it is on this basis that the metal will be purchased when sent in settlement of indebtedness from one country to another. *Par* signifies equality. Hence *the term mint par of exchange means the equivalent of one currency into another on the basis of mint prices of gold or silver in any two countries.* It should be remembered that there cannot be a mint par of exchange between a gold standard and a silver standard country, or a gold standard and a paper currency or tabular standard country, or paper currency or tabular standard countries. It can be only between countries (1) having gold standard, or (2) silver standard.

But one currency will be exchanged with another currency at mint par of exchange only when the debits and credits between two countries exactly balance. Needless to say, the state of accounts is rarely, if ever in that position. In the illustration taken at the beginning of this chapter, however, as we started with this very assumption, we may say that the equivalents of £100 in Indian currency will be determined at the mint par of exchange rate.

The question may, then, be asked; how the rates of exchange between any two countries are in actual practice determined—and specially, when mint par of exchange is not applicable? In fact, this is the state of affairs prevailing at present, all over the world. We shall examine it in the following chapter.

SUMMARY

1. Foreign exchanges mean buying and selling of the money of other countries, and refer to (1) the bills of exchange, (2) the rate of exchange, and (3) the institutions through which exchange business is conducted.

2. There are different kinds of bills of exchange. The parties to them may be the drawer, the drawee, and the payee. They are used as media for making foreign payments.

3. Exchange banks bring about settlement between individuals by purchasing from and selling to them bills of exchange.

4. The use of foreign bills brings about an economy in the use of precious metals.

5. The rate of exchange between currencies based on gold is determined by mint par of exchange between them. But the actual rate depends upon various other factors. Then, there is also the question of the determination of the rates of exchange between currencies other than gold. To all of these we shall look in the next chapter.

TEST QUESTIONS

1. What is meant by foreign exchange? To what things does this actually refer?

2. Define a bill of exchange. In what way is it used in payment of foreign debts? Give an illustration.

3. What services do foreign banks render in the settlement of foreign debts? Show that they economise the use of gold by employing bills of exchange.

4. What do you understand by the term mint par of exchange? In what cases it exists and in what not?

CHAPTER XII

FOREIGN EXCHANGES—II

Having looked to the art side of the foreign exchanges, we now turn to the science side of it as well. This is concerned with the knowledge of the rates of exchange and the methods of exchange control. A good deal has been said on both these topics very recently. We shall, however, for the present, confine ourselves only to what is necessary for a clear understanding of the elements of foreign exchanges, and leave the rest.

1. Rate of exchange

The term : rate of exchange means *the price of a foreign currency in terms of home currency.* If we look to the Market Reports column of a newspaper, we shall, however, find that *it is quoted either in terms of home currency or in those of the foreign currency.* If quoted in the former way, it will be the units of home currency given equal to one or hundred units of foreign currency ; and if quoted in the latter way, it will be the units of foreign currency given equal to one or hundred units of home currency. For example let us take the following :—

I

The following are the exchange quotations :—T. T. London $18\frac{3}{32}$; New York $269\frac{7}{8}$; Paris 830 ; Berlin $91\frac{1}{2}$ Amsterdam $67\frac{1}{4}$; Tokio $77\frac{3}{4}$; Shanghai 81 ; Hongkong $82\frac{3}{4}$; Singapore $156\frac{1}{4}$; Java 67 (From an Indian Paper).

They mean :—Re. 1=1s. $6\frac{3}{32}$d. (The quotation is in the terms of a foreign currency) ; Rs. $269\frac{7}{8}$=$100 (The quotation is in the terms of home currency) ; Rs. 100=830 Francs, Rs. 100=$91\frac{1}{2}$ Marks, Rs. 100=$67\frac{1}{4}$ Gldrs. (All quotations are in the terms of foreign currencies) : Rs. $77\frac{3}{4}$ =100 Yens, Rs. 81=100 Tael. Rs. $82\frac{3}{4}$=100 Hongkong Dollars, Rs. $156\frac{1}{4}$=100 Singapore Dollars, Rs. 67=100 Java Gldrs. (All quotations are, again in the terms of home currency).

II

The following are the exchange quotations :—T.T. Bombay 1s. $6\frac{1}{8}$d ; New York 4·93 ; Paris 110·89 ; Berlin 12·29½ ; Amsterdam 8·98¼ ; Brussels 29·22¾ ; Berne 21·54¼ ; Milan 93·72 (From an English paper).

They mean 1s. $6\frac{1}{8}$d. = Re. 1 (The quotation is in the terms of home currency); £1 = 4·93 Dollars, £1 = 110·89 Francs, £1 = 12·29½ Marks, £1 = 8·98¼ Gldrs., £1 = 29·22¾ Belgas., £1 = 21·54¼ Sw. Frs., £1 = 93·72 Liras (All quotations are in the terms of home currency).

Different kinds of rate of exchange. In both the above cases, we have got *T. T. rates*, which means money will be available at the foreign centres as soon as the cable reaches there, the cable charges being borne by the purchasers of T. T.

The rates may be also *on demand* (O. D.) which means money will be available at the foreign centres at least three weeks after. Ordinarily, T. T. rates are more expensive than O. D. rates.

Usance bills are six, four, three and two 'months after sight' (m/st) bills which are dealt with in the discount markets. Of these the six m/st bills are the cheapest, and two m/st the dearest.

In the quotations given here, we have got *bank's selling rates.* There may be also the *bank's buying rates.* Usually banks' buying rates for T. T. and O. D. are not given ; they are for usance bills. The reason is simple. We know that the sellers of bills to the banks are generally exporters and businessmen who cannot possess large balances abroad. Hence neither they can sell, nor the banks can purchase such exchanges to any considerable extent.

Cheapness and dearness of the rates of exchange. The banks always try to keep a margin between their buying and selling rates which represents their profit. This means they buy cheap and sell dear. It may, however, be remembered that *high or low rates* do not imply any cheapness. *They refer simply to the nominal amount of the quotation.* Similar is the case with the terms *rise and fall.* The difficulty is due to the fact that quotations are sometimes made, as has already been seen, in home currency and at others in foreign currencies.

When quotations are made in foreign currencies, a *high* rate or a *rising* rate will be cheap, and a *low* rate or a *falling* rate will be *dear.* And, when quotations are made in home currency, a *high* rate or a *rising* rate will be dear and a *low* rate or a falling rate will be cheap.

Favourable and unfavourable rates of exchange. There is also some confusion with the terms *favourable and unfavourable.* When used in connection with the exchange quotations, they always refer to the buyers and not sellers. Hence, cheap exchanges are always favourable,

and dear unfavourable. If, however, they refer to the sellers, it is just the opposite. This is also the case, if considered from the point of view of the Mercantilists who attached a great importance to the importation of precious metals. In fact, they regarded an exchange rate favourable only if it led to the influx of gold. In case, it was otherwise, they regarded it as unfavourable. Finally, exchange rates affect different classes of people differently. We shall look to these later on.

Short and long rates of exchange. There are the terms *short and long exchange.* The rates for T.T. and D.D. are known as sight or cheque rates or short exchanges, and the rates for usance bills are called long exchanges. The long exchanges are not now usually quoted, but given the short exchange with any centre, and (*i*) the rate of discount ruling in the market where the bill is payable and also where it has been discounted—the former being of primary importance, because bills are usually discounted at the rates ruling in the markets where they are payable, (*ii*) the stamp duty which is charged on usance bills, and (*iii*) the insurance charges to cover the risk and uncertainty involved on usance bills, they can be easily computed. What will be required to be done actually is to add the latter three items to the former one item when quotations are in foreign currency, and to deduct them when they are in home currency: Thus, it appears that long rates are primarily dependent upon short rates and other things being equal should vary *directly* with them. But the truth is that other things do not remain equal in most of the cases, and hence the variation is not usually direct. Finally, it may be mentioned that discount charges, in this case, will relate only for the period which is actually required to be run before maturity and not the usance. To take a concrete example, suppose X has got a six months' sight bill which, after retaining for 2 months, he wants to discount. The discounting charges will be for only four months, and not for six months. Hence, only these are added or deducted. The rate charged in this way is known as the '*tel quel*' or '*t. q. rate.*'

Cross rate. *Cross rate* is the rate of exchange between two currencies quoted in a foreign country, *e.g.*, rate of exchange between Pound Sterling of England and Dollars of America quoted in India.

Ready and forward rates. There is one more classification of the rates of exchange, *viz.*, *ready and forward.* Ready rates or spot rates are the rates for the present delivery of exchange, and forward rates refer to future delivery. All classes of exchange, including long as well

short, are bought and sold in the market at forward and ready rates. Businessmen and bankers are interested in the former as much as in the latter. Businessmen are interested in it because they wish to make arrangements for the receipts and payments of money in connection with their exports and imports respectively and bankers are interested in it because they want to cover themselves in connection with their sales and purchases of foreign exchanges.

2. Determination of the rates of exchange

Different writers have advanced different theories about the determination of the rates of exchange, and the earliest of them is that of the Mint Par of Exchange.

1. Mint Par of Exchange Theory. According to this *the normal rate of exchange depends on the relative values of the two currencies in terms of gold, i.e.,* on the relative weights of gold defined in the laws of the countries as the basis of their respective standards. *The actual rate of exchange also cannot diverge from this normal rate of exchange in either direction by an amount which exceeds the cost of sending gold from one country to the other.*

And in banking parlance, as we know, the relative values of the two currencies in terms of gold is known by the term mint par of exchange ; hence the designation of the theory. With regard to the divergence of the actual rate from the mint par of exchange it may be said that the limits are set by what are known as gold points or specie points. There are two gold or specie points—one the upper and the other the lower—upto which rates can usually shift. The *lower gold or specie point* is determined by subtracting from and the *upper gold or specie point* by adding to the mint par of exchange the cost of the transmission of gold from one country to the other.

Accounts in connection with foreign trade are, as we know, settled by means of bills of exchange. As a result, if exports and imports of a country balance, supply and demand of bills of exchange also balance. Under such circumstances, the normal rate of exchange, as determined by mint par, will also be the actual rate of exchange. There will be no variation. But this seldom happens. Hence, *the price of bills varies as its supply in relation to demand, and consequently also the actual rate of exchange.*

The variations are, of course, always within the gold or specie points Let us take a concrete example to illustrate it. Suppose there is a greater supply of bills in London on New York than the demand for them. The sellers will, in this case, perhaps not mind giving a little

more of American currency than the mint par. But this cannot exceed the mint par by the cost of transportation of gold, *i.e.*, the upper gold or specie point. As soon as it exceeds, they will prefer to import gold. The upper gold or specie point is, for this reason, also known as the *gold import point*. Similarly, let us suppose that the demand for bills is greater than their supply. In this case, buyers will be willing to accept a little less of the American currency than the mint par. But this can again, in no account, be less than the mint par minus the cost of transportation, *i.e.*, the lower gold or specie point. If it is so, they will prefer to export gold. This point is, therefore, known as the *Gold export point*. Thus it is obvious that the actual rate of exchange will fluctuate in the market within the gold or specie points according to the supply of bills in relation to demand, and not cross them.[1]

Mint Par of exchange, as we know, exists only between countries having gold standard. It may, therefore, be argued that this theory is also applicable only to them. But its advocates carry it further. They say, *it is applicable to countries having paper standards as well.* Ricardo emphasises the point that if a country has adopted a paper standard, its exchange rates may deviate from par in the same proportion as the quantity of its currency is increased beyond the amount which would be retained by the country if it had a metallic standard and trade in that metal were free.[2] This is no doubt true, but the objection to the use of the term : mint par of exchange remains standing, and hence the difficulty.

2. *Balance of Trade Theory.* As we know that the supply and demand of bills upon which the ultimate determination of the actual rate of exchange depends, *arise due to trade*, there are people who advocate what is known as the balance of trade theory. If a country's balance of trade is favourable, its claim upon the currencies of other countries will be greater than what is theirs to its own. As a result, the currency of this country will be at a premium, *i. e.*, it would command greater value in respect of the currencies of other countries, and the rates of exchange will be obviously favourable to it. Quite opposite to this if the balance of trade is unfavourable to it, its currency in

[1]Exchange rates would cross the gold or specie points only (1) when gold standard does not exist in either or both of the countries. (2) when a nominal gold standard exists, but gold exports are not allowed, or exchange control is exercised, (3) when gold or specie points themselves vary either due to a variation in the charges of transmission, etc., or due to the levying of a premium by the central bank for all gold purchased from it for export.

[2]Money and Foreign Exchange after 1914—Gustav Cassel.

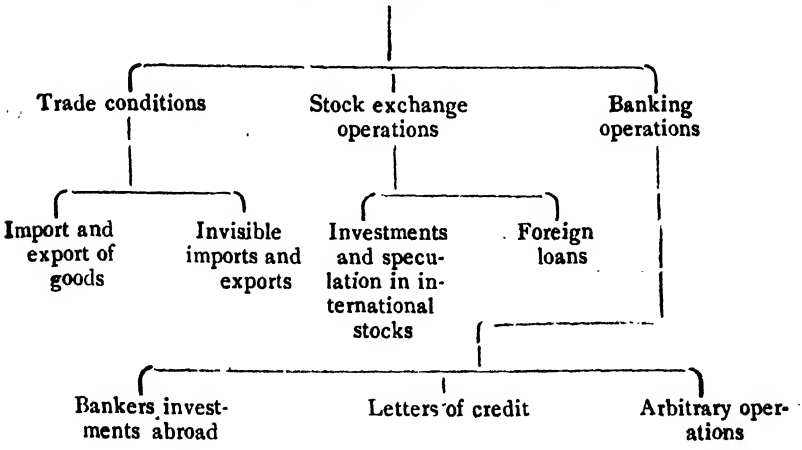
respect of the currencies of other countries will be at a discount, *i.e.*, will command less exchange value, and the rates of exchange will be unfavourable to it.

This is right but bills do not arise only due to trade. They arise due to various other influences as well. Hence, it will be better, if the Balance of Trade theory is changed into the Balance of Accounts theory.

3. *Balance of Accounts of Theory.* Mill and Goschen had all to say something on the balance of accounts theory, they referred to it only in connection with the mint par of exchange theory. Mill said, 'the actual rate of exchange in the case of such a depreciated currency is the result of two factors : the "real" rate which follows the alteration in the balance of payment, and the 'nominal" rate which is determined by the amount of the depreciation of the currency below its metal parity.' Goschen said, 'in the case of currencies maintained at their metal parity, the exchange rate is determined by the balance of payment – that is to say by the supply of and demand for bills.'

From the above, it is obvious that while Mill dwelt on the determination of the rates of exchange between depreciated currencies as well, Goschen chose not to say anything regarding it. Mill went on to say, 'A depreciation of the currency causes a premium on gold, and prices of foreign bills rise in proportion to this premium in exactly the same way as prices of any purchasable article. If, however, gold cannot be sent as means of payment, this ground for determination does not exist. Prices of foreign currencies will then depend entirely on supply and demand ; if the demand for bills exceeds the supply theoretically there is no limit whatever to the price of bills.' This means he left the problem in this case undetermined. So, we may say he did not expound a theory of exchange between paper currencies.

Supply and demand of bills depend upon various factors.



(1) *Import and Export of goods.* While imports of merchandise and treasure create demand for bills their exports increase the supply. If the former exceed the latter, the exchange rates go unfavourable, and if it is otherwise they turn favourable. But it should not be expected that trade conditions between one country and another act only upon the rate of exchange with that particular country, they act as a whole. Payments can be made also indirectly, *i.e.*, out of the balances in a third country.

(2) *Invisible imports and exports.* Under this heading are included services rendered by one nation to another which have to be paid for. They, therefore, exert the same influence on exchanges as trade conditions.

If, for instance, foreigners tour in a country, they utilise the services of the people residing there, and hence draw upon their country to pay for them. This has the same effect as exports have. Supply of bills is increased, and the rate of exchange tends to rise.

Next, if foreigners are employed in a country, they transmit their savings to their home countries, and this creates a demand for bills which has the same effects as imports. The exchange, thus, tends to fall.

These are only two of the examples. There may be services rendered by insurance companies, shipping companies, bankers and brokers, etc.

(3) *Investments and speculation in international stocks.* The prices of certain international stocks which find a ready market all the world over are telegraphed continually from one centre to another, and variations, if any,

give rise to orders for buying or selling. This necessitates transference of money and gives rise to the supply of or demand for bills. These dealings may be for the purposes of either investments or speculation as well.

(4) *Foreign loans.* The effects of foreign loans are of a varied nature. First of all, when loans are received money flows in. This creates a supply of bills and thus raises the rates of exchange. Next, interest is paid upon it annually. This lowers the rates of exchange. Similarly, at the time of the repayment of loans, the rates tend to fall. The opposite takes place when loans are given.

(5) *Bankers' investments abroad.* Bankers in some countries keep their money in other countries. Formerly, this was done because there were certain 'free gold centres,' *i.e.*, the places from where gold could be obtained for export. At present, this is done because most of the countries keep their balances either in sterling or in dollars, as they have got either a sterling or a dollar exchange standard. Moreover, bankers may also find their investments in foreign countries more paying because of a higher rate of discount prevailing in them in comparison to what is in their own countries. All these transactions have their effects on the supply or demand of bills.

(6) *Letters of credit.* They are chiefly used by travellers[3] and may be either for maintaining them in foreign countries or for doing business. The exchanges go against or in favour according as a country issues them or receives them.

(7) *Arbitrage operations.* Such operations may take place in connection with bills, bullion stocks and shares, and foreign exchanges as well. They constitute a form of speculation which is carried on with a view to earn profit out of the differences in prices ruling in two or more centres at the same time.

Besides the above factors, as given by Sykes, there may be many other; *e. g.*, remittance of money for benevolent purposes, tolls levied by one nation upon another, etc.

The Principal short-coming of the balance of trade or accounts theory.

The principal short-coming of the balance of trade or accounts theory is that we ignore in both these cases the influences on the rates of exchange dependent upon the condition of the currency of the countries concerned. In fact, the rates of exchange are influened by two sets of

[3] For a detailed discussion, please see my book Banking –Principles : In India.

causes: (1) those dependent upon the demand for and supply of bills, and (2) those dependent upon the condition of the currency of the countries concerned. In the mint par of exchange theory, as we have already seen, both these sets of causes have been given due weight. The condition of the currency of the countries concerned influences the normal rate, and demand for and supply of bills influence the deviation from it; and hence the actual rate. In the purchasing power parity theory as well which we shall take up next, both these sets of causes have been taken into consideration.

4. Purchasing Power Parity Theory. Purchasing power parity theory was advanced by a Swedish Economist: Gustav Cassel by name. As he says, he hit at it in 1904, but actually introduced it in 1918.[4] According to this theory exchange rate between any two countries is determined by the quotient of the purchasing power of money in either country.

First of all, he says "what is the principal reason for a foreign currency being in demand, and what effect has an alternation in the intrinsic value of that currency upon the demand for the same? The putting of this question has brought me to the following line of argument: Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money possesses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so much of our own money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries."

But 'this,' as he says, "presents a solution of the exchange problem in only a first and rough approximation." In other words, it gives us only a normal rate of exchange. In order to arrive at the actual rate, supply and demand of bills shall have to be taken into consideration. Moreover, a variation in the normal rate may also be brought about by inflation or deflation in either currencies. The rule given by him to be applied in such a case is: When two currencies have undergone inflation, the normal rate of exchange will be equal to the old rate multiplied by the quotient of the degree of inflation in

[4]The actual term "purchasing power parity" I introduced at a later date (my article, "Abnormal Deviations in International Exchanges in the Economic Journal, December, 1918).

the one country and in the other." This will hold good for deflation as well. Rates of exchange deviate from the purchasing power parities due to the following circumstances :—

(1) *Anticipation of the future inflation or deflation, specially inflation.* 'The world sees that the process of inflation is continually going on, and that the condition of the state finances, for instance, is rendering a continuation of the depreciation of money probable. The international valuation of the currency will, then, generally show a tendency to anticipate events, so to speak, and becomes an expression of the internal value the currency is expected to possess in a few months, or perhaps in a few years' time.'

(2) *Speculation in exchanges.* The actual rate of exchange may be raised or lowered by speculation in exchanges. This has been made the scapegoat for the changes in the international value of money by the authorities in the same way as for those in the prices of commodities.

(3) *Sale or purchase of currencies with a view to procure or invest funds respectively.* An instance of the former is provided from the case of Germany which sold just after the war of 1914-18 German marks abroad on an ever-increasing scale at any price available with a view to procure funds in foreign currencies to meet first of all the dire needs of the central government, the municipalities, the banks and business enterprises, and then the reparations.

(4) *Difference in the degree of changes in general price-level and that of the export and import commodities.* 'Our calculation of the purchasing power parity rests strictly on the proviso that the rise in prices in the countries concerned has affected all commodities in a like degree If that proviso is not fulfilled, the actual exchange rate may deviate from the calculated purchasing power parity. If a rise in prices in country A, for example, has affected in a particularly high degree those commodities which that country exports to B, the consequence must be that A exchange in B is depressed to a value somewhat below the purchasing power parity calculated on the basis of the alteration in general price-level in A. The reverse may follow, if the rise in prices has affected in a particularly low degree the export commodities. Similarly, a difference in the degree of changes in general price-level and that of the import commodities will have its own effects.

Economic forces, *however*, always tend to bring about adjustment, and deviations from the purchasing power parities due to the above influences will in the long run

be made up. But there are deviations due to the influences which may be more permanent, *e.g.*, trade restrictions by law or artificial and natural hindrances. As an example of the former, we may have absolute prohibition of export, prohibition covering a system of licenses, rationing of export, export duties, measures adopted for maintaining higher prices for foreign buyers than those payable on the inland market, etc., or the import prohibitions. Coming to the latter, there are transport difficulties.

Certain safeguards in connection with purchasing power parity theory. There are certain safeguards in connection with purchasing power parity theory which must not be lost sight of.

First of all, purchasing power parity is a moving par and hence varies with every change in the price-level of the countries concerned. But, it does not follow that with every change in the price-levels, the rate of exchange is affected. If the price-levels in the countries concerned increase or decrease to the same extent, the rate of exchange between them remains unchanged.

Secondly, the normal rate of exchange of a country represents the point where there can be no disparity between the external and internal purchasing powers of the currency of that country. If there is a difference, the existing rate is not normal, and it does not, therefore, represent parity. In such cases also economic forces begin to operate and remove the disparity.

Finally, the theory does not in any way suggest that the price-levels in two countries will be equal.[5] In fact, they are never so, because of the differences in national dividends, standards of living, mobility of labour and capital etc.

A critical estimate of purchasing power parity theory. First of all, the advocates of purchasing power parity theory claim that it must be the foundation of every sound theory of exchanges. Even when both countries under consideration possess a gold standard, the rate of exchange between them must correspond to the purchasing power parity of their currencies. The purchasing power of each currency has to be regulated so as to correspond to that of gold; and when this is the case, the purchasing power parity will stand in the neighbourhood of the gold

[5]Consequently the statement gold parity is not purchasing power parity. If Re. 1—8.475 grains of gold or 18d., it does not follow that the purchasing power of Re. 1 in India is equal to the purchasing power of 18d. in England.

parity of the two currencies. Only when the purchasing power of a currency is regulated in this way will it be possible to keep the exchanges of the currency in their parities with other gold currencies. If this fundamental condition is not fulfilled, no gold reserve whatever will suffice to guarantee the par exchange of the currency. Under stable currency conditions and when no radical alterations in the conditions of international trade take place, no great or lasting deviation from purchasing power parity is possible. Of course, small fluctuations in the rate of exchange may be caused by fluctuations of demand and supply of bills on the exchange market. A rate of exchange which deviated considerably from the purchasing power parity would be a great stimulus to the exports and a great obstacle to the imports of one country and would work in the opposite direction in the case of the other country and thus a reaction of immense strength would be created tending to bring back the rate of exchange to the equilibrium determined by the purchasing power parity. This equilibrium, therefore, possesses a very considerable stability. It, no doubt, holds good in the cases of paper currencies.

Secondly, its opponents point out that one of the greatest difficulties is to calculate the price-levels in the countries concerned. Index numbers, as we know, cannot be regarded reliable, and hence if we take two index numbers of two different countries and specially because of the different ways followed in them in their construction, the results may not be convincing.

Thirdly, as already pointed out, the actual rate of exchange may remain different from the normal rate of exchange determined by the purchasing power parity for long due to the restrictions to trade between any two countries. This took place in the case of the Swedish exchange as pointed out by Miss Van Drop, the famous Dutch economist. She showed that during the war of 1914-18, in view of the inflation of currency in Sweden, the Swedish exchange should have depreciated by 133 per cent as compared by the pre-war figure whereas it actually depreciated by only 125 per cent.

5 Artificial regulation of rate of exchange In connection with the discussion of the various monetary standards, we saw that there are also countries with exchange standards. In their case, rate of exchange is not determined by the application of any scientific theory. It is arbitrarily fixed and artificially regulated. The case of India provides an instance. In such cases, huge reserves are held both in the home and foreign count-

ries for meeting the bills drawn by the authorities in the former country or by their agents in the latter on each other at the maximum and minimum rates above or below which the actual rate of exchange cannot go. It, however, fluctuates according to the supply of and demand for bills.

Then there are certain countries with paper currencies but these have made arrangements for the convertibility of their home currencies at fixed rates in one or more currencies. They take for this purpose the services of the Exchange Equalisation Accounts. During the latter years of the war of 1914-18 as well, exchange rates between Sterling and Dollar had been pegged, *i.e.*, arbitrarily fixed, and maintained at this level. There are other examples as well of such arrangements.

3. Factors influencing rates of exchange

From the above, it is quite obvious that the main factors influencing the rates of exchange are (1) *the currency conditions*, and (2) *the demand for and supply of bills*. Besides, there are certain *subsidiary factors* as well But before taking them up we must turn to the currency conditions once more. We know that as between gold standard or silver standard countries, normal rates of exchange are determined by their mint par of exchange. If there are debased coins in circulation, and they are not taken back by the mint at their full value, due allowance has to be made for them. The relative values of gold and silver are ascertained and these, as we know, are always varying according to market conditions. As between a gold standard and a paper standard country, the extent of the depreciation of the paper currency has to be taken into consideration. Similarly, as between any two paper standard countries, the extent of the depreciations of the paper currencies in both the countries is required to be found out. Or, we may say that in all the above cases currency conditions can be determined by purchasing power parities, and perhaps, it is on this account, that the advocates of purchasing power parity theory say that it must be the foundation of every sound theory of exchange. Lastly, in case of exchange standard countries, exchanges are arbitrarily fixed and artifically regulated. As regards the demand and supply of bills, we have already looked to the factors influencing them.

Subsidiary factors. Coming to subsidiary factors they are the banking development, the bank rate, the national budget, the political and industrial outlook and tariff rates, exchange restrictions and quotas, etc. We will take now each one of these:—

(1) *Banking development.* The factors influencing rates of exchange exert themselves through banks, and hence in cases where banking development has reached its perfection, even a slight variation in them has its immediate effects. Where this is not the case, they remain ineffective, or at least exert themselves after much delay.

(2) *Bank rate.* Bank rate also has its own influences. If it is high in relation to other centres, it attracts funds from those places, and thus creates a demand for home currency, which turns the rate of exchange favourable. Opposite happens when the rate is lowered.

(3) *National budget.* National budget is an index to the national finances. In case, it shows a surplus, it inspires confidence which leads the speculators in exchange to buy up the currency of such a country in the expectation of rise in its value because of the increased prosperity which ensues under such circumstances. Quite reverse happens in the opposite case.

(4) *Political outlook.* If political outlook in a country is pessimistic, its exchanges are depressed. Stability of government, maintenance of law and order, cordial relation between different classes of people residing in the country—all have their own effects.

(5) *Industrial outlook.* Industrial outlook in a country also has the same effects, as political outlook. An optimistic view leads to an inflow of capital, while a pessimistic view leads to its outflow.

(6) *Tariff rates, exchange restrictions, and quotas.* Tariff rates, exchange restrictions, and quotas - all act as impediments to foreign trade, and thus change the course of exchange rates. They have been increasing since the passing of the Hawley Smoot Tariff of 1930. The world war II has resulted in increased export, import and exchange restrictions. The working of the I. M. F. and International Bank may, however, set the matters right.

4. Exports pay for Imports

Balance of trade, and balance of accounts theories have, in fact, got as their basis the principle—*exports pay for imports.* The advocates of the latter are, however, correct to a larger extent than those of the former as they take exports and imports in a broad sense. 'Commerce is simply, as its name implies the exchange of commodities for commodities.' Each country keeps, so to say, a trading account with the rest of the world—an account which it debits with what it gives and credits with what it receives. The debits act as a set-off against the credits, and only

the balance is left for settlement in money. In a more primitive state of society, before the use of money became general, there could not be any question of there remaining any balance, and of its being settled in money. Traders from all over the world came to this country in middle ages and exchanged commodities with commodities. This had been going on in all the parts of the globe for long. King Solomon, the builder of the historic Temple, raised loans from Hiram, King of Tyre, by resorting to a similar expedient. He wrote to the latter asking him to supply him with cedar and fir, and offering in return to send wheat and oil. The latter's reply is very interesting:—

'And Hiram sent to Solomon, saying I have considered the things which thou sentest to me for; and I will do all thy desire concerning timber of cedar, and timber of fur. My servants shall bring them down from Lebanon unto the sea; and I will convey them by sea in floats unto the place that thou shalt appoint me, and will cause them to be discharged there, and thou shalt receive: and thou shalt accomplish my desire in giving food to my household.'

'So Hiram gave Solomon cedar trees and fir trees according to all his desire, and Solomon gave Hiram twenty thousand measures of wheat for food to his household, and twenty measures of pure oil' as the account goes.

When gold and silver had been firmly established as money material, if there was any balance left, it was adjusted through the remittance of specie. But this paying out of the specie and receiving of it affected the supply of money and produced such changes in prices as led to the equalising of exports and imports. Hence, taking a long period in view, the principle continued to be true. This was what was called an automatic working of gold standard, or as corrective of exchanges. This tendency was visible in U. S. A. also after the heavy influx of gold in that country during and after the war of 1914-18, and during and after the slump of 1929-33 but it was checked by the sterilisation of gold and abandonment of gold standard respectively on both these occasions. At present, gold lies imprisoned in Fort Knox, and silver at West Point; and their free movement has been thus checked.

In the present-day conditions of the world, with tariff rates, exchange restrictions, and quotas existing in every country, the principle is applicable to the utmost. The balances, if any, are carried over to a following period, and settled by changing the course of trade. No movement of money-specie is allowed.

5. Effects of changes in exchange rates upon different classes of people

If the value of the home currency in terms of foreign exchanges rises, it affects the different classes of people as follows:—

(1) *The importers gain*, as they are enabled to charge the same price in the home currency as before for the goods which cost them less. But should they decide to charge a lower price on this account, they increase their sales, and hence ultimately increase their profits.

(2) *The exporters lose*, as they are forced to charge a lower price in home currency for their exports in order to enable them to be sold at the same price in the importing countries as before. If, on the other hand, they charge the same price in the home currency as before, they increase the cost of their goods in foreign countries. This results in a reduction of sales, and hence, of profits as well.

If, however, articles of exports are of necessity or of a monopolistic nature, they may not lose.

(3) *The producers, as a class lose.* In case, there is a competition between home-made and foreign goods producers have to reduce their prices. Besides if their products are the items of exports, they have to charge lower, or if they do not do this they are hit by a reduction in their demand. Finally, even if there is no competition in the home market in the goods produced by them and those imported or if they do not form the items of exports, they have to lower their prices in sympathy with the lowering of the prices of other commodities.

In cases of, however, the producers of articles of necessity, there may not be any difficulty.

(4) As a result of depression in home industries, *wages are reduced and figures of unemployment go up*, hence labourers as a whole lose.

(5) *The creditors as a whole gain* while *the debtors as a whole lose* in this case also as in the case of the fall in prices.

(6) *People with fixed incomes benefit* just as they do when there is a fall in prices.

(7) In case the government of the country has to meet certain fixed expenses in foreign countries *it gains* by a reduction in the amount of the home currency required to send the fixed amount.

(8) Foreigners residing in the country are enabled to

transmit more money in their home currencies by sending the same amount in the currency of the country in which they reside as before.

(9) *Consumers as a whole gain* in the same way as they do when prices fall.

The opposite happens in the case of a fall in the exchange value of a currency.

But all this is temporary. Economic forces always work with a view to bring about adjustment in relations between different classes. Hence, what is bad is not a change in the rates of exchanges, this way or that, but changing rates. During the period of adjustments, trade is hampered and a number of difficulties crop up as they did in our own country between the years 1872-92 and during and after the war (1914-18). We shall look to these in connection with Indian currency.

6. What is an ideal rate of exchange?

With regard to the answer to the question: what is an ideal rate of exchange, it may be said that there are different opinions about it. First of all, there is what is known as the Mercantilists' Theory, a reference to which has already been made. According to it, when the rates of exchanges are *above par*, they are regarded favourable, and when they are *below*, they are regarded unfavourable. We know that there are gold export and import points. *The Mercantilists wish the rate to be always above the gold import point* Then, there is the opinion of the political economists. They regard that rate of exchange favourable which gives a *stimulus to exports and production.* This brings increasing employment and resultant prosperity. From this point of view, a rate below par will be regarded as favourable.

But *rates cannot remain for ever below or above par.* Economic forces tend to bring about an adjustment If there is an inflow of gold for sometime, an outflow is also bound to occur one day or the other. Similarly, if there is a boom period in production, it is sure to be followed by a slump period in its wake. As an eminent writer says "Falser and more misleading expression cannot be conceived than the terms favourable and unfavourable exchanges They survive still the memorable refutation of their untruth by Adam Smith; they involve ignorance of the very nature of all trade; they efface the living fact that men buy of foreign countries to procure goods for use and consumption, that all trade is only an exchange of goods. This language is profoundly unconscious that gold is a mere tool. It teaches that gold, or coin, or money is an end, a good thing for its own sake, an article worth

giving one's wealth to obtain. It is saturated with the Mercantile Theory, so utterly in vain has Adam Smith written .....The value set on favourable exchanges is the greatest intellectual and literary wonder of our age"

7. Recent Depreciation and Devaluation of currencies

Before looking to the recent depreciation and devaluation of currencies it is necessary that we must understand these terms fully. First of all, our definition of the term devaluation as given in Chapter IV needs a little modification. It was said at that place that it is a reduction in the metallic contents of the standard coins sanctioned by law. If there are no standard coins in circulation it will mean *a reduction in the exchange value of the token currency in circulation in terms of gold or foreign exchanges, as* the case may be. The consequent effect of every devaluation will be a fall in the purchasing power of the currency, first of all in gold and then generally which, in other words, means depreciation. Hence, the difference between a devaluation and depreciation lies only inasmuch as the former is sanctioned by law and the latter is only as a result of the economic forces.

Bearing the above difference in mind, it may be said that the pound has depreciated in terms of gold since 1931, and American dollar has been devalued. The gold value of the dollar was reduced by law in the year 1934 by 41 per cent of what it was before the abandonment of gold standard by U. S. A. in 1933. There has, on the contrary, been no devaluation.[6] of the pound ; and taking the reduced value of the dollar and the mint par of the pound, the exchange between them should be £1=$8·24. But as the pound purchases only 4·03 American dollar, it has depreciated in terms of gold.

8. Exchange Control

There is, all the world over, at present, a system of inconvertible paper currencies in prevalence. But the exchanges between the n are not allowed to be governed according to any scientific theory. They have, rather, been *arbitrarily fixed* and are *artificially regulated* by their respective governments. It is, in fact, to this governmental interference in foreign exchanges that we refer, when we use the term exchange control or exchange regulation.

Paul Einzig defines it in his 'Exchange Control' published in 1934 as '*all interferences by monetary authori-*

[6]No doubt the gold holdings of the Paper Currency Reserve and the Exchange Equalisation Fund were revalued in 1939 at £7.8s. 5d. per ounce.

ties on the exchange markets.' Another writer Heilperin says that 'it consists only in the centralisation of all dealings in foreign exchange in the hands of a public authority.' This may be done either with a view to stabilise exchanges or with a view to prevent a flight of capital and hence gold.

So long as world currencies were linked with gold, they were stable at least in terms of foreign exchanges. But since their abandonment of it, they need control. The importance of the stability of foreign exchanges *for the development of foreign trade and the conveniences of the states* for the purchase of stores and meeting of other expenses arising out of foreign relations is great and should not be overlooked. They have *their bearings upon the whole national life as well*, and are, therefore, of sufficient consequence. Next, there is the question of *the movement of capital.* Depressing exchanges result in its flight, and *vice versa.* Every nation wants its capital for its own use. Besides, *gold reserves cannot be allowed to fall below a certain level*, and this cannot be prevented so long as the flight of capital continues. Hence also, there is the need of its abatement.

Methods of Exchange Control. There are several methods of exchange control, and their number has been increasing in recent years. We shall, however, be able to look to only such of them as are most in use.

(*1*) *Regulation of foreign trade.* Under this heading, we have to study various devices, *e.g.*, those of Tariffs, Quotas and Licences. *Tariffs have been long in use.* For about hundred years from the date of the Industrial Revolution, they were regarded as the most important weapons for protection and giving stimulus to home industries Then, there was a change. But they were revived again after the war of 1914-18. No doubt, for a brief period after the Geneva Conference of 1927, as a result of its report, a check was put to their growth. But since 1930, after the passage of the Hawley-Smoot Tariff in U. S. A. of that year they have been ever on an increase. With the coming into force of I. M. F, and Bank, they may again be removed.

When the value of home currency in terms of foreign exchanges is desired to be raised, a system of '*subsidies*' '*bounties*' *or* '*drawbacks*' to exports comes in vogue. In the opposite case, *prohibition duties* are levied on imports.

The system of *quotas and licences* is, however, of somewhat recent origin. Under the quota system only a fixed amount worth or quantity of goods is allowed to be imported during a fixed period of time. Licensing of

imports also has the same effects. At present, almost everywhere we have got a system of licensing of both exports and imports. In our own country, we have to do it in most of the cases. But it will be removed very soon.

(2) *Rationing the supply of exchange.* Under this method, right of buying and selling foreign exchanges at fixed rates is monopolised by the state, directly or through a central bank. This is done to control the exchange rate and conserve the foreign exchanges. A number of such examples are provided in the history of our own currency. The supply of reverse councils was restricted in 1907, and again on the outbreak of war in 1914. Next, the supply of Council Bills was restricted in 1916. When exchanges between two independent currencies are maintained in this way at a level arbitrarily fixed, it is known as *pegging.* In the case of U. K., during the period January 1, 1916 to March 21, 1919, American exchange was effectively pegged. 'By raising loans in the United States and by vast sales to America of "dollar securities" held by British nationals, the rate was maintained at 4·76½ dollars to the pound sterling." This has been done since 1935 as well. At present, the system of rationing is prevalent due to the post war conditions all over the world.

(3) *Exchange Equalisation or Stabilisation Fund.* Great Britain was the first[7] to create such a fund in June 1932 with assets of about £150 million in Treasury Bills. Additions to it since then have been £600 million in three instalments of £200 million each in April 1933, June 1937 and February 1939. It was followed by several other countries of which the United States and France are important. These funds consist of foreign exchanges, gold and home currencies. They are meant to check exchange fluctuations, the portion held in foreign exchanges and gold being used for preventing a fall in the rates, and that held in home currencies for preventing a rise in them.

(4) *Bank Rate.* Bank rate has been used for long as a method of exchange control. We know that there is a tendency for funds to move from one country to another in response to a rise in the rate of interest. For example, if Indians find that a higher rate of interest can be earned by sending funds to England than by keeping them in India, they will gladly do so. Besides, as various rates of interest in a country are dependent upon bank rate, if an influx of capital is desired what is required is to raise the bank rate. An influx of capital

[7]Gold Standard Reserve of India also served the same purpose.

in its turn strengthens the exchange rates as has already been observed previously. If, opposite is desired, reverse may be done.

(5) *Blocked Accounts.* If the Government of a country forbids the transfer of funds of the foreigners held in it, the accounts are said to be blocked, and the funds to be frozen. They may also be allowed to be spent in the country either freely or with some restrictions Its natural result is to check a fall in the rates of exchanges. We already know that the accounts of Germany were blocked up in the year 1931 by different nations of the world after the granting to it of Hoover moratorium. A recent example of this is provided from the issue of the Japanese and Chinese Freezing orders by the Government of our own country on the 28th July, 1941 and 30th July, 1941, respectively. It was done in view of the deteriorating relations between respective governments.

(6) *Standstill Agreements.* When foreign creditors are induced to agree not to withdraw their loans, it is known as a standstill agreement. Such an agreement was made first of all in connection with Austria in 1931. Later on, there came up several of them. The effect of this agreement on the country to which this facility is granted is that its rates of exchanges are prevented from falling further.

(7) *Clearing agreements.* Such agreements are necessary in the cases of those countries which exercise exchange control. Without them, there cannot be any foreign trade, for nobody would like to export so long as he is not assured of payments for it. A number of such agreements have been made in recent years because of the increasing force with which exchange control is being exercised at present.

SUMMARY

1. Rate of exchange means price of a foreign currency in terms of home currency. It may be quoted in terms of foreign currency or of home currency. This may be T. T., on demand, time, and banks' selling or buying rate. Then, it may be cheap or dear, high or low, rising or falling, and favourable or unfavourable. Each of these terms is required to be used with great care. There may also be short or long rates, tel quel rate, cross rate and ready or forward rates.

2. Rate of exchange is determined differently according to different writers. There are (i) mint par of exchange theory, (ii) balance of trade theory, (iii) balance of accounts theory, and (iv) purchasing power parity theory. In certain cases there is an artificial regulation of the rate of exchange as well, and hence none of the above theories hold good.

3. Main factors influencing the rate exchange are (1) currency conditions, and (2) demand for and supply of bills. Subsidiary factors are (1) banking development, (2) bank rate, (3) national budget, (4) political outlook, (5) industrial outlook, (6) tariff rates, exchange restrictions and quotas, etc.

4. In the long run, exports pay for imports. Though this has been always the case, it is more true of present when no export of specie is allowed. If there is a difference in the balance of accounts in a particular year, it is settled next year by changing the course of trade or doing things like these.

5. Fluctuations in exchange rates affect different classes of people differently. But this is only for a short period. In the long run, economic forces bring about an adjustment. Hence, what is bad is fluctuation, and not any permanent rise or fall.

6. Mercantilists regard a rate above par an ideal rate as it tends to cause an influx of gold. Political economists, on the other hand, regard a rate below par favourable as it gives a stimulus to exports and production. But rates cannot remain for ever below or above par, and hence the question : what is an ideal rate of exchange, cannot be answered satisfactorily.

7. Currencies have been recently devalued and depreciated almost everywhere. The result of devaluation, in the long run, is depreciation as well.

8. Exchange control or regulation is interferences by monetary authorities on the exchange markets. Exchanges are not allowed to be governed these days by any scientific theory. They are controlled or regulated everywhere. The usual methods of control are :—(1) Regulation of foreign trade, (2) rationing the supply of exchange, (3) exchange equalisation or stabilisation fund, (4) bank rate, (5) blocked accounts, (6) stand-still agreements, (7) and clearing arrangements.

TEST QUESTIONS

1. What do you understand by the following :—(1) rate of exchange, (2) T. T. rates, (3) on demand rates, (4) 3 months' rate, (5) bank's selling rates, (6) bank's buying rates, (7) a cheap rate, (8) a dear rate, (9) a high rate, (10) a low rate, (11) a rising rate, (12) a falling rate, (13) a short rate, (14) a long rate, (15) cross rate, (16) ready rate, and (17) forward rate ?

2. Explain the term mint par and specie points, and show how and why the actual rates of exchange in the market fluctuate within the specie points. (U. P. Board).

3. On what do the gold points depend ? Can exchange go beyond the gold points ? If so, when and why ? (Punjab—B. A.)

4. What do you understand by favourable and unfavourable balances of trade ? What other factors influence the rate of exchange ?

5. Explain briefly the factors which determine the rate of exchange between two countries.

How is the rate of exchange of a country affected by (*a*) foreigners touring in it, (*b*) foreigners employed in it, and (*c*) foreign loans ? (U. P. Board).

6. Explain clearly what is meant by invisible exports and imports. Why is it not easy to gauge aright the exact amount and value of these invisible exports and imports at any particular moment ? (Delhi B. A.)

7. Give your opinion regarding the balance of trade and balance of accounts theories of the determination of the rates of exchange.

8. Show that exports pay for imports. Why is this more true of recent days ?

9. What do you understand by purchasing power parity ? How would you account for the deviation of exchanges from it ?

10. What are the different theories which are advanced in connection with the determination of the rates of exchange ? Examine them critically.

11. How do the fluctuations in the rates of exchange affect different classes of people in a country ? Do you think that these can be avoided in any way ?

12. What do you understand by the term : favourable and unfavourable rates of exchange ? What in your opinion is an ideal rate of exchange ?

13. What do you understand by a devaluation of currencies ? How does it affect exchange rates ? What will be the effect of devaluation upon different classes of people ?

14. What do you mean by 'exchange control' ? Why has it been rendered necessary ? What are the usual methods of exchange control ?

INDIAN CURRENCY

CHAPTER XIII

PRE-BRITISH CURRENCY*

Currency in India, as currency elsewhere, has passed through various stages. Among primitive peoples there was trade by barter. Later on, a number of articles had come into use as media of exchange, and the cow amongst them stood as the highest unit. At the lower end of the scale, for small purchases, stood shells, beads, knives and bars of copper and iron. The cowrie shell, brought from the Maldive islands, remained by far the most prominent even till the outbreak of the Great European War 1914-18. One finds a very frequent mention made of *suvarna* (gold) in the Sanskrit books. From 518 B. C. to about 350 B. C., when an Indian province or satrapy was included in the Achaemenid Empire of Persia, 360 talents in gold dust was, Herodotus tells us, paid annually as tribute from the province into the treasury of the Great King. Coming to the development of coinage, it must be said that this also passed through the same stages as in Europe.

1. Currency during Hindu period

Certain small ingots of silver, whose only mark is three circular dots, represent probably the earliest form. Next, in order, are some heavy bent bars of silver with devices stamped out with a punch on one side. These and other indigenous coins remained in circulation in Southern India till the end of the fourteenth century. But the coins in Northern India, under foreign influences brought about by a series of foreign invasions, under-went many and varied modifications. First of all, there was an imitation from Greek coinage, then from Parthian, and then from Roman through Yuch-chis. Gupta coins of Gupta Dynasty which lasted from about A. D. 320 to 480, were perhaps the best. This period synchronises with a great revival of Hinduism and along with it of literature, arts and sciences. The Huns introduced the Sassanian type. The Sassanians either belonged to Persia or owed allegiance to the Persians. Rajput coins, which followed, did not vary much from Gupta coins.

2. Currency during Mohammadan period

The conquests of Muhammad Ghori wrought a re-

*From The Coins of India - C. J. Brown, page 14.

volution. The engraving of images was forbidden by the Faith Hence, both obverse and reverse were devoted to the inscription which set forth the King's name along with his titles, the date in the Hijri era, the place of mint and the profession of Faith ; there is no God but Allah, and Muhammad is the prophet of Allah. During the Hindu period, coins usually in circulation consisted of gold, copper and billon. Silver was almost absent. But during this period, it re-appeared because of the opening of commercial relations with Central Asia, and finally drove gold. Besides, thee mployment of billon for smaller money at this period was made impossible as the mixture of silver and copper in varying proportions had begun to be unworkable. Till then, it was not known that they form a homogeneous alloy only when mixed in the ratios of 71'89 and 28'11 respectively. So gradually, there remained in circulation in course of time in Northern India only silver and copper coins. Rupee was firmly established by Sher Shah.

A passing reference may, at this stage, be also made of Muhammad Bin Tughlaq. Thomas calls him as 'The Prince of Moneyers.' His coins were the best of all made till then. Next, there was a large output of gold : the issues were of all denominations ; the inscriptions were varied and experiments several—the most striking being that of the forced currency which all students of history know and for which they have given him the title of 'the mad', though there is no madness in introducing iron currency when paper currency can be issued without much adverse comment. The art of coinage, however, being at an imperfect stage at the time, forgeries were fabricated with ease, and as the historians say 'The house of every Hindu was turned into a mint'. The Sultan had, thereupon, to withdraw the issue and redeem genuine and forged coins alike at his own cost.

The reign of the first two Moghul Kings, *viz.*, Zahiruddin Babar and Humayun was nothing more than a kind of military occupation, and hence their silver *Shahrukhis* or *dirhams* were issued only as occasion warranted. Sher Shah, who after the expulsion of Humayun, ruled the country ably for a brief period of five years showed originality in all spheres. His innovations in coinage lay in establishing the rupee and the *dam*. Rupee, a silver coin of 178 grains, and *dam*, a copper coin of 330 grains were issued by him from at least twenty-three places. There were half, quarter, eighth and sixteenth parts of *dam* as well. Akbar and Jahangir expressed their artistic tastes in their issues which were made of both gold and silver varying from 2000 tolas to a few grains in weight.

Big pieces were not current; they were presented by the King. Akbar's and Jahagir's love possessed them the most. Their standard gold coin was the Muhar of about 170 to 175 grains. There were half and quarter Muhars, and some smaller pieces as well. The rupee, adopted from Sher Shah's currency, weighed 178 grains. Its halves, quarters, eighths and sixteenths were also struck. Special coins were issued for special purposes. Gold and silver *nisars* were often issued by Jahangir, Shahjahan, Aurangzeb, Jahandar and Farrukhshiyar for giving presents. Besides, Jahangir issued *Nur Afshan* "Light scattering" and *khair qabul* 'May these alms be accepted.' Aurangzeb and Farrukhshiyar issued *dirham shari* for the collection of Jaziya. The copper coins of the Moghals were based on those of Sher Shah's. The half-dam was called the *nisfi*; the quarter, the *damra*; the eighth of a dam, the *damri*. Akbar issued silver tankahs of 644 grains and their halves, quarters, one-eighths and one-sixteenths, and four, two and one tanki pieces as well.

All these coins were highly ornate; Jahangir's most of all. In the beginning there was Kalima on the obverse, and the name and title on the reverse. But later on, fine couplets were added to them. Sometimes, one couplet was used by one mint, at others by a group and still at others by all. These changed so often. Then followed the Emperor's name on the obverse, and the month, date and mint name on the reverse. For some years, Jahangir issued square and round shapes alternately every year. In his later coins there are pictorial representations of the signs of the Zodaic as well. In some coins, he is shown seated cross-legged with a wine cup in his hand. These were presented by the King to the ladies of his court.

3. Currency during the period of chaos that followed the break-up of the Mogbal empire

Currency had fallen in confusion during the period of chaos that followed the break-up of the Moghal Empire. Independent kings with their territories spreading over only one or more of districts issued their independent coins. The result was that at the beginning of the nineteenth century there were no less than 9 4 different gold and silver coins, old and new, passing as current in the country. Many of them were debased, and there was nothing to distinguish the genuine from the spurious. The English factories coined the South Indian pagodas and copper and silver coins in European style and also reproduced rupees of the Moghals. In 1742 the emperor Muhammad Shah granted the East India Company the right to coin Arkat rupees. Gradually, it assumed control

of all mints within its expanding territories. This was also done by the Marahtas when they were assuming power after the fall of the Moghul Empire Numerous Rajput states had copied the imperial coinage in their mints. The Nizams of Hyderabad had done it in their own territories, and the Rohillas of Rohilkhand in Najibabad, Moradabad, Bareilly and Saharanpur. First of all, this was done under the name of the Moghal Emperor with some distinctive mark showing the authority of the respective issuer. But in course of time, the name of the emperor was dropped Haidar Ali struck pagodas and *fanams* Tipu continued these. In addition he ordered the coinage of muhars and half muhars, silver double and full rupee with its half, quarter, one-eighth, one-sixteenth and thirty second parts, and copper pieces of 40, 20, 5 and $2\frac{1}{2}$ cash. The 40 cash piece weighed 340 grains. The Sikh league, known as the khalsa, formed with a view to safeguard the country from the repeated invasions of Ahmad Shah, had assumed the right of coinage in 1764. For about 12 years, it struck Gobindshahi rupee at Lahore. Nanakshahi rupee was struck at Amritsar. During the reign of Ranjit Singh, coins were struck at several places, notably Lahore Amritsar, Multan, Kashmir, Peshawar and Jhang The Wazirs of Oudh issued Machhlidar rupees from Lucknow from 1784 till 1818. In 1818 Lord Hastings pursuaded the then Wazir to assume the title of king and from that year till the deportation of Wazid Ali Shah in 1856, silver and gold were struck in this part of the country to the Moghul standard.

SUMMARY

1. Certain small ingots of silver with three circular dots in the beginning, and then some heavy bent bars of silver with devices stamped out with a punch on one side were the indigenous coins in India. In Northern India, which was subjected to a series of foreign invasions, they were later on modified from foreign influences.

2. During Muhammadan period, there was a revolution in coinage. Muhammad Bin Tughlaq is famous for his various experiments, and specially that of a forced currency. Akbar's and Jahangir's coins were the most ornate. Rupee had been established by Sher Shah.

3. Currency had fallen in confusion after the break up of the Moghul Empire. There were 994 different gold and silver coins passing as current in the beginning of the nineteenth century. Each king had begun to issue his own coins.

TEST QUESTIONS

1. Show that the conquests of Muhammad Ghori wrought a revolution in the art of coinage in this country.

2. Give a short account of the Moghul coinage. Is rupee a reproduction of the same ?

3. Give a short account of the currency after the break-up of the Moghul Empire and before its revival by the British.

CHAPTER XIV

CURRENCY BEFORE 1835

We have already seen that both gold and silver coins were in circulation in India, when the East India Company came to assume power. But there was *never any fixed legal relation between them.* First of all, the Company tried to maintain *status quo.* But this could not be possible for long. There was *difficulty experienced in carrying on the internal trade.* The exchange value of the coins was determined by their weight and fineness. In making even moderate payments the parties were obliged to call in a shroff to declare the value of each coin, or else everybody had to keep in his pocket a balance and a touch-stone. Then, *it tried to improve currency by taking coinage from the Moghul Kings in its own hands.* It also tried to *establish a bimetallism* by fixing a legal ratio between its gold and silver coins, but this could not prove successful even in the least. The English Governor would fix one rate of exchange between them, the French Governor another, the Nawab of Arcot the third, and the Nizam of Hyderabad the fourth, and there was *the operation of Gresham's law.* The legal ratio had to be changed according as there was need to attract one or the other metal.

1. Despatch of 1806

About this time Lord Liverpool published in England his famous *Treatise on the Coins of the Realm.* This enunciated the principle of monometallism. The Directors of the East India Company, seeking a way out of the currency trouble in India, were much influenced by it, and in their despatch on the 25th of April, 1806, to the Governments of Bengal and Madras wrote that 'they were fully satisfied with the propriety of the *silver rupee being the principal measure of value and the money of account.' Nor was it their intention to drive gold out of circulation* from places where it was the general measure of value, and they took care to specify it. They even proposed that a gold rupee of the same weight and fineness as the silver rupee should be coined, but that no fixed legal ratio should exist between them.

The recommendations of the Directors as contained in the above despatch, of course, allowed discretion to the Indian authorities as regards the time and manner giving effect to them, and hence, were not acted upon immediately.

2. Steps taken between 1818 and 1835

The various Presidencies under the East India Company took steps, in accordance with the provisions of the despatch of 1806, in different years, Madras being the first. *In 1818, the silver rupee of 180 grains, 11/12th fine, was substituted for the gold pagoda* which had been a standard coin there for long. The coinage of the latter was stopped, but it could not be altogether given up. In fact, this was not possible. The people had been associated with it for thousands of years. It continued to be paid and received by all the public offices at such rates as were proclaimed from time to time.

In 1823, Bombay rupee was made indentical with the Madras rupee. The final step was, however, taken in 1835 by the Coinage Act of that year.

3. The Coinage Act of 1835

The Coinage Act of 1835 placed India on silver monometallism. Its essentials were :—(1) The silver rupee of the weight of 180 grains troy (165 pure and 15 alloy or of 11/12th fineness) was declared to be a standard coin and unlimited legal tender *throughout the British India.* Provisions were made for the issue of its half, quarter and one-eighth parts as well. They were to contain silver of the same fineness and proportionate weight as rupee. (2) Gold was completely *demonetised* and gold coins did not at all remain legal tender in any part of the British territories in India. (3) *Gold was, however, allowed to be coined freely.* Mints remained open to the public for the free coinage of both gold and silver. Gold mohurs of the same weight and fineness as the silver rupee could be issued from the mints, and they were meant to circulate at Rs. 15. Gold coins of Rs. 5, 10, and 30 denominations could also be minted.

SUMMARY

1. East India Company tried to improve currency by taking coinage from the Moghul kings in its own hands. It also made attempts to establish bimetallism. The Directors recommended silver monometallism for the country in their despatch of 1806.

2. In 1818, rupee was made legal tender in Madras, in 1823, in Bombay, and in 1835 throughout British India.

3. The Coinage Act of 1835 made rupee standard coins and legal tender throughout British territories in India. It demonetised gold, but allowed its coinage. Mints were open to the public for the free coinage of both silver and gold.

TEST QUESTIONS

1. Give a brief history of the currency system in India in the earlier years of the nineteenth century. What were the peculiarities of the Coinage Act of 1835 ?

CHAPTER XV

CURRENCY FROM 1835-93

From 1835 to 1893 India had a silver standard. *Mints were open to free coinage of silver.* The face value of the rupee was equal to its intrinsic value, *i.e.*, the value of the rupee against gold or commodities was equal to the value of silver contained in it. This period of the history of Indian currency is very instructive. *First of all*, a change in the value of precious metals—silver and gold—brought with it great difficulties in maintaining the stability of the rupee. *Secondly*, with a view to doing away with these difficulties, a number of experiments were suggested and tried. We shall come up to these presently.

1. Attempts to introduce gold in circulation (1835-74)

We know that gold had been completely demonetised by the Coinage Act of 1835, though mints had been left opened to the public for its free coinage. Gold mohurs and Rs. 30, 10, and 5 pieces though coined had ceased to be legal tender currency It is difficult to understand why gold coins struck under the Act were not to be legal tender. Indians had been for long, using gold in circulation, and they continued to demand it even after the passing of the 1835 Act.

The proclamation of 1841. In pursuance of the people's demand, a proclamation issued in 1841 authorised *receipt of gold coins* at public treasuries in payment of public dues at their face value. This meant that the rate of exchange between gold and silver was fixed at 1 : 15, as the gold mohur and the silver rupee were of identical weight and fineness. This satisfied the people though they did not tender gold coins in any considerable quantity. It may be mentioned that *the people could not demand gold coins from the treasuries.* Nor could they enforce payment in these between their own-selves.

Withdrawal of the privilege given in 1841 (1853) During 1848-51 gold mines were discovered in California and Australia. The result was a fall in the value of gold relatively to the silver. This led the people to pay the treasuries in gold coins which were accepted there at the old rate. Gold began to flow to the treasuries in large quantities and the Government lost by accepting it at a

rate higher than the market rate. Hence, *a Notification was issued on 25th December, 1852*, by which the privilege given in 1841 was withdrawn and it was declared that, on or after 1st January, 1853, 'no gold coin will be received on account of payments due, or in any way to be made, to the Government in any public treasury within the territories of the East India Company.'

This had the effect of driving out of circulation and turning into hoard £120 million worth of gold coins, as H. D. Macleod estimates in his book on Indian currency.

Gold continued to be received into the mint for coinage under the Act of 1835.

Revival of the privilege in 1864. There was again an agitation in favour of gold. Almost all the Finance Members of the Government of India championed its cause. In 1864, the Chambers of Commerce of Bengal, Bombay and Madras sent memorials to the Government of India favouring a gold currency. As a result, *the Government agreed to receive and pay when convenient* sovereigns and half-sovereigns minted at any authorised mint in England or Australia at the rate of Rs. 10 and Rs. 5 respectively. But they were not to be legal tender. It may, however, be remarked that gold coins were parted at these rates neither by the Government nor by the people.

Mansfield Commission, 1866. The agitation in favour of a gold currency in active circulation went on and the Government had to appoint the Mansfield Commission, which was the first of the Committees and Commissions which have set from time to time to deliberate upon the problems of Indian currency. *It concluded that* :—

(1) Gold coins of Rs. 15, Rs. 10 and Rs. 5 should be issued as these would find more favour in the eyes of the people than notes[1] of like value;

(2) The introduction of gold coins would pave the way to the establishment of the currency notes;

(3) The currency should consist of gold coins, silver coins and paper notes;

(4) Some of the notes should be made universal[2]; and

(5) The Government should recommend after sometime to the Secretary of State the making of gold coins legal tender in India in pursuance of the general wish of the country.

But nothing substantial resulted from these conclusions

[1] Notes had been begun to be issued by the Government of India since 1862.

[2] This was not done till 1909, see chapter XXI.

and the experiment of the limited introduction of gold into circulation by keeping open the offer to receive and pay at convenience sovereigns and half sovereigns at Rs. 10 and Rs. 5 respectively continued to be carried on. In 1868, the rate for receipt of sovereigns and half sovereigns was raised from Rs 10 and Rs. 5 to Rs. 10·8 and Rs. 5·4 respectively, as the old rate was sometimes below their average market value.

Sir Richard Temple Episode. In 1872, Sir Richard Temple, the then Finance Member, put before the Government of India a scheme for making gold coins legal tender in the country. The following extracts taken from his minutes represent his honest opinion.

'On the whole, it seems clear that while in all branches of administration, we endeavour to give to India the best of everything so far as we can, yet, in respect to metallic currency, we deliberately withhold from her the first rate article and afford her a second rate one.'

Sir Richard Temple resigned in April 1874, and in May following, the Government of India decided finally against the recognition of gold as a standard of value for the country.

2. The Indian coinage act of 1880 1870

In 1870, the Indian Coinage Act was passed *consolidating* all previous legislation on the subject of coinage in British India.

3. Fall in the gold price of silver (1874-1893)

By 1874, a great change had begun in the monetary status of silver. Commencing from 1871, a number of countries, *viz.*, Germany, Denmark, Sweden, Norway and Holland had given up silver standard and adopted gold standard in its stead. Besides, several other countries, *viz.*, France, Belgium, Italy and Switzerland that had joined the Latin Monetary Union, beginning to find it difficult to maintain a pucca bimetallic standard because of the operation of the Gresham's law, due to which over-rated metal (silver) had begun to be poured in them, had suspended the coinage of silver. The effect of these two events was the beginning of a fall in the price of silver. It was further accentuated in the following years due to a number of causes. For the sake of convenience, these may be divided into (*i*) those on the side of silver, and (*ii*) those on the side of gold.

Causes of the fall in the gold price of silver

(*i*) In the early years of the fall *much redundant silver*

coinage was coming on the market from those countries which had given up silver standard and adopted gold standard in its stead.

(*ii*) *The world production of silver went on increasing.* Within a course of about fifteen years from 1875, it rose from about 78 million ounces to about 144 million ounces. This was the result of (*a*) discovery of a number of silver mines in Maxico and other silver producing countries, (*b*) the invention of the Pattinson process for separating silver from lead, which made it profitable to extract comparatively small quantities of silver which in previous times would have been left in the lead as sent to market. A number of lead roofs were taken off the buildings in Europe and were replaced with new lead, merely in order to extract the silver from the old lead.

(*iii*) The cost of production of silver had gone down over and above the fact mentioned in (*ii*) (*b*) due to the *introduction of a new mining machine.*

(*iv*) On the other hand, *the demand for silver was reduced.* A number of countries had given up silver standard and several others though continuing to have bimetallism had suspended the coinage of silver. There were only two countries, *viz*, China and India, left on silver standard at that time Demand from them remained, but this was not sufficient to support the price.

On the gold side the causes were as follows :—

(*1*) *The richest beds of gold fields had been exhausted.* There had not been any discovery of new mines after those of the Australian and Californian. South African and Klondyke gold-fields were discovered at a much later period.

(*2*) *Demand for gold had been rising.* A number of countries had adopted gold standard. Besides, trade was expanding rapidly, and this was giving rise to a greater and greater demand for money.

Attempts to arrest the fall in the price of silver. Several attempts were made to arrest the fall in the price of silver. The most important of these were *connected with the establishment of international bimetallism.* For this purpose, four great International Monetary Conferences were held between the years 1867-1892.

The First International Monetary Conference. The first International Monetary Conference was held at Paris in 1867. This was attended by the representatives of 18 principal countries of Europe and the United States of America. It was a scramble for gold. The Conference declard gold standard to be the only standard suited to

international money. But it opposed the adoption of gold standard by new countries vehemently.

The Second International Monetary Conference. This Conference was held in August, 1878, at the instance of the United States of America after the passing of the Bland Allison Act (of which we shall take a notice later on) by it. It was proposed therein that a common ratio should be adopted between gold and silver by the principal nations of the world to enable the establishment of an international bimetallism. But there was no agreement as gold using countries did not want (*i*) to give up gold standard and adopt bimetallism and (*ii*) to allow gold to be introduced in the currency system of silver-using countries in any form.

The Third International Monetary Conference. This conference met in July, 1881, at the instance of France and the United States of America with the same proposal to consider as before, *viz* , the introduction of international bimetallism. One delegate was sent by England, but on the clear understanding that he would oppose bimetallism. The purpose of sending him was only to give information required by the Conference. Two delegates were sent by the Government of India as well, but it was understood that she was not committed to the principle of bimetallic system in India.

In 1886, the Government of India wrote to the Secretary of State favouring international bimetallism but without any effect.

The Fourth International Monetary Conference. This Conference was called by the President of the United States of America in June 1892 at Brussels. The proposal before it was not the introduction of bimetallism, but to settle "what measures, if any, can be taken to increase the use of silver in the currency system of nations." But there was no agreement even with regard to this point. The Government of India evinced a great interest this time.

The Bland Allison Act. This Act was passed in the United States of America a few months before the calling up by it the second international monetary conference of 1878. Its purpose was to restore[3] silver as legal tender money in that country and to do this it authorised the Secretary of the Treasury to purchase and coin each month not less than 2 million dollars and not more than 4 million worth of silver into standard silver dollars. The purchases were made, but the fall in the price of silver could not be arrested.

[3] It had been dethroned as money in 1873.

The Sherman Act This Act was passed by the Government of the United States of America in 1890, and required the purchase of not less than 54 million ounces of silver by it annually. It was 35 to 43 per cent of the world's production and thrice of what was bought under the Bland Allison Act. There was, no doubt, a temporary rise in the price of silver, but this could not help much. The representatives of the United States had declared at the fourth International Monetary Conference held in 1892 at Brussels that their Government might be inclined to repeal the Sherman Act as a result of the failures of the conference to arrive at an agreement with regard to the measures to be taken to increase the use of silver in the currency system of nations. On November 1st, 1893, the silver purchase clause of the Act was repealed accordingly, and the artificial demand having been thus out off, the price of silver fell further in consequence.

The Gold and Silver Commission. A Royal Commission, *viz.*, the Gold and Silver Commission, set in England in 1886 to enquire into the changes that were taking place at that time in the relative values of the precious metals but without any practical results. Half of the members wrote against bimetallism and half favoured it.

The part played by the Government of India. All through the years 1874—93, the Government of India had been feeling acute distress because of the fall in the price of silver, and hence it could not sit silently. *First of all*, there was the scheme of Col. J. T. Smith, Master of the Mint at Madras, for the adoption of gold currency. *Next*, there was the scheme of the Government of India itself. But they were rejected by the Secretary of State for India. *Thirdly*, it expressed itself in favour of bimetallism. But this as well did not receive the support of the Secretary of State. *Finally*, it sent a despatch to the Secretary of State in June 1892 containing certain proposals to be accepted by the latter on the failure of the Brussels Conference. These proposals were :—

(1) that the Mints in India be closed to free coinage of silver, and

(2) that arrangements be made for the introduction of a gold standard (A fresh scheme was put this time as well).

A further statement was made by the Government in its telegram to the Secretary of State on January 22, 1893, which amongst other things recommended the rate to be established between rupee and gold at 1s. 6d.

4. Herschell Commission, 1893

This Commission was appointed by the Secretary of

State for India to examine the proposals contained in the Government of India despatch of 1892 and statement in the telegram to the Secretary of State on January 22, 1893. *First of all*, the Commission examined the effects of the fall in the gold price of silver. The mint in India, being open to the free coinage of silver at that time, there was a corresponding fall in the exchange rate of the rupee with a fall in the price of silver. This is evident from the following :—

Year		Price of Silver Per ounce in (d.)		Rate of exchange s. d.
1871—72	...	$60\frac{1}{2}$	...	$1\cdot11\frac{1}{8}$
1875—76	...	$56\frac{3}{4}$	...	$1\cdot9\frac{5}{8}$
1879—80	...	$51\frac{1}{4}$	...	1·8
1888—89	...	$42\frac{7}{8}$	...	$1\cdot4\frac{3}{8}$
1890—91	...	$47\frac{11}{16}$	...	$1\cdot6\frac{1}{8}$
1891—92	...	45	...	$1\cdot4\frac{3}{4}$
1892—93	...	39	...	1·3
1893—94	...	$35\frac{5}{16}$	...	$1\cdot2\frac{1}{2}$
1894—95	...	$28\frac{15}{16}$	...	$1\cdot1\frac{1}{8}$
1895—96	...	30	...	$1\cdot1\frac{1}{2}$
1896—97	...	$30\frac{3}{4}$	...	$1\cdot2\frac{1}{2}$
1897—98	...	$27\frac{9}{16}$	...	$1\cdot3\frac{3}{8}$
1898—99	...	27	...	1·4

1. Financial Difficulties of Government of India

(1) *Home charges.* Each year, the Government of India had to remit to the Secretary of State and High Commissioner for India a huge sum in connection with what were known as home charges which were payments for loans contracted in England for Indian railways and irrigation, purchase of bar silver for Indian Silver currency, stores purchased, pensions and furlough allowances, expenses of the High Commissioners' office, etc. In 1892-93, this amounted to £16,532,215,[4] and the fall in the value of silver and hence the exchange rate of the rupee meant that more and more rupees were required to remit every £ than previously. And this resulted in the conversion of a surplus budget into a deficit budget. It was also feared that the price of silver would still go down and hence entail difficulties. The means available for making up the deficit were either increase of taxation or curtailment of expenses. But none of these alternatives was possible, as the taxable capacity of the people had been reached and economies could not be made in the expenses.

[4] In 1936-37 it was £41 million ; in 1937-38, £37 million ; in 1938-39, £36 million ; in 1939-40, £20 million ; in 1940-41, £23 million ; in 1941-42 £25 million ; approximately.

(2) *Fall in customs receipts.* Falling exchanges mean curtailment in imports and hence in customs receipts. The Government was hard hit by this.

(3) *Demand of government employees for a higher salary.* Rise in prices led to a demand of the employees, both government and private, for a higher salary. European officials began to put forward claims for compensation for the loss which they sustained owing to the fall in exchange. They received their salaries in rupees, and to remit a given amount in terms of pounds to England for the support of their families, they had to spend a larger and larger portion of their income than before.

2. Difficulties of the people

(1) *Effect of the financial difficulties of the government on the people.* As far as the effect of the financial difficulties of the government on the people was concerned, it may be said that this was not, on the whole, detrimental to them. In estimating the burden, it must be borne that it is measured by the quantity of product which it represents. When silver fell and prices rose, the increased burden did not represent a greater quantity of produce which had also been simultaneously rising in value. But adjustment between value of money and prices of commodities takes some time to complete, and during the interval Indian producers, particularly the agriculturists suffered some loss for a short time. No doubt this loss was only temporary.

(2) *Shifting of burden.* The burden of increased taxation consequent upon the government's financial difficulties did not fall uniformly upon all the classes of people. For instance, the burden of those who paid a fixed land revenue under a permanent settlement was lightened, and the increased salt-tax was pressing the people at large. It rendered the burden heavier on those who had suffered rather than gained because of the rise in prices, *i.e.*, the consumers' class of people.

(3) *Harassment by trade uncertainties due to fluctuations.* People do not suffer much either by a rising or a falling rate of exchange and consequently falling or rising prices. What they suffer from is trade uncertainties due to fluctuations. It is always good if commerce is free from all the inconveniences of fluctuations arising from the changes either in exchange rates or prices consequent upon an increase or decrease in the supply of money.

(4) *Alleged stimulation of exports.* The tendency of a falling exchange is to stimulate exports. But this is only temporary. In the long run, an adjustment is brought

about by various other factors which are always on the run. In this case, *there was not even this temporary stimulation* as is evident from the figures during this period.

(5) *India made to buy depreciating silver.* Silver was losing in value, and people suffered tremendously on account of this, as they had all of their savings and hoards in this metal. The foreigners finding it cheap to export silver in payment of their Indian imports did it. Had the standard been changed to gold, they would have to send gold instead.

(6) *Difficulties of the people because of a general rise in prices.* Great quantities of silver were imported into India to settle the favourable balance of trade, and this silver was very largely converted into rupees, because mints were open to an unlimited coinage of silver. There was thus a considerable increase of rupee circulation, and at the same time some increase of paper currency. The result was an unprecedented rise in prices, specially during the period 1883-97. This was particularly evident in the prices of foodstuffs, and of other commodities produced and consumed within the country. As a result the consumers as a whole suffered, but the distress was acute in the case of those who had fixed incomes.

(7) *Difficulties of British Officers in employment of India.* British Officers suffered in remittance of money to England for maintenance of their families and children. In addition, they suffered as consumers as well because of a rise in prices.

But it was pointed out by several witnesses before the Herschell Commission that they were not in much difficulty as they were drawing a much higher salary than was required by them. In the next place, the loss in remitting money to England was compensated, to a great extent, by the fall in prices which was taking place in England and other gold using countries.

3. Effect on inflow of foreign capital

A fluctuating exchange or more particularly a falling exchange *tended to check the inflow of foreign capital into India.* Much of it used to come in those days from the London money market and this hesitated to lend money to countries on silver standard specially when there was uncertainty about the rate of interest and a likelihood of a diminution of the principal in case it was to be transferred to London.

4. Effect on Industries

India did not possess at that time any manufacturing

industries worth the name. But she was beginning to have them. This necessitated an import of machines and technical experts *for which more and more money had to be found* as the rate of exchange fell. Besides, whatever industries were being established, they were being established with the help of foreign capital to the import of which as has already been observed, there was a considerable impediment because of the fall in the exchange rates. As far as agriculture is concerned, this as well did not make any progress. We have already noted that there was no stimulus to export.

5. Effect on trade and commerce

A fluctuating exchange has a disturbing effect on the growth of trade. *It has a paralysing effect.* We know that exports did not make much headway during this period. This was the case with imports as well. As regards internal trade this too did not obtain any stimulus due to a falling exchange. Prices were all along rising due to the import of silver and consequent increase in the supply of rupees. But the consumers not being well off, there was no improvement in trade. The element of uncertainty created panic in the minds of the businessmen who, in consequence, contracted their business of whatever form it was whether external or internal.

Consideration of the proposals of the Government of India. Though the Government of India proposed to stop the free coinage of silver and to establish gold standard, *it did not want to substitute gold for silver* as the ordinary currency of the country. It was contemplated that in the vast majority of transactions silver would still be used as a medium of exchange as it was in France and U. S. A. The rate for the exchange of rupee with gold was proposed to be fixed at 1s. 6d.

The Commission considered first of all *effects of stopping free coinage of silver*, and in this connection it took up (1) gold value of uncoined silver, and (2) future relation of uncoined silver to the coined rupee.

Gold value of uncoined silver. It was found that for some times past the whole of the silver imported had been passing through the mints, and this represented one-fourth of the total world production. Hence, in case free coinage of silver was stopped, *there was bound to be a tremendous fall in the gold value of silver.* Besides, the effect of the stoppage of the demand for silver from India, it was feared, might induce U. S. A. to repeal the Sherman Act. Finally, it could also induce China the only country remaining on

silver standard to give up that standard. In such cases, the fall in the gold value of silver, it was pointed out, would be heavier still.

Future relation of uncoined silver to the coined rupee. The stoppage of free coinage of silver at the mints *was bound to raise the value of rupee in terms of silver.* But it was pointed out that a considerable time must pass before the price of rupee could be expected to rise. There was a redundant supply of rupee at this time.

Next, the commission considered whether it was possible *to introduce gold standard without a gold currency and even without a legal convertibility of the existing silver currency into gold.* The example of several countries was cited, and it came to the conclusion that *this was possible.*

Finally, there was the question of *the rate of exchange.* The Government of India had recommended a rate of 1s. 6d. Even if it was to be the existing rate, this was bound to become greater than the value of the silver contained in the rupee with a fall in the price of silver which was expected to continue. Hence, whatever the rate of exchange, *it was bound to cause a divergence in the value of the rupee and the silver contained in it.* Its probable effects were considered and they were expected to be as follows :

(*a*) *Stimulus in spurious coinage.* It was pointed out that divergence in the value of rupee and silver contained in it would give encouragement to spurious coinage. But the Commission was of opinion that this had not happened in other countries and there was no reason why it should happen in India. Besides, this could be stopped by severely penalising it.

(*b*) *Fall in the value of hoarded wealth and ornaments.* A vast majority of Indians had their savings in silver bars or ornaments. If mints were closed, there was bound to be a fall in their value.

(*c*) *Conversion of the whole of India's currency into token currency.* It was also pointed out that divergence in the value of rupee and silver contained in it would result in the conversion of the whole of India's currency into token currency. But the Commission opined that there was a good deal of difference between rupees and inconvertible paper money, inasmuch as the expansion of the former would not be so easy as that of the latter.

(*d*) *An indirect increase in taxation.* It was pointed out that a rise in the value of rupee would mean a rise in the burden of taxation. The Commission admitted the truth of this statement. But it ruled it out by saying that this was not in the hands of the Government. If price

of silver falls, how can the Government be held responsible for it ?

(*e*) *Effect on India's trade with other silver using countries specially China.* Effect of closing the mints to free coinage of silver on India's trade with silver using countries specially China, was also considered. But as this trade amounted to about only half the trade with gold-using countries it was regarded better to fix the rates between gold and silver. Besides, *arguments*[5] were advanced which showed that India would not fare worse in this respect as well.

(*f*) *Currency would be rendered unautomatic.* It was also pointed out that by closing the mints to free coinage of standard coins, the currency system of the country would be rendered unautomatic. But the Commission stated that the people would take gold to the mint and the Government would give them rupees in its stead, and thus the currency system would be made automatic on a gold basis.

Considering the above, the Commission decided to *fix a rate of exchange but not very much higher than the existing one.* The rate of 1*s.* 6*d.* as proposed by the Government of India was much higher than the existing one and hence that of 1*s.* 4*d.* was considered to be better than this.

Recommendation of the Commission. Having considered the proposals of the Government of India, *the Commission recommended the following* :—

(1) That the mints be closed to free coinage of both silver and gold. Till then they were open to free coinage of the latter as well, though gold coins were not declared legal tender.

(2) That the Government could coin rupees in exchange for gold at a rate of 7·53344 grains troy of fine gold or 1*s.* 4*d.* per rupee.

(3) That gold coins be received at public treasuries at the rate of 1*s.* 4*d.* per rupee.

(4) That rupee coins should continue to be unlimited legal tender.

Evidently, *it did not make any specific provision for the introduction of a gold standard.* But this was contemplated *to be established in future.* It was thought that a transition period was necessary in which the rate of exchange would be brought up to 1*s.* 4*d.* When this was achieved a gold

[5]Inquisitive students may be referred to the Original Report of the Commission.

standard would be established. At least this is what was emphasized by Lord Farrier and Lord Welly. They also thought that a gold reserve would be provided for in the meantime.

SUMMARY

1. India had from 1835-93 silver standard. Several attempts were made during this period as well to introduce gold in circulation specially between 1835-74. The proclamation of 1841 authorised receipt of gold coins in public treasuries at their face value. But they were not to be paid out. This privilege was, however, withdrawn by a notification of 1852. In 1864 again, the Government agreed to receive and pay when convenient sovereigns and half sovereigns at fixed rates. In the same year Mansfield Commission was appointed, but its recommendations could not be given effect to. In 1872 Sir Richard Temple, the then Finance Member, put a scheme for making gold coins legal tender in India, but this as well was not accepted.

2. In 1870, the Indian Coinage Act consolidating the previous Acts was passed.

3. During the period 1874-93, there was a tremendous fall in the value of silver due to a number of causes. Of course several attempts were made to arrest it but all of them proved abortive. Among these may be mentioned, the establishment of the four international conferences, passing of the Bland Allison and Sherman Acts by the Government of U. S. A., appointment of Gold and Silver Commission in England, and finally the anxiety of the Government of India to do something.

4. Herschell Commission which was appointed to examine and report upon the proposal of the Government of India first of all, pointed out the difficulties of the Government and the people, and effects on inflow of foreign capital into the country and on her industries, trade and commerce, as a consequent upon the fall of the value of silver. Then, it gave consideration to the proposal of the Government and in this connection mentioned the effects of stopping the free coinage of silver, and pointed out the possibility of the introduction of gold standard without a gold currency and even without a legal convertibility of the existing silver currency into gold. Finally, it took up also the question of the exchange rate and showed the need of putting it as near the existing rate as possible. In conclusion, it made also its recommendations which included the closing of the mints to the public for the coinage of silver but keeping them open to the Government for this purpose, the issue by it of rupee coins in exchange for gold at 1s. 4d. rate, the acceptance of gold coins by it at public treasuries at this rate, and continuance of the unlimited legal tender characteristic of the rupee.

TEST QUESTIONS

1. What attempts were made to introduce gold in circulation in India between 1835-74 and with what results ?

2. What were the causes of the fall in the value of silver after 1872 ? Mention in this connection the steps taken by the important countries of the world.

3. Examine the effects of the fall in the value of silver after 1872 upon India's trade, industry and state.

4. Detail the circumstances leading to the closing of Indian mints to free coinage of silver and mention the effects of this step. (U. P. Board.)

CHAPTER XVI

CURRENCY FROM 1893-1898

The period from 1893-98 was a period of transition. The recommendations of the Herschell Commission were accepted and Act VIII of 1893 was passed on June 26 of the same year. Three notifications were also issued in this respect.

1. The coinage act of 1893 and notifications relating thereto

This Act amended the Indian Coinage Act of 1870 and the Indian Paper Currency Act of 1882. It provided for *closing the mints to free coinage of both gold and silver* as recommended by the Herschell Commission. But it allowed *the Government to retain the right to coin silver on its own behalf.* The notifications issued were :—

(1) Gold coins and gold bullion would be received at the mints in exchange for rupees at the rate of 7·53344 grains troy of fine gold, *i.e.*, 1s. 4d. per rupee.

(2) Sovereigns and half sovereigns would be received in payment of sums due to Government at Rs. 15 and Rs. 7-8-0 respectively.

(3) Currency notes would be issued in exchange for gold coins or bullion[1] at the same rate.

Its inherent defects. The legislation had certain inherent defects.

(1) *First of all*, rupee, though unlimited legal tender and principal coin, was inconvertible.

(2) *Secondly*, there was no obligation on the part of the Government to pay gold in exchange for rupees though there was an obligation on its part to receive gold in exchange for them.

(3) *Thirdly*, rupee melting point had not been considered. A rise in the value of silver beyond a certain limit was never contemplated.

2. Effect on the rate of exchange

From the year 1893-95, the rate of exchange, contrary to the expectations of the people, continued to fall.

[1]Currency notes could be issued against gold in accordance with the Paper Currency Act of 1882 as well. But the amount of notes thus issued could not be more than 25% of the total metallic reserve.

(*i*) *First of all*, the people thought that the Government would not be able to maintain the value of rupee. The Secretary of State for India sold bills in London on the Government of India, called *Council Bills*, to collect sterling for meeting home charges on behalf of the Government of India. These, at first, *he continued to sell at the market rate* which was much below 1s. 4d. This led the people to believe that the Government could not raise the rate of exchange and caused great inconvenience. But later on, it was decided by the Secretary of State that to allay fears, the bills would be sold at the minimum rate of 1s. 4⅛d. per rupee. This rate was higher than the market rate then existing, and debtors in England *did not buy bills for sometimes but sent silver to India.* But mints being closed to its free coinage, *this could not continue for long*, and ultimately they had to purchase the bills.

(*ii*) There had been going on a large coinage of silver for sometimes past, and *the supply of rupee, was in far excess of the demand.* The relative scarcity could be felt only in 1899.

(*iii*) The years 1896 to 98 were bad years for the country. It was *in the grip of famine and plague.* Its result was a reduction in the production of commodities, and hence in the need for money.

But the rate of exchange began to rise in 1895 and reached 1s. 4d. in 1898. It may be mentioned here that price of silver continued to fall during the whole of this period.

3. Gold Note Act of 1898

By 1898, shortage of money had begun to be felt, and to relieve that stringency an Act (No. 11 of 1898) was passed, empowering the Government of India to direct, by order notified in the Gazette of India, *to issue currency notes in India, against gold received by the Secretary of State for India in London.* This Act was to remain in force for six months, but was further extended for two years by an amending Act of that year. Prior to this, currency notes could be issued only against rupees and gold[2] held in India and rupee securities.

4. Fowler Commission (1898)

When the rate of exchange was near 1s. 4d. another Commission, namely, the Fowler Commission, was appointed

[2]Currency notes could be issued against gold held in India in accordance with the notification issued by the Government of India in 1893 to an unlimited extent.

to recommend measures which might lead to the establishment of a *satisfactory system of currency in India*, and for securing as far as practicable, *a stable exchange between* that country (India) and the United Kingdom. Early in 1898, the Government of India had addressed the Secretary of State with proposals for securing early realization of a gold standard in India. These involved a very large withdrawal of rupees from circulation. It supposed that rupees were still in excess of the requirements of trade. Together with its proposals, the Government had forwarded two other schemes, one by Mr. Lesley Probyn, and the other by Mr. A. M. Lindsay. A. M. Lindsay's scheme became much famous later on, as it had meant the establishment of a gold exchange standard which was, in course of time, established in this country. Mr Lindsay had proposed that a gold standard reserve should be created in London by means of a loan of £10 million raised by the Secretary of State, and to be deposited with the Bank of England. Sterling drafts were to be sold in India when required at 1s. $3\frac{3}{4}$d., and met out of this fund. As against this, there would be a rupee section of the gold standard reserve kept in India on which council bills would be sold in London at 1s. $4\frac{1}{16}$d. for trade demands when necessary. But the Commission rejected both the schemes.

There were some who recommended restoration of silver standard, but this too was rejected by the Commission.

Recommendations of the Commission. The Commission recommended *a gold standard with gold currency in active circulatino* for this country. The reasons advanced for a gold standard were as follows.

(*i*) Four-fifths of India's trade was with gold standard countries, and importance of gold in foreign trade had been emphasised by Dr. Marshall in the course of his evidence before the Commission. Introduction of gold standard in India was, according to him, like a movement towards bringing the railway gauge on the side branches of the world's railways into unison with the main line.

(*ii*) A gold standard would stimulate inflow of capital in India, which was greatly needed. First of all, during the busy part of the year, owing to a heavy demand of money for moving the crops the rate of interest generally rose very high. Secondly, capital was needed for bringing about development of large-scale enterprise in India.

(*iii*) A considerable amount of gold worth £2 million has been accumulated in the paper currency reserve within a very short time. When this could be done so soon and in a period of transition, the Commission held

that much more could be done in future with the growth of confidence.

(*vi*) The Government of India had publicly announced that they were willing to take steps for the early establishment of a gold standard and a stable exchange. The Commission thought that no time should be lost in doing it, otherwise there would be doubts in the minds of the people, and various rumours would arise which might result in the withdrawal of confidence in India's monetary future and thus jeopardise the country's material interests.

Its arguments for a gold currency in active circulation were as follows :–

(1) A system without a visible gold currency such as recommended by Mr. Lesley Probyn or by Mr. Lindsay would be looked upon by the people of this country with disgust.

(2) An exchange standard would check that flow of capital into India which was so much needed for the development of her resources.

(3) Gold coins were in common circulation in India not long ago and constituted the principal currency in Madras till 1806. If hoarding did not render a gold circulation an impossibility in the past, such results could not be envisaged for the future. The Commission thought that people of India might have hoarded in the past, but with the disappearance of the causes that led them to hoard, the habit was sure to be given up.

(4) There was always an inflow of gold into India, because of its tendency to have a favourable balance of trade. The Commission thought that this would make possible accumulation of sufficient gold reserves for monetary purposes.

Other recommendations of the Commission in this connection were as follows :—

(1) British sovereigns be made *legal tender* and current coins in India. *Indian mints be thrown open* to unrestricted coinage of gold on such terms and conditions as govern the three Australian branches of the Royal Mint.

(2) The Government should *continue to give rupees for gold but fresh rupees should not be coined* until the proportion of gold in the currency was found to exceed the public requirements.

(3) Any profits on the coinage of rupees should not be credited to revenue but be *kept in gold as a special reserve* entirely apart from the paper currency reserve and ordinary Treasury balances.

(4) When the Government has accumulated a sufficient gold reserve and so long as gold is available in its Treasury, *it might discharge its obligations in India in gold instead of rupees.* It may be mentioned that the amount of rupee circulation being very large, imposition of an obligation on the Government to convert all rupees into gold would have been a serious liability, and hence this was not recommended by the Commission.

(5) The Government *was obliged to make gold available for export, if exchange showed a tendency to fall below the specie point.* Thus it is clear that while the Government was under obligation to pay gold for external purposes, it was not so for internal purposes.

(6) *The value of rupees was fixed at 1s. 4d., i. e.,* Rs. 15 to a sovereign or 7·53344 grains troy of fine gold per rupee. Reasons for doing so were : (*a*) This rate had been steady since January 1898. (*b*) This had also been recommended by the Herschell Commission and everybody had pinned his faith on it. (*c*) In 1898-99, at this rate total volume of export trade amounted to Rs. 120 million, a figure which was never attained in the past. (*d*) Prices and trade had adjusted themselves to this rate.

(7) Rupee although made a token coin *be kept unlimited legal tender.* This had been the position of silver coins in France and U. S. A. as well, where they had not been coined since 1878 and 1893 respectively. In neither country were they convertible into gold for internal purposes, though they were as good as gold for it. For international purposes, however, both these countries used gold, though it was also legal to use only silver.

SUMMARY

1. The period from 1893-98 was a period of transition. The Coinage Act of 1893 closed the mints to the public for free coinage of both gold and silver, though left them open to the Government for this very purpose on its own behalf. The notifications issued in this connection authorised the Government to receive gold coins and bullion in exchange for rupees and in discharge of sums due by the people to it at 7,53344 grains per rupee and issue notes in exchange for them at this very rate. The inherent defects of this legislation were inconvertibility of rupee coins, absence of an obligation upon the Government to pay gold in exchange for rupees and ignoring the rupee melting point.

2. The rate of exchange continued to fall from 1893 to 95 due to certain causes but thereafter it rose slowly but steadily.

3. The Gold Note Act of 1898 authorised the issue of notes in India against gold received by the Secretary of State for India in London though in the first instance only temporarily.

4. The Fowler Commission was appointed in 1898 to establish a satisfactory system of currency in India and secure as far as practicable a stable exchange between India and the United Kingdom. They recom-

mended a gold standard with gold currency for circulation for this country and advanced convincing reasons for it. Their other recommendations were (1) giving a legal tender characteristic to British sovereigns, and opening the Indian mints to their free coinage, (2) allowing the Government to give rupees in exchange for gold but forbidding it to coin them for some time more, (3) establishment of a special gold reserve out of future profits of coinage, (4) allowing the Government to discharge its obligations in India in gold instead of rupees if convenient, (5) making availability of gold obligatory upon it for export if exchange showed a tendency to fall below the specie point, (6) fixing the value of rupee at 1s. 4d., and (g) keeping it unlimited legal tender in spite of its being a token coin.

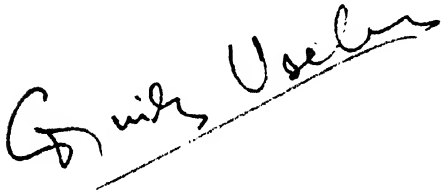
TEST QUESTIONS

1. What important changes were brought about by the Indian Coinage Act of 1893 and notifications issued in that connection? Give in brief the inherent defects of this legislation.

2. Why did the rate of exchange did not rise immediately as a result of the passing of the Indian Coinage Act of 1893 and issuing of the notification in that connection? Discuss the reasons advanced by you.

3. Give in brief the arguments advanced by the Fowler Commission in support of a gold standard with gold currency in active circulation for this country.

4. Summarise the recommendations of the Fowler Committee. How far do you think it meant the establishment of a gold standard with gold currency?



CHAPTER XVII

GOLD EXCHANGE STANDARD

The Fowler Commission had set before the Indian authorities the object of an effective establishment of gold standard. The Government of India decided to take action on its recommendations. *The Indian Act No. XXII of 1899 was passed.* It made *sovereign and half-sovereign legal tender* throughout India at Rs. 15 : £ (1s. 4d. : Re). *Active steps were taken to open a mint for the coinage of gold in India.* An active effort was also made to induce the people *to use gold coins* as a medium of exchange ; and Currency Offices, Post Offices, and other Government institutions were instructed to pay these to the public. But this proved unsuccessful. A large number of gold coins returned to Government Treasuries. In many places sovereigns went to a discount of 4 as. But there was a demand for rupees, and *the Government contrary to the recommendations of the Fowler Commission, was compelled to resume their coinage* early in 1900. The profits on it were, however, credited to a *separate gold reserve* which finally came to be known as a gold standard reserve[1]. After 1900, *the experiment of putting gold coins into circulation was not repeated.*

1. Divergence made from Fowler's scheme

Subsequent events are such as show that there was a great divergence made from Fowler's scheme.

(1) It has already been pointed out that the Government, contrary to the recommendations of the Fowler Commission, was compelled *to resume coinage of rupees* early in 1900. There were certain reasons for this. In the first place, there was a general monetary stringency. We know that rupees had not been coined since 1893. On the other hand, production and trade had in general increased. Secondly, there were consequences of the Gold Note Act of 1898. Paper Currency was being issued under this Act against gold deposited in London. This additional issue had the result of adding to the drain on rupee reserves of the Government of India. Notes were then convertible in rupee coins. Thirdly, gold coins which were issued to make good the shortage of rupees, returned to the Treasuries. Fourthly and finally, famine conditions which

[1]The designation of the reserve was changed from Gold Reserve to Gold Standard Reserve in 1906 when it was decided to hold a part in rupees ; but this change of title did not make the position clearer as acknowledged by Keynes *vide* Indian Currency and Finance,

prevailed about this time necessitated small payments, and these could only be made in silver coins, not in gold.

(2) Because of the return of gold coins at this time to the Treasuries, it was concluded by the Government that *the people did not want gold coins.* The conclusion was wrong because both the time and manner of putting gold coins into circulation were ill-chosen. Famine conditions were prevailing then. Besides, the method of forcing gold coins simultaneously from several sides on the people was not good; it rather created suspicion in their minds.

(3) A gold mint could not be instituted without the sanction of the Royal Mint, if it was to coin British sovereigns and half-sovereigns. And we know that the Fowler Commission had made only these and no other gold coins legal tender. Hence, the sanction of the Royal Mint was necessary. But far from giving the sanction, the British Treasury objected to the establishment of a gold mint in India on various grounds. It did not think that sufficient gold would be available in this country to enable the mint to continue for a long time. Nor did it think that it would be advisable to let the Indian Treasury bear its cost. Besides, it questioned the very necessity of a gold mint for India. The failure of the Government to introduce sovereigns, as already pointed out, helped it a good deal in its arguments against an active circulation of gold currency in this country. As a result *the idea of a gold mint had to be dropped in 1902* after the completion of the steps taken in this connection.

(4) The gold standard reserve had been created according to the recommendation of the Fowler Commission, but *its form, location and use were changed.*

First of all, the Secretary of State decided that the profits on coinage be sent to London for investment in sterling securities. He argued that since London was the place in which the reserve would be needed on the occasions of emergency against which it was created, it would be the best place for keeping it. Accordingly, for the first few years from 1901 onwards, the profits on the coinage of rupees were sent to London for investment. Gold in paper currency reserve was taken out for this purpose in exchange for newly coined rupees. The interest earned on securities was also credited to the gold standard reserve. It may be pointed out that according to the recommendations of the Fowler Commission, the whole of it was required to be kept in gold, and in India.

Secondly, in 1906 some difficulty was felt in the conversion of notes out of the paper currency reserve,

as a portion of it had been transferred to London in the previous year on the plea that it could be used there, as and when required, in purchasing silver, thus saving three or four weeks' delay in shipping them from India at the moment when actually required. This necessitated the formation of a special reserve in rupee coins, besides the paper currency reserve. Hence, two branches of the gold standard reserve came to be formed, (1) in the form of rupees in India, and (2) in the form of sterling securities in London. But both these forms were contrary to the one recommended by the Fowler Commission.

Thirdly, the whole of the profits on coinage did not continue to be credited to the gold standard reserve. In June, 1907, a Committee, known as the Mackay Committee, appointed by the Secretary of State to consider the question of Indian Railway Finance, recommended the transference of a sum of £1 million out of the profits of coinage in that year to the provision of adding rolling stock and other improvements for Indian railways. The Secretary of State went much beyond it. He decided that in future one-half of any profits on the coinage of rupees should be used for capital expenditure on railway until the gold standard reserve reached £20 million. From this, it appears as if all the profits on silver coinage were to be diverted from the reserve after its reaching this figure. In actual practice, £1,123,000 had been so transferred before the crisis of 1907-08 occurred which made him change his decision.

Fourthly and finally, the use of gold standard reserve was changed We know that from 1901 onwards, profits on coinage were sent to London for investment on the plea that the reserve would be needed on the occasions of emergency against which it was created in that place. In 1907-08 this emergency arose. India's balance of trade turned unfavourable and there came up a demand for gold for exports. According to the recommendations of the Fowler Commission the Government should have met this. But there was no gold in the gold standard reserve in India. First of all, it was given out of the paper currency reserve with some limitations. Then, it was decided on the 4th March, 1908, to make weekly sales in India of a certain maximum quantity of sterling bills on London at the fixed rate of 1s. $3\frac{29}{32}$d. and on the 26th March, 1908, they were first sold During the interval, the Secretary of State took steps to realise some of the securities held in the gold standard reserve in order to have cash to meet the bills sold in India. These bills continued to be sold in this country till the 11th September, 1908, on which date the exchange strengthened. In all £8,058,000 were

withdrawn during this period out of the gold standard reserve to meet these bills. Besides, it has already been said previously that a branch of the gold standard reserve was held in India from 1906 onward in rupees for conversion of notes.

(5) The Fowler Commission thought that gold would continue to flow into India. *But this was not allowed to be so.* We already know that the Secretary of State sold council bills to obtain funds to meet home charges. After the passing of the Gold Note Act of 1898, he sold these also to obtain funds to purchase silver for coinage of rupees required to enable the Government to convert paper currency into them. It has already been said that this Act was, at first, meant to be in force for only six months but later on extended for two years. In 1899, it was made permanent In 1904, the Secretary of State notified his willingness to give rupees for sterling without limit (*i. e*, over and above his requirements) at the price of 1s. $4\frac{1}{8}$d., which was the normal gold export point from London to India. Sometimes, he increased the sales of the bills by selling them below the gold export point as well. The net result of all this was what is obvious. In normal times, one of the methods of paying for India's favourable balance of trade was by the remittance of gold bullion and sovereigns to India. But the action of the Secretary of State as given above resulted in its prevention. Whatever gold was imported into India during this period was imported as merchandise and not in payment for her exports.

It may be concluded that while the Fowler Commission recommended the establishment of a gold standard with active gold in circulation for this country, *the Government of India built up a system of currency which was quite different from it and had nothing in any legislative enactment as its basis.* It grew of itself from executive practice and depended on the executive will. We shall look to it presently.

2. Evolution of gold exchange standard in India

The system of currency built up by the Government of India in all these years was the same as proposed by A. M. Lindsay and placed before the Fowler Commission but rejected by it. He had always maintained that "they must adopt my scheme despite themselves" and he was right. Gold exchange standard as it was called, as has already been observed, was first adopted by Holland in 1877 and then by Russia and Austria-Hungary in 1892. But it was first adopted in a complete form in India, as pointed

out by J. M. Keynes in his book entitled Indian Currency and Finance, page 33.

We know that *the Secretary of State sold Council Bills*, and when he began to sell these without limit at the price of 1s. 4$\frac{1}{8}$d which was the normal gold export point as well or less, the exchange rate could not rise above it. Importers of Indian goods had the other alternative of paying for them, *i. e.*, by sending gold bullion or coins into this country. These were accepted here at 1s. 4d. per rupee, and the cost of sending them though always varied was never more than $\frac{1}{8}$d. Hence, it was always preferable to them to purchase council bills if they were available at a rate of 1s. 4$\frac{1}{8}$d. or less. Nor could the market rate of exchange under the circumstances rise above this rate. Hence, the Secretary of State prevented the rate of exchange from rising above this point by offering to sell council bills without any limit at this rate.

The usual procedure for selling these bills was that they were offered in London for tender at the Bank of England every Wednesday morning, the Secretary of State for India in Council (or, for short, the India Council, whence the name Council Bills) having previously announced the amount for which tenders were invited. There was a reserve price which was not published below which he did not sell. Tenders disclosed the amount tendered for and the number of pence per rupee which was offered. The total amount was then allotted to the highest bidders, the allotment at the minimum rate accepted being proportionate to the amount applied for at that rate.

It should be added that cash was required to be paid for bills in London as soon as they were allotted. But on account of the time taken by the mail, they could not be changed into rupees at Calcutta for about a fortnight. Interest for this period was, therefore, lost and it was worth paying extra to obtain telegraphic transfers by means of which rupees could be obtained at Calcutta immediately. The Secretary of State, therefore, was usually willing to sell telegraphic transfers at a rate $\frac{1}{32}$d. per rupee higher than the rate for bills.

The sale of council bills was one facet of the gold exchange standard system, and it continued so long as India had a favourable balance of trade. But in 1907-8, the balance of trade of the country turned unfavourable. There arose a demand for gold for export purposes. According to the recommendations of the Fowler Commission, the Government of India should have met this. But there was no gold in the gold standard reserve in India. First of all, it was given out of the paper currency reserve

with some limitations. Then, it was decided on the 4th March, 1908, to make weekly sales in India of a certain maximum quantity of sterling bills on London at the fixed rate of 1s. $3\frac{29}{32}$d., and on the 26th March, 1908, they were first sold. *These bills were known as Reverse Councils, and they completed the other side of the picture of gold exchange standard.* So long as they were available at 1s. $3\frac{29}{32}$d., the rate of exchange could not fall below it as nobody would have liked to have less than this amount for a rupee from anywhere else when this was available from the Government. On this particular occasion, the Government though sold these every week till the 11th September, 1908, on which date, the exchange strengthened, it sold only a certain maximum quantity. What was necessary was a sale without any limit. Later on, and specially when the rate of exchange showed a tendency to fall just after the out-break of the war, it sold these without any limit.

3. Mechanism of gold exchange standard in this country

The mechanism of gold exchange standard in this country consisted of (1) the council bills and reverse councils, (2) the gold standard and paper currency reserves and cash balances of the Government of India and the Secretary of State for India.

The Council bills were paid in India out of the rupee reserve held partly in the paper currency reserve, partly in the gold standard reserve and partly out of the cash balances of the Government of India. Reverse councils were, on the other hand, paid in London out of the sterling reserves held partly in the paper currency reserve, partly in the gold standard reserve and partly in the London cash balances.

4. The period from 1909-13

From 1909 to 1913 India enjoyed a period of exceptional prosperity, and during this period, demand for remittances from London to India was so strong as not only to call for the re-issue of the large stocks of rupees accumulated during the crisis of 1907-8, and thus incidentally *to restore the gold standard reserve in London to its former amount*, but also to necessitate coinage of fresh rupees, the profit on which went to increase the Reserve far beyond the maximum point reached before 1907-8.

Next, during the period under review *a lengthy correspondence* passed between Government of India and the Secretary of State on the subject of active circulation of gold

currency in this country, and of the form, location and use of and the limit to the gold standard reserve.

The Government of India proposed as follows :—

(1) In its despatch of April 1, 1909, the Government of India pressed for *a larger gold standard reserve* to meet greater emergencies than that of 1907-8. It considered that the minimum amount in the gold standard reserve should be £25 million, apart from the gold in the paper currency reserve and its Treasuries, and therefore, desired that the decision of July 1907 to use a part of the profits on rupee coinage for capital expenditure be held in abeyance until that amount was secured.

(2) It also proposed that a substantial portion of the gold standard reserve should be kept *in a liquid form*, instead of being invested in securities, because during a crisis, the latter could not be readily realised or realised without considerable loss. In this connection, the loss on realisation of securities during the crisis of 1907-8 was pointed out.

(3) It held that it could face another exchange crisis with far greater equanimity, could it be assured of both an active circulation of sovereigns in the country and of a strong reserve in its currency chest. In its despatch of September 30, 1909, it pointed out that though gold was still far from having obtained that popularity which interests of exchange render desirable, *there were indications of a greatly extended use of sovereigns in commercial transactions.*

(4) In its despatch of May 16, 1912, it also asked the *sanction for the coinage of sovereigns* at the Bombay mint. From 1903 to 1910 little was heard of any proposal for an active encouragement of the circulation of gold. But the intention of having a gold currency had not been altogether given up. In the Budget debate of 1910, Sir James Meston, the then Financial Secretary to the Government of India said, we have reached a gold exchange standard. The next and final step is a true gold currency. In March 1911, Sir Guy Flatwood Wilson, Finance Member to the Government of India in reply to Sir Vithaldas Thackersey who suggested the introduction and minting of a new 10 rupee gold coin said that much has happened since 1902 which justifies the re-opening of the question.

But the Secretary of State was not in favour of an active circulation of gold in India. He championed gold exchange standard. *The reply of the Secretary of State to the above proposals is very interesting.*

(1) As regards the amount of gold to be kept in the gold standard reserve, *the Secretary of States agreed* after

a great pursuation that £25 million should be the standard before the profits on coinage could be diverted.

(2) As regards the maintenance of a considerable portion of the gold standard reserve in a liquid form, *he, however, did not agree.* In its stead, he decided to let out £1 million in short loans or to put into bank deposits. Of the balance, he agreed to hold a considerable portion in high class securities with a near date of redemption, and the remainder in Consuls or other approved stocks.

(3) As regards the maintenance of exchange rate, he held that this did not require an active circulation of sovereigns or gold to be kept in currency chests. He decided that *the proper place for the location of gold* in the Paper Currency Reserve was London, as it could be made available to defray home charges in case the sale of Council bills was rendered impossible on any occasion. Besides, it could be used to strengthen the rate of exchange by being made available to pay up the reverse Councils sold by the Government of India during an emergency.

(4) On an objection of the British Treasury to sanction the coinage of sovereigns at the Bombay mint, and a request of the Government of India, therefore, to grant permission for the coinage of a new 10 rupee gold coin in its despatch of October 18, 1912, the Secretary of State acceded to it. But *the minting was postponed* until the decision on it was given by the Chamberlain Commission which had by then been appointed.

5. The Chamberlain Commission (1913)

This Commission was appointed under the Chairmanship of Mr. Joseph Austin Chamberlain in 1913 to enquire into the methods of maintaining exchange and the location and use of the reserves and balances and to report whether the existing practice was conducive to the interests of India. Obviously enough, it was *precluded from recommending a system other than the one existing,* and in fact supported it.

The Commission said that the belief of the Committee of 1898 was that a gold currency in active circulation is an essential condition of the maintenance of gold standard in India, but the history of the last 15 years shows that *gold standard has been firmly secured without this condition.* It added that the people of India *neither desire nor need* any considerable amount of gold for circulation as currency, and the currency more generally suitable for the needs of India consists of rupees and notes. Under the circumstances, it was natural it concluded that a gold mint was neither required nor considered necessary for

India. But it added if Indian sentiment genuinely demanded it and the Government of India was prepared to incur the expense, there was no objection to it provided that the coin minted was sovereign or half-sovereign. The other recommendations of the commission were in connection with the gold standard and paper currency reserves.

Arguments advanced in favour of a gold exchange standard (1) To a great extent the system evolved by the Government of India is the *result of a series of experiments*, and hence it cannot but be the most suitable for the country.

(2) The establishment of the exchange value of the rupee on a stable basis has been and is of the first importance to India, and as *this has been achieved* under the system evolved by the Government of India, it cannot but be extremely sound.

(3) The system evolved has *close affinities with other currency systems* in some of the great European and Asiatic countries, *e. g.*, Holland, Russia, Austria-Hungary and Japan In these countries, as in India, gold actually in circulation is of secondary importance, and the internal medium of exchange, whether it be a silver coin or a paper note, depends for its value in exchange not on its own intrinsic worth, but on the maintenance in reserve of gold or resources readily convertible into gold, and in the case of Russia and Japan, at any rate, large portions of gold resources are held not at home but in London, Paris and other monetary centres, just as India's gold standard reserve is held in London.

(4) It is desirable *to educate the people in the use of more economical forms of currency than gold.*

Sir James Begbie, a member of the Commission, did not support this standard.

Arguments advanced against gold in circulation. (1) Most people believed that gold in circulation was calculated in the long run to strengthen exchange. But the Majority of the Commission *did not agree with this view.* It said that there was, first of all, a belief that if gold were to be used in India to the same extent as say, in the United Kingdom or Germany, the exchange problem would be largely simplified. But this was erroneous. The stability of exchange depended in those countries in fact on the central reserves of the banks of these countries with their influence on other banks and the money market. If, however, the people thought that gold in circulation should be used to a very great extent as for example in Egypt, it would necessitate the reduction of note-issue to a comparatively insignificant position, and withdrawal

from circulation, at large expense, of a considerable part of rupees. This would surely result in the performance of gold of the function of strengthening exchange successfully. Instead of a wholesale introduction of gold, there was also a possibility of its gradual introduction. But gold must, under the circumstances, continue to occupy for many years to come a subsidiary position in the currency, and exchange would not benefit materially thereby. Finally, there was the question of the source from which gold was to come, and if it was to take the place of rupees, profit on coinage would be stopped and the very source of the gold standard reserve would be choked up ; and if it was to take the place of notes, there would be depletion of the paper currency reserve which serves as a substantial aid to the gold standard reserve.

(2) *Gold is a far more formidable rival to note-issue* than to rupees, and to habituate a people to the use of sovereigns is almost certain in the long run to militate against the use of notes which is not a desirable goal. Notes constitute a more desirable form of currency than gold coins.

(3) Many people believed that gold currency was a necessary step towards what may be regarded as the ideal currency, *viz.*, paper backed by gold in reserve. The Majority *did not subscribe to this need.*

(4) It was argued by some that the Indian system was artificial and hence bad. But the Majority *did not subscribe to this view as well.*

(5) The Majority also regarded *gold in circulation as wasteful*, because of the wasteful habit of hoarding prevailing in India It held that this habit was sanctioned by the experience of centuries in India and by religious and racial laws and customs.

(6) The Majority also concluded that India *neither demanded nor required gold coins for currency.* This statement was quite wrong in view of the experiences of the past several years.

Sir James Begbie argued differently in respect of all these points.

Summary of the recommendations of the Chamberlain Commission.

(1) The gold exchange standard is suited to India.

(2) The gold standard reserve be strengthened.

(3) No limit be placed to the amount of the gold standard reserve. All profits on coinage be credited exclusively to it.

(4) A much larger portion of the gold standard reserve be held in actual gold. It should be raised, as opportunity offers, to £15 million, and thereafter one-half must be held in gold.

(5) The rupee branch be abolished, rupees being handed over to the paper currency reserve in exchange for gold.

(6) The proper place for the location of the gold standard reserve is London.

(7) The Government of India should undertake to sell bills in India on London at the rate of 1s. $3\frac{29}{32}$d. per rupee, whenever called upon to do so (in case of a fall in exchange).

(8) The paper currency system of India be made more elastic. The fiduciary portion of note issue be increased at once from Rs. 14 crores to Rs. 20 crores, and thereafter fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus $\frac{1}{3}$rd of the net circulation.

(9) 500 rupee notes be universalised and greater facilities given for the encashment of paper currency.

(10) Temporary advances be made out of the fiduciary portion of the paper currency reserve to the Presidency Banks on prescribed terms to relieve seasonal stringency.

(11) It would not be to India's advantage to encourage increased use of gold, and gold currency is not necessary for India.

(12) A gold mint is not necessary for India. But if Indian sentiment genuinely demands it, and the Government is prepared to incur the expenses, a mint may be opened for the coinage of British sovereigns and half-sovereigns. If, however, this is not done, the notification of the Government's readiness to receive refined gold in exchange for rupees or notes at the Bombay mint be renewed. (The notification of 1893 had been withdrawn in 1906).

(13) The Secretary of State should continue to sell Council bills if he can,[2] so long as there is a demand for them but at rates never below par.

6. Break-down of gold exchange standard in India

Before the recommendations of the Chamberlain Commission could be given effect to, the Great War came

[2]They were to be sold so long as there was a need for transference of public funds from India to England, whether in the gold standard reserve or paper currency reserve or government balances and they could be paid in India.

on, and the Indian currency system was once again left to the will of the executive.

Amongst other effects of the war, the first was *the weakening of exchange.* It was met by the proved expedient of offering reverse Councils on London. Between 6th August, 1914 and 28th January, 1915, they were sold to the extent of £8,707,000. In February, 1915, demand for Council bills revived. There arose a slight weakness again in 1915-16 and between November 1918 and April 1919. But this was tide over on these two occasions as well by resorting to the sale of reverse Councils.

There arose at the end of 1916 acute complications in the sphere of Indian currency and finance, and these resulted finally in *the break-down of gold exchange standard* which had received the praise and approval of the Chamberlain Commission. We know that there was one defect in the fixation of the value of rupee at 1s. 4d., *viz.*, that the rupee melting point had not been considered. When the price of silver rose to more than 43d. per ounce, it could not be possible to continue selling bills at 1s. 4d. for which one rupee had to be paid by the Government of India and which cost more than 1s. 4d. We shall discuss it in a greater detail in the next chapter.

SUMMARY

1. As a result of the recommendations of the Fowler Commission Indian Act No. XXII of 1899 was passed making sovereigns and half-sovereigns legal tender in India. Steps were also taken to open a mint for the coinage of gold in this country and to use gold coins as a medium of exchange. But soon a divergence was made from the Fowler's Scheme. ***First of all***, coinage of rupees had to be resumed in 1900. ***Next***, on the return of gold coins from circulation because of the peculiar conditions then existing in the country, it was concluded that the people did not want gold coins and the experiment of putting them in circulation again was not repeated after 1900. ***Thirdly***, the idea of a gold mint had to be dropped in 1902. ***Fourthly***, the form, location and use of the gold reserve which was established in pursuance of the recommendations of this Commission were changed. ***Fifthly***, quite contrary to the wishes of the Commission gold was not allowed to flow into India by issuing Council bills in London to an unlimited extent.

2. Gold exchange standard though not adopted first in this country was adopted in its complete form here. The Secretary of State prevented rate of exchange from rising above 1s. $4\frac{1}{8}$d., by issuing Council bills to an unlimited extent at this rate and the Government of India prevented it from falling below 1s. $3\frac{29}{32}$d. by issuing reverse councils. The Council bills were paid in India out of the rupee reserves held partly in the paper currency reserve, partly in the gold standard reserve and partly out of the cash balances of the Government of India. Reverse councils were, on the other hand, paid in London out of the sterling balances held in two reserves and cash balances with the Secretary of State.

3. The mechanism of gold exchange standard, as is obvious from what has been said above, consisted of the council bills and reverse councils and the two reserves and cash balances.

4. During the period from 1909 to 13, first of all, gold standard reserve went on rising. Next, a lengthy correspondence passed between the Secretary of State for India and the Government of India regarding the future of Indian currency.

5. As a result of above correspondence Chamberlain Commission was appointed in 1913 to enquire into the methods of maintaining exchange and the location and use of the reserves and balances and to report whether the existing practice was conducive to the interests of the country. This in its turn, gave an unequivocal support to gold exchange standard, singing songs of its praises and denouncing gold currency standard. Its other recommendations were regarding the actual working of the system and popularising and management of note currency.

6. But before the recommendations of the Chamberlain Commission could be given effect to, the war of 1914-18 broke out. Amongst other things, the first was the weakening of the exchange rate. But this was maintained by the device of issuing reverse councils. At the end of 1916, arose acute complications in the sphere of Indian Currency and finance which resulted in the break down of gold exchange standard.

TEST QUESTIONS

1. What important deviations were made by the Government of India from the recommendations of the Fowler Commission after the year 1900 ? Give a brief discussion of these.

2. When and why did India adopt gold exchange standard ? Name the authority responsible for its maintenance indicating the methods adopted by such authority for this purpose.

3. Why and how was gold exchange standard established in India ? (Delhi-Inter).

4. What part did gold play in Indian Currency system before the war of 1914-18 ?

5. What arguments were advanced by the Chamberlain Commission in support of a gold exchange standard and against gold in actual circulation ?

6. What were the findings of the Chamberlain Commission ? Mention in brief their various recommendations.

CHAPTER XVIII

THE PERIOD 1914-19 (WAR AND ITS EFFECTS)

The history of Indian currency during the war may well be divided into two parts :—

Period I. The first period ends with the completion of the year 1916. During this period there was *general dislocation of trade and business* as a result of the first shock of the war, with its attendant effects.

Period II. The second period begins with 1917 and continues up to 1919. This is the period of *an abnormal rise in the rate of exchange and consequent difficulties.*

1. Period I (dislocation of trade and business)

The outbreak of war caused a panic which led to a dislocation of trade and business of which *the principal symptoms were as follows* :—

(1) Weakening of exchange.

(2) Withdrawal of savings bank deposits, and bank deposits.

(3) A demand for the encashment of notes.

(4) A run on Indian gold stock.

Remedial measures. (1) The remedial measures in connection with the weakening of exchange have already been mentioned (*the offering of the reverse councils*). The Chamberlain Commission had strongly approved of this measure.

(2) Net withdrawals of savings bank deposits in the first two months of the war amounted to Rs. 6 crores, and subsequent withdrawals during the year 1914-15 amounted to about Rs. 2 crores. But *continuous payment restored confidence*, and in the following years there was a net increase (in 1917-18, however, there was a fall by Rs. 1 lakh). The amounts outstanding at the end of the years 1913-14, 1914-15, 1915-16, 1916-17, 1917-18, 1918-19, and 1919-20 were in lakhs of rupees 2316, 1489, 1532, 1659, 1658, 1882 and 2134 respectively. There was also a run on banks, but this proved of short duration.

(3) Net encashment of notes during the year 1914-15 and specially after the outbreak of the war amounted to Rs. 601 lakhs. But after this, there was *an increase in active circulation.* At the end of the years 1914-15, 1915-16,

1916-17, 1917-18, 1918-19 and 1919-20, it was in lakhs of rupees 4396, 5319, 6708, 8430, 13358 and 15378 respectively.

(4) There arose a keen demand for gold in exchange for notes, and the Government desired to meet it to restore confidence. Between the 1st and 4th of August, 1914, it lost about £1,800,000 worth of gold. From 5th August, *the offer to private persons had to be suspended.*

The loss of confidence also gave a set-back to trade and business. But after sometimes this also revived.

2. Period II (abnormal rise in the rate of exchange and consequent difficulties)

The most serious effect of war came to be felt from the end of 1916. During the period following, there was witnessed *a rapid rise in the price of silver*; and it became increasingly difficult to supply it to meet the heavy demand for coinage of rupees in India. This high price of silver together with its dearth made it extremely difficult to maintain the currency system and the exchange rate.

The difficulties arose because of the following reasons. (*1*) *Favourable balance of trade.* India had usually a favourable balance of trade. But this went on rising during the war years.

Year	Exports £	Imports £	Favourable balance
19 4-15	121,061,100	91,952,600	29,108,500
1915-16	131,586,800	87,500,200	44,026,600
1916-17	160,591,200	99,748,000	60,843,200
1917-18	161,700,000	100,280,000	61,420,000
1918-19	169,230,000	112,690,000	56,540,000

The reasons of the increase in the favourable balance of trade were mainly two. (1) India could not import much from foreign countries, as they were engaged in war and whatever production they had, it was for the immediate need of the battlefield. The slight increase was due to a rise in prices. The quantity fell. (2) Exports from India increased both in bulk and price, as they were in great demand in belligerent countries which required more raw materials and foodstuffs than before, not only for home consumption, but also for carrying on the war.

The large balance of trade indebtedness in India's favour resulted in the strengthening of exchange and heavy demand on the Secretary of State for Council bills and on the Government for home currency.

(*2*) *Exceptional disbursements.* India formed the base of military operations in the Eastern theatres of war, and the Government of India had to pay the soldiers and meet

civil expenditure of the occupied territories on behalf of the British Government. Total amount in this connection reached the figure of £240 million. It was, of course, recoverable. But in the meantime, it had to be paid in home currency. In addition, purchases were made in India on behalf of certain Dominions and Colonies.

(3) *Heavy decline in imports of precious metals.* Ordinarily, India imported a huge amount worth of precious metals. But these could not be brought during the war period because of the war-time export restrictions in foreign countries and transportation difficulties.

(4) Absorption of rupees. There was a great absorption of rupees because of above reasons. Besides, trade and business were on an increase and this naturally created a demand for currency. The annual average for five years preceding the war, and during the war, of the absorption of rupees, was in lakhs of rupees 878 and 2208 respectively.

(5) *Rise in price of silver.* Besides the rise in India's demand for silver, there was also a rise in its demand from other countries. Most countries used silver in absence of gold. Demand from China also came up. Before 1917, it was a seller, but since that year it became a competitive purchaser. On the other hand, the world production of silver, during this period, decreased heavily due to political disturbances in Mexico which was a principal silver producing country of the world. This resulted in an unprecedented rise in its prices as is evident from the following figures :—

Years.	Prices per standard ounce.
1915	27¼d.
1916 (April)	35⅝d.
1917 (August)	43d.
1917 (September)	55d.
1919 (May)	58d.
1919 (December)	78d.

The rise after the war, *i.e.*, during the year 1919 was due to *the fall of the sterling dollar exchange rate.* The price of silver is determined by U. S A as that of gold, and hence a fall in the value of sterling in terms of dollars meant a fall in its value in terms of silver as well, which was the same as a rise in the prices of silver. During the latter years of war, sterling remained pegged with dollar, but just after it, the arrangement was cancelled.

Demand for rupees could not be met due to an abnormal rise in the prices of silver. Besides, *it became profitable for Indians to melt rupees* when the price of silver

went above 43d. per ounce or Re. 1 per tola. Finally, *the Secretary of State for India could not continue selling bills at 1s. 4⅛d.*, for the obvious reason that while he received only this much for a rupee, the Government of India had to give in home currency silver worth more than this amount.

Steps taken by the Secretary of State and the Government of India. (1) *Control of exchange.* The Secretary of State had to put a limit to the sale of Council bills in London on India, or else the convertibility of notes which were issued in India would have been endangered. This resulted in a divergence between the market rate of exchange and the rate at which the bills were sold. Next, the bills were sold only to the importers of materials necessary for the prosecution of war.

(2) *Raising the rate of exchange.* When the price of silver rose above 43d. per ounce, it was not possible to sell Council bills at 1*s.* 4⅛*d.* and make payment in rupee coins which cost more than this sum. As notes were convertible into rupees, payment could not be made in notes as well. There was always a need for the maintenance of a sufficient amount of rupees for their encashment. Hence, the rate of exchange at which Council bills were sold was raised with a rise in the prices of silver.

Date of change	Minimum rate for immediate T. Ts.
3rd January, 1917 ...	1s. 4⅛d.
28th August, 1917 ...	1s. 5d.
12th April, 1918 ...	1s. 6d.
13th May, 1919 ...	1s. 8d.
12th August, 1919 ...	1s. 10d.
18th September, 1919 ...	2s. 0d.
22nd November, 1919 ...	2s. 2d.
12th December, 1919 ...	2s. 4d.

It may be pointed out that there was a marked rise in the rate of exchange in the year 1919. This was due to the fact that the prices of silver also rose during this year because of the cancellation of the agreement by which sterling dollar exchange rate had been pegged during the latter period of the war.

(3) *Purchase of silver.* To meet the demand for rupees, the Secretary of State for India purchased silver for coinage. But the demand was so enormous that the ordinary market could not satisfy it and an approach had to be made to the Government of U. S. A. for a sale of silver. In April, 1918, U. S. A. Government passed the Pittman Act authorising sale of silver from their reserve and the Government of India purchased 20 crores of fine

ounces. It was the timely arrival of this silver which enabled the Government to avert a serious currency crisis in this country.

(4) *Exclusion of private buyers from the silver market.* With a view to avoid the competition of the Secretary of State with Indian public in purchasing silver in foreign markets, an import of silver into India on private account was prohibited from the 3rd of September, 1917.

(5) *Acquisition and use of gold.* The shortage of silver led the Government to acquire and use gold. An Ordinance, issued on the 29th of June, 1917, required all gold imported into India to be sold to the Government at a price based on the sterling exchange value of the rupee. A branch of the Royal Mint for the establishment of which sanction could not be received on previous occasions was opened in August, 1918. Pending the establishment of the Mint, a gold mohur, *a 15-rupee coin of the same weight and fineness as sovereign was minted.* The branch of the Royal Mint opened and was closed in April, 1919.

(6) *Sale of gold.* We know that the sale of gold was stopped immediately after the outbreak of the war (5th August, 1914). After the armistice, on the removal of war-time restrictions on the export of gold from belligerent countries, the Government of India bought it in London, U. S. A. and Australia, and made it available to the people. The immediate effect of these sales was a fall in the price of English bar gold from Rs. 32-12 per tola on the 15th August, 1919 to Rs. 27 per tola on the 22nd September, 1919.

(7) *Prohibition of the use of silver or gold coins for other than currency purposes.* Silver and gold coins had begun to fetch a higher value as metal than as coins. Hence, their use for purposes other than currency was declared illegal from June 19, 1917. Besides, their melting and exporting was also declared illegal from 3rd September, 1919.

(8) *Issue of nickel* coins and Rs. *2½ and Re. 1 notes.* With a view to economise silver, eight-anna, four-anna and two-anna bits were made of nickel instead of silver, and Rs. 2½ and Re. 1 notes were issued to supplement rupee coins.

(9) *Increase of note-issue.* In spite of the run for encashment of notes made from time to time their gross circulation went on increasing. On 31st March, 1914, while it was Rs. 66·12 crores, on 31st March, 1919, it was Rs. 153·46 crores, and on 30th November, 1919, Rs. 179·67 crores.

(10) *Increase in the fiduciary issue.* On the commence

ment of the war the fiduciary issue amounted to Rs. 14 crores. But by the end of the year 1919, it had reached the stupendous figure of Rs. 120 crores. Restrictions were imposed on their encashment as well, and the result was a small discount or butta on them in many parts of the country.

(11) *Financial measures.* Other measures taken by the Government, were *to keep down expenditure* as low as possible. *Additional taxation* was levied, and *extensive borrowing* was resorted to from 1917 onward, yielding about Rs. 130 crores. From October 1917, short term Treasury Bills were issued which brought in nearly Rs. 65 crores. During the year 1917-18, *post office cash certificates were also introduced.*

3. Babington Smith Commission

All the difficulties enumerated above, and specially that of securing the convertibility of note-issue led to the appointment of a fresh Commission in May, 1919, presided over by Mr. Babington Smith. It was required to examine the effects of war on Indian exchange and currency system and practice and upon the position of Indian note-issue, and to consider whether, in the light of this experience and of possible future variations in the price of silver, modifications of system in practice may be required, and if so, to make recommendations as to such modifications and generally to the policy that should be pursued to meet the requirements of trade, to maintain a satisfactory monetary circulation, and to ensure stable gold exchange standard.

As the terms of reference definitely asked the Commission to make recommendations *to ensure gold exchange standard* after going exhaustively into all the facts of currency and exchange during the war, it made recommendations to ensure gold exchange standard and not any other standard.

Conclusions drawn from war history. The Commission went through the war history very ably, and drew following conclusions :—

(1) The system built up since 1893 worked well, and *was beneficial to India.* It had supplied suitable media for internal circulation, provided means for a settlement of the balance of trade, secured stability between rupee and sterling, and prevented a fall in the value of rupee below 1s. 4d.

(2) *But the system was not a proof against a great rise in the value of silver.* In framing it, this contingency had

not been taken into account. Hence, when the unexpected happened, it threw the currency system out of gear.

Stability of exchange is desirable. The Commission regarded the stability of exchange desirable because of the following reasons :—

(1) It is *a necessary condition for a free investment of foreign capital* in India, as well as for a protection of capital already in existence, and this was at that time the most required.

(2) It facilitates *free movement of funds* to and from India. This was necessary for assisting commercial finance.

(3) The evils and inconveniences of instability are greater if brought about by administrative acts and not by economic causes. The commercial community is prepared to deal with fluctuations of exchange resulting from economic causes, but it cannot deal with them if they are brought about by administrative acts as *they introduce an element of uncertainty* which is beyond reckoning.

(4) A stable exchange gives *the most healthy condition for production and trade.*

The case for a higher ratio. The Majority preferred a higher ratio for rupees specially because of the following reasons :—

(1) *The price of silver was bound to continue to be high* and if rupee was to be fixed at a higher ratio, it would continue to be a token coin and thus enable the Government to control and regulate the amount of currency in circulation.

(2) The existing rate was high and *its lowering was bound to result in rising prices* and thus cause hardship to the poorer classes.

(3) A high ratio was *advantageous to Indian producers,* as it was expected to keep the cost of materials and machinery down in terms of rupees.

(4) *It was not expected to discourage exports,* as the world shortage of raw materials and food-stuffs was expected to continue and give India a monopoly in its trade.

(5) *Government finances were to gain enormously* by a saving in the remittance of home charges.

Distinction between gold exchange standard and sterling exchange standard. This Commission was the first to draw a distinction between a gold exchange standard and a sterling exchange standard. Sterling had been always considered as a synonym to gold. But during

the war, the former had depreciated in terms of the latter, and hence a distinction was necessary. The main argument in favour of a sterling exchange standard was that, as the larger part of the trade of India was with sterling-using countries, rupee-sterling exchange would be advantageous to India. During the year 1918-19, Indian's trade with such countries amounted to 40 per cent for exports and 48 per cent for imports, and with gold-using countries (Japan and America) to 25 per cent for exports and 30 per cent for imports of the total exports and imports. The Commission admitted the weight of the argument but held that *a fluctuating exchange would not hamper trade with the United Kingdom and India*, provided trade requirements for remittance were met freely and fully. Next, the Commission thought that *sterling would soon be restored to gold.*

The arguments in favour of a gold-exchange standard were as follows :—

(1) *Sterling, being a depreciated currency, had many inconveniences.* To link Indian currency to a depreciating currency was to invite all those inconveniences.

(2) It was necessary to maintain the token character of the rupee. If it was to be fixed in terms of sterling, and the latter was to depreciate still further, there was a possibility that this *token character of the rupee would be jeopardised.*

(3) To avoid the difficulty mentioned in (2) *it was possible to fix it in terms of sterling at a very high value.* But the Commission feared that if in the course of the next few years sterling once more became equivalent to gold, *rupee-sterling exchange might be found to be very high.*

(4) The Commission recommended that *gold sovereigns be made unlimited legal tender* along with rupees. Hence, it was essential that the relation of rupee should be fixed with gold.

Hence, the Commission preferred a gold exchange standard. Certain witnesses wanted *to postpone the decision* on the plea that the conditions then existing were abnormal and it was difficult to ascertain how things would take their turn in future. But they were not listened to. The Commission, of course, admitted that the existing circumstances were abnormal ; but as it was anxious to ensure a stable gold exchange standard immediately, it said it could not wait any longer.

Summary of recommendations of the Majority. (1) Rupee be made stable, and automatic working of Indian currency be re-established.

(2) Exchange value of rupee be fixed in terms of gold rather than sterling.

(3) The rate between rupee and gold be fixed at Rs. 10 to a sovereign or rupee one for 11·30016 grains of fine gold or 2*s*. both for foreign exchange and for internal purposes. Sovereigns should continue to be unlimited legal tender, but at the new rate, and a mint be opened at Bombay for their coinage. The recommendation to fix the exchange value of rupee at 2*s*. gold was qualified by the following remark : if contrary to expectation, a great and rapid fall in world prices were to take place and if the costs of production in India fail to adjust themselves with equal rapidity to the lower level of prices, then it might be necessary to consider the problem afresh.

(4) The obligations of the Government to give rupees for sovereigns be withdrawn.

(5) The embargo on the import and export of gold be cancelled.

(6) The prohibition on the import of silver be removed but that on the export of silver be continued. The duty on its imports be also withdrawn.

(7) No limit be fixed to the amount of the gold standard reserve.

(8) The gold standard reserve should contain a considerable proportion of gold.

(9) The balance of the gold standard reserve be kept in securities issued by governments within the British Empire (other than the Government of India) and having a fixed date of maturity of not more than 12 months.

(10) A portion of gold, not exceeding one half, be kept in India.

(11) Though there was no obligation on the Secretary of State to sell council bills, and a settlement of the balance of trade in favour of India could be made by export of gold to India, Council bills be sold so long as possible at rates varying with the cost of shipping gold to India.

(12) The Government of India should announce its readiness to sell reverse Councils as soon as the rate of exchange shows a tendency to weaken.

(13) The fiduciary portion of the paper currency reserve be fixed at not more than 60 per cent of the gross circulation.

(14) An emergency currency of Rs. 5 crores be issued to the Presidency Banks on the security of export bills having a maturity not exceeding 90 days.

(15) The permissive maximum of Rs. 120 crores of securities be retained for a limited period.

(16) The holding of the Government of India securities should not exceed Rs. 20 crores.

(17) The balance of the fiduciary portion should consist of securities of other governments within the British Empire, redeemable at a fixed date, of which all except Rs. 10 crores worth should be short-dated maturing within one year.

(18) The metallic portion of the paper currency reserve be held in India except for transitory purposes.

Conclusions of the Minority. The Minority consisted of the only Indian member Mr. Dadiba Merwanji Dulal. He concluded as follows :—

(1) The legally established money standard of India was the sovereign with rupees related to each other at 1 : 15. Fowler Commission had recommended this and the Government of India had accepted it. Of course Chamberlain Commission had recommended a gold exchange standard, but this had not even been considered because of the outbreak of war. *Gold exchange standard had no validity.* Neither had it been clearly and explicitly defined. The authorities used wide discretionary powers in managing it. The endless issue of token coins, much in excess of what is needed for internal exchange purposes, amounts to a form of taxation on the money of the public, Indians are compelled to be fond of precious metals to seek value for their token currency. The standard broke down at a time when India enjoyed a large measure of prosperity.

(2) *There was no need of raising the rate of exchange* on the plea of a rise in prices of silver which could have been prevented by removing the embargo on its exports from India after the signing of the armistice. The prices of silver rose very high only after the ending of the war. He maintained that India could easily have spared silver for exports. This would have been beneficial to her and would have prevented the great rise in prices. The Pittman Act had compelled the Government of U. S. A. to replace all the silver which she had given to other countries, and American production alone was not sufficient for this. Hence, it was expected that a rise in the prices of silver would be continued. Had Indian silver been made available, this would not have been so.

(3) A rise in exchange ratio would cause *set-back* to *several Indian industries and big losses to Indian exports.* It would also involve enormous loss to India on account of revaluation in terms of rupees of reserves invested in

sterling securities and of gold held as part of the metallic reserve against note-issue.

Besides, he took a strong objection to the *interference of the Secretary of State for India* on matters of Indian currency and finance. He held that there was no need for the sale of the Council bills at a rate more than 1s. 4⅛d., when the prices of silver had risen. The Secretary of State should have allowed the trade balance to be settled in other ways, *e. g.*, import of gold or sovereign, and this would have resulted in the avoidance of unprofitable coinage of rupees. The one advantage claimed of the circulation of rupee was that it was more economical than gold. But it had ceased to be so, because of a rise in the prices of silver. Hence, *there was no need of its circulation.*

SUMMARY

1. The history of Indian currency during the war of 1914-18 may be divided into two periods. During the first which lasted till 1916, there was a general dislocation of trade and business with its attendant effects. The outbreak of war caused a panic, the principal symptoms of which were (1) weakening of exchange, (2) withdrawal of savings bank and bank deposits, (3) a demand for encashment of notes and (4) a run on Indian gold stock. But soon confidence was restored and the situation improved.

2. The most serious effect of the war came to be felt from the end of 1916, and specially because of a rapid rise in the prices of silver. There was, at that time, a demand for more and more of rupees because of India's favourable balance of trade, exceptional disbursements of the Government in the country, heavy decline in the imports of precious metals and increase in trade and business. This could not be met because of a rise in the prices of silver brought about by a number of causes. The steps taken in consequence of this were control of exchange raising the rate of exchange, purchase of silver from the Government of U. S. A. exclusion of private buyers from the silver market, acquisition and use of gold, sale of gold after the signing of the armistice, prohibition of the use of gold and silver coins for other than currency purposes, issue of nickel coins and Rs. 2½ and Re. 1 notes, increase of note-issue and of the fiduciary issue, keeping down expenditure as low as possible, levying of additional taxes, borrowing and introducing post office cash certificates.

(3) The difficulties mentioned above and specially that of securing the convertibility of note-issue lead to the appointment of the Babington Smith Commission. The terms of reference precluded it also to recommend any other standard than the gold exchange standard. Hence, it recommended the same. It went for this purpose, very ably through the war history of Indian currency and pointed out the merits and demerits of the system. According to the Commission, it suffered only from the defect of not being a proof against a great rise in the value of silver, and to avoid this and certain other difficulties it recommended ultimately a higher ratio for the rupee, *viz.*, 2s. gold. The Commission also drew distinction, for the first time, between gold exchange standard and sterling exchange standard and recommended the former. Its other recommendations were in connection with removing the difficulties experienced and restrictions imposed during the war period. The Minority consisting of the only Indian member Mr. Dalal differed from the view taken by the Majority. He took a strong

objection to the interference of the Secretary of State for India on matters of Indian currency and finance.

TEST QUESTIONS

1. What difficulties were experienced during the first period of the war of 1914-18 and what steps were taken to alleviate them ?

2. Account for the break-down of gold exchange standard during the war of 1914-18 mentioning the causes in detail.

3. What steps were taken by the authorities to meet the situation which had arisen during the latter period of the war of 1914-18 ? Discuss these as elaborately as you can.

4. Trace the causes of the break-down of gold exchange standard in India during the last Great War, and give a brief survey of the measures adopted by the Government to prevent an under-appreciation of exchange. (U. P. Board, 1939)

5. Account for the violent fluctuations in the rupee-sterling exchange during the last Great War.

6. Examine the effects of the rise in the value of silver in 1914-18 on India's trade, industries and the State. (U. P. Board, 1941)

7. Discuss the strong and weak points of gold exchange standard as it prevailed in India before the war of 1914-18. (Punjab B. A.)

8. Why did the Babington Smith Commission recommend 2s. gold ratio ? Mention in this connection the arguments advanced by them in favour of the stability of exchange, adoption of a higher rate than what prevailed before the war and gold exchange standard as opposed to sterling exchange standard.

9. What were the important recommendations of the Babington Smith Commission ? Mention in this connection the criticism by the Minority.

CHAPTER XIX

POST-WAR DEVELOPMENTS 1920-27

The Government accepted the recommendations of the Babington Smith Commission, and modified the currency system accordingly embodying them into various notifications.

(1) It was notified that Council bills *and telegraphic transfers would be sold weekly* at competitive prices with a minimum rate varying with the cost in sterling of shipping gold from London to India. Similarly, reverse Councils would be sold in India on London whenever exchange would show a tendency to fall below 2s. gold.

(2) The Government of India had begun selling gold in September, 1919. When the recommendations of the Babington Smith Commission were accepted in 1920, it still commanded a high premium over the price recommended. Hence, the Government announced in February that *during the next six months, it would sell a minimum of 15 million tolas of gold. But this programme was extended by further sales* in August and September. After selling a large quantity at an average rate of Rs. 22 per tola, gold sales were stopped in October, 1920. In the meantime by an Ordinance of 21st June, 1920, *sovereigns and half-sovereigns were declared to have ceased to be legal tender.* But as they had been used as currency for long, *a provision was made for their acceptance* by the Government at the ratio of Rs. 15 during a moratorium of 21 days, on the expiry of which the *restrictions on imports of British gold coins were also withdrawn.* Then, in pursuance of the recommendations of the Babington Smith Commission, *sovereigns and half-sovereigns were made unlimited legal tender at Rs. 10 and Rs. 5 respectively.* But market price remained higher than this, and hence they did not come in circulation. Neither was there any chance for tendering gold for mintage, and hence *the idea of opening a gold mint in Bombay was also dropped.*

(3) In February, 1920, *the prohibition on the import of silver was withdrawn. The import duty of four annas per ounce was also abolished.* Similarly, *the prohibition of the use of gold and silver coins for other than currency purposes was also cancelled.* The price of silver had begun to fall on the very day on which the report of the Babington Smith Commission was tendered, and hence rupees had, since May 1920, begun to come out of hoards. In June,

restriction on behalf of the Government were accordingly withdrawn.

1. Breakdown of gold exchange standard (1920)

From the beginning, it was apparent that there was little chance for the maintenance of the new ratio. Mr. D. M. Dalal had been against it. Even the Majority of the Babington Smith Commission, while recommending it, had remarked that *it might be necessary to consider the problem afresh*, if contrary to expectations a great and rapid fall in world prices were to take place and if costs of production in India fail to adjust themselves with equal rapidity to the lower level of prices. *When Government issued the notification regarding the sale of reverse Councils, market price of rupee was higher than 2s. gold. There was thus absolutely no necessity to sell them.* But this was done, and it aggravated the situation.

(1) The Government sold reverse Councils. The exporters in India, who had to receive sterling in London also sold their export bills. *There was thus a competition between them and the market rate of exchange went up to 2s. 8½d. sterling.* On February 2, sterling fell in terms of dollar and hence gold. This brought the rupee-sterling rate at 2*s.* 10½d. But after this *the tide of the exporters anxious to sell the bills ebbed.* The exporters had sold the bills fearing that *a depreciation of sterling in terms of gold in future would give them less rupees* as they were now linked with gold.

(2) As the rupee-sterling rate rose, *there arose a keen demand for remittances to London. First of all* there were genuine Indian importers. They sent money in advance, lest it might fetch less of sterling in future. *Next*, foreign businessmen and firms in India found this the most profitable time for remitting their profits to England. *Thirdly*, huge war profits had also led to a boom in company promotion, and those wishing to import machines remitted in advance the payment for them. *Finally*, there were speculators who believed that the Government would not be able to maintain a high rate like the 2*s.* gold rate, and they remitted their money to England in the hope of bringing it back after exchange fell sufficiently, thereby making large profits.

(3) From January to June 1920, *the favourable balance of trade diminished gradually.* Imports increased owing partly to the increased demand for those articles specially piece goods—which had not been imported during the war and whose stock had run low by this time, and partly to the stimulating effect of the rise in exchange on demand. Exports, on the other hand, declined owing

to a combination of adverse circumstances. First of all, Japan, an important market for Indian cotton, failed to purchase her usual amount owing to an internal financial crisis. Secondly, Central Europe which used to buy a fairly large amount of Indian goods, stopped purchases for want of purchasing power brought about by political and economic troubles caused by the war. Thirdly, demand for Indian jute, tea and hides fell off partly owing to the accumulation of their large stocks in England and partly to the general uncertainty prevalent at the time in the international market. Finally, the rains of 1920 failed, and food and raw materials could not be continued to be exported.

As a result of the above, *there arose a demand for reverse Councils. The Government provided them at 2s. gold.* At this rate, the price of gold ought to have been Rs 15-14 per tola. The market price was about Rs. 22-4 per tola. This meant that the *Government undertook to provide gold at a lower rate than available in the market.* Such a great disparity could not obviously be continued. But *the Government persisted.* Babington Smith Commission, as has already been observed, had realised that there was a possibility of the failure to maintain the rate and had provided for its reconsideration. *It was the least pardonable of the errors of the Government* to have ignored this warning.

Various attempts to raise exchange. The Government made serious efforts in various directions to pull up the exchange.

(1) *It sold reverse Councils* at rates determined by the fall in the value of sterling in terms of gold less expenses for the shipment of gold during the early months of the year 1920 as follows :—

January	...	...	...	£5,394,000
February	...	...	...	£11,000,000
March	...	...	...	£9,988,000
April	...	...	...	£7,000,000

From the 29th April, the amount of reverse Councils offered weekly was reduced to £1 million and this amount was continued to be offered weekly up to 23rd June.

(2) Finding that the rate could not be maintained at 2s. gold *the Government tried to maintain it at 2s. sterling* on the plea that it would become 2s. gold when sterling would reach the parity. Hence, from 24th September, the rate adopted was 1s. $11\frac{13}{32}$d. But by the end of September, it had become evident that even this rate could not be maintained. Hence, the sale of reverse Councils was altogether stopped.

(3) Beside the sale of reverse Councils, *the Government continued the sale of gold.* In all 53 million ounces were sold, but this had no effect on its premium.

(4) The Government also tried *to contract currency* with a view to raise the exchange value of rupee. When reverse Councils were sold, currency notes and rupee coins were received in their stead. The currency was thus[1] cancelled. The reverse Councils were paid out of the paper currency reserve, and to the extent the currency notes were cancelled, the paper currency reserve was reduced.

Withdrawal of support (September 1920). At the end of September, 1920, the sale of reverse Councils was stopped and the Government regarded the battle to be lost. Left to itself, the exchange adjusted according to the forces of supply and demand, and in December reached 1s. 5d. sterling.

Sacrifices involved in the attempts to raise the exchange rate. The sacrifices involved in the attempts to raise the exchange rate were tremendous. An enormous loss was caused to the Indian Exchequer and industrialists and traders.

(1) In all reverse Councils to the extent of £55,382,000 were sold to maintain the rate of exchange. They were paid in London out of the sterling securities and Treasury bills. These had been acquired at Rs. 15 for a pound, but sold at Rs. 7 to Rs. 10 per pound. *The difference was a heavy loss borne by the Indian Exchequer.* It amounted to about Rs. 40 crores.

(2) 'The collapse of exchange within 12 months from the level of 2s. 4d. prevailing in April 1920 to below 1s. 3d. was *critical for importers*, many of whom had ordered goods when exchange was high without fixing their exchange and who were unable or unwilling to settle at the low rate when the goods arrived. At the close of the year Indian ports remained congested with imported piece-goods, motor cars and other articles of which delivery had not been taken.'

(3) *Exporters found themselves loaded with produce* for which there was no foreign demand. Prices went down in the country and they had to suffer.

(4) Besides, *deflation of currency brought the people in difficulty.* In the first place, it made the money market

[1]There were two other methods of contraction of currency, *viz.*, (1) selling of the metallic portion of the reserve (the coins were melted and silver sold in the market), and (2) selling of the rupee bills from out of the reserve. They were also resorted to by the Government from time to time.

tight and raised the bank rate of interest on loanable money; and in the second place, it tended to lower down the already lowering down prices. Company promoters did not get capital, the already existing concerns did not get market for their produce, and the agriculturists could not realise in many cases even their expenses of production.

2. The Policy of Masterly inactivity (1921-25)

In 1921, balance of trade was still against India The rate of exchange which had fallen to 1s. 5d. in December 1920, fell still lower to 1s. 2⅛d (under 1s. gold) in March, 1921. In 1922, the balance of trade began to turn favourable to India, and the rate of exchange reached pre-War level of 1s. 4d. in January, 1923. By October, 1924, it reached 1s. 6d. (about 1s. 4d. gold).

The revival of the export trade was due to good harvests and an improvement in the purchasing capacity of the European countries consequent upon the reconstruction of their currencies.

The rate of exchange strengthened owing partly to the revival of exports and partly to the contraction of currency. Some of the writers say that the Government followed during this period a policy of masterly inactivity, but this is not true. As Dr. Jain says, '*the exchange was not, as is sometimes supposed, left to look after itself. But it was managed on expedients different from those adopted before.*' Reverse Councils were not sold, but in their stead currency was contracted. According to an official statement currency was contracted to the extent of Rs. 31,58,00,000 in the year 1920-21 and it continued to be so in the years 1921-22 and 1922-23 by the transfer of sterling securities held in London to the Secretary of State's cash balance and by the discharge of Indian Treasury bills held in the reserve. The net contraction affected during 1921-22 and 1922-23 was 111 lakhs and 569 lakhs respectively.

A rise in exchange rate above 1s. 6d. sterling was prevented by the Government by introducing the practice of purchasing sterling in India. The purchase of sterling in India has the same effect as the sale of Council bills in London.

Advantages of sterling purchase over sale of Council bills. The advantages claimed for sterling purchase are as follows:—

(1) Initiative in making remittance of sterling to London is transferred to the Government of India to whom it should rightly belong.

(2) Purchases of sterling can be regulated with reference to the conditions of Indian exchange market and heavy fluctuations in exchange rate avoided.

The system of sterling purchase has gradually displaced since 1924 the sale of Council bills. At present, as we shall see later on, this is the main weapon adopted for the prevention of the rate of exchange to rise above the maximum of *1s. 6d.*

3. Hilton Young Commission

In April 1925, sterling was restored to gold and U. K. adopted what was known as a gold bullion standard. The rupee-sterling rate which was at that time at *1s. 6d.* also became rupee gold rate. In August, 1925, a Commission was appointed under the chairmanship of Mr. Edward Hilton Young to examine and report on Indian exchange and currency system and practise and to consider whether any modifications were desirable in the interests of India and to make recommendations.

The report of the Commission was published in 1926. First of all, it pointed out the defects with which Indian exchange and currency system as prevailing at that time suffered and then it made its own recommendations.

Defects of Indian exchange and currency system as prevalent in 1926. The Commission pointed out the following defects:—

(1) *The system is far from simple,* and the basis of the stability of rupee is not readily intelligible to the uninstructed public. The currency consists of two tokens[2] in circulation, with the unnecessary excrescence of a third full value coin[3] which does not circulate at all. One form of token currency[4] into which there is an unlimited obligation to convert the other[5] is highly expensive, and is liable to vanish if price of silver rises above a certain level.

(2) There is *a cumbrous duplication of reserves,*[6] with an antiquated, and dangerous division of responsibility for the control of credit and currency policy.

(3) The system *does not secure automatic expansion and contraction of currency.* Such movements are too wholly dependent on the will of the currency authority.

(4) *The system is inelastic.* The utility of the provision for elasticity made on the recommendation of the

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[2]Rupee coins and notes.
[3]Sovereign.
[4]Rupee coins.
[5]Notes.
[6]Gold standard reserve and paper currency reserve.

Babington Smith Commission is affected by the methods[7] of financing Indian trade.

Recommendations. The Commission made the following recommendations:—

(1) *Gold bullion standard be adopted* as the system of currency. Gold coins should not be introduced into circulation but an obligation should be imposed by law on the currency authority to buy and sell gold in the form of gold bars without limit in exchange for rupees and currency notes. The legal tender characteristic of sovereigns and half-sovereigns should be withdrawn. There should be no legal obligation on the Government to give rupees for currency notes.

(2) The control and management of currency should be entrusted to *a central bank* to be established.

(3 *The rate of exchange* should be stabilised at 1s. 6d.

(4) *One-rupee notes should be re-introduced* as unlimited legal tender. Notes of higher denominations be made convertible into notes of smaller denominations or rupee coins at the option of the currency authority.

(5) The paper currency reserve and the gold standard reserve *should be amalgamated.* The constitution of the combined reserve was laid down.

The minority again consisting of only one Indian member, *viz.*, Sir Purshottamdas Thakurdas differed on most of the points. According to him the change from gold standard to gold exchange standard in the past was in absolute contravention of the currency policy officially adopted in 1899, binding on the Government and the country. He agreed with the recommendation regarding the adoption of gold bullion standard, but wished that there should be *no interference with the free inflow of gold* into India except with due publicity and the concurrence of the Legislature. In his opinion, *demonetisation of sovereigns and half-sovereigns* as recommended by the Majority *was unnecessary.*

He was *in favour of developing Imperial Bank of India into a central bank* as far as possible.

He was against the stabilisation of rupee at 1s. 6d. *He recommended 1s. 4d.*

Alternative standards. The standards alternative to gold bullion standard were (1) sterling exchange standard, (2) gold exchange standard, and (3) gold currency standard.

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[7]Indian trade is financed on the basis of cash credits and not on that of discounting bills, and emergency currency can only arise through the latter process,

The first two were rejected by the Commission on general grounds. The *objections to gold currency standard* were, the following :—

(1) 'A large extra demand for gold from India would cause *increased competition for gold* among the countries of the world and lead to a substantial fall in gold prices and a substantial curtailment of credit.' Credit is based upon gold, and a fall would cause its shortage.

(2) *The actual demand for gold cannot be estimated.* It is possible that people may begin to prefer gold coins to notes. The fear of a fall in the status of rupee may also cause their conversion into gold coins.

(3) The fall in the demand for silver because of the adoption of a gold currency standard would reduce its price. This would involve *a loss to the Indian Exchequer* on the sale of the surplus silver. It would also *lower down the value of the savings* of the poorer Indian people who invest them in silver ornaments.

(4) The adoption of gold currency standard by India might lead to *demonetisation of silver by China* as well. This would raise the price of gold and thus result in the difficulties mentioned in (1). It would also raise the price of silver and thus raise the difficulties mentioned in (3).

(5) India would not get gold without the co-operation of Great Britain and U. S. A. and *these countries are against the adoption of gold currency standard by India.*

(6) The scheme would prove *costly.* It might mean Rs. 3 crores a year for about 10 years.

Then, there were certain other general objections.

(7) *Gold in circulation is expensive,* while gold in reserve is more useful for bringing about stability in exchange.

(8) Gold currency standard is *a sign of backwardness.* Many countries returning to gold standard after the war did not return to its gold currency form.

(9) The bulk of transactions in India involve *small payments* and hence gold in circulation is not required for them.

Merits of gold currency standard. But Indians had for long been in favour of gold currency standard. The following were the advantages claimed for it :—

(1) It is an automatic standard.

But it was difficult to say whether it would have been so in India. If the imported gold were hoarded by the people and thus sterilised, prices would have remained the same, and the automatic working of gold currency standard checked.

But this contingency was possible only when the hoarding habit of the people would have persisted even after the introduction of gold currency.

(2) The introduction of gold currency would discourage uneconomic habit of hoarding gold. The assurance that all other forms of currency would be convertible into gold currency would render them as good as gold.

But the Hilton Young Commission thought that mere introduction of gold currency would not result in the abandonment of the habit of hoarding.

(3) Gold currency standard would inspire confidence which no other standard can do to the same extent

(4) India wants gold currency in circulation as is evident from the heavy importation of sovereigns and half-sovereigns during 1900-1914. Besides, the weight of good academic opinion is in favour of gold currency. 'This is pre-eminently a question in which Indian sentiment should prevail.'

(5) Gold currency standard is a stage through which India must pass to attain the ideal, *i. e.*, gold bullion standard.

Gold bullion standard as recommended for India. But gold bullion standard as recommended for India by the Commission was different from that adopted in Great Britain.

(1) While in Great Britain, pound sterling retained its pre-war gold parity, *i e.* 113·0016 grains gold, rupee in India was recommended to be linked to *a new gold parity*, *i. e.*, 8·47512 grains gold instead of the pre-War gold parity, *i. e*, 7·5334 grains gold. Rupee had a statutory gold parity of 11·30016 grains gold after 1920, but that parity had been inoperative.

(2) Bank of England was under a statutory obligation to buy gold in unlimited quantities at the rate of £3.17*s.* 9*d.* per standard ounce (11-12th fine) and to sell gold without limit, but in quantities of not less than 400 ounces fine at £3.17*s.* 10½*d.* per standard ounce. But in India, the currency authority was to be under obligation *to purchase as well only in quantities of not less than 400 ounces.* But in the succeeding Act, this limit of purchase was reduced to a minimum of 40 tolas or 14 ounces of gold. In India the conditions as well which were to govern the sale of gold by the currency authority were to be so framed as *to free it in normal circumstances from the task of supplying gold for nonmonetary purposes.* In order to achieve this object proposals were made for fixing the selling prices of gold. Finally in the succeeding Act, the option was

given to the currency authority to sell gold for delivery at Bombay or sterling in London.

(3) *Sovereigns and half-sovereigns were not demonetised in Great Britain*, but they were so done in India. But with a view to make gold standard visible to the ordinary public, it was proposed to offer 'on tap' savings certificates redeemable in three or five years in legal tender money or gold at the option of the holder. But this was never embodied in a law.

(4) *All silver coins in Great Britain continued to be legal tender up to 40 Shillings only.* In the Indian system rupee coins were to continue to be unlimited legal tender. This was, however, not a defect as pointed out previously. But they were not to be coined until their circulation was reduced to the amount required for small change, the object being to bring them to the same position as silver coins in Great Britain.

(5) In India, *a distinction was proposed to be made between old notes and new notes.* Old notes were to continue to be converted into silver rupees. But new notes were to be convertible only into gold bars. In Great Britain, all notes were convertible into gold bars. In the Act however, no such distinction was made.

From the above, it is obvious that the Commission did not recommend for India a full-fledged gold bullion standard, and an examination of the law that was subsequently passed, embodying these recommendations, reveals that inasmuch as the currency authority retained and actually exercised the option of selling, in return for internal currency, sterling for delivery in London, the standard adopted in this country was *sterling exchange standard* But so long as sterling was convertible into gold, it was actually *gold exchange standard.* It may be pointed out that both these standards had been discarded by the Commission.

Ratio question. As we know, the Commission recommended a 1s. 6d. ratio. The arguments advanced in its favour may briefly be stated as follows :—

(1) At the existing ratio, prices in India have attained *a substantial measure of adjustment with world prices*, and any change in the rate would mean a difficult period of adjustment, involving widespread disturbances.

(2) *Wages have also adjusted* themselves to the prices at the existing exchange rate of 1s. 6d.

(3) As regards *contracts* least injury will be caused by adhering to 1s. 6d. ratio. It is true that land revenue, etc., were settled when the ratio was 1s. 4d., but owing to the rise

of prices since then, the incidence has not increased—rather it has become lighter. Contracts settled after 1918 have been settled on the basis of higher rates. They will not at all be affected.

(4) As regards the contention that the then existing depression in jute industry and cotton mill industry could be done away with by adopting a lower ratio the Commission thought that *the depression in question was due to causes which the manipulation of exchange rate could not remedy.*

The arguments against reverting to 1s. 6d. ratio as advanced by the Commission were as follows:—

(1) Though 1s. 6d. rate has been described as the 'natural' rate, it is difficult to understand *in what sense it can be so described.* If Indian exchange were left to itself, there would ensue wide fluctuations in it, and it would be impossible to determine a 'natural' rate.

(2) It was argued that 1s. 6d. rate was approached through *Government manipulation.* The Commission pointed out that the question of the means by which a particular rate has been arrived has no bearing on the extent or violence of the economic disturbances which would result from an alteration in the rate.

(3) It was said that 1s. 6d. ratio would accentuate the fall of prices in India resulting from the fall of world gold prices. But the Majority held that such *a fall in prices was not likely to take place.*

(4) A reversion to 1s. 4d. *would affect the budget very much adversely.* It was estimated that the loss per annum to the Indian Exchequer would be near Rs. 6 crores.

(5) A reversion to 1s. 4d. *would mean a general rise in prices.* This would effect the consumers in general, and will mean an arbitrary reduction of the real wages of labour.

(6) The effect of a reversion to 1s. 4d. would be immediate on foreign trade. *The sudden fall might create a boom which would be followed later by a slump.*

(7) It has been suggested that the stabilisation of rupee at 1s. 4d. will raise the price of gold and check its abnormal import into India for being hoarded. But *import of gold is due to causes which cannot be removed merely by adopting a lower ratio.*

The Minority's arguments against 1s. 6d were as follows:—

(1) 1s. 4d. ratio was a *de facto* ratio. It had been disturbed during the war, because of abnormal conditions.

Even then, the Secretary of State should have ceased selling Council bills when he could not sell them at the legally fixed ratio rather than sell them at higher rates as he did. The Babington Smith Commission deliberately threw it out and fixed an unnatural ratio of 2s. gold which could not be maintained. But when the attempt to stabilise it at 2s. gold was abandoned, and rupee was allowed to adopt itself to the market conditions, it reached approximately 1s. 4d. gold the *de facto rate* in September, 1924. But it was not stabilised at that. Subsequently, when in April, 1925, pound sterling reached gold parity, the Government fixed it at 1s. 6d. gold. Hence, 1s. 6d. gold rate was achieved in April 1925 and not in September, 1924. In September, 1924, it was 1s. 4d. gold or 1s. 6d. sterling.

(2) From the above, it is obvious that 1s. 6d. gold rate had been in existence only since April 1925. As the discussions were being made in 1926, it was argued that *the new rate had had no time to allow the adjustment of prices, wages, and contracts.* The main argument of the Majority had been that they had adjusted, and a reversion to 1s. 6d. rate would cause a considerable disturbance.

(3) *There was no gain to the Government by the adoption of 1s. 6d. ratio.* No doubt, it meant a saving in the payment of Home charges. But there was bound to be a loss, on the other side, in receipts in connection with customs on exports which were sure to decline. Besides, the adoption of 1s. 4d. rate would have brought about a reduction under bounties to certain industries given on the rise of exchange to 1s. 6d. Then, there was Income-Tax and Corporation Tax which would have increased as a result of impetus given to industries by the adoption of 1s. 4d.

(4) It would be possible to maintain the currency system of the country with a lesser reserve in gold and sterling if the rate were to be fixed at 1s. 4d. rather than if it were to be fixed at 1s. 6d. The question was whether it was right to fix a ratio that *would require larger resources* to maintain if the fixing of the ratio could be avoided.

(5) A change to 1s. 6d. *would hit the large bulk of the debtor class* to the benefit of the creditor class, and there was no justification to give the latter an unearned increment at the expense of the former.

(6) The Majority had argued that 1s. 6d. rate had no adverse effect on Indian trade with other countries. The Minority replied that *exports had not fallen in the meantime only because of good harvests and low holding power of Indian*

agriculturists, and imports had not gone up only because of the fall in the purchasing power of the masses.

(7) This raising of rate from 1s. 4d. to 1s. 6d. *would give the foreign exporters a bounty* to the extent of 12½%, and thus be detrimental to the interests of Indian industries.

4. Government Action on the Report

The report was published in 1926. Three bills embodying the recommendations contained therein were introduced in the Indian Legislative Assembly on 25th January, 1927. They were (1) the Currency Bill, (2) the Gold Standard and Reserve Bank of India Bill, and (3) the Imperial Bank of India (Amendment) Bill. Of these only the first was passed into an Act.

The Currency Act (1927). (1) The currency notes, the silver rupee, the half silver rupee, all remained legal tender without limit, and open to issue at the will of the Government. *The parity of exchange was fixed at 8·47512 grains troy of fine gold* which was at that time equivalent to 1s. 6d. per rupee.

(2) *Gold coins did not remain legal tender*, but could be received at any Government Treasury and Currency Office as bullion at the rate of 8·47512 grains fine gold per rupee.

(3) *The Government was obliged to purchase gold at Rs. 21-3-10 per tola* in the form of bars of not less than 40 tolas 15 ounces) of gold at the Bombay Mint.

(4) *The Government was also obliged to sell gold for delivery at the Bombay Mint or sterling for delivery in London* in amounts of not less than 1065 tolas (400 ounces) of fine gold or the equivalent amount of sterling) at the option of the Controller of Currency, Calcutta, or the Deputy Controller of Currency, Bombay at Rs. 21 3-10 per tola of fine gold or as much sterling as was required to purchase one tola of fine gold in London at the rate at which Bank of England was bound by law to give sterling in exchange for gold, after deduction therefrom of an amount representing the normal cost per tola of transferring gold bullion in bulk from Bombay to London, including interest on its value during transit. As this was bound to fluctuate, the Governor General had to notify from time to time the rate determined as above in the Gazette of India.

SUMMARY

1. The recommendations of the Babington Smith Commission were accepted by the Government and steps were taken to give effect to them. When Government issued the notifications regarding the sale of reverse

Councils, the market price of rupee was higher than 2s. gold. There was thus absolutely no necessity for it to sell them. But the Government did so. The exporters also sold their bills as they were afraid lest a depreciation of sterling in terms of gold in future would give them less rupees, as they were then linked with gold. There was thus a competition between reverse Councils and export bills and exchange in the market went up to 2s. 10$\frac{1}{32}$d. But soon export bills were exhausted. With a rise in the rupee-sterling rate, there arose, on the other hand, a keen demand for remittances to London. Besides, from January to June 1920, favourable balance of trade diminished and this also aggravated the situation. The Government provided reverse Councils at 2s. gold rate. At this rate, price of gold ought to have been Rs. 15-4-0 per tola. This meant that the Government undertook to provide gold at a lower rate than that available in the market. The Commission had realised that there was a possibility of the failure to maintain the rate and had provided for its reconsideration. But the Government persisted. It made various attempts to raise the rate. First of all, it continued selling reverse Councils at 2s. gold rate and then at 2s. sterling rate. Next, it continued selling gold. Thirdly, it contracted currency. At the end of September, 1920, however, sale of reverse Councils was stopped. In the attempt to maintain the rate of course, huge sacrifices had to be involved: First of all, sterling securities which had been acquired at Rs. 15 per pound had to be sold at Rs. 7 to Rs. 10 per pound. The difference was a heavy loss borne by the Indian Exchequer. Next, the collapse of exchange was critical for importers. Thirdly, exporters could not find market for their exports at such a high exchange rate. Fourthly and finally, deflation of currency brought the people in difficulty.

2. From September 1920 onward, the rate was left to find its own level. By March, 1921, it reached 1s. 2$\frac{7}{8}$d. sterling (under 1s. gold). In 1922 the balance of trade, however, turned favourable and the rate reached in January 1923 to 1s. 4d. and in October 1924 to 1s. 6d. (about 1s. 4d. gold). This was due to the revival of trade and also contraction of currency. Hence, it is wrong to say that during the period the Government followed a policy of masterly inactivity. Finally the rise in the rate beyond 1s. 6d. was checked by introducing the policy of sterling purchase by the Government which was advantageous to that of selling Council bills by the Secretary of State.

3. In 1925 Hilton Young Commission was appointed. This Commission unlike the two previous Commissions, was free to recommend any standard. The report was published in 1926. It pointed out the defects of exchange standard as prevalent at the time. The recommendations included the establishment of a gold bullion standard and of a central bank to control credit and currency, 1s. 6d. rate of exchange, reintroduction of one rupee notes, and unification of gold standard and paper currency reserves. The Minority though welcoming the establishment of gold bullion standard, neither wanted any interference with the free inflow of gold into India, nor demonetisation of gold coins as recommended by the Majority. It also wanted Imperial Bank to be developed as a Central Bank and restoration of rupee to 1s 4d. The Commission examined the alternatives to a gold bullion standard, and rejected gold currency standard. Gold bullion standard as recommended by the Commission differed in certain essentials from that prevailing in England and did not ultimately prove to be different from sterling or gold exchange standard. There was a good deal of difference of opinion between the Majority and Minority regarding the adoption of the exchange rate. In fact, the recommendation of the Majority in this connection provided the main theme of criticism in the following years.

4. The Government in its turn introduced in the Indian Legislature three bills embodying the recommendations of the Majority. But of these only one *viz.*, the Currency Bill was passed into an Act. This Act fixed the exchange parity at 8·47512 grains of gold, demonetised gold coins, and made it obligatory upon the Government to purchase gold at Rs. 21-3-10 per tola in the form of bars of not less than 40 tolas at the Bombay mint and to

sell gold for delivery at the same place or sterling for delivery in London in amounts of not less than 1065 tolas of fine gold or sterling of an equal amount at the option of the Controller of currency at Rs. 21-3-10 per tola of fine gold or as much of sterling as was required to purchase one tola of fine gold in London after deduction therefrom of an amount representing the normal cost per tola of transferring gold from Bombay to London including interest during transit. As this was bound to fluctuate it was notified from time to time in Government Gazettee.

TEST QUESTIONS

1. What notifications were issued by the Government of India in consequence of the recommendations of the Babington Smith Commission ? Give detailed explanation of these.

2. What were the effects of the policy of the Government to maintain 2s. gold rate as recommended by the Babington Smith Commission and what steps had to be taken in consequence thereof ? Also please mention in this connection the sacrifices involved.

3. 'The period from 1921 to 25 was a period of masterly inactivity in connection with Indian currency and exchange.' Comment.

4. What were the advantages of the system of sterling purchase over that of the sale of Council bills ?

5. What were the defects of the existing Indian currency system as pointed out by Hilton Young Commission ? Mention also the defects of a gold currency standard as pointed out by them.

6. What were the recommendations of Hilton Young Commission ? Mention in this connection the points of difference between gold bullion standard as recommended by them for India and as prevalent in England ?

7. What were the recommendations of the last Royal Commission on Indian currency and Finance and how far have they been given effect to ? (U. P. Board).

8. Distinguish between gold exchange standard and go'd bullion standard as proposed by Hilton Young Commission. State your views on the latter as a scheme of currency arrangement for the country. (Punjab—B. A)

9. What were the arguments advanced by the Majority of the Hilton Young Commission in support of 1s. 6d. rate and against 1s. 4d. rate ? Mention in this connection also the arguments advanced by the Minority against 1s 6d. rate.

10. What were the main clauses of the Indian Currency Act of 1927 ? Give your own opinion on the clause relating to the sale of gold and sterling as contained therein.

CHAPTER XX

CURRENCY FROM 1927-1939

During the period under review, *agitation centred at first mainly round exchange ratio, and then round exchange ratio and gold exports both.* Besides, there occurred a crisis in 1931, which brought out *the real characteristic of Indian currency.* The standard adopted in 1927 was fairly elastic. It was sterling exchange standard as the Government really exercised its option of giving sterling for delivery in London in exchange for Indian currency. But so long as sterling was in parity with gold, as has already been said, this was gold exchange standard as well. Finally, if Government chose to exercise the other option open to it of offering gold in exchange for rupees, it could be, in point of fact, if not in law, gold bullion standard. Since the occurrence of the crisis referred to above, it has been, however, only sterling exchange standard as we shall see presently.

1. Controversy regarding exchange ratio (April 1927 to September 1931)

From April 1927 to September, 1931, trade conditions in India were favourable, both exports and imports registering a rise. This improvement in trade, it was pointed out by the supporters of 1s. 6d. rate, clearly showed that an adjustment had been brought about and the new rate did not affect business at least adversely. But the fact is that the improvement in question was in a large measure the counterpart of much greater improvement in world trade. The supporters of 1s. 4d. rate held that *a lower ratio would have communicated the improvement to Indian trade in a greater measure.*

Next, during the whole of this period, the Government had to resort to *artificial devices* to strengthen the exchange rate. *First of all,* it raised the rate at which it was prepared to lend emergency currency to Imperial Bank. *Secondly,* the Government sold treasury bills and thus contracted currency. *Thirdly,* it sold sterling bills and met the sales by transfers from gold standard reserve and paper currency reserve.

After September, 1929, India became involved in *world trade depression.* There was a crisis in America from where it blew over to other countries of the world. Prices

of commodities and securities collapsed everywhere, and in India also they shared the same common fate. There arose a natural reluctance on the part of the investors under the circumstances, to invest money. In India this was accentuated by a strong political agitation that was then going on. The Government also continued resorting to artificial devices referred to previously with a view to strengthen the exchange rate, and the contraction of currency that was brought about as a result of this *made the matter still worse.* Prices fell here in a greater measure than anywhere else and balance of trade declined.

2. Crisis of 1931 (Divorce between sterling and gold and its reactions in India)

Britain had adopted gold standard in 1925 with the same parity as it had before the War, while most of the other countries had done this with a lower parity. The consequent result of this was that the cost and prices in the former country remained higher in terms of gold than in the latter countries. It may be said that all through the period from 1925 to 1931, the British Government had to labour hard. There was, on the one hand, *an unfavourable balance of trade*, and on the other, *unemployment and depression in industries.* The task of balancing the budget had been under the circumstances, made difficult. Over and above this, there had been *the effects of the 1929 crisis also which* accentuated the flight of gold from the country. First of all, attempts were made to meet the situation by raising credits in France and U. S. A. But in the end, there was no way left except that of *the abandonment of gold standard.* This was done on September 21, 1931. The obligation placed on the Bank of England by sub-section (*ii*) of section I of the Gold Standard Act of 1925 to give gold bars in exchange for internal currency at fixed rates was removed, and sterling was allowed to find its equivalent by the forces of supply and demand. From this date, it began to fall, and this went on so long as it was not pegged again to American dollar.

Rupee had been linked to gold by the Currency Act of 1927, but an option had been given to the Government to offer its equivalents in sterling as well. The question arose at this stage, when sterling was divorced from gold, whether the Government should in future offer only gold or sterling. There was no legal equivalent of sterling in terms of gold. Hence, it could offer only one at fixed rates. The Governor-General could not take any decision without consulting the Secretary of State. The Legislature was sitting, but he did not think it proper to refer the matter

to it. Hence, an Ordinance had to be promulgated which repealed Section 5 of the Currency Act, 1927 and *relieved the Government of the obligation to sell gold or sterling at fixed rates.* The following three days were also declared as bank holidays to prevent speculative activities in exchange. The Secretary of State on the same day, *i. e.*, on the 21st September, 1931, made a statement before the Federal Structure Sub-Committee of the Indian Round Table Conference informing them that it had been decided to maintain the present standard on sterling basis. On 24th September, 1931, therefore the previous Ordinance was repealed and a new Ordinance, namely, the *Gold and Sterling Sales Regulation Ordinance, 1931*, was promulgated. It imposed restrictions on the sales of gold[1] and sterling to genuine trade purposes and reasonable personal requirements. The rules made under the Ordinance laid down £25,000 as the maximum amount to be sold to any recognized bank. The object underlying all this was to maintain the sterling value of rupee at 1s. 6d. In its absence, it was feared that rupee would seek conversion into foreign currencies in large quantities causing exchange weakness. In Bombay, in the first ten minutes after business opened and before the market was aware of the issue of the Ordinance, demands for 425,000 pounds sterling were received. But after sometime exchange restrictions did not appear necessary and as a consequence the *second Ordinance was also repealed* on 30th January, 1932. *Since then, the Currency Act of 1927 has come into force.* But as the Executive sells only sterling, we have got only sterling exchange standard and not gold exchange standard or gold bullion standard. Rupee remains thus divorced since September, 1931, from gold *only because of Executive will.*

The action of the Government in linking rupee with sterling was perhaps the best under the circumstances. But it has been subjected to adverse criticism partly because Indian Legislature which was sitting at that time was not consulted in the matter, and partly because the ratio was not revised.

The alternatives to a link with sterling were a link with gold and a free rupee. If rupee had been linked with gold, at 8·47512 grains or 7·53344 grains, it would have become difficult to maintain it. We know that all currencies had to be divorced from gold or linked with it at a much lower figure. In fact, there is nowhere in the world at

[1]It does not mean that it linked rupee with gold. It only allowed the Executive to sell gold or sterling; and as the Executive sold only sterling, it was sterling exchange standard, and rupee remained divorced from gold.

present maintained an effective gold standard. To leave rupee free also would have caused much inconvenience both to the people and Government because of their relations with the world outside India.

Arguments advanced by Government spokesmen against the linking of rupee with gold. The following were the arguments advanced by Government spokesmen against the linking of rupee to gold.

(1) If rupee had been linked to gold *strong gold reserves* would have been necessary to maintain the link. The combined gold reserves of both the gold standard and paper currency reserves at that time amounted to £32½ million sterling, according to 8·47512 parity.

(2) To maintain the convertibility of rupee into gold at a time when there was rush for gold in other countries, *deflation* might have become necessary. This would have worsened the position of Indians.

(3) A fixed ratio in terms of gold would have meant a *fluctuating ratio in terms of sterling* so long as sterling remained fluctuating rather depressing in terms of gold. A fluctuating sterling rate would have reacted adversely on India's trade with Britain and other countries which had their currencies linked to sterling.

(4) If 1s. 6d. sterling rate was regarded as unduly high, 1s. 6d. gold rate or even a lower gold rate would have been still more *objectionable.*

Consequences of stabilisation in terms of sterling. (1) Rupee was tied to *sinking boat of sterling* and thus the fate of India was linked with that of Great Britain.

(2) The depreciation of rupee consequent upon the depreciation of sterling reduced Indian prices in terms of gold, and hence tended to stimulate exports to countries having their currencies based on gold and to discourage imports from them. In actual practice, *the stimulus to exports was neutralised* by declining world prices and high import duties and other restrictions on imports in them. *In connection with imports as well, it may be said that the effects were neutralised by declining prices.*

(3) This, however, did give *a preference to British exports* in this country over exports from other countries, and specially from those which maintained gold standard. But gradually, this was also neutralised, as other countries also gave up gold standard or devalued their currencies.

(4) It enabled the Government and the people to meet their *sterling obligations* without embarrassment or uncertainty.

(5) The most important effect of this action was the *export of gold* from India in huge quantities. This was bound to happen, as sterling and rupee fell in relation to gold which means the same thing as a rise in the prices of gold. The prices of gold would have, however, not risen, had rupee been kept linked to gold at the old ratio. But then, the position of Indians would have worsened still, and as a result, they would have been compelled to sell gold to make their both ends meet. The Government could have, of course, purchased most of it. But it did not interfere. We shall take up this question in greater detail presently.

3. Gold exports (1931-1940)

India imported gold and silver on a large scale under Moghul Kings. This was due to the character of her balance of trade.

India's Balance of trade is still in her favour. But there is * a Burden of *Home Charges*—a charge to the revenue of India, a drain of profits from important industries, which are a monopoly of, or controlled by foreign capital, as tea, copper, rubber, petroleum, jute, coal, etc., and invisible imports in the shape of services of foreign shippers, bankers and commission agents etc. These make her balance of payments turn unfavourable or less favourable than what it would otherwise be. Nevertheless, in normal years, she has even then something to receive. Below is a summary of net receipt of silver and gold by India since 1900-01.

*This burden has been very much lightened during the war of 1939-45.

Average for	Receipts of gold		Receipts of silver	
	Quantity in Ounces	Value in rupees	Quantity in Ounces	Value in rupees
1900-01 to 1904-05	9,76,206	6,23,43,774	...	10,11,61,514
1905-06 to 1909-10	18,44,779	11,74,53,065	...	16,14,20,372
1910-11 to 1914-15	41,11,388	25,34,21,717	...	10,61,41 326
1915-16 to 1919-20	21,45,834	13,41,42,776	...	27,96,38,686
1920-21 to 1924-25	45,19,807	28,70,95,282	...	15,72,70,821
year				
1925-26	61,35 581	34,35,45,799	...	17,12,41,150
1926-27	33,85,529	19,40,05,448	...	19,86,80,335
1927-28	31,81,759	18,10,00,023	...	13,83,68,227
1928-29	37,85,441	21,19,86,978	...	9,77,06,926
1929-30	25,23,562	14,22,08,396	...	8,62,12,198
1930-31	22,42,653	12,75,18,115	...	10,07,93,056
1936-37	...	...	...	13,59,17,471
1937-38	...	...	...	1,50,65.835
1938-39	...	...	...	57,91,606
1939-40	...	...	...	1,48,44,287
Total ...	8,92,44,592	5,47,75,47,829		1,77,02,53,810

From the above, it is obvious that India imported huge quantities of both gold and silver during the first 31 years of this century. In the years 1931-32, there came a change. The net annual exports of both gold and silver for the years 1931-32 and onward are given below :—

Year	Exports of gold		Exports of silver	
	Quantity in Ounces	Value in rupees	Quantity in Ounces	Value in rupees
1931-32	76,29,377	57,97,27,842	...	42,17,088
1932-33	83,53,829	65,52,27,956	...	2,01,30,951
1933-34	66,95,298	57,05,35,961	...	6,35,71,426
1934-35	56,94,820	52,33,74,607	...	5,40,64,802
1935-36	40,19,262	37,35,59,955	...	57,40,862
1936-37	30,11,036	27,84,61,129		
1937-38	17,66,817	16,33,18,129		
1938-39	23,87,647	23,26,02,068		
1939-40	41,55,343	44,64,30,422		
Total ...	4,37,13,429	3,82,52,38,069		14,77,25,129

Before the outbreak of the World War II, as is obvious from the statistics given above, exports of silver had ceased but those of gold had not abated. It is said that *exports of gold were due to a rise in its prices.* The value of gold is fixed in dollars by U. S. A. which, being the country holding the largest stocks of precious metals, is in a monopolistic position. With the abandonment of gold standard, sterling fell in terms of dollar and hence gold, and as rupee was linked to sterling this also fell in terms of dollar and gold. After sometime dollar was also devalued. Hence, ever since the pegging of sterling in terms of dollar, sterling or rupee has not appreciated in terms of gold. Depreciation of a currency in terms of gold means the same thing as a rise in the prices of gold. The prices of gold would have not risen had rupee been kept linked to gold at the old parity.

The first question in connection with the export of gold is whether, it was 'distress gold' or 'investment gold.' Truly speaking *it was both.* Gold was sold to make both ends meet, as far as poor people were concerned. But it was sold to take profit as far as rich people were concerned.

Advantages of gold exports. (1) Gold exports enabled the country to maintain *a favourable balance of accounts,* and their quantity was small compared to the vast reservoir of gold built up in years preceding 1931.

(2) They enabled the Government *to obtain large quantities of sterling* and to pay off the sterling debt of £15 million which matured on January 1, 1932.

(3) They also enabled the Government *to meet Home charges, and to reduce the floating debt of India* in London.

(4) The *credit* of the Government was improved in foreign markets because of the facts mentioned in (2) and (3) and the rates at which it could borrow were substantially lowered.

(5) Less of gold enabled *the cancellation of sterling debt* which had been accumulated at a time when more of gold would have been required to pay it off.

(6) *The position of the reserves* was strengthened. As a result of the exports of gold, balances in the paper currency reserve had mounted to enormous figures even before the war.

(7) They strengthened the *rupee-sterling exchange* in particular and sterling in general.

(8) They stimulated the *foreign trade* of the country.

Imports of gold were enabled to have increased[2] purchasing power, which they utilised[3] in purchasing Indian goods and this stimulated the exports of the country. Indian sellers of gold were also enabled to have increased purchasing power, which they utilised in purchasing foreign goods and thus stimulated their imports.

(9) They allowed the sellers of gold *to get higher prices* which they used in tiding over temporary financial difficulties. Those using the proceeds for investment purposes supplied capital to Indian industries.

(10) It was also pointed out that the future price of gold was uncertain. It might fall[4] at any time. But sterling appreciated[5]. Hence, *investment in sterling was better* than investment in gold.

Disadvantages of gold exports. (1) India parted with *an appreciating metal* for a depreciating currency, and the loss thus incurred was far in excess of any interest that was earned due to investments. This is true both of the individuals and the Government. The individuals acquired rupees which lost in value. The Government acquired sterling.

(2) It is doubtful if King Gold has been dethroned for ever. If this is not so, *it would be difficult for India to acquire it.* It is also possible that it might be required to be purchased at a higher price.

Possible remedy. The possible remedy, under the circumstances, was *acquisition of gold by the Government.* It could have parted with as much of it as was necessary to meet sterling obligations and retained the rest. This would have increased the gold reserves of the country. In the past, India was denied to have gold standard mainly because of the shortage of gold. If ever world were to return to gold standard, India could also have the opportunity to do so.

4. Government's sales of silver

Though nothing was heard of exports of silver in

[2]It is doubtful whether import of gold into America increases the purchasing power of the people in America. Gold imported into America was sterilised, and not used as the basis of increased currency.

[3]During this period foreigners tried to place restrictions on their imports. It is doubtful if they utilised their increased purchasing power if any in purchasing foreign goods.

[4]It is doubtful if the prices of gold will fall in future. I feel that it cannot be so, unless the very nature of man changes, which is not possible.

[5]Sterling has been depreciating since the war. After the war, when restrictions on exchange will be withdrawn, it is bound to fall still.

comparison with those of gold since the abandonment of gold standard, the figures given above show that the former were also enormous. The cause in this case was also the same, and there was no abatement of exports of silver so long as its prices did not fall. But exports of silver were not alarming in comparison to its sales by the Government from 1927. Sales of silver were undertaken *in pursuance of the recommendations of Hilton Young Commission.* It had recommended the notes to be declared inconvertible into rupee coins, and hence also ended the need for the maintenance of big silver reserves. We know, however, that no legislation was passed declaring notes inconvertible into rupee coins. But the Government began selling silver, and upto 31st March, 1934, had sold a little over 196 million fine ounces or about 57 crores of rupees. Sales of silver depressed the price of silver and also caused deflation of currency.

In July of 1933, there was made *an International Silver Agreement* which bound the Government of India to sell not more than an average of 35 million ozs. annually for four years, *i.e.*, from 1st January, 1934 to 31st December, 1937. On the other hand, the governments of U. S. A., Australia, Canada, Mexico and Peru promised to purchase an equivalent amount. U. S. A. went a step further in 1935. It undertook to buy silver until its silver stocks constituted 25% of its metallic reserves and until the price of silver touched 64d. per ounce *i.e.*, about Re. 1/8 per tola, Immediately after the passing of the Act, when the Government commenced operations, the price rose to 36·25d. per ounce. Had this policy been continued, the effect would have been to bring rupee to a melting point. China, finding it difficult to maintain her silver currency, had to give up silver standard. The Government of India also got one rupee notes printed to provide for the contingency. But the occasion for putting these into circulation did not arise, as the Government of U. S. A. reversed its policy, and the price of silver receded back to the low level of 20d. in 1936 and remained between 16d. and 23½d. during 1936-41. The Government of India, however, continued selling silver from time to time both in Bombay and London.

5. Exchange rate during 1931 to 1939

We know that prices had begun to fall in India as everywhere else in 1929. This had its effects upon her balance of trade as well. India's exports consisting mostly of agricultural commodities and imports mostly of manufactured goods, it declined greatly. In 1933-34 there was a slight improvement. But next year again there was a

deterioration. Then, for two subsequent years again there was an improvement. But the year 1937-38 again witnessed a change. Since 1938-39, again the position has improved. During the first year of war, there was of course a fall in both exports and imports, but the balance of trade was not affected. Since the second year, however, both exports and imports and balance of trade as well have been improving.[6]

It may be pointed out that *the fall in the balance of trade had the tendency to weaken the exchange rate.* But this was *maintained because of the continued exports of precious metals* and specially gold. From April 1938, however, the effects of falling exports and increasing imports began to be visible, and the exchange rate began to fall and reached a point lower than 1s. 6d. in the first week of June of that year. On June 6, the Government issued a communique notifying its determination and capacity to maintain the exchange rate and this had a steadying effect. But the rate did not rise higher than 1s. $5\frac{15}{16}$d. for the time being. In December, forward exchange rate weakened and the Government again issued a communique. During the last quarter of 1938-39 there was an improvement in the balance of trade and exchange rate which went up to 1s. $5\frac{31}{32}$d. in March, 1939.

The demand for a lower exchange rate had been pressed since 1931. *The arguments advanced in this connection* may be briefly stated as follows :—

(1) When after the war, the currencies of different countries were re-organised, their value was fixed at or below the pre-war level. But unfortunately in the case of Indian currency, it was fixed above it. It is said so often that the United Kingdom had to face industrial and financial setback during the years between 1925 and 1931 only because it had restored sterling at the pre-war level. At the end, it had ultimately to delink it as it could not bear the burden any longer. India being no exception, her industrial and financial position was hit to the most due to this over-valuation. *Consequently, it gave a setback to her industries, and employment figures continued swelling.*

(2) Prior to September, 1931, maintenance of rate had been made possible only by resorting to *artificial devices* and then uptill the out-break of the World War II *gold exports* helped the Government to maintain it.

(3) There is no doubt that after the divorce of sterling from gold, rupee was also devalued in terms of the latter and other currencies to the same extent as the

[6]This is true only as far as the value is concerned. Quantity has certainly gone down.

former. But the weightiest reason for the devaluation of rupee, *viz.*, undoing of the injustice done to rupee by fixing it above the pre-war level after the war remained unremoved. Besides, *rupee remaind overvalued in terms of sterling*, and most of India's trade being with sterling countries, she suffered in competition with them.

(4) Of course 18d. ratio became as sacrosanct as 16d. ratio after being in force for a very long time and prices, wages and contracts had all adjusted to it in the meantime. But there was no harm in causing disturbance to these, if it was expected to be beneficial as a whole. The main ground on which the question of ratio should be decided must in all fairness be dependant upon the fact *whether a particular ratio will be beneficial to the country in the long run or not.*

(5) It was pointed out by those opposed to devaluation that devaluation of rupee would lead to *competitive devaluation*. This was really very strange. France had devalued her currency at least thrice without caring for others. What is India or rupee in the scheme of world finance that others should have taken notice of it ? Even if they would have done so, where was the harm ? India did not check them from doing what they had liked in the past.

(6) The up-holders of 18d. ratio said that the advantages of devaluation was bound to be only *temporary*. The answer to their argument is, but that would have been enough for the country.

(7) It was also said by some that devaluation could not help exports as foreigners would have imposed high tariffs against them. But people abroad are not so foolish. India's exports were largely in demand in manufacturing countries of the world and surely they were only too happy to get their requirements. Even countries importing our manufactured goods would not have done so as they had no industries to protect. Besides, *the main aim of devaluation is not to encourage exports but to discourage imports*, and if that was achieved any setback to the former could not be felt because of the increased demand of the country itself.

It was expected that devaluation would result in giving stimulus to both the country's internal and external trade and manufacturing and agricultural industries. This would have surely solved *the question of unemployment*. In May, 1938, the Prime Ministers of the Congress-governed provinces resolved to secure the co-operation of all the provinces to send representations to the Government of India for devaluation of rupee. This was a significant move The matter was taken by the Indian National

Congress as well, which passed a comprehensive resolution on the subject on December 14, 1938.

SUMMARY

1. During the period 1927-39 agitation centred at first mainly round exchange ratio and then round exchange rates and gold exports both. Besides, the crisis of 1931 brought out the real characteristic of Indian currency. From 1927-29 trade conditions in India were favourable, and the supporters of 1s. 6d. rate pointed out that the country did not suffer on account of this. But those against it pointed out that a lower ratio would have communicated the improvement to Indian trade in a greater measure. Next, during this period, the Government had to resort to artificial devices to strengthen the exchange rate. After 1929, India became involved in world trade depression. The contraction brought about during the previous period to maintain the exchange rate made the matters still worse.

2. Britain had adopted after the war gold standard at a pre-war parity, and this factor alone was in the absence of any other responsible for the deterioration in the condition of its trade and industries. The crisis of 1929 made the matters still worse. In the end, in September 1931, it had to give up gold standard. In India also there arose the question whether she should remain on gold standard or adopt sterling exchange standard. The Executive after a suspension of four days decided in favour of the latter. The alternative to a link with sterling in consequence of the adoption of sterling exchange standard were a link with gold and a free rupee and both of these positions would have proved to be detrimental to the interest of the country. Coupled with other consequences of the step taken, the most important was the continued export of gold. It was only after the outbreak of the World War II that this abated due to the imposition of war-time restrictions and other causes.

3. India had always been in normal years prior to 1931 importing precious metals. Since September 1931 till the outbreak of the World War II it had, however, been exporting them and specially gold. The immediate cause of this situation was a rise in their prices. The Government and some of the people also claim that the export of gold was to the advantage of the country. But the fact is that it would have been better had the Government purchased a considerable portion of it instead of allowing the whole to be exported.

4. The continued sales of silver as well by the Government was not in the interests of the country.

5. During the period 1931-39 also the exchange rate could be maintained only because of the exports of precious metals and specially gold. Demand for a lower exchange rate continued to be pressed all through this period as well. Arguments advanced in this connection were that it gave a setback to Indian industries, that it could be maintained only because of the continued exports of gold, that rupee remained overvalued in terms of sterling in comparison with pre-war, level that the question of ratio should be decided mainly upon the ground whether a particular ratio will be beneficial to the country in the long run or not, that India should not care for what other nations would say if she devalued her currency, that she did not mind even if the advantages of devaluation were to be only temporary, and finally that she wanted this not to encourage exports but to discourage imports.

TEST QUESTIONS

1. What arguments were advanced by the supporters of 1s. 6d. ratio and its opponents during the period 1927-31 in consequence of the conditions existing in this country at that time ?

2. What were the re-actions of the divorce between gold and sterling in India ? Do you think that the step taken thereupon was a right course ? Give arguments for your answer.

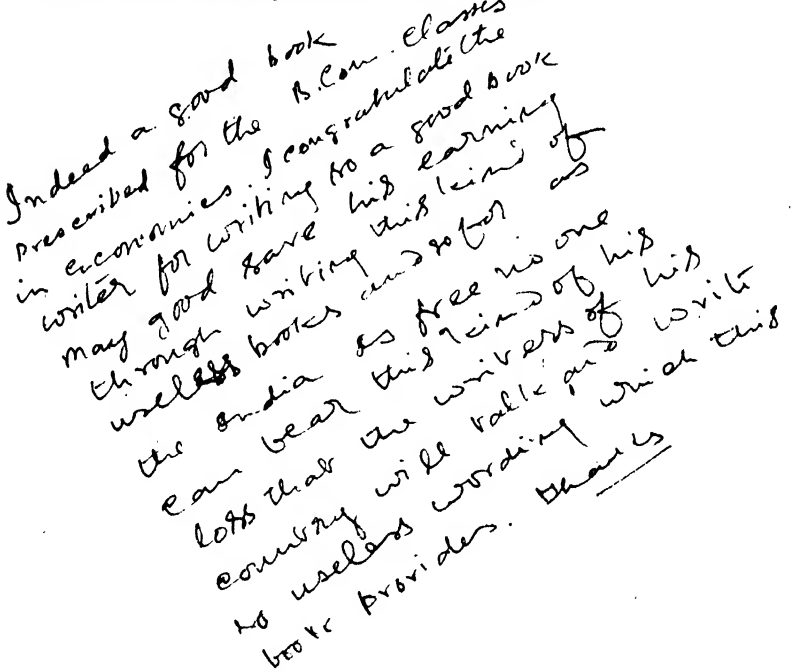
3. What arguments were advanced by the Government and its spokesmen against the 'linking of rupee to gold ? Mention the consequences of its stabilisation in terms of sterling.

4. What led to the exports of gold during the years 1931-39 ? Do you justify them ? If not suggest your alternative.

5. Was there any sanction for the sale of silver by the Government of India after the recommendation of the Hilton Young Commission ? What is your own opinion on this step ?

6. What was the condition of the exchange rate during 1931-39 ? Examine the case of 18d. exchange value of rupee as against 16d. exchange value.

7. Write a short essay not exceeding four pages of your answer book on Indian currency since 1931. (U. P. Board).



CHAPTER XXI

PAPER CURRENCY IN INDIA

Indian paper currency has a long history behind it, dating as far back as the 18th century. We have, of course, made a passing reference in the previous chapters of some of the steps taken in this connection. But there is a need of discussing it here in a greater detail and in a coherent manner. This can be done by dividing the whole period into certain distinct stages, each with its own characteristics and leading to the other.

1. Period I (up to 1861)

Upto the year 1861, notes were issued by the three *Presidency Banks and a few other private banks.* Their circulation was practically confined to the three Presidency towns. They were *not legal tender.* By far the most important of these were those of only the Presidency Banks which were allowed by their charter to issue notes in all up to the maximum amount of *5 crores of rupees* against which they were to hold *one-fourth in specie.* The causes of their limited circulation were *firstly* absence of legal tender characteristic in them and *secondly* absence of facilities for their conversion into rupees at a distance from the Presidency towns. It was perhaps not thought proper at that time to make them legal tender, as *the Government could not take any responsibility of their conversion.* Besides, facilities of their payment into specie or coins was not available because of the *difficulties of communications.*

2. Period II (1861 to 1914)

In the year 1861, after a good deal of hesitation and careful consideration the Government by virtue of an Act passed in 1861 *deprived all banks* of the right of note-issue and provided for the issue of a paper currency through a Government department by means of notes payable to bearer on demand. It divided the whole country into three *circles of issue, viz.,* Calcutta, Madras and Bombay and notes issued from the headquarters of any of these circles were *legally encashable* only at their respective headquarters. Later on, as paper currency increased in

circulation more circles[1] were created, the total number reaching seven at the end. For the accommodation of the public, however, the notes of other circles could be encashed at any paper currency office at any Government treasury, provided such encashment could be done without any inconvenience. In the first instance, they were, therefore, made *legal tender* as well within the area of their respective circles. Had the notes been made universal legal tender but only encashable at the headquarters of their respective circles, they would have been placed at a discount at certain times of the year and this would have impaired their popularity.

The Act also required that a metallic reserve, called the paper currency reserve, be kept against the whole of the notes issued, with the exception of such amount not exceeding 4 crores of rupees as might be fixed by the Governor-General-in-Council with the consent of the Secretary of State for India. This amount was to be invested in Government securities. This was, in fact, an imitation of the principle of the English system or *Fiduciary Issue System* or Currency Principle of note issue.

The first notes issued were of the denominations of Rs. 10, 20[2], 50, 100, 500, 1,000 and 10,000.

Subsequent changes. The subsequent changes during the period under review were as follows :—

(*1*) *Increase in gross circulation.* In the beginning the gross circulation of notes was small, but gradually it increased. The average of 1862-63 was Rs. 3·69 crores ; that of 1890-1, Rs. 15·77 crores ; that of 1900-1, Rs. 28·88 crores ; that of 1906-7, Rs. 45·14 crores ; that of 1911-12, Rs. 57·37 crores ; and that of 1912-13, Rs. 65·62 crores.

(*2*) *Introduction of 5 rupees notes.* 5 rupee note was introduced in 1891. It became suitable for payment of small sums. It was perhaps on this account that the average gross circulation increased after this very rapidly.

(*3*) *Universalisation of notes.* The circle system greatly restricted the normal expansion and popularity of notes. The first step was, therefore, taken in 1903 *to abolish it*, when 5 rupees note was made universal legal tender except in Burma. In 1909, it became so in the latter place as well. In 1910, notes of the denominations of Rs. 10 and 50 were similarly universalised, and power

[1] Additional circles were those of Rangoon, Karachi, Cawnpore and Lahore.

[2] Rs. 20 notes could not be very popular, and hence, were discontinued in 1910.

was taken to universalise notes of higher denominations by Executive order. In 1911, accordingly, Rs. 100 note was universalised. This also had its effects upon the increase in gross circulation.

(4) *Increase in fiduciary portion.* Changes were also made in fiduciary portion. Additions were made in 1881 to the extent of Rs. 2 crores ; in 1891, to Rs. 1 crore ; in 1892, to Rs. 1 crore ; in 1897, to Rs. 2 crores ; in 1905, to Rs. 2 crores, and in 1911, to Rs. 2 crores. Adding to these Rs. 4 crores allowed by the Act of 1861, the total reached Rs. 14 crores.

(5) *Investment of fiduciary portion in sterling securities.* Of the fiduciary portion mentioned in (4) a sum of Rs. 2 crores was allowed to be invested in sterling securities in 1905 and of another Rs 2 crores in 1911.

(6) *Changes in the metallic portion and its location.* Before the closing of mints to free coinage of silver, the metallic portion of the paper currency reserve was held in silver coins. (1) By the Act of 1893, currency notes were issued in exchange for gold coins or bullion to any amount, and hence the metallic portion of the paper currency reserve also began to be held in silver coins and gold coins and bullion as well. (2) By the Gold Note Act of 1898, notes were also allowed to be issued against *gold deposited in London* with the Secretary of State. This was intended as a temporary measure to remove the stringency in the money market. In 1902 it was made permanent. *Finally*, the 1905 Act allowed the metallic portion of the paper currency reserve to be held in rupees, gold coins and bullion either in India or London and fiduciary portion in rupee and sterling securities (the latter only to the extent of Rs. 2 crores).

(7) *Changes in the use of paper currency reserve.* Paper currency reserve was originally meant for the *encashment of notes.* In the Gold Note Act of 1898, however, there was included a clause authorising the Government to use gold held in the paper currency reserve *for the purchase of silver for coinage.* This was in the beginning intended to be a temporary measure, but was made permanent at last in 1902 From 1905 gold held in London and sterling securities held there also began to be used *for the support of exchange* and reverse councils issued in India began to be paid out of both the gold standard reserve and paper currency reserve without any distinction of any sort. On the other hand, both paper currency reserve and gold standard reserve (its rupee branch) were used for the purpose of conversion of notes into rupees as well. It was because of these

arbitrary uses without keeping any distinction in mind for the purposes for which the two reserves were kept that the Hilton Young Commission recommended their unification which was ultimately brought about by the transference of the note issuing business to the Reserve Bank of India in 1935.

Chamberlain Commission. Chamberlain Commission pointed out that Indian paper currency system was inelastic. It recommended the following for making it more elastic :—

(1) The *fiduciary portion should be raised* at once to Rs. 20 crores and thereafter be fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus one-third of the net circulation.

(2) The Government should take power to make *temporary investment* out of the fiduciary portion mentioned both in India and London. The practice of thus lending money temporarily would result, it held, in the following advantages :—

(*a*) Such temporary loans would help the money market and relieve the seasonal monetary stringency specially in India.

(*b*) The Government would be able by such loans to earn a considerable profit.

(*c*) It would be able, as the note circulation would increase, to add to the fiduciary portion without any legislation. This was because of the adoption of the percentage system as recommended in (1).

(*d*) The temporary investment in London would help the Secretary of State to sell council bills against paper currency reserve in anticipation of silver purchased without causing any loss of interest as in the case when gold is 'earmarked' by him for that purpose. In fact, the Commission did not favour the holding of gold in paper currency reserve in London earmarked for the purchase of silver.

Besides, the Commission wanted to popularise notes, and for this purpose it recommended the granting of extra facilities for the *encashment of notes.* It recommended the universalisation of 500 rupee note as well.

The Commission also recommended that the gold held in India in the paper currency reserve should be made *available* in normal times to the public in exchange for notes. But when exchange fell, it was to be made available only on condition that it would be immediately *exported* out of the country to meet trade requirements.

The Secretary of State was according to it not to hold gold worth more than £5 million in the paper currency

reserve. This along with its sterling securities would, it was pointed out, serve as a final source for securing the convertibility of notes in an internal crisis in India. Moreover, it was also expected to be used as a second line of defence in case exchange showed any sign of weakness.

But before the Government could take any action on their recommendations the war broke out and everything else was postponed.

3. Period III (War and Babington Smith Commission)

(1) It has already been said that during the first few months of the outbreak of war, *the active circulation of notes fell down but after some time it began to increase and reached* a very high figure. The total note-issue was almost trebled by 1920.

(2) The difficulty of obtaining sufficient quantities of precious metals as backing for the issue of additional notes, made it necessary to *increase the fiduciary portion* of the reserve. By various Ordinances and Acts of the Legislature, the limits were raised from Rs. 14 crores prior to war to Rs. 120 crores by December, 1919.

(3) Of the fiduciary portion, Rs. 6 crores were invested in *British Treasury Bills* according to an Act passed in 1916. This was raised to Rs. 100 crores by the end of December, 1919.

(4) Prior to the war, steps were being taken to give greater and greater facilities for the encashment of notes. But the policy had to be *reversed* from 1916 owing to the shortage in metallic reserve and silver for coinage purposes. As a result the facilities for the encashment of notes at district treasuries were in a large degree withdrawn. The *transmission of rupee coins* by rail or river steamer or post office was also prohibited. In connection with the supply of coins a sort of *rationing* system was also resorted to. The net effect of all this was a discount in notes of as high as 19 per cent in several places.

(5) To encourage the use of notes in small payments, *Rs. 2/8 notes were introduced in 1917 and Re. 1 notes in 1918.* In fact, it was because of this step taken by the authorities that the active circulation of notes increased specially during and after 1917.

Babington Smith Commission. The essence of the recommendations of the Babington Smith Commission as that of the Chamberlain Commission was to give greater elasticity to note issue. But the question of the composition of the paper currency reserve also being under discussion recommendations of the Commission related to this as well.

(1) It recommended the adoption of the *Banking principle* of note-issue in place of the currency principle so far adopted. The fiduciary portion was not to exceed 60 per cent of the gross circulation in any case.

(2) With a view to meet the *seasonal demand* for additional currency, it recommended the issue of Rs. 5 crores worth of notes to the three Presidency Banks on the security of export bills having a maturity not exceeding 90 days. Something like this had been recommended by the Chamberlain Commission as well. But there was one important difference, *viz.*, while according to the recommendations of the Chamberlain Commission, this additional issue was to form a part of the fiduciary portion laid down, according to the recommendations of the Babington Smith Commission, this was to be over and above the fiduciary portion laid down.

(3) It allowed the retention of the securities to the extent of Rs. 120 crores in the fiduciary portion of the paper currency reserve only *temporarily*. But ultimately this was to be in accordance with the recommendations contained in (1).

(4) Of the fiduciary portion in the paper currency reserve, the holding of securities issued by the Government of India could not exceed Rs. 20 crores. The remainder was to consist of securities of other governments within the British Empire, redeemable at a fixed date of which all except Rs. 10 crores worth were to be *short-dated securities* maturing within one year.

(5) The metallic portion of the reserve was required *to be held in India* except for transitory purposes.

4. Period IV (1920-1935)

As soon as the report of the Babington Smith-Commission came out, and reverse Councils began to be sold in order to maintain the rate of exchange recommended by it, the Secretary of State felt the need of making their payment out of the proceeds of the sterling securities in the paper currency reserve. But in accordance with the existing legislation, rupee securities could not be held in India for a larger amount than already permitted, and hence it would have become necessary to cancel the notes to the same extent. To avoid this, *a temporary legislation was passed* in March, 1920, continuing the then existing figure of Rs. 120 crores as the limit of permissible investment, but abolishing the restrictions as to the location of the investments and their sterling or rupee character. The Act remained in force up to the 1st October of the year, when it was replaced by the Indian Paper Currency Amendment Act of 1920.

Indian Paper Currency Amendment Act of 1920. This Act provided for the issue of currency notes against gold coins and bullion at the *new rate.* Besides, it accepted the *banking principle* of note-issue in place of the currency principle followed till then. According to it the metallic portion of the reserve was to be not less than 50 per cent of currency notes in circulation instead of 40 per cent as recommended by the Babington Smith Commission. Of this, gold held by the Secretary of State could not exceed Rs. 5 crores. As regards the fiduciary portion, it laid down that the Government of India rupee securities held at that time to the extent of Rs. 85 crores could be held only for a transitional period. In the end, however, they could not be held for more than Rs. 20 crores. Then, inasmuch as a result of the revaluation of gold coins and bullion and sterling securities at the new rate, there was bound to be caused a huge loss to the paper currency reserve, it was allowed to be made up by the issue of a special creation of the Government of India rupee securities which were christianed as *'created' or 'ad hoc' securities.* But they could not be permanently held for an amount exceeding Rs. 12 crores which was also to form a part of the permissible limit of the Government of India rupee securities. The revaluation was to result in a loss of more than this amount, and hence, it was enacted that as long as the 'created' securities exceeded Rs. 12 crores, they could be held as a part of the fiduciary portion of the reserve and that too of the permissible limit of the Government of India rupee securities and gradually they were to be written off out of the interest derived from the securities in the reserve with effect from the 1st April, 1921. The interest on securities held in the gold standard reserve and profits on coinage also were to be utilized for the same purpose when the gold standard reserve reached £40 million. It may be said that during the years that followed, the provision of utilizing the interest on securities in the reserve towards writing off created securities was suspended. *Finally,* they were reduced by valuation at 1s. 6d. after the acceptance of the recommendations of the Hilton Young Commission to that effect.

The Act also provided for the *issue of emergency currency* against bills of exchange. It laid down that loans be given to Imperial Bank of India only when the bank rate rises to 6 per cent., and when the bank rate is below 7 per cent., a maximum of Rs. 4 crores be used, when it is 7 per cent., another Rs. 4 crores and when it is 8 per cent., another Rs. 4 crores be used. During 1921-24, there was made contraction to strengthen the rate of exchange. This was, however, met by issuing an emergency currency as laid down above. Finally, in September, 1924, an announcement was made

changing the rules under which loans were made to Imperial Bank of India from currency so as to make it possible for the Bank to borrow Rs. 4 crores when the rate was at 6 per cent and Rs. 8 crores when it was 7 per cent., instead of Rs. 4 crores at each rate from 6 to 8 per cent.

Paper Currency Amendment Act of 1925. This Act increased the permissible limit of the Government of India rupee securities from Rs. 85 to Rs. 100 crores provided that the total amount of 'created' securities did not exceed Rs. 50 crores.

Withdrawal of Rs. 2/8 and Re. 1 notes. Rs. 2/8 note was never popular, and its issue along with that of Re. 1 note was discontinued from January 1, 1926.

Hilton Young Commission 1926. Along with other recommendations, it made also those in connection with paper currency. So far, currency was controlled by the Government, and credit, as far as it was controlled, by the Imperial Bank of India. This Commission recommended the establishment of the *Reserve Bank of India* with (1) the sole right of note issue and (2) the power to impose upon the country a judicious credit policy.

As regards the paper currency reserve, it favoured the *proportional reserve system* for the country and laid down for the separation of the Issue and Banking Departments of the proposed Reserve Bank of India.

In the light of experience of other note-issuing banks which are working this system, it recommended the provision of gold and gold securities in the reserve to be not less than 40 per cent of the liabilities as a minimum which were to include the notes in issue plus Rs. 50 crores set aside as provision against conversion of the hoarded-rupees into gold. Of this, gold was ultimately to be at least 25 per cent of liabilities (to be attained by stages in 10 years) with a minimum of Rs. 30 crores. As regards the remainder, rupee securities were to constitute not more than 25 per cent liabilities with a minimum of Rs. 50 crores. Then, there were rupee coins to the extent of Rs. 85 crores. The Commission recommended their reduction to Rs. 25 crores in due course. It has already been said that it did not recommend the conversion of new notes into rupee coins and hence it thought that the demand for them would after sometime be considerably reduced.

We already know that the Commission had recommended *the conversion of only old notes into rupee coins.* New notes were to be redeemable only in notes of smaller denominations—one rupee notes were also to be issued. But this does not mean that the notes were to be inconvertible. The

whole of the Indian currency was made *convertible into gold bullion by the Hilton Young Commission.*

The recommendations of the Commission regarding paper currency could not be given effect to till the year 1935. In the meantime, gold securities in the paper currency reserve were revalued at the new rate.

Universalisation of Rs. 500 and Rs. 1,000 notes. Rs. 500 and Rs. 1,000 notes were universalised during 1931-32.

5. Period V (1935—up to date)

Establishment of Reserve Bank of India and changes introduced in Indian paper currency system. Reserve Bank of India was established by the Reserve Bank of India Act 1935, and it began functioning from 1st April 1935, on which date it took over the management of the Currency Department of the Government of India by the erection of a special department called the Issue Department. The assets of the gold standard reserve and the paper currency reserve were combined and transferred to the extent of the liabilities assumed by it in respect of the notes issued[8] in the forms in which it was required to hold them in pursuance of provisions in the Act constituting it. The Bank also took over the duty of supplying the Secretary of State with sterling for his London requirements and maintaining the exchange rate. Besides, it holds all the balances of the Government of India, provincial governments and scheduled banks of the country and is a banker to all of them.

Since the taking over of the management of the Currency Department of the Government of India by the Reserve Bank, we have got bank issue of notes in this country instead of the Government issue which had been in vogue here since 1861. At the time of the commencement of the note-issuing function, however, the Bank did not issue its own notes. The notes of the Government of India issued and in existence at that time became the notes of the Reserve Bank of India. The Bank made in the meantime arrangement for the issue of its own notes and they were completed in 1938, in which year it issued them in denominations of Rs. 5, 10, 100, 1,000 and 10,000. In view of the fact that the circulation of Rs. 50 and Rs. 500 notes was negligible, it did not issue its own notes of these denominations, though Government of India notes of these denominations continued to be

[8]The recommendation of the Hilton Young Commission that the assets should consist of the liabilities of the notes issued plus Rs. 50 crores in lieu of the lower intrinsic value of rupee coins in circulation was not evidently accepted.

legal tender. The notes of the Reserve Bank of India are legal tender throughout the country and guaranteed by the Government. There were separate notes for India and Burma, and the notes of one place were not legal tender in the other.

The liabilities of the Issue Department of the Reserve Bank of India consist of the notes in circulation and those held in the Banking Department.

The assets in the paper currency reserve consist of gold coins and bullion and sterling securities, rupee coins,[4] rupee securities of the Government of India and bills of exchange and promissory notes which the Bank is allowed to deal in. Of these gold coins and bullion and sterling securities cannot be less than 40% of the total with a provision that gold coins and bullion cannot be held to the extent of less than Rs. 40 crores valued at 8,47512 grains per rupee at any time. Of the remainder, rupee securities including bills and promissory notes could not be more than Rs. 50 crores or $\frac{1}{4}$th of the total assets whichever be greater and with the previous sanction of the Governor General-in-Council of such amounts plus a sum of Rs. 10 crores. But by an amendment to the Reserve Bank of India Act which came into force on the 8th February, 1941, this limitation on the maximum holdings of rupee securities was removed. The balance is to be held in rupee coins which include Government of India one rupee notes since July, 1940. Of the total amount of gold holdings at least $\frac{17}{20}$ is to be held in India. Since July 1940, however, the whole of the gold stock is held in India, as gold held in India by the Reserve Bank on behalf of the British Government was exchanged in that month with that held by the latter in London on behalf of the Reserve Bank.

The minimum limit of gold coins and bullion and sterling securities can also be reduced with the previous sanction of the Governor-General-in-Council for periods not exceeding 30 days in the first instance, which may with a like sanction be extended from time to time by period not exceeding 15 days. During such periods of deficiency the Bank is required to pay a tax on the amount by which it falls short, at the current bank rate with an addition of 1% per annum when such holdings exceed 32½% of the total assets, and of a further 1½% in respect of every further decrease of 2½% or part of such decrease provided that the tax is in no event at a rate less than 6% per annum. Since the inauguration of the Reserve Bank of India, however, total holdings of these have always

[4]Since June 1940, rupee coins include one rupee notes as well

been much above the minimum percentage normally allowed by law.

Improvement effected by the above changes. As a result of the change of the issuing authority of notes from the Government to the Bank, the supply of currency can be kept more in accordance with its demand than it could be kept previously. The Bank, being in intimate contact with the money market, is in a position to know constantly more accurately and more quickly the day to day demand for it than the Government could. Besides, Government machinery being slow by nature could not be expected to move in this direction rapidly even if it could know the requirements so correctly and accurately. Moreoevr, Government policy of note-issue is guided by political considerations rather than by trade requirements. Bank's policy of note issue, on the other hand, is not guided by any other motive. But so far as the Reserve Bank of India is under the control of the Government, there is still a fear of this.[5]

Formerly there were two reserves maintained by the Government of India, *viz*, (1) the gold standard reserve and (2) the paper currency reserve. But in practice, there was, no demarcation between their functions. Hence, their unification had been recommended by the Hilton Young Commission. It was brought about only with the establishment of Reserve Bank. Of course, the Commission had recommended the holding of Rs. 50 crores in reserve over and above the liabilities of the Issue Department in lieu of a lower intrinsic value of rupee coins in circulation. But this was not laid down in the provisions of the Reserve Bank Act, and hence the reserve is maintained only to the extent of the liabilities in the Issue Department. At the time of the transference of the assets of the Issue Department of the Bank from the Currency Department of the Government, the whole stock of gold in the paper currency reserve and the gold standard reserve was transferred to the Issue Department of the Bank. Besides, Section 36 (1) of the Banks' Act requires Government to pay full legal tender value for surplus rupees returned by the Bank under the provisions of that section. To meet this obligation the *silver redemption reserve* amounting to Rs. 10 crores was constituted by the Government with effect from 1st April, 1935.

The changes in the composition of the paper currency reserve have also brought out an improvement in the paper

[5]In fact note circulation has increased far in excess of trade requirements since the outbreak of the World War II, and this has resulted in a tremendous rise of prices as well.

currency system in so far as it is more elastic now than it was previously. The Government of India could issue emergency currency on the recommendations of Imperial Bank of India only to the extent of Rs. 12 crores on the security of bills of exchange. The Bank, on the other hand, can issue it now to a much greater extent. This has not only made it elastic but also automatic. When notes are issued on the security of bills, money flows out of the Bank, but when they get matured it comes back to it. Then, the reserve of gold bullion, coins and sterling securities can be reduced even below the minimum percentage on certain conditions if there be any necessity. This could not be done under the previous system.

Finally, before the establishment of Reserve Bank of India a portion of the paper currency reserve was held in England for purchase of silver. This discouraged the silver market of the country. With the establishment of the Reserve Bank, no portion is kept in England for this purpose and it was hoped that all silver purchases would be made in this country if need be. But it is doubtful if such need will ever arise. The Government has reduced the use of silver for currency purposes recently by a reduction of fineness of rupee and subsidiary coins and issue of one rupee notes.

Reforms still necessary. Paper currency is exchangeable into rupee coins or notes of small denominations including those of rupee one since June, 1940. This means that one token currency is convertible into another or say it is wholly inconvertible. As a result of this, public has no confidence in currency and hence instead of investing its savings in banks and industries, it prefers to hoard these in the form of gold and silver bullion. This is a set-back to industries and cause of resultant poverty and misery in the country.

Besides, a portion of the assets is maintained in sterling securities perhaps because the Bank is under obligation to maintain the rupee sterling exchange rate. This is not conducive to the interests of the country. In case value of sterling falls, the amount of reserve would also be threatened. Moreover, investing money in a foreign country when there is already a field for investment within the country itself is not good. But this has to be done so long as rupee is kept tied to the chariot wheel of sterling.

SUMMARY

1. History of paper currency in India can be divided into different periods. The first lasted up till 1861. During this period notes were issued by the three Presidency Banks and a few other private banks. They

were not legal tender. The total issue of the three Presidency Banks was restricted to Rs. 5 crores only and one-fourth of this was to be kept in specie. They could not be made legal tender, as the Government could not take any responsibility of their conversion, and they could not be converted at all places due to the difficulties of communications.

2. In 1861, the Government assumed the monopoly of note issue. The whole country was divided into three circles which were later on increased to seven. Notes of one circle were legal tender only in that circle and convertible only at their respective headquarters of the particular circles. It was at first a fiduciary system of issue. Gradually, there was an increase in note circulation. The lowest denomination of the notes in the beginning was Rs. 10. Rupees five notes were introduced in 1891. Rs. 5 notes were universalised in 1903, Rs. 10 and Rs. 50 in 1910, and Rs. 100 in 1911. The fiduciary issue was also increased from Rs. 4 crores to Rs. 14 crores between 1861 and 1911. Of the fiduciary portion mentioned above a sum of Rs. 2 crores was allowed to be invested in sterling securities in 1905. The remaining was to be invested only in Government of India rupee securities. The Act of 1893 allowed the metallic portion to be held in gold coins and bullion as well in addition to silver coins. In 1898, the location of gold was allowed to be in London as well. The paper currency reserve was in the beginning meant only for the convertibility of notes, but gradually, it began to be used for the purchase of silver for coinage and support of exchange as well. The Chamberlain Commission raised the fiduciary portion to Rs. 20 crores and gave the Government power to make temporary investments as well out of this in both India and London. Besides, it recommended the granting of extra-facilities for the encashment of notes, and universalisation of Rs. 500 notes as well. It also recommended for the giving of gold to the public in normal times in exchange for notes and when exchange showed a sign of weakness only on condition that it would be exported in payment to foreign countries. A limit was also placed upon the holding of gold by the Secretary of State in London. But the war broke out and nothing could be done.

3. During the third period after a temporary fall, total note circulation increased tremendously. Along with it there was also an increase in the fiduciary portion. A part was also allowed to be invested in British Treasury Bills. The policy of giving facilities for the encashment of notes was reversed. Rs. 2/8 and Re. 1 notes were also issued. The Babington Smith Commission recommended the banking principle of note issue. It also recommended the issue of notes to meet seasonal demands against bills. Other recommendations of the Commission were of a temporary nature.

4. The fourth period began with the passing of a temporary legislation in pursuance of the Commission's recommendations of a temporary nature. Finally, Indian Paper Currency Amendment Act of 1920 was passed. It legalised the Commission's recommendations of permanent nature with small changes. Rs. 2/8 and Re. 1 notes were withdrawn from January 1, 1926, Paper Currency Amendment Act, 1925, authorised a larger holding of the Government of India rupee securities. Hilton Young Commission recommended, (1) Bank issue, (2) Proportional reserve system, (3) Unification of the paper currency and gold standard reserves, and (4) Conversion of new notes into notes of smaller denominations and of the whole currency into gold bullion. Rs. 500 and Rs. 1,000 notes were universalised in 1931-32

5. Reserve Bank of India was established in 1935 and took over the monopoly of note-issue business on April 1, of that year. On that date unification of the two reserves was also brought about, and the assets in the paper currency reserve were acquired in the form required by the Reserve Bank of India Act. As a war time measure, the Government of India has, however, since 1940 begun issuing notes of Re 1 as well. A number of improvements have been affected by the transference of the business of note issue to the Reserve Bank. There are, however, still certain defects which must be remedied in due course of time.

TEST QUESTIONS

1. Give a short history of Indian Paper Currency system from 1861 to 1914. (Delhi).

2. What do you mean by elasticity? How far did the recommendations of the Chamberlain Commission and Babington Smith Commission try to secure it?

3. Bring out the special features of Indian paper currency system during the war of 1914-18. What important decisions were reached by the Babington Smith Commission in this respect?

4. What was the system of note issue in India up to 1935? What changes were introduced by the Reserve Bank of India Act and why? (U. P. Board.)

5. What do you understand by elasticity of currency? Briefly indicate to what extent elasticity has been secured in Indian currency system in consequence of the establishment of the Reserve Bank. (U. P. Board)

6. Describe briefly the changes introduced in Indian paper currency system with the establishment of the Reserve Bank of India, indicating the improvements effected by such changes. Is any reform still necessary in your opinion? (U. P. Board)

7. Describe the existing system of paper currency in India, explaining the main items appearing in the weekly statement of the Issue Department of the Reserve Bank of India. (U. P. Board)

APPENDIX

The following statement shows the total liabilities and assets of the Issue Department of the Reserve Bank of India as on the last Friday of each month of the year together with their annual averages since the commencement of the operation of the Bank in April 1935.

(In Lakhs of Rupee)

Liabilities				Assets				
Annual Average of Friday Figures	Notes held in Banking Department	Notes in circulation	Total liabilities (total notes issued)	Gold coins and bullion	Sterling securities	Rupee coins[1]	Rupee securities	Total Assets	Percentage of gold and sterling securities to total note-issue
1935-36	27,54	1,64,11	1,91,65	44,42	62,13	55,52	29,58	1,91,65	55·60
1936-37	25,70	1,75,98	2,01,68	44,42	69,63	64,01	23,62	2,01,68	56·55
1937-38	25,64	1,86,14	2,11,78	44,42	79,90	60,24	27,22	2,11,78	58·70
	(1)	(4,03)	(4,04)						
1938-39	28,22	1,82,36	2,10,58	44,42	66,88	67,10	32,18	2,10,58	52·85
	(...)	(7,97)	(7,97)						
1939-40	18,89	20,8,86	2,27,75	44,42	78,32	67,59	37,42	2,27,75	53·89
	(8)	(11,07)	(11,15)						
1940-41	17,15	2,41,62	2,58,77	44,42	1,29,97	35,81	48,57	2,58,77	67·39
	(20)	(13,42)	(13,62)						
1941-42	12,17	3,08,46	3,20,63	44,42	1,65,44	35,21	75,56	3,20,63	65·45
	(23)	(2025)	(20,48)						
1942-43	11,80	5,13,44	5,25,24	44,42	3,19,11	22,33	1,39,38	5,25,24	69·21
1943-44	10,50	7,17,17	7,87,67	44,42	6,43,52	14,28	85,45	7,87,67	87·34
1944-45	10,93	9,68,69	9,79,62	44,42	8,63,73	13,52	57,95	9,79,62	92·70
1945-46	16,41	11,62,64	1,79,05	44,42	10,61,25	15,52	57,84	11,79,95	93·78

N. B. :— Burma figures shown in brackets below totals.

[1] Including Government of India Rupee Notes from July, 1940.

CHAPTER XXII

EFFECTS OF WORLD WAR II (1939—1945)

The commencement of the World War II on September 3, 1939, brought about inevitable dislocation in many spheres in India as well. We can study it under two heads, *viz.*, (1) immediate effects of war, and (2) permanent effects, and steps taken thereon.

1. Immediate effects of war (September 1939 to March, 1940)

First of all, *commodity prices* took an upward trend owing to the belief that the intensification of economic warfare meant brighter prospects for industries and agriculture. Calcutta index number of wholesale prices (1914=100) advanced sharply from 100 in August, to 137 in December, 1939, being the highest since 1929. But in the following month, there was a fall owing to a general feeling that the initial rise had been over-done. It also became more generally realised with the publication of the Excess Profits Tax Bill that war profits would be subjected to taxation.

Gold prices were also affected, and they moved erratically in an upward direction both in England and India. Hence, London Market had to be closed from the 2nd to the 4th September, 1939, and Bombay Market from the 4th to the 7th. On the 5th September, dealings in gold were prohibited in the United Kingdom under the Defence (Finance) Regulations ; sterling was officially pegged to dollar at 4-02 to 4-06 and Bank of England fixed its buying price of gold at 168 S. at which it remained till June 9, 1945, when it was raised to 172s. 3d. In India, an *embargo was placed on its exports and imports* by an Ordinance of the Government except on the authority of a license granted by the Reserve Bank. The prices varied after that mainly on account of the forces of supply and demand, the net effect being a rise from about Rs. 37 per tola on the outbreak of war to about Rs. 100 per tola at the end of 1945.

Prices of silver also rose due to the appreciation of dollar and speculative buying, ready price touching Rs. 63-12 on the 21st September. Price in London also reached 23½d. on the 20th September, but the situation was eased by sales of spot silver for London delivery at 23½d. for account of the Indian Government. In India, owing to

increased supplies accompanied by a fall in up-country offtake the price declined to Rs. 56-2 on the 4th October. With a view to conserving foreign exchange, the British and Indian Governments announed respectively on the 26th and the 30th October, their decisions *to prohibit imports of silver except under license*. Thereafter mainly as a result of sharp upswing in commodity markets, prices continued to advance and touched Rs. 66-4 on the 1st December, on rumours regarding Government's intention to suspend the sales of silver for delivery at the Bombay Mint. It was announced on the 14th December, that thereafter the sales of silver for delivery ex-mint, Bombay, which till then had been conducted through London, would be conducted by the Bombay office of the Reserve Bank of India. As a result of this and other measures and the fact that the demand in India was more speculative than for genuine investment purposes there was a reaction and prices sagged. But finally they began to rise again, and reached Rs. 137 in August, 1945. After that there was a rise in prices in U. S. A. and U. K. as well, and as a result thereof there was again a rise in India also, the new level being about Rs 200.

Rise in the prices of *commodities* was also accompanied by an increased demand for them from allied countries. The result was that *the value of exports during the year 1939-40 rose* to Rs. 213,67 lakhs as against Rs. 169,35 lakhs of the preceding year. At the same time *the value of imports also rose* during this period to Rs. 164,72 lakhs as against that of Rs. 151,79 lakhs during the previous year.

India's internal trade also recorded an improvement during this period, and was the largest since 1933-34 when the publication of the statistics regarding it was begun. As a result of this, railway earnings also rose and were the highest since 1929-30, while the number of wagons loaded was the largest recorded since 1928-29.

On the outbreak of war the central government also delegated to the Reserve Bank authority under the Defence of India Ordinance to administer the regulations controlling dealings in coins, bullion, securities and foreign exchanges. On the 4th September, the Reserve Bank issued an explanatory memorandum to the public giving the general line of the control of foreign exchange transactions. *All dealings in foreign exchange were required to be transacted through authorised dealers* and the exchange banks and certain Indian joint stock banks were licensed as such. *No restrictions were placed on the purchase and sale of Empire currencies with* the exception of Canadian, Newfoundland and Hongkong dollars, while *the purchase and sale of non-Empire currencies was restricted to genuine*

trade purposes, travelling expenses and small personal remittances. The policy of exchange control was to ensure that all foreign exchange transactions in India were done on the basis of the rates quoted by London Exchange Control combined with the current rupee rate for sterling. and authorised dealers in foreign exchange were informed that no business must be done by them outside these rates.

Finally, as during the war of 1914-18, at the outbreak of hostilities this time as well, the people began to *sell their Government securities, encash Post Office cash certificates and notes and withdraw deposits from banks including Postal Savings Banks.* This tendency was due to panic and became widespread soon after the enactment of the Emergency Powers Defence Act by the Government of the United Kingdom because rumours were current that the Government of India contemplated drastic measures for the control and confiscation of private wealth and property. The Government immediately and emphatically contradicted these rumours and public confidence was soon restored.

2. Permanent effects and steps taken thereon (The year 1940 and after)

It has already been said that after a rise in Calcutta index number during the first four months of the war, there had begun to come a fall. But after July. 1940, there began to be registered *a rise again* and it reached a mark of 245 by 1945. A mention has already been made of the rise in the prices of gold and silver. In this connection, it may be said that the termination of the war did not terminate the rise in their prices. On the contrary higher and still higher levels were recorded after it. As regards *foreign trade* as well, it may be said that though the gains or the beginning were neutralised during the year 1940-41 specially because of the loss of European markets, control of imports and exports and scarcity of freight, they were again made up in the following year and *continued to increase*—specially the exports. The price level of both imports and exports rose in almost equal degree. Trade with sterling group of countries continued unhampered by exchange restrictions and recorded a significant rise alike in respect of exports and imports. The most striking increase in India's trade outside the Empire was with the United States, both the imports and exports registering a rise. The rapid rise in imports from Japan since the beginning of the war was stopped by the freezing of Japanese assets in July 1941.

Government Securities. With the outbreak of hostilities there arose a desire to sell Government securities, and their prices continued to fall for some time with certain interruptions, of course. On the 26th June, 1940, the Board of the Bombay Stock Exchange had to *fix minimum prices* for them. Next, the Government of India, by an order issued under the Defence of India Rules on the 2nd March, 1942, had to do the same. On the 14th March, 1942, the order had to be extended to Provincial Government securities as well.

Post Office Cash Certificates. During the first month of the war, while the repayment of Post Office Cash Certificates increased enormously, their sales declined sharply. But gradually the former went down and the latter rose up. Total amount outstanding, however, went on going down up till the year 1942-43 as also from the year 1936-37. Since 1943-44, it has again been going up. On the next page is a statement giving figures since 1935-36.

In early June of 1940, however, 10 year Defence Savings Certificates with a higher yield were introduced. Their net receipts during 1940-41, 1941-42, 1942-43 and 1943-44 amounted to Rs. 229 lakhs, Rs. 206 lakhs, Rs. 121 lakhs and Rs 141 lakhs. They were replaced by 12 year National Savings Certificates from Oct. 1, 1943, their net receipts for 1943-44, 1944-45 and 1945-46 being Rs. 8,65 lakhs, Rs 19,54 lakhs and Rs. 2,032 lakhs respectively.

Encashment of notes. Prior to June, 1940, rush for encashment of notes was not great, it being less than a crore of rupees per week, but with the collapse of France in that month it increased and suddenly rose to Rs. 4 crores a week. In that month, however, free encashment of notes was stopped and a sort of rationing system was introduced in important places. Besides, one rupee notes were introduced, and these began to be exchanged for notes of higher denominations.

Absorption of Currency. Absorption of note currency went on during the war and continues even to this day. It was Rs. 35,43 lakhs for the first 7 months, *i.e.*, till 31st March 1940. Since then it was enormous and reached Rs. 121,654 lakhs (upto March, 1946). Absorption of rupee coins as well during the first 7 months of war was Rs. 19,53 lakhs. This was due to encashment of notes and rise of a new demand because of the impetus given to trade and industry by war. Since then, it was Rs. 13,934 lakhs including Government of India rupee notes also upto March, 1946. Absorption of small coins was also till then for about 70,83 lakhs.

Statement giving figures relating to Post Office cash certificates (In Lakhs of Rupees.)

Year	Receipts	Repayments	Net Receipts	Total amount outstanding
1935-36	13,45	13,43	2	65,98
1936-37	14,88	16,46	—1,58	64,40
1937-38	13,97	18,16	—4,19	60,21
1938-39	14,71	15,35	—64	59,57
1939-40	10,25	12,80	— 2,55	57,02
1940-41	4,89	14,93	—10,04	46,98
1941-42	3,97	11,94	—7,97	39,01
1942-43	3,76	8,20	— 4,44	34,57
1943-44	5,50	5,43	7	34,64
1944-45	5,48	4,31	1,17	35,82
1945-46	6,66	3,71	2,95	38,77

Graze for hoarding rupee coins. Demand for rupee coins for hoarding increased in January, 1940, and was accentuated towards the last week of May, 1940, on the news of French reverses, and turned into a scramble in June when the Reserve Bank had to part with Rs. 15·12 crores of rupee coins ; and from the 15th June to the end of August, there was a record return of notes to the extent of Rs. 21·93 crores. The authorities continued to issue coins, and their holding in the Issue Department of the Reserve Bank which had stood at Rs. 78·87 crores on the 1st September, 1939 fell below the statutory limit of Rs. 50 crores by the 24th March, 1940 and was further reduced to Rs 35·1 crores on the 21st June. Some action was necessary to deal with a situation under which the mints working at full pressure could not replace the coins disappearing from circulation and which involved great inconvenience to the public and danger to the community. The withdrawal from circulation of over 40 crores of units of value from the credit structure of the country threatened a dislocation of trade and slump in prices.

On the 25th June, therefore, the Government of India promulgated a rule under the Defence of India Act making it an offence for any person to acquire coins in excess of his personal or business requirements. Earlier on the 10th of June, an amendment of sub-rule (2) of rule 90 of the Defence of India Rules had prohibited refusal to accept coins or notes in payment of a debt or otherwise. While the notification of 25th June succeeded in its objective of reducing the total demand for conversion of notes, its immediate effect also was to intensify the demand for smaller units of value and a special measure had to be taken to cope with it. In Bombay, Rs. 50 in rupee coins and Rs. 10 in small coins were regarded as ordinary individual requirements, and indents up to that limit were met in full, while in Calcutta Rs. 50 for an individual and Rs. 500 for a business firm were considered as the maximum limit to which rupee coins could ordinarily be issued. In Calcutta, as in Bombay, larger banks and leading business houses were supplied with their demands in full. In Bombay, arrangements were further made with the 30 Scheduled banks having their offices in the city to give rupee coins and small coins up to the maximum of Rs 50 against currency notes. Special facilities were also offered by the Reserve Bank by opening 6 small change depots on the 4th July and 4 more on the 5th at the principal municipal markets. These depots worked till the afternoon of Saturday, the 13th July, when rush subsided and demand for coins declined.

Government of India one rupee notes. Scarcity of a unit of exchange smaller than the lowest

denomination of notes was acutely felt as a result of the hoarding of rupees. Government accordingly issued an Ordinance on the 24th of July providing for the issue and putting into circulation of Government of India one rupee notes with immediate effect. We know that such notes had been printed in 1935 to provide for a contingency which, however, did not arise at that time. It may be mentioned that they were also introduced during World War I in December 1917 with a view to economising the use of silver, and had attained a considerable popularity.

Reserve Bank of India two rupee notes. Reserve Bank of India issued two rupee notes as well early in the year 1943 with a view to reduce the demand for rupee notes and coins which had been rising very rapidly.

Reduction in the fineness of silver coins. The Indian Coinage (Amendment) Ordinance issued on the 26th July, 1940 reduced the fineness of the half rupee, and the Indian Coinage (Third Amendment) Ordinance issued on the 23rd December, 1940, that of the whole rupee from 11/12ths of fine silver to one-half of fine silver. In view of the increasing simultaneous demand for half rupees and whole rupees, it was felt that it would be wasteful to turn out large quantities of these coins of the old fineness. It was also felt that this reduction of fineness would discourage their hoarding as well. The new rupee coin is milled on the edge with a serrated or upright milling in the centre of the milled edge, there is a shallow groove with a design inside in two sections separated by blank spaces, and the design inside the groove consists of alternate beads and diagonal lines in relief. No rupee coin was minted between 1922 and 1940. From 1940 to 1945, approximately 104 crores rupee coins were minted, of these only 98 lakhs being of 11/12th fineness the rest being of 50 per cent fineness. From 1835 to 1945 approximately 750 crores of rupee coins were minted in all.

Withdrawal of silver coins. In exercise of the powers conferred by the Indian Coinage (Second Amendment) Ordinance, promulgated on the 11th of October, 1940, the Finance Department Notification called in with effect from the 1st of April, 1941 all rupee and half rupee coins bearing on the obverse the effigy of Her late Majesty Queen Victoria, and directed that on and from that date, these coins should cease to be legal tender except (1) at the offices of the Issue Department of the Reserve Bank at Bombay and Calcutta until further notice, and (2) at any Government treasury or post office till the 30th September, 1941. Apart from improving the quality of coins in circulation, an object of the Ordi-

nance was to recover the coins from uneconomical hoarding. Next, with a view to replace the silver coins by the King George VI coins with the security edge in order to minimise the use of silver for coinage purposes and also to discourage counterfeiting, the Finance Department Notification dated the 4th of November, 1941, called for the King Edward VII rupees and half rupees as well from circulation. They were declared to cease to be legal tender after the 31st of May, 1942. but to continue to be accepted till the 30th of September, 1942 at Government treasuries, post offices and railway stations and thereafter, until further notice, only at the Offices of the Issue Department of the Reserve Bank, Bombay, Calcutta and Madras. Finally, according to a Notification of 1942, George V and VI silver coins of 11/12th fineness were also called for.

For some times past, because of a rise in the price of silver, it has, however, become profitable to retain them. In fact, they have begun to command at present a higher value as bullion than as coin, and hence command premium.

As a result of this we have got in circulation at present only the rupee coins of 50 per cent fineness which amounted to nearly Rs 103 crores at the end of 1945.

Issue of small coins in a nickel brass alloy. With a view to meet the demand arising out of wartime activities, the Government of India issued in January, 1942, a new half-anna coin which economises metal and is convenient to the public. Further, with a view to economising the use of nickel, it was decided to mint the new half-anna piece and the one anna coin and later the two-anna coin in a nickel brass alloy instead of the cupro-nickel alloy. The nickel brass is composed of 79% copper, 20% zinc and 1% nickel. These coins are, however, unpopular and hence there is a proposal for their being replaced by new coins.

Shortage of small coins. During the later months of the year 1942, acute shortage began to be felt in small coins in general and one pice bits in particular. Hence, their hoarding was declared to be illegal. Besides, the standard weight of the two-anna, one-anna, half-anna and quarter-anna (or pice) was reduced with effect from January 28, 1943 to 90, 60, 45 and 30 grains troy respectively.

Post Office Savings Bank. Withdrawals from and deposits into Post Office Savings Banks followed war developments. The amounts outstanding at the end of the years 1938-39, 1939-40, 1940-41, 1941-42, 1942-43, 1943-44, 1944-45 and 1945-46 were Rs. 81·94 crores, Rs. 78·38 crores, Rs. 59·57 crores, Rs. 52.13 crores, Rs. 52·28 crores, Rs. 64,24 crores, Rs. 80.28 crores, and Rs. 113,93 crores. respectively. With a view to encouraging

people of limited means who wished to invest their savings so as to assist the war effort, a new scheme of Post Office Savings Bank accounts known as the *Indian Post Office Defence Savings Bank* was announced and came into operation from April 1, 1941. The principal feature of the scheme was that the deposits were repayable not on demand but a year after the war, the rate of interest on them, having been fixed at 2½ per cent, free of income tax, *i.e.*, 1 per cent higher than the rate on ordinary Postal Savings Bank accounts. Finally, its scope was further extended by a provision in the Indian Finance Act, 1942 under which an option was offered to assessees under the lowered exemption limit for income tax to deposit in the Defence Savings Bank one rupee for every Rs. 25 by which his income exceeded Rs. 750.

Repatriation of sterling debts. Large acquisitions of sterling as a result of the growing favourable balance of trade enabled the Reserve Bank to put considerable amounts at the disposal of the Government of India. Desirability of repatriating sterling debt had been constantly before the Government and the Reserve Bank, and a beginning in this direction had been made in 1937, but it had to be temporarily discontinued owing to the slackening of Government's remittances. However, during this period, the Government completely liquidated its liabilities on account of the Family Pension Funds and transferred to England to the extent of £9½ millions in this connection. Next, as soon as possible, it took the opportunity provided by the availability of sterling to reopen the former scheme by which the Reserve Bank was authorised to purchase *non-terminable* Indian sterling securities in the open market as and when they became available and transfer them to the Government for cancellation. In their place, additional Rupee paper, the 3½% and 3% non-terminable loans, was created up to the same nominal value. The first such cancellation was effected on the 15th November, 1939 and it was continued throughout the year. After this, the scheme for the repatriation of *terminable* loans was announced by the Government on the 22nd of February, 1940. It consisted of the creation of rupee loans as counterparts of the Indian sterling loans. Then, early in 1941 *the above scheme was replaced by a more comprehensive scheme of repatriation* in order to accelerate the process with the help of the accumulated sterling resources with the Reserve Bank. On the 8th February, 1941 Government announced that they had with the co-operation of the British Government taken action to *acquire the bulk of India's terminable sterling debt* of the face value

of £84 million and a market value of approximately £90 million. The British Treasury issued on the 7th February, 1941 a vesting order requiring all residents in the United Kingdom to surrender their holdings of India's terminable sterling loans at prices fixed on the basis of the market price as on the 7th February, 1941 plus an allowance for the period necessary to examine surrendered documents before making payment. The Government of India issued a notification to the same effect on the 8th February, 1941 under the Defence of India Rules, requiring residents in British India to surrender their holdings of these sterling loans, payment being offered at their option in rupee counterparts or cash. The rupee finance required for the operation was found by Government from its balances supplemented by a ways and means advance from the Reserve Bank and by the sale of the rupee counterparts to the Bank. To enable the Bank to hold the additional rupee securities thus created, the Reserve Bank Act was amended so as to remove the restriction on the maximum amount of rupee securities which it could hold in its Issue Department. The option given to the residents in British India to receive rupee counterparts in payment of the surrender of their holdings of terminable sterling loans was availed of to the extent of Rs. 10·22 crores. Finally, the Government announced on the 24th December, 1941 that it had taken action *to acquire as far as possible the whole of its remaining debt* other than railway debentures and stocks, etc). A year's notice was given by the Secretary of State to holders of 3½% sterling stock which was to be re-paid on January 5, 1942. There remained two more stocks after this and the British Treasury issued a Vesting Order on the 23rd December, 1942 requiring all residents in the United Kingdom holding either of these loans to surrender them by the 9th February, 1942 to the Treasury at prices based on the market prices for the day plus an allowance for the inevitable delay involved in examining the scrips before making payment. It was also announced that payment subject to good delivery would be made from the 2nd March, 1942. The Government of India issued a similar order requiring residents in British India to surrender their holdings of these sterling loans at prices equivalent to those fixed in the U. K. order referred to above converted into rupees at 1s. 6d. The payments under the British and Indian Vesting Orders commenced on the 2nd March and continued throughout the year, sterling payments being effected by the transfer of sterling treasury bills from the Issue to the Banking Department of the Reserve Bank and rupee payments by the creation of ad hoc treasury bills in the Issue Department, which were gradually cancelled.

The whole of the sterling debt of £276 million or Rs. 368 crores outstanding at the end of 1936-37 was thus wiped off. The Finance Member, during his speech while introducing the budget for the year 1943-44, truly said that India had completed the transition from a debtor to a creditor country and extinguished within the brief space of about 3 years accumulations over decades of its public indebtedness to the United Kingdom.

Paper Currency Reserve. With an increase in note circulation, a corresponding increase was brought about in the paper currency reserve as well. Besides this, as has already been observed elsewhere, (1) rupee coins include now one rupee notes also, (2) the limit to the holding of rupee securities originally prescribed in the Reserve Bank Act does not stand, and (3) gold holdings in London were cancelled by a transference of the gold holdings of Bank of England with the Reserve Bank to the paper currency reserve. Finally, the percentage of the holdings of sterling securities in the paper currency reserve went up due to India's favourable balance of trade and purchases made and expenses incurred by the Government of India on behalf of His Majesty's Government. A portion was utilised in the cancellation of sterling loans as noted above. But even then, it increased with a tremendous rapidity, and has become a source of embarassment to the country. As against this, it may be said that with an increase in note circulation, gold holdings in the reserve being fixed, their percentage to total note-issue went down. But the point of satisfaction is that while its market value went up, its book value stands at the old level, and if we take it up at the market value, the percentage rises much above what it appears to be.

Government of India Defence Loans. The loan programme of the Central Government was carried on under the Indian Defence Savings Movement first announced on the 4th June, 1940, and took various forms including Defence Savings Certificates and Post-office Defence Savings Banks referred to previously. It was, however, not so successful as it ought to have been mainly because of political reasons. Further, on May 17, 1943, an Ordinance was issued, according to which all except six and two-thirds per cent of excess profits was usurped by the Government in the form of loans. Attempts were also made to raise loans from the agriculturists as well out of their increased earnings due to the increased prices of agricultural commodities.

Additional Taxation. The war brought home the necessity of additional taxation as well. The Supplementary Finance Bill, 1940 imposed a 25% surcharge on all

taxes on income and increased letter postage, telegram and telephone charges. After this enhancement of old taxes and imposition of new ones went on every year till the cessation of the hostilities.

Bank Deposits. Though in the beginning, heavy withdrawals of bank deposits were noticed, as time passed on and confidence was restored, demand and time liabilities of banks went on increasing.

Exchange Control Restrictions. Control of foreign exchange transactions continued to be exercised by the Exchange Control Department of the Reserve Bank of India through the medium of the authorised dealers. Sterling area, however, continued to expand or contract according to war developments. As regards 'hard currencies', *i. e.*, the currencies of non-Empire countries but not those of the enemies or occupied by them, Bank of England had fixed rates at which it bought and sold them. But this was only for dealings in the United Kingdom and other Empire countries. Rates in the outside markets for sterling known as 'free markets' fluctuated widely and at one time, it was quoted at a discount. Now, owing to this discount on sterling in New York, it became ultimately more advantageous to sell Empire imports to the United States, or to other 'hard currency' countries, on a sterling basis than it was to sell the goods on a foreign currency basis as the foreign importer was able to buy sterling cheaply for his imports in 'free' sterling markets. India also took advantage of this difference in rates and the bulk of Indian shipments to the United States for the first few months of the war was financed through the medium of sterling bills drawn by the importers in the United States on London. Hence, rupee-dollar transactions had to be forbidden at other than the basis of the official London rates, and by an agreement with American banks, the rupee rate in New York was quoted on the same basis as the dollar in India, and no 'free' market in rupees was allowed to develop. In order to put a stop to the loss of foreign exchange caused by the finance of Empire exports in 'free' sterling in other countries, Bank of England introduced at the end of March 1940 an export control system covering certain commodities whereby their export to 'hard currency' countries was not allowed unless the shipper produced satisfactory evidence that he was receiving 'hard currency' and not sterling for the shipment. Similar restrictions were placed in India and elsewhere. In India, the commodities affected were jute and rubber. Later on, their shipment was allowed only if a further assurance came that the 'hard currency' so received would be handed over to the Reserve Bank and through it to the Bank of England. In

June, 1940, this export control scheme was extended to cover all commodities to U. S. A. and Switzerland. An interesting result of the new regulations was a large increase in the volume of exports financed by bills in foreign currency and the fall in those financed under London sterling credits. This was accentuated by the suspension of air mails to London after the collapse of France. Hence, Reserve Bank of India announced its decision to purchase foreign currency from Indian exporters at rates based upon those fixed by the Bank of England.

As the war developed and the strain on U. S. dollar resources of the Empire became heavier, further measures were taken to conserve foreign exchanges. The Government of India in May, 1940 introduced a system of import control and licensed the import of certain commodities from certain countries. This was later on extended to all commodities. Restrictions on remittances for other than trade purposes were also increased. In December, 1940, the Government took over U. S. dollar holdings of all residents in British India and their rupee equivalents were paid out by the Reserve Bank. Similarly, on March 10, 1941, the holdings of residents in India of certain U. S. dollar securities were acquired. Finally, all notes of Bank of England with residents in this country were requisitioned.

With the extension of war to the Near East, the Japanese Government imposed restrictions on the drawing of bills in sterling or on places west of Bombay against exports from Japan. The result of this was that importers in the Middle East were forced to make their purchases of Japanese goods through Bombay. A large entrepot trade in Japanese goods thus developed in this country, and measures had to be taken to ensure that India was not called upon to provide foreign exchange for which she received no corresponding return..

In July, 1941, orders were issued freezing the balances of all Japanese companies and firms residents in India. On the outbreak of hostilities with Japan, the assets of Japanese companies and firms in India including those of Japanese banks became vested in the custodian of the enemy property.

Besides, several other orders were issued from time to time with the main object in view, but we cannot make at this stage a detailed study of all of them.

Rise in prices and control exercised by the Government. It has already been observed that the initial rise in prices stopped in March, 1940. But after some time, there was again a change. A number of causes are attributed to

it but the most important is increase in the supply of currency. Profiteering and speculation only intensified the tendency.

Just after the outbreak of the war, the Government received many reports to the effect that prices of many articles of necessity had gone considerably high. There was nothing to justify this specially in a number of cases. The Defence of India Ordinance, and the Defence of India Rules drawn up thereunder had empowered the central government to make provision for controlling the prices at which articles or things of any description whatsoever could be sold. Further, these powers could also be delegated by the central government. Hence, provincial governments were authorised by a notification dated the 8th September, 1939 *to fix limits to the extent of the rise of prices* at each stage of the productive and distributive process, in the case of necessities and in particular of medical supplies, foodstuffs, salt, kerosene oil and the cheaper quality of cotton cloth. The minimum price in each case was not to be less than 10% above the prices ruling on September 1, 1939. All the provincial governments took immediate action.

Controllers of Prices, were appointed at headquarters of each district. In the beginning, Deputy Commissioners and Collectors in charge of districts were empowered to act as local controllers. But later on, in many places, there was felt the necessity of the appointment of whole-time staff. Both the Provincial and District Controllers began to be assisted by Advisory Boards of Price Control Committees.

The Government of India also convened a number of *conferences* of the representatives of all provincial governments and administrations in India *to discuss questions connected with price control.* They were very useful in chalking out programmes of common interest.

Rationing of supplies. With a view to make arrangement for a fair distribution of the necessaries of life a number of rationing schemes were introduced. In certain cases they proved to be of immense benefit to the people concerned.

Receipt of silver under lease and lend agreement. Steps were taken to obtain silver from the United States Treasury under Lease and Lend Agreement on condition of its return on an ounce to ounce basis within 5 years of the official announcement of the cessation of hostilites.

Sale of Bullion by the Reserve Bank of India. Reserve Bank of India sold both gold and silver in Indian markets at different times and different rates mainly with a view to

arrest the expansion of currency, the sales of gold during the period 1943-44 to 1945-46 amounting to 7·5 million ounces, and those of silver during the period 1939-40 to 1945-46 amounting to 181 mililon ounces.

Gold was obtained from South Africa and sold first of all on behalf of the British Government and later on on behalf of both the British Government and the South African Government. This was, however, objected to very much by responsible Indians. Gold was commanding a very high premium in this country, and they said that the Reserve Bank of India was helping the foreigners in the Act of profiteering. The best course was for the Bank itself to purchase gold and sell it in India on its own accounts.

Demonetisation of High Denominational Notes. With a view to discouraging black market opreation and tax evasions the Government of India demonetised in January, 1946, notes of the denominations of above Rs. 100. It was, however, provided that a non-scheduled bank could exchange them at the Reserve Bank or a scheduled bank for value in one hundred rupee notes or for credits with the Reserve Bank. Similarly, scheduled banks and Government treasuries could obtain for them value in one hundred rupee notes or in deposits with the Reserve Bank. Other holders of these could also get them exchanged at the Reserve Bank, a scheduled bank or a Government treasury on their presentation and a declaration in the form prescribed within a fixed period. Although the bulk of the demonetised notes aggregating Rs. 109,66,91,000 were exchanged immediately applications for exchanges continued to be received for long. The total value of high denominational notes exchanged up to the 31st March, 1946 was Rs. 123,36,52,500.

It may be said that this step of the Government of India was unprecedented. It was a bombshell. The Times of India editorially remarked that even the atomic bomb with all its applications created less of sensation when news of its detonation first reached India than the first repercussions of the Demonetisation Ordinances The Free Press Journal of Bombay wrote that it was opposed to all canons of jurisprudence, national and international law and was a blend of black mail and day-light robbery, and an act of gangsterdom.

The Government notification justified it by declaring that the working capital of black market operations was believed to be held in large measure in the form of high denominational notes and Government were aware of the persistent public demand for effective action against black

marketeers who were first class enemies of public welfare. It expected to book them as well as tax-dodgers and thought that no inconvenience would be caused to ordinary honest citizens. But this was not to be. Black-marketing, rather a new kind of black marketing in these very notes sprang up for some time. Tax-dodgers because of the influence they wielded with the Government officials and by offering them bribes continued evading taxes quite all right. On the contrary, honest citizens who had their hard-earned savings in the form of these notes were put to great inconvenience and in certain cases due to the shock administered to them by this step of the Government suffered a loss of money and here and there of their lives as well. The net effect of it, it may be said was loss of faith in currency and a rise in the value of precious metals and hoarding habit.

SUMMARY

1. Effects of the war of 1939—up to date can be studied under the heads of immediate and permanent. Immediate affects lasted till March, 1940. They included in, upward trend in commodity and bullion prices, increase in the value of both exports and imports and internal trade as well, exchange control, sale of Government securities, encashment of post office cash certificates and notes and withdrawal of deposits from banks including postal saving banks by the people.

2. Then there are the following permanent effects and steps taken thereon.

(1) After an initial rise in prices, there was a fall in them. But after some time, they began to rise again, and this time permanently.

(2) The gains of the beginning in the foreign trade were neutralised during 1940-41. But soon there was a rise specially due to the increase in prices and demand from allies.

(3) Fall in prices of Government secuirties continued, hence a control had to be exercised. Minimum prices of the securities of both the central and the provincial governments had also to be fixed.

(4) Total amount outstanding of the post office cash certificates continued to decline. 10 year Defence Savings certificates have, however, been introduced, though they have not been very popular.

(5) Rush for encashment of notes increased in June, 1940, and steps had to be taken to discourage it. Re. 1 notes were introduced in the same month. Later on, two rupee notes also came in circulation.

(6) Absorption of currency notes, rupee coins (these now include Re. 1 notes as well) and subsidiary coins— continued to be great. In the beginning, there developed a craze for hoarding rupee coins. Hence, soon after, steps had to be taken to check it. Ruduction in the fineness of silver coins had also to be undertaken to economise the use of silver and discourage hoarding.

(7) With a view to bring about (1) an improvement in existing currency, (2) an enconomy in the use of silver and (3) discourage hoarding, silver coins of 11/12th fineness where withdrawn gradually beginning from those bearing the effigy of the queen Victoria. They were deprived of their legal tender characteristic with this end in view.

(8) With a view to economise the use of nickel, small coins were issued in nickel-brass alloy instead of in a nickel-cupro alloy.

(9) Shortage of small coins compelled the Government to declare their hoarding as well illegal. Further, a reduction was also made in their weight.

(10) The amount outanding of the post office savings banks continued to fall. A new scheme of these, however, known as the Indian Post Office Defence Savings Banks was announced Further, its scope was extended by allowing the assesses under the lowered exemption limit from income tax to deposit in the account Re, 1 for every Rs. 25 by which his income exceeded Rs. 750.

(11) The scheme of repatriation of sterling debts of the Government of India introduced in 1937 but suspended thereafter had to be revived in order to reduce and check the holding of sterling balances of the Reserve Bank of India in consequence of a great rise in the country's favourable balance of trade and in the expenditure incurred by the Government of India on behalf of His Majesty's Government in connection with the financing and carrying on the war operations.

(12) Changes have been brought about in the composition of the Indian paper currency reserve by including one-rupee notes in the categery of rupee coins, withdrawing the limit to the holding of rupee securities as laid down in the original Act, and cancelling gold holdings in London of the Issue Department of the Reserve Bank by a transference of gold holdings in India of the Bank of England to the paper currency reserve. It may also be said that the percentage of holding of sterlings securities in the paper currency reserve has been going up in spite of the undertaking of the scheme of repatriation of sterling debts.

(13) New loans were issued by the Government of India to finance war and check inflation, though they were not as popular as they ought to have been.

(14) Additional taxation was also levied with these ends in view.

(15) Bank deposits were on an increase.

(16) Exchange control was exercised more and more vigorously.

(17) Government exercises control over prices with a view to check and unwarranted rise in them. For this purpose, it has appointed Controllers of Prices, and called a number of conferences to devise ways and means to be more successful.

(18) Rationing of supplies of certain articles has also been undertaken.

(19) The Government received silver from U. S. A. on the basis of what is known as Lease and Lend Agreement.

(20) The Reserve Bank of India sold both gold and silver with a view to arrest inflation—gold on behalf of the foreigners who made profits at the expense of this country.

(21) High denominational notes were demonetised in January, 1946 with a view to book black-marketeers and tax-dodgers. But the object was not achieved. Rather it shook confidency in currency, increased prices of precious metals and encouraged hoarding.

TEST QUESTIONS

1. What were immediate effects of the present war on prices, trade, exchange and people in India? Discuss these in brief.

2 Give in short the difficulties experienced by the government and the people of this country during the present time and the steps taken thereon to alleviate them.

3. Write short notes on the following :—repatriation of sterling debts, exchange control restrictions, price control, hard currencies, free markets for purchase of sterling and rupees, rationing scheme, demonetisation of high denominational notes.

CHAPTER XXIII

PRESENT SYSTEM

The present system of currency in India is based upon *sterling exchange standard. Technically, gold bullion standard or gold exchange standard* as contained in the Currency Act of 1927 remains on the Statute. Clauses 40 and 41 of the Reserve Bank of India Act have, however, *legalised the sterling exchange standard as well* by making it obligatory upon the Reserve Bank of India to purchase and sell sterling from and to any person if he makes a demand on that behalf in sums of not less than £10,000 at 1s. $6\frac{3}{16}d$ and 1s. $5\frac{49}{64}d$. per rupee respectively. This is, of course, only for a *temporary period.* The preamble to the Reserve Bank incorporates that the question of the monetary standard best suited to India should be considered when the international monetary situation has become sufficiently clear to make it possible to frame permanent measures. Clause 55 of the Act requires the Bank to report its views (in the contingency contemplated above) to the Governor-General-in-Council regarding a suitable permanent basis for the Indian monetary system and to frame measures for the future monetary standard of India.

1. Description of the Existing Currency System in India

Under sterling exchange standard which is prevalent in this country at present, there are *two currencies,*—one for internal circulation and the other for external purposes. These are *inter-convertible* at fixed rates.

The *internal currency* consists of both metallic and paper money.

Metallic money consists of the silver rupee and the eight-anna piece, four anna and two anna silver and nickel pieces, one anna and two pice nickel pieces and bronze pice, half-pice and pies. Of these, the weight of the rupee is 180 grains and eight anna and four-anna pieces 90 and 45 grains of 50 per cent fineness. Prior to 1940, all silver coins were of $\frac{11}{12}$ fineness. An Indian Coinage (Amendment) Ordinance promulgated on the 26th July, 1940 reduced the fineness of the eight-anna and four-anna pieces to 50 per cent and that promulgated on the 23rd December, 1940 reduced the fineness of the rupee to the same level. Two-anna silver

pieces of the proportionate weight as other coins being not popular had ceased to the issued for some time past, and hence there was no question of the reduction of their fineness. The silver coins of the reduced fineness as distinguished from those of $\frac{11}{12}$th fineness are known as quarternery coins. Of the nickel pieces, two-anna, one-anna and two-pice pieces are now issued in a nickel-brass alloy—the composition being 79 per cent copper, 21 per cent zinc and 1 per cent nickel. Prior to 1942, all nickel coins, *i. e.*, four-anna, two-anna and one-anna pieces were issued in a cupro-nickel alloy, and the two-pice bronze piece was in the course of withdrawal. All these coins are token coins. Rupees and half-rupees are, however, full legal tender, and the former form the principal medium of exchange as well. Other coins are legal tender upto Re. 1 only. All coins are minted by the Government of India at its will and supplied to the public through the Reserve Bank of India, according as it demands them.

Paper money consists of Re. 1 Rs. 2[1], 5, 10, and 100 notes, rupee-one notes being issued by the Government of India and only since July, 1940, and other notes being issued by the Reserve Bank of India. Prior to the establishment of the Reserve Bank, they too were issued by the Government. Though the Bank took over the management of the note-issue business from the Government on April 1, 1935, it issued its own notes only in 1938. The Bank did not issue the notes of the denominations of Rs. 50 and 500 as they were not popular, though those already in circulation remained legal tender. Before January, 1946, the Reserve Bank of India had Rs. 1,000 and Rs. 10,000 notes as well. But in this month, all notes above Rs. 100 were demonetised, so that now there are no notes of the denominations of Rs. 500, Rs. 1,000 and Rs. 10,000.

There is a reserve maintained against the issue of these notes known as the *Paper Currency Reserve*. Its details are published in the weekly statement of the Issue Department of the Reserve Bank of India Balance Sheet. The law requires at least 40% of the total amount of notes issued to be kept in gold coins and bullion and sterling securities, provided that the amount of gold coins and bullion does not at any time fall below 40 crores of rupees. The gold coins and bullion are valued at 8·47512 grains per rupee, and the sterling securities at 1s. 6d. per rupee. The balance is held in rupee coins (including one-rupee notes since July 1940), Government of India rupee securities and bills of exchange. The limitation to the holding

[1] Rs. 2 notes have been issued recently as a war measure.

of the Government of India rupee securities was cancelled during war period. Of the gold reserve not less than $\frac{17}{20}$ is to be held in India. At present, however, the whole of it is held in India.

The Reserve Bank of India notes are *convertible into rupee coins and one rupee notes* which are issued by the Government of India But this responsibility rests upon the Bank only so long as the Government keeps it supplied with rupee coins and one-rupee notes according to the demand. Notes of higher denominations are convertible into notes of smaller denominations. All the notes of the Reserve Bank of India are guaranteed by the Government.

For external purposes, there is sterling, the currency of the United Kingdom. The Reserve Bank of India is under obligation to convert internal currency into sterling and sterling into internal currency at 1s. $5\frac{29}{32}$d. and 1s. $6\frac{1}{32}$d. respectively to the rupee, in a sum of not less than £10,000.

2. Defects and Merits of the Present Currency System of India

The following are the defects of the existing currency system of India :—

(1) The currency system as it exists at present in this country is artificial and hence has *failed to inspire confidence* in the public. This is also responsible for the development of the habit of investment of their savings in gold and silver rather than that of keeping them in the form of currency or investing as such.

(2) *1s 6d rate has also been subject to much criticism.* Formerly, it was 1s. 4d. and Indians have been in its favour since the change was introduced in 1927.

(3) Since September, 1931, sterling has not been convertible into gold. As a result, *rupee is also not convertible into gold. Linking of rupee with sterling which in* itself has no fixed value has also been a subject of much criticism. It has so often been pointed out that the currency of the country has been unnecessarily tied to the chariot-wheel of sterling, and thus moves in accordance with the dollar sterling ratio—the fluctuations in which reflect changes in English economic conditions rather than in Indian economic conditions. When sterling left gold, it fell in terms of dollar as well (dollar being in parity with gold) and hence rupee also fell in terms of dollar to the same extent. When dollar was devalued and sterling pegged to it, rupee also became stable in terms of dollar. On the outbreak of the present war, sterling once more fell in terms of dollar and hence rupee as well. But a

few days after, sterling was again pegged with dollar though at a lower parity. The result was that rupee went down in terms of dollar and gold once more.

(4) As most of the countries adopting exchange standard are not free countries, it is regarded to be *a symbol of political dependence* and looked at with contempt by Indians who aspire for freedom in near future.

(5) The experience of the past has shown that in times of crisis *large sums* are required to be used up in maintaining the existing standard. We know that this could be done during the twenties by bringing about a huge contraction in the volume of Indian currency which in itself proved sufficiently detrimental to the interests of the country's trade and industries. During the early years of the thirties, it got support by the continued exports of her hard-earned gold and silver. In 1938, there was again witnessed a tendency towards weakness, but this was somehow or other postponed. Since 1939, war conditions have helped it.

Notwithstanding the above defects, there are some *merits* of the Indian currency system as well.

(1) *First of all*, it provides the people with *the most convenient forms of currency*. Most of the country's foreign trade being with sterling-group countries, our external currency *viz.*, sterling is so much convenient for it. Then, there is the internal currency. Payments of huge amounts can be conveniently made in notes, while those of small sums in rupee and subsidiary coins.

(2) *Secondly*, issue of notes has been made over to a central bank which can *expand or contract* it according to requirements.

(3) Since the replacement of the fixed fiduciary system by the proportional reserve system, *elasticity* has also been secured.

(4) *Finally*, the linking of the internal currency with sterling has the advantage of *comparative stability* as well. The currencies of the different countries of the world have been, in fact, subject to a far greater fluctuation than our own.

3. Actual Operation of the Sterling Exchange Standard in India

When anybody requires sterling for payment in a foreign country, he approaches one of the exchange banks, which issues a draft of its own payable at its head-office or branch in London (it being an international clearing centre) in exchange for internal currency at rates varying according to the market conditions. Similarly, those who

have to receive sterling in London sell them to these banks in exchange for internal currency. The banks in their turn sell or purchase the difference to or from the Reserve Bank in sums of not less than £10,000.

More usually, there is a surplus of sterling with these banks as India has normally a favourable balance of trade, and hence they sell these to the Reserve Bank of India On the other hand, the latter requires them for meeting the needs of the Government of India which arise in connection with its foreign relations. Before 1924, the Secretary of State sold Councils bills in London to provide funds for this purpose, but since then as was pointed out in a previous chapter the practice of purchasing sterling in India has been gradually introduced, and this business is now undertaken by the Reserve Bank on behalf of the Government. It invites weekly tenders for this purpose, and those below a fixed rate are rejected. Intermediates are also purchased at average rates. Because of the repatriation of sterling debts and changes in the stores purchase policy of the Government, its sterling requirements have been going down in recent years. The Reserve Bank of India, however, purchases sterling of a much larger amount than that required by the Government, and thus helps in the maintenance of the sterling exchange standard.

4. Future of India Monetary System

The future of Indian monetary system cannot be very certain when the future of the world itself is hanging in the balance. In fact, the whole of the period during the thirties had been a period of international tension and economic instability, and under the circumstances no definite decision could be taken at that time about the permanent basis of the Indian monetary system. This fact was recognized when the Reserve Bank of India Act was passed, and hence the provision in the preamble for changes in the Indian monetary system in future on *the improvement of international situation and attainment of economic stability*. It may, however, be said that the past record of currency management in this country is not such as to inspire public confidence. The excessive dependence of her monetary system on currency and credit changes in England has been a serious disadvantage for the country.

The Indian monetary system in future must be suited to Indian needs and managed to promote Indian interests involved. Keeping this in view the following important points may be laid down in this connection.

(1) The internal currency of the country must be

the cheapest possible to accord with the poverty of the people. It may continue to consist of rupees and currency notes. The use of cheques may also be developed by the adoption of special measures.

(2) But this currency must be *convertible into gold bullion* specially with a view to inspire public confidence and encourage savings and investments. A very pessimist view has been taken in the past of the ability of the currency authority to accumulate sufficient stocks of gold for this purpose. The truth is, however, that this can be done provided the Government of the country is willing to do so. The rate of exchange of course may have to be lowered.

(3) In the past *stability of exchange ratio was made a fetish of.* In future as well, as a member of International Monetary Fund which has been joined by most of the countries of the world including India, we have to keep the I. M. F. informed of the par value of the rupee. Changes can, of course, be made in this but to a limited extent and according to the rules of the Fund. It may be said that but for this requirement, there was no need for the maintenance of the exchange rate at a fixed level or near it. Our foreign obligations have been reduced. As regards foreign trade, it shall have to be regulated in future solely in the interests of the country, and could be carried on under barter system as Russia, Germany and several other countries did it before the war. But now this cannot be done. The par value of the rupee has already been quoted in terms of gold and dollar.

(4) Adequate provision should be made for the *expansion of currency* to meet seasonal requirements. The Reserve Bank of India should encourage the development of a bill market so that in busy season, movement of crops and internal trade may be financed by bills against which the Reserve Bank is empowered to issue currency.

(5) During war period we have had an unprecedented inflation in this country. But deflation is not a remedy to inflation. Rather it is as bad as inflation or even worse than it. Hence, steps should be taken to check it. This can of course be done by Government spending more and more on Public Works and National Building Departments and people spending on capital goods. More and more industries should be established and production encouraged.

5. Immediate Problems

Certain problems have, however, been engaging our immediate attention. These are the problems of (1) the standard, (2) the ratio, (3) the price-level, (4) the sterling balances, and (5) the international cooperation.

The Problem of standard. In this connection, we may (1) continue the sterling exchange standard, (2) adopt the dollar exchange standard, (3) adopt the gold standard, (4) keep the rupee free from any link. Much can, of course, be said in favour and against each choice.

Those who favour the continuance of sterling exchange standard say that India's trade being mainly with the countries belonging to the sterling group, it would be the best for her to continue sterling exchange standard. Not-with-standing the establishment of International Monetary Fund, sterling area is certain to continue commanding enough influence during post-war period as well. Those who are against it say that the economic situation of the United Kingdom during the coming years will not be such, as to allow full and free utilisation of India's sterling resources, and hence we shall not be able to carry on our economic programme in the manner most advantageous to us. It is also pointed out by them that the advantages claimed for sterling link for the rupee in the past no longer exist now. Our sterling debt has been practically wiped off. Home charges have been considerably reduced. England is no longer the best place for keeping one's reserves.

Those who favour the adoption of dollar exchange standard say that dollar commands now the highest prestige; U. S. A. is the best place for keeping one's balances; dollar resources shall be available for utilisation everywhere in the world; and finally sterling as well depends more or less on dollar. But the difficulty in its adoption is where from to get dollar reserve fund. This could be done either by loans or creating a large surplus of exports to U. S A., or by the conversion of a portion of our sterling balances into dollar balances. But none of these alternatives seem to be feasible for the present.

Gold standard can be adopted only if we have sufficient reserves of gold. But it is not so. Moreover it would not be worthwhile to do so when important countries of the world are off the gold standard. Our ideal should, however, be to adopt it when circumstances permit us. Hence, we will do well to go on accumulating gold reserves when possible. In the meantime we may try to maintain the gold prices at a reasonable level, as this is the only way to inspire confidence in currency.

Finally, we have got the suggestion to leave the rupee free of any particular link. As has already been said, we had made in the past a fettish of the maintenance of the external value of the rupee. If we leave it free to find its level through the play of market forces, we

shall be able to offset price changes in the outside world by varying our exchange rate. But this course will also be advantageous only if some countries adopt it. It may be pointed out that leaving the rupee free of any particular link does not mean that foreign exchanges will not be available for it. They will be available, but without any legal binding. In fact a *de facto* link will be maintained in this case as well with sterling, dollar and gold.

In conclusion, it may be said that our Interim Government has for the present decided the continuance of Sterling Exchange Standard.

The problem of the Ratio. This problem has always been, as we know, a bone of contention in this country. It has, however, to be looked at in the light of the present circumstances, the most important of which being the price levels between important countries of the world and India. The present price-level in this country is certainly abnormally high in comparison with the price levels in U. S. A. and U. K. But with the success of our production drive, our prices may fall to some extent in future. On the other hand, there seems to be a tendency for them to rise in U. S. A. and U. K. Hence, an equilibrium may result in near future ; or else exchanges may be settled finally only after the stabilisation of the prices in these countries.

Normally, low exchanges discourage imports and stimulate exports and *vice versa*. But in the present circumstances this is not to be. The world conditions including our own are at present not such as to be effected by merely changes in the exchange rates. In the current situation of global scarcity and sellers' markets, every country is trying to conserve its supplies and achieve its trade objectives by negotiations. We, on our part, do not want to export our food-stuffs, raw cotton, cotton manufactures and oil-seeds though foreigners will simply welcome them. In the matter of jute as well, we do not want its export as we want to discourage its farming with a view to replace it with that of food-stuffs. As against this, we want to import capital goods and to some extent consumer's goods as well. Now, these are the conditions which could ordinarily be fulfilled by a higher rate of exchange. But in a sellers' market this stimulus to imports is hardly necessary, and exports do not need of this check. Sellers will sell wherever they like, and buyers will buy from wherever they can. This will be done as pointed out by negotiations, and their success will ultimately depend upon power politics and not adjustments in exchange rate.

A high rate of exchange is also suggested with a view to facilitate the repayment of sterling balances and lowering the present abnormally high prices. As for the former, the device is open to objection on the ground of justice and equity, as the debts contracted at 1s. 6*d*. rate should be repaid at 1s. 6*d*. and not at 1s. 4*d*. or a still lower rate. Coming to the latter, it may be said that this is not to be for the simple reason that the prices are not going to fall as a result of a high rate because, as we have already seen, it will fail to stimulate imports and discourage exports, which are necessary for a lowering of the price.

In conclusion it may be said that this controversy has now been set at rest for sometime at least as our Interim Government finally notified the International Monetary Fund in November of 1946 that they did not propose a change in the rupee-dollar rate as prevalent at that time on the basis of 1s 6d. rate. It may be added that the U. S. Treasury Secretary and the U. K. Chancellor of the Exchequer had also done the same for dollar and pound, the respective rates being 15—5/21 grains of gold nine-tenths fine, the weight set by proclamation in 1934, and 4·03 dollars the rate prevailing in the market at that time.

The Problem of the Price-level. Two sets of forces are acting on the prices at the moment. On the one hand, the pent up demand of the starved consumers expressing itself in the growing expenditure of hoarded money and idle bank balances has a tendency to bolster up the prices of building materials and consumers' goods, and on the other hand a reduction in Government expenditure on war materials and services, stoppage of expenditure on behalf of His Majesty's Government and appearance of foreign competition have a tendency to lower them down. In between these two, we have got the price controls which are to be maintained for the time being. The non-availability of capital is a limiting factor to any large scale industrial development. The Indian Industrial Delegation which visited the U. S. A., and the U. K. have given out that these countries will take some time to supply us with machines. Moreover, the question of finding a finance for them rests upon repayment of our sterling balances. It may, however, be said that our future policy should be neither to bring the prices down quickly as that would lead the country's economy into a serious slump and nor to maintain them at the present high levels which are embarrassing to the common people. A controlled lowering of prices should be aimed at. The price-level must be such as to make our agricultural and industrial activities

reasonably remunerative, and to put out the goods at the disposal of the common man and foreign importers on a fair basis and prevent an excessive flow of imports. This will certainly be possible only by fixing it somewhere mid-way between the present too high and the pre-war too low levels.

The Problem of Sterling Balances. The problem of our sterling balances is the most pressing one. They had accumulated to the extent of about Rs. 1700 crores by the middle of the year 1946. In this connection, it will not be out of place to look to the sources of this accumulation. They were in short (1) direct purchases of Indian raw materials and food-stuffs by the British Government, (2) expenditure incurred by them under Defence Expenditure Plan, (3) annual surplus in dollars due to India's favourable trade with U. S. A. and also U. S. A's. military expenditure in India which were acquired by U. K. in the Empire Dollar Pool, (4) annual surpluses of India's external trade, and (5) a compulsory acquisition of India's dollar and other non-sterling assets in the Empire Dollar Pool. From the above, it is clear that most of it was due to the force employed by the United Kingdom because of its privileged political position upon this country. No doubt the British opinion has not so far openly repudiated it. But it hesitates to regard it as a debt in the ordinary sense of the term. Arguments have also been advanced from time to time in the British Press with a view to reduce it considerably. American opinion as well seems to favour this. Britain has turned into a debtor country because of this war. She has lost almost the whole of her income from overseas investiments. Her economy depends upon imported food and raw materials and hence she must build up a large export trade which she cannot, if left to herself specially because she has accepted the principle of free trade by agreeing to become a member of the International Monetary Fund. It was, in fact, at the request of the U. S. A. that U. K. agreed to join the Fund, and hence the former must help the latter. She has granted her a loan to the extent of 4·4 billion dollars and is prepared to sacrifice a part of her debt to the latter provided other creditors including India also do the same.

As regards the arguments advanced for India's cancellation of at least in part of her sterling balances they are as follows:— (1) the financial settlement apportioning war expenditure in India between U. K. and India left off India too lightly with the result that India, a poor country has been turned over-night from a debtor country into a creditor country. (2) These expenses were

incurred as much in the defence of India as in the defence of U. K. (3) India has already undergone sacrifices in their accumulation and it is not fair on her part to ask for compensation on this account from U. K. (4) U. K. purchased her supplies in India at inflationary prices. (5) Rupee-sterling rate was kept at a very high level taking into consideration the fall in the internal value of the rupee, and had this not been done, the accumulation of these balances would have been considerably lower. Now as regards (1) the financial settlement, it had been arrived at between the representatives of the United Kingdom and India after a careful consideration of all the factors based specially upon the recommendations of Chal-field Commission, and to say that it was in any way unreasonable to the former is more than any one can believe. If it could be unreasonable at all, it could be for India whose representatives were not the representatives of the people. Taking (2) these expenses were incurred as much in India's defence as in the defence of U. K., it should be noted that India has already borne more than what was necessary in connection with her defence. No part of the expenditure incurred for the defence of India was borne by U. K. Rather India provided at all times a force approximately by strength of one division for operations outside her frontiers. She spent in the latter years of war as much as Rs. 1 crore per day which is sufficiently enough taking into consideration her requirements and position. As regards (3) the fact of India's having already undergone the sacrifices, it is to be pointed out that she made them when it was needed of her. Now when she wants money for her economic development, she has every right to ask for compensation from the country on whose account they were made. They have meant under-nourishment of her people and deterioration in their already low living standard. Something must be done now to raise it, and the least that she expects of the country on whose account she had to suffer is to help her by repayment of these in her recovery. Coming to (4) purchases at inflationary prices, it must be understood (1) that inflation had not been brought about in any way due to India's economic conditions, and she had to suffer on this account as much as any other country and (2) that the prices that U. K. paid were controlled prices and in certain cases much lower than the prices in U. K. itself for similar commodities and services. Finally, with regard to (5) keeping of the rupee-sterling rate at a high level, it must be said that the exchange rate does not depend only upon price-levels. Demand for Indian products being high enough during war, rupee sterling exchange rate would have

also risen up. In fact, the probability is that the exchange value of the rupee would have been higher still.

Taking above facts into consideration it may be concluded that there is no ground whatsoever for the cancellation of any part of India's sterling balances. They must be paid by U. K. and paid in full. Now the question is what form this payment should take and when it should be made. As regards the first, the form of payment, it may be pointed out that U. K. has neither gold nor goods. India wants capital goods immediately and these U. K. cannot offer for the present. Then, if U. K. wishes to make the payment gradually and in consumers' goods, India cannot accept this proposition as it would not solve her problem of carrying out her development plan and moreover it would result in killing her industries. Under the circumstances, what can be done is that British assets in India as well as in U. S. A. must be immediately transferred to India. Notwithstanding what is said of the depletion of British overseas investments, it is estimated that there is a considerable amount left of them even now. Next, Britain has raised a loan in U. S. A. A part of this should be transferred to India through conversion of Indian sterling balances into dollars. Further, Britain should pay India from out of the industrial plants it is removing from Germany. Finally, India's dollar resources as acquired by U. K. from out of India's assets in U. S. A., and India's surpluses with the same as a result of her favourable trade and U. S. A. spending in India must be handed back to India in exchange for a corresponding amount in sterling.

The Problem of International co-operation. India has joined the International Monetary Fund as well as the International Bank. There was a section of public opinion which opposed this in the beginning as (1) the question of the settlement of India's sterling balances was not taken up at the Bretton Woods Conference, (2) India's quotas to the Fund and the Bank were not fixed at sufficiently high levels taking into consideration her importance, and this would place her in disadvantage in case she decided to have a loan from the Fund and the Bank in future for carrying out her development programme, and (3) India was not given a permanent seat in the Directorates of the Fund and the Bank. Since then, the situation has much changed. Because of Russia's not joining them, India has in order of rank been offered permanent seats in their directorates and there is a possibility of her making a headway in the matter of obtaining a loan as well when and if there be a need for the same. As regards the question of the settlement

of her sterling balance, it has certainly been left out; but there would have been no solution of it even if India had decided to withhold her co-operation from these.

As against this, it may be said that in the near future India will need large amounts of capital for her development. The Bank can be expected to give a loan to her on the security of her sterling balances with U. K. Again, India's balance of trade is likely to be unfavourable for sometime to come due to pent up consumer's demand and capital imports. International Monetary Fund will enable her in the maintenance of her balance of payment. Finally, India must play a part in shaping international decisions, and hence she must offer her co-operation to all international schemes. This would give her a prestige as well which she needs at this time.

6. Decimalisation of the coinage

As the nickel brass coins introduced in 1942 as a war-time measure have been found to be unpopular, it has been decided to replace it with a new set of coins. There is, however, a section of opinion in this country which favours the decimalisation of the coinage. Under this system, the rupee would remain unaltered, and the half-rupee and the quarter-rupee, while retaining their present shape, size and weight would be issued as 50 cent and 25 cent coins. The existing lower denominations of small coins would, however, be discarded and instead cupro-nickel coins of 10 cents, 5 cents and 2 cents and bronze coins of 1 cent and if necessary $\frac{1}{2}$ cent will be issued. It is said that this system would simplify accounting and facilitate calculations. But this view is wrong. It might simplify accounting and facilitate calculations for English writing and English knowing people. But it will not do so for the people writing and knowing Hindi and such other languages specially Mahajani which most of the businessmen of this country use. They have got their own formulas for these which will become stale. The change will be embarassing to them and result in complicating the matters. Again, there seems to be no use in changing the denominations of Indian coins from traditional ones into of foreign patterns. This is a whim of certain people educated on foreign lines. The Bill incorporating the changes referred to above which was introduced in the Central Legislative Assembly on the 18th February, 1946, has, however, been circularized to elicit public opinions in the meantime.

SUMMARY

1. The present system of currency is based on the sterling exchange standard. It has been legalised by the Reserve Bank of India Act, though it is not expected to be permanently adopted by the country. Under this

system there are two currencies, each convertible into the other. (1) The internal currency consists of the notes issued by the Reserve Bank, rupee coins and rupee notes and subsidiary coins issued by the Government. They are inter-convertible. The Reserve Bank has to maintain a reserve for the convension of notes. (2) The external currency is sterling. The Reserve Bank is bound to maintain the relation between internal and external currencies at fixed rates.

2. The present currency system has failed to inspire confidence and hence give encouragement to investments. The rate of exchange has also been subject to much criticism. Rupee has no fixed relation in terms of gold. Its linking with sterling has also been subjected to much criticism. This currency system is also regarded as a symbol of political dependence. Besides, large sums have been required to be used up in maintaining it. Notwithstanding the above defects, it has also got certain merits. It provides the most convenient form of currency. Next, being controlled by a central bank, it can be kept according to the requirements. Thirdly, it is also elastic. Finally, it has been comparatively stable as well.

3. Holders of internal currency can get external currency and vice-versa from exchange banks, and the exchange banks in their turn, sell or purchase the difference to and from the Reserve Bank in sums of not less than £ 10,000.

4. Indian currency system shall have to be modified in future on the improvement of the international situation and the attainment of economic stability. In that case the internal currency shall have to be the cheapest possible and convertible into gold bullion. Besides, there will be no necessity of its stability in terms of foreign exchanges. It should also contain the provision for expansion in times of need. Finally, during war period we have had an unprecedented inflation in India but deflation is not a remedy to it. Rather it should be set aright by increasing production.

5. Certain problems have, however, been engaging our immediate attention. The first, is the problem of standard. The present standard is to be continued. The second, is of the ratio. The present ratio is to be continued The third, is of the price-level It should be fixed somewhere midway between the present too high and the pre-war too low levels. The fourth, is of sterling balances. They are to be liquidated immediately in dollars. Final is the problem of international co-operation. India has joined I. M. F. and international Bank. This step has been in right direction.

6. There is a proposal for the decimalisation of the coinage. The bill embodying it is under circulation. Decimalisation of the coinage will not be in the interest of the country.

TEST QUESTIONS

1. Describe the existing currency standard in India. What are its defects and merits, if any ? (U. P. Board).

2. Mention and classify the various forms of legal tender money circulating in India. How is the face value of rupee and that of the nickel coins maintained at a higher value than their respective intrinsic values ? (U. P. Board).

3. Explain the system of sterling exchange standard as it operates in India at the present time. Would you advocate any change in this system ? Why ? (U. P. Board).

4. What do you mean by sterling requirements of the Government of India ? On what factors do they depend, and to what extent is the rupee-sterling exchange affected by these sterling requirements ?

5. On what lines you wish to improve Indian monetary system ? Discuss your programme.

6. What are the immediate currency problems of India ? Discuss them fully.

7. Write short notes on India's sterling balances. Decimalisation of coinage, I. M. F.

APPENDIX A

ENGLISH CURRENCY SYSTEM

(A Historical Development)

English standard was originally a silver standard. During Anglo-Saxon age pound weight (lb) was equal to 4 ounces, and money value assigned to a pound of silver was a money pound (£). Of course, no pound coin was coined probably because its weight would have been ridiculous and because money value of commodities being low there was no need of a coin of a high value. Shillings were coined, and they being one-twentieth part of a £ contained one-twentieth of an Anglo-Saxon pound (lb) of silver, *i.e.*, 4 oz. ÷ 20 or $\frac{1}{5}$ ounces in weight. These came to be gradually supplemented with other silver and bronze coins as well. In 1663, a number of gold coins were also coined with a view to circulate at 20s. But silver coins being much worn out, they were exchanged according to weight—sometimes as many as 30s. being available for one gold coin. 'Guinea, as the gold coin was called, perhaps because gold came from Guinea coast, was equal to 30s. in clipped and counterfeit coins and not in good money.' There was brought about subsequently a recoinage of silver and the price of guineas fell to 22s. But the new silver rapidly disappeared and gold poured into the country.

'Gresham's law was in operation in its second form. Gold was over-rated, and therefore was driving silver from circulation.' Of course no legal ratio had been fixed but the Treasury Board had issued instructions to the tellers in the receipt of Exchequer to receive guineas at 22s. each pursuant to the advertisement in the Gazette.

Sir Issac Newton was asked to give his advice, and he issued a report in 1717, wherein it was showed that in France, Holland, Italy, Germany, Poland, Denmark and Sweden, the ratio between gold and silver did not exceed 15 to 1, and that at this ratio the guinea would be worth 20s. 8½d. in silver. But in England, the guinea at this time passed at 21s. 6d., and it was, therefore, a profitable business to send gold to England and buy silver with it for export to these countries. Hence, he thought that the taking off about 10d. or 12d. from the guinea would serve the purpose, though his recommendation in the

first instance was for a reduction of only 6d. and find out by experience what further reduction would be most convenient for the public. As a result, a Royal proclamation rated the guinea at 21s. This should have been the first step only according to Newton, but no further steps were taken, although this reduction was quite inadequate as events soon proved.

Thenceforth, gold and silver were by custom, in the absence of any legislation on the subject, legal tender to any amount. The mint was also open to the free coinage of both, and they circulated at a fixed ratio to each other as well. This means that there was a perfect bimetallism. But no one tendered silver to the mint to be coined because it was worth more as bullion than as money. The result was that the amount of silver coins in circulation went on decreasing and what was left was much worn out. In 1774, they were declared for this reason, to be legal tender for sums exceeding £25, only by weight and not by tale at 5s. 2d. an ounce.

Slowly though steadily they relegated to a subsidiary position, and by an Act of 1816 were made legal tender only to the extent of 40s. Their metallic contents were also reduced. From 1816, 1 ounce of silver was contained in 5½ shillings instead of in 5 shillings. So far the standard unit of account in England did not coincide with the standard unit of the coinage. Sums had been reckoned in pounds, shillings and pence; but pounds had never been coined - a shilling was only one-twentieth part of a pound and gold coin, *viz.*, the guinea at first circulated at varying rates and then from 1717 onward at 21s. Hence, payments were made in guineas. This double system was very troublesome; and by the Act of 1816 gold sovereigns of a lower weight and rated at 20s. came to be minted. This brought the unit of coinage into conformity with the unit of account.

As a result of the War of 1914-18, there were brought about two very important changes. Firstly, gold coins went out of circulation and secondly the alloy in the silver coins was increased to 50 per cent.

At present, British currency consists of notes issued by the Bank of England and silver and bronze coins of various denominations - silver coins being legal tender up to 40s. and bronze coins up to 1s.

APPENDIX B

HISTORY OF THE GOLD STANDARD RESERVE

The gold standard reserve was established in 1900. The Fowler Committee had recommended that the profits on the coinage of rupees should be set apart and kept in gold as a special reserve in India. The principal use of the gold r-serve as laid down by them was to make it available for foreign payment whenever the exchange fell below specie point.

Functions. But as soon as the reserve was established, the profits on coinage were remitted to London and invested in securities, and since then although the original purpose remained the same, the method of performing its function changed. In case there was an unfavourable balance of trade in the country and exchange tended to fall below the specie point, the Secretary of State stopped issuing council bills and thus checked an addition to Indian currency. This had the desired effect of raising the value of rupee by restricting its supply. At such times, if the Secretary of State needed funds in London, he could fall back upon the reserve. The Government of India also sold reverse councils in India on London. The effect of doing this was that the internal currency being withdrawn from circulation its value in terms of sterling tended to rise. Thus, besides strengthening the exchange rate, it also liquidated the unfavourable balance of trade, as importers of commodities purchased reverse councils and sent them to their creditors in London who got payment in gold from the gold standard reserve on their presentation to the Secretary of State. Thus it served three purposes, *viz.*, (1) strengthening of the exchange rate, (2) liquidation of the unfavourable balance of trade, and (3) meeting of home charges.

Position. It has been observed that the Fowler Committee had recommended the reserve to be kept in gold in India, but this was not done Instead, it was transferred to London and invested in securities. In 1906 came another change. The difficulty in meeting the demands for rupees led to the formation in India of a special reserve for the purpose, out of the gold standard reserve. This was to be in coined rupees and was to form a part of the profits on the coinage of rupees. Thus two branches of the reserve were formed. (1) London branch, and (2) the Indian branch in the form of rupees.

In 1907 on the recommendation of a Committee

known as the Mackay Committee, appointed by the Secretary of State to consider the question of Indian railway finance, a sum of more than a million pounds was transferred from the reserve to the provision of rolling stock and other improvements on Indian railways. It was also decided that in future one-half of any profits on the coinage of rupees would be transferred for this purpose until the gold standard reserve reached £20 million. It was apparently contemplated that after the total had been reached, all profits on the rupee coinage would be diverted from the reserve. But a serious crisis occurred in the year following, and the decision had to be changed. The reserve was hard hit by this crisis. In all, more than £8½ million were withdrawn from the reserve to meet the reserve councils for strengthening the exchange value of the rupee. There was much public criticism on the location and composition of the reserve. The Chamberlain Commission appointed to give its opinion decided many of the points in this connection. Firstly, it recommended that no limit was to be placed on the total reserve and the profits on the coinage of rupees were to be exclusively credited to it. In addition, it recommended that (1) a much larger portion of the reserve be held in actual gold, (2) the Indian branch of the reserve in which rupees were held be abolished, and (3) the most suitable place for the location of the reserve was London. These recommendations were accepted and given effect to with the only exception that during and after the war the reserve was held chiefly in securities. The recommendations of the Babington Smith Commission were also to the same effect as those of the Chamberlain Commission with the only exception that it considered the holding of a portion in gold in the reserve in India as necessary in order to inspire confidence in the public. In the years that followed the amount of the reserve mounted upto more than £40 million, at which figure it was kept till its unification with the paper currency reserve on the establishment of the Reserve Bank of India, as proposed by the Hilton Young Commission.

The silver redemption reserve. It will not be out of place to mention here the establishment of the silver redemption reserve consequent upon the dissolution of the gold standard reserve on its unification with the paper currency reserve. Section 36 (1) of the Bank's Act requires Government to pay full legal tender value for surplus rupees returned by the Bank under the provisions of that section. To meet this obligation a silver redemption reserve amounting to Rs. 10 crores was constituted by the Government with effect from the 1st April, 1935, and held in gold and securities.

APPENDIX C

HISTORY OF THE PAPER CURRENCY RESERVE

The paper currency reserve was established in 1862 with the issue of the notes by the Government of India, its sole aim being to ensure the convertibility of the latter in rupee coins. It has always been kept entirely separate from all other balances. Not only are separate accounts kept, but the actual money in the reserve is kept separate. In the beginning, so much of it was kept in rupee coins as was likely to be needed for any possible demand for encashment of notes in rupees for use within India, and the rest could be invested in securities. In order to keep a margin of safety, the fiduciary (invested) portion was regulated by law. As has already been observed in a previous chapter the first limit was placed at Rs. 4 crores, and this was gradually increased to Rs. 14 crores. The Chamberlain Commission further raised it to Rs. 20 crores and during and after the war the same mounted to a very high figure. Indian Paper Currency Amendment Act, 1920, accepted the banking principle of note issue as recommended by the Babington Smith Committee, in place of the currency principle followed till then. The Reserve Bank of India Act also provided for the same in pursuance of the recommendation of the Hilton Young Commission.

Composition of the Reserve. The composition of the reserve was changed several times with the changes brought about in its use. In the beginning its sole aim being to ensure convertibility of notes, so much of it was kept in rupee coins as was needed for this purpose ; the rest was invested in Government of India rupee securities. In 1905, a portion of the latter was allowed to be invested in sterling securities, and this went on increasing gradually. The Act of 1893 authorised the issue of notes against gold coins or bullion as well and hence the metallic portion of the reserve soon after this began to be held in silver coins and gold coins and bullion as well. The Gold Note Act of 1898 authorised the issue of notes also against gold deposited in London with the Secretary of State. Indian Paper Currency Amendment Act of 1920 accepted the banking principle in place of the currency principle followed till then. According to it, the metallic portion of the reserve was to be not less than 50 per cent of the currency notes in circulation, and of this the gold held by the Secretary of State could not exceed Rs. 5 crores. The Act also provided for the issue of emergency currency against bills of exchange and hence these too were included in the invested portion. Finally, the Reserve Bank of India Act, 1934, which brought about unification of the gold standard reserve and the paper currency reserve in pursuance of the recommendations of the Hilton Young Commission

laid down as follows in this connection. The assets of the paper currency reserve should consist of gold coins and bullion and sterling securities, rupee coins, rupee securities of the Government of India and bills of exchange and promissory notes which the Bank is allowed to deal in. Of these, gold coins and bullion and sterling securities cannot be less than 40% of the total with a provision that gold coins and bullion cannot be held to the extent of less than Rs. 40 crores valued at 8·47512 grains per rupee at any time. Of the remainder, rupee securities including bills and promissory notes could not be more than Rs. 50 crores or $\frac{1}{4}$th of the total assets whichever be greater and with the previous sanction of the Governor-General-in-Council of such amounts plus a sum of Rs. 10 crores. But by an amendment to the Reserve Bank of India Act which came into force on the 8th February, 1941, this limitation on the maximum holdings of rupee securities was removed. The balance is to be held in rupee coins which include Government of India one rupee notes since July 1940. Of the total amount of gold holdings at least $\frac{7}{10}$ is to be held in India. Since July 1940, the whole of the gold stock is held in India as gold held in India by the Reserve Bank on behalf of the British Government was exchanged in that month with that held by the latter in London on behalf of the Reserve Bank.

The minimum limit of the gold coins and bullion and sterling securities can also be reduced with the previous sanction of the Governor-General-in-Council for periods not exceeding 30 days in the first instance which may with a like sanction be extended from time to time by periods not exceeding 15 days. During such periods of deficiency the Bank is required to pay a tax on the amount by which it falls short, at the current bank rate with an addition of 1% per annum when such holdings exceed 32½% of the total assets, and of a further 1½% in respect of every further decrease of 2½% or part of such decrease provided that the tax is in no event at a rate less than 6% per annum. It may be mentioned that since the inauguration of the Reserve Bank of India, the total holdings of these have always been much above the minimum percentage normally allowed by law.

Uses of reserve. The first use of reserve was the conversion of notes into rupee coins. The Gold Note Act of 1898, authorised the Government to use gold held in the paper currency reserve for the purchase of silverf or coinage. From 1905, gold held in London and sterling securities held there also began to be used for the support of exchange. Since the establishment of the Reserve Bank of India, the reserve is used both for the conversion of notes and support of exchange. Purchase of silver has to be carried out in India these days out of the balances of the Government of India with the Reserve Bank.