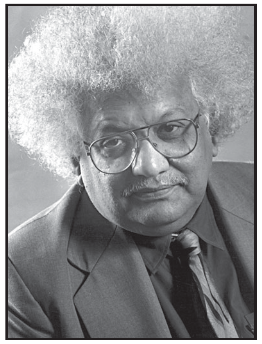
RESERVE BANK OF INDIA

FIRST P. R. BRAHMANANDA MEMORIAL LECTURE

by Lord Meghnad Desai

DRAINS, HOARDS AND FOREIGNERS: DOES THE NINETEENTH CENTURY INDIAN ECONOMY HAVE ANY LESSONS FOR THE TWENTY FIRST CENTURY INDIA?



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Governor and Distinguished Guests

Introduction:

Thank you for doing me the great honour of inviting me to give the Inaugural Brahmananda Memorial Lecture. Brahmananda, or PRB as we often referred to him as, was my teacher and an exemplary person for many of us. As his students we relied on him to teach us, counsel us, often feed us late in the evenings. He nagged and cajoled us to work but above all made us think independently. He was always an unorthodox economist- classical when all around were neoclassical, favoured a wage goods led growth strategy while all around were enamoured of the Mahalanobis capital intensive one, fiercely patriotic in choosing to stay at home and develop his arguments in a distinctly Indian way and yet widely read in the best literature of economics from around the world. He was also a great editor for the Indian Economic Journal and nursed many talents in that role. But he was above all a superb researcher. It is his monumental monetary history commissioned by the RBI which I shall refer to several times in my lecture. Indeed my Lecture is not only in his memory but concerns his great volume on the 19th century monetary history.

Money, Income and Prices in 19th Century India [MIP 19] is a mine of information not only on the Indian economy but also on high points of monetary history of many other nations. It is a statistical cornucopia, a storehouse of material on the various Reports on Indian currency as well as the thinking of many British and Indian economists. It contains statistical analysis of the data using econometric tools as well as a theoretical and historical discussion of the development of India. Brahmananda has written the story of Indian economic growth in the 19th century.

Indian Economic Growth 1860-1900:

It is a story which has been often recounted though without reliable data. There have been strong views held about the role of British Imperialism in holding back India's growth , the burden of the drain, the iniquities of laissez faire policy imposed on a country which would have preferred an activist national government. MIP 19 allows us now to reexamine some of those issues. Needless to say there are surprises, some as I shall reveal, not even obvious to the author himself. Again as you would expect from me, my reinterpretation of the 19th century story is revisionist but it has lessons for the 21st century.

How did India's economy do in the 19th century? The crude nationalist version is a story of gloom and doom. The British, we are told, deindustrialised India, sucked its wealth abroad, distorted its economy by integrating it in a world economy and by applying laissez faire principles retarded its growth. MIP 19 discusses the problem of the drain and argues about alternatives to the policy of laissez faire. But its statistical picture of India's growth is not one of gloom and doom. Indeed one can say that during the second half of the 19th century where the data are best available, India was an open

economy enjoying an export led growth. There was indeed a drain of the export surplus to pay Home Charges. The question I want to examine is about the likely impact of the drain being eliminated on Indian growth.

The Indian economy was a large one in relative terms. Its population was 256 million in 1861 and the total NDP was Rs. 731 crores, with a per capita income of Rs. 28.60. But in Sterling terms the NDP was 730 million pounds. By 1899, the population was 296 million, the NDP Rs. 1196 and per capita income Rs. 41.20 The Rupee depreciated through this period from around Rs. 10 to Rs. 15 per Pound. So the 1899 NDP was 797 million Pounds. But in PPP terms, the Indian economy was larger than the UK economy in 1871. Angus Maddison has done a lot of comparative and long run growth measurement. His measure is the international PPP Dollar at 1990 prices. I shall label it M$. In these terms, in 1871 Indian GDP was M$ 134 billion, while the UK in 1870 had a GDP of M$ 100 billion. China alone was larger than India in these terms at M$ 189.7 billion. In 1913, UK had outstripped India with M$ 224.6 billion compared to India's M$ 204 billion. China was by then M$ 240 billion. India was catching up with China, then at least.

The Indian economy grew at about between 1 % to 1.5 % per annum between 1861 and 1900 depending on which of the four definitions of income given in MIP 19 you choose.[1] The growth of population was 0.42 % per annum, so per capita income grew

[1] All the data cited in this Lecture unless otherwise explicitly stated are from MIP 19.

between one half to one percent per annum. Angus Maddison's calculations cover a longer period from the Mughal period onwards. He shows no growth of per capita income, but rather a slight decline in the 250 years from 1600 to 1857 from M$ 550 in 1600 to M$ 520 in 1857.[2] In the years covered by MIP 19, Maddison shows income going up from M$ 533 in 1870 to M $ 599 by 1900 implying a growth rate of 0.4 % but as between 1870 and 1913 as 0.54 per annum. [Maddison, 2001]. Thus Brahmananda's growth numbers are broadly in line with Maddison's.

Capital stock grew at 2.4% per annum in this forty year period. Thus while per capita income growth was between ½ to 1 %, capital stock per capita grew at about 2 %. A production function regression for NDP gives the coefficients of Labour land and capital, respectively as 0.37, 0.56 and 0.12. This growth of per capita output was partly due to agricultural growth [0.70% p.a.], mainly due to a modest expansion of area under cultivation [by about one third] and a spectacular advance of industrial production [8.4 % p.a.]. Indeed industrial production starting at a very low level of 4 in 1861 reached 99 by 1900 where the base is 1948-49=100. To put these rates in perspective, the Indian economy grew at only between 1.25 % and 1.5 % in per capita terms in the first thirty years after Independence and the growth rate of manufacturing has not been sustained at the historic rate of 8.4 % for any forty year patch since 1900.

[2] Maddison dollars are international 1990 PPP dollars [Maddison, p.165 for explanation. In rupee terms , the per capita income in 1900 was Rs. 37 and Rs. 204 at 1948-49 prices. Thus one rupee in 1948-49 was worth three PPP dollars !

There was also a structural transformation in the economy. Thus, the share of agriculture in total income fell from 56.5% to 45.3 %. India had a share in world trade of about 7 %, and it absorbed a quarter of the world silver production and around 10 to 15 % its gold production. India had a net export surplus of 2 % of NDP in 1861 rising to 3.2 % by 1899. But of course of this surplus about half was taken in Home Charges, from 1.1 % in 1861 rising to as much as 2.34 % in 1894 but falling to 2.05 in 1899 (after abandonment of the silver coinage and adoption of the Gold Exchange Standard). The central question for the nationalists was the adverse impact of the drain on the economy.[3]

The Drain : Its Size and Its Burden:

The drain was a charge for Imperial purchases of British goods and services, service charges for past capital investments and pensions of retired British India personnel. The issue of whether the charges were justified or not reverberates through the literature but for my purpose today I accept PRB's verdict which is C.N.Vakil's as well that about half of the charges were unrequited transfer [MIP 19, p.507]. Dadabhai Naoroji of course developed a powerful critique of the drain and Brahmanada says,

"We submit that the Drain theory was a theory, satisfying the requirements of a general theory containing an interconnected model with applicability for the period " [p.507].

[3] Again Maddison makes the Drain a smaller ratio of NDP at 1.0 % in 1868-1872, 1.3 % for 1911-15 and 0.9 % for 1926-30 [Maddison, p.87]. I shall stick with PRB's estimates.

The drain was in effect a combination of salaries and pensions paid in Sterling as well as materials (stores) bought in London and interest charges for East India company investments and Railway and irrigation investments. MIP 19 shows that the Sterling debt was Rs.105 crores (100 million Pounds) in 1861, peaking in 1894 to Rs. 234 crores (130 million Pounds) and in 1899 was Rs 179 crores (119 million pounds) Home Charges were Rs. 8 crores in 1861, Rs. 29 crores in 1894 and Rs. 24.5 crores in 1899. As a proportion of NDP, the debt was 13.6 % in 1861 and 15 % in 1899; the drain amounted to between 1 % and 2.5 % of NDP over the same period, which in contemporary terms of debt servicing burden is hardly remarkable. Indeed if it was not for the fact that the creditor foreigners were rulers of India, the debt service charge would hardly have had the emotional impact it did. Thus for example there was no critique of the drain caused by the rulers of the native states as well as the feudal zamindars who indulged in profligate luxury consumption abroad or of imported luxury goods at home. This 'internal drain' did not attract the same attention since it was native and not foreign rulers who were causing it. Indeed this internal drain has not even been estimated to the best of my knowledge.

But the strong nationalist feeling was that the quantity of inputs bought and the price paid for them were both not quite what an independent India would have paid. But apart from that, the Drain created problems of repayment because it was incurred in terms of Pound Sterling then based on gold and paid in Rupees based on silver. Since the Rupee was depreciating against the Pound (since

silver was falling against gold), the domestic burden of servicing the debt was getting heavier during 1870's and 1880's. It was only when in the mid 1890's the Rupee was put on a Gold Exchange Standard that the burden stabilised. The rupee depreciation helped Indian exports, of course, but as UK prices in Gold terms were falling over the period and Indian prices were rising in silver terms, the real exchange rate was not as favourable as it could be. The Drain was thus as much a problem for the Government of India *vis-à-vis* Whitehall as for the nationalist opinion which resented the outflow of resources. It is interesting to note here that in the USA at this time, there was a strong agitation for a silver reflation of the dollar and for cheap credit by the farmers and merchants but the bankers and East Coast industrialists wanted sound money and gold. The USA also plumped for a Gold Standard and stopped silver coinage. The Indian debate on the exchange rate of the Rupee runs parallel with this and the outcome was the same in a free as in a slave country-upward revaluation of the currency.

In his book PRB examines the effect of the drain on the economy. He does this by regressing money supply, net exports, exchange rate , the Gold Silver price ratio, etc. on the drain and other variables [Chapter 27]. The way of financing Home Charges *via* sale of council bills in London obviously affected money supply since these bills were bought by British importers of Indian goods and paid to Indian exporters who in turn cashed them in India for silver. But for variables such as the Gold Silver price ratio which is exogenous to India, it is not clear why a regression on the drain tells us anything. In a regression for the determinants of income, the real burden of the drain even turns out to have a positive and significant coefficient [Table 24.1, p.459]. I shall, however, set these regressions aside as I do not need them either way.

The time has come to examine this theory of the Drain carefully. This is not to question that there was an unrequited transfer from India to Britain but I do wish to question that it was crucial to an explanation of India's underdevelopment. Indeed the Drain theory was not only an impediment to clear thinking about India's economic growth. It became a general theory of nationalist economic critique of colonial rule and impeded the rapid growth of countries everywhere in the Third World.[4]

The Drain theory in effect says that there is investible surplus already present in the home country but that it is drained away abroad by the Colonial power. Come Independence, the drain would vanish and growth would result by using the drain now retained. To quote Dadabhai Naoroji's classic statement,

" The chief cause of India's poverty, misery, and all material evils is the exhaustion of its previous wealth, the continuously increasing exhausting and weakening drain from its annual production by the very excessive expenditure on the European portion of all its services, and the burden of a large amount a year to be paid to *foreign* countries

[4] The most blatant case of this thinking was in the case of Bangladesh whose leaders argued when it was East Pakistan that it was being kept in poverty because of a drain to West Pakistan. Since independence, one has failed to locate this surplus.

for interest on the public debt, which is chiefly caused by the British rule" [Naoroji, p.131].

Dadabhai's critique was very powerful not least because in the course of mounting that critique he pioneered the construction of national income conceptually as well as statistically. Yet in my view, this statement exaggerates the size of the surplus in the economy and diverts attention away from the real cause of poverty which is the small size of the surplus itself due to the social and economic structure which results in low productivity. The problem is that the surplus, drained or not, is inadequate and the task of development policy for the leaders of a newly independent country is to raise the surplus and not hope that stopping the drain would cure all. Indian economic thinking was impeded by too much hope that the stoppage of the drain would cure India's poverty. This is what explains the slow growth in the first thirty years after Independence as I shall argue below.

First some stylised numbers. Let us suppose that the export surplus of about 3 % of NDP was split 2:1 between drain and home retention. Now it is well known that India was also absorbing a vast amount of gold during this period. So we can surmise that around 1 % of NDP was being hoarded as gold while 2 % was being drained. For simplicity, I shall assume that the entire sum of the drain was an unrequited transfer. So what would have been the change in growth of NDP had the entire Drain be retained and invested ?

The Capital output ratio was 1.26 in 1861 and rose to 2.28 in 1900, so let us say around 2 on average. A one per cent of income would be a half per cent addition to the Capital stock roughly speaking and given the coefficient of 0.12 for the Capital Stock variable in the income equations in MIP 19, it would lead to 0.12 x 0.5 = 0.06 % addition to the annual growth rate of NDP. Thus if the 2 % of NDP drained had been invested entirely into productive investment, it would have added between 0.12 to, let us say, at most 0.15 to the growth rate of NDP thus raising it from between 1 to 1.5 % to around, say 1.15 to 1.65 %, or, in per capita terms, 0.70 to 1.20 %.

This is not a large and dramatic effect and it is a maximal estimate since I take the entire 2 % as unrequited implicitly assuming that all the goods and services bought abroad would have been bought at home. The question is – Would that have been enough to take India out of poverty? Note first that the per capita growth rate between 1947 and 1980 was very much in the range indicated above, and poverty by the Head count ratio hardly moved during that period.[5]

But the more important question is – Had the drain not occurred would the money have been invested ?

It is assumed in the nationalist discourse that investment of the drain in productive assets would be automatic. But there are two objections to that presumption. Firstly, the remaining 1 % from net exports was hoarded in gold and silver rather than invested. The gold and silver

[5] Maddison puts the growth rate of per capita income at 1.40 % for 1950-1973.

ornaments hoards are estimated as being as much as 50 % of NDP [Table 8.1a, p.213-215]. Between 1861 and 1894 the value of the hoards grew from Rs. 389 crores to Rs. 576 crores or about 50%. Just the increment of Rs. 187 crores would have been an extra 8 to 10 % of the Capital stock in any of the years 1861-1894. Thus at half the drain, the hoards if reinvested would have boosted the growth rate by 0.06 % per annum. But of course no such investment took place.

It could be argued that in the absence of a pro - growth government, there was no incentive for people to dishoard, and hence, this is not a fair test. If there had been a nationalist government, it would have invested in growth. Is that true and had such investment been made, would it have been effective ?

The test of that proposition was carried out in the years after Independence. India had Sterling balances accumulated from the War. These balances amounted to Rs. 1724 crores by end of the War in March 1946 and of that sum Rs. 1512 crores [1.134 billion Pounds Sterling] were available to the two independent countries India and Pakistan in 1947. Of the share India had, after giving Pakistan its share [which caused much debate], what with buying pension annuities, and imports of food and stores, capital outflow only Rs. 621 crores was left by end of 1949, the new Government having spent the money in words of C.D. Deshmukh ‘as if there is no tomorrow.’[6] After that, there was Sterling devaluation which shrunk

[6] I am grateful to Dr. Jadhav for providing me with material on Sterling balances which is incorporated here. The responsibility for errors and interpretation is mine.

the purchasing power of the balances in terms of dollars. There followed a pact to spend the balances at a steady rate. By about 1957, they had been spent and the Second Five Year Plan faced its resources crisis in 1958 and had to be pruned. So what were the Sterling balances spent on? One major use was to buy out British owned assets and transfer them to Indian hands both private and public.[7] This was thus not investment but paper transfer of ownership, satisfying to the nationalist consciousness but not a productive use of accumulated surplus. The other was a liberalisation of imports of consumer goods and some capital goods. It cannot be said that the Sterling balances transformed the Indian economy.

But more than that, once Independence came, why did the Drain not stop and replenish the Indian economy? My view is that by this time, the drain was not very large since there had been import substitution both in personnel and goods as between Britain and India. Maddison's estimates put the drain at 0.9 % of NDP for 1926-30. This is nearly 30 % down from the level in the 1911-1915 period. The trend of the economy was downward but even of the reduced income the drain as a proportion was lower. Thus by the time Independence came, the drain was a negligible proportion of NDP; though one presumes, in absence of reliable data, the nationalist leadership was not to know this.

The period 1860-1900 was thus a period of modest growth but such as had not been seen for the two centuries previously. One reason

[7] Michael Kidron (1965) Foreign Investment in India [Oxford; Oxford University Press]

for this is the expansion in area cultivated which at around one third was more rapid than population growth which was about 16 % over the period. Productivity was of course not rising on land but as irrigated area expanded[8], agricultural output expanded at 0.7 % per annum and food grains at 1.04 %. But the effect of exports should also be included here. Since per capita agricultural output was expanding, some of it was exported. In this period although prices were falling, the World economy was expanding as a market for Indian exports. Britain was also growing in this period although USA and Germany were catching up with it. India's share in world trade was 7 % according to MIP19. By 1913, India had $ 7 per capita foreign capital ($ 2.1 billion) while China had only $3.7 ($ 1.6 billion). India was plugged into a growing system.

Roots of India's Pauperisation:

So why did India get its image as a poor country? Of course even despite the growth of forty years, the absolute level of per capita income was still low since productivity was low and stagnant. The extra output had come from new land irrigated in Panjab and elsewhere and a bit more from the fledgling industrial growth. But of course the first fifty years of the 20th century were much less favourable for the Indian economy than the forty years of the 19th century. The growth rate of per capita of income was negative for 1913-1950; Maddison puts it at –0.22%. Even here the sub periods

[8] " The colonial government increased the irrigated area about eightfold. Eventually more than a quarter of the land of British India was irrigated , compared with 5 per cent in Moghul India " [Maddison, p.115].

are interesting to examine. Maddison's time series for India's GDP shows growth albeit with fluctuations until 1929/30 when income reached M$ 728 from its level of M$ 599 in 1900 [a growth rate of 0.65 % per annum]. It is after that in the next 20 years that income declines to M $ 618 by 1947 [-0.96 % per annum]. Of course it was also in this period that India's rate of population growth stepped up. Thus while between 1860 and 1900 rose from 256 million to 296 million [MIP19, p.213] by 1946 the population of undivided India was 410 million [0.70 % per annum]. Hindi hai hum challis karod ![9]

This was also the period in which agricultural growth came to a halt, in area as well as productivity. The data given in MIP 19 say that industrial output had reached a value of 99 with base 1948-49 as 100. So industrial growth also collapsed, presumably after 1929. This was despite a slightly more active industrial policy following the Industrial Commission Report of 1916 as well as tariff autonomy for India. But the world economy was also shrinking. Trade was declining due to tariffs and capital movements were drying up. The world had de-globalised.[10] Britain was also lagging behind the world in this period unlike in the earlier period. India was plugged into a stagnant if not shrinking world economy.

It was during this period that India began losing its share of world trade so that by Independence the share was closer to about

[9] I do not however subscribe to the Malthusian explanation for the slow growth. I cite the population growth figures for simple accounting of the per capita income growth figures.
[10] I have dealt with this in Desai (2002).

3 % (though between 1913 and 1950 Asia's share of World Exports grew from 10.8 % to 14.1 % [Maddison, p.127]).

Thus the first half of the 20th century especially the interwar period was a period, unlike the 19th century, of stagnation and even retrogression in the Indian economy. India was falling behind Asia in its export performance and its per capita income stagnated over the period. India's picture as a labour surplus country with a largely rural and poor population comes from this period. Indeed one can say that India began its withdrawal from world economy during this period. This trend continued, was indeed encouraged upon independence. Indian economic policy became hostile to foreign trade especially once the Sterling balances ran out. This is because the nationalist logic saw all foreign trade and not just the classic Home Charges as a 'drain' of resources. India was to retain all its output at home, regulate foreign trade exports as well as imports. It was to develop as a self sufficient economy not integrated into the world economy.

Ambition and Reality in Independent India :

But before Independence and before the Second World War when the Sterling balances accumulated, nationalists were confident that once the foreign rulers had been thrown out, India will be able to be prosperous quite rapidly. Thus Nehru summarises the goals as set by the National Planning Committee of the Congress Party as follows :

"The aim was declared to be to ensure an adequate standard of living for the masses, in other words, to get rid of the appalling poverty of the people. The irreducible minimum, in terms of money, had been estimated by economists at figures varying from Rs. 15 to Rs.25 per capita per month……We calculated that a really progressive standard of living would necessitate the increase of the national wealth by 500 to 600 per cent. This was, however, too big a jump for us, and we aimed at a 200 to 300 per cent increase within ten years"[Nehru(1945), p.333].

This quotation tells us how ambitious the leadership thought it could be. A growth rate of 200 to 300 % over ten years [7 to 11 % per annum] is to be contrasted with the much more modest goals set out in the Plans subsequently, to say nothing about the even more modest achievements. A minimum living standard of Rs. 15 in pre - War prices would have meant at least twice as much by the mid 1950s. Thus the poverty level when fixed in the 1960's at Rs. 15 was way below what would have matched expectations of the Independence movement. The reason for this downward revision is not too far to look.

The shock for the planners of post-independence India was to be that there was an acute shortage of investible surplus. The expectation was that since the surplus was there and would be enhanced by the drain ending, the priority was how to allocate the resources to industrial development. The real issue was the lack of surplus due to the low productivity in agriculture. Here again agrarian policy concentrated on land reform and hence the issue of distribution of the surplus rather than its enhancement. The only policy it could

suggest for raising productivity on land was expansion of the unit of cultivation by pooling of land .

The lack of surplus became obvious in the mid 1950's. Efforts to mobilise surplus by taxation along the lines suggested by Prof. Kaldor ran into political resistance. Even Nehru's dream of cooperative farming ran aground thanks to Charan Singh. Yet the strategy of planned development was to invest all in capital goods industry not for export but for building up a self sufficient economy immune from foreign trade. It ended in low growth and the persistence of poverty while the Mahalanobis strategy lasted. Of course Brahmananda was innocent in all this . He did propose a wage goods strategy but his model was not mathematically elegant as the Mahalanobis model was.[11]

Internal Drain and Economic Underachievement :

The lack of surplus put a brake on growth. In the 1950s, once the Sterling balances had run out and the good harvest of 1954-55 not repeated, there was inflation. Foreign aid plus deficit financing filled the gap. Luckily for India, the constraint on agricultural productivity was lifted during the 1960s by the Green Revolution. This was a happy combination of foreign technology and private sector, i.e., farmers' response to some government incentives. The windfall of the Green Revolution was *hors du plan* Thus a possibility existed

[11] I have discussed this in my article in the Manmohan Singh festschrift . See Desai (1998) also reprinted in Desai (2004)

of lifting the Indian economy to a high growth path once the food grain constraint had been lifted. But there was an *internal drain* to contend with. Brahmananda is eloquent about this in the concluding paragraph of his Chapter 27 on the impact of the drain. Let me quote him :

"The new dimension on poverty has no direct relation to Naoroji's analysis but there can exist an internal drain, which potentially keeps large portions of population below the poverty line. Such a drain can be inbuilt in economic policy formulation and in planning strategies" [MIP 19, p.519].

As an early and prescient opponent of the Mahalanobis strategy, PRB was entitled to point to this internal drain but he does not further specify what it is but goes on to talk in general terms about contracts and exploitation. Let me spell out what the internal drain is.

This is made up of diverting the surplus into capital intensive industries which were surplus absorbing rather than surplus enhancing [loss making in other words] and into public sector employment at real wages rising faster than the real growth rate of the economy as they have done till very recently. Although the public sector labour force accounted for only 15 % of the labour force, it absorbed a lot of the surplus. With other forms of internal drain- subsidies costing nearly 15 % of GDP, the drain assumes alarming proportions. Industry enjoyed a positive tariff of around 45 % and agriculture a negative tariff of about 20 %. Thus as in the Soviet Five Year Plan, agricultural

surplus financed industrial investment. But since the industries enjoyed no comparative advantage and were largely loss making, the investment did not lead to rapid growth or elimination of poverty.

India's per capita income did not regain its pre - Independence peak of 1929 till 1960 according to Maddison's figures. Poverty numbers did not begin to move down till twenty years later during the 1980s. But by then one important plank of India's economic dogma had been abandoned. The fear of foreign borrowing had been removed by the time Mrs. Indira Gandhi came back to power in 1980. India abandoned the goal of self sufficiency, i.e., the belief that there was enough investible surplus at home. Foreign debt went up from $ 20 billion to $ 83 billion over the 1980's [Maddison, p.166]. There was a drain of course; the debt had to be serviced. But the GDP growth rate improved from around 3.5 % in the 1950-1980 period to 5.5 % in the 1980s. But the growth was not export oriented as was the case in the 19th century. There was not a sufficient export surplus to service the 'Home Charges' of 20th century. So the economy crashed in 1991.

There is also parallel to the 19th century a hoard but again it is an internal hoard whereby people hoard cash in large amounts. Its estimates vary but it is not less than the 50 % of GDP proportion that the 19th century hoard of gold attained. Part of this so called black money enters the circuit of expenditure in real estate, films and crime related activities but a large proportion is just hoarded. It is as much of a drain as the other one. Since independence governments have not only not reinvested the drain effectively but created a new and larger one. Add to it the internal hoard [though this may involve some double counting]. India is wasting a much larger part of GDP than when Dadabhai spotted the drain. Perhaps the consolation is that the wastage is not by foreigners but by Indians themselves.

Lessons for the 21st Century:

Since the Indian economy crashed in 1991 and changed its course things have improved tremendously. The growth rate of total and per capita income is now respectable. Nehru's dream of doubling income in ten years required a growth rate of 7 % per annum and this is now for the first time in fifty seven years after independence attainable. As in the 19th century, the economy is becoming export oriented though as yet India's share of world exports is nowhere near what it was then.[12] The pattern of capital import in the Gandhi-Gandhi decade of 1980s was very much like that in the 19th century- at high and fixed interest rates. What is needed is foreign direct investment as equity rather than debt. This is the new pattern of capital imports in the 21st century globalisation as against the fixed interest borrowings of the 19th century. China has shown how much can be borrowed this way. Thus the 'drain' will be there only if the imported capital benefits the economy, i.e., if it generates profits, if it is surplus generating.

[12] As I write this, the new trade policy aims to double the share from 0.9 to 1.8 % by 2009. It is to be hoped that the policy succeeds.

With the 19th century drain, no one was certain if the benefit exceeded the cost and since the rulers were foreign the suspicion was that any investment they made was not beneficial. While I did not question that proposition, it is worth pointing out that in the 21st century, India enjoys some advantage in the globalisation game because of the English language as well as the legal system that the British imposed on India. Not all the railways and canals were entirely useless. One should perhaps now sit down and do a careful analysis of the returns to investments made then and compare it to the cost to get a better estimate of the unrequited proportion of the drain.

But the lesson for the 21st century is clear. Any drain internal or external should be minimised if not eliminated. A nation where even after nearly six decades of independence a quarter of the population is poor cannot afford to waste resources. The internal drain has to be cut. This means budget deficits and for that purpose subsidies which are all regressive. But its also means eliminating the hoards and harnessing them for development. Let me finally turn to that problem.

Harnessing the Hoards :

Since I am enjoying the hospitality of a Central Bank, let me try out a policy proposal. The excessive hoards are an example of acute liquidity preference. In the past various schemes have been tried to make hoarders disgorge without much success. Now one way to tackle such liquidity preference is to do what Silvio Gessell prescribed.[13] He of course advocated stamping money frequently, e.g. monthly, to preserve its value thus taxing hoarding. This is rather inconvenient. I would propose periodic, say quinquennial, renewal of the currency. The present currency should be replaced, one for one, for a new currency every five years. Bank deposits are of course no problem and can be automatically converted into the new currency. But cash hoards should be convertible at variable rates. Thus up to a certain limit reasonably required for transaction purposes, say up to one million rupees per person, the conversion should be one to one and automatic. Beyond that conversion should be permitted only if the holder can prove that tax has been paid on the income. Otherwise they should be offered zero interest bonds in exchange for their hoards. These bonds can of course be traded after a decent interval of the reissue.

This scheme is designed to plough the hoards into government coffers by way of bonds sold. If the hoards are anything like 50 % of GDP then the sale should realise a hefty sum enough to retire a substantial part of the National Debt. It is of course a tax on hoarding. When the bonds are cashed in a rush by the hoarders the market will price them down. Thus the tax on hoarding will be market determined. Then this scheme is to be repeated every five years or so to discourage rehoarding. Governor I offer you my scheme as a

[13] Silvio Gessell's ideas contained in his book 'The Natural Economic Order' were given publicity by Keynes who praised him in 'The General Theory' as being better than Marx in understanding capitalism. Keynes's hope that Gessell will be read more than Marx in the future has not been fulfilled.

small recompense for the kind honour you have done me in inviting me to give this inaugural lecture.

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