

The Pattern and Consequences of War Financing

Of the several functions of a central bank, perhaps the most significant one during a period of war is that of banker to Government. Apart from handling the vastly expanded volume of Government transactions, the central bank has a special role to play in assisting Government to raise resources in the form of borrowings, to supplement those raised through taxation. The fundamental principle of war financing is to divert such portion of the Gross National Product to Government as might be necessary for the defence effort; the community has to make the requisite sacrifice. Some responsibility is also cast on the central bank to advise the Government in the sphere of fiscal policy, so that resources are maximised without generating severe inflationary pressures and equity ensured as between the various sections of the community as regards sacrifice of current consumption and investment.

The problems of war finance which India had to face were not materially different from those of other countries, although the country was not, by and large, an actual theatre of war. As a dependency, it was called upon to make a substantial contribution to the war effort of the U.K. and her Allies. This very circumstance, however, also imposed limitations on the ability of the British rulers in India to maximise the mobilisation of resources in a non-inflationary way. For, apart from the factor of low per capita income, the lack of enthusiasm for the war on the part of the country as a whole and non-cooperation from the leading political party set a serious limit to Government's efforts in raising resources in the form of taxation and non-inflationary borrowing from the public. Perhaps it is these factors rather than complacency or lack of understanding of problems of war finance that explain why the financial mobilization fell short of the needs of the situation. Considering

all the circumstances, perhaps the fiscal effort actually made was not altogether disappointing. While inflation did occur in a substantial way, it was of far less serious magnitude than it looked likely at one stage.

Budgetary Position of Government: General View

As already mentioned, it was the responsibility of the Government of India to find the resources not merely for the Government of India's own defence expenditure but also for the requirements of the Allied Governments, in particular the U.K. It turned out that the requirements of the Allies were in the aggregate almost as large as those of the Government of India. Of course, the Government of India were entitled to recover from the U.K. (and other Allies) the expenditure incurred on behalf of the latter. The basis of reimbursement of defence expenditure on behalf of the U.K. was set out in an agreement, called the Financial Settlement, which was concluded in November 1939 between the British Government and the Government of India and given retrospective effect from April 1, 1939. According to the Agreement, the whole of the defence expenditure incurred by India was to be apportioned between the two Governments on the following basis: India was to bear (1) a fixed annual sum representing the normal net effective costs of the Army in India under peace conditions, (2) an addition to allow for rises in prices, (3) the cost of such war measures as could be regarded as purely Indian liabilities by reason of their having been undertaken by India in her own interests, and (4) a lump sum payment of Rs. 1 crore towards the extra cost of maintaining India's external defence troops overseas. The total amount by which the net annual defence expenditure incurred in India during the war years exceeded the aggregate of items (1) to (3) was to be recovered from the British Government.

The budgetary position of the Government of India, including expenditure incurred on behalf of the Allied Governments, is set out in the following table. Considering first the Government of India's own outlay, it will be seen that the increase in expenditure was rather modest in the first two full financial years of the war, namely, 1940-41 and 1941-42. But in the next two years there were sharp increases; total outlay rose from Rs. 148 crores in 1941-42 to Rs. 367 crores in 1942-43 and further to Rs. 504 crores in 1943-44. However, in 1944-45 the rate of increase in expenditure was rather modest and in 1945-46 there was a slight decrease in expenditure, reflecting the cessation of war in August 1945. The aggregate outlay on India's account in the six-year period 1940-46 was Rs. 2,261 crores, of which expenditure on revenue account was Rs. 1,971 crores. The Recoverable War Expenditure began to rise sharply from 1941-42, in which year it amounted to

BUDGETARY POSITION OF THE GOVERNMENT OF INDIA

	(Rs. crores)										Total for 6 years 1940-46
	1938-39	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46			
Fiscal years (April-March)											
1. Revenue Account											
(i) Revenue	84	95	108	135	177	250	336	361			1,366
Of which Tax Revenue	74	81	77	98	125	171	254	282			1,007
(ii) Expenditure	85	95	114	147	289	440	496	485			1,971
(iii) Balance*	- 1	-	- 7	- 13	- 112	- 190	- 161	- 123			- 605
2. Aggregate Outlay on India's Account (Revenue and Capital Accounts)	94	99	121	148	367	504	578	542			2,261
3. Overall Position (including Capital Transactions)*	+ 2	+ 3	- 2	+ 1	+ 2	+ 65	+ 183	+ 263			+ 513
4. Recoverable War Expenditure	-	4	53	194	325	378	411	375			1,736
5. Total of items 2 and 4	94	103	174	342	693	882	989	917			3,997
6. Budgetary balance* on Indian and Allied Accounts combined (3-4)	+ 2	- 1	- 55	- 193	- 323	- 312	- 228	- 111			- 1,223

* + Surplus; - Deficit.

Sources: Reserve Bank of India, *Banking and Monetary Statistics of India, 1954*, and Government of India, *The Indian War Economy (Supply, Industry and Finance)*, 1962.

Rs. 194 crores. It reached a peak of Rs. 411 crores in 1944-45; in that year the expenditure on Government of India's own account was also at the peak of Rs.578 crores. The total of Recoverable War Expenditure in the six-year period was Rs. 1,736 crores. In other words, the aggregate outlay which the Government of India were called upon to finance was of the order of Rs. 4,000 crores. The peak of the combined expenditure at Rs. 989 crores in 1944-45 was almost ten times that of 1939-40, which included seven months of the war period.

It should be explained at the very outset that the reimbursable part of the war expenditure was received by the Government of India in the form of sterling, which could not be spent for the time being on buying goods either in the U.K. or elsewhere. Thus, in the six fiscal years 1940-46, the payments of sterling by the British Government totalled the equivalent of Rs. 1,633 crores, against the Recoverable War Expenditure of Rs. 1,736 crores. India also acquired sterling as a result of a surplus payments position on private account; the Reserve Bank's net purchases of sterling, relating primarily to non-Government transactions, were of the order of Rs. 650 crores in the period 1940-46.

While the Government of India received an asset in the form of sterling not immediately usable, they had to find the rupee resources for meeting that expenditure. It was not possible for the Government of India to raise the entire resources in a non-inflationary way through taxation and genuine borrowing. What the Government did was to finance a substantial part of the expenditure through the simple device of currency issue. The fact that India obtained sterling from the British Government in respect of their expenditure in India did not alter the fact that there was a substantial draft on India's real resources, the community having to make a cut in current consumption and investment. The Government transferred the sterling to the Reserve Bank and got rupee currency against these assets. In terms of Section 41 of the Reserve Bank of India Act, the Bank was bound to buy sterling in exchange for rupees at around the rate of 1S. 6d. a rupee. While undoubtedly there were factors at work to absorb the currency expansion, such as increase in national output and increase in the holding of cash, about which precise data are not available, their impact was modest; in the result there was an inflationary upsurge. How the thinking of the Government and of the public proceeded on the matter of the sterling-induced inflation and what the Government did to intensify the mobilisation of resources is discussed in subsequent sections of the chapter.

The Government of India endeavoured to raise additional tax resources both through levy of new taxes and enhancement of the rates of existing taxes. Even so, tax revenue did not keep pace with the Government of India's own requirements. In the result, there were

substantial deficits on revenue account, from the year 1942-43 onwards, the largest, namely, Rs. 190 crores, being in the year 1943-44. In the six-year period 1940-46, the tax revenue of the Central Government totalled a little over Rs. 1,000 crores or about 45 per cent of the outlay on Government of India's account. Tax revenue in 1945-46, at Rs. 282 crores, was about $3\frac{1}{2}$ times that in 1939-40. There was a significant increase in non-tax revenue (net earnings of Railways, Posts and Telegraphs, profits of the Reserve Bank, etc.), which increased from Rs. 14 crores in 1939-40 to Rs. 79 crores in 1945-46 and totalled in the six-year period 1940-46 Rs. 359 crores or a little over one-third of tax revenue.

As regards tax measures, briefly, there was a substantial stepping up of income and corporation taxes, including the introduction of excess profits tax in the budget for 1940-41. In respect of income-tax, a Central surcharge of 25 per cent was levied in November 1940, on all taxes on income. In the year 1941-42, the surcharge was raised to $33\frac{1}{3}$ per cent. In 1942-43, the burden of surcharge was raised through a change in the basis of the levy. In subsequent years, the surcharge was raised in respect of higher slabs of income. The super tax on companies was raised steadily from one anna in the rupee to three annas. In the budget for 1942-43, the exemption limit for income-tax was lowered from Rs. 2,000 to Rs. 1,500, though the higher limit was restored in 1944-45. Towards the close of the war, a differentiation was also introduced between earned and unearned income. As regards the excess profits tax, the rate was 50 per cent in 1940-41 and was raised to $66\frac{2}{3}$ per cent in 1941-42; the total yield was Rs. 265 crores in the six-year period 1940-46. In 1944-45, the 'Pay-as-you-earn' system of income-tax collection, that is to say advance payment, was introduced. In the field of indirect taxation, additional receipts came mostly from excise duties. The duties were raised on sugar, motor spirit, matches and kerosene, and fresh duties were imposed on several commodities, namely, tobacco, pneumatic tyres and tubes, vanuspati, betelnuts, tea and coffee. Revenue from Central excise duties rose from Rs. 6.5 crores in 1939-40 to Rs. 46 crores in 1945-46. The revenue from customs declined over the first three years, but from 1943-44 onwards there was a rise, the yield of Rs. 74 crores in 1945-46 being about 60 per cent higher than that in 1939-40.

Despite these efforts, it should be noted that the tax and non-tax revenue together met not much over two-thirds of the expenditure on revenue account, leaving a large deficit on revenue account, aggregating Rs. 605 crores in the period 1940-46.

In the three years 1940-43, the deficits on revenue account were met by surpluses on capital account, with the result the overall budget on Government's own account was in balance. Nevertheless, from 1943-44

onwards, on account of the inflationary pressures an effort was made to raise much larger sums through borrowings than were required to meet the revenue deficit and the capital expenditure of the Indian Government; the surpluses were utilised to finance a part of the Recoverable War Expenditure. Thus, the overall surpluses in the three years 1943-44 through 1945-46 were Rs. 65 crores, Rs. 183 crores and Rs. 263 crores, respectively. In the six years 1940-46, the overall surpluses on Government of India's own account totalled Rs. 513 crores. However, the surpluses were inadequate to meet the Recoverable War Expenditure which totalled Rs. 1,736 crores. In the result, the budgetary gap, on the combined account of India and the Allies, was as much as Rs. 1,223 crores, which was met by issue of currency. The largest deficit of Rs. 323 crores occurred in 1942-43, after which there was a steady decline, tapering off to Rs. 111 crores in 1945-46.

To complete the budgetary record, a brief reference may be made to the financial position of the Provincial Governments as a whole during the war period. The consolidated position of these Governments showed a surplus on revenue account in all the war years (1940-46), totalling Rs. 57 crores. There was also overall (i.e., in respect of combined revenue and capital accounts) surplus in all the years except in 1944-45, aggregating Rs. 23 crores. The total outlay of the Provincial Governments in the period 1940-46 was a little under Rs. 1,000 crores (or about two-fifths of that of the Central Government). About two-thirds of the Provincial outlay was covered by tax revenues, including the Provincial share of income-tax to the extent of about Rs. 100 crores.

Evolution of Fiscal Policy

The question naturally arises whether the Government of India could not have raised even larger resources on their own account, especially through additional taxation, so as to meet Recoverable War Expenditure to a greater extent. It is not easy to answer this question in a categorical way; what one can do is to place before the readers the relevant circumstances of the case. The capacity of a poor nation to contribute resources to the national cause in times of an emergency like war is elastic only to a limited extent. Moreover, it depends to some extent upon the kind of leadership that is provided by the political parties to arouse the patriotic spirit of the people. In India, as already mentioned, on account of the fact that there was a foreign Government and the major political party boycotted the war effort, this favourable circumstance was singularly absent. In the circumstances, the Government preferred to follow to an extent the line of least resistance by financing the deficit through monetary expansion. The authorities in India and the U.K. were alive to the need for an all out effort to mobilise resources



Sir Chintaman D. Deshmukh

Governor, 1943-49

but their ability was not equal to the task. The very low per capita income of the country and the inadequacy of the administrative machinery for collecting taxes also limited Government's ability to achieve any spectacular results in tax raising. Nevertheless, in retrospect it would seem that in absolute terms the performance of the Government in raising resources, both through taxation and borrowing, was not altogether unimpressive. Total tax revenue (including the Provincial share of income-tax) in 1945-46 was almost four times the level in the year 1939-40. Taxes on income recorded a sharp rise; the 1945-46 yield was over nine times that of 1939-40. In a period when there does not appear to have been a marked expansion of industries there was only limited scope for the levy of excise duties. While fairly large amounts were raised in the period 1943-46 through borrowing, they were not adequate to cover the entire budgetary gap. In other words, the main point of criticism against Government policy would appear to be not so much that they could not raise all the resources in a non-inflationary way but that the contribution to the Allied war effort that was demanded from India was of a magnitude that was beyond the country's capacity to finance in the conventional manner.

In his first war budget speech made in February 1940, the Finance Member outlined the budget strategy for war time. After referring to the growing view that budget should be planned not for a single year but for a longer period corresponding to a trade cycle, the Finance Member observed as under:

Now whatever the view which one may hold on the subject of budgeting for a year at a time or budgeting for a longer period more nearly corresponding to a trade cycle, there can, I hold, be no question that in the circumstances of India today the additional requirements of Government should clearly be met by drawing on the additional taxable capacity which the war has produced. It would in my opinion be indefensible in circumstances such as these to postpone for the future any part of the burden which can more easily be shouldered today.

As already mentioned, the main tax measure in the above budget was the levy of the excess profits tax.

The British Government also gave serious thought to the financing of the war effort in India. As early as May 1940, the India Office wrote to the Government of India that they had been 'giving some consideration to the effect on India's economy of the monetary expansion arising from war conditions, and the necessity of looking ahead so that we are ready to take timely action to prevent the situation getting out of hand'. The communication referred to the danger of inflation and the need to take effective measures. Apart from taxation, the need for the 'inauguration of a substantial rupee borrowing programme' was emphasised.

The anxiety of the British authorities was understandable in view of the rising trend of prices. In the first few months after the outbreak of war, commodity prices had recorded a sharp increase of a little under 40 per cent. While this appears to have been mainly due to exaggerated fears of acute shortages consequent on the outbreak of war, there was also general buying pressure financed by bank credit. After a decline in the first eight months of 1940, mostly reversing the rise in the first few months after August 1939, the trend of commodity prices was upward; even so, for the year 1940-41 as a whole, the general index recorded a decline of about 7 per cent, to 118.8 (Base: week ended August 19, 1939 = 100).

In the budget speech for the year 1941-42, the Finance Member did not seem to be much concerned with inflationary possibilities; he laid emphasis on the borrowing programme for augmenting the resources. On the other hand, the Reserve Bank authorities appeared to be rather worried. Writing in the middle of 1941 to the Finance Department, the Governor referred to the need for careful watch for signs of inflation. The only suggestion he had at that stage was that increases in wages and salaries of employees of business concerns drawing more than a certain maximum amount (say Rs. 75 per month) should not be allowed as expense in assessing income-tax or excess profits tax. In his address to the Bank's shareholders at the seventh annual general meeting held in August 1941, the Governor again struck a mild note of warning with regard to inflationary possibilities. He did not consider the rise in commodity prices that had taken place as being due to unhealthy speculative forces. He warned, however, that they could not afford to neglect the risk of such a possibility.

In his communication to the Finance Secretary in October 1941, however, the Governor was more forthright in his analysis of the inflationary potential, arising from allied expenditure in India. He seemed to favour a measure of Governmental compulsion to make people place a larger proportion of their income at the disposal of Government on the lines indicated by John Maynard Keynes for the U.K. In the context of conditions in India, his suggestion was that income and excess profits taxes should be increased, but that the increase should be compulsorily loaned to Government to be repaid after the war. The loan was to carry a relatively low rate of interest or no interest at all so that it might not compete with the normal borrowing operations of Government. He also suggested for consideration the taxation of profits from speculation.

With the entry of Japan into the war in December 1941, it was clear that the war would be more intense and widespread. In this context, the India Office again addressed the Finance Department in January 1942, about the likelihood of inflation reaching serious proportions in

India. Since an increase in supplies of goods was possible only to a limited extent during war time, it was suggested that attention ought to be given to drawing off purchasing power by additional taxation and/or borrowing and in this connection the India Office made several suggestions such as issue of six months Treasury bills at higher rates of discount, larger borrowing by Provincial Governments for repayment of debt to the Centre, introduction of a separate category of savings bank deposits, with restricted withdrawal facilities but carrying a higher rate of interest, levy of additional income-tax to be credited to the savings accounts of assesseees not withdrawable during the war, and introduction of a security on the lines of the tax reserve certificates of the U.K. The Finance Department consulted the Governor, who regarded most of the proposals unacceptable and Government would appear to have concurred. Governor, however, favoured borrowing by the Provincial Governments.

The Finance Member's budget speech of February 1942, presenting the estimates for the year 1942-43, recognised the need for intensification of the effort to mobilise resources. While some enhancement of taxation was effected, the main emphasis came to be placed on savings schemes. The measures took the form of option being given to new assesseees for income-tax (consequent on the lowering of the exemption limit from Rs. 2,000 to Rs. 1,500), to escape the liability by depositing in the Post Office Defence Savings Bank an amount approximately $1\frac{1}{4}$ times the amount of tax assessed, such deposits not being ordinarily withdrawable till one year after the end of the war. In practical terms these measures did not add to much.

The Central Board and Sterling Accumulation

By about the middle of 1942, the Central Board of the Bank became quite concerned with the large increase in currency circulation and the sterling assets of the Bank. The Recoverable War Expenditure had begun to show a substantial increase from the year 1941-42; the total for that year was Rs. 194 crores as against Rs. 53 crores and Rs. 4 crores, respectively, in the preceding two years. The increase in Recoverable War Expenditure was reflected in about an equal measure in the receipt of sterling from the British Government. In the result there was acceleration in the rate of growth of money supply, from Rs. 90 crores in 1940-41 to Rs. 168 crores in 1941-42, or from 21 per cent to 33 per cent. Both as a result of the monetary expansion and the psychological impact of Japan's entry into the war, the uptrend in commodity prices became much more pronounced, the aggregate rise for the year 1941-42 being 23 per cent; hence the anxiety of the Directors for a discussion of these matters. They must have felt that the

consideration of the Bank's annual report for the year 1941-42 would provide a convenient opportunity for this. So they enquired of the Governor:

Whether it would be possible to circulate some portion of the draft relating to these matters in advance so that the Directors could give them more lengthy consideration and would also have time to ask for further information or elucidation of points not clear to them.

The Governor did not see any objection to the course proposed and circulated on June 25, 1942, a brief letter outlining his views on these issues and also the preliminary draft of the relevant portion of the Bank's annual report for the year 1941-42. The Governor's view on the price rise was as under:

my view is that though there has been a considerable rise in internal prices, I do not consider that this is the result of the increase in the note currency, but rather that the two phenomena together are the unavoidable result of the large purchases of goods and services which are being made by the British Government in India. Unless this increase in purchases can be met by an equal increase in the supply not only of the articles being directly purchased by the British Government but of the foodstuffs and other necessities of life which those who are producing these supplies require to keep them going and which they are now in a position to purchase owing to the money accruing to them, there is bound to be an increase in commodity prices in this country. The remedy could only lie in advising Government to do all it can to encourage the production of foodstuffs and other necessities of life, and, on the other hand, by encouraging investment so that as much as possible of the increased purchasing power may not be spent unnecessarily now but may be kept as a reserve for the future.

The Governor welcomed the accumulation of sterling as being useful for India's post-war reconstruction. He did not think that there was 'any practical danger that these assets will not be convertible into such producer goods as and when they are required'. He also recommended continuance of the policy of repatriation of sterling debt (see Chapter 13). It is apparent that the Governor wished to put the matter of inflation in as subtle a way as possible, so that his Board and the public might be reasonably satisfied with the state of affairs and that the war effort should go on with undiminished vigour.

The Board had a comprehensive discussion on this item at its meeting of July 20, 1942, judging from an office note recorded by Deputy Governor Deshmukh. A suggestion was made that insofar as there was a payments surplus with the U.S.A., 'irrespective of the Lease and Lend arrangements', the possibility of acquiring gold or dollars should be explored and that arrangements should be made to sell the gold to the Indian public at a suitable price. It was also suggested that an

embargo should be placed on the export of gold; it was pointed out that 'such a course would depress the price of gold and inflict a loss on large number of people' ! The question of acquiring British investments in India was also mentioned as one which should be examined; in fact, Directors Mr. Kasturbhai Lalbhai and Mr. B. M. Birla had mentioned this to the Governor earlier. Some of the objections to this suggestion were stated to be that there would be problems of making satisfactory arrangements about the direction and control of the foreign owned enterprises and that repatriation would pose many administrative problems. All that the Board's resolution said on the annual report was that, while transmitting it to Government, the Governor be authorised to convey to them the Board's suggestion that the remaining sterling liabilities of the Government, including Railway debentures and annuities, be repatriated, with a view to using up the surplus sterling assets.

The annual report itself (for the year 1941-42) had the following to say on currency expansion and inflation:

The remedy for any inflationary tendency that the expansion of currency might have must take into consideration the causes which are producing the increased demand for currency, and these in present circumstances are not amenable to any action which the Reserve Bank can itself take. It may be stated, however, on a review of the facts and figures bearing on inflation, e.g., the course of prices, the extent of currency expansion, the increase in bank deposits and the volume of bank clearings, that although most of the recognised elements of inflation are present, there is no evidence that inflation is present in the country in any serious form.

It may be mentioned that the first sentence in the above quotation was as redrafted by the Finance Secretary. The Bank's draft had stated that 'the remedy for any inflationary tendency that the expansion of currency might have lies outside its proper sphere of action'. The Finance Secretary feared that the above statement 'might be attacked by financial critics as unsound and by political critics as an admission of what they are continually harping on, namely, that the Reserve Bank is not an independent currency authority but is entirely subservient to the Government'. In his speech to the Bank's shareholders in August 1942, the Governor gave his analysis of the problem of inflation (which term, he said, he 'disliked') on the lines of his earlier letter to the Directors. He said, in short, that there was nothing that the Bank could do about it and referred to the activities of hoarders and, speculators!

From about the middle of 1942 onwards the inflationary situation started assuming serious dimensions, with a substantial stepping up of the Government of India's own outlay as well as the expenditure on account of the Allies. Thus, the combined outlay more than doubled

from Rs. 342 crores in 1941-42 to Rs. 693 crores in 1942-43. There was a sharp increase in the rate of expansion of money supply, from Rs. 168 crores to Rs. 464 crores, or percentage wise, from 33 to 68. The general index of wholesale prices also recorded a marked increase, from 145.6 in March 1942 to 186.2 in December 1942 and further to 219.8 in March 1943, making a total of 51 per cent for the year 1942-43. The country's top economists, under the lead of Professor C. N. Vakil of the Bombay School of Economics and Sociology, realised the seriousness of the situation and wrote persistently giving an analysis of the inflationary situation and the directions in which fiscal action was called for to stem the inflation. The pride of place to the literature on the subject should go to Professor Vakil's booklet, *The Falling Rupee*, which was first issued in January 1943. This was the first systematic effort to focus public attention on the financial problems posed by the war. According to Professor Vakil, the correct methods of financing the allied expenditure in India were: (1) payment in durable assets, (2) payment to India in gold, (3) raising of rupee loans in India by the U.K. and (4) liquidation of British assets in India.

On account of the seriousness of the situation, a number of economists* issued a joint statement on April 12, 1943 analysing the causes of inflation and suggesting a comprehensive programme of action. Important portions of the statement are reproduced below. †

The Government seems to act as if it is enough for it to take care of its own budget deficit while meeting the needs of the British Government by printing more notes. This is a grave misreading of the whole situation and has resulted in an ever increasing expansion of currency unrelated to the needs of internal production and trade. As a result, the inflationary spiral is already at work in India. The inflation in India is, therefore, a deficit-induced, fiat-money inflation. It is the most disastrous type of inflation.

Inflation is the most inequitable way of distributing the war burden and usually large transfers of wealth from the poorer and the middle classes to the richer classes. It is also undesirable because it increases the cost of war and impairs the war effort by hindering production and distribution. Its consequences to economic society are immediately felt; it, however, also holds the threat of bringing about later, political consequences of an even graver nature.

We earnestly feel that immediate and drastic measures to check inflation are called for. In this connection we urge on the Government of India the primary necessity of closing the 'gap' by increased taxation and borrowing. Taxation, in our opinion, should be raised to the highest practicable pitch, adjusted to shoulders that can best bear it. We suggest a much steeper progression in income-tax rates, the laying of

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† Source: *Financial Burden of the War on India* by Professor C. N. Vakil.

a maximum limit to individual consumption income and absorption of all profits above a limit, either in tax revenue or to be impounded into special loan contributions. To increase the volume of borrowings to the required level, it is necessary to institute a comprehensive scheme of compulsory savings as well as a rigid control of all investment outlets. This programme should be brought into effect with great rapidity. However, it will take some time before the inflationary gap is completely closed and the total currency in circulation is today already greatly redundant, even at the existing high prices. To tie up this vagrant purchasing power we propose the immediate initial steps of a blanket control of all prices followed by a strict examination of all later allowable increases. A rationing of the essential necessities of life should be undertaken to as large an extent as possible. An effective control of prices will involve a wage stop but this will mean no hardship as long as the price rise is stayed. An equally strict profits stop is indicated as a corollary of this policy as well as independently on account of financial considerations.

The leading Directors of the Central Board showed renewed concern regarding these developments, their anxiety being, it would appear, more about the accumulation of sterling with the Bank in a very visible manner than the emergence of inflation. In January 1943, Sir Purshotamdas Thakurdas, after discussions with the Governor, made two suggestions, one of which was that sterling that might accumulate thereafter in London should not be taken over by the Reserve Bank but should be kept by the Government of India for a temporary period, that is, until they negotiated a rupee loan to the U.K., sterling being converted on the basis of 1S. 6d. This was to 'remove the apprehension of people that large amounts of sterling continue to accumulate in London, and the apprehension of some at least that this sterling may not be worth in the future what it is today in rupees'. Sir Purshotamdas's other suggestion was that Government should revise their loan policy and offer attractive terms for short periods, if necessary free of income-tax. In making this suggestion, Sir Purshotamdas had in mind the substantial withdrawal of postal savings deposits and post office cash certificates that had taken place. Replying to Sir Purshotamdas, the Governor referred to the real difficulty of Government's being committed to cheap money policy. As regards the rupee loan to the U.K. Government, he was not clear what precise object that would achieve. Answering this in another communication, on January 9, Sir Purshotamdas explained that a Government-to-Government loan would 'serve the purpose of taking away from the public eye the enormous sterling balance, which, I am afraid, tends to make people nervous. However, I have an open mind on this and put this suggestion to you in order to benefit by your expert knowledge'. He was also critical of the argument of cheap money. Concluding, he remarked:

It strikes me on the whole that the Reserve Bank is being used at present to finance the Government of India under circumstances unforeseen at the time that the Reserve Bank Act was passed, and I wonder whether it is not putting too much strain on the very credit which the Reserve Bank does enjoy with the people, and thus tend to shake the of the people in the Reserve Bank of the country, i.e., in the currency of the country.

Two weeks later, that is, on January 22, 1943, Sir Purshotamdas Thakurdas requested the Governor to put on the agenda of the Board meeting to be held on February 8, 1943, in Delhi, 'the question of the increasing sterling balances in London and the general dissatisfaction regarding what has been termed "inflation in India" including the steadily rising prices of all commodities and manufactured articles in India'. As a matter of fact, the Governor and the Deputy Governor had also considered the need for a discussion of these matters at the next Board meeting and a memorandum was under preparation. This was circulated to the Directors on January 25. Sir Purshotamdas also suggested to the Governor that it might be useful for him (the Governor) to wire to the Governor of the Bank of England ('it may not be unprofitable to invest even a few hundreds in sending him a full and elaborate telegram') his frank opinion on the current inflationary situation in India and the sterling accumulation and 'invite his guidance and suggestions for an early solution of this'. Sir James replied that he had kept the Governor of the Bank of England informed of general developments in India and he did not see 'what advice he could give beyond the obvious in a matter which is essentially for domestic and administrative solution'.

Governor's Memorandum on Sterling Balances and Inflation

The memorandum, which the Governor circulated to the Board on January 25, 1943, entitled Sterling Balances and Inflation in India, was only a more forthright restatement of his earlier views on inflation in India and its causation. The memorandum also commented on the suggestion that Britain and the U.S.A. should float rupee loans in India for financing their own purchases. Surprisingly, there was no reference at all in the memorandum to Sir Purshotamdas Thakurdas's suggestion regarding a rupee loan from the Government of India to the British Government. This was later taken up by Mr. Deshmukh, after he became Governor.

In connection with the consideration of the inflationary impact of the currency expansion in India, the Governor drew the attention of the Directors to the increase in the hoarding of currency and consequent reduction in the velocity of circulation; a part of the currency had also

been transformed into bank deposits. He also observed that in assessing the rise in prices it should be remembered that the prices of many of India's staple agricultural commodities had been markedly below the normal in relation to those of manufactured articles for the period immediately preceding the outbreak of the war.

Regarding the role of accumulation of sterling as a direct cause of inflation, the Governor had the following to say:

It is hardly necessary for me to draw attention to the underlying fallacy. It is obviously not the form in which we receive credit from Britain that releases purchasing power in India but the rupee disbursements that have to be made for war supplies, etc. Unless therefore we make the ridiculous assumption that the war effort should be arbitrarily curtailed, it clearly follows that even if we received no sterling, our currency would have to be expanded just the same, unless either the Government taxed more, or the public were prepared to lend more. The only difference would be that the expansion would be against rupee securities, that is against the credit of the Indian Government instead of sterling, that is the credit of the British Government. I would go further and say that the problem of inflation that would arise in the former case would be of a more difficult order than at present since, when any reverse currency trends make their appearance in the post-war period, in the former case the return of currency would have to be purely deflationary while in the latter case it will occur against sterling expended on the purchase of a variety of useful imports.

The Governor considered that India was not doing so badly in regard to raising of public loans and that it would be difficult to do much better in this sphere. In his view, the scope for increasing public interest in Government securities or other forms of public debt was not so large as to make by itself a vital difference to the problem of inflation. He considered it would be fatal to try to increase the rates of interest paid on Government loans, as it might set in motion speculation regarding a continuous increase in the rates and that 'the cheap money policy on which the present war is being financed is therefore of vital importance'. In view of this analysis regarding the scope for public borrowing, the Governor did not 'think it necessary to make more than a passing mention' of the suggestion that Britain and the U.S.A. should float rupee loans in India. The Governor's comments on this were as under:

To my mind in view of the extent to which our war effort is being financed from outside, now running to twenty or so million pounds a month, this idea is chimerical and could only appeal to theorists in experienced in the practical scope and limitations of the Indian securities market. Put briefly if the general structural of interest rates is not to be disturbed by these foreign floatations, there seems no likelihood of their attracting investment would not go in any case into the

Government of India's own loans, and if the rates of interest offered were to mark an appreciable increase over the prevailing Indian rates in the hope of tapping fresh sources of investment, the entire structure of the securities market, which has been built up as a result of such careful control, would be disrupted and economic consequences set in train which would be far more serious than the evil, partly imaginary or at least exaggerated, which the floatations would be intended to serve. Further, if distrust of the future of sterling is at the back of this suggestion, it is difficult to see what difference would be made by an alteration of the currency in which credit is granted to Britain.

The Governor concluded his analysis of the problem of 'rising prices' in the following terms:

Thus on a comprehensive survey of the position from the purely financial side, one arrives at the conclusion that there can be no complete solution to the problem of rising prices in war time, if the war effort is to be maintained at its fullest pitch and pace and that such remedial action as is possible in the circumstances prevailing in India does not lie on monetary lines, but on those of practical administration. There is also no means open to the Reserve Bank of putting any artificial restraint on the rate at which sterling is accumulating with it. If therefore the Reserve Bank desire to communicate any opinion to Government it can only be in the nature of an advice to intensify governmental effort on the production of food and other necessaries of life and to draw up and pursue vigorously plans for promoting the rural development of the country not only so as to draw off surplus purchasing power and counterbalance the economic maladjustments created by the war but, what is more important from the long range point of view, also to improve the capacity of the country to deal with the problems of the post-war period.

Sir James's account of the discussions at the meetings of the Central Board and the Committee, held on February 8 and 10, 1943, respectively, is very interesting. (This is contained in the draft of a letter he dictated for issue to the Finance Secretary but which he never vetted and signed, as he became ill and passed away on the 17th night. It was, however, forwarded to Government by Mr. Deshmukh). Sir James's view of the Board's general reaction to his memorandum was as under:

I was somewhat surprised to find that the memorandum met with general approval from the Directors, particularly . . . , and after thinking over the matter it seems to me that what was really pleasing him was the line we were taking about inflation. They have always been inflationists themselves and naturally inflation suits the big businessmen and, whatever are its attendant evils, would be far better to them than any curtailing of war expenditure as a deflationary measure.

The meeting also discussed the terms of a draft resolution which Sir Purshotamdas Thakurdas had submitted. This draft made no mention of repatriation or acquisition of British business interests in

India. It referred mainly to the need to secure an assurance from the British Government that any future depreciation of the value of sterling would not affect the value of sterling possessed by India and that to ensure this the accumulation was to be related to the U.K. price index at the average rate prevailing when the sterling was acquired. An assurance was also sought from the British Government that the sterling would be freely convertible after the termination of the war, to finance India's purchases abroad. Sir James remarked that 'obviously the brain wave behind the resolution was that it would enable India both to eat its inflationary cake and have it, that however much prices might be pushed up by inflation it would not matter because the assets would be going up *pari passu*'. After the discussion had 'rambled on' for an hour, the Governor pointed out that any constructive suggestions which the Board wished to make might be on the lines of his memorandum, 'namely, that Government should start at once to examine and correlate schemes for post-war reconstruction, particularly those requiring foreign assets, as there would undoubtedly be a tremendous scramble for productive machinery after the war, and no country whether it happened to be a creditor or not in its own petty way would be able to get priority unless it could establish a case based on the common good'. The terms of the final resolution were to be finalised at a meeting of the Committee of the Central Board on February 10. The resolution as adopted by the Committee (which was in fact a Committee of the whole Board, since as many as eleven Directors were present) was as under:

The Central Board of the Reserve Bank are concerned at the rapidly growing volume of the Bank's external assets exclusively in the form of sterling (apart from the small holding of gold), the bulk of which represents a curtailment in current consumption by the country in the interests of the common war effort, notwithstanding India's backward industrial development and its low standard of living, and with a view to safeguarding the value of these assets and arranging for their utilization after the war to India's best advantage, the Board would recommend to Government -

- (i) That they draw up in consultation with business and commercial opinion in the country a considered programme of development and reconstruction for India for the post-war period and frame in connection therewith as approximate an estimate as is possible of her requirements of capital and other goods and the sources from which they can be most speedily and suitably secured, and
- (ii) that they concert with H.M.G. equitable safeguards for ensuring that these assets, or their equivalent in foreign currency, will be available to India on a basis which will not involve a loss to India in the value of the accumulated sterling.

Curiously, a report on the Central Board's deliberations on the above subject was sent to the India Office by the Finance Department only

as late as May 10, 1943, apparently after receipt of a telegram that day from the India Office, referring to the indications that inflation was developing in India and asking for a brief statement of what steps had been taken or were in contemplation, 'for drawing off purchasing power or providing outlets for it or regulating supplies and prices', including important measures considered but rejected.

In its reply to the above telegram, the Finance Department sent a telegram and also a longish note, discussing the question whether and at what rate potential inflation develops into actual inflation apparently, in the opinion of the Government actual inflation had not yet occurred! The note referred to the factor of the psychology of the population and in this connection drew attention to 'widespread underground propaganda' by the Congress party to 'destroy' confidence in the currency. It was mentioned that this campaign had been actively supported by big business and financial interests. The note also referred to the 'huge press campaign' initiated by the publication of Professor Vakil's pamphlet *The Falling Rupee*, 'which on political grounds developed into an out and out scare publicity aimed at compelling Government to curtail India's war effort'. The note said that the cumulative result of the above was the emergence of a hoarding mania. Reference was also made to the difficulty of imposing direct controls on distribution and prices of essential commodities. Finally, the note referred to an Ordinance that had been issued on May 17 to speed up the process of collection of excess profits tax in order to draw off a part of the surplus purchasing power seeking avenues, largely speculative, of short-term investment. In reply, India Office sent another long telegram on June 10, 1943, suggesting further measures for consideration of the Government for intensifying the resources mobilisation. The telegram concluded as follows:

While I am conscious that there probably are objections to all above expedients, there are also such grave objections, political as well as economic, to allowing inflation to take charge, that I feel we must face question as one of a choice of evils and not necessarily rule out measures which are per se unpalatable or even potentially dangerous if they offer prospects of escape from something on balance even more disagreeable or dangerous.

One such measure which it was decided to adopt was the sale of gold and silver in India, and sales of gold actually began on August 16. The borrowing programme was also intensified. These matters are dealt with in some detail in Chapter 11.

The Directors' annual report for the year 1942-43, issued in July 1943, also recognized the presence of inflation in the economy, in less ambiguous terms than the earlier report; of course, by this time

inflation had become much more pronounced. In his speech to the shareholders, the Deputy Governor (Mr. Deshmukh), then in charge of duties of the Governor, referred to the far-reaching shifts in economic position of the different classes of the population, and especially the deterioration in the position of people with fixed incomes, as a result of the steep rise in commodity prices and the need for corrective action, in the following terms:

The public has received directly or indirectly assurances from the highest Governmental quarters that energetic measures are being planned and put into operation to remedy the situation. These assurances are received none too soon; for with the social sense of the population imperfectly developed, as is unfortunately yet the case in the country because of its size and diversity, inequalities in the real sacrifices imposed by war conditions on the community can only be corrected by vigorous Governmental action, both constructive and regulative; and, in the alarms and excursions of war, 'everyone for himself and the devil take the hindmost' becomes a perilously attractive philosophy of life. Anti-social tendencies flourish in an inflationary atmosphere Speculative tendencies can, therefore, be effectively regulated only if efficacious measures are adopted to ensure an enlarged supply of essential goods to meet the minimum needs of a large population and are combined with measures to encourage genuine and voluntary savings, as well as direct measures to regulate the distribution and prices of essential commodities. This is particularly important having regard to the real difficulties of direct control in our country with its size and diversity of local conditions, the small scale and unorganised character of her productive and distributive systems, the extremely low standard of literacy and account-keeping as well as the lack of proper economic statistics and indices.

Rupee Loan to His Majesty's Government?

Earlier, a reference was made to a proposal by Sir Purshotamdas Thakurdas that a rupee loan be made to the British Government by the Government of India and Sir James Taylor's opposition to it. In the light of the possibility of substantial cash balance accumulation as the combined result of large scale market borrowing, large refunds of Recoverable War Expenditure, provisional collection of the E.P.T., and transfer to Government account of a part of the proceeds of official gold sales, Governor Deshmukh revived in November 1943 the suggestion in the form that Government should lend their surplus funds to the British Government as a ways and means advance. Such an advance would not affect the figure of Government's cash balances with the Bank, since the British Government did not have any separate account with the Bank; it could be shown merely as a book entry in Government's accounts. The advance might carry interest at a rate which might be the average for all borrowings of Government, say

2 ½ per cent and might be made repayable after twelve years. The arrangement, if implemented, would have had the same effect as if the British Government had borrowed in India themselves and slowed down the pace of sterling accumulation.

The Government of India, however, did not consider certain features of the proposed arrangement attractive from political and accounting aspects. The merger of the two balances, they feared, would lead to 'a lot of misinformed criticism'. They therefore suggested opening of a separate account for the British Government by the Reserve Bank. They also considered it essential that any loan or advance granted by the Government of India to the British Government should be included in the demand dealing with 'loans and advances by the Central Government' and put to the vote of the Legislative Assembly. The Bank gave its consent to have a separate account in the British Government's name in its books. The proposal was cabled to the Secretary of State on November 16, 1943. While forwarding the proposal, Government tried to impress on the Secretary of State that the Government were faced with the problem of preventing their cash balance rising beyond a certain limit and that the object of Government's surplus market borrowing was to counter inflation, which had resulted from the procedure adopted for financing the British Government's expenditure in India. If they had borrowed direct in India, it would not have been necessary for the Government to raise loans on such an extensive scale.

The Secretary of State replied to say that he did not understand what particular embarrassment Government had from an abnormal rise in cash balance and why Government could not repurchase from the Bank a substantial block of other rupee securities held in the Issue Department and cancel them since only Rs. 2 crores of ad hocs were left. As regards the proposal regarding a loan to be taken by the British Government from the Indian Government, the Secretary of State commented:

Seeing that safeguarding of India's economic position dictates maximum borrowing on part of Government of India, suggestion that Treasury here should take a ways and means advance from you at say two and a half per cent seems to us tantamount to a suggestion that they should finance to that extent the cost of your anti-inflation campaign.

The cable was forwarded to the Governor by the Finance Department with a request to suggest an effective reply. The reply suggested by the Governor was:

(I) High balances embarrassing because of the attention they must focus on our apparent indifference to the just incidence of the cost of raising rupees for H.M.G's war expenditure.

(2a) Apart from the inadvisability, which we should have thought was obvious, of holding the backing to Indian currency almost wholly in sterling, we expect the Reserve Bank to object strongly to parting with their rupee securities which they use for the purpose of regulating the money market.

(b) Taking over the Bank's sterling will imply currency expansion against ad hoc treasury bills, i.e., undisguised Central Bank credit inflation. In essence, problem remains the same, viz., that the cost of countering the inflation caused by the method of financing H.M.G.'s war expenditure falls on India.

(3) Since current requirements of H.M.G. are met by recourse to the inflationary currency printing press, the argument that cost of fighting inflation should be borne by India appears almost cynical. In view of uncertainty about liquidating heavy accumulations India could fairly refuse to accept any more sterling and ask H.M.G. to raise the rupee finance required by direct rupee loans in India. Would the Treasury be prepared to consider this alternative?

The Secretary of State cabled back on January 4, 1944, stating that 'matter under reference to Treasury but it may be little time before decision is reached'. No decision was reached and Government balance with the Reserve Bank went up to Rs. 481 crores by the end of 1945, which was several times larger than Government's indebtedness to the Bank, in the form of the latter's holdings of Government securities of Rs. 83 crores.

Attempts to fix a Ceiling to Currency Circulation

In the Central Board, some Director or the other kept on taking an active interest in the matter of sterling accumulation and inflation. At the April 1944 meeting of the Board, Mr. Kasturbhai Lalbhai wished to move a resolution as under:

The Board of Directors of the Reserve Bank of India consider it essential to fix the maximum limit to currency expansion. Before taking the decision, however, they require the Governor to find out if the Government of India have any suggestions to make.

Apparently, the Board did not wish to pass a resolution not likely to be acceptable to Government! As no previous notice had been given and as there was inadequate time, the matter was postponed for discussion at the next meeting of the Board. The Governor (Sir C. D. Deshmukh) conveyed this to the Finance Department. The Finance Department sent a long letter to the Governor in May 1944 expressing Government's serious concern at the continued currency expansion, but pointing to the objections to setting an arbitrary limit to the expansion of currency or sterling accumulation, which would in effect set a limit to India's contribution to the war effort. It was clearly in India's

interest to bring about a speedy termination of hostilities. The Government desired that the Governor discuss the whole matter informally with the Board in the hope that Mr. Kasturbhai Lalbhai might be persuaded not to move the resolution but rather the Board might ' pass a resolution urging the maximum possible support for Government borrowings of all kinds, including small savings '. The Finance Department also wanted the Board to examine possibilities of further efforts to draw off extra spending power from the public.

The Finance Department also dealt with the difficulty in the British Government's giving at that stage any hard and fast guarantee with regard to the value of sterling balances, as proposed in the Central Board's resolution of February 1943. Such arrangements, it was stated, would probably have to provide for reduction in the balances should sterling appreciate after the war. The communication concluded with the words ' every effort would, however, continue to be made to keep the accumulations of sterling as low as possible whilst maintaining India's effort at the minimum pitch which the desirability of the speedy termination of the war demands '. Meanwhile, the subject of sterling balances got merged to an extent with the discussions on the currency plans and arrangements for international monetary co-operation in the post-war period, for which proposals had begun to be made as early as from 1943 (see Chapter 14).

Mr. Kasturbhai Lalbhai's resolution actually came up before the Board only at the December 1944 meeting. First, Mr. Lalbhai himself preferred some postponement as the Governor was out of India. The Board was also busy with the important matter of post-war monetary plans. Of course, the Government themselves wanted the matter to be delayed if they could not succeed in persuading Mr. Lalbhai not to move it! Mr. Lalbhai's resolution recommended to Government that they take such steps as would limit the total note liability of the Reserve Bank to Rs. 1,200 crores (the note issue at that time was Rs. 981 crores), and that in particular the British Government be requested to find the rupees for their disbursements 'either by raising local loans, or by the transfer of gold or silver or other assets, readily saleable in India, at world parity prices '. The resolution that was finally adopted, after considering an amendment moved by Mr. B. M. Birla, was as under:

That the Board is of the opinion that the expansion of currency that has been continuously taking place in India as a result of the method which has had to be adopted for the financing of Allied war expenditure has approached a level beyond which it may prove disastrous to the larger interests of the country, by reason of the inflationary trends it creates. In the opinion of the Board it is imperative to check these trends forthwith. To this end the Board recommends to the Government

of India that in order to enable the Reserve Bank to limit their further note liability to the barest minimum possible as well as to arrest effectively further accumulation of sterling they take the following steps:-

- (a) make renewed efforts to stop the export of essential manufactured articles and raw materials of which there is shortage in this country; and
- (b) to request His Majesty's Government to find, as far as possible, the rupees for their disbursements in India by
 - (i) the sale of gold and silver in India and
 - (ii) the facilitating of the supply of capital goods to India at fair prices.

It will be seen that the resolution deleted the reference to the limit of Rs. 1,200 crores for currency expansion; likewise, the suggestion that the British Government raise loans in India was also dropped.

The Finance Secretary desired that the word 'disastrous' in the above resolution should be toned down, though he did not press the point. The Governor replied that as it was, he had had difficulty in getting the Board accept amendments to the original draft and he felt himself unable to suggest to the Board further amendments. The Governor consoled the Secretary by saying that:

After all, the meat of the resolution lies in the concluding portion, and the verbiage of the introductory portion does not seem to me to matter very much from the point of view of either Government or the Reserve Bank.

The subject of inflation or sterling balances did not again come before the Board formally till about the early months of 1946.

Accent on Government Borrowing and Economic Controls

From 1943 onwards, Government's principal measures to deal with the inflationary situation were (i) intensification of the borrowing programme, including small savings and (ii) substantial reliance on controls over prices and distribution of essential commodities. In his speech introducing the budget for the year 1943-44, while the Finance Member echoed the Governor's views on the nature of the inflationary situation in India, Government embarked on a substantially larger borrowing programme. Whereas in the years 1940-43 net market borrowing amounted to Rs. 260 crores, in the next three years, that is, 1943-46, the figure was as much as Rs. 809 crores. In the case of the small savings schemes, the improvement was even more marked. In the three years 1940-43, there was a net withdrawal of funds by investors to the extent of Rs. 43 crores but in the following three years (1943-46) Government collected a net sum of Rs. 129 crores. In the six years 1940-46, net market borrowing amounted to Rs. 1,068 crores and small savings receipts to Rs. 86 crores. The two together were about Rs. 150 crores larger than the aggregate receipts on tax revenue account.

The performance of India in respect of borrowings compared not unfavourably with that of the U.K. or of the U.S.A. In respect of tax effort, however, India's performance was much less impressive than that of the other two countries. Consequently the percentage of funds raised in the form of money creation was much higher in India. The result was a substantial rise in commodity prices.

In India, as in many other countries, Government resorted to various physical controls during war time to ensure proper distribution of essential commodities at reasonable prices, curb speculative tendencies and prevent diversion of scarce resources for inessential purposes. The scope of the controls was widened from 1943 onwards. The Governors of the Bank backed the use of physical controls, to supplement fiscal and monetary measures in combating inflation. Control measures had also the support of the academic economists; in fact, their general view was that Government were not going far enough in this matter.

Soon after the outbreak of war, the Government of India armed themselves with powers to regulate prices under the Defence of India Rules, and by a notification dated September 8, 1939 they empowered Provincial Governments to fix prices of essential articles, such as, foodstuffs, kerosene, cheaper varieties of cloth and medical supplies. These regulations were generally allowed to be inoperative as the rise in prices during the early stages of the war was quite moderate. However, from 1942 onwards close attention came to be paid to the institution and administration of controls, especially in respect of essential items like foodgrains and cloth. Controls were also imposed during the war on transactions in shares and bullion and on capital issues.

It is beyond the scope of this volume to go into the details of the control measures. Perhaps it would suffice to say that the administration of the various controls was far from satisfactory and that they were evaded in many ways in letter and spirit, although the extent to which this happened varied from commodity to commodity. However, in their totality it would seem that they did help curb the rise in prices; and this was particularly so in the case of cloth. Over a period of about two years from the middle of 1943 the general index of wholesale prices recorded hardly any net variation, the fluctuations during this period being very narrow. The index for August 1945 was 241.5 as compared to 243.4 for June 1943. It should be mentioned that in these two years the expansion of money supply also slowed down in absolute terms as well as percentagewise. In the financial years 1943-44 and 1944-45 the expansion was Rs. 428 crores and Rs. 300 crores or 37 per cent and 19 per cent, respectively. Further, from 1944 onwards, imports were substantially stepped up. Thus, in the years 1944-45 and 1945-46 imports amounted to Rs. 201 crores and Rs. 245 crores,

respectively, as compared with Rs.119 crores and Rs. 110 crores in the earlier two years 1943-44 and 1942-43.

Overall Inflationary Impact

Taking the period of six years 1940-46, approximately 55 per cent of the combined outlay of the order of Rs. 4,000 crores, on account of the Government of India and the Allies, was financed in a non-inflationary way, that is, through current revenues and borrowing from the public. * Because of the high proportion of deficit financing, there was substantial monetary expansion of the order of 400 per cent. Data on India's Gross National Product for the war years are not available. However, the growth of GNP must have been of a modest order, for agricultural output did not record any major change during the war years as a whole, and the increase in industrial output was less than 20 per cent. The situation thus was inherently one leading to a substantial rise in commodity prices. The general index of wholesale prices at the end of March 1946, at 254, represented a rise of 100 per cent over March 1940 and about 150 per cent from about the time the war began in September 1939 (see table below). The official index no doubt underestimated the extent of the rise; for, on account of the partial success in administering price controls, the prices used for the compilation of the index did not fully reflect the true level of prices which had to be paid. It would also appear that to an extent there was a decline in the velocity of circulation of money- both deposits and currency. Besides increased cash holdings by banks, hoarding of currency by the public must have occurred on a significant scale, not only for purposes of tax evasion but also for owning an asset which had been scarce for the rural population in particular during the long years of depression.

International economic comparisons are difficult even with the advances in data availability and analysis in the last twenty-five years; it would be hazardous to make such comparisons for the war period. Even so, a few remarks on the pattern and consequences of war financing in the U.K. and the U.S.A. could be hazarded. Broadly, in both the countries, as compared with India a much larger share of Government expenditure was met by taxation and genuine borrowing (90 and 75 per cent); the monetary expansion was considerably smaller (180 and 150 per cent); there was also significant growth of GNP in real terms, especially in the case of the U.S.A., of the order of 75 per cent, the rise in the U.K. being 23 per cent. In the result the extent of rise in the general price index was smaller in those two countries than in India. Using the statistics published in the Annual Report of the Bank

* Investment of banks in Government securities to the extent of the increase in their time deposits is treated as non-inflationary financing.

SELECTED ECONOMIC INDICATORS

Last Week	(Rs. crores)										
	Bank Credit to Government*			Sterling Securities			Money Supply†		Wholesale Prices		
	Outstanding	Variation over previous March	Outstanding	Variation over previous March	Outstanding	Absolute	%	Absolute	Index (Week ended Aug. 19, 1939 = 100)	Variation over previous March	%
March 1939	6		74		339				100.3		
August 1939	39		67		327				127.5		
March 1940	4	- 10	142	68	425	86	25.3		118.8	- 8.7	- 6.8
" 1941	105	109	144	2	515	90	21.2		145.6	26.8	22.6
" 1942	216	111	248	104	683	168	32.6		219.8	74.2	51.0
" 1943	332	116	509	261	1,148	464	68.0		233.5	13.7	6.2
" 1944	193	- 139	946	437	1,576	428	37.3		248.1	14.6	6.3
" 1945	11	- 204	1,363	417	1,876	300	19.0		241.5		
August 1945	61		1,507		1,955				254.2		
March 1946	241	- 230	1,724	361	2,120	244	13.0			6.1	2.5

Variation of

(i) Aug. 1945

over Aug. 1939

(ii) March 1946

over March 1940

141.2

140.8

1,628

498.4

1,440

2,151.4

- 100

- 237

126.7

99.4

* Bank credit to Government is the total of (i) holdings of Government Securities of the Reserve Bank and the scheduled banks and (ii) Reserve Bank's loans and advances to Central and Provincial Governments, less (i) deposits of Central and Provincial Governments with the Reserve Bank and (ii) time deposits of scheduled banks.

† Data relating to rupee coin in circulation are not available prior to October 1943. Monthly figures of absorption or return of rupee coin are, however, available, and on the basis of these, figures of rupee coin in circulation have been worked backwards from October 1943; these have been used for arriving at figures of money supply with the public. However, it would appear that pre-October 1943 rupee circulation figures are underestimated; hence the percentage variations of money supply given in the chapter calculated on the underestimated base figures are somewhat overstated.

for International Settlements, whereas the increase from January-June 1939 to December 1945 was 186 per cent in India (Calcutta), in the U.K. and the U.S.A. the rise was only 74 per cent and 40 per cent, respectively.

Everything considered, that is to say, the low standard of living of the masses, the magnitude of the effort that was demanded of the country, the troubled political situation and the difficulty of administering an effective system of price and distribution controls, it would appear that India did not fare too badly in its fiscal effort. The economic and social distress caused by inflation had the alleviating feature that at the end of the war the country was in possession of a substantial volume of sterling assets, offering great scope for economic development in the post-war years.