12

Exchange Control

One of the areas of economic policy wherein advance preparation had been made by most countries prior to the outbreak of World War II was exchange control; consequently, it was possible to introduce the control immediately on the outbreak of war. This was so in India too, though control was considered necessary not on grounds of shortage of foreign exchange in general -it was the other way about -but for conserving non-sterling area currencies, especially the U.S. dollar. The scheme formulated for India was intended to be a part of a much larger and integrated plan of control devised for what came to be known as the 'Sterling Area', co-ordination being exercised by the British Treasury and the Bank of England. The control was to be administered by the Reserve Bank as agents of the Government of India. The relevant notifications were issued by the Government under the Defence of India Rules and the Sea Customs Act, 1878, from time to time; a separate Foreign Exchange Regulation Act was passed only in 1947, The Bank exercised control through instructions issued to the public and the authorised dealers in foreign exchange and bullion in the form of circulars, public notices, etc. The directions in which control was required were a matter for decision by Government, but the Reserve Bank's advisory role was an important one; a great deal of initiative in this matter lay with the Bank.

Throughout the war, exchange control was confined to transactions with non-sterling area countries, the currencies of which, particularly U.S. dollars, had to be conserved for purchases of essential war materials. Thanks to the elaborate advance preparations, the system of control was quite comprehensive even at its inception, although there was considerable evolution and widening of its scope in the light of experience and the special circumstances created by the different turns in the war. By the time the war neared its end, the control had become fairly well established, in the sense that many loopholes had been located and plugged and there had been an effective contribution to the Allied war effort by way of the substantial dollar surpluses made over to the sterling area's dollar pool.

Mention should also be made here of the Bank's efforts for the segregation of India's contribution to the Empire Dollar Pool with a view to ensuring its ready availability for post-war reconstruction and development. While this objective was not achieved, the Government of India succeeded in getting the U.K. Government to agree to earmark some sterling which would be convertible into dollars for meeting post-war requirements. These developments are covered in a separate section at the end of this chapter.

After the war, there were gradual relaxations in the control system in the developed countries, particularly as regards current transactions. But in the developing countries like India, generally, exchange control was not only retained but was made more and more stringent; indeed, it has become a part of the permanent apparatus of planned economic development. Although the scope of the control in India has undergone several changes, its basic structure has remained what it was during the war time.

The First Steps

The first move towards devising a system of exchange control for the sterling area was made in April 1939. With growing tension in Europe, the Governor of the Bank of England, in consultation with the British Treasury, felt it necessary to address confidentially his counterparts in the central banks of all the Dominions and India, detailing the regulations that the British Government proposed to put into force in the financial sphere in the event of outbreak of a war involving the U.K. The object of the regulations was to conserve the country's resources in gold and foreign exchange and apply them to meet national needs. The proposal made by the Bank of England was that all the countries of the British Empire (with the exception of Canada, Newfoundland and Hong Kong, which had closer financial and trading relations with other countries than with the U.K.) should adopt similar measures of exchange control in respect of their dealings in currencies other than those of the Empire and that all their earnings and disbursements of these currencies should be centralised in London. That is to say, all the foreign exchange accruing to these countries known collectively as the sterling area would go into a general pool under the control of the Bank of England, and out of that pool the Bank of England would provide foreign currencies to meet the requirements of any part of the sterling area. The first enquiry of the Bank of England was whether India would be in a position to establish a system of exchange control, enabling her to be admitted to the sterling area in which financial transactions between member countries were as far as possible to be free.

Sir James Taylor's first reaction to the proposals was typical of the concern he always had for India's interests. Judging by the experience of World War I, India herself, he felt, would have no difficulty in maintaining her rate of exchange as war conditions would lead to an intensified demand for her exports and a slackening of imports owing to a reduction in the supply of goods for civilian consumption from belligerent countries, shipping difficulties, etc. ' If history is any guide at all', he wrote in May 1939 to the Governor of the Bank of England, ' everything points to our ultimate difficulties being not to maintain exchange at its existing level but to prevent it from rising above the present statutory limit . . . . . ' The Bank of England was informed that while India would be prepared to come into the sterling area arrangements, a rigid system of exchange control from the outset would be difficult to enforce as well as undesirable, as that would create the feeling that the central bank was doubtful of its ability to maintain the rupee on an even keel, and this in turn would lead to an increased demand for remittance and probably also gold for hoarding. Besides, India had large overseas commitments in respect of debt servicing, repayment and also private remittances. In order to ensure the necessary exchange to meet these commitments, there had to be the least possible interference with legitimate trade. Again, since the bulk of India's financial operations, private as well as official, were being conducted through London, there were adequate safeguards in the proposed U.K. regulations against irregular transfer of the funds to third countries. Furthermore, as there was every likelihood of her maintaining a favourable balance of payments throughout the war, the non-introduction of exchange control in India on the scale contemplated in Great Britain could not be a material objection to her admission to the sterling area.

The Governor, therefore, considered that the control in India would be adequate if it guarded against loopholes through which transactions which were unauthorised under the U.K. regulations could pass unchecked. This objective was to be secured thus: in respect of sales of sterling, which would not be subject to any restriction, banks which would be authorised to deal in foreign exchange would be instructed to maintain complete records of all transactions, and as regards other foreign currencies banks would provide exchange only for legitimate trade purposes, so that the banks would be put on enquiry if it was found that they were acting contrary to the prescribed arrangements. It was also suggested by the Governor that a War Trade Department should be set up which, in the light of events, might consider it necessary to introduce a system of rationing of imports; in that case, licences would be issued by them and the Reserve Bank could regulate the corresponding releases of foreign exchange.

On the side of exports, the Governor considered it sufficient for the Control to purchase the proceeds of exports to the extent to which they were offered for sale in the open market. The foreign currency proceeds of exports from India to the non-sterling area countries would accrue in any case to the sterling area as a whole, strengthening the area's external reserves. At the same time, the Governor saw some justification for the Bank of England's fear that if the Indian regulations were less exacting than those imposed in London, the tendency might be for exchange transactions with the rupee to be effected outside the sterling area on an increasing scale. The Governor, however, considered that the existing organisation of India's foreign trade made it impossible to institute a system of export licences coupled with a regulation making it necessary for everyone acquiring foreign exchange as a result of export (or other transactions) to offer the exchange to the Reserve Bank. The object had, therefore, to be to ' make India as a whole a source of strength to the sterling area rather than weakness, without endeavouring to tighten control to such an extent that it might defeat its own object ' .

As regards other financial transactions, e.g., personal remittances on current account, foreign travel and capital transfers, the same procedure as was adopted with regard to trade would generally be followed so that, while not imposing the same measure of control as was proposed in London, the regulations would provide an adequate check on undesirable movements of funds. If the measures introduced initially proved to be inadequate, there would be no insurmountable difficulty in stiffening up the control later to any extent necessary. As for transactions in bullion, the Governor did not consider it necessary to go beyond licensing of imports and exports thereof at the outset, any further restrictions being left to be decided as the situation developed. Calling for declaration of holdings beyond a limit to be specified and requiring banks to report all advances against bullion would put the Bank in a position to take effective action immediately on its being required.

The Bank of England, despite the Governor's assurances of the fullest co-operation consistent with Indian conditions, did not agree. The Bank made it clear that admittance to the sterling area without the establishment of a complete system of exchange control was not possible. In the words of Mr. Montagu Norman, the Governor:

> Our own ideas incline towards stringency. In principle, we think it will be best, this time, to get the whole position under control at the outset,and then see in which directions it may be possible to relax.

> We cannot look forward, as you can, to a strengthening of exchange in an emergency; but we expect to have ample resources if they can be reserved for national needs. Our main preoccupation is therefore to prevent their being dissipated, and this can only be done by a control which extends to all possible methods of evasion. As you clearly realise, one of our stable doors -to which you have the key -is in Bombay.

The Bank of England also stated that as long as there were no restrictions on transfers between London and India, it would be possible for residents in the United Kingdom who had been refused foreign exchange to transfer sterling to India and buy their foreign exchange there. As a consequence, India would provide a loophole for the escape of sterling funds outside the sterling area. The fact that India herself had a favourable balance of payments was immaterial as the balance might be reversed owing to the weight of remittances through her by other countries in the sterling area. In addition, the Bank of England considered that a strict control on dealings in bullion would be necessary.

The matter was, of course, one of policy and for the Government of India to decide; Government, whom the Governor kept apprised of the exchange of correspondence with the Bank of England, supported his views, especially in view of the likely adverse political repercussions in India of introducing a stringent system of controls right at the outset. The Finance Member (Sir Jeremy Raisman) made these views known to the India Office. In view of the importance and urgency of the matter, the Governor paid a visit to London in July 1939 to work out an agreement. After detailed discussions with the Bank of England officials and India Office and in consultation with the Government of India, it was ultimately agreed to adopt a stringent system of control on the lines proposed for the U.K.

The Control System in Outline

The system of exchange control to be established was as follows:

Powers were to be taken by the Government of India under the Defence of India Rules (these Rules were set out in Part XIV Financial Provisions):

(a) to prohibit the acquisition of foreign exchange either directly or indirectly or the dealing in foreign exchange by residents in British India except under their authority (Defence of India Rule 91);

(b) to require residents in British India to declare their belongings of foreign currencies and foreign securities and on the issue of special orders to surrender them (Defence of India Rules 92 and 94);

(c) to prohibit the acquisition by residents of securities from persons resident outside India or the export of securities from India except with their permission (Defence of India Rule 93) ; and

(d) to prohibit dealings in bullion except under their authority(Defence of India Rule 91).

The Government we're also to prohibit the export and import of gold except under licence from the Reserve Bank (this was to be done by a notification to be issued by Government under Section 19 of the Sea Customs Act, 1878).

Action on these lines was taken immediately after the outbreak of the war, that is to say, on September 3, 1939, when the Defence of India Ordinance and the Rules framed there under were issued. The authority to deal in foreign exchange, to empower other firms to deal in foreign exchange and to license the acquisition of foreign securities, the export of securities and dealings in bullion was transferred to the Reserve Bank by a notification* issued on September 4. The licensing of imports and exports of gold coin and bullion was also delegated to the Reserve Bank.

The administrative action taken by the Bank under these powers is indicated in the following paragraphs. 'Foreign exchange' as defined in Rule 91 (1) of the Defence of India Rules meant any currency other than currency which was legal tender in India or Burma†. Rules 91 to 95 therefore applied to all currencies other than the rupee. General permission was granted by the Bank for purchases and sales of sterling‡ by the public from and to the authorised banks and for the acquisition of sterling securities. Rules 92 and 94, which provided for compulsory acquisition by the Government of foreign exchange and foreign securities, respectively, were not intended to be enforced immediately. The system contemplated was similar in form and scope to that introduced in the U.K., except that in the latter country all private holdings of specified foreign currencies and gold had to be surrendered to the Treasury and private dealings in gold were prohibited.

Sir James arranged to get the drafts of the preliminary instructions to banks on exchange control, in the event of an outbreak of war, and the various specimen forms of applications, returns, certificates, etc., approved by the India Office and the Bank of England before he left the U.K. The Bank's offices were to issue them immediately on receipt of intimation from Government regarding receipt of war telegram from India Office and promulgation of the Defence of India Ordinance. As

* Finance Department Notification No. 123-SRB.

† The words 'or Burma' were deleted on June 6, 1942.

‡ In addition to sterling, currencies of all the Dominions (except Canada, Newfoundland and Hong Kong), Colonies and Protectorates were to be treated on the same basis as sterling. Currencies of all' other countries as also the three excepted Empire currencies mentioned above were to be treated as 'foreign currencies'. Thus, the terms 'Empire currencies' and 'non-Empire currencies' (or 'foreign currencies ') were used synonymously with the terms'sterling area currencies' and 'non-sterling area currencies ', respectively.

identical measures were to be introduced in Burma also, it was arranged with the Government of Burma for simultaneous issue of instructions to the Manager of the Rangoon Office of the Bank.

From the records it would appear that the Central Board was not formally consulted at any stage during the preliminary discussions; the Governor informed the Committee of the Central Board at its weekly meeting held on September 8, 1939, that 'following the outbreak of war the Central Government had taken powers to control transactions in foreign exchange and had by notification appointed the Reserve Bank as their agents to exercise these powers'. He also mentioned that as the work developed special staff arrangements might become necessary, for which he would approach the Committee in due course, and that the question of payment of any extra charges incurred by the Bank in this connection was left open for settlement with the Government of India later. Subsequently also, the practice was -and this continues to the present day -for the management to apprise the Central Board (or the Committee) of important developments from time to time, rather than to obtain its formal concurrence to each major change in policy, as the Board was not responsible for the framing of exchange control policy. Of course, as in other cases, energetic Directors sometimes had their own points to make on one or the other aspect of the control, which helped in a fuller study of the relevant problems being made with a view to making the control more effective while at the same time minimising inconvenience to the public.

The notice to banks, which was addressed to all scheduled banks, was very elaborate. The covering letter drew their attention to the Financial Provisions of the new Defence of India Rules and explained that transactions in foreign exchange could only be made in accordance with the special notice attached. The notice embodied the following instructions and information.

First, it stated that the Reserve Bank had been authorised by Government. to deal in foreign exchange, to license other banks or persons to deal in foreign exchange and to issue directions to these ' authorised dealers ' regarding such transactions from time to time. In exercise of these powers, the Bank was prepared, on application made to it, to grant licences to deal in foreign exchange to banks which had offices in British India, were included in the Second Schedule to the Reserve Bank of India Act and had exchange dealings with the Reserve Bank in the past. This stipulation limited the granting of licences to banks with some experience of foreign exchange transactions and which were therefore unlikely to break the regulations through ignorance of exchange matters.

Secondly, general limits for the foreign exchange operations of licensed banks were laid down. These were briefly as follows:

(a) Purchases and sales of sterling were allowed without restriction subject only to the general prohibition of trading with the enemy and with enemy firms;
(b) Purchases of foreign currencies (i.e., currencies other than sterling) were allowed freely;
(c) Sales of foreign currencies (i.e., other than sterling) could only be made to persons who had made applications to an authorised bank on prescribed forms. These forms had later to be submitted to the Reserve Bank. Sales could be made for the purposes of meeting reasonable trade or business requirements, performing contracts made before the outbreak of the war and defraying reasonable travel or other petty personal expenses;
(d) In the case of purchases of sterling for ultimate transfer into other currencies, authorised dealers could sell sterling freely but they had to certify to their London offices or correspondents, the correctness of the statement made by the applicant regarding the purpose for which the exchange was required, to enable the U.K. authorities to consider providing the necessary exchange (the supply of foreign exchange against sterling was entirely a matter for the U.K. authorities, the certificate conferring no right on the purchaser in this behalf) ;
(e) Forward transactions in exchange were allowed provided they were limited to bona fide commercial purposes;
(f) Rupee transfers to the credit of the accounts of foreign banks were permitted provided the transactions were reported to the Reserve Bank on the appropriate form; and
(g) The opening of foreign currency accounts (i.e., other than sterling accounts) for private persons in India was prohibited.

To begin with, no restriction was imposed on imports; foreign exchange was provided freely for all goods arriving into India. The Bank had also made it clear to Government that any such restriction, if found necessary later, should be introduced through the medium of a prohibition under the Sea Customs or other Act accompanied by a system of licensing to be administered by a Government department. The Bank would then dovetail this into its scheme of exchange control.

The notice to banks and leading bullion dealers advised them that while domestic dealings in gold were being allowed to be continued freely, the Central Government had prohibited the import and export of gold coin, gold bullion and ingots except under a licence from the Reserve Bank and that such licences would only be issued to approved banks and dealers who had been duly registered as authorised dealers by the Reserve Bank. Registration as authorized dealers in gold would be done on application being made to the Reserve Bank subject to the condition that returns of the amounts of gold held and purchases and sales effected during each week were submitted regularly. The reason for the establishment of this system of registering dealers in gold was to comply with the wishes of the Bank of England which was afraid that an uncontrolled bullion market operating in India might lead to the evasion of exchange control. The system of registration was, however, discontinued after a brief trial as it was found to serve no useful purpose. It was also announced that (i) licences would be issued freely to authorised dealers for imports or exports of gold from or to the U.K., (ii) in order to comply with the U.K. regulations, the exports should be consigned to the Bank of England or to a dealer authorised by that Bank and (iii) the Reserve Bank was prepared to make arrangements to facilitate such exports. As for exports to or imports from other non-hostile countries, licences were to be granted subject to such conditions as the Reserve Bank might consider necessary in each case, e.g., in the case of exports, the exporters might be required to offer the foreign exchange proceeds thereof to the Reserve Bank against payment in rupees at rates to be intimated by it.

An explanatory memorandum was also issued for the information of the public, indicating the salient features of the control over transactions in foreign currencies and the import and export of gold. The public were also advised that while they should continue to deal direct with their usual bankers, all dealings in foreign currencies, including sterling, must be made through authorised dealers in foreign exchange.

All the notices were issued by the Bank on September 4, 1939, immediately after the Government's notification of the same date empowering the Bank to discharge on their be half the various responsibilities in regard to control of dealings in foreign exchange and bullion was issued.

It was mentioned in Chapter 9 that the intricacies of the administration of exchange control required that a separate department be set up to tackle it with expedition and competence. The Managers (who were ex-officio Assistant Controllers) were told that until a comprehensive set of instructions could be framed, they should interfere as little as possible with the customary methods of doing business, so long as they had no reason to suspect that these were likely to lead to evasion of the objects of the control. An important function of the Exchange Control Department was to keep in close touch with the Censorship of the Posts and Telegraphs, and the Enemy Trading and Enemy Property Departments, so as to get wind of possible loopholes and evasions.

The initial instructions issued by the Bank in respect of exchange control as well as those issued from time to time modifying, deleting or adding to them were codified and published in the form of an

Exchange Control Manual in June 1940; revised editions of the Manual were issued from time to time.

It should be of interest to note briefly the major points of difference between the Indian and the U.K. controls. In the U.K., licences to deal in foreign exchange were limited to a few leading British joint-stock banks, whether or not they had transacted foreign exchange business before. The authorised dealers operated as direct agents of the Bank of England, and all their transactions had to be conducted at the actual buying and selling rates for each currency as fixed by it. The exchange difference was retained by the Bank of England but the authorised dealers were permitted to charge commission on each transaction to their customers. On the outbreak of war, all the banks had to surrender their foreign currency balances to the Bank of England, which thereafter released reasonable amounts to them as working balances.* The system established in India was a more loosely-knit one; this to some extent was due to the vast size of the country and the less developed banking organisation but, more importantly, because the Reserve Bank, as mentioned earlier,, did not have enough staff of its own experienced in foreign exchange matters to deal with the detailed technical operations of the authorised banks from day to day. This was also just as well, for a highly centralised control was not really called for, from the point of view of the country's foreign exchange position. Authorised dealers in India were allowed to continue their normal methods of operation provided all their foreign exchange transactions were conducted on the basis of the London Control rates and the ruling rupee-sterling rate. Subject to this, the operative rates were fixed by the Exchange Banks' Association and when granting licences to deal in foreign exchange, the Reserve Bank stipulated that banks must follow these rates. Alterations in these rates were made only after consultation with the Reserve Bank. The Reserve Bank did not buy and sell U.S. dollars (except the proceeds of gold shipments to the U.S.A.) or other foreign currencies on its own account. If it undertook to purchase some currencies in 1940, it was with a view to facilitating the operation of the new export control regulations; the arrangements made in this connection are detailed in a separate paragraph.

Essential uniformity of control and collaboration between the territories comprising the sterling area was secured by the Bank of England by advising the exchange control authorities in the different countries of any new measures instituted to enable these countries to issue corresponding orders with such variations as might be necessary to suit local conditions. Member countries were required to deliver all their earn

***** The system was discontinued in January 1947 and arrangements similar to those in vogue in India were introduced.

ings of foreign currencies to the Bank of England which held them in a common pool (this came to be known as the Empire Dollar Pool as the U.S. dollar was the most important component); in return, they could draw on this pool for their essential requirements, the drawals bearing no relation to the size of their individual contributions. In India, the returns of foreign currency purchases and sales made by banks enabled the Reserve Bank to watch their exchange positions; if any bank became overbought to an extent that was considered excessive it was requested to reduce its position by a sale to the London Control. In addition, banks were permitted to deal in foreign currencies with each other without restriction, and as the rates at which they did this inter-bank business were within those quoted by the London Control, authorised dealers always tried to cover their requirements locally. As a consequence, it was only the final balance of foreign exchange that was sold to or bought from the London Control. In effect, therefore, the functioning of the Indian system differed little from that in the U.K., except in regard to the retention of the exchange profit by the Indian authorised dealers themselves.

On the whole, the Indian system worked smoothly, and many problems were settled by the Bank through direct discussion with the Chairman of the Exchange Banks' Association. The interference with normal trade transactions resulting from the introduction of exchange control in India appeared to be considerably less than in many other countries.

It would be appropriate to discuss, in separate sub-sections hereafter, the manner in which the various facets of exchange control actually developed during the war time.

Licensing of Authorised Dealers

All the exchange banks, whether British or foreign, were eligible for licences to transact foreign exchange business as all such banks were included in the Second Schedule. At the beginning, these and a few Indian scheduled banks, numbering 28 in all, which had carried on exchange dealings with the Reserve Bank before the war, were licensed as authorised dealers; some of these banks, whose operations so warranted, were granted limited licences, i.e., licences to deal in sterling only. Although the Bank of Cochin was a non-scheduled bank and had no offices in British India, it was permitted to continue to transact foreign exchange business, on the condition that it abided by all the rules of the Indian exchange control. The Bank's policy was not to license a large number of banks, which was in keeping with the policy of the Bank of England except that in the U.K. the list was limited to British joint-stock banks. There were no enemy banks operating in India in

1939 although later (i.e., on July 31, 1941)) of course, the three Japanese banks had their licences cancelled on the suspension of trade relations with Japan. As mentioned earlier, the licensed banks could transact business only at the rates laid down by the Exchange Banks' Association.

The list of authorised dealers remained practically unaltered until 1943; a few banks had been licensed to deal only in sterling during this period. However, as newly established Indian banks with sizeable capital wished to take up foreign exchange business, the Bank was obliged to reconsider its policy. With the expansion and development of Indian banks-which could not have been foreseen in 1939-it became apparent that strict adherence to the original rules would mean that no newly formed Indian bank or an Indian bank which had not dealt in foreign exchange in the past would be able to take part in financing the foreign trade of the country as long as the control lasted. It was largely due to the initiative of Governor Deshmukh that the policy was liberalised so as to enable the discriminating admission to the list of authorised dealers of Indian banks with reasonable capital, which wished to take up foreign exchange business. It was then decided that licences would be granted if the following conditions were fulfilled: (a) the bank was of good standing, (b) it showed reasonable chances of attracting exchange business and had made arrangements for the appointment of overseas agents and (c) it had appointed managers experienced in exchange dealings. In cases where the third condition was not fulfilled but where the Reserve Bank considered that there was a reasonable prospect of its being complied with at not too distant a date, a restricted licence to deal only in sterling area currencies was issued, with the object of ensuring that the bank concerned obtained some experience before it could be given a general licence. The following remarks of the Governor made in August 1943 on the application of a bank which held a restricted licence, for a full-fledged one, indicates the reorientation of policy:

> I think we must look beyond the immediate War conditions and give a fair chance to any scheduled bank which gives evidence of having the necessary technical equipment. Even if the operations are not large they may yield experience both to the bank concerned and our selves. These questions are bound to arise as soon as the preoccupations of the War are over and no charge should be laid at our door that we have thwarted Indian banks' efforts to enlarge their experience, unless we have very good reasons of public interest. These do not appear to exist and I would grant the licence applied for.

The stipulation that the banks should adhere to the exchange rates fixed by the Exchange Banks' Association (within the limits set by the London rates and the rupee-sterling rate) was continued to be imposed while granting new licences so that the Reserve Bank's control over rates could still be exercised through this Association as in the past. On the other hand, with a view to assisting the new banks to establish satisfactory agency arrangements with foreign banks, particularly in the U.S.A., without locking up large funds abroad, the Reserve Bank introduced the following procedure. These banks would deposit rupee securities with the foreign banks' agents in India to cover roughly the average value of outstanding letters of credit opened by them against imports and confirmed by the foreign banks; the Reserve Bank agreed to guarantee the convertibility of the sale proceeds of these deposits into foreign currencies in the event of the banks' failure to honour their commitments. The facility of deposit of rupee securities as collateral was granted also to banks desirous of availing themselves of overdraft facilities from their foreign correspondents.

As with all forward-looking innovations in policy, this one too encountered opposition from vested interests. Even the Finance Department, which had until then not thought it necessary to interfere with the Bank's discretion in the matter of issue of licences, wanted to ascertain the considerations that led to the grant of a licence to a new Indian bank, marking a departure from the Bank's expressed policy as laid down in 1939. 'Apart from the undesirability of granting licences to new and untried institutions when the dollar exchange is under such close control', the Finance Department wrote in January 1944, 'there is the further danger that trouble may arise when the difficulties of the post-war period emerge should such a bank become committed on a large scale '. Government's doubts were set at rest by the Governor who explained at great length the considerations which had prompted a revision of the earlier policy. He pointed out that it had clearly not been the intention of the initial statement of policy to exclude for ever new and promising Indian banks from the field of financing of the country's foreign trade. The development of banking in India during the preceding few years had been rapid and this had no parallel to conditions in the U.K. or the Dominions where the appearance of new banks was unlikely. The Governor also drew the Government's attention to the irony of the previous situation where, on political grounds, licences had to be granted to foreign banks of which the country knew nothing, while at the same time they were being refused to respectable Indian banks. ' A private word by me in the ear of the Finance Member ', Sir C. D. Deshmukh recalled in retrospect years afterwards, ' that India was the only country in which Government could bring itself to question why a trading privilege had been granted to a national . . . proved to be the last word on the subject '.*

***** op.cit.

As the war drew to a close, the licensing policy was again reviewed. An examination of the operations of the banks licensed till then -these numbered 38* at the beginning of 1945, of which 11 held licences to deal in sterling area currencies only-revealed that practically the whole of the exchange business, i.e., over 99 per cent, was being handled by 15 banks, the other 12 authorised dealers doing only about one half of 1 per cent. The banks which transacted the bulk of the business were the leading exchange banks established before the war and three or four of the Indian banks. The other Indian banks did little more than the business of a few of their small merchant customers, since the big traders preferred to deal with the established exchange banks having large resources and experience and also because the banks experienced difficulties in establishing satisfactory agency arrangements abroad. The commercial community at the important centres was served adequately by the existing authorised dealers and there was no public need for more dealers. Further, an expansion in the number of authorised dealers meant more administrative work for the Reserve Bank by way of increased supervision and scrutiny of a larger number of returns. Also, with the limited business available, any large increase in the number of dealers posed the danger of a lowering of the quality of the staff employed, including defections from the existing dealers, as also a scramble for business.

On the other hand, it was important that the financing of the foreign trade of the country did not remain a virtual monopoly of the old exchange banks; successive Presidents of the Indian Merchants' Chamber had reiterated the necessity for establishing Indian exchange banks. Taking all factors into account, the Governor felt that while it was necessary and desirable to continue to encourage Indian banks to take up an increasing share of the financing of the foreign trade of the country, the Bank must proceed cautiously in this matter. It was considered that the issue of new licences should be restricted to banks which commanded sizeable resources and could demonstrate their ability to develop their foreign exchange business substantially within a reasonable time. To this end, it was decided in the middle of 1945, with the approval of Government -which was specifically sought on this occasion to strengthen the Bank's hands while refusing fresh licences-that licences to deal in sterling area currencies alone should be given initially to applicant banks satisfying the criteria laid down earlier. The extension of the licence to cover operations in all foreign currencies was not to be granted unless the bank's sterling operations during a year revealed that it was developing its business to a level comparable

* One authorised dealer ceased to do banking business and was consequently excluded from the Second Schedule, but its licence to transact foreign exchange business was not withdrawn.

to that of one of the smaller exchange banks and its paid-up capital and reserves amounted to Rs. 50 lakhs and its deposits to Rs. 4 crores. Although some of the banks already licensed were liable to have their licences withdrawn under the revised formula, no action in this direction was taken; a general advice was, however, issued to all the authorised dealers that the list would be reviewed periodically and that it might be curtailed, if necessary, by the exclusion of banks the volume of whose exchange business did not warrant their continuance on it. The banks were, at the same time, called upon to give an undertaking to the Reserve Bank that they would abide by the rates, terms and conditions laid down by the Exchange Banks' Association, whether or not they were members of that Association; the object was to prevent unhealthy and uneconomic competition among them. Such an under-taking was obtained thereafter from the newly licensed banks.

It should be added that around the same time, i.e., May 1945, the Bank of England also decided to expand its list of authorised dealers in foreign currencies to meet the requirements of the post-war period. The criteria for inclusion in its list were, however, laid down with reference to categories of banks (such as members of the British Bankers' Association), avoiding altogether any scope for individual selection. In pursuance of this policy, the U.K. offices of central banks or banks of issue in other parts of the sterling area were also to be licensed as dealers. The Reserve Bank's London Office, which fell in this group, was thus granted a full licence; this conferred on it the power to deal in all foreign currencies and the power to approve sterling transfers to non-resident accounts. However, the London Office did not deal in foreign currencies.

The Reserve Bank's policy in regard to licensing of dealers in foreign exchange underwent little change in the next few years. Periodical reviews revealed that only a few large Indian banks were able to expand their foreign exchange business considerably, the share of other Indian authorised dealers remaining negligible. From the point of administration of the control, it was considered desirable that the exchange business was handled by a few banks with good resources and technically competent personnel and so there was no liberalisation of the policy adopted in 1945. In fact, it called for cancellation of some of the licences already issued, although this was not done having regard to the adverse repercussions this action would have had on the general reputation of the banks concerned and consequently on their internal business.

Early in 1947, there was a slight tightening up 'of the policy of licensing of authorised dealers. With the possibility of sterling becoming multilaterally convertible, necessitating extension of exchange control to the sterling area currencies also, it was considered probable that banks holding licences to deal only in sterling would automatically have their. licences extended to cover transactions in all foreign currencies. Hence the issue of new licences to deal in sterling area currencies was itself made subject to fulfilment of all the prescribed conditions including that with regard to the bank's paid-up capital and reserves as well as deposits. Owing to this, hardly any new licences came to be issued from early 1947 onwards. An exception was made in the case of the Australasia Bank Ltd., Lahore, which was granted a licence in December 1947 in compliance with a special request from the Pakistan Government to license it, in view of the prevailing banking difficulties in the Punjab, where many of the offices of the other authorised dealers were not functioning.

After the Foreign Exchange Regulation Act was passed in March 1947, fresh licences were issued by the Bank to all the authorised dealers in exercise of the powers conferred on it under Section 3 of the Act, the licences issued earlier under the Financial Provisions of the Defence of India Rules being no longer valid. There was, however, no change in the Bank's licensing policy. In the middle of 1948, the number of authorised dealers stood at 45, of which 11 held restricted licences; the increase of 7 over the 1945 figure which occurred almost entirely before the end of 1946 was due to the issue of a few new limited licences and the conversion of some such licences issued earlier into full-fledged ones. Of the 34 full licensees, 15 were exchange banks. Co-operative banks were not considered suitable for issue of licences to deal in foreign exchange.

The total volume of foreign exchange business handled by the Indian authorised dealers at the end of the war was relatively small; even in 1948, it amounted only to about 16 per cent of the total business transacted by all the authorised dealers. The Bank felt, however, that there was little that it could do to assist the Indian banks to secure an increasing share of the financing of the foreign trade of the country, besides such indirect encouragement as its licensing policy gave to these banks for increasing their foreign exchange business and beyond seeing that rules were not framed or market practices established that impeded their progress or operated to their disadvantage. Mention has already been made of the facilities provided by the Bank to resolve the difficulties experienced by some banks in meeting the demands of their foreign correspondents for deposit of security. The Bank also allowed reasonable remittance facilities to the Indian banks to meet the requirements of their foreign branches in the initial period of their operations. In the Bank's view, the steady increase in the volume of exchange business of some of the Indian banks, both during the war years and afterwards, clearly showed that there were no major obstacles in the way of the others developing their business similarly.

Several suggestions for assistance from the Reserve Bank were put forward by the banking or business community from time to time, e.g., provision of direct financial assistance through the rediscounting of sterling bills under Section 17 (3) of the Reserve Bank of India Act or that the Reserve Bank's London Office should act as agent for Indian authorised dealers who did not have branches in London. As regards the first suggestion, the London Office of the Reserve Bank had actually received no requests for discount facilities, and this was apparently due to the fact that there were ample facilities in the London market for the discount of bills. If the banks did come to the Bank's London Office for the purpose, the latter could easily offer assistance provided the bills satisfied the requirements of Section 17(3) of the Act. As for discount of import bills, for various reasons it was felt that it would be more advantageous for banks to obtain assistance from the Reserve Bank in the form of advances under Section 17(4) (c) rather than by discounting them under Section 17 (2) or (3). The suggestion that the Bank's London Office might act as agent for the authorised dealers was not a feasible proposition nor was it likely to be to the advantage of the banks concerned. While Section 17 of the Act did not authorise it to act as agent for commercial banks in the handling of shipping documents and dealing in all types of bills, such a step would also be contrary to the Bank's policy of not taking an active part in commercial banking. Besides, in view of the Bank's lack of experience of this type of business and the general absence of the competitive motive, it was hardly likely that the commercial banks would get as good service from it as from their own foreign correspondents.

The Governor (Sir C. D. Deshmukh) was strongly of the opinion, when a review was made in January 1947, that the fault of those banks whose foreign exchange business showed little increase lay mainly in the fact that they were not prepared to establish active foreign exchange departments and carry on a vigorous campaign to obtain business, rather than in the lack of financial resources, absence of branches abroad or inability to obtain satisfactory service from banks in foreign countries. The fact was that in most cases it was the exporter and the importer who determined the bank through which they wanted to conduct their exchange business. A proposal made that the Indian banks combine to float a separate exchange bank which would open branches in various places overseas and handle the foreign exchange business of all its share-holding banks was found to be beset with considerable practical difficulties. The Central Board concurred with the Governor's view that the Reserve Bank could be of little assistance to banks which regarded their exchange business merely as a side-line and the licence to deal in foreign exchange as a symbol of prestige.

Some specific Aspects of the Control

Broadly, the extent of the control in the war years depended on the dollar position of the sterling area as a whole. Incidentally, in India, the sterling area was not legally defined until the Defence of India Rules were amended on July 12, 1941, by introduction of Rule 92A; the new Rule described it as being His Majesty's Dominions (excluding Canada, Newfoundland and Hong Kong), the British Protectorates and Protected States, and such other territories as might be declared by the Reserve Bank to be included for the time being in the sterling area. The inclusion or exclusion of any country in or from this group by the Reserve Bank was done entirely in the wake of the decisions taken by the Bank of England. In the Reserve Bank's own notices and instructions, however, the term was being used even earlier. The dollar position of the sterling area in turn closely depended on the vicissitudes of the war, e.g., the occupation of the major part of Europe by Germany, the entry of Japan into the war and the overrunning of many of the Far Eastern territories by Japan, as these resulted in shipping difficulties, and loss of overseas sources of supply of raw materials or manufactured goods or of overseas markets. These turns in the war also necessitated special measures to safeguard the exchange value of the sterling area currencies, particularly sterling. Then there were the Lend-Lease arrangements* with which came a considerable easing of the dollar scarcity; these rendered a relaxation in the control possible. Thus, there were continuous modifications in the original system;

* Lend-Lease was an arrangement under which the U.S. Government, instead of granting direct dollar loans, made available to various Allied Governments during the war a widely defined range of 'defence articles ' not excluding essential civilian needs, for which the receiving country had to make no cash payments: It may be mentioned that the Johnson Debt Default Act (1934) had prohibited grant by the U.S.A. of dollar loans to foreign Governments in default of the& World War I obligations, while the Neutrality Act (1925 and amended in 1937) prohibited shipments from the U.S.A. to countries involved in war. The Neutrality legislation was amended again in November 1939, repealing in effect the embargo provision of the earlier Act, but insisting that exports to belligerent countries were not to involve the extension of credit or the use of U.S. vessels. Under this 'cash and carry' rule, as it was called, the U.K. financed its purchases in the U.S.A. initially out of its gold and dollar resources resulting in their substantial depletion. With a view to assisting the U.K., the Lend-Lease legislation was enacted on March 11. 1941. empowering the U.S. President to provide aid on &ms which he considered satisfactory including' payment or repayment in kind or property, or any other direct or indirect benefit '. Under the Mutual Aid Agreement entered into between the U.S.A. and the U.K. in February 1942 for the provision of such assistance, the latter was under the obligation to extend Reciprocal Aid (or Reverse Lend-Lease) to the U.S.A. and to promote the obiective of freer international trade, with reduction of tariffs and other tariffs barriers, in the post-war period.

India was also an indirect recipient of Lend-Lease aid through the U.K.; she accepted the benefits subject to the important reservation that she was free to pursue her own tariff policy. She also undertook to provide Reciprocal Aid, up to the value of Lend-Lease goods received by her, in the form of goods and services to the U.S. forces stationed in India. Approximately equal benefits, of the order of Rs. 206 crores in each direction, were received by the two countries under the arrangement. Lend-Lease assistance from the U.S.A. to India ceased on VJ Day (September 2, 1945), but Reverse Lend-Lease by India continued till May 31, 1946. Final settlement of all transactions was effected in terms of an agreement entered into by the two countries in May 1946.

correspondingly, the latitude given to authorised dealers in making sales of foreign exchange varied.

In the administration of the control, there was considerable delegation of authority to the Reserve Bank from the Central Government. The application of the broad principles of the control involved scores of day-to-day decisions at the top executives' level, for there were innumerable marginal cases to which the provisions, whether of import control or export control or the freezing orders, could not be applied without some modification.

There was also some delegation of authority to the authorised dealers. Besides co-operation from the authorised dealers, the successful administration of the control was also facilitated by the fact that there was seldom any criticism of the regulations by the press or the public. What Professor Sayers had to say of the British control in his book Financial Policy, 1939-45 could be said to be largely true of India also:

> Administration of the Regulations was greatly helped by the full support they enjoyed throughout the war from public opinion, and by the willingness of the banks to undertake all the routine work. There were inevitably some awkward problems, but public acceptance of the control eased the task of the authorities in overcoming the difficulties.

Import Control: The main object of exchange control, as mentioned earlier, was to conserve the foreign currency resources of the sterling area as a whole. This was achieved, first, through import control, established in May 1940, whereby exchange could only be sold to importers holding import licences issued by the Import Controllers situated at each of the major ports. The issue of import licences was determined to a considerable extent by the availability of shipping space, although in many cases, licences were refused on the ground that the currency of the supplying country was ' difficult '. In the concluding stages of the war, the licensing system was relaxed considerably, to permit larger imports as a means of combating inflation and of meeting extreme shortages.

Regulation Of Other Remittances: Along with the introduction of control on imports, regular procedures were also laid down for making other trade remittances, e.g., those on account of insurance premia, freight, royalties, and earnings from steamers and films. The facility whereby authorised dealers were allowed to approve remittances without reference to the Reserve Bank was withdrawn in April 1940.

Control over remittances of profits, however, came much later, i.e., on October 21, 1941. Other parts of the sterling area had already taken steps to restrict them; in India, the delayed action was due to the fact that the bulk of the foreign interests were engaged in the manufacture of essential articles and there was fear that any curbs placed on remittances might result in curtailment of output. The basis for allowing remittances was to be decided by the Commerce Department of the Government of India; the Reserve Bank was called upon to assist Government in dealing with the applications for remittances made by the various concerns. There was a gradual lifting of the restrictions from December 1942, due to improvement of the dollar position consequent on the Lend-Lease arrangements, and by April 1944 all the restrictions were removed.

Release of exchange for foreign travel and remittances for miscellaneous private purposes also came to be regulated from the middle of 1940. Subsequently, to check the evasion of the regulations through travel ' without any foreign exchange ' resulting in deferred exchange liabilities to the hosts abroad, a system of issue of Exit (Finance) Permits by the Reserve Bank (the forerunner of ' P ' form !) was introduced effective August 2, 1943. The initial regulations in regard to remittances for other private purposes, such as maintenance of families abroad, transfer of capital and of interest, dividend and insurance premia were also gradually made more stringent, in line with the policy of the U.K. Control.

Vesting Orders Concerning Dollar Holdings: A measure to consolidate the existing private holdings of U.S. dollars in the official coffers was the requisitioning, by vesting orders issued by the Government of India, of all privately owned U.S. dollar balances and certain specified U.S. dollar securities against payment of value thereof in rupees. Unlike in the U.K., action was not taken in India immediately on the outbreak of the war nor was it considered necessary to take over holdings in currencies other than dollars. The entire administrative work relating to the taking over of the vested securities and balances devolved on the Reserve Bank. After the relevant data were collected by the Bank, a Government notification was issued on November 23, 1940 requiring the surrender of all private holdings of U.S. dollar balances. The vesting order requisitioning private holdings of twenty-four of the principal U.S. dollar securities followed soon afterwards, on March 10, 1941. The amounts of U.S. dollar balances and securities surrendered till the end of March 1945 were $4.8 million and $2 .95 million, respectively.

Control Over Export Proceeds: Control over exports also became necessary to ensure that the foreign exchange proceeds of exports to non-Empire countries accrued to the sterling area. The Reserve Bank had, as early as in October 1939, taken steps to prevent goods which were shipped to the U.S.A. and other countries outside the sterling area being paid for in cheap sterling obtainable in the free markets of New York and other centres. It prohibited banks from negotiating or collecting sterling bills drawn on countries outside the sterling area, the bills covering shipments to non-Empire countries were required to be drawn in the currency of the country concerned or, if in sterling, had to be drawn on London under credits registered with the Bank of England, (The London Control would exercise the necessary check over the sterling provided by the foreign importers to meet these bills). The Bank also prohibited authorised dealers from purchasing sterling from non-Empire banks for the purpose of laying down rupee funds in India unless the sterling had been bought in London at the Control rates. In framing these regulations it turned out that the Reserve Bank was ahead of London policy as it was only eight or nine months later that the Bank of England took effective steps to control the free sterling markets.

Steps were also taken simultaneously to ensure that rupee transactions with the United States were conducted on the basis of the rates fixed by the London Control. Transfers from the rupee accounts of foreign bank branches or correspondents held with banks in India were not permitted unless the holding bank certified that the rupees had been sold on the basis of the London Control rates. In January 1940, at the request of the Reserve Bank, the Bank of England issued an order to London banks that rupees could not be sold to foreign banks or parties against sterling unless the sterling had been provided by the sale of the currency of their country of residence to the London Control. However, as the transactions in 'free' sterling were not yet within the control of the Bank of England, these measures only resulted in Indian exporters and American importers financing their business in sterling in order to take advantage of the lower rates quoted for sterling in the New York free market. The regulations therefore proved effective only when measures were eventually taken by the London authorities to control outside (i.e., non-resident) sterling.

Export control proper was introduced in India and throughout the sterling area in March 1940. The system at first covered a limited number of commodities which were good dollar earners and applied to exports made to the American Continent (excluding Canada and the Argentine), Belgium, the Netherlands and Switzerland. In India, the commodities covered were jute and jute manufactures and rubber. The objects of the scheme were to ensure, first, that the foreign exchange proceeds of exports were returned to India and surrendered to the Control and, secondly, that the exports were financed in certain specified ways so that full export proceeds were received. The system was worked through the Customs, the Export Trade Control, the Reserve Bank and the authorised dealers. Considerable initiative and supervision were also called for from the Reserve Bank in devising special procedures to meet certain peculiar trade practices, and ensuring the timely submission of the forms completed by the exporters and the authorised dealers. In June 1940, the export control scheme was extended to cover all commodities shipped to the U.S.A. and Switzerland. Other changes were also made from time to time.

Problem Of Cotton Exporter: In the early stages of the war, the East India Cotton Association raised the question of the inferior position in which the cotton exporter was placed by the Bank's control of the rupee-dollar exchange rate. Raw cotton was a commodity which was both imported by India from the U.S.A. and exported by her to that country. Owing to the existence of a free market for sterling in New York in the initial stages of the war, the sterling-dollar rate was ruling lower in the New York market than in London; in view of this and the requirement of the Indian exchange control that the exporters should deal only with the authorised dealers and that they should deal with them only at the Control rates, the Indian exporters to the U.S.A. were at a disadvantage compared to the American exporters, and their competitive position was thus adversely affected. In other words, the American exporter could quote less for the same quantity of cotton, as he could sell the dollar proceeds at the free market rate for sterling whereas the Indian exporter could only do so at the Control rate. Sir Purshotamdas Thakurdas, who was also Chairman of the East India Cotton Association, held that it was unjustifiable that the control should react to the disadvantage of the Indian cotton grower, either directly or indirectly, and was keen to secure for him the full benefit of the New York-London free sterling rate. In view of the importance of the subject, he wrote to the Governor early in November 1939 and requested that it be brought before the Board.

The Governor (Sir James Taylor) was already seized of the problem but thought that Sir P.T.'s fears were exaggerated. The Bank of England with which he was already in correspondence was not in a position to give any estimate of the actual extent to which foreign purchasers of Indian produce were enabled to purchase sterling at the free market rates (and through sterling, the rupees to pay for the goods) as such transactions were illegal under the British exchange control regulations and would therefore be clandestine. Owing to the large foreign holdings of sterling at the outbreak of the war, control in the U.K. was obviously a much more difficult matter than it was in India, but he had no reason to doubt that it was being steadily tightened.

The problem was discussed at two successive Central Board meetings held on December 4, 1939 and January 22, 1940. The Governor was then able to convey to the Board the results of his communication with the British Control. The latter was already trying its best to stop the leakage of sterling into unauthorized channels and hoped that the business which was evading the Control-probably not more than one-tenth of the total-would dwindle in course of time. The Bank of England was also contemplating tighter control over the foreign exchange proceeds of shipments to non-Empire countries and was in correspondence with the other Empire Controls so that the scheme could be introduced simultaneously by all of them. Sir James hoped that with the introduction of this scheme it would be possible to block up the remaining loopholes within a comparatively short time. He also indicated broadly the steps that India herself was taking to prevent the American importer from providing cover through the non-official market. Besides, as a prelude to a more complete control over export finance, the Government of India had already issued a notification on December 27, 1939 requiring exporters to non-Empire countries to furnish information regarding the channels through which payment for the exports was being obtained.

The East India Cotton Association brought up the matter before the Governor formally in April 1940. The Governor took special trouble to clarify to it the various steps already taken and those in the offing to reduce the size of the free market for sterling. The Association's insistence that the free market channel of finance through sterling should be opened up to the cotton trade however annoyed the Governor greatly. Nor did he agree with its methods of controversy, including the 'confidential release' of the entire correspondence with the Bank to its members, which was tantamount to full publicity, against which the Governor had advised the Association. He thought that no useful purpose would be served by carrying on the discussions with it in these circumstances, but Government (to whom he had reported the matter in detail) desired that he should ' keep the ball rolling ' until the British Government did something in the matter, as his proposal to close the correspondence with the Association would only lead to the subject being taken up again by the Board (at Sir P.T.'s instance, of course!) or by the Federation of Indian Chambers of Commerce and Industry or similar body. However, Sir James took no action and the East India Cotton Association also did not pursue the matter further, perhaps because of the subsequent war developments. The Central Board, which was kept apprised of the Association's views and the subsequent developments with regard to export control, also appears to have been satisfied that the Governor was doing all in his power to reduce the disadvantage to the Indian exporter.

Provision Of Forward Cover By The Reserve Bank: The Bank entered the forward market in foreign exchange in October 1939 to provide cover for exporters, as banks were reluctant to do forward business owing to the difficulty of obtaining cover in London for positions other than spot and the rise in discount rates there. It intimated its willingness to purchase sterling from banks up to three months forward at a rate 1/32d. higher per month than the spot rate. On February 12, 1940, the offer of three months forward purchase of sterling was extended to six months at 1S. 6d. The Reserve Bank did not, until then, purchase other foreign currencies either ready or forward, barring US. dollars resulting from gold shipments (the dollar proceeds of gold exports were to be surrendered to the Bank either ready or on arrival of the gold in the U.S.A.). However, as it was apparent that under the new export control regulations there would be a large increase in foreign currency bills, the Bank announced simultaneously that in order to assist banks to cover immediately any large purchases they might make of foreign currencies, it would purchase from them, on behalf of the Bank of England, Belgian francs, Swiss francs, Dutch guilders, Norwegian kroners and Java guilders, delivery up to four months forward, and U.S. dollars up to six months forward, on the basis of the Bank of England buying rates for these currencies and its sterling buying rate of 1S.6d. less a commission of ⅛ per cent. The occupation of the major part of Europe by Germany by the middle of 1940 led to the cancellation of these arrangements, excepting those for Swiss francs and U.S. dollars. The Bank discontinued the purchase of these two currencies also in August 1945; actually this facility had not been utilised by authorised dealers to any great extent for quite some time previously.

Export of Notes And Jewellery: With a view to plugging loopholes in exchange control, it became necessary to regulate the export of Indian and foreign currency notes, as well as the exports of jewellery. For these purposes, the Government of India promulgated a new Defence of India Rule (90B) on November 2, 1940, requiring the Reserve Bank's permission for export of money in any form to any place outside British India (except Burma); Government also issued a notification on January 11,1941, imposing a similar requirement with respect to the export of diamonds, precious stones and jewellery. Import Of Currency Notes: Regulation of the import of foreign currency notes also became necessary, but for different reasons either to preserve the exchange value of the Bank of England notes, or to restrict the import of notes from territories occupied by Japan. In the former case, the Reserve Bank co-operated closely with the Bank of England; so did the other Empire Controls.

There were no restrictions on the import of rupee notes except that with the extension of the war to Burma, limits were laid down by Government on the amounts that could be brought in by refugees from that country.

There are other aspects of exchange control which, on account of limitations of space, cannot be dealt with even briefly; these are also, of course, of very little current interest. These relate to such matters as releasing exchange for operations of Indians in foreign commodity markets and the administration of the various freezing orders issued by the Government of India at different stages of the war in the Far East. With the entry of Japan into the war and its occupation of various territories in the Far East, the Government issued freezing orders applicable to transactions between India and those countries; the objects of the orders varied, however. The objects of the Japanese freezing order were to bring Japanese business with India to a standstill and to control Japanese assets in the country; in the case of the Chinese freezing order, the object was to help the Chinese Government to gain control over the foreign exchange earnings of exports from China. The control over exchange transactions with China proved most difficult to enforce on account of severe inflation in China, the marked increase in smuggling of goods from India and the black marketing in currency prevalent in both countries.

As already mentioned, the administration of exchange control imposed enormous strain on the Bank's senior executives, but on the whole it would seem that the control worked well. Judging from the almost complete lack of criticism in the press or from the commercial bodies, it may be said that the regulations were administered satisfactorily. Of course, in those years, there was no dearth of foreign exchange. But in later years, as the foreign exchange reserves began to decline, the control necessarily became more elaborate and stringent, rendering the task of administering the regulations more difficult, and inevitably led to a more critical attitude on the part of the public.

India and the Empire Dollar Pool

Before concluding this chapter a brief account may be given of the efforts of the Central Board and the Government of India towards the segregation of India's contribution to the Empire Dollar Pool so as to conserve dollar earnings for post-war reconstruction and development. During the period September 1939 to March 1945 India's net contribution to the Pool was of the magnitude of $300 million.

As the war drew to a close, there was a growing opinion in India that steps should be taken to ensure the availability of the country's earnings of dollars in the post-war period for purchase of plant and machinery. A more drastic proposal was that the country should come out of the Empire Dollar Pool straightaway and hold its dollar earnings separately.

The Board's anxiety to acquire dollars or gold with the Bank's sterling balances dated back to the early months of 1940. The matter was also discussed actively at the Board's meeting on July 20, 1942. The Directors were keen to see that India should secure for herself the balance in her favour of her exchange operations with the U.S.A., irrespective of the Lend-Lease arrangements, in the form of either gold or dollars.

Another suggestion was that India should obtain an assurance from the U.K. that after the war she would be allowed to purchase dollars with the accumulated sterling at the existing rate of exchange for payment of imports from the U.S.A. Sir James Taylor himself did not share the Board's uneasiness; he was genuinely optimistic about the sterling balances being available for the purchase of producer goods, as and when they were required, after the termination of the war. He, therefore, saw no strong reason for commending these suggestions to the Government of India.

The question came up again informally at the October (1942) Board meeting. In view of the importance of the matter, the Governor sought the Government's approval for the stand he proposed to take before the Board, should the point be raised again; he was actually expecting it to come up at the very next meeting of the Board. In the Governor's view, the process of determining the actual balance of payments between the U.S.A. and India was a complicated one, and the figures that might be worked out could only be very approximate. He also felt that the problem could not be separated from the more general one of whether India should have a separate Lend-Lease arrangement with the U.S.A. or whether she should remain linked with the U.K. Even if she were to be separated, apart from the reciprocal Lend-Lease aid which would have to be provided by her immediately, it was extremely doubtful whether the American Government would agree to incur a dollar debt to India or make payment in gold while they were incurring Lend-Lease obligations of any sort to this country. The two principles seemed, in fact, to be fundamentally inconsistent. ' India could not be expected to be allowed to pick out the plum without taking the rest of the bun. ' Sir James wished not only to apprise the Board of these difficulties but also to tell them, should Government agree, that apart from the general arguments, the country's favourable balance with the U.S.A. would be drastically reduced, if not changed into an unfavourable one, if the amount of Lend-Lease assistance to India was taken into account, and that if that was not the case so far, it was likely to happen very soon.

The Government of India fully agreed with the line that Sir James Taylor desired to adopt. To quote from a communication they sent to him on November 24, 1942:

> Lease-Lend must inevitably be brought into the argument because the very raison d'etre of Lease-Lend was the Empire's inability to pay in dollars or gold for the further American supplies necessary to carry on the war. India has accepted and is accepting Lease-Lend goods and by that very fact she must be regarded as estopped from also claiming the dollars she has earned. It must also be obvious that as His Majesty's Government have already thrown their gold and the entire Empire

> Pool of dollars into the common war effort, they are not in a position to release gold or dollars as and to the extent suggested. This argument will apply irrespective of the amount of Lease-Lend assistance received by India. It is however quite certain that the net receipts by India under "mutual aid" would greatly exceed in value her own earnings of dollars.

It seems, however, that the Government of India did have doubts about the free availability of the sterling accumulations for use after the war; they had, in the meantime, been considering seriously the question of requesting the U.K. Government to constitute a Development and Reconstruction Fund* to which an agreed portion of India's sterling balances would be credited, for being made available to India in regular amounts annually for purchase of capital equipment from the U.S.A. or other sources after the war. It would appear that the proposal emanated from the India Office early in 1942† and that in the correspondence with the Government of India which ensued, it was contemplated that the Fund might be of the size of £ 200 million, to be drawn on at a rate not exceeding £ 20 million per annum. By the end of the year, the scheme had reached the stage of being recommended to the British Treasury for acceptance as part of an Anglo-Indian settlement concerning the whole of the sterling balances. When the scheme of funding the sterling pensionary liabilities (which is discussed in the next chapter) came before the Governor General's Executive Council in January 1943, the Council made, in fact, a demand that there should be a simultaneous announcement by the British Government of their acceptance in principle of such a Fund, and an assurance from them that the goods ordered against this Fund under an agreed plan would be duly forthcoming. Another suggestion made by the Council was that India's net dollar earnings resulting from the sales of her goods in the U.S.A. should not henceforth accrue to the Empire Dollar Pool, but should be held separately and reserved for post-war use in connection with Indian reconstruction; the suggestion was based on the view, though erroneous, that with the introduction of Lend-Lease financial arrangements, the Empire Dollar Pool was not necessary for the conduct of the war.

The proposal for the Reconstruction Fund, like that for the funding of the sterling pensionary liabilities of the Government of India, was, however, dropped subsequently due to the opposition of the British Government, which was just as well; as Professor Sayers remarked, 'Had it materialised on the scale suggested in these 1942-43 discussions, the Reconstruction Fund might conceivably have operated to

* The Finance Member, Sir Jeremy Raisman, described the scheme broadly in his budget speech of 1943-44, paragraph 49.

† Prof. R. S. Sayers, Financial Policy, 1939-45, History of the Second World War, United Kingdom Civil Series.

restrict India's post-war demands, as compared with those the United Kingdom actually had to meet in the early post-war years '.*

In the meantime Mr. Deshmukh, who had on Sir James Taylor's sudden death been empowered to carry on the Governor's functions, was consulted by Government about the best manner in which the dollars could be held, should the British Treasury agree to India's secession from the Dollar Pool. Mr. Deshmukh believed strongly in the need for early arrangements satisfactory to India being arrived at. He felt that the dollars could be held initially as part of the Reserve Bank's Banking Department balances abroad; if it became necessary later, the surplus dollars could be held in the form of short-dated securities in the Issue Department by amending Section 33† of the Act. The matter would, he added, require a lot of consultation with the Bank of England regarding fundamental issues affecting trade finance, especially in view of the large part of the imports from the U.S.A. into India being financed through London. An elaborate procedure of maintaining dollar debits and credits would have to be worked out, with perhaps a periodical adjustment with the Bank of England. He pointed out also that if India contracted out of the Dollar Pool, the Bank of England would expect her to provide dollars against any adverse balance of payments with other countries outside the sterling area such as Switzerland, Canada and possibly also Iran.

The idea of a Reconstruction Fund was revived late in 1943 when the question of extending the scope of India's Reciprocal Aid to the U.S.A. to cover raw materials and foodstuffs also (she was already providing certain military supplies under Reciprocal Aid) came to be considered. The Government of India actually pressed the Secretary of State to agree to the segregation of India's dollar earnings (i.e., the proceeds of her exports to the U.S.A. and payments received for services rendered to the U.S. forces stationed in India otherwise than under Reciprocal Aid). In other words, the proposal now was for India to break away from the Empire Dollar Pool altogether rather than that some portion of India's sterling balances should be designated for special convertibility privileges after the war. It was explained that the favourable effect of such an arrangement on public opinion in India, which was highly critical of the existing methods of financing the Allied war expenditure in India, 'would go far towards reconciling them to the additional liability involved in the proposed extension of India's Reciprocal Aid ', as such extension would result in increased rupee expenditure in India without a corresponding accrual of sterling.

The British Treasury and the Bank of England were understandably reluctant to agree to the proposal that India should hold her dollars

* op. cit.

†Only sterling securities could be held in the Issue Department, in 'terms of this Section.

herself as it involved ‘a radical departure from the basic principle of the sterling area which has been tried and proved in all the strains of the war’. The Treasury felt, however, that a proposal under which any such dollars were segregated in a Reconstruction Fund to meet urgent post-war needs might be less difficult to accept than one of holding them in the currency reserve. Its agreement to the creation of such a Fund was eventually communicated to the Government of India by the Secretary of State in November 1943. The amount to be held in the Fund was to be related to the proceeds of sales by India to the U.S.A. of raw materials for civilian use, but the existing banking and exchange channels were to be left undisturbed. The Secretary of State, therefore, suggested that while the existing procedure, whereby banking arrangements were centralised in London and the surplus dollars accruing directly to India were sold to the U.K. Control, would continue, an annual amount not exceeding $20 million would be paid over to India, this being held by the Reserve Bank in a dollar account with the Bank of England. (The arrangement subsequently made was for the amount to be held physically as part of the U.K. Exchange Equalisation Account under a specific earmark.) For the year 1944, the Secretary of State suggested the maximum figure of $20 million as a ‘ lump sum settlement’; a similar allotment was proposed for 1945 ‘ provided statistics of trade justified a figure of this order ‘. Whether any contribution was to be made for subsequent years was to be considered in 1945. The Fund was not to be drawn upon until after the conclusion of hostilities with Japan and then it was to be utilised for restocking and capital expenditure in the U.S.A. before any call on the U.K. dollar resources was made for these purposes. In the meantime, the U.K. would continue to provide India with dollars against sterling for her current needs as heretofore. The whole scheme was to come into operation only after an acceptable settlement of the Reciprocal Aid question was reached between India and the U.S.A.

The Governor welcomed the Treasury’s response but was puzzled at the amount mentioned by the Secretary of State for the maximum annual contribution to the Fund. Even after making allowances for various factors, such as the U.S. gold sales in India, he felt that the real trade surplus with the U.S.A. should be around three times that figure annually.

Meanwhile, there was public criticism in the U.S. commercial circles to the effect that the surrender of India’s surplus dollars to the U.K. was detrimental to their interests as it shut U.S. exporters out of the Indian market. In India too, trade and industry began to refer to the adverse effects on India of the whole scheme of the dollar pool and demanded that the country’s favourable trade balance with the U.S.A. ‘ should be accounted for by accumulation of dollars ‘.

The Central Board had also not lost sight of the matter. When it considered the British and American plans for post-war monetary arrangements in October and November 1943, and again when it discussed the Joint Statement by Experts in May 1944 -these matters are discussed in a later chapter -it took the opportunity to press Government to pursue vigorously the question of obtaining and retaining India's balance of accounts with the U.S.A. in dollars.

In the course of his budget speech in February 1944, the Finance Member announced the British Government's acceptance of the principle of starting a nucleus dollar fund for meeting India's postwar reconstruction requirements; this was to be ' an integral part of the reciprocal aid arrangement '. The Fund, he added, would be apart from and in addition to India's current dollar requirements which were met from the Empire Dollar Pool under the existing arrangements. The actual size of the contribution was, however, not disclosed.

As mentioned earlier, Governor Deshmukh was keen to know the basis on which the U.K. Treasury had specified the ceiling of $20 million for the annual contribution to the Fund. He was also eager that some part at least of India's pmt contributions to the Pool should be made available. At his instance, the Government of India pursued the matter with the Secretary of State and urged him to persuade the British Treasury to enhance the limit substantially. They met with no luck however. Nor did the Secretary of State's argument that the amount was 'a reasonable round sum in all the circumstances' carry any conviction. The Governor felt strongly that the British Government and the Secretary of State owed it to India to explain satisfactorily the reasons for fixing such a low figure as well as the refusal to reopen past transactions. In a letter to the Government of India in April 1944, he said:

> Since, however, this arrangement of creating and maintaining an Empire Dollar Pool is based on the voluntary action of all the members of the Commonwealth, it seems only fair that H.M.G. should furnish all the contributors with a precise statement of all credits and debits to the Pool, and of the prospective demands on the Pool in order to convince the nations which contribute that the continuance of their contribution is still required in the interests of the common war effort and that if any exceptions are to be made, the scale of such exceptions is necessarily to be strictly limited. . . . Briefly, I think it is only fair that the Treasury should take the Government of India into their confidence and lay all their cards on the table, even if in the interests of security the Government are precluded from making public this information or any part of it. It would then be possible for the Government of India to say in justification of any proposed figure that although it is not open to them to state all the relevant considerations, they have satisfied themselves that the figure they propose to adopt is a reasonable one in all the circumstances.

The Government of India thereupon pressed India Office for an upward revision of the proposed annual allocation. The continued agitation by the public and the Reserve Bank Board, they said in a cable to India Office in September 1944, made it impossible for them to hold off announcing the amount of the contribution much longer. They added that in their view enhancement of the allotment to 20 per cent of the actual surplus or $50 million would be reasonable. The Government did not, however, consult the Governor before these figures were suggested. When, therefore, India Office rejected these proposals again, Sir Chintaman was quick to deplore their action. There was a wide variation in the assessment of the actual surplus by India Office and the Government of India (who relied largely on data compiled by the Reserve Bank from the returns of the authorised dealers and periodical statements received from the Bank of England) due to various factors, and neither could be considered accurate. The proposed percentage of 20 had, according to the Governor, no logical relation to any important factor in the situation, What mattered was the extent to which India's surplus dollars were required for the common war effort; the excess available over this contribution rightly belonged to India. In his letter of December 5, 1944: to Government, that is, some months after his visit to the U.S.A. and the U.K. in connection with the Bretton Woods Conference, the Governor said:

> The informal conversations which I had in London with Bank of England officials and which H. M.* and the Economic Adviser and I had with the Treasury officials indicated that the principal use to which our surplus dollars are now put is the strengthening of the backing of gold and dollars of the United Kingdom's sterling liabilities to the outside world. To a certain extent, this use of India's surplus dollars is in India's interests, as it strengthens the currency in which all her foreign assets are held. But it is conceivable that a stage has been reached when all reasonable requirements of this nature are being met, and if, that is the case, then India is entitled to the whole of her surplus, after every possible allowance has been made for contingent liabilities on India's behalf. There can be no question here of generosity, and if the India Office feel that they are accepting on India's behalf an arrangement which errs on the side of generosity to India and is correspondingly onerous to U.K., then Government would be justified in suggesting that India would be prepared to take over all the surplus, together with all the current and contingent dollar liabilities. I think Government owe it to the public to satisfy themselves that only that amount of dollars is retained by U.K. out of its surplus earnings which can reasonably be regarded as furthering the common war effort.

In the budget speech of 1945-46, the Finance Member announced the contribution of $20 million by the British Government for each of the years 1944 and 1945; he described the arrangement as' a fair and

* Honourable Member (for Finance).

valuable concession '. The actual allotment for 19 was however made only in July 1945; a similar sum was credited for the subsequent year on the same basis. A detailed procedure was drawn up for utilising the amounts released. The earmarking would appear to have been discontinued with the termination of Reciprocal Aid.*

The conclusion of the first interim sterling balances agreement between India and the U.K. on August 14, 1947, for the period up to the end of December 1947, did not affect the unexpended balances (of approximately $25 million) in the Fund which came to be known as the Post-War Dollar Fund. These balances were at the disposal of India in addition to the releases, which were multilaterally convertible, agreed upon in terms of the above-mentioned settlement. However, when the agreement was extended in February 1948 to be in force till June 30, 1948, the remaining balance in the Fund was included in the limit fixed for India's drawings upon the central reserves during the half year. Thus, India was to have no further claim on the Post-War Dollar Fund after that date.

After the war, the problem was not so much to secure the country's dollar earnings as to ensure the availability of the accumulated sterling balances for expenditure in dollars to meet India's essential requirements. This matter formed an important part of the discussions between the Governments of India and the U.K., the Reserve Bank playing an active role in the negotiations.

* Prof. R. S. Sayers, op. cit.