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Exchange Control And Management

In the post-war years, there was hardly any evidence of the dismantling of the exchange control system built during the war. In fact, the general tendency, especially in the developing countries including India, was to widen the scope of the control and to put it on a permanent footing, with the necessary legislation to support it as an integral part of greater Government control over the economy, in the interests of speeding up economic growth. In India a separate Foreign Exchange Regulation Act was passed in 1947. In the early post-war years, while there was an attempt to relax the rigour of the controls in countries like India, which had built up substantial foreign exchange reserves, the position of debtor countries, especially the U.K., remained difficult. With few exceptions, like the U.S.A., member countries found it difficult to implement the International Monetary Fund's objective of restoring freedom in respect of current transactions between members. In fact, all but five members chose to avail themselves of the transitory provisions under Article XIV, permitting continuance of the exchange restrictions for some time until they were able to strengthen their balance of payments position sufficiently to do without them. It was only in 1961 that the Western countries and Japan were able to assume the formal obligations of convertibility under Article VIII of the I.M.F. The majority of the developing countries have not yet been able to opt for this status.

Exchange control in India continued to be modelled closely on the British pattern, as India remained a member of the sterling area and a participator in the Empire Dollar Pool. Modifications in the Indian exchange control system were brought about from time to time principally by the U.K.'s balance of payments position, general as well as

vis-a-vis the dollar area, as this determined to a large extent the amount of sterling available for India's use as also its convertibility into hard currencies. The two years 1945 and 1946 constituted a distinct phase of exchange control, when the system was gradually changed from one based on war-time conditions to one suitable for peace-time conditions. Particular mention should be made here of the numerous payments agreements which the U.K. entered into with European countries in order to facilitate the resumption of commercial and financial transactions with them and of the introduction, a little later, of the Transferable Account area with the ultimate objective of making sterling fully convertible. These arrangements affected India also, either directly or indirectly.

An important development in the field of Indian exchange control during this period was the introduction of control on exchange transactions with the U.K. and the other sterling area countries in July 1947.

As during the war years, the Reserve Bank acted as Government's adviser on all aspects of exchange control policy during the postwar years. The Bank had a vital advisory role in matters relating to import control, which largely set the pace for exchange control policy since expenditure on imports constituted the largest item of foreign exchange disbursements. The drafting of the Foreign Exchange Regulation Act was done mostly by the Bank. During this period, there were also some changes in the area of the control, consequent on the complete monetary separation of Burma and the partition of India.

In the field of exchange management, an important development was the de jure severance of the sterling-rupee link as a corollary to India's membership of the International Monetary Fund and the declaration of the par value of the rupee in terms of gold. The relevant provision of the Reserve Bank of India Act were suitably amended for the purpose. The Bank was also authorised to buy and sell foreign exchange, although actually it did not deal in foreign exchange other than sterling and Pakistan rupees. Another landmark was the devaluation of the rupee, effective September 22, 1949, by 30.5 per cent, that is, to the same extent as that of sterling. Many difficulties arose consequent on Pakistan's decision not to devalue her currency simultaneously, which disrupted trade and the payments arrangements between the two countries and led ultimately to the introduction of control on financial transactions with that country in February 1951. The Bank's advice was sought on these matters.

In this chapter, the fields of control where the Bank made significant contributions have been dealt with in some detail while other developments are touched upon briefly.

EXCHANGE CONTROL

Foreign Exchange Regulation Act

The powers under which the exchange control system was operated during the war were derived from the Defence of India Rules, which expired in September 1946. These were continued in force for a further six months (up to March 25, 1947) by the Emergency Powers (Continuance) Ordinance, 1946, promulgated on September 25, 1946, during which period a permanent legislative measure for the control of foreign exchange was drafted. This measure, called the Foreign Exchange Regulation Bill, 1946, was introduced in the Legislative Assembly in November 1946 and was passed in February 1947. The Act (VII of 1947) came into force on March 25, 1947.

The point whether the powers to control transactions in foreign exchange needed to be continued after the cessation of hostilities had engaged the Government's attention long before the end of the war. At one time, the Finance Department believed that exchange control would terminate with the close of the war but later, in September 1944, on a closer study it felt that the retention of the powers in this behalf was necessary at least temporarily until the post-war commercial and financial position was clear. It was however of two minds about having a single comprehensive legislation for the control of imports and exports as well as of exchange. As usual, the Bank's counsel was sought, both as to the need for an Exchange Control Act and the lines on which it could be framed. The matter was examined at length in the Bank. Its view was that whatever the policy in the future might be, a system under which operations in foreign exchange were completely unregulated was unlikely to return in any country; the monetary authority in India should therefore be given powers to control and regulate foreign exchange transactions within certain statutory limitations, in the same way as it had been given the power to control the internal supplies of money. The Bank thought also that the legislation should be framed in such a way that it would not only serve to carry on the existing system but would also allow this system to be modified or altered to meet post-war conditions without further amendment by the Legislature. The Government concurred. Matters relating to the legislation were not referred to the Central Board or its Committee at any stage. Mr. Cayley, Deputy Controller, was closely associated with the drafting of the Bill and its passage; he was also a member of the Select Committee on the Bill.

Before drafting the Bill, Mr. Cayley made an exhaustive study of the Defence (Finance) Regulations of the U.K. and the National Security Regulations relating to exchange control in Australia. Generally the draft followed the lines of the Defence of India Rules but several new sections were added, based on the U.K. or Australian regulations, which appeared to be necessary either to prevent the existing control being evaded or to fill certain lacunae in the rules. The first object of the new Act was to be to continue the existing powers given by the Defence of India Rules; the second was to establish a system of exchange control that would enable India (a) to carry out the obligations incumbent on members of the I.M.F. and (b) to manage her foreign exchange resources should the I.M.F. not come into existence or India not become a member.

Mr. Cayley suggested that a single Act be framed entitled the Import, Export and Exchange Control Act, which would be divided into parts covering Imports, Exports, Exchange and Securities. Exchange considerations would, in the post-war period, be the overriding reason for both import and export control and these control systems had, therefore, to be worked in very close liaison with the Reserve Bank. If two separate 'measures were enacted, he felt, the clause covering control over the proceeds of exports should be included in the Exchange Control Act rather than in the Import and Export Control Act, as it was primarily an exchange control measure. Eventually, it was decided to legislate separately for exchange control and for the other two control systems. *

Although the Bill for an Indian Exchange Act drafted by Mr. Cayley was sent to the Government of India in October 1944, Government could scrutinise it only after almost a year had elapsed, on account of other urgent preoccupations. Meanwhile, Mr. Cayley who had proceeded to the U.K. in July 1945 on furlough found that a new Exchange Control Bill had been drafted there to take the place of certain provisions of the Defence (Finance) Regulations. The Bill had not, however, been presented to the Parliament and was, therefore, still secret. The Governor, Sir Chintaman, who was also then in the U.K., considered that it would be prudent to delay the preparation of the final draft of the Indian Bill until the Government had had an opportunity of studying the British Bill. The Government were, however, keen to finalise the draft in time for its submission to the Legislature in the budget session of 1946 and desired that Mr. Cayley be made available to assist them in this work as also in drafting the Statement of Objects and Reasons and Notes on Clauses. The Governor thereupon again pointed out to the Government on January 17, 1946 that the Bank of England had informed Mr. Cayley before he left the U.K.

* The Imports and Exports (Control) Act, 1947 also came into effect on March 25, 1947.

that the authorities were postponing their Exchange Control Bill until the implications of the U.S. Loan Agreement had been fully worked out, e.g., it might not be possible to use the phrase ' sterling area ' in the future; thus, it was desirable to put off the finalisation of the Indian Bill until these points were clear. Incidentally, Government modified the title of the Bill from 'Indian Exchange Bill' to 'Indian Exchange Control Bill'; it was later modified to Foreign Exchange Regulation Bill as possibly being more acceptable to the Legislature which disliked the idea of 'controls'. Simultaneously, the Governor requested the Bank of England to indicate, if it was possible for it to do so, whether the terms of the American loan, if sanctioned, would necessitate any radical alteration in the sterling area system, for the Indian Bill was drafted on the lines of the Defence of India Rules which permitted transactions freely within the sterling area. The Governor also desired to know if the introduction of the Bill in the U.K. was being postponed specifically for these reasons.

The Bank of England replied more than a month later, on February 22, 1946, after consulting Whitehall. The introduction of the U.K. Bill was being delayed for various reasons, of which one was that a public discussion of the issues involved was undesirable when the question of ratification of the loan was before the U.S. Congress. The Bank of England added, however, that the general lines of the exchange control administration would not be greatly modified, though it was probable that the Bill would be drawn in wider terms than the Defence (Finance) Regulations and would reflect the more permanent nature of the new legislation. The concluding remarks of the Governor of the Bank of England were:

> The main purpose of our exchange control in future will be to supervise capital transactions between residents of the Sterling Area and nonresidents. I believe this policy to be essential during the very difficult conditions we shall meet during the next few years. It rests on the assumption that India and the Dominions will enact comparable legislation.

From then onwards, there was close consultation with the Bank of England, both directly and through the Secretary of State for India, on the various aspects of the control system that were to be covered by legislation. There was, however, no suggestion from the British side that the Indian legislation should be held up pending the decision of the U.S. Congress on the Loan Agreement. Nevertheless, the Indian Bill was not introduced in the budget session of the Legislative Assembly in 1946. Meanwhile, the draft Bill was revised further in the light of the discussions which Mr. Cayley had with officials of the British Treasury and the Bank of England in March 1946 on his way back from the U.S.A. after the meeting of the I.M.F . in Savannah

(where he had accompanied Sir Chintaman) but the material could not be sent to Government before the middle of July 1946.

The Defence of India Act was to lapse on September 30, 1946, and it was clear that the Bill could not be passed by the Legislature before that date. Of the two alternatives proposed by Government for continuing the legal backing for exchange control pending the enactment of the Bill, viz., to enact by Ordinance the revised Bill prepared by Mr. Cayley or to continue by Ordinance the relevant Defence of India Rules under which the system was being operated, the Governor favoured the first alternative. The reasons, in Mr. Cayley's words, were:

> It seems to us that with the general prejudice against the Defence of India Rules even though the measures framed thereunder are desirable and in the interests of the country, it would be easier to get a new Exchange Control Act passed which is a continuation and in confirmation of an existing measure even if it had been promulgated by Ordinance than it would be to put through a Bill which is intended to carry on powers derived from the Defence of India Rules. Also, if there are fundamental constitutional changes in the near future in order that Government can continue at all, it will probably be necessary to pass a general measure for the continuation of existing legislation with modifications as to area of application, etc., and if the Exchange Control regulations are based on an Act even though it had been enacted by Ordinance, it will probably be a simple matter for it to be continued along with other Statutes, while the framing and passing of a new Act in continuation of the Defence of India Rules might on the other hand be difficult to accomplish in time.
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> With regard to the objection raised by you to this proposal, I do not think that the present draft Bill goes beyond the Defence of India Rules except to a very small degree, as the additions in the Act are merely the conversion of existing rules which have been made by Reserve Bank into legislative form, while in certain instances the new Bill has less stringent provisions than the Rules especially in regard to penalties, powers of search, etc.

Government, however, preferred the other alternative as a matter of general policy. The Emergency Provisions (Continuance) Ordinance 1946, promulgated on September 25, 1946 and which came into effect on October 1, 1946, continued for six months from the date of its promulgation the validity of the Defence of India Rules pertaining to exchange control as well as many other aspects of control in regard to which permanent legislation was necessary but had not yet been undertaken.

The Foreign Exchange Regulation Bill was introduced in the Legislative Assembly on November 6, 1946, and came up for consideration on November 12. The Finance Member, Mr. Liaquat Ali Khan, who piloted the Bill, explained in his opening remarks that after very careful consideration Government had come to the conclusion that it was

necessary to continue exercising control over foreign exchange transactions not only in India's own interests so as to ensure the best use of the foreign exchange resources in implementing the Government's programme of industrialisation and development, but also in virtue of her position as a member of the I.M.F. to promote exchange stability and to maintain orderly exchange arrangements. After a short debate on November 12**,** the Bill was referred to a Select Committee consisting of 17 members. The Bill was welcomed generally by all the Members who spoke. As Mr. Cayley reported to Mr. P. S. Beale of the Bank of England, 'the only criticism that was voiced against the Bill was doubts as to whether it was sufficiently stringent. There is of course under present conditions no opposition in the Assembly '.

The main feature of the Bill was that it was purely an enabling measure, and the majority of the clauses would not come into effect except under notification by the Central Government. As the Statement of Objects and Reasons put it:

> the provisions of the Bill have been drafted in such a manner that the degree of restriction on foreign exchange transactions can be relaxed or increased by executive orders, either generally or for particular foreign currencies, in accordance with the needs of trade and finance or international agreements thus ensuring that flights of capital or wild speculation, which proved so injurious to foreign trade in the period between the two wars, can be immediately controlled.

The legislation was to extend to the whole of British India and also to all British subjects in India even if they were resident outside British India. This provision was necessary to guard against evasions of the Act by persons residing in Indian States operating through agents in British India. The Bill incorporated the provisions of the Defence of India Rules or of notifications issued thereunder relating to the licensing of authorised dealers in foreign exchange, the imposing of restrictions on the acquisition of foreign exchange and on payments to or on behalf of non-residents, the opening of blocked accounts, exercising control over exports, placing restrictions on transactions in securities and on the export of gold and currency, and the vesting of powers in Government to call for information regarding private holdings of foreign securities as well as foreign exchange and to requisition such holdings if necessary. The import of gold, silver and currency notes, which was hitherto regulated by the issue of notifications under the Sea Customs Act, was also covered; as the restrictions were being imposed for exchange control purposes it was considered desirable to have the powers incorporated in this Bill. Government also reserved the right, as in the Defence of India Rules, to levy a licence fee on imports of gold and silver and took powers to regulate the use of imported gold and silver.

There were several new provisions, such as: the restriction on the rates at which transactions in foreign exchange could be entered into, necessitated by the provision in the Articles of the I.M.F. which set a limit to the fluctuations in exchange rates; the prohibition on the creation of trusts in favour of non-resident beneficiaries in order to supplement the regulations on the transfer of money or securities to nonresidents ; the provision empowering Government to require the deposit of bearer securities in authorised depositories or to prohibit the issue of bearer securities, for preventing transfers on capital account evading the control imposed by the restrictions on transfer of securities to nonresidents; the prohibition on the transfer of the controlling interest in a company from Indian or British* hands to non-residents; the restrictions on the grant of accommodation to companies controlled by nonresident interests other than British* interests; and the provision empowering the Government to set up special or clearing accounts which would be necessary for the working of bilateral trade or payments agreements with countries which were not members of the I.M.F. The Government also took powers to call for information of a general or special nature so as to be able to fulfil the obligation to supply information to the I.M.F. as and when required. Another important provision was the power of Government to give directions to the Reserve Bank for the purposes of the Act, the Bank being obliged to comply with such directions. In regard to securities control, the Reserve Bank did not consider it necessary to go as far as the Bank of England wished to, as enemy or non-sterling area holdings of rupee securities were negligible and the market in bearer securities in India was also small.

The most important feature of the Bill was, however, that unlike the Defence of India Rules: the use of the term ‘sterling area’ was avoided throughout and powers were taken to impose exchange control between India and the rest of the world includig the sterling area countries. Apart from the consideration that a term such as the sterling area could not be used for the purpose of singling out countries outside the group for the application of exchange control without infringing the obligations under the Bretton Woods Agreement, it was impracticable to include it in a permanent legislative measure as it was likely to lose its existing meaning in the course of the next few months. When sterling became multilaterally convertible under the terms of the Anglo-American Loan Agreement, the U.K. would possibly be precluded from controlling transfers from the sterling accounts of residents in India to the sterling accounts of U.S. residents. Thus, if transfers between India and the U.K. remained unrestricted, it could result in unauthorised

* The preferential treatment accorded to British companies, which was necessary in view of certain provisions in the Government of India Act, 1935 (which required that no distinction should be made between Indian and U.K. commercial interests) was withdrawn by an amendment to the Foreign Exchange Regulation Act in April 1950.

transfers to the U.S.A. or other 'hard' currency countries for purposes for which India herself would not have granted any exchange. It was, therefore, considered necessary to provide for control between India and the U.K. (and other sterling area countries) being exercised without amending the Act. At the same time provision was made for the granting of exemptions by the Reserve Bank and it was intended that when the Act came into force transactions with sterling area countries should be exempted.

In the U.K. Bill, certain territories were specified in the First Schedule, the Treasury having powers to add to, or exclude territories from, it. There was to be no exchange control on transactions with these 'scheduled territories ', which were the same as those in the existing 'sterling area' group. Thus, the position under the Indian and the English Bills was, in effect, the same. The Select Committee on the Indian Bill considered recasting the Bill on the lines of the British Bill as certain members considered that restrictions on transactions with the U.K. were unnecessary in view of the large holdings of sterling, but decided against that course, the reason being that ' in view of India's new status it was not desirable to include in a new Act a schedule of territories to which exchange control restrictions would not apply, as this might give the impression that India wished to continue permanently the system of pooling her foreign exchange resources which is a feature of the present sterling area arrangements '. *

The Select Committee's report which was submitted on February 3, 1947 was almost unanimous, there being a minute of dissent by Sir Cowasjee Jehangir on only one recommendation. viz., the decision not to exclude the sterling area by providing a Schedule of 'scheduled territories' and making Government's intentions explicit. An important change made by the Committee was to limit the validity of the Act to five years in the first instance, giving powers to the Government to extend it by a further period not exceeding three years. † The Bill, as amended by the Select Committee, was passed by the Legislative Assembly without any change on February 10, 1947, and by the Council of State on February 25. It received the assent of the Governor General on March 11 and came into force on March 25, 1947, the date on which the Emergency Powers (Continuance) Ordinance, 1946 expired.‡

The Finance Member's speech at the second reading of the Bill was devoted, at the Bank's instance, to a statement of the policy which the

* Finance Member (Mr. Liaquat Ali Khan)' speech on February 10, 1947 during the second reading of the Foreign Exchange Regulation Bill.

† This clause was amended in February 1952, extending the life of the Act till December 31, 1957. The Act was made a permanent measure by an amendment, deleting the clause, in September 1957.

‡ The British Act was also passed in March 1947 but came into force much later, on October 1, 1947.

wide powers given under the Act would be used to implement. He stated that India had advised the I.M.F. that she wished to take advantage of the transitional arrangements under Section 2 of Article XIV of the Fund which would permit her to continue for a minimum of three years any exchange control measures she considered necessary in order to maintain her balance of 'payments in equilibrium. Thus there would be no appreciable changes in the existing system of exchange control when the I.M.F. commenced operations in March that year. (As the Governor had pointed out to Government earlier, even the U.K. had elected to avail herself of the transitional arrangements, which meant that although she had undertaken to make sterling multilaterally convertible by the middle of July, she was not prevented from maintaining general restrictions on current payments so that she could limit the amount of fresh convertible sterling created.) However, Government's aim and policy were to achieve the multilateral convertibility of all currencies including the rupee as soon as possible and therefore to confine the restrictions to those necessary to ensure control and regulation of capital movements. In the words of the Finance Member, the exchange control system would be operated so as

> to permit nearly all transactions of a current nature subject to certain restrictions as to amount, to ensure that capital is not being transferred in the guise of a current payment and in addition to allow moderate transfers of capital where such amounts are required for trade purposes such as for the establishment of overseas branches of Indian trading firms and for banking and insurance operations.

The Governor had also brought to the Government's notice in January 1947 that there were persistent reports, particularly among the European community, that as soon as the Act was passed the Government would place an immediate embargo on all sterling remittances. In fact, there had also been reports in the press to the effect that sterling might be declared as a ' foreign currency ' and British employees were so alarmed that many even contemplated giving up their jobs so that they could transfer their savings, etc., in time before the freedom of transfer of capital was extinguished. The position was complicated by the fact that the British Government might not release any extra sterling, outside the balances with convertible rights, to meet an adverse balance of payments between India and the U.K., in which case some regulation of movements of capital to the U.K. would have to be introduced. This would, of course, not have meant imposing any restrictions beyond what already existed in the case of non-sterling area nationals, who were permitted to take their Provident Funds and reasonable savings with them when they retired to their own countries; but to allay popular misapprehension, the Governor suggested that Government issue a press note. The Bank later suggested that the matter be covered

in the Finance Member's speech very tactfully so as to avoid a panicky flight from the rupee. The Finance Member dwelt on the subject thus:

> the Act was not framed by Government with the intention of making any sudden changes in the existing Exchange Control system immediately it comes into force and it is the present intention of Government to instruct the Reserve Bank to issue the necessary notifications to allow payments to continue to be made freely to other countries in the sterling area. It is only common prudence to recognise, however, that circumstances might arise or develop in which it may not be possible to continue this system indefinitely as freedom to allow capital payments as distinct from current transactions must depend on our having freely available to us sterling to meet any resulting adverse balance in payments.
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> I am hopeful, Sir, that conditions will not emerge in which any restrictions on the release of sterling to meet the repatriation of British capital from India are called for. But whatever the occasion or extent of. any such restriction might be, I cannot foresee any set of circumstances, of which India has control, in which Government would deem it essential to apply such restrictions to transactions other than large transfers of capital, and to place restrictions on normal remittances from India to the United Kingdom or on the transfer of provident funds and savings by British nationals returning to their own country.

Following the introduction of the Act fresh notifications corresponding to those so far in force, covering the import and/or export of money, gold and silver, and jewellery, the surrender of U.S. dollar balances, the registration of U.S. dollar securities and the surrender of the foreign exchange proceeds of exports to certain countries, were issued both by the Government of India and the Reserve Bank for continuing the existing scheme of control. General permission was granted by the Reserve Bank for the continuance of transactions with countries inside the sterling area as under the Act this had been prohibited except with the sanction of the Reserve Bank.

In order to simplify the existing procedure and to obviate delays in dealing with applications, authority was delegated to the authorised dealers to approve certain types of remittances which hitherto had to be referred to the Reserve Bank for prior sanction. The process of delegation of powers by the Reserve Bank to the authorised dealers was in fact a continuing one; from time to time powers to administer new regulations were transferred to banks after the Bank had gained sufficient experience of their working and devised adequate safeguards against evasion.

Extension of Control to the Sterling Area

When the Finance Member announced during the second reading of the Foreign Exchange Regulation Bill in the Legislative Assembly that Government did not intend to impose any restrictions on transactions

between India and the rest of the sterling area, no agreement had yet been reached on the withdrawals from the sterling balances, although negotiations had commenced with the U.K. Government during the visit to India in February 1947 of the mission headed by Sir Wilfrid Eady. The announcement was intended to dispel the widespread fears that with the passage of the Bill, there might be a flight of British capital from India in anticipation of the imposition of such restrictions particularly in the absence of any agreement between the two Governments on the free availability of the sterling balances even for the purpose of meeting an adverse balance of payments between India and the U.K. or to meet the repatriation of British.capital from India. Even otherwise, there was the possibility that when sterling became multilaterally convertible on July 15 and the sterling area arrangements were either terminated or modified, some restriction on payments in sterling area currencies would become necessary, as all foreign currencies would then be of *equal* value to India and her sterling resources would have to be conserved and used judiciously in much the same way as U.S. dollars or Swiss francs. With a view to keeping a close watch on remittances from India in sterling area currencies, pending the completion of satisfactory arrangements with the U.K., the Bank instituted, in April 1947, steps to collect detailed statistics of such remittances from the authorised dealers. To be able to act quickly if the need arose the Bank also got ready in May in consultation with Government, the necessary notifications and circulars to authorised dealers.

On July 1, 1947, the India Office alerted the Government of India of the possibility of large scale capital transfers from India following the announcement, to be made shortly, of Egypt's decision to leave the sterling area, and suggested that early joint action should be taken to control Indian balances until an interim arrangement was agreed upon. The Bank of England took up the matter simultaneously with the Reserve Bank and emphasised the need for immediate extension of exchange control in India to cover sterling payments in all directions. The Government of India and the Reserve Bank did not think that the announcement of Egypt's agreement with the U.K. would precipitate any such development as was feared by the British authorities. Besides, Sir Chintaman felt that the balance of advantage lay in not advancing the date of imposition of the various controls that would have to come in on July 15; in fact, it was considered preferable to wait until after the return of the Indian delegation (for the sterling balances negotiations) from London in the beginning of August, as it was not even clear whether India would remain in the sterling area and it would be impracticable to introduce radical changes on July 15 and to follow them up with further changes a week or two later. Should there be any evidence of commencement of a flight from the rupee, capital transfers were to be

prohibited immediately, the new general measures of control coming later, after the results of the London discussions were known. Government advised the Secretary of State that they were watching the situation closely and had found no signs of any substantial movement of funds from India to the sterling area in anticipation of impending changes in the exchange control regulations. They added, however, that arrangements were well in hand to meet any situation arising from an indiscriminate remittance of funds from the country. The Reserve Bank replied to the Bank of England similarly.

While the Bank's reply went out on July 2, and Government's on July 4, 1947, the situation changed within a few days. Heavy sales of sterling to banks by the Reserve Bank averaging £1½ million a day since July 5 and the large sales of rupee securities by the Hyderabad State to the Bank for the purpose of investment of the proceeds in sterling securities led the Governor (who had been given full discretion to act) to decide that it was time to introduce the contemplated restrictions on sterling. As arranged, the Government of India issued a direction to the Bank on July 7, under the provisions of the Foreign Exchange Regulation Act (Section 25), to the effect that all capital remittances outside India were prohibited with immediate effect. On its receipt on July 8, the Bank issued notifications cancelling the general permission granted for transactions in sterling area currencies and authorising the maintenance of existing accounts in these currencies by persons domiciled in India. Limits were laid down for the various classes of remittances to the sterling area countries, normal trade payments being however allowed without any restrictions. The controls imposed were in the nature of a standstill arrangement pending the institution of more definite measures in the light of the result of the negotiations then being held in the U.K.

To ensure that the restrictions on capital remittances to sterling area countries introduced in July were not evaded, on August 4, 1947 the Government of India issued two notifications extending as from August 19 the export control procedure to all countries outside India except Afghanistan, Tibet, Nepal and Portuguese and French India.

India continued to remain in the sterling area under the interim agreement on sterling balances with the U.K. Government concluded on August 14, 1947, but further restrictions were imposed on remittances in sterling area currencies. This was necessary because of the limited drawal on the sterling balances agreed to by the U.K. The arrangements now made between India and the U.K. were similar to the transferable account arrangements entered into by the U.K. with the other countries, except that owing to India's remaining a member of the sterling area, the suspension of the convertibility of the sterling held in such accounts into U.S. dollars (with effect from August 21,1947) was

not applied to her holding in the No. 1 Account. Remittances against imports from sterling area countries were as from September 1 subject to the same conditions as for imports from non-sterling countries; in many other directions also remittances to countries in the sterling area were to be treated in the same manner as those to countries outside it. It was also found necessary to introduce certain restrictions on the operations of authorised dealers in sterling and to bring under control their own holdings of sterling and sterling securities. This was done in terms of letters exchanged between the Governors of the Bank of England and the Reserve Bank after the conclusion of the interim agreement on sterling balances which made no reference to, and therefore excluded from its purview, the sterling holdings of banks authorised to deal in foreign exchange in India. In order not to restrict unduly movements of capital in the sterling area, a provision was made under the agreement for certain capital sums, e.g., the savings of British nationals retiring from India and taking up permanent residence in the U.K., to be paid out of the No. 2 Account (that is, the blocked Account) of the Reserve Bank with the Bank of England. Control over transactions in sterling area currencies continued thereafter, its nature and extent varying with the balance of payments position of the country from time to time and the quantum of the releases made by the U.K. under the subsequent sterling balances agreements.

Import Control Policy

In the immediate post-war years, there was need for large imports of capital goods as well as food, besides consumer goods, for meeting the backlog of war-time demand. On the other hand, there was uncertainty over India's continuance in the sterling area Dollar Pool; the scale of withdrawal from the accumulated sterling balances was itself a matter for negotiation with the British Government. In these circumstances, and with the restoration of communications and the reopening of trade with the enemy countries which made a wider choice of the sources of supply possible, exchange considerations became more important than freight in determining the countries from which imports could be permitted and their quantities.

As already mentioned, from September 1,1947, the conditions applicable to remittances against imports from non-sterling countries were extended to remittances in respect of imports from the sterling area; in other words, duplicate copies of import licences and Customs bills of entry had to be issued for exchange control purposes, in regard to sterling area imports also, as from that date. This brought in its wake an enormous increase in licensing work. The availability of multilaterally convertible sterling in terms of successive sterling balances agreements

set a new limiting factor to imports. Throughout these years, the Government relied much on the Bank to advise them on the direction of import control policy. In fact, it would be correct to say that changes in the policy, particularly during 1946-48, were made almost entirely on the Bank's advice and initiative. The Bank, with its close contact with the authorised dealers and through them the import trade, made many suggestions (which were implemented practically in toto) for streamlining the administration of import control and for removing vexatious delays.

The ' Consumer Goods Drive ' which the Government of India had started at the close of 1943 to relieve the very serious inflationary position had led to a substantial increase in the licensing of imports of consumer goods even from countries outside the sterling area, including the U.S.A., during 1944-45. When the U.K. gradually became able to meet more of India's demands, they were switched back to the U.K. In July 1945, the British Government decided to allow small quantities of imports from Canada and the U.S.A., even if these goods were available in the sterling area, provided that the goods were essential and there were established trade connections through which the U.S.A. was the normal supplier of such goods before the war. The Government of India fell in line with this policy.

A major change in the import policy for the half year July-December 1946 was initiated by Governor Deshmukh in April 1946. The figures of India's balance of payments during the preceding few months showed that contrary to the earlier fears India was running an increasingly favourable balance with almost all countries, owing to an increase in exports combined with an extremely restrictive licensing policy for imports from the U.S.A. following the cessation of Lend-Lease aid in September 1945 and the stringent dollar position of the sterling area. Hence the Governor urged the Government strongly to adopt a more liberal import policy which would slow down the rate of sterling accumulation without harming India's interests and also serve as an anti-inflationary device. He advocated increased purchases from outside the sterling area also.

The Governor was also greatly concerned with the delays experienced by Indian importers in obtaining licences from the Import Trade Controller, which prevented India from getting a share of the limited supplies of goods available from Continental sources. The Import Licensing Department was not administratively geared to handle the large increase in applications and a thorough reorganisation and expansion were called for immediately. While not overlooking the need to control the import of goods which would compete with those produced by nascent Indian industries, the Governor suggested that the import of certain ranges of goods which was only subject to restrictions

on exchange grounds be allowed under *open* general *hence* as this would give considerable relief to the Import Trade Controllers and speed up the issue of licences for goods whose import had to continue to be restricted.

The Governor's suggestions resulted in the addition, early in July, 1946, of a large number of items to the existing Open General Licence No. VII (introduced in January 1946) which permitted the import of goods from Empire countries within the sterling area without individual licences and the issue of a new *universal* Open General Licence No. VIII covering the import of a limited range of goods from all countries. At the Bank's instance, the validity of import licences was also raised in July 1946 from six months to one year, to assist importers as well as the authorised dealers through whom the letters of credit were opened. Henceforth, Government's policy was to allow import of goods from outside the sterling area provided two conditions were fulfilled, viz., that (1) the goods were 'essential to the maintenance and development of the national economy or the maintenance and increase of the standard of life' and (2) they were not available in the sterling area. There was to be no question of imposing any ceiling on dollar (or other difficult currency) expenditure for the import of goods. Thus an impetus was given to the import of a large variety of consumer goods.

However, much to his chagrin, the Governor found very soon that his representations to Government in April 1946 had resulted in a more or less complete abandonment of all control over the import of consumer goods. The full effects of the relaxation began to be felt in the last quarter of 1946 when imports began to arrive in large quantities. The value of licences issued during the quarter October to December 1946 for imports from the U.S.A. was well over $500 million. Alarmed at the huge orders already-placed for such articles as fountain pens, pencils, parachutes, combs, mirrors, imitation jewellery and toilet requisites, the leading banks themselves, the Governor found, were tightening up their policy for granting letters of credit facilities to holders of import licences and were also raising the margin requirements. What was even more disconcerting was that control was still exercised over essential goods such as machinery, tools and agricultural implements for which licences were only issued on a quota basis to established importers often on the basis of the value of their pre-war imports, even these being subject to inordinate delays.

In January 1947, Sir Chintaman wrote strongly to Government, bringing these facts to their notice. The inflationary dangers apparent in April 1946 having receded now, he urged that Government should lose no time in taking stock of the position and reimposing restrictions wherever required. He .also suggested that Government consider introducing the same system of licensing imports of consumer goods on a

quota basis to established importers as operated in the case of the more essential goods.

Simultaneously, the Governor made certain other suggestions for a thorough revision of the import licensing policy to meet the needs of the situation when sterling became multilaterally convertible. Nearly 75 per cent of the reduction of £ 100 million in India's sterling balances since April 1946 represented a deficit in India's balance of payments on current account. In the Governor's view, India could not afford such a large adverse balance of payments in the future especially as drawings from the I.M.F., permissible up to Rs. 33 crores in a full year, would have to be reserved for meeting unexpected deficits caused by monsoon failures or other unforeseen contingencies. Steps would have therefore to be taken immediately to bring such a situation under control.

The Governor reasoned that the only practical method by which import control could be administered in the future was to constitute a standing departmental policy committee as in the U.K. or a Foreign Exchange Control Board as in Canada on which representatives of the spending departments of Government (e.g., Industries and Supplies, and Food), the Commerce Department and the Reserve Bank met under the chairmanship of the Finance Department to allocate the available foreign exchange, including sterling, among competing demands. In other words, the existing qualitative licensing had to give way to a system of quantitative licensing. The tasks of this committee were elaborated by the Governor thus:

> The first action of this Committee must be to make an estimate of foreign exchange resources both actual and prospective. This will have to be based on crop forecasts and calculations as to the volume of exports of primary commodities. The statistical tables compiled by the Reserve Bank on a monthly basis and the Customs returns will act as a check on the estimates and show to what extent they can be relied on. Once this is done, the Committee must fix the amount of foreign exchange that can be allotted for different categories of imports, food, fertilisers, capital goods, consumer goods, petroleum products, raw materials such as cotton and wool, and miscellaneous commodities, and on the basis of these allotments import licences can be issued. The Committee must work out long term plans covering import programmes for a year or longer, but it must always be prepared to revise its policy with changing conditions. For that reason, the Committee must meet regularly and frequently. When sudden and unexpected demands for foreign exchange arise, the importance of the new demands must be considered in relation to the existing programme and adjustments made by reducing expenditure on other goods which are less essential. Alternatively, in the event of an unexpected expansion in exports resulting in an increase in foreign exchange holdings, a decision must be made whether to let the foreign exchange accumulate to meet the cost of capital goods imports in the future or whether to allow the windfall to be used to relieve existing shortages in goods for current consumption.

The Governor also suggested to Government that advantage be taken of the offer of Sir Wilfrid Eady to allow some of their officers to study the modus oberandi of the Treasury Committee which had the task of estimating and allocating the foreign exchange resources of the U. K. To this end, he proposed that the officer of the Finance Department who would be associated with the committee and the Chief Controller of Imports be sent to London. Taking up the theme with the Chief Controller of Imports, the Governor made detailed suggestions for facilitating the change-over of the licensing system to on& based on allotments of foreign exchange, and to enable it to operate with flexibility and efficiency. He also urged that senior officials of the Commerce Department should study the practices and procedures of the Board of Trade in the U. K., which had gained considerable experience in this difficult matter.

The Governor's advice to Government resulted early in March 1947 in the cancellation of O.G.L. VIII and in the termination of the validity of all import licences issued since January 1, 1947 and permitting shipment up to December 31, 1947 (other than those for the import of capital goods) on June 30, 1947. During the next few months, there was almost complete chaos as considerable time elapsed before procedures were devised for extending beyond June 30 the validity of those licences which covered essential imports, and for issuing licences for import of articles covered by O.G.L.VIII where firm commitments had already been entered into by the Indian importers with the overseas suppliers. Besides, the issue of new licences against all types of commodities other than those covered by O.G.L. VII and capital goods was suspended by Government for quite a while pending a decision as to the articles whose import was to be restricted. In the middle of May, the Government announced that on a review of the entire import trade control policy they were cancelling forthwith O.G.Ls. I and III applicable to imports from Ceylon, Portuguese possessions in India and other neighbouring countries and substituting O.G.L. VII applicable to imports from the U.K. and other Empire countries (except Canada, Newfoundland and South Africa) by a new O.G.L. IX covering a limited number of items. Goods covered by these cancelled Open General Licences (including O.G.L. VIII) were, however, to be allowed to be imported without a licence provided shipment was made on or before June 30, 1947. Where such shipment was not possible but firm orders had been placed or letters of credit opened before the dates of cancellation, licences were to be issued valid for shipment up to September 30, 1947. Licences expiring on June 30 under the March order were to be similarly revalidated up to September 30, on individual application.

These far-reaching changes in import policy as well as the extension of exchange control to sterling area imports threw an almost impossible burden of work on the Import Trade Controllers and importers were put to extreme difficulties and inconvenience by the delays that occurred in the revalidation of licences or in the issue of new ones. There was also delay in the announcement of the policy for the second half of 1947. Throughout, Mr. Cayley kept in close touch with banks and importers in the ports and made innumerable suggestions to the licensing authorities for speeding up the work, The confusion continued till practically the end of 1947 but Government did not realise the seriousness of the situation, as could be seen from the Finance Department's remark that 'in the period of administrative change through which we have been passing, a certain amount of confusion was inevitable '. This attitude was not relished by the Bank and on its strong recommendation as well as in the interests of the reputation in the foreign markets of not only the Indian importers concerned but also the country at large, the Government agreed to remittances of foreign exchange being made against all goods actually imported into the Dominion of India up to December 31, 1947, regardless of whether the importers had import licences or not. In order that the flow of trade might not be interrupted and the commitments already made might be honoured, the Government also extended the validity of the licences issued or revalidated up to September 30, 1947 for a further period up to December 31, 1947 ; imports under the cancelled O.G.Ls. were likewise allowed to be made during this extended period without licences if certain conditions were fulfilled.

The licensing policy for the half year July-December 1947, which Government announced on July 3, 1947, classified imports into three categories, namely, (i) free (food, capital goods and certain essential raw materials and consumer goods), (ii) restricted (certain raw materials and consumer goods which would be licensed up to specified value ceilings) and (iii) prohibited (luxury items). There was to be no distinction between hard, soft and sterling area currencies, all foreign exchange being considered equally difficult. Thus, the Governor's suggestion for quantitative licensing of imports had been accepted by the Government fully. Individual import licences also came to be issued thereafter with the c.i.f. value as the limiting factor in all cases.

There were many other problems faced by the import licensing authorities, on which the Bank made suggestions to Government. The Bank also made recommendations with regard to export promotion, being an essential concomitant of the policy of restricting imports.

After 1947, the Bank's role in this field was more in regard to advice on administrative problems, particularly in the matter of the types of payments for imports from different countries, which changed frequently,

rather than in the sphere of policy. Import policy in the subsequent years was determined largely by India's balance of payments position, with the hard and soft currency countries separately and the ceilings imposed on the drawals from the sterling balances. An important change made early in 1948 was the abandonment of the policy of non-discrimination regarding the sources of imports, which had been a feature of import control earlier; a distinction between dollar and non-dollar sources of supply was made so as to bring imports from the former under stricter control. A noteworthy step towards the smooth and efficient administration of import controls, the origin of which could perhaps be traced to the Governor's suggestion for the constitution of a departmental policy committee, was the announcement by Government on September 27, 1948, of their decision to set up an Import Advisory Council. Consisting of representatives of industry and commerce and of the different Government Departments, Members of the Legislative Assembly and non-officials, the Council met for the first time on February 26, 1949. In September 1948, it was also arranged that the Deputy Controller of Exchange should visit New Delhi twice a month and also attend the inter-Ministry meetings whenever possible, with a view to establishing closer, liaison between the Bank and the Government in matters pertaining to import, export and exchange policies.

When the Post-War Dollar Fund was established, the Government of India worked out a procedure in consultation with the Bank to ensure that drafts were made upon it only in appropriate cases. Expenditure was debitable to the Fund in respect of specific categories such as the import of capital goods which came under the Capital Goods Registration Scheme (introduced in December 1944 for registration with the Chief Controller of Imports of-orders placed or to be placed for capital goods), import of heavy electrical plant (these two categories of licences bore special notations, viz., C.G.P.W.and H.E.P.), imports of capital goods on Government account and the employment of American technicians on new industrial undertakings. Under the arrangements made, the expenditure was initially to be financed by drawings from the Pool and the Bank of England was to debit the Fund and credit the Pool on receipt of periodical statements from the Reserve Bank showing the allocations made against the Fund and the expenditure incurred against these allocations.

As mentioned in Chapter 12**,** the Post-War Dollar Fund ceased to exist after June 30, 1948, the unexpended balances therein having been treated as part of the amount of convertible sterling released under the second interim agreement of February 1948 on the sterling balances with the British Government.

Bullion

The licensing of imports of gold and silver bullion was a function of the Reserve Bank and not of the Import Trade Control.

Since 1940, a system of licensing imports of silver had been operated by the Reserve Bank, the object of which primarily was to control the price of silver in India. A licence fee was charged, taking into account the current parity with the country concerned, so as to reduce the margin of profit to the importer to a level of about Rs. 3 per 100 tolas. From about the middle of 1943 onwards, the Bank's licensing policy was based on the essentiality criterion in line with the general licensing system operated by the Chief Controller of Imports. The imports were thus generally for small amounts, from sterling area countries and the Middle East. The bulk of the supplies of silver to the market during the war period was made by official sales amounting to about 181 million ounces.

After the close of the war, both the Government and the Bank felt that in view of the demand for silver in India and the prevailing high prices, imports of small quantities of the metal should be allowed even from non-sterling area sources provided the currencies of those countries were not regarded as 'difficult'. The Secretary of State who was consulted saw no objection to this but urged the Government of India to go slow so as not to push prices up against both the U.K. and India. The Governor also thought that the imports should be permitted only on the basis of a licence fee as hithertofore so as to secure the bulk of the profit for Government. Another suggestion of his was that if any large offers were forthcoming from sterling area sources, these could be taken advantage of by Government and the import arranged by them on their own account outside the scope of the licensing scheme. Licences for imports involving payments of U.S. dollars were not, however, to be granted. This policy was continued up to March 1947, but the upward trend of domestic silver prices continued. While in the early part of 1946, imports were mainly from sterling area sources, from August 1946 there were imports from the U.S.S.R., Iran and Spain also, via London.

With the enhancement of the existing import duty on silver in the budget for the year 1946-47, the Bank discontinued the levy of a licence fee on silver imports except for a nominal levy to cover administrative expenses. The import duty on silver was halved with effect from August 12, 1946.

The position in regard to imports of gold was more or less similar. It was late in 1944 that the Government of India amended the Defence of India Rules so as to authorize the Reserve Bank to levy a licence fee on the imports of gold allowed by it in the same way as on imports

of silver. The licence fee was to represent a proportion of the premium ruling in India over the London parity price. The licensing scheme was not, however, actually operated as it was finally decided early in 1945 to prohibit the import of gold altogether from foreign countries. The supplies to the market in the war period came mainly from official sales to the extent of 7.5 million ounces.

Following the imposition of an import duty on gold bullion and coin at the rate of Rs. 25 per tola in February 1946 (pari passu with the increase in the existing duty 'on silver mentioned earlier) by the Government of India, in view of the abnormally high and artificial level of the Indian price of gold as compared with the prices in the U.K. and the U.S.A., the Bank began to allow imports of gold from the sterling area countries, but without levying a licence fee. A few months later, the Bank began to authorise imports from outside the sterling area also if the currency in which the payment was to be made was 'easy' regardless of the country of origin of the gold. This policy of allowing imports freely against easy currencies was adopted as the Bank considered that the anti-inflationary effects of the imports of bullion justified the expenditure of foreign exchange. With a view to encouraging the import of gold bullion, the duty thereon was halved, along with that on silver, on August 12, 1946.

However, as in the case of silver, the limited imports of gold did not help restrain the price rise. In the circumstances, the continuance of imports of bullion would only have meant depletion of the country's sterling balances needed for essential imports. Besides, the Bank's policy enabled merchants in Continental Europe (e.g., Belgium and Holland which were short of sterling) or China, who obtained gold at parity prices from various sources and sold it at the Indian inflated prices, to lay down sterling funds at well below the official rates of exchange. Further, with the introduction of the system of 'transferable accounts' in respect of Belgium, Holland and Portugal, payments in sterling to these countries were as good as payments in U.S. dollars. Consequently, the licensing of further imports of gold and silver from any source was stopped on March 6, 1947, outstanding commitments being allowed to be completed.

The total amount of gold imported between July 1946 and March 5, 1947 was 765,000 ounces; the amount of silver imports licensed between August 1946 and March 5 next was 39 .76 million ounces.

As for the future policy regarding the allocation of foreign exchange for imports of bullion, the Governor considered that this should be a matter for decision by the foreign exchange policy committee the creation of which he had recommended to the Government only in February 1947. Unlike in the U.K., the demand from industrial users in India was likely to be small and the Governor felt that this could

be met, if necessary, by sales by Government from their own stock. Import of bullion for the making of jewellery was not, of course, to be permitted.

There was a sharp rise in the prices of both gold and silver following the imposition of the ban on their imports on March 6, 1947 as this meant, once again, the isolation of the Indian market from the rest of the world. The ban on bullion imports was further tightened by an amendment to the Foreign Exchange Regulation Act, 1947**,** later in December that year, making it illegal to import gold or silver into any port in the Provinces of India without the permission of the Reserve Bank even though the bullion so brought was in transit to a place outside the Dominion of India, say an Indian State; the object was to prevent the smuggling into India of the gold imported into such territories.

There were also some purchases of silver by the Reserve Bank on Government account in the London market commencing from December 1946. Some months earlier, the Governor had considered that in view of the advantageous prices of silver obtaining in London - it was 63d. per ounce in July 1946 -Government should utilise the opportunity to purchase as much silver as possible on their own account, with a view to building up reserves so that India would in due course be in a ,position to return the whole quantity of Lend-Lease American silver without allowing the price to go against her. Government agreed with the proposal. Purchases could, however, commence only in December as the prices in London began to rise soon afterwards. Between December 1946 and February 1947 the Bank was able to purchase 4.3 million ounces, the bulk of it at 55d. and the balance at 541/2d. The Governor discontinued the purchases with the imposition of the ban on private imports on March 6, 1947 ; if sterling was soon going to become as difficult as dollars, it was 'clearly illogical to continue buying silver at 55d. per ounce in London when it is as now available in New York at about 86 cents or roughly 51 pence '.

In April 1948 again, Government wished to take the opportunity offered by the 'unexpectedly large' sterling balances in the Bank's No. 1 Account with the Bank of England to replenish their stocks to meet the future liability to the U.S. The Governor saw no objection to utilising part of the balances towards the purchase of silver, if it was available at a reasonable price. A million ounces were purchased by the Bank partly in London and partly in Hong Kong before the purchases were called off by the Government shortly afterwards for fear of the possibility that such purchases might prejudice the course of the forthcoming sterling balances negotiations with the U.K.

Foreign Capital Investment in India

One of the important aspects of exchange control policy in the postwar years concerned the extent of facilities to be offered for repatriation of capital by foreign companies established in India. The problem engaged the attention of the Bank towards the close of the war in the context of the growing demand for ensuring Indian participation in existing foreign business ventures in India. The view then held by the Bank was that the repatriation of British capital would present no difficulty in view of the abundant sterling balances; the only problem would be in regard to the provision of dollars for paying out American interests. Following the British policy the Bank was not then granting repatriation facilities for withdrawal of American capital. The Governor considered that if a new policy of a minimum of Indian participation was brought into force it would be necessary to allow these companies to repatriate their capital. However, not being current transactions, the necessary dollars for these remittances would have to come from the special allocations for post-war capital development (viz., the Post-War Dollar Fund). The Bank's views underwent a change in the middle of 1946 as India's balance of payments with the U.S.A. had been favourable to a far greater extent than anticipated. There was also the added advantage that if repatriation facilities were allowed that would encourage the inflow of fresh American capital. The Governor therefore recommended to Government that the earlier policy of refusing repatriation facilities be reversed and the transfers of American holdings to' Indian hands allowed if the operations were otherwise unobjectionable.

As the year 1946 drew to a close, and the balance of payments with the U.S.A. began to show an adverse trend, the Bank's opinion veered round to its original view that repatriation of American capital, on the basis of knocking the amount off the Post-War Dollar Fund, would retard the rate of industrial expansion. It would not also be possible to draw from the I.M.F. to buy out foreign investments as the Fund's resources were not available for meeting capital-transfers. The Bank, however, welcomed fresh American investment in India in the form of participation in rupee companies; the bigger the American subscription to a new issue of capital in India, the less dollars India would have to find to pay for imports of machinery, etc., for the project.

Owing to the unsatisfactory exchange position and the absence of any clear idea as to the extent of availability of India's foreign exchange resources pending agreement on the utilisation of the sterling balances, the Bank advised the Government in February 1947 that each application for repatriation of capital could be considered on its merits, that is to say, depending on factors such as whether the capital was being

taken out for failure of the Indian company to establish itself or whether the foreign interests were selling out in view of the good prices offered or for fear of the worsening of the Indian economic or political outlook. The Government of India concurred in this view. They also agreed that if the foreign interests were compelled by Government policy (e.g., by nationalisation or insistence on a certain minimum Indian participation) to repatriate their capital, it would be the duty of the Control to afford them facilities for doing so.

With the conclusion of the first interim sterling balances agreement in August 1947, capital transfers between India and the U.K. and the rest of the sterling area came to be governed by letters exchanged between the Reserve Bank and the Bank of England in terms of Article VIII thereof. The 'agreed' transfers of capital covered by the letters were to be accounted for through the Reserve Bank's No. 2 Account, i.e., by transfer from the No.2 to the No.1Account or vice versa as the case might be. While the voluntary repatriation of sterling area investments in India and Indian investments in the sterling area were to be allowed freely and adjusted through the No. 2 Account in the aforesaid manner, the question whether transfers representing fresh capital investments both in the sterling area by Indian companies and in India by sterling area concerns should qualify for similar treatment was to be subject to mutual consultation in each case. Transfers between the two Accounts of the agreed amounts were to take place at monthly intervals.

In his reply to the letter from the Bank of England confirming the proposed arrangements, the Governor made it clear that the Reserve Bank would not allow the sale of sterling either from the No.1 or the No.2 Account purely for purposes of investment, e.g., investment in sterling area stock exchange securities, as this would lead to the deflection of Indian capital from the finance of Indian enterprise. In regard to transfers from other countries of the sterling area to India, the Governor explained that it was not the policy of the Government of India to allow the No. 2 Account to be used as a means of facilitating further British capita! investment in India, as this would have the effect of increasing the accumulated balances (on which the interest earned was nominal) and also create an additional charge on the No.1 Account for interest and profits earned on the investments. Approvals would, therefore, be given only 'in exceptional cases where the advantages to India's economy were clear and substantial '.

The formulation of a definite policy regarding investment of foreign capital in India was first made in the Industrial Policy Resolution of April 1948. Till then the Bank had to refer every application to the Government for a decision, resulting in considerable delay and inconvenience to both the overseas investor and the Indian party, if any,

sponsoring the venture. The Bank was particularly concerned with cases where the total capital investment was less than Rs. 5 lakhs as these were outside the scope of the Capital Issues Control. The provisions of the Foreign Exchange Regulation Act were being used to control such investments in India involving foreign capital; In the case of inward capital movement from the U.K., there was a further reason for control as the transfers might be effected through the No.2 Account if both the Governments were agreeable. Taking up the matter with Government in December 1947 the Bank pointed out that in the past few months, while there had been no large movements of foreign capital to India, a number of proposals had been received from foreign interests for starting small companies with capital of less than Rs. 5 lakhs. The risks of the pioneer plant were to be borne by the overseas investors and a public issue of rupee capital was intended to be made only at a later, date if the ventures proved successful. The Bank felt that there were great advantages to India in giving facilities for the establishment of such concerns as the investment would act as a pump primer for considerable industrial development in the future. The capital amounts being small, there was also no question of such permission resulting in foreign control of any key or basic industry or the domination of Indian enterprise by foreign interests. The Bank therefore proposed to Government that pending the formulation of a general policy, it should be empowered 'to allow the issue of shares in new concerns to non-residents where capital is less than Rs. 5 lakhs or such lower figure as Government care to name, provided the concerns are directly concerned with the establishment of manufacturing projects, or performing useful services in the expansion of overseas trade or in assisting Indian industry '. Government were unable to take a decision immediately on this proposal also.

Early in 1948, the Finance Ministry invited the Bank's comments on a note prepared in its Research Section on the investment of foreign capital in India. The note traced the historical developments in regard to the steps taken till then and the recommendations of responsible authorities from time to time. Its conclusion was that foreign capital should be welcomed in certain restricted spheres subject to essential safeguards, in the interests of rapid industrialisation. The matter was examined at length in the Bank by the Department of Research and Statistics and the Governor placed its proposals before the Committee of the Central Board at its meeting on March 17, 1948. The Committee approved the Department's recommendations generally but Director Kasturbhai Lalbhai suggested certain modifications which also commended themselves to the other Directors. In view of the importance of the subject the Committee desired that it should be placed before the Central Board for consideration at its next meeting on April 5. The

Board considered the issues involved very carefully and made several positive recommendations to the Government in a lengthy resolution which it would be appropriate to quote here in full:

RESOLVED

(1) That in view of the urgency of raising the already low national standard of living, the inadequacy of national savings to meet the requirements of rapid economic progress and the country's balance of payments difficulties, the Central Board of the Reserve Bank of India are strongly of the view that, generally, definite encouragement should be given to the investment of foreign capital in India, and that, in particular, Government must so determine and inspire confidence in their policies as to establish such conditions as would prove attractive to the foreign investor who is prepared to invest his capital in India purely with economic and business objectives ; that to this end Government should restrict the field of nationalisation of industries to the minimum necessary in the interests of the country and avoid making loose or general pronouncements about nationalisation likely to scare away the potential foreign investor.

(2) That although Government would always have to bear in mind the necessity of ensuring that control of investments by foreigners did not lead to political difficulties, the Board did not deem it to be desirable in India's interests to recommend a hard and fast rule that in every case control should remain vested in Indian hands through a majority of nationals on board of management of any enterprise having foreign participation.

(3) That in order to ensure that essential national interests were safeguarded, it should be prescribed that the' previous sanction of the appropriate Ministry of Government be required where the interest proposed to be retained by the foreign investor was over 24 per cent, only such concerns being regarded as foreign concerns.

(4) That in addition to the safeguard referred to in (3) above, the following safeguards be also laid down, namely-

(a) That Government reserve to themselves or to, the nationals of the country industries which they determine to be of basic importance;

(b) Foreign concerns engaged in primary production should undertake that, wherever possible, they develop processing and complementary industries in the country :

(c) Foreign concerns should follow a consistent policy of reinvesting a part of their profits in the country ;

(d) That foreign concerns should agree to the training of nationals in the technique of industry where foreign capital has brought with it foreign technicians ;

(e) That foreign concerns do not discriminate between foreign technicians and nationals, other things being equal, and do not exploit labour in the country ;

(f) That no foreigners are allowed, in future, to participate in the managing agency of any concern, or, if any such participation became inevitable, it is not allowed to exceed 24 per cent; and

(g) That Government retain the freedom to discriminate against foreign concerns in appropriate cases in respect of tariff, bounties and subsidies.

(5) That, to counter balance the safeguards, foreign capital be given an assurance in respect of-

(a) Equality of treatment regarding taxation ;
(b) Protection of patents and copyrights ;
(c) Adequate compensation in the event of nationalisation ;
(d) Inviolability of person and property of foreigners ;
(e) Facilities for the transfer of capital and profits ; and
(f) Provision for the avoidance of double taxation of any burdensome character, both corporate and individual, as, for instance, for foreign technicians.

In addition, the Board desired that the Governor should separately advise the Government that:

> in view of the terms of the Indo-British Financial Agreement, they see how further investment of British capital could be permitted take place, unless it is demonstrably advantageous to the country, or necessary from some national point of view. The Board were inclined to the view that considering the difficulties of the availability of capital and other goods today, encouragement should be given to the invest of private American capital in the country, in addition to financing the purchase of capital and other essential goods through loans obtained from the Export Import Bank or the International Bank for Reconstruction and Development.

The Board's resolution, passed on the eve of the debate on Government's Resolution on Industrial Policy in the Legislative Assembly, would seem to have been of much assistance to Government. Paragraph 10 of the Resolution, the whole of which was accepted by the Assembly, welcomed the participation in Indian industry of foreign capital and enterprise, particularly as regards industrial technique and knowledge, but contemplated the enactment of legislation providing for the scrutiny and approval by the Government of every case of foreign participation. The legislation was also to provide that as a rule the major interest in ownership and effective control should always be in Indian hands. Besides, in all cases, the training of suitable Indian personnel for eventually replacing foreign experts was to be insisted upon.

The Industries (Development and Control) Bill introduced in the Legislative Assembly on March 23, 1949 did not, however, make any specific provision covering the participation of foreign capital in Indian industries.* As the Prime Minister, Mr. Nehru, announced in the

* The Bank's Central Board, which considered the draft Bill in a special meeting held on August 31, 1949, at the Government's request, felt that the powers of control contemplated were so drastic that they would seriously affect investment of domestic as well as foreign capital and hamper industrial development.

Legislative Assembly on April 6, 1949, Government had come to the conclusion that such regulation as was necessary ' to secure the utilisation of foreign capital in a manner most advantageous to the country ' could be secured through existing laws. In regard to the foreign exchange aspects of such participation, the Prime Minister announced that (i) remittances of profits earned by foreign interests would be allowed freely as heretofore; (ii) Government had no intention to place any restriction on withdrawal of foreign capital investments, but remittance facilities would naturally depend on foreign exchange considerations; and (iii) if any foreign concern came to be compulsorily acquired, Government would provide reasonable facilities for the remittance of proceeds. Referring to the British interests in India which formed the largest part of foreign investments in the country, the Prime Minister stated that even with Government's policy to encourage the growth of Indian industry and commerce, there would continue to be considerable scope for the investment of British capital in India. ' The Government of India ', he concluded, ' have no desire to injure in any way British or other non-Indian interests in India and would gladly welcome their contribution in a constructive and co-operative role in the development of India's economy '.

The procedure for consideration of applications for foreign capital investment was revised by the Government in March 1949. The decisions were to be taken by an Inter-Ministerial Committee consisting of representatives of the Ministries concerned. All applications received by the Reserve Bank were therefore continued to be referred to Government who placed them before the Committee.

Following a communication from the Bank of England in January 1950 about the British Government's decision that capital directly invested in the U.K. after January **I,** 1950 by non-residents (i.e., by those resident outside the sterling area) in projects approved by the Government might be allowed to be repatriated at any time thereafter to the extent of the original investment, i.e., excluding any appreciation thereon, and from the proceeds of that investment, a similar policy with regard to non-sterling area investments was adopted in India on the Reserve Bank's recommendation. As an incentive for ploughing back into the business a part of the profit earned by foreign companies, the Bank suggested that such capitalisation of the profit as had received the prior sanction of the Government should be treated as additional investment eligible for repatriation facilities. The facilities were not to be available in respect of purchase of shares on the stock exchange unless this formed an integral part of an approved investment project. In regard to whether the facility should also be extended to existing foreign investments, although the amount of such investments was not large the Bank did not think it was desirable for Government to accept

the responsibility for their repatriation. All these recommendations were accepted by the Government. * Remittances to residents of the Scandinavian countries were however allowed freely in respect of investments made before January 1, 1950 also, in line with the U.K. policy; and, of course, in the case of sterling area investments where transfers took place through the No. 2 Account, no restrictions existed or were contemplated.

These decisions were made known to the public in a press note issued by the Government of India on June 2, 1950. The policy of repatriation of foreign capital investments in India remains largeyl the same to this day.

Exchange for Foreign Travel, etc.

With the opening up of communications after the close of the war and the emphasis on the rapid industrialisation of the country, increased visits abroad by businessmen for purchase of plant and machinery, and reviving old contacts and establishing new ones for rebuilding trade, became necessary as well as practicable. To facilitate such visits, relaxations were made in the exchange control restrictions on foreign travel, including the abolition in February 1946 of the Exit (Finance) Permit system. In September 1946, the Reserve Bank was authorised to deal with all applications for purposes of travel for business without reference to Government. The rules for release of exchange for journeys abroad for medical treatment and for education were also liberalised in the immediate post-war period. Foreign exchange was also granted for visits abroad for reasons of personal convenience, but the amounts varied according to the overall foreign exchange position and the degree of softness of the currencies of the countries visited. In these as also in matters relating to release of exchange for emigrants, the policy of the Bank of England was followed closely.

Jurisdictional Changes

There were also some changes in the Bank's jurisdiction for administration of exchange control during the years 1945 to 1951. After the reoccupation of Burma, the Government of India amended the Defence of India Rules so as to restore the position that existed prior to the Japanese occupation in 1942 ; this had the effect of removing all restrictions on financial transactions between India and Burma except that on the export of gold from India. When the Rangoon Office of the

* Capital appreciation in the value of any investment made after January 1, 1950(including profits reinvested in the projects) with Government approval, was also allowed to be repatriated from March 1953.

Bank was reopened, it continued to administer the exchange control regulations in Burma, which were the same as those in force in India. When the Bank severed its last links with Burma in April 1947, it gave up the control of foreign exchange in Burma also. As regards the Persian Gulf area, where the administration of exchange control was in the hands of the Reserve Bank, control was taken over by the Political Resident, Bahrein, acting under the supervision of the Bank of England, on July 1, 1948. The changes in the Bank's functions in relation to exchange control in Pakistan are mentioned in a separate section.

In regard to the Indian States, which were part of the sterling area, following the passage of the Foreign Exchange Regulation Act the Political Department of the Government of India arranged with most States for the enactment of parallel legislation delegating to the Reserve Bank powers to operate exchange control in their territories with a view to ensuring uniformity in the system of exchange control throughout the country. In terms of the Foreign Exchange Regulation (Amendment) Act, 1950, which came into force on April 18, 1950, the main Act was extended to all the Indian States, then known as the Part B States, except the State of Jammu and Kashmir.

EXCHANGE MANAGEMENT

Separation of the Rupee-Sterling Link

An important development in the post-war period relating to the Bank's function of maintaining the exchange value of the rupee was the formal severance of the rupee-sterling link as an offshoot of India's membership of the I.M.F. The rupee-sterling link was ensured through

(1) the obligation placed on the Reserve Bank through Sections 40and 41 of the Reserve Bank of India Act to sell and buy sterling for rupees on demand without limit at certain fixed rates and (2) the power conferred on the Bank by the Defence of India Rules to license dealings in foreign exchange, in terms of which the Bank did not permit authorised dealers to alter their quotations. To enable banks to transact business at fixed rates in spite of fluctuations in demand and supply, the Bank bought and sold sterling, both ready and forward*, for unlimited amounts and gave them facilities to cover their foreign exchange transactions with the London Control at its fixed rates.

Under the Bretton Woods Agreement (Article IV, Section I), the par value of the currency of each country adhering to it was to be

* The Bank began to sell sterling forward in October 1946 only. This is mentioned later in this section.

expressed in terms of gold or U.S. dollars. It followed, therefore, that once India signified her acceptance of membership in the International Monetary Fund, the external value of the rupee would no longer be tied to sterling alone but would be determined directly by its par value compared with the par values of the currencies of other member countries. If in these circumstances the statutory link with sterling was to be continued, it could only be ensured by changing the par value of the rupee identically with sterling whenever sterling was appreciated or depreciated, whether or not the situation required it.

As early as March 1946, the Government of India sought the Bank's views on whether the repeal of Sections 40 and 41 would be necessary or desirable in India's interests both if she continued to be a member of the I.M.F. and if she withdrew her membership. However, the Bank was not in a position to make any specific recommendation, in view of the prevailing uncertainties in regard to the ratification of the Anglo-U.S.Loan Agreement by the U.S. Congress, continuance of India's membership in the I.M.F. and the arrangements to be made for realisation of the sterling balances. It indicated the possible courses of action in very general terms.

With the settlement of the question of India's membership of the I.M.F. in sight, the issue of amendment of Sections 40 and 41 again became a live one. On October 9, 1946, the Bank sent its 'provisional views on the various points in issue' for Government's consideration. The Bank agreed with the Finance Secretary's view that the par value of the rupee should be stated in concrete terms in the Reserve Bank Act and that the Bank should be authorised to buy and sell foreign exchange at such rates and on such conditions as might be specified by Government. It suggested amendment of Section 17 of the Act for conferring on it the authority to enter into foreign exchange transactions, the authority being designed to cover transactions both on its own account and on behalf of Government. The Bank also suggested the addition of two new clauses in Section 17 for authorising it (i) to purchase and sell securities issued by foreign Governments expressed payable in a foreign currency and maturing within a period of ten years from the date of purchase and (ii) to open accounts with or make agency arrangements with foreign banks other than the currency authorities of those countries, to enable the Bank to utilise their services in cases where the currency authority might not be considered the most appropriate agency.

In regard to what new provisions should replace Sections 40 and 41, the Bank considered that it was first necessary to decide whether the existing arrangement under which the foreign exchange resources of the country were held by the Bank should continue or whether there should be a change to the British system under which they were held

by the Government in the Exchange Equalisation Account and were operated by the Bank of England acting on behalf of the Treasury. The Bank was in favour of allowing the existing practice to continue, an important reason being that since the currency circulation in India formed by far the greater portion of the monetary media it was desirable that the responsibility for maintaining the exchange value of the rupee should rest with the note issuing authority. Examining the question further in November 1946, Deputy Governor Trevor told the Government that amendment of Sections 40 and 41 was intimately bound up with the revision of Section 33 covering the forms in which the assets in the Issue Department were to be held: points such as the revaluation of the gold, the determination of the proportion of sterling backing to the note issue and the inclusion of other foreign currencies in such backing had to be settled, while the final decision would also have to depend to a certain extent on the outcome of the sterling balances negotiations. However, he felt that as long as the existing par value of the rupee was not altered, there was no need for any urgent action to amend Sections 40 and 41. Since the amendments to Sections 33, 40 and 41 were of a controversial nature, he preferred that the amendments to Section 17 alone be enacted as early as possible and the others held over until the future policy could be clearly worked out.

However, it was finally decided to retain the existing system under which the Bank operated in foreign exchange on its own account and to replace Sections 40 and 41 by a new Section 40, which enjoined the Bank to sell to or to buy from any authorised person, on demand, ' foreign exchange at such rates of exchange and on such conditions as the Central Government may from time to time by general or special order determine, having regard so far as rates of exchange are concerned to its obligations to the International Monetary Fund '. There was, however, to be no statutory provision defining the par value of the rupee. The Bank's other proposals regarding the amendments to Section 17 were broadly accepted by Government. The Reserve Bank of India (Second Amendment) Act, 1947, giving effect to these changes was passed by the Legislative Assembly on April 8, 1947 and came into force on April 18. Amendment of Section 17(3) authorising the Bank to purchase and sell foreign exchange and foreign bills of exchange (instead of sterling and sterling bills only) from and to scheduled banks and of Section 33 permitting it to hold foreign securities (instead of sterling securities) in the Issue Department assets was made separately in 1948 when the Act was amended for the purpose of transfer of the Bank's ownership to Government.

The obligation of the Bank under the new Section 40 was limited to transactions with 'authorised ' persons, i.e., persons entitled under the Foreign Exchange Regulation Act to buy or sell foreign exchange.

The minimum amount to be bought or sold was fixed at Rs. 2 lakhs as against £10,000 earlier.

In pursuance of the powers conferred by the new Section 40, the Government of India issued on April 19, 1947 notifications fixing a new selling rate of IS. 5 55/64d. and a new buying rate of IS. 6 9/64d. Since the notifications only prescribed the rates at which the Bank was bound to sell and buy sterling without limit, their issue did not affect in any way the rates at which the Bank conducted its day-to-day operations with the authorised dealers, which was under Section 17 of the Act. The new spread between the buying and selling rates for exchange transactions conformed to the Articles of the I.M.F. which required that the maximum and minimum rates, in the case of spot exchange transactions, should not differ from parity by more than 1 per cent. As mentioned in an earlier section, for the same reason, the Bank was also given power under the Foreign Exchange Regulation Act [Section 4(2)] to prescribe the rates at which authorised dealers could transact foreign exchange business.

From the inception of exchange control, all authorised dealers in foreign exchange were required to operate at the rates fixed by the Exchange Banks' Association. As there was no uniformity in the rates quoted by the Association at the different centres -it was the practice for the Association in certain upcountry centres to quote wider rates there was a disparity in the rates quoted by the authorised dealers in the same town: while the branches of some banks in the port towns quoted the port rates upcountry, others operated at the rates published by the local Exchange Banks' Association. With the coming into force of the Foreign Exchange Regulation Act, it was decided to ensure a uniform practice and to this end, the Bank advised all authorised dealers that they should henceforth operate on the basis of the rates published by the Exchange Banks' Association, Calcutta. A further step in the direction of uniformity was taken in 1950 when, in consultation with this Association, the Bank standardised the rates quoted by the authorised dealers in foreign exchange and the authorised money changers for the encashment of foreign currency notes.

A few other developments of some interest or importance could suitably be mentioned here. Unlike the war years, the post-war period up to 1951 did not find the Bank a net buyer of sterling throughout. During the two years 1946-47 and 1948-49, the Bank made net sales of sterling owing to the disappearance of the major factors responsible for sterling acquisitions as also a liberal import policy. Figures of the Bank's net purchases or sales of sterling during the years 1945 to 1951 are given on page 664. The substantial net purchases during 1949-50 and 1950-51 reflected a favourable balance on private account caused by restrictive import policies and the spurt in exports

(£million)

April-March	Purchases	Sales
1945-46	79.27	
1946-47	___	65.54
1947-48	91-48	
1948-49	___	52.66
1949-50	139.55	
1950-51	235.56	

consequent on the devaluation of the rupee. However, foreign exchange reserves registered a modest fall during 1949-50 and a relatively much smaller rise during 1950-51 due mainly to imports on Government account. For a brief while (between January and June 1948), the Bank operated on Pakistan's account also, the net purchases amounting in all to £23 million.

A sudden demand for forward sterling became evident in October 1946 owing to public uncertainty over the par value of the rupee to be declared by the Government of India to the I.M.F., and in order to assist banks to meet the demand the Reserve Bank commenced selling as from October 7, 1946, ster1ing.T.T. for delivery up to six months forward at IS. 5 31/32d. maintaining the ready rate unchanged at IS. 5 63/64d. Like the ready selling and the spot and forward buying rates, this rate also remained unchanged until the devaluation of the rupee in June 1966. The demand for forward sterling from the banks subsided, however, after some time, and was negligible during the rest of the period covered by this volume.

Devaluation

In the field of exchange management a major event was the devaluation of the rupee in September 1949, by 30 '5 per cent, following an identical devaluation of the pound sterling. Sterling devaluation was followed immediately by the devaluation of a number of other currencies, as part of what looked like concerted action to correct the over-valuation of currencies in relation to the U.S. dollar. Of considerable significance to India was the non-devaluation of the Pakistan rupee. As under the Payments Agreement between India and Pakistan, the exchange rate between the two countries was to be at par and was not to be altered without due notice and mutual consultation, controversy started between the two Governments as to which of them acted contrary to the Agreement, and trade relations between the two countries were disrupted for quite some time.

The devaluation of the pound sterling was the result of a general view in the U.S.A., and in the I.M.F. circles too, that exchange rate

adjustment was necessary, and of the substantial loss in the sterling area's gold and dollar reserves partly under the influence of speculative forces. On September 17, the U.K. Government intimated to the I.M.F. that they proposed to devalue the pound by 30 .5 per cent (from $4.03 to the £ to $2.80); the Fund Board accorded approval. The order of devaluation (effective September 18) was appreciably larger than had been anticipated, apparently to set at rest any possible doubts regarding the ability of the U.K. to maintain the new rate. Other sterling area countries (excepting Pakistan) and several Western European countries followed suit.

In India, the Government made an announcement to the press in the early hours of September 19, to the effect that September 19 to 21 had been declared as public holidays, with a view to obviating speculation and dislocation of the markets following the devaluation of the pound sterling. The communique also stated that the Government proposed, in consultation with the I.M.F., to devalue the rupee to the same extent as sterling. This was followed by another communique issued on September 20 stating that the Government of India's proposal to devalue the rupee to the same extent as pound sterling had been accepted by the I.M.F. and that the rupee was to be equivalent to 21 U.S. cents as against the prevailing rate of 30.2250 cents. Its par value in grams of fine gold per rupee was to be 0.186621 giving a value of Rs.166.6666 per fine ounce of gold. The new rate was to become effective immediately; as September 20 and 21 were holidays, it came into effect on September 22, 1949. The exchange rate between the pound sterling and the rupee remained unchanged at IS. 6d. a rupee.

The press communique explained the reasons for the devaluation, as under:

> Devaluation as a corrective to the balance of payments difficulties in regard to dollars has been urged for some time. The Government of India did not favour such a course as it was felt that in view of the general conditions of Indian economy, devaluation was not likely to solve India's problem of dollar shortage. India's imports are regulated by controls, and the deterrent effect of high prices resulting from devaluation is therefore neither necessary nor desirable. Since the supply of India's exports is inelastic, her aggregate export earnings are not likely to increase by reducing export prices through devaluation. However, the decision of the United Kingdom to devalue Sterling, followed by similar devaluation by other countries, created a situation in which it became impossible for India to avoid similar action without detriment to her economy. India's trade, both export and import, being so largely a trade with sterling area countries and the price level being already high, it was clear that the Rupee could not be allowed to appreciate against Sterling without undermining India's competitive position and endangering the markets for most of her exports and ultimately being compelled to reduce the volume of imports still further.

> Over and above the pure economic factors of relative competitive positions, current expectation that India would not be able to avoid devaluation in the face of the action taken by other countries would have acted as a powerful psychological barrier to any transactions at the old rate of exchange, and trade might have been brought to a standstill. There was thus no alternative for India but to follow the other sterling area countries and devalue the Rupee as a defensive measure. As regards the actual extent of devaluation, it was clear that a smaller measure of devaluation of the Indian Rupee than Sterling would not have met the requirements of the new situation created in world export markets. A larger measure of devaluation than Sterling was equally out of the question as it would have meant creating greater difficulties in regard to essential imports and aggravating the loss in export earnings due to inelasticity of supply.
>
> The Government of India have taken this decision after the most careful consideration of all the factors and they have no doubt that it will work out in the best interests of the country. This is in consonance with the view in favour of maintaining the existing Rupee-Sterling rate expressed almost unanimously two years ago when the par value of the Rupee was first discussed.

In his speech in the Legislative Assembly on October 5, 1949 moving the motion 'that the situation arising out of devaluation of the rupee in terms of the dollar be taken into consideration', the Finance Minister, Dr. John Matthai, mentioned a further consideration which influenced Government's decision to devalue the rupee. India, being a member of the sterling area, was under an obligation to ensure that whatever she did was in keeping with the general objective of that area, which was 'to enable the countries included in that area to achieve a balance of trade at the highest possible level, partly by expanding exports and partly as a temporary measure -if that was necessary in order to restore equilibrium -by reducing imports also '.

The authorities also considered and rejected the alternative of not having a fixed parity, allowing the rupee to fluctuate. The reasons for this decision were set out in the note which Mr. J. V. Joshi prepared for the information of the Bank's Central Board which considered the matter at its meeting on October 13, 1949**.** Mr. Joshi observed:

> even in the period after 1931 when sterling went off gold and was fluctuating vis-a-vis dollar freely, yet, as far as parity with countries in the sterling area was concerned it was fixed and that area covered a major portion of Britain's foreign trade. And even then in order to minimize the evil effects of fluctuating dollar rate Britain had to institute an Exchange Equalisation Fund, the function of which was to iron out temporary and abnormal fluctuations in the exchange value of sterling. The realisation of the disadvantages of a fluctuating rate made the framers of the constitution of the International Monetary Fund at Bretton Woods to emphasize the need for the declaration of the par value and its maintenance as well as the consequent maintenance of cross-rates. The Fund has always been against a free and fluctuating

> exchange rate except in most abnormal circumstances and that too for very short periods . . . . . . .Our foreign trade would have been adversely affected by such a free market.

Mr. Joshi also pointed out that India would have been forced to leave the I.M.F. and consequently the I.B.R.D., as the Fund would not have approved a free and fluctuating rate. India would have been forced to leave the sterling area too. 'India would have been ill-advised to follow such a course', he concluded.

While there was some criticism in the country and the Legislature regarding Government's decision to devalue, by and large, it was realised that such a decision could not have been avoided. Among financial journals, the *Indian Finance* and the *Eastern Economist* supported Government's decision. In fact, in a leading article published as far back as May 14,1949 the Indian Finance had expressed the view that:

> With Britain if possible, and without Britain if necessary, India must devalue her currency.

Referring to the devaluation of the pound sterling, the *Eastern Economist* * observed:

> The hammer has fallen. It was, indeed, due to fall, and those who saw it poised, knew it was only a question of time and a question of the force with which it would descend.

As regards the devaluation of the rupee, the journal's comments were:

> The problem of the Rupee has not so far been examined in detail. And to examine it at this stage is very much like bolting the stable after the horse has galloped away. For the moment we are concerned with the consequences of a decision which has been taken - we believe rightly - in circumstances which broadly offered us no choice.

Although India resorted to devaluation as a defensive measure following the devaluation of sterling, it resulted in an improvement in the country's balance of payments in respect of the over-all position, as well as in the dollar sector, through both expansion of exports and the curtailment of imports.† It was of course difficult to estimate to what extent the fall in imports was due to devaluation and to what extent to other factors like import controls. Similarly on the side of exports, while devaluation did provide a considerable stimulus to jute manufactures and cotton textiles, it was not possible either to estimate the contribution made by other causes or to assess how long the improvement brought about by devaluation was expected to last. The declining trend

* September 23, 1949.

† *See Devaluation and After,* by P. S. Narayan Prasad, in the November 1950 issue of the *Reserve Bank of India Bulletin.*

of exports during the second quarter of 1950 was probably an indication that the effect of devaluation had ' neared exhaustion '. The improvement in exports from the middle of 1950 was largely due to the Korean War and the resultant world-wide stimulation of demand for essential raw materials. The problem of achievement of a more permanent equilibrium was linked up with the elimination of shortages of raw materials like cotton and jute. The nine-month period between devaluation and the outbreak of the Korean War was characterised by price stability; the general index of wholesale prices recorded a rise of only 6 points, from 390 to 396, over this period.

Exchange Relations with Pakistan

Exchange relations with Pakistan posed many difficult problems, especially after the devaluation of the Indian rupee in September 1949. The Bank not only participated in all the discussions between the two Governments for resolving the various issues but also drew up the detailed regulations for enforcing exchange control with Pakistan. The latter proved a difficult task and called for close consultation between the Bank, the Export and Import Trade Control authorities, the Customs and the Railways, owing to the extensive land frontiers and the peculiarities of the border trade.

As mentioned in Chapter 18, on the partition of India the Bank, in its capacity as banker to the Government of Pakistan, also became the authority responsible for the administration of exchange control in Pakistan. On July 1, 1948, when the Reserve Bank ceased to be banker to the Government of Pakistan, exchange control in Pakistan was taken over by the State Bank of Pakistan. There was however to be no exchange control *between* India and Pakistan even after the complete monetary separation in July 1948; a Payments Agreement was entered into to regulate monetary relations between the two countries, the salient features of which have also been mentioned in Chapter 18. Remittances from one country to the other were free of exchange restrictions and cover was provided by the central banks of the two Dominions to banks for the purchase and sale of each other's currencies at rates based on the parity between the two rupees.

There was uncertainty about the renewal of the Payments Agreement on its expiry at the end of June 1949; the imposition of exchange control vis-a-vis Pakistan was inevitable if the Agreement was not extended. However, the two countries reached a decision on June 29, 1949 to renew the Payments Agreement for another year (on the basis OT the same holding limit of Rs. 15 crores for each other's currency as before and an enhanced limit of £15 million for settlement in No. 1 Account sterling).

Trouble arose very soon by the non-devaluation of the Pakistan rupee in September 1949. The Payments Agreement required, for its working, the maintenance of parity between the Indian and Pakistan rupees. Neither Government could alter it 'except after due notice and mutual consultation '. However, as the Finance Minister later explained to the Legislative Assembly in early October, the circumstances in which the sterling devaluation occurred were such that India had to take action urgently but effort was made to inform Pakistan and Ceylon promptly after the I.M.F. was notified on September 17 of India's desire to devalue the rupee by 30.5 per cent. The Pakistan Government's reply to Dr. Matthai's telegram of September 18 was sent only on the 22nd, intimating that they had decided not to devalue. This news item had in fact appeared in Indian newspapers on the 21st morning; the news item also stated that the new rate of exchange between India and Pakistan had been announced by Pakistan as Pakistan Rs. 100 = India Rs. 144.

The Finance Minister defended India's action and met the charge that India (and not Pakistan) was responsible for the disturbance that had occurred in the economic relations between the two countries by reference to the fact that the trade and payments agreements were, inter alia, based on the consideration that the final settlement would be made in sterling. Besides, since Pakistan was not yet a member of the I.M.F., the only standard in terms of which the value of the Pakistan rupee could be determined was sterling or the Indian rupee. It was, therefore, the appreciation of the Pakistan rupee which had caused the rupture.

There was rather protracted correspondence between the two countries, each charging the other with breach of the Payments Agreement. Normal trade relations between the two countries came to a standstill. On September 21, the Reserve Bank issued a press communique informing banks that it would not be in a position to quote any rate for the purchase and sale of Pakistan rupees, thus suspending the cover facilities it had hitherto provided. But banks were free to carry out such remittance transactions as they could within the limits of their resources at whatever rates they liked. Later, on September 27, ' solely with a view to facilitate resumption of business between the two countries ', the Government of India informed the Pakistan Government of their preparedness to allow transactions to commence on the basis of the new rate of Pakistan Rs. 100 equal to India Rs.14315/16 as decided upon by the Pakistan Government. The Pakistan authorities, however, wanted the Reserve Bank to transfer sterling in respect of the balances of the State Bank of Pakistan with the Reserve Bank under the Payments Agreement, but this was flatly refused by the Finance Ministry.

In the absence of fixation of the exchange rate between the two currencies, the deadlock in Indo-Pakistan trade relations continued. Meanwhile, on September 28, Mr. Ambegaokar, Additional Finance Secretary, sought the advice of Sir Chintaman Deshmukh who by that time had retired as the Reserve Bank's Governor and was in Washington in his capacity as India's representative in matters of external finance. After considering the various alternatives placed before him, Sir Chintaman supported the alternative of not recognising officially the new parity fixed by Pakistan but of letting the rates find their own level.

The actual rates prevailing in the free markets were nowhere around the Pakistan official parity of Rs.100 Pak. = Rs.144 Indian. It appears that there were at least four different rates prevailing in the Calcutta market in mid-October 1949. Probably the most important rate, according to a Government investigation, was in respect of transactions by people who had money in India as well as in Pakistan or people who wished to transfer money from one side to the other agreeing to accept payment in Calcutta against an advance in Dacca or vice versa; such transactions began on a ratio of India Rs.102 to Pakistan Rs.100, but the rate later went up against India, being India Rs.115 = Pakistan Rs.100 in mid-October.

There was also consultation between a few senior officials of the Bank and the Government of India regarding exchange policy, trade and payments arrangements, etc. A few notes were prepared in the Bank and were forwarded to Government for consideration. There were sharp differences of opinion at the Secretariat level over the methods to be adopted to tackle the problem of the exchange rates.

Exploratory talks were held on October 22, 1949 between Mr. Ambegaokar of the Ministry of Finance and Mr. Mumtaz Hasan of the Pakistan Finance Ministry. The two main issues that required to be considered were the treatment of accumulated balances under the Payments Agreement and the basis for resumption of trade between the two countries. As regards the first, the Pakistan Government wanted their balances (of the order of Rs. 25 crores) to be written up and then paid to them in terms of the Payments Agreement, i.e., Rs.15 crores in Indian rupees and the balance in sterling, but Mr. Ambegaokar argued that since the Payments Agreement had ceased to be operative, the settlement of balances was not automatic but should be negotiated between the two Governments. In regard to the second, Mr. Ambegaokar's suggestion of a free rate of exchange was not acceptable to the Pakistan representative, who hinted at the possibility of Pakistan imposing exchange control.

The difficulty of making remittances through the banking system added to the hurdles to trade caused by the suspension of the Open

General Licences and other restrictions. While banks in India had the freedom to deal in Pakistan rupees out of their own resources at the free market rates, in Pakistan directives were issued to banks to operate in Indian- rupees only at the official rate (the State Bank of Pakistan issued an order on November 15, 1949 making transactions between the Pakistan rupee and the Indian rupee illegal at a rate other than the official rate which was declared to be Rs.14311/16 selling and Rs.1443/16 buying for Pakistan Rs.100). The State Bank of Pakistan was not, however, prepared to support this new official rate and except for a very few selected transactions (which included transactions under the April 1950 trade agreement described later), did not extend cover facilities for remittances from Pakistan to India. In other words, banks in Pakistan could purchase and sell India rupees within the limits of their own resources but only at the official rates.

Trade between the two countries therefore remained restricted to exchange of commodities on the frontiers. Such transfers of funds as took place to finance these transactions were effected at rates which, though initially at varying premiums in favour of the Pakistan rupee, soon approximated to the pre-devaluation parity between the two currencies, the Indian rupee ruling on occasions at a premium.

A Bill authorising Pakistan to become a member of the I.M.F. and the I.B.R.D. and to pay her share was passed by the Pakistan Parliament only in early April 1950. The declaration of her par value was therefore awaited in India with interest. Pakistan had, in the meantime, i.e., since the devaluation of the Indian rupee, taken -certain steps which could only be interpreted as a preliminary to the introduction of full exchange control. Soon after devaluation, the Pakistan Control began to insist on what it called ' proof of remittance ' in respect of pre-devaluation purchases of jute. Attempts were also being made to repatriate Pakistan's capital assets in India through the permission given for the import of Pakistan bonds purchased out of funds held by Pakistan banks with their Indian correspondents. Rules were prescribed, effective June 1,1950 requiring the proceeds of exports from Pakistan to India (other than those in respect of which trade was to be allowed freely in terms of the trade agreement of April 21,1950), to be surrendered to the Control in full. On the Indian side, it was previously thought that the high parity of the Pakistan rupee which was not justified by the facts of Pakistan's trade with India would itself provide the necessary check on capital exports to Pakistan. The continuance of the movement of funds in spite of the obvious unprofitableness to the holder showed that factors other than purely economic ones were also in operation. India had, therefore, no option but to impose exchange control as soon as she was in a position to do so, i.e., as soon as the rate of exchange with the Pakistan rupee was settled. Control was

felt to be necessary not only on dealings with Pakistan but also on financial transactions with Afghanistan (which were hitherto free) in order to prevent the former restrictions being circumvented by persons professing that their dealings were with Afghanistan.

With a view to reopening trade relations, negotiations were held between the two Governments early in 1950, at which the Reserve Bank was also represented. As a result, a short-term trade agreement was signed on April 21, 1950, valid in the first instance up to July 31, 1950. The agreement provided for a limited resumption of trade; the movement of commodities was so arranged as to achieve a balance between imports and exports in terms of the Indian rupee. The pivot of the agreement was a deal between the Indian Jute Mills' Association and the Pakistan Jute Board for the sale by Pakistan of 8 lakh bales of raw jute in terms of Indian rupees which were to be credited to a special account of the State Bank of Pakistan with the Reserve Bank of India and made available to Pakistan for the purchase in India of specified commodities, e.g., jute manufactures, cotton textiles, woollen goods, tobacco, mustard oil and steel. The practical difficulties encountered in operating the agreement were considerable, 'necessitating its extension up to September 30, 1950. In the meantime, Pakistan had become a member of the I.M.F. in July 1950 and had communicated to it the par value of her currency for acceptance. In anticipation of the Fund's decision, there were again close consultations between the Reserve Bank and the Government of India regarding the detailed arrangements for imposing exchange control with Pakistan. In September 1950, the Bank's offices were also alerted, as in June 1949, to keep themselves in readiness to extend the control to Pakistan and Afghanistan immediately Government's decision was known.

The fixation of the par value of the Pakistan rupee by the I.M.F. however got postponed beyond September. In November 1950, at the Government of India's instance the Bank examined whether in the event of further delay in the settlement of the exchange rates, such exchange control measures as might be practicable should not be introduced immediately, and came to the conclusion that the imposition of exchange control should await a fuller resumption of trade with Pakistan.

The outbreak of the Korean War in June 1950 however brought an entirely new factor into the situation. With the development of a strong sellers' market for primary products, India began experiencing an acute shortage of raw jute at a time when demand abroad for jute manufactures was at a peak. Therefore India on her own initiative resumed trade negotiations with Pakistan in February 1951 and an agreement was concluded on February 25 between the two countries. At the same time, India also accepted the official par value of the Pakistan rupee as

communicated by the Government of Pakistan to the I.M.F. Shortly thereafter, that is on March 19, the I.M.F. accepted the par value communicated by Pakistan, namely, Pakistan Re.1 =30 .225 U.S. cents. *

The trade agreement valid for a period of 16 months up to the end of June 1952 provided for the export and import between the two countries of specified quantities of certain commodities. Another feature of the agreement was that a number of commodities were placed on the Open General Licence both for import and export by the two countries.

Following the trade agreement and the acceptance of the exchange rate, exchange control was extended to Pakistan and Afghanistan on February 27, 1951 ; from that date the Pakistan and Afghan currencies were treated as foreign currencies for all purposes and financial transactions with these two countries became subject to the restrictions imposed under the Foreign Exchange Regulation Act,1947.Although, with the introduction of the control, the settlement of surpluses or deficits arising out of transactions with Pakistan had to be made in sterling as in the case of other sterling area countries, it was the intention that financial transactions between India and Pakistan should continue to be conducted in rupees, either Pakistan or Indian. For this purpose, the two central banks undertook to buy and sell from and to authorised dealers in the respective countries Pakistan or Indian rupees, as the case might be, on a ready basis. The Reserve Bank's buying and selling rates for Pakistan rupees were Rs. 69-8-3 and Rs. 69-6-6 for Indian Rs.100 respectively, while the State Bank of Pakistan's rates were Rs. 144-0-9 buying and Rs.143-13-3 selling for Pakistan Rs.100. The rupee balances accumulated by the two central banks on account of current transactions taking place on or after February 27, 1951 were to be convertible into current sterling at any time, without any restrictions whatsoever. † Agreed capital transfers were to be settled between the two banks in blocked sterling.

In order to facilitate trade with Pakistan and Afghanistan, the Reserve Bank was prepared to consider granting limited licences to scheduled banks, which were not authorised dealers then, to undertake exchange dealings with these countries. The Bank was also prepared to consider the claims of indigenous bankers who had conducted hundi business in the past with these countries. Exports to Pakistan and Afghanistan also became subject to the normal export regulations, the Control's requirements being however varied to suit the particular needs of trade with these countries. In the case of large firms which regularly imported goods from and exported goods to these countries,

* The Pakistan rupee was devalued on July 30, 1955 resulting in its being at par with the Indian rupee again.

† The outstanding balances in the State Bank of Pakistan's accounts under the 1948 Payments Agreement and the 1950 trade agreement were thereafter not operated upon.

the Bank was prepared to grant permission to set off the value of the exports and imports provided the firms had the necessary valid import licences. Capital remittances to Pakistan were banned; the grant of exchange facilities for personal visits as well as for transfer of current items such as profits, dividends, interest and pensions, and maintenance remittances was also held in abeyance pending the establishment of corresponding facilities by the Pakistan Control for remittances to India.

As a further step towards facilitating trade between the two countries, with effect from April 16, 1951, the two central banks began to provide forward cover facilities also to banks for delivery up to six months, on a reciprocal basis, each bank squaring its overbought or oversold position in the other's currency through purchases or sales of sterling, as the case might be, from or to the other at the official rates applicable to such transactions. *

* These arrangements for the provision of both ready and forward cover by the two central banks were discontinued with effect from September 2, 1958 as financial transactions between the two countries from then onwards could be settled in Indian rupees, Pakistan rupees, sterling or any other sterling area currency.

21

Monetary Management And Allied Issues

The post-war period, 1945-51, is full of interest in the sphere of monetary management; the authorities in India, like their counterparts abroad, had to face many challenges. The prolonged political crisis, culminating in the transfer of power and the partition of the country, with its aftermath of vast social upheavals, added to the complexities of the situation. Largely as a result of this, Government's economic objectives and policies at times lacked the necessary continuity and cohesion, although this was also partly the unavoidable result of numerous changes at the topmost level affecting the direction of economic affairs. However, it was fortunate that in the Reserve Bank there was continuity of the top management, which by its clear, consistent and yet pragmatic approach exercised a salutary influence during this critical period. There prevailed a remarkable identity of views between the Bank and the Government and, even when there was a divergence of opinion between the two as on occasions in the immediate post-war years, the Government accepted the Bank's judgement on monetary matters.

The end of the Second World War ushered in a period of reawakened awareness of the vital importance of international co-operation in the economic and other spheres. It would be useful therefore to study the course of events in the Indian economy against the background of developments abroad. Generally speaking, despite the extensive damage suffered by industrial capacity, the recovery of national economies after World War II was spectacular compared to the experience after World War I as, profiting from its lessons, there had been in most countries advance preparations for meeting post-war problems. Intense domestic effort and substantial foreign aid from the United States, which had