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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

nearly two-thirds of the official gold reserves and had its productive capacity almost intact, enabled most of the belligerent countries not only to restore pre-war levels of output of goods and services but even surpass them within a period of three or four years. A substantial measure of relaxation of war-time controls was generally brought about, though price controls continued to be retained in a number of countries as a check against inflationary forces. In some countries, drastic measures of monetary reform had to be undertaken to eliminate the bloated money supply and thus remedy the abnormal war-time inflation. Gradually there was also a return to monetary orthodoxy, that is to say, a retreat from war-time cheap money. Adjustments of exchange rates vis-a-vis the U.S. dollar, as an essential corrective of inevitably inflationary war finance, were also brought about, such changes occurring on an extensive scale and in an orderly way in September 1949. The post-war period was especially characterised by growing international monetary co-operation under the aegis of the International Monetary Fund and the International Bank for Reconstruction and Development. The substantial assistance provided by the United States for the rehabilitation of devastated areas, especially under the Marshall Plan, symbolised the growing awareness of the economic inter-dependence of nations. Also, financial assistance towards achievement of stability as well as for reconstruction and developmental needs began to flow, albeit on a modest scale, from the twin Bretton Woods institutions.

In India, mainly because of political uncertainties relating to the transfer of power, the course of the economy was far from smooth. On the whole, economic problems received less than due attention and growth during the post-war years was insignificant; indeed, industrial production, an important segment, received a set-back. There was even some confusion in authoritative quarters in the analysis of the economic situation and in policy prescriptions. In the beginning, although there was concern regarding the prolongation of inflationary pressures, the view prevailed for a while that a depression was likely soon after the war as a result of the abrupt contraction of public expenditure; it is worth noting that a similar view was widely held in the developed countries abroad. It would appear that the problem of a vast pent up demand and the consequent danger of latent inflation were not so prominently studied or sufficiently understood. Hence, at first, a policy of fiscal relaxation was pursued and there was also an attempt on the part of Government to cheapen money, despite resistance from the Reserve Bank. The only noticeable effort to tackle inflation took the form of a feeble attempt to mop up money accruing from tax evasion through demonetisation of high denomination notes early in 1946. However, it soon became clear that it was not any

depression but inflation that would be the aftermath of war, and with the intensification of the inflationary pressures arising from the withdrawal of controls and the marked stepping up of private spending, as well as budgetary deficits, a reversal of policies in the fiscal and monetary spheres became necessary. There was indeed a sharp departure in taxation policy underlying the budget for 1947~48, as it was, additionally, directed towards egalitarian social objectives through heavy direct taxation. Subsequently, taxation policy was gradually oriented so as to serve the twin objectives of withdrawing surplus funds from the community to counter inflation and at the same time of providing selective incentives for stimulating production and investment. There was also a gradual retreat from the abnormal cheap money conditions of the immediate post-war period. Also, in the beginning, there was much confusion and indecision in regard to physical controls. This resulted in too rapid a swing in the direction of decontrol ; but when this resulted in a sudden and serious rise in prices, there was a return, albeit reluctant, to controls, the desire to do away with restrictions ultimately being affirmed at the same time.

The frequent changes in fiscal policies during the period perhaps stemmed, to an extent, from the fact that in the five post-war years the country had no fewer than five Finance Members/Ministers! Fortunately, however, there was no change in the Governorship of the Bank till the end of June 1949 and this made for some continuity and stability in fiscal/monetary policy-making.

From the very beginning the Bank was aware of the danger of intensification of inflationary pressures in the post-war period. It therefore counselled great caution in the matter of dismantling the various physical controls and pleaded for their retention in the case, especially, of essential articles, like food and clothing. The Bank was also opposed to the further cheapening of money; it successfully resisted the suggestion of Government, in 1945-46, to lower the Bank rate as part of Government's drive to cheapen money. In fact, before long, the Bank skilfully piloted a modest retreat from cheap money. At the same time, the Bank's open market operations were reoriented to maintain confidence of the gilt-edged market in a period of successive shocks to confidence arising from political and other factors and to facilitate the return of the banking system to the normal credit-deposit ratio as also to enable it to move out of a Government securities portfolio with an excessive concentration of long-dated scrips. In the result, the Bank had to buy substantial quantities of Government securities. These purchases did not contribute much to monetary expansion because of the contractionist effects of heavy deficits in the balance of payments.

By about the close of 1949, the rupee had been devalued (in company with some thirty other currencies), and a substantial measure of normalcy had been achieved in the monetary sphere; latent inflation had been worked off to a considerable extent partly through a rise in prices and partly through balance of payments deficits met by drawing on war-time sterling accumulations. However, the trend towards stability in the economy received a set-back in June 1950, with the outbreak of hostilities in Korea which at one time threatened to assume larger dimensions. About the time our narrative in this volume comes to a close, namely, around March 1951, the Korean boom had started subsiding, although it was not till a year later that a sharp break in prices occurred.

MONETARY MANAGEMENT

Economic and *Financial Trends*

The developments in the economy may now be narrated in some detail. For a review of economic trends and policies, the post-war period falls into five phases, namely,

(I) August1945 to mid-August 1947, that is, the pre-partition period ;
(2) mid-August 1947 to June 1948, the period when the Reserve Bank was the common central bank for India and Pakistan;
(3) July1948 to September 1949, the devaluation phase;
(4) Septemberrg4g to June **1950,** the return of normalcy, and
(5) June**1950** to March 1951, the period of the Korean boom.

(1) 1945-47: During the early part of this period there were apprehensions in India, as in other advanced countries, that deflationary tendencies in the economy would dominate the scene. The Finance Member (Sir Archibald Rowlands), in the course of his speech presenting the budget for I 946-47, referred both to the existence of 'pockets of inflationary forces which require to be closely watched and controlled' and the likelihood of deflationary tendencies in Indian conditions following the cessation of war expenditure. Accordingly, he stated that the objective before Government in the following year should be to avoid 'the Scylla of increasing inflation and the Charybdis of too precipitate a deflation '. In fact, economic policies and measures of Government were mainly in the direction of avoiding deflation and rebuilding the economy. To this end, the budget for 1946-47 provided various tax reliefs, including the abolition of the Excess Profits Tax and introduced special initial depreciation allowances in respect of new buildings and plant and machinery for promoting investment.

The Government also embarked on a policy of gradually withdrawing controls. The Finance Member stated in his budget speech in February 1946 that some 150 control measures had already been withdrawn. The Hoarding and Profiteering (Prevention) Ordinance of 1943 and the Consumer Goods (Control of Distribution) Order of 1944 lapsed on September 30, 1946, with the expiry of the Defence of India Act. However, the continuance of controls in respect of certain essential commodities including foodgrains and cloth was ensured by the passage of the Essential Supplies (Temporary Powers) Act, 1946, in November. In view of their reservations in the matter of decontrol, the Government of India appointed in February 1947, a Commodities Prices Board, for keeping under review the movements of commodity prices and to advise Government in the formulation and administration of appropriate price policies. The Board did not favour the abolition of the system of controls but urged its improvement.

As already mentioned, the Government also endeavoured to bring about a further cheapening of money. It is hard to say whether this step was motivated only by the desire to fight the threatened slump. In any case, the boom in share and property values resulting from such a policy, reinforced by large tax reliefs, was of help to the British investors to sell their holdings at good prices and transfer the proceeds to the U.K. The Government's plan was apparently to bring down their borrowing rate by ¼ to ½ per cent. The Government were also most keen to carry out conversion of outstanding 3½ per cent undated Rupee Paper to a 3 per cent basis. To facilitate this objective the Government also unsuccessfully tried towards the close of 1945 to persuade the Reserve Bank to lower the Bank rate. The conversion was announced in May 1946 and this led to an intensification of the boom in the share and commodity .markets and added to the inflationary psychology. The situation was further aggravated by industrial unrest and a trend towards upward adjustment of wages and prices to compensate for the rise in the cost of living that had already taken place; this very adjustment constituted a factor of further inflation.

Besides, during the first post-war year, sterling continued to accumulate in a fairly large amount (Rs.190 crores) and although Government made strenuous efforts to counteract its expansionary impact through achieving a budgetary surplus, there was monetary expansion of the order of a little under 10 per cent. At the same time there was a marked expansion of commercial bank credit, of over 50 per cent, due partly to increased trade activity, particularly of imports, and a rise in advances against shares and securities. The result was a further marked rise in commodity prices, the Economic Adviser's general index (base: week ended August 19, 1939 = 100) rising from 244 .1 in August 1945 to 271.3 in August 1946, i.e., by over 11 per cent in a year.

In the second post-war year, there was no sterling accumulation but, on the contrary, a substantial decline of Rs.180 crores, on account of payments on current and capital accounts. At the same time, a deficit on Government's budgetary account began to emerge. Commercial bank credit recorded hardly any net change over the year. The net impact of these factors was a modest contraction in money supply, of about 3 per cent. Commodity prices continued to advance, the general index rising to 299 by August 1947, or about 10 per cent higher than a year earlier. However, the unhealthy boom that characterised the stock market in 1945-46 -the rise in the share index (1927-28 = 100) was 48 per cent between August 1945 and August 1946 -received a set-back in September, when a sharp decline set in, owing among other reasons to the conviction that there would be no further cheapening of money and to the disturbed political situation in the country,

(2) 1947-48: The second phase, namely, mid-August 1947 to June 1948, was a period of great stress and strain. The loss of predominantly agricultural regions, consequent on partition, meant a reduction in the supply of food and other primary commodities. There was also a decline in agricultural production on account of the dislocation caused by communal disorders and the failure of crops in parts of the country. Industrial production also continued to suffer as a result of widespread civil disturbances, mounting labour unrest and the general atmosphere of uncertainty affecting business activity. The growing imbalance in the economy arising from the worsening supply position was aggravated by the broadening demand of individuals and industry for satisfying their deferred wants. There was substantial deficit in the Central Government budget as a result of the large expenditure on the relief and rehabilitation of displaced persons. This, as well as the Reserve Bank's open market operations (which were continued partly on account of extra-monetary factors), contributed to a substantial expansion in money supply.

Aggravating these inherently inflationary forces in the economy, the first post-Independence Government also ventured on a policy of substantial decontrol of the production, distribution and prices of important commodities like foodgrains and cloth, towards the close of 1947 and early in 1948. This decision was taken by the Government against the advice of the Commodities Prices Board, the Reserve Bank management and the opinion of the financial press. By and large, the expectations of Government with regard to larger availabilities on decontrol and consequent decline of prices were not fulfilled and there was a sharp rise in prices, especially of foodgrains and cloth, transport bottlenecks also being a contributory factor. The rise in the general index of wholesale prices in the period August 1947 to June 1948 was of the order of 30 per cent.

(3) 1948-49: During the third phase, from about the middle of 1948 till September 1949, the general index of wholesale prices remained more or less stationary and in fact recorded a temporary decline to 370 by March 1949 which was no doubt partly seasonal in character and was also in part due to a reimposition of controls on prices and distribution of many essential articles like foodgrains and cloth. However, this price stability would appear to have been substantially due to a large import surplus, representing imports both of consumption goods and capital equipment for the rehabilitation and modernisation of industry. Government pursued a very liberal policy with regard to imports through the institution of two Open General Licences. The large current account deficit and the sizeable outflow of capital on official account had a heavy impact on foreign exchange reserves, as reflected in the decline of sterling balances by Rs, 273 crores in the 14month period July 1948-August 1949; this more than neutralised Government's budgetary deficit. The net impact of these factors on money supply was a decline of over Rs. 300 crores or 15 per cent.

Government were much exercised during this period over the rise in prices that had occurred since December 1947 and held a series of discussions with economists and industrialists to evolve an anti-inflationary policy; the Reserve Bank's economists also participated actively in these discussions. The main features of this policy, announced in October 1948, were to enlarge availability of goods, through both increased domestic production and larger imports and to restrain the aggregate demand through the avoidance of Government's budgetary deficits and increased saving, personal as well as corporate. The introduction of a new form of short-term Government obligation, viz., the Treasury Deposit Receipts, raising of permissible limits for investment in small savings media, the promulgation of an Ordinance to limit dividends payable by public limited companies, the liberalisation of depreciation allowances, exemption from taxation of new industrial undertakings, abolition of capital gains tax, reduction of super tax and of import duties on plant and machinery as well as essential industrial raw materials were some of the measures taken to implement the above objectives. Although these measures were nearly all essentially long range ones, they did produce an immediate favourable psychological impact.

During this period bank credit recorded a net decline. Banks also experienced a substantial contraction in deposits, necessitating sales of Government securities which the Reserve Bank had to buy to help maintain orderly conditions in the gilt-edged market. The decline in deposits stemmed mainly from the very sharp balance of payments deficit which the country experienced during the year. By this time the abnormally low money rates prevailing during the war and immediate

post-war years had given way to a phase of stringency, the short-term rates ruling higher in the range of ½ to 1 ½ per cent as compared with a mere ¼ per cent in the latter part of the war period. There were distinct signs of the revival of the seasonal pattern of short-term interest rates characteristic of the Indian money market. The long-term gilt-edged yield also was restored to the level of slightly over 3 per cent prevailing at the close of the war. The higher yield basis and the petering out of inflationary forces were also reflected in a further substantial marking down of share prices, a process which began in the autumn of 1946. The index of equity prices (1938 = 100) declined from 262.5 in June 1946 to 112.9 in June 1949.

By about the middle of 1949, it could be said that the economy had returned substantially to normalcy. The latent inflation had been worked off to a considerable extent. The banking system had also reverted to the traditional pattern of assets. Economic and financial policies had fairly crystallised. This process was consummated so to say by the devaluation of the rupee in September 1949, which helped to a certain extent in restoring balance of payments equilibrium, through larger exports and restraint on imports.

(4) I949-50: The year 1949-50 witnessed Government's endeavour to realise the benefits of devaluation as also to restrain the inflationary impact of the measure. In October 1949, the Government announced a comprehensive eight-point programme, with the main objectives of bringing about a reduction in the level of prices and an increase in the country's foreign exchange resources. Special emphasis was laid on a rapid expansion of exports and reduction in imports from hard currency areas consistently with maintenance of the flow of essential goods. Bilateral agreements were entered into for the exchange of goods with several countries. Steps taken for tackling the problem of the price level included a cut in the prices of controlled commodities like foodgrains, cloth, yarn, pig iron and steel, a check on speculation through the prohibition of futures trading in several commodities, and the levy of export duties on some of the articles exported mainly to hard currency areas. Other steps taken were the reduction in Governmental expenditure, the regulation of credit facilities with a view to discouraging speculative holding of stocks and attempts to augment national savings. A scheme for compulsory savings applicable to Government employees was introduced as from December 1, 1949. The National Savings campaign was reorganised and substantial tax reliefs and other concessions to industries as well as to individuals were granted for encouraging investment.

These policies were largely successful. The Bank's sterling assets recorded a net increase of about Rs. 50 crores in the period September 1949 June 1950, from Rs. 779 crores to Rs. 827 crores. As regards

commodity prices, there was a rise of a little under 5 per cent in the 12 month period July 1949-June 1950 and of under 2 per cent in the period September 1949-June 1950. The expansion of money supply and of bank credit were of modest dimensions. There was no budgetary deficit. The Reserve Bank's net purchase of securities during the year was also very modest.

(5) 1950-51: The last phase witnessed mainly the impact of the Korean War boom. There was a substantial improvement in the balance of payments position on account of larger exports resulting in an increase in foreign exchange reserves of the order of Rs. 30 crores in the year 1950-51 (July-June). At the same time, in contrast to the position of the preceding two years, commercial bank credit recorded a phenomenal expansion, of almost Rs.100 crores. The banks financed this to a large extent by sale of Government securities, which were bought mostly by the Reserve Bank. In the result, there was a sharp expansion of money supply of the order of Rs.100 crores or 5 -6 per cent between July 1950 and June 1951. Commodity prices also rose sharply by over 15 per cent. The halting recovery of share prices in 1949-50 gave place to a mild boom, the general index of equity prices recording a rise of 18 per cent. It was only with the cooling off of the Korean War in the spring of 1951, supplemented by the imposition of large export duties in the Government of India's Budget for 1951-52, that the boom conditions in the economy began to taper off.

Altogether, by about the middle of 1951, the abnormal forces operating in the economy in the war and post-war years had been nearly worked off and the economy was poised to embark on a modest developmental effort. By this time the Planning Commission had been established and the preliminary outline of the First Five Year Plan had been prepared and circulated. Close relationships had also been established with the I.M.F. and the World Bank, assistance from both the institutions having already been obtained to some extent.

Looking at the period as a whole, the main features of the economy were as follows:

(i) A substantial decline in foreign exchange reserves. The Bank's sterling assets which rose from Rs. 1,478 crores on the eve of the termination of the war in August 1945 to a peak of Rs. 1,733 crores in early April 1946 ,stood at Rs. 857 crores at the end of June 1951. About Rs. 500 crores of the decline was, however, accounted for by extra-ordinary transactions, namely, payment to Pakistan and payment to the U.K. towards sterling pensions, etc.;

(ii) a large budgetary deficit on Government account. The balances of the Central Government with the Reserve Bank which reached a peak of Rs. 533 crores in April 1946 came down to

Rs. 163 crores at the end of June 1951; Rs. 75 crores of the decline was accounted for by transfers to Pakistan;

(iii) a considerable expansion of commercial bank credit. Scheduled bank credit which stood at Rs. 284 crores on the eve of the termination of World War II rose to Rs. 552 crores at the end of June 1951**,** the credit-deposits ratio almost doubling in this period from 32 per cent to 62 per cent. The expansion in credit was largely financed by sale of Government securities, which were mostly taken up by the Reserve Bank, whose purchases were substantial, of the order of Rs. 250 crores;

(iv) a rather modest monetary expansion, the expansionary effects of budgetary deficit and bank credit expansion being mostly neutralised by the deficit in balance of payments; and

(v) a marginal decline in industrial production and a sharp rise in the price level of the order of 90 per cent reflecting mainly the release of pent up demand in the system.

With this background of the developments in the economy, attention may now be turned to the details of monetary management. Principally, this will be an account of the Bank's efforts initially to restrain Government from their policy of further cheapening of money and then to 'consolidate' the cheap money, which really meant a gentle retreat from the position reached in the middle of 1946. The Bank had also the task of facilitating the return of the banking system to the traditional pattern of assets, that is, higher credit ratio and lower investments ratio as compared to the war years, and enabling the economy to finance the balance of payments deficit, on current and capital accounts, which was partly necessary and partly unavoidable. These involved substantial purchases of Government securities.

Matters relating to regulation and supervision of banking and the steps taken to deal with the banking crisis in Bengal are dealt with in Chapter 22**.** A brief account is also given in this chapter of the Bank's role in devising a suitable framework of regulation of the stock and commodity exchanges.

Retreat from Cheap Money

During the major part of the war period, official policy in India was to maintain a stable pattern of interest rates, with the Bank rate unchanged at 3 per cent and the Government borrowing rate also remaining at that level. In other words, while there was support to the doctrine of cheap money, there was no desire to proceed very far in that direction. Rather, the objective was to raise as much money as possible through sales of Government securities at stable rates. There was complete identity of views in this matter between the Finance Member

(Sir Jeremy Raisman) and the Reserve Bank authorities. The next British Finance Member, Sir Archibald Rowlands, who assumed office in April 1945**,** however, was desperately anxious to usher in an era of cheaper money after termination of the war. The Government's view then was, as already mentioned, that deflationary forces were likely to predominate after the cessation of hostilities. To counteract this, the Finance Member was anxious to use fiscal and monetary devices. Reference has already been made to the tax concessions given in the budget for the year 1946-47. The Finance Member was also keen that interest. rates should be brought down and he wanted to signalise it by the redemption of the 3 ½ per cent Non-terminable Paper and its conversion to loan(s) carrying lower rate(s). Apparently, the Reserve Bank authorities were not enthusiastic about this but ' to give the views of the Finance Member a fair chance ' the Governor suggested, in November 1945, that they ' should test the market with a suitable dated loan on distinctly ungenerous (to the market) terms'. The Governor also favoured the issue of a longish loan at 2 ¾ per cent, to be floated about the middle of January 1946. While accepting this suggestion, the Joint Secretary of the Finance Department (Mr. Sundaresan) sounded the Bank on a reduction of Bank rate. Wrote Mr. Sundaresan, on November 30, 1945:

> Hon'ble Member would also like you to consider whether the Bank rate could not be reduced just before the floatation of the new loan inorder to give it a chance of success by indicating to the market our new policy of inaugurating cheaper money.

Replying to this on December 5, the Governor suggested that the best time to put the matter of Bank rate reduction before the Committee of the Central Board would be after the announcement of the new loan but before the loan was open for subscription. Since the announcement of the new loan (2 ¾ per cent Loan 1960, at par) was scheduled to be made on January 8, the Governor suggested that if during the course of the next morning he received a telegram from the Finance Department requesting him to invite the Committee to consider the desirability of changing the Bank rate with reference to the new loan, he could place the matter before the Committee in the afternoon. The Governor added:

> On the merits, I agree that there is something to be said for giving such an indication to the market of your new policy. It assumes, of course, that you are confident of your ability to maintain that policy by the sustained volume of your expenditure. If you feel confident in that respect, it would help if you included the expression of such confidence in the telegram which I have suggested your sending me on the morning of the 9th January.

Accordingly, on January 8 the Finance Department sent the following telegram to the Reserve Bank:

> Secret. New Loan. As you will appreciate, 2 ¾ per cent Loan rg6o is being floated to signalize Government's intention to inaugurate a cheaper money policy which will be both necessary and helpful for development expenditure. We intend to maintain that policy by sustained volume of public expenditure and we should greatly appreciate if at tomorrow's meeting of your Committee you would invite them to consider desirability of immediately lowering Bank rate. As you know, list for new loan opens on fifteenth.

So, the Governor placed the matter before the Committee and, in fact, the draft of a circular to be issued to the scheduled banks, in the event of the Committee's agreeing to a reduction of the Bank rate, was kept ready; the new Bank rate mentioned in the draft of the circular was 2 ½ per cent.

The Committee of the Central Board was attended, besides the Governor (he came down from his ' enforced rest ' to guide the discussions ' in the right channels ') and Deputy Governor (Mr. Trevor), by only two outside Directors, namely, Sir Purshotamdas Thakurdas and Sir Homi Mehta. The decision of the Committee was that 'on very careful consideration of all the relevant factors, it was resolved that the Bank rate remain unchanged at 3 per cent '. Sir Chintaman Deshmukh's account of what transpired in the Committee on this subject is contained in his D.O. letter of January, 1946 to the Finance Secretary:

> Sir Purshotamdas, who said he had given his very careful consideration to the proposal, expressed the view that while Government's policy over the past few years had been to curb inflation, it appeared that their present intention was in a reverse direction, and that while a cheap money policy at the proper time would be of great advantage to the country, the indication is that inflationary conditions are still present. A decrease in the Bank Rate would unleash an unbridled bout of speculation. He also doubted Government's ability to maintain a cheap money policy throughout the full period of the country's postwar development, unless a full and restrictive control is continued over capital investments, which would be most unpopular with the general public, and considered it would be disastrous if Government had to revert to a higher rate after a short period through failure to implement its policy. The present rate is, to all intents and purposes, an ineffective one and does not reflect the true present rate for money, but why run the risk of reducing it to a rate which it might be found impossible to maintain? It is not anticipated that any benefit from a reduced rate would be passed on to agriculture, and the return on gilt-edged investments would become so unattractive as to discourage the general investor. Sir Purshotamdas considers there is a grave danger of overdoing the cheap money policy, and that further experience is necessary before running the risk of failure to implement Government's monetary

> policy. To sum up, he considers that the time may soon come when, Government being fully satisfied as to their ability to maintain a cheap money policy throughout the full period of their development programme, it will be desirable to reduce the Bank Rate, but that time is not yet. In any case, he would like to see first what Government have planned for the next budget.
> Sir Homi was in general agreement with these views, but held especially that a change in the Bank Rate will make no difference, although he did not quite see how lowering it would increase speculation.
> In view of these expressions of views, I did not feel justified in pressing for a lowering of the rate.

It is interesting to note that the Indian Finance, which had campaigned vigorously for a reduction in Bank rate as also for the conversion of the 3 ½ per cent Paper, welcomed the decision not to reduce the Bank rate. Wrote this journal, in its issue of January 12, 1946, as under:

> It may seem surprising that " Indian Finance ", which has been the first and foremost to advocate a reduction in the bank rate, is pleased that the bank rate has been maintained in the current week. There have been wild fluctuations in prices in the share markets in Bombay as in Calcutta. If the Bank rate had been reduced, it might have induced an uncontrollable boom. The Reserve Bank has, therefore, adopted a very appropriate policy in withdrawing tap loans and thereby maintaining the bank rate at the unchanged rate of 3 per cent by inducing a flow of subscriptions to the New Loan, and thereby withholding what might have proved a highly inflationary stimulus to the share markets in their present state.

The issue of the 2 ¾ per cent Loan, 1960 was, however, a failure, in that out of an offer of Rs. 25 crores, as much as Rs. 22 crores had to be taken up by the Government and the Reserve Bank. The failure of the loan seems to have been due less to intrinsic market forces than to the temporary confusion caused by the Demonetisation Ordinance. It was not long before the gilt-edged market witnessed the return of firm conditions, the stimulus being provided especially by the bullish budget of Sir Archibald Rowlands. It was possible for the Government to come out with special issues of the 3 per cent Loan, 1970-75 and of the 2 ¾ per cent Loan, 1960 in February and April, 1946, respectively. The Finance Department was anxious that the Bank should so conduct its operations that security prices rose quickly. The Governor was in fact annoyed at what looked like pressure tactics of the Government in this matter.

Incidentally, in February 1946, the Governor recommended the issue of a short-medium (8 years) tax-free loan carrying an interest of 1 ¾ per cent and also having the feature of bearer security. This was intended to offer attraction to owners of high denomination notes wishing to invest the proceeds of their demonetised notes. 'Our object in making this suggestion ', the Governor stated, 'is merely that a facility

may be offered for investing in Government loans to those who would wish at the same time to keep their holding clear of the net of the tax gatherer '. For some reason this idea was not pursued.

In view of the improvement in the gilt-edged market, the Finance Department became keener and keener to announce the redemption of the 3½ per cent Loan. The cheap money operations undertaken by the U.K. Government in 1945-46 provided no doubt a further stimulus to Government thinking in this behalf. Sir Archibald Rowlands, who was due to relinquish the Finance Membership, was most anxious to tackle this before he left.

In the circumstances, the Governor agreed to the redemption operations. On April 27, 1946, he wrote to the Finance Secretary as under:

> Having regard to the present money market situation and prospects, I am of the opinion that the time is opportune for reviewing the possibility of undertaking the redemption of 3 ½ per cent Paper. Although in earlier discussions on the subject I had expressed myself as being averse to carrying out such an operation on grounds of caution and circumspection, in view of the success of the 2 ¾ per cent rg6o loan which I had suggested as a tester, I now consider that the conditions in the money market have altered sufficiently to justify a revision of that opinion and that, judging from the prevailing situation and outlook an undertaking of this character would be attended by reasonable prospects of success. In forming this opinion, I assume that Government are satisfied that they would be able to exercise reasonable control with regard to the food and cloth position and that there will be no deterioration of the general financial and economic situation during the ensuing months.

As to the scrip into which facilities for conversion of the 3 ½ per cent Paper (which was redeemable only at the Government's option) should be offered, the Governor advised that while it should also be an irredeemable issue it should not carry a yield below 3 per cent. The Governor also suggested a 2 ¾ per cent dated issue maturing in 1985**,** the issue price being 98 per cent, giving a redemption yield of approximately 2. 84 per cent. Notice of redemption was to be given about the end of May. To meet the Finance Member's doubt about unduly long maturity and low issue price, the Governor later suggested a 2 ¾ per cent Loan, 1976 at Rs.99 giving a yield of 2.80 per cent. The Government accepted the recommendations; the announcement of redemption was made on May 24.

The Governor desired that a 2½ per cent rate for medium-term loans should be established, and for this purpose he recommended o Government in June 1946 the issue of a loan with a maturity of 10 to 12 years. Unfortunately the letter, which had not been registered, was lost. Meanwhile the market had also improved and so the Bank recommended that the maturity could be lengthened for the same 2 ½ per

cent coupon rate. This was the issue of the 2 ½ per cent Loan 1961 at par. The loan was a success, no doubt largely under the bullish impact of the announcement of the redemption of the 3 ½ per cent Paper made in May.

The conversion operation was a complete success. Out of an outstanding amount of Rs. 273 crores, Rs. 263 crores were converted till the end of January 1947 -Rs. 249 crores into the 3 per cent undated Loan.

The conversion operation met with a mixed reaction. While a section of the financial press *(the Indian Finance and the Eastern Economist)* welcomed it, there was also widespread feeling that the conversion was uncalled for, having regard to the long run interest of the money and capital markets. The senior Director of the Bank, Sir Purshotamdas Thakurdas, in his capacity as Chairman of the Oriental Life Insurance Company, was highly critical of the conversion operation, especially on the ground that incomes of large numbers of people who had invested their savings in this would suffer. It should also be a matter of interest to mention that the 3 per cent Conversion Loan steadily declined over the years and is now (March 1970) quoting at Rs. 60; this loan (which may be called the 3 per cent Rowlands), incidentally, has fared better than the 2 ½ per cent Daltons, which are quoting at about £29 ½ !

Meanwhile, the Bank undertook a comprehensive study of the subject of cheap money, this being one of the first tasks allotted to the newly-created Department of Research and Statistics. The conclusions of this detailed study of the Bank's economists (Messrs Joshi, Prasad and Simha), which was completed in June 1946, was that while it was undesirable to reverse the policy of cheap money there was clearly no case for pushing this policy any further; what was called for was a consolidation of the position already attained and of ensuring that the benefits of cheap money percolated to all the different economic sectors in the country. The Governor accepted these conclusions and in his address to the shareholders at the annual general meeting of the Bank held in August 1946 made detailed observations on the subject. While noting the general desire all over the world to maintain cheap money conditions, the Governor pointed out that this policy involved Government regulation of economic activity, though the extent to which such regulation became necessary would vary from country to country. Discussing the subject of further advance in the direction of cheap money, the Governor mentioned that the matter would have to be considered carefully in the light of the conditions peculiar to each country. In India, where the percentage of saving to national income was smaller than in the developed countries, enforcing a given rate of interest needed a much greater degree of interference with the market forces, involving controls. On the other hand, the administration of

controls was difficult. Moreover, in India cheap money had to percolate to many sectors of the economy. The Governor also referred to the likelihood of cheap money policy intensifying the boom conditions in the share markets and of aggravating the inflationary potential in the country. The Governor concluded that 'our efforts should be directed towards consolidating the progress that has already been made '.

The press reaction to the Governor's views on cheap money was varied. While the staunch exponent of cheap money, viz., Indian Finance was disappointed, the Eastern Economist warmly welcomed the policy of ' thus far and no further ', In its issue of August 23,1946, the paper stated as follows:

> on a balance of conflicting considerations, the Government is justified in pursuing the cheap money programme to the extent that they have done ; but, the time has now come to take steps to make cheap money available for irrigating the channels of production investment, particularly in agriculture. We are glad to note that the Governor of the Reserve Bank is in substantial agreement with these views.

In October 1946 the Bank recommended the issue of an eight-year loan at 2 ¼ per cent at par for Rs. 35 crores. The Bank also recommended a long-term loan not open to banks for subscription, on the model of the U.S. practice followed in war time. The reasons for restricting the issue to the investing public, other than banks, were explained by Deputy Governor Trevor in his letter to the Finance Secretary. According to the letter:

> The taking up of securities by banks is generally inflationary as additional purchasing power is created in this manner, whereas the issue of loans to investors other than banks draws off vagrant funds from the hands of the public. . . .The prohibition on banks holding this scrip will be in furtherance of Government's anti-inflationary programme, the proposed restriction being also desirable on the ground that banks should be discouraged from holding any significant amount of long-term loans in their investment portfolios.

The proposal for the long-dated issue was not, however, accepted by the Government. The lists for the 2 ¼ per cent Loan, 1954 were opened on November 15 and the loan was a failure, the Government and the Reserve Bank having to take up between themselves Rs. 30 crores. Apart from the fact that the sentiment in the gilt-edged market had changed following the Governor's warning about the further cheapening of money, the loan was floated after the busy season had well begun. For several months the market had been fed on speculation fervour and when once this bubble burst the sentiment turned adverse. Another important factor was the strained political situation in the country. The Bank was of the view that the Government's conversion operation had alienated to some extent the support of institutional

investors. Further, the yields obtainable from investments other than Government securities had gone up significantly. Moreover, there was a general desire to remit funds abroad partly on account of the political uncertainties and partly on expectations of lowering of the exchange rate of the rupee.

In the next 3-4 years the gilt-edged market continued to be on the whole uneventful. The Government were hardly able to get any net subscriptions to Government loans, the redemptions of maturing loans being about the same as, if not larger than, the subscriptions to new loans. Besides, the Reserve Bank had to make substantial purchases of the order of Rs.280crores, in pursuance of its policy of maintaining reasonable stability in the gilt-edged market and to restrain excessive rise of short-term interest rates. From 1946-47, the market witnessed the return of the pre-war pattern of slack and busy periods.

In his address to the shareholders of the Bank in August 1947, the Governor explained again the Bank's policy of consolidation of cheap money rather than further movement in that direction. Indeed, the Governor was more forthright in his warning against excessive cheapening of money. The Governor remarked that:

> It is being increasingly recognised that, beyond a certain limit, cheap money not only ceases to be beneficial but in certain conditions, as for instance, when inflation outlives the forces that engendered it, becomes positively harmful to the economy. . . Indeed, even the maintenance of low yields, in the face of an upward pressure as a result of sales by individual and institutional holders for financing consumption and productive purposes, would itself be an achievement, involving a very heavy strain on the resources of the monetary authorities.

The Governor referred to the unpegging of short-term interest rates in the United States and the process of consolidation of cheap money in the U.K. after the conversion operations. The Governor also explained how the market had misread the Government's intention by concentrating too much on the coupon rate and ignoring the maturity of the loan. Thus, when the 2 ½ per cent 1961 Loan was issued, there was the superficial view that this was cheapening, though the maturity was 15 years -shorter as compared to the 2 ¾ per cent Loan, 1976. Finally, the Governor clarified that stable interest rates did not mean pegged rates and that the variation of yields within a certain range was not only inevitable owing to the operation of seasonal factors but was also necessary for providing the central bank with a certain measure of control over the money and capital markets.

The first Finance Minister of independent India, Mr. R. K. Shanmukham Chetty, echoed the Governor's views with regard to consolidation of cheap money, in the course of his budget speech in November 1947. In fact, on this subject there were questions in the Legislature

and in the debate on December 1, 1947, the Finance Minister clarified the Government's position further in wanting to adhere to the state of cheap money already attained. The Minister also referred to the extreme difficulty of retreating from the policy of cheap money.

These remarks of the Finance Minister provoked the *Indian Finance* to draw the conclusion, in its issue of December 6, 1947, that:

> The ostentatious wobbling, which the Finance Minister indulged in regard to the cheap money policy in his budget speech, is slowly yielding place in his subsequent utterances to definite confessions of partiality for its opposite.

The journal referred to the views of the Governor of the Reserve Bank on this subject and desired that the Finance Minister must not merely endorse the views of the Governor; rather he should favour a policy of cheap money which would be ' of demonstrably wide benefit to the national finances and the national economy '. Apparently, the journal did not notice that maintenance of cheap money had meant substantial purchases of securities by the Reserve Bank. In 1946-47 (April-March) the Bank had to make net purchases of Rs. 62 crores.

Once again, in August 1948, using the occasion of the Bank's annual meeting of shareholders, and the last one, the Governor expounded the Bank's philosophy and operations in the field of interest rates. He drew the attention of shareholders to the phenomenon of central banks and Finance Ministers bowing with varying degrees of grace and reluctance to the inevitably upward trend of interest rates. The Governor pointed out how in India, despite the sweeping political and economic changes, the gilt-edged market had presented a remarkably steady appearance. The Bank had contributed to this by substantial and yet discriminating support to the gilt-edged market. The Governor also explained how indiscriminate purchases by the Bank would only have encouraged sales and pointed to the inflationary impact of such purchases by the Bank, especially in the context of the policy of decontrol on which the Government had embarked earlier. The Governor quoted chapter and verse to mention how even in foreign countries the short-term money rates and gilt-edged yields had gone up substantially in the post-war period.

The subject of cheap money continued to engage the attention of financial journals, bankers and industrialists. Some industrialists, notably Mr. G. D. Birla, were champions of the cause of cheap money at all costs. There were also protagonists of dear money policy. Thus, in his address to the shareholders of the Punjab National Bank, on April 8, 1949, the Chairman, Lala Yodh Raj, expounded the case for higher interest rates as follows:

> The policy of cheap money has had its run for over 16 years and appears now to be out of tune with the economic forces in the country. The

demand for capital has outstripped its supply. The fundamentals have changed and the obvious remedy appears to be to use the monetary policy again as an active instrument of disinflation with its reliance on credit restrictions and increase in interest rates.

Another fact should not be lost sight of. Cheap money and disinflation necessitate a large and continuous surplus of revenue over expenditure in the national budget which means that the State saves instead of the general public. A budget surplus, however, cannot, in the long run, replace private savings. At best, it is a cumbrous form of saving and is likely to lead to equally cumbrous forms of investment. A heavily taxed nation is not, in the long run, going to bear still heavier taxes for the purpose of providing a permanent budget surplus. The weakening of the individual incentive to save, which must be the inevitable result of this policy, is also not desirable at all and the incentive to save has no meaning without the ability to save.

Considered from all points of view the benefits of higher interest rates very well overweigh the minor disadvantages. Other things being equal, the capital formation will also be encouraged.

In the context of the altered conditions in the gilt-edged market, Government's borrowing programme had to be kept modest and efforts to consolidate cheap money mainly took the direction of keeping the coupon rates unaltered but of substantially shortening the maturity. Thus, while in August 1946 a coupon rate of 2 ½ per cent was offered for a Is-year loan, in October 1948 the same rate was offered for a 15 -year loan and in January 1950 for a s-year loan. Similarly, whereas earlier a rate of 2 ¾ per cent had been offered for a 7-year loan, in June 1950 a rate of 3 per cent had to be offered. After the conversion operation of 1946, this was the first loan bearing a coupon rate of 3 per cent. The terms of the various loan issues in the period 1945-51 are summarised in the table on page 694.

As already mentioned, the Government's net borrowing during the 5-year period 1946-51 was negative, that is to say, there was a reduction in debt. The funded debt of the Government of India, which stood at Rs. 1,498 .93 crores at the end of March 1946, declined to Rs. 1447.11 crores by the end of March 1951.

Trends in Gilt-edged Yields and Money Rates

The net result of the consolidation process was that the decline in yields that occurred between the end of the war and August 1946 was reversed. In fact, the pattern of yields in March 1951 was some what higher than that prevailing at the close of the war in August 1945. However, the general pattern of yields was still lower as compared to that prevailing on the eve of World War II. In other words, as compared to the pre-war years, there had occurred a noticeable progress in the direction of cheap money. These movements are well

LOAN FLOATATIONS, 1945-51 — CENTRAL GOVERNMENT

Date of issue	*Name of loan*	*Period of loan*	*Issue price* (Rs.)	*Amount offered*	*Form in which subscriptions were called for*
2- 7-1945	Special Issue of 3 per cent Loan, 1970-75	25-30 years		Rs. 30 crores	
16- 7-1945	$2^{1}/_{2}$ per cent Bonds, 1950	5 years	At par	Rs. 20 crores	
29- 9-1945	Special Issue of 3 per cent Loan, 1963-65	18-20 years		Rs. 25 crores	
13-10-1945	Special Issue of $2^{1}/_{2}$ per cent Bonds, 1950	5 years		Rs. 15 crores	
15-11-1945	Special Issue of 3 per cent Loan, 1970-75	25-30 years		Rs. 25 crores	
15- 1-1946	$2^{3}/_{4}$ per cent Loan, 1960	14 years	At par	Rs. 25 crores	Cash
16- 2-1946	Special Issue of 3 per cent Loan, 1970-75	24-29 years		Rs. 20 crores	
9- 4-1946	Special Issue of $2^{3}/_{4}$ per cent Loan, 1960	14 years		Rs. 20 crores	
1- 8-1946	$2^{1}/_{2}$ per cent Loan, 1961	15 years	100-0	Rs. 35 crores	Cash
5- 8-1946	Special Issue of $2^{1}/_{2}$ per cent Loan, 1961	15 years		Rs. 20 crores	
15- 8-1946 to 14-10-1946	3 per cent Loan, 1986 or later &	Non-terminable	100-0		Subscriptions to be in form of $3^{1}/_{2}$ per cent Loans (non-terminable).
	$2^{3}/_{4}$ per cent Loan, 1976	30 years	99-0		
15-11-1946	$2^{1}/_{4}$ per cent Loan, 1954	8 years	99-8	Rs. 35 crores	Cash
15-11-1947	$2^{3}/_{4}$ per cent Loan, 1962	15 years	100-0	Rs. 40 crores	Cash & in $3^{1}/_{2}$ per cent Loan, 1947-50.
1- 6-1948	$2^{3}/_{4}$ per cent Loan, 1962	14 years	100-0	Rs. 35 crores	Only in form of $2^{3}/_{4}$ per cent Loan, 1948-52.
1-10-1948	$2^{1}/_{2}$ per cent Loan, 1955	7 years	100-0	Rs. 20 crores	Cash
4- 7-1949 to 8- 7-1949	$2^{1}/_{2}$ per cent Loan, 1955	6 years	99-12		Subscriptions in form of 3 per cent Loan, 1949-52 to be accepted at par.
	$2^{3}/_{4}$ per cent Loan, 1962	13 years	99-8		
16- 1-1950	Special Issue of $2^{1}/_{2}$ per cent Loan, 1955	5 years		Rs. 15 crores	
19- 6-1950	3 per cent Loan, 1964	14 years	100-0	Rs. 30 crores	In cash or $2^{1}/_{2}$ per cent Bonds, 1950 at par.

reflected in the yield of the 3 per cent Rupee Paper. From 3.54 in August 1939 it came down to 3.15 in August 1945 and further to 2.83 in August 1946, the lowest level of the cheap money era. Subsequently there was a rise in the yields, the level in March 1951 being 3.23.

The trend of the money market rates also reflected the departure from the post-war low levels as well as the increasing strength of demand for funds. Besides a marked increase in the requirement of funds for imports, the abnormal political conditions in the country also put a premium on liquidity. The decontrol experiment and the rise in commodity prices also accentuated the stringency in the money market. During the three years 1945-48, this was reflected in a marked expansion of scheduled bank credit. In the following two years, that is, 1948-50, there was not much of credit expansion but there was a marked decline of deposits. After the outbreak of the Korean War, however, there was large scale expansion of bank credit. The inter-bank call rate, which stood at ¼ of one per cent in 1945, steadily rose to 1-1 ¾ per cent in 1951. The rising trend of short-term rates is also evidenced by the raising of the Imperial Bank Hundi Rate from 3 to 3 ½ per cent in January 1949 and further to 4 per cent in January 1951.

The Reserve Bank provided substantial assistance in mitigating monetary stringency. As already mentioned, this took mainly the form of purchases of Government securities, the bulk of the purchases representing sales by banks. The transactions year by year are given in the table below.

(Rs.crores)

Financial Year (April-March)	Purchases	Sales	Net Purchases (+) Sales (-)
1945-46	45.77	70.30	- 24.53
1946-47	95.35	33.06	+62.29
1947-48	75.76	23.42	+52.34
1948-49	121.84	30.42	+91.42
1949-50	89.22	70.68	+18.54
1950-51	155.06	98.79	+56.27

While the Bank purchased Government securities sold by the banks, it warned the banks, in March 1948, against the tendency to prefer long-dated securities, in view of the need for a more balanced maturity distribution to provide a stronger second line of defence in the shape of short-term securities. There was also a veiled threat that if the banks did not correct the position, legislation might have to be introduced to compel them to hold a certain percentage of short-dateds. To enable the banks to follow this advice, the Bank was prepared to make swap

transactions, that is, buy long-dateds in exchange for short and medium-dateds. In his address to the shareholders in August 1948, the Governor repeated the advice. To the extent the banks followed this, they would have been better prepared to face the Bank rate rise of November 1951.

Measures to Relieve Seasonal Stringency

The Reserve Bank also made larger short-term advances to the scheduled banks, to relieve seasonal stringency. The advances were insignificant till 1948, but thereafter they became rather significant. Thus, whereas the borrowings from the Reserve Bank rarely exceeded Rs. 1 crore during the war time, they were somewhat larger in 1946 and 1947. However, from September 1948 onwards borrowings were substantial. Thus, in 1948, the peak of borrowing was reached at the end of December at Rs. 17 .28 crores. In 1949 and 1950 the average outstanding was of the order of Rs. 6-7 crores.

The Bank authorities gave considerable attention to the policy aspects of loans and discounts to the scheduled banks to relieve seasonal stringency and also to meet abnormal situations as a result of loss of confidence on the part of depositors. The subject figured at several Board meetings, namely, December I 946, February, April, and December 1947, and February, April and July 1948. Matters relating to banking crisis, especially in Bengal, and the arrangements for making emergency advances will be discussed in detail in Chapter 22. It will be convenient to discuss in this section the policy with regard to meeting the stringency in the money market owing to the operation of normal economic factors. In a very comprehensive memorandum submitted to the Central Board for consideration at the April 1947 meeting, the steps to relieve seasonal stringency in the past 25 years, that is to say, even in the days prior to the Bank's existence, were described. The Governor's view was that the best method of relieving seasonal stringency was the purchase, rediscount or advance against bills of exchange and promissory notes, arising out of bona fide commercial or trade transactions, under Sections 17(2) (a) and 1 7(4) (c). This device would enable the Reserve Bank to follow and exercise control over the end-use of credit which was not possible in the case of purchase of securities by the Reserve Bank. The reluctance of banks to disclose to their clients that they were borrowing from the Reserve Bank and their unwillingness to convert their advance into bills were noted but it was expected that these prejudices would gradually disappear. Also, with experience, the Reserve Bank would be able to complete its enquiries about the standing of the constituents of banks quickly and provide credit promptly.

This conclusion of the Bank was, however, only the reiteration of what had been clearly recognised by the framers of the Reserve Bank of India Act. It was, however, worth emphasising, particularly in view of the likely expansion of bank credit and the depleted Government securities portfolio of banks. (Progress in this direction, however, occurred only early in 1952: following the raising of Bank rate and the suspension of purchase of securities to relieve seasonal stringency announced in mid-November 1951.) It was possible for the Central Board to consider this matter only at its December 1947 meeting, on account of the preoccupation with many matters relating to partition. Meanwhile, at the Bank's suggestion, Government had promulgated an Ordinance on September 20, 1947, amending Section 18 of the Reserve Bank of India Act, to enable the Bank to make advances to scheduled and non-scheduled banks against such form of securities as the Bank considered sufficient. Later, the Board also asked for a memorandum examining the practicability of making advances against demand promissory notes. The conclusion of the Bank was that the existing facilities for meeting seasonal requirements were adequate and that there was no need to amend Section 17. This matter was not, however, formally considered by the Board again.

Another device to provide some relief to the stringency in the market was continuously to reduce Treasury bill offerings. Thus, the annual Treasury bill tenders were reduced from Rs.160 crores in the year 1945-46 to Rs. 44 crores in the year 1949-50. Treasury bill sales were suspended from December 1949 to early September 1952. Treasury bills outstanding with the public steadily declined from Rs. 37 crores at the end of March 1945 to nil by the end of January 1949. On the other hand, the Provincial Governments took greater interest in Central Treasury bills, the outstanding of their holdings going up from Rs. 46.18 crores in March 1946 to Rs. 83 .51 crores in March 1951.

Besides reduction of Treasury bill offerings, the Reserve Bank also provided greater facilities to scheduled banks for rediscounting these bills. The Bank reduced, effective July 1, 1946, the minimum interest charged for rediscounting Treasury bills from one anna per cent to half anna per cent actual, i.e., the price that could be paid for any bill was raised from Rs.99-15-0 to Rs. 99-15-6 per cent. The rate of discount continued to remain the same, viz., one anna above the average rate for CentraI Government bills at the preceding auction rounded off to the next anna above. The minimum of one anna per cent was originally fixed (in 1938) to represent interest for a period of about a fortnight. At the rates prevailing in 1946, viz., eight annas, the minimum of one anna per cent represented interest for a period of about 45 days. In the changed circumstances, the minimum was reduced to half an anna, which, it was considered would not be penal

and yet would be sufficiently high to eliminate any abuse of the concession by the scheduled banks.

While on the subject of discounting of Treasury bills, reference may be made to the withdrawal of a concession which the Imperial Bank had enjoyed for many years. It will be recalled that in view of the support accorded by the Imperial to Government's Treasury bill policy, the Reserve Bank allowed it a concessional rate for discounting both Central and Provincial Treasury bills, the rate for Central Treasury bills being the average rate of the last preceding auction, whereas the other banks had to pay a slightly higher rate. In November 1939, the general question of the rate to be charged for discounting Treasury bills was examined by the Bank and it was decided that the special terms set out for the Imperial Bank were no longer necessary. But something went wrong in implementing this decision and the Bank continued to rediscount bills at the concessional rate. The position was reviewed again in April-May 1946 and the concession was withdrawn. In respect of Provincial Government Treasury bills, however, the Bank did not withdraw the concessional rate, as in respect of these bills, the Imperial Bank's support was regarded as essential.

Ways and Means Advances to Provincial Governments

During the period under review, the Reserve Bank had to provide substantial short-term accommodation to Provincial Governments too, in the form of ways and means advances. The Provinces made comparatively little use of Treasury bill tenders to obtain short-term requirements. In 1946-47**,** Assam and Bengal were the only Provinces to resort to Treasury bill borrowing; in 1947-48, West Bengal alone issued the bills and in the following two years only Madras and the U.P. issued these bills. From January 1950**,** Provincial Governments stopped issuing Treasury bills. As compared to sales of Rs. 35. 5 crores in 1946, sales in the following 4 years were Rs.16.50 crores, Rs. 4 crores, Rs.1.54 crores and Rs.13.50 crores, respectively. Public interest in Provincial Treasury bills was even less than in the Central bills. The Imperial Bank was the main subscriber; the Reserve Bank and the Provincial Governments themselves were other subscribers.

The Bank's policy regarding ways and means to Provincial Governments as laid down in Clause 6 of its Agreement with the Provinces, viz., (1) outstanding ways and means were not to exceed the amount of the minimum balance prescribed for the Provincial Government concerned and (2) the advances were to be fully paid off at intervals not exceeding three months, continued to remain basically unchanged. However, on several occasions, the Bank considered it expedient to grant, only as a temporary measure, ways and means advances to

certain Provincial Governments considerably in excess of the prescribed limits; a substantial portion of the excess advances was against cover of Government of India securities. Also, in exceptional cases, advances were allowed to remain outstanding beyond the prescribed period of three months. Total ways and means taken by Provincial Governments rose from Rs. 7.67 crores in 1945-46 to Rs. 38.22 crores in 1948-49 and further to Rs. 64.74 crores in 1949-50; in 1950-51 they were lower at Rs. 42.15 crores.

As large advances tended to become a chronic feature of State Government finances, the Bank decided in May-June 1950 to call a halt to this practice and regularise its ways and means transactions with the State Governments. The Bank submitted a memorandum to the Government of India in June 1950, drawing their attention to the situation and emphasising that ways and means were not intended to be an expedient for financing Governments for any long period. When such advances could not be repaid from the resources at the disposal of State Governments, the Bank observed, the States should resort to one or more of the following courses, viz., (i) floatation of public loans, (ii) issue of Treasury bills, (iii), obtaining loans from the Centre and (iv) sale of their investments. The Bank, however, pointed out that the mere holding of Government of India securities did not entitle State Governments to claim encashment thereof at any time they wished. The Bank required reasonable notice for framing its programme of sale of securities on several accounts. The Bank also stressed the desirability of evolving a uniform and well integrated plan in dealing with the four courses indicated by it and requested the Government of India to initiate suitable action. The Bank's views were communicated by the Finance Ministry to the Governments of Part A States on July 8, 1950, Even subsequent to this communication the Bank received requests from a few States for temporary relaxation of limits, but initially these were declined by the Bank in consultation with the Central Government, who commented:

> The States must realise that they cannot continue to live beyond their resources by running a deficit account for an indefinite period and hope for the Reserve Bank or the Centre to finance them for their requirements either direct or by purchasing their investments.

The Bank, however, realised that in view of the busy season which was then about to set in, the State Governments had hardly any chance to secure funds by floating Treasury bills, while other alternatives for raising funds were also not feasible. The Bank's advice to the State Governments, therefore, was a severe curtailment of their expenditure supplemented by such temporary accommodation as the Government of India would grant them. Earlier, the Bank had suggested to the

Central Government to consider the expedient of granting advances to States against their share of income-tax receipts to the extent of 50 per cent.

One of the State Governments approached the Bank for its formal approval to an arrangement the State proposed to enter into with a commercial bank for cash credit accommodation for financing their foodgrains purchase scheme; this was accorded. It was considered that such financing was outside the scope of the Bank's function as a central bank and that an advantage in letting private banks undertake such financing was that it was not inflationary in character so long as banks were able to finance State Governments without recourse to the Reserve Bank.

The Governor, Mr. Benegal Rama Rau, was sympathetic to a request from another State Government for financial assistance needed among others, for financing food procurement, even if it meant an amendment of the Act. However, after discussion with the Finance Secretary, Government of India, it was agreed that the Bank should not press for an amendment of the Reserve Bank Act, and that the State Governments should be advised to approach commercial banks for such accommodation. Any impact emanating from such a procedure was to be absorbed by the Reserve Bank in its open market operations. The same State Government requested a ways and means advance for financing capital expenditure; their schemes were in an advanced stage and any slowing down would have delayed the returns expected from them. Although a ways and means advance was not appropriate for financing capital expenditure, the Bank agreed, with reluctance, to grant the advance against Government of India securities. The reasoning of the Bank, as stated by the Deputy Governor, Mr. Sundaresan, in his letter dated December 8, 1950, to the Finance Ministry was:

> If we declined to come to the assistance of. . . . . . , the Government of India will be under pressure to find out the necessary funds, which may result in the Reserve Bank expanding currency to the extent required by the Central Government. The whole problem resolves then to the appropriate procedure to be followed. If the Central Government took over the responsibility to find funds, you may run the danger of setting up a bad precedent and may even be induced to treat the amounts as fairly long term loans on a favourable rate of interest. From that point of view, it may be the lesser evil to let the Reserve Bank grant ways and means advances during the current financial year on the usual terms on the distinct understanding that this will be an exceptional treatment accorded to State Governments where in the opinion of the Central Government it would be a loss of public money if an abrupt termination of a project in progress were to be allowed. The position then will be that the temporary relaxation of the Reserve Bank's policy not to finance. capital expenditure by means of ways and means advance will be at the special request of the Central

> Government for one single year, pending a review by the Planning Commission or any other appropriate authority of the works in progress and the need for their completion.

The Provincial Governments were also sources of substantial short-term funds, which they invested in Central Treasury bills. Effective October 22, 1949, a new procedure was introduced for meeting the requirements of these Governments and special public bodies for investment in Central Government Treasury bills. Till then, the Bank had been selling Treasury bills to Provincial Governments and other bodies out. of its own Issue Department holdings; this was done with a view to precluding them from competing with regular institutional investors at open auctions of Treasury bills. Whenever Treasury bills were thus sold out of Issue Department holdings, fresh bills were created in their place. As investments by Provincial Governments were made for varying amounts and on different dates, the ad hoc Treasury bills created in lieu of the bills issued to them and available for future sales consisted of various denominations with maturities varying from a few days to three months. Also, at times, a number of bills had to be issued to the same party resulting in a considerable waste of Treasury bill forms and clerical labour. It was therefore decided, with the Central Government's approval, that instead of selling Treasury bills from the Bank's Issue Department holdings, special ad hoc bills should first be created for the actual amount required in favour of the Reserve Bank at the bulk of tender rate of the immediately preceding Central Government Treasury bills auction, and thereafter those bills would be sold by the Bank to the party concerned at the usual rate of 3 pies above the bulk of tender rate. The whole transaction would pass through the Banking Department of the Bank, and would be shown as ' Treasury bills sold in favour of the Reserve Bank of India ', instead of ' Treasury bills sold in favour of the Issue Department '.

Provincial Loan Floatations

Market borrowing by the Provincial Governments, in the post-war period, was of smaller dimensions than in the war period, although the need for such borrowing was larger. However, because of the diminished capacity of the market to absorb Government securities, their issue had to be pruned. The aggregate borrowing in the period 1946-51 was Rs. 24.50 crores, as compared to Rs. 41 crores in the period 1940-46.

Except in 1947-48, the Provincial Governments raised loans from the market in all the four years, namely, 1946-47 and 1948-49 through 1950-51. Eight issues for a total amount of Rs. 24.50 crores were floated by four Provinces; Bombay, three for Rs. 11crores; Madras and C.P.

(M.P.), two each for a total amount of Rs. 8 crores and Rs. 3 crores, respectively; and U.P. one for Rs. 2.50 crores. The two loans floated in 1946-47 were with 2 ¾ per cent coupon rate and were issued at Rs. 100-8, the yield working out to 2.71 per cent. The loans were to mature in 1961. All loans floated subsequently, i.e., during the years 1948-49 to 1950-51 were with a higher coupon rate, viz., 3 per cent, and the issue prices were below par, the discount ranging from eight annas in the case of the Bombay loan to Rs.1-8 in the case of the Madhya Pradesh loan; the yields worked out higher, varying from 3.06 to 3.18 per cent. The maturity period, which was fifteen and sixteen years, respectively, in the case of the loans floated in 1946 and 1948, was reduced to ten years for the floatation in 1950-51, in accordance with the stringent trend of the gilt-edged market. Excepting one loan, viz., the 3 per cent Tapti Irrigation Development Loan, 1961, for Rs. 2 crores, issued in March 1951 by the Bombay Government, subscriptions, in respect of which were confined to the Surat District, all the loans were underwritten; in respect of two loans, the Bank had to underwrite small amounts to make up the deficit in acceptable tenders.

While eight loans aggregating Rs. 24.50 crores were actually floated, another four loans for Rs. 13 crores had been contemplated and offered for underwriting, but were dropped subsequently, as in respect of three issues (two in 1949-50 and one in 1950-51), the amount underwritten fell far short of the amount proposed to be issued, while in respect of the fourth loan (in 1948-49), the issue price fixed on the basis of underwriting tenders was considered unfavourable by the Provincial Government concerned.

Of the seven loans underwritten and offered for public subscription, five were oversubscribed, while two loans (one floated in 1946-47 and the other in 1949-50) were undersubscribed to the extent of over 20 per cent. The underwriters were called upon to take up the unsubscribed portion; the Bank had underwritten one of these issues. In respect of the other issue underwritten by it, the Bank subscribed at the time of public subscription the amount it had underwritten; there was no call on the underwriters.

Beginning with 1946, the Bank made two important changes in the underwriting system. In order to meet the wishes of Provincial Governments, the Bank started, as an experimental measure, the system of calling tenders in quarter rupees too, instead of in even rupees and half rupees as had been the practice till then. Provincial Governments were of the view that if tenders were invited in quarter rupees, it might enable them to issue a loan at a price four annas higher than otherwise. The other change made by the Bank was the reduction in under-writing commission from eight annas to four annas per cent; such a reduction

was expected to check excessive competition amongst the underwriters. In the Bank's view, the generous rate of commission, viz., eight annas, acted as an incentive for the underwriters to overreach themselves when tendering for the underwriting; also it afforded a margin which enabled them to sell their surplus holdings at a discount without loss to themselves but to the detriment of investors subscribing to the public issue of loans. The reduced commission was, however, considered inadequate and was raised to six annas in respect of loans floated in 1950.

A serious drawback of the underwriting system was its rigidity either a loan would have to be issued at the lowest rate quoted by the underwriters to secure the full amount of the loan (even though a substantial portion of the amount might have been tendered at more favourable rates) or the loan issue abandoned altogether. A modification of the scheme to enable the Bank to reserve to itself a right to accept whatever amount it considered as suitable at rates acceptable to the State Governments was considered in June 1950. There was also an informal suggestion by the Governor for revival of the Provincial Loan Fund system*. It was, however, decided that for the loan floatations in 1950, the Bank should first ascertain carefully from selected underwriters and brokers the amount of Provincial loans likely to be successfully underwritten at an acceptable rate and then advise the Provincial Governments concerned regarding the amount to be floated. This worked reasonably well in 1950, but in 1951, in view of the lack of interest among the underwriters for the proposed issue, it was decided to dispense with underwriting and thereafter the underwriting practice was not revived.

Although the possibility of different issue prices was inherent in the system of underwriting of individual Provincial issues, the Bank was criticised for the disparity in the issue prices of the loans floated in 1950. According to the Hindustan Timest† :

> The Reserve Bank; with all its careful generalship and active sponsoring of the loans has not been able to secure more even terms as between the various borrowers. In this connection, it is relevant to point out that it is the Reserve Bank which is reported to have persuaded the State Governments that the issues should be underwritten. But the bank

* The Local Government Borrowing Rules framed under the Act of 1919 empowered Provincial Governments to raise loans in India for specified purposes, but it was found that they had to pay rates of interest higher than those paid by the Government of India. It was, therefore, found more advantageous for the Provinces to borrow from the central exchequer, and to systematise such borrowings a Provincial Loans Fund was established in1925. Its object was to regulate the terms and conditions, the rates of interest and the period of amortisation of all advances made by the Central Government to the Provinces. With the adoption of Provincial Autonomy, the Provincial Loans Fund was wound up on March31, 1937 and all Provincial debts to the Government of India were consolidated on the terms set forth in the Niemeyer Report (see page 317, foot-note, of this volume).

† July 26, 1950.

> has not been successful in ensuring that, by agreeing to have their loans underwritten, States other than Bombay, would get reasonable terms. There is not much substance in the argument that the financial affairs and the budgetary position of the Madhya Pradesh Government is not as satisfactory as that of Bombay or Madras. . . . In view of the fact that there will be numerous occasions on which the State Government may have to enter the capital market in the future, it is not too soon for the Reserve Bank to realise that the present technique of floating State Government loans is completely unsatisfactory and to set about fashioning a different technique, such as lump sum borrowing by the Centre on behalf of the States, which will help to eliminate illogical and fanciful preferences and prejudices. Otherwise, barring the luckier ones, other State Governments will have to borrow money on burdensome terms, as is the *case* with the Madhya Pradesh Government or may be compelled, like the Uttar Pradesh Government, to keep away from the capital market indefinitely.

The issues stated in the above editorial have been raised again and again, but it has not been possible either to confine all borrowing to the Central Government or have identical terms for all the State Governments.

Bank's Attitude with regard to Controls

The principal developments with regard to the Bank's monetary policy and its role as banker to Government have been narrated in the preceding pages. Before proceeding to cover developments with regard to currency and coinage and the Bank's advisory role in the regulation of the stock and commodity markets, it is necessary to refer in some detail to the Bank's attitude with regard to physical controls, a brief reference to which has been made earlier. In the post-war period, few aspects of economic policy were more controversial and confused than the matter of controls. Government's views underwent frequent changes; it would appear that while the Government recognised the necessity of controls, they found that administration of controls was unsatisfactory and caused widespread public discontent. So they embarked on decontrol, while being prepared to restore it if the experiment was unsuccessful. On the other hand, the Bank's management was clear and consistent in its views on this subject. These are best expressed in the Governor's address to the shareholders in August 1947:

> Vitally connected with the immediate problem of stabilisation is the question of controls, which in the case of some commodities has been lifted, and the removal of which in other cases is being urged. Whilst the maintenance of demonstrably needless controls only clogs the administrative machine and irritates the public into infractions of the law, there seems to be every need for the continuance of controls in the case of essential commodities. But to be effective such controls should be integrated and administered with efficiency and thoroughness. Controls are very essential for any project or large-scale economic

> planning, and it would seem to be necessary to educate public opinion and seek its whole-hearted co-operation in their enforcement. The political developments resulting in the partition of the country emphasise the need for the maintenance of controls as the trade between the two areas which was hitherto internal trade will, in the future, partake of the character of foreign transactions. In the long run it is probable that most prices will come down, owing not only to increased output at home but also to larger imports. It is necessary that whenever it comes, the decline in prices should be orderly, causing the least dislocation to the productive system, and this will appear to be best achieved not only by resisting any further rise in prices, but also by inaugurating a policy of voluntary price reduction as is being attempted in the U.S.A.

In the report of the Central Board of Directors for the year 1947-48, there was again a long discussion on the subject and the general tenor of the report was on the lines of the Governor's address to the shareholders in 1947. After referring to the experiment of decontrol, after the war, in a number of countries including the U.S.A., the report commented as follows:

> But it cannot be concluded that removal of controls, therefore, is gene rally the prescription for all countries for regaining economic health. The rate at which readjustment to normality could be induced through the removal of controls will necessarily vary from country to country.In a comparatively backward economy like that of India production is not very elastic to price changes and the degree of scarcity even in regard to the ordinary needs of life is very high. In such an atmosphere where the root of the trouble is not so much over-spending as under-production, the removal of controls has to be especially slow and cautious. Otherwise the restoration of freedom is likely only to lead to an increase in the price levels, not necessarily accompanied by an increase in production of the required magnitude. In fact in the kind of small-scale agricultural economy which is not geared too well to a market economy it is even likely that increased prices might, at the margin, actually lead to a lower volume of output. If this were to happen, decontrol can only lead to a high and rapid rise in prices with all the attendant consequences of an inflationary spurt. This undoubtedly is what is being witnessed to-day so vividly in the movement of the price structure in this country.

Two Directors, namely, Messrs B. M. Birla and K. P. Goenka, placed on record, in the report, that they did not subscribe to the views expressed in the report in connection with controls. This is the first occasion, and so far the only one, on which individual Directors have recorded their dissent from the views of the Board, in the Bank's annual report.

In his speech to the shareholders in August 1948, the Governor again referred to the subject of controls. After giving a sympathetic account of the reasons which had prompted the Government to embark on the

policy of decontrol, the Governor pointed out how Government's expectations had not been fulfilled, by and large. To quote him:

> From the meagre data that is available it would appear that there has been improvement in production in a few directions since November 1947 but that is far below expectations, the present output still being far short of even the existing productive capacity in the major indus tries. In the short run production is in any case very inelastic, especially in the context of the prevailing shortages of capital equipment, technical personnel and essential raw materials, and above all the break down of the country's transport system. There does not seem to have been much dehoarding either, partly because the hoarded stocks themselves were not probably large and partly because stocks continued to be withheld from the market in anticipation of higher prices. The gap between supply and demand has therefore come to be covered predominantly by a rise in prices.

From the foregoing it will be seen that so far as the Bank was concerned, it anticipated clearly the need for a system of controls, conceived in a co-ordinated manner and effectively implemented, for a programme of integrated development of the Indian economy.

CURRENCY AND COINAGE MATTERS

In regard to currency, two developments have to be recorded. The first, the demonetisation of high denomination notes, was a fiscal measure, taken against the Bank's advice. The second was the replacement of silver coinage by nickel, the Bank lending strong and active support to the change-over.

Demonetisation of High Denomination Notes

Soon after the war, while Government were giving attention to ways and means of averting the expected slump, thought was also given to check black market operations and tax evasion, which were known to have occurred on a considerable scale. Following the action in several foreign countries, including France, Belgium and the U.K., the Government of India decided on demonetisation of high denomination notes, in January 1946. It is interesting that as early as April 7, 1945, in an editorial on the tasks before the new Finance Member, Sir Archibald Rowlands, the Indian Finance referred to the action of the Bank of England in calling in notes of ₤ 10 and higher denominations and suggested similar action in India as 'one more concrete example for the Indian Government to follow in its fight against black market money and tax evasions which have now assumed enormous proportions '.

It is not known when the Government authorities started thinking on the demonetisation measure, but the final consultation with the Governor and Deputy Governor Trevor took place towards the end of 1945, when Mr. N. Sundaresan, Joint Secretary, Ministry of Finance, called for a discussion, for which he had earlier prepared a note and the drafts of the Ordinances to implement the scheme. According to a note recorded by Mr. Sundaresan, it would appear that the Reserve Bank authorities were not enthusiastic about the scheme. The Governor stated that the Finance Member had given him the impression that the scheme would be launched only when there were signs of the onset of an inflationary spiral. The Governor saw no special signs of such a situation. 'It appeared to him that the main object of the scheme was to get hold of the tax evader. The Governor wondered if this could be called an emergency to justify the promulgation of an Ordinance, just before the newly elected Legislative Assembly met. The Governor wanted Government to be satisfied that there was no harassment to honest persons. As a currency authority, the Bank could not endorse any measure likely to undermine the confidence in the country's currency.

The Governor agreed that about 60 per cent of the notes would be in the Indian States and so co-operation of the State Governments was very necessary. Apparently he had some doubts about this. According to Mr. Sundaresan, the ideal thing was to block high denomination notes, but this course was not favoured by either the Finance Member or the Governor.

Subject to these observations, the scheme as drafted by Mr. Sundaresan was considered by the Governor to be theoretically all right, but he and the Deputy Governor pointed out the considerable administrative difficulties involved in covering nearly 5,700 offices of scheduled and non-scheduled banks. The Governor's concluding remarks, as recorded by Mr. Sundaresan, were as under:

> Sir Chintaman Deshmukh felt that we may not get even as much as Rs. 10 crores as additional tax revenue from tax evasion and that the contemplated measure, if designed to achieve such a purpose, has no precedent or parallel anywhere. If value is going to be paid for value (no matter whether such value is in lower denomination notes), it is not going to obliterate black markets. His advice is that we should think very seriously if for the object in view (as he deduces from the declaration form) whether this is an opportune time to proceed with the scheme. Provided Government are satisfied on the points of (i) sparing harassment to the unoffending holders and (ii) a worthwhile minimum of results in the shape of extra tax revenue, he does not wish to object to the scheme as drafted, if Government wish to proceed with it notwithstanding the administrative difficulties involved.

The Government went ahead with the scheme. On January 12, 1946, two Ordinances were issued, demonetizing notes of the denominational

value of Rs. 500 and above. The first Ordinance, viz., the Bank Notes (Declaration of Holdings) 0rdinance, 1946, required all banks and Government Treasuries in British India to furnish to the Reserve Bank of India by 3 p.m. on the same day, a statement of their holdings of bank notes of Rs.100, Rs. 500, Rs. 1,000 and Rs.10,000 as at the close of business on the previous day. January 12, 1946 was declared a bank holiday. The second, the High Denomination Bank Notes (Demonetisation) Ordinance, 1946, demonetised bank notes of the denominations of Rs. 500 and above with effect from the expiry of January 12, 1946. This Ordinance provided that a non-scheduled bank could exchange high denomination notes declared by it under the Bank Notes (Declaration of Holdings) Ordinance at the Reserve Bank or a scheduled bank, for value in one hundred rupee notes or for credits with the Reserve Bank or a scheduled bank. Scheduled banks and Government Treasuries could obtain from the Reserve Bank value in one hundred rupee notes or in deposits with the Reserve Bank in exchange for high denomination notes declared by them under the above mentioned Ordinance. Other holders of high denomination notes could get them exchanged at the Reserve Bank, a scheduled bank or a Government Treasury on presentation of the high denomination notes and a declaration in the form prescribed in the schedule to the Ordinance, within 10 days of the commencement of the Ordinance. Under a press note issued subsequently by the Government of India on January 26, 1946, Managers and Officers in charge of offices and branches of the Reserve Bank of India were authorised to allow exchange of high denomination notes, up to and inclusive of February 9, 1946, on production of sufficient and valid reasons for delay in the presentation of notes. Thereafter the Governor and the Deputy Governor of the Bank were authorised to allow exchanges up to and inclusive of April 26, 1946. The power for the extension of the time limit beyond April 26, 1946 was reserved for the Government of India.

The provisions of the second Ordinance, which was applicable to British India, were also extended, with suitable modifications, to the Administered Areas on January 22, 1946. Many Indian States also issued parallel Ordinances. States which did not enact such legislation were required to exchange their holdings of demonetised notes before March 7, 1946.

The measure did not succeed, as by the end of 1947, out of a total issue of Rs. 143.97 crores of the high denomination notes, notes of the value of Rs. 134.9 crores were exchanged. Thus, notes worth only Rs. 9.07 crores were probably ‘demonetised ‘, not having been presented. The results of the demonetisation measure were summed up by Sir Chintaman, in his Dadabhai Naoroji Memorial Prize Fund Lectures, delivered at Bombay in February 1957, as under :

> It was really not a revolutionary measure and even its purpose as a minatory and punitive gesture towards black-marketing was not effectively served. There was no fool-proof administrative method by which a particular note brought by an individual could be proved as the life-savings of the hard-working man who presented it or established as the sordid gains of a black-marketer. Another loophole of which considerable advantage was taken was the exemption of the princely States from scrutiny or questioning when such notes were presented by them. In the end, out of a total issue of Rs.143.97 crores, notes of the value of Rs.134.9 crores were exchanged up to the end of 1947 as mentioned in the Report of the Board of Directors of the Reserve Bank. Thus, notes worth only Rs.9.07 crores were probably "'demonetised ", not having been presented. It was more of "conversion ", at varying rates of profits and losses than "demonetisation ".

There was an echo of this measure in 1948. In September, while Government were considering anti-inflationary measures, rumours spread that the 100 rupee notes would be demonetised and that bank deposits would be frozen. The Prime Minister had to make a statement in the Legislature, categorically denying any such intentions on the part of Government.

Nickel Coinage

Advising the Government on matters relating to coinage is an important responsibility of the Reserve Bank, though often such matters tend to be regarded as routine affairs. The Governor put his considerable weight in favour of nickel coinage and his urging no doubt helped expedite the changeover from silver to nickel in the matter of coinage of higher denomination, that is, quarter rupee, half rupee and one rupee. In May 1944, the Mint Masters considered a number of matters relating to coinage in the post-war period. They suggested the introduction of decimal coinage. They also discussed in detail the pros and cons of replacing silver coinage by pure nickel ones, although on this matter the opinion among the Mint Masters was not unanimous. The Finance Department was naturally conservative in its approach to these matters. While decimalisation of coinage was regarded as beneficial, it was considered desirable to go slow in the matter, and for this purpose ascertain public opinion fully. The Department was, however, opposed to the changeover from silver to nickel on the score, among others, that it would give a shock to the public. These proposals were referred to the Reserve Bank and the Governor generally endorsed the views of the Finance Department.

However, about the middle of 1945, the Governor came to support the view that in the interests of conserving silver, particularly for the purpose of repaying the lend-lease silver to the U.S.A., nickel coins

of one rupee, half rupee, etc., should be introduced expeditiously. Further, with the same object in view, he proposed (in August 1945) not only the stoppage of sales of silver to the public but also purchases of silver by Government, preferably through the agency of the Imperial Bank, at a price around Rs.125 per 100 tolas, the price at which the bulk of the sales had been effected. The Government, however, seemed to be in no hurry to purchase the metal, towards meeting the lend-lease obligation, since they anticipated a substantial fall in the price in due course; however, they were prepared for extending support to the market by purchases at ' Rs.120 per hundred tolas or below ' for the purpose of preventing 'too precipitate a fall' in price. The Governor did not attach much importance to the principle of supporting the market. He considered that if the decline in silver price was temporary there would be an automatic recovery. If, on the other hand, it was part of a downward trend, then it was undesirable on the part of the Government to interfere with it. The Governor also felt that purchasing silver gradually, as he had suggested, was better than extensive purchases towards the end of the five-year period, when the lend-lease silver would be due to be returned. The price then might be higher, what with the silver interests in America clamouring for a higher price for the metal. It is interesting that at about the same time the British Treasury Delegation in Washington, headed by Lord Keynes conveyed more or less similar views to the British Government and the Government of India. There was a distinct possibility of the price of American silver going up and the British Mission was anxious that every effort should be made to conserve the existing stocks of silver and reduce the use of silver in coinage. While forwarding a copy of the cable from the British Treasury Delegation, the Finance Department clarified that their objective was to prevent a collapse in silver price spreading to other markets and they gave the Governor discretion to buy silver when the price fell below Rs.120.

The Governor continued to urge the Government to introduce nickel coinage which, according to him was 'the only card which we can play in order to win the trick against American silver interests'. On May 23, 1946, the Government issued a notification, discontinuing the mintage of half and quarter quaternary rupees, these to be replaced by nickel coins. In June 1946 the issue of quaternary whole rupee was discontinued. The proposal to introduce nickel rupee was approved by the Cabinet in January 1947 and in February, legislation was introduced to amend the Indian Coinage Act for the purpose. The amending Bill was passed in April 1947, authorising the Government to use any metal for coining rupees. The new nickel rupees were issued in June 1947. Pending approval of the introduction of nickel rupees by the Cabinet and the Legislature, the Government, under

the urging of the Reserve Bank, had acquired sufficient quantities of nickel, to put the coins into circulation as soon as possible after the legislative sanction was obtained. The Bank's initiative in the matter helped conservation of large quantities of silver in the form of bullion as well as quaternary coins, enabling the Government to return without any difficulty the silver loan to the U. S. A., in 1957**.** None of the fears entertained with regard to the introduction of nickel coinage materialised, the public taking to these coins as well as to the decimal coins later with remarkable ease and confidence.

ADVISORY ROLE IN THE REGULATION OF STOCK AND COMMODITY MARKETS

In the post-war years the Government of Bombay and the Central Government gave much attention to the regulation of commodity and share markets. It was only in 1950, that is to say, with the coming into force of the Constitution, that regulation of these markets came to be done through Central legislation. Till 1950 such regulation was done on a comprehensive basis by one State only, namely, Bombay; in Bengal, there was Government regulation of futures trading in jute and jute goods, The Reserve Bank's advice was sought on various matters relating to regulation; especially in respect of the regulation of trading in bullion and stocks and shares, on account of the intimate contacts which the Bank had with these markets. In fact, in this matter on a number of occasions the initiative came from the Bank itself. The Bank was favorably placed both to urge the Government to initiate regulatory action and also to restrain Government from embarking on excessive -or impracticable regulation. The Bank also agreed to Government's requests to have its officers nominated on the governing boards of the recognised associations engaged in trading in bullion, shares; etc.

Stock Exchange Regulation

Although Central enactment to regulate transactions in securities was accomplished only in 1956**,** considerable preparatory work was done from as early as 1948, by Government and the Reserve Bank. The Government arranged for a detailed study of the subject of regulation of stock exchanges to be made by its Economic Adviser, Dr. P. J. Thomas, who submitted his report in 1948. The Reserve Bank also devoted considerable attention to the subject. One of the first tasks allotted to the newly created Department of Research and Statistics in

1945 was to collect detailed information on the working of stock exchanges in India and abroad and to formulate concrete proposals for their regulation, after discussions with the different stock exchange authorities and leading brokers. These studies were made in 1945 and 1946 and were published in the Reserve Bank of India Bulletin * (January and February, 1948), to enlighten the public on various aspects of the subject and to stimulate public discussion. In May 1948, the Finance Minister (Mr. Shanmukham Chetty) took a decision to initiate comprehensive legislation to regulate stock exchanges all over the country; he also. indicated the general principles which should govern such legislation. To work out detailed proposals for drafting legislation and also, examine specifically certain issues such as the abolition of blank transfers, he appointed a committee of officials with Mr. K. G. Ambegaokar, Additional Finance Secretary (who later became a Deputy Governor and for a brief while also the Governor, of the Bank), as Chairman, and including representatives of the Bombay Government and the Reserve Bank. The Bank's representative (Mr. S.L.N.Simha) was appointed as Member-Secretary of the Committee, which submitted its report in August 1948. Later, the Member-Secretary toured Madras and Calcutta to have discussions with the stock exchange authorities, leading stock brokers and the Provincial Governments, on various matters relating to statutory regulation of stock exchanges, and submitted a comprehensive report to Government.

The Bank's views with regard to regulation of stock exchanges are best summed up in Governor Deshmukh's address to the Bank's shareholders in August 1948:

> Extraneous factors apart, the health of the stock exchanges can only be preserved by the observance of their professional code by those that operate there. In order to assist them in securing this, the management need the guidance of a modicum of legislation. It may not be out of place here if I make a few observations about the form such legislation should take. I am of the view that the proposed legislation should attempt to curb only unhealthy speculation, which implies recognition of the fact that healthy speculation if properly directed contributes a great deal to the efficient performance of the essential functions of the securities market. Informed and moderate s peculation contributes to liquidity and price continuity of the market and any attempt to deny the requisite facilities for such speculation would, besides defeating its purpose, prevent the orderly working of the market. I am inclined to favour Government's framing minimum legislation covering only the vital aspects of reform, rather than its attempting a complete regimentation of the stock exchanges. It is also very necessary that the regulation should be conceived in practical rather than theoretical terms, for, failure to enforce any measure or measures will

* *Stock Exchange Reform, by S.* L. N. Simha.

> create a state of affairs which is worse than what is sought to be remedied. Further, before finalising proposals for regulation the Government should hold consultations with the authorities of the various stock exchanges, explaining its point of view to them and getting to know the practical difficulties of the exchanges. What emerges in the final shape should, without compromising on fundamentals, be such as to cause the least inconvenience to the exchanges as regards their day-to-day working. The success of stock exchange regulation depends to a large extent upon the active co-operation of the members and the authorities of the exchanges and it is therefore desirable that the Government should enlist it, and I am sure such co-operation will be readily forthcoming in a matter that concerns, in the long run, the well-being of the exchanges themselves.

Early in 1951, an informal committee was set up to process the recommendations of the official Committee of 1948 and to prepare a draft Bill. The work of this Committee was guided by the Bank's Executive Director, Mr. B. Venkatappiah. Thereafter, in all the stages leading to the passing of the law -the Securities Contracts (Regulation) Act, 1956 - the Bank was closely associated. The Bank's officers also came to be appointed as Government Directors on the principal stock exchanges.

The Bank also endeavoured to restrain the extension of bank credit for speculative purposes. In the immediate post-war year, stock exchange speculation assumed dangerous dimensions, this being accentuated by the tax concessions announced in the Rowlands' budget and the announcement of the conversion of the 3l/s per cent Paper. When the speculative fervour in the equities market was in full swing, the Bank issued in May 1946 a circular to the scheduled banks, drawing their attention to the unhealthy rise in share prices during the previous half year and the dangers of granting accommodation purely for speculative purposes. To ascertain the factual position, the Bank called for information regarding the banks' outstanding advances against shares (excepting those below Rs. 25,000), classified according to the margins taken. On a study of the information thus obtained the Bank found that advances against shares had recorded a much faster rise than the total advances of all types and that in some cases they exceeded 25 per cent of the total advances of the banks. A circular was issued in January 1947, drawing the attention of the banks to the need for restricting advances to a reasonable proportion of their resources or total advances and the advisability of fixing an absolute maximum for advances per share in the case of speculative counters. When this step was misconstrued as an advice to the banks to suspend the extension of credit to the market, the Governor explained the position in his address to the shareholders at the annual general meeting held in August 1948, as follows:

> the Reserve Bank has at no time asked the banks to suspend the extension of credit to the market. What it has done is to warn the banks against excessive and indiscriminate granting of credit for speculative purposes, and had the Bank not done so, it would have failed in its duty as the watch-dog of the country's banking and financial interests.

When the share market took its long downward course in September 1946, despite the prevalence of inflationary forces in the economy, there were many suggestions that the Reserve Bank should have asked the banks not to lighten then commitments in equities. The Bank made it clear that such a direction would not have been proper, since under the law it was not possible for the Bank to come to the aid of the banks either by purchases of or advances against shares, as part of the Bank's normal operations, besides the inflationary impact of such operations. There were also proposals that Government support should be extended to the share market either through the agency of the Reserve Bank or a newly created National Investment Board. It was believed that share prices in general were standing much below their intrinsic levels and that open market operations would help. prices to go up. It was also suggested that the National Investment Board might conveniently combine with the function of open market operations in shares, other functions such as control of capital issues and regulation of joint-stock companies and stock exchanges. Early in 1949**,** the Bank examined the proposals in great detail and came to the conclusion that the proposal to give open market support to shares raised complex issues of principle and administration and that it, was not feasible. However, the Bank saw merit in the proposal to have some organisation for co-ordinating the regulation of new capital issues, joint-stock companies and stock exchanges, generally on the lines of the Securities and Exchange Commission in the U.S.A. The Government were in agreement with the Bank's views.

Regulation of Forward Trading in Bullion

The Bank also took much interest in the regulation of forward trading in bullion. During the war time, forward trading in bullion as well as options had been banned under Defence of India Rule 90-C. The ban had not been very effective and in February 1946 the restrictions on forward trading were removed, as part of the policy of gradual dismantling of controls. Speculation in the bullion market continued to be rampant, since, except for a brief period in 1946-47, imports of bullion were banned, and the Bombay Government desired to regulate trading in bullion as part of the general framework of regulation of forward trading in commodities and shares. The Bank rendered much assistance in the preparation of a questionnaire to elicit public opinion

on the regulation of trading in bullion. Later, in November 1947, the *Bombay Forward Contracts Control Act* was passed, enabling the Government to regulate forward transactions. In terms of this Act, the bullion trade in Bombay City came to be regulated under a scheme of unitary control, the three associations then dealing in bullion futures trading being compelled to form a single association, namely, the Bombay Bullion Association. The Association was formed. in September 1948 and in October the Government of Bombay requested the Reserve Bank to agree to the nomination of an Officer of the Bank as Government Director. The Government had always intended that one of their two Directors should be an Officer of the Bank, conversant with the working of forward markets. The Bank agreed to the request, the first nominee being Mr. S. L. N. Simha
.

The Bank was closely associated with the framing of the bye-laws of the Association and of dealing with important and complex matters that came before the Board of the Association from time to time. Over the years, the Bank took considerable interest and initiative in the matter of devising a stringent system of margins to check unhealthy speculation which was inherent in the context of a ban on imports of bullion. The Bank's general view was that notwithstanding the ban on imports, it was desirable to permit forward trading under the auspices of a recognised Association and subject to the discipline of the Forward Contracts Act, rather than allowing it to take place in the street in an unorganised way.

Central Legislation on Futures Trading in Commodities

In 1950 the Bank was also called upon to give its comments on the draft of the Futures Markets (Regulation) Bill, prepared by a Committee of which Mr. A. D. Shroff was Chairman. The Committee of. The Central Board, and later the whole Central Board, considered the matter on the basis of detailed memoranda drawn up by the Bank's Economic Adviser (Dr. B. K. Madan), which had taken into account the comments and criticisms of the various associations engaged in futures trading, such as the East India Cotton Association. The memoranda generally endorsed the provisions of the Bill. Among the suggestions made in the memoranda were that where Government revoked recognition granted to an association, there should be a provision for a right of appeal, the desirability of bringing under the scope of the Act all delivery contracts whether transferable or nontransferable, the reduction of the penalty of imprisonment from three years to one year and the imposition of an obligation on Government to collect and furnish to producers, consumers and distributors information regarding demand, supply and prices and other conditions

regarding operations in the markets of commodities brought under regulation.

While the Bank management favoured statutory regulation of futures trading, it also struck a note of caution in regard to Government's intervention in the working of these markets. In his memo 1 andum of August 5, 1950, to the Central Board, Governor Rama Rau made the following observation:

> Government should not lightly interfere in the delicate working of futures markets in commodities, that the diversity of conditions in respect of trading in the different commodities should be duly taken into account in the actual application of regulatory measures, and that the building up of a suitable machinery in the form of technically competent personnel equipped with a knowledge of the working of the markets in commodities is an essential pre-requisite to the satisfactory exercise of powers of control by the Government in respect of any commodity.

Later, as in the case of the bullion and share markets, the Bank's Officers were nominated to the Boards of the East India Cotton Association and the Bombay Oilseeds Exchange.