
The Problems of Plenty, 1947–56

India's wartime sterling balances amounted to over £1,134 million (Rs 1,512 crores) on the eve of independence.¹ Financing commodity imports and capital outflows, making payments to Britain for surplus military stores and pension annuities, and paying the new dominion of Pakistan its share of undivided India's external financial assets, ate into a major portion of these reserves during the next three years. But India's sterling balances still stood at a comfortable £621 million (Rs 828 crores) at the end of 1949. There followed a net accretion to the country's external reserves which lasted until the mid-fifties.

Arising as they did from India's membership of the sterling area and the resulting restrictions on its use of these resources, the main problems which Indian policy-makers faced during these years in the external sector may be more aptly described as those of plenty than of want. Though exchange controls were put on a statutory footing with the enactment of the Foreign Exchange Regulation Act in March 1947, these were dictated by India's adherence to sterling area arrangements. Planning was a goal at the outset of this period rather than yet a strategy, and despite the sterling devaluation of September 1949 having extinguished nearly a third of their dollar or gold value, the existing level of exchange reserves appeared to provide a comfortable cushion for the foreseeable future. The rupee too, was a stable currency, or as one source described it, the 'hardest of soft currencies'. Although learning their lessons from the 1949 experience, the Bank and the government evinced some interest in issues relating to exchange rate management such as wider margins, the appropriate peg, and the possibilities of pursuing independent exchange rate policies, external monetary management did not pose any fundamental problem either, during the years covered by this chapter. Sterling devaluation was no doubt a disconcerting shock, one moreover which greatly

¹ Until 6 June 1966, a rupee was worth 18 pence, and a pound equalled Rs 13.33.

complicated the country's economic relations with neighbouring Pakistan. Though it caught India by surprise, devaluation also helped calm, at least initially, further fears about the sterling's value in the near future. India's commitment to the sterling area did waver on one or two occasions because of Britain's manner of dealing with its claims. But in general the view prevailed that unless British policies and attitudes made it unavoidable, no Indian interest would be served by withdrawing from the sterling area. Once fears also ceased of Britain repudiating these balances or seeking their negotiated reduction, the best course appeared to lie in increasing India's freedom, consistent with sterling stability, to spend them as it thought fit.

The same factors limiting India's freedom to use the accumulated balances moved its policy-makers to test these limits to the utmost. In a more normal environment, the accumulation of large external reserves in the hands of the world's poorer countries, who for the most part comprised the sterling area, would have been locally and globally an expansionary influence. Though the post-war world was in dire need of some form of expansionary stimuli to ease the burdens of reconstruction, overseas sterling balances were unsuited to that task. The pound was an inconvertible currency. Sterling balances were, both in principle and effect, inconvertible. Since members of the sterling area could not use their balances freely to finance imports from hard currency areas, they were forced to erect a formidable array of exchange controls to husband the 'central reserve' of gold and dollars. There were fewer restrictions, in principle, on trade within the sterling area. In practice, however, large sterling holders were also forced to restrict imports from Britain to minimize the risk of excess demand and inflation in that country, any further worsening of its weak external position, more stringent controls on hard currency imports, and possibly, another fall of the sterling and in the value of their assets.

Even if they did not carry much conviction until the early 1950s, Britain's efforts to move towards convertibility and the American desire for an early consummation of the process were both important factors in the sterling balances controversy.² Sterling holders welcomed the prospect of convertibility, but India was not alone in feeling that Britain hoped to make the ascent on the backs of the other members of the sterling area rather than by its own sacrifices.

² Readers should note that 'convertibility' did not carry the same connotation in the 1950s as it does in the 1990s. In the 1950s, the term 'convertibility' was used in this unqualified form to represent the absence of controls over current account transactions. In this case it also meant the transferability of non-resident sterling. Not to talk of capital controls which several European countries maintained until quite recently, even some trade and current account restrictions were judged at various times during this decade to be consistent with convertibility.

The Americans focused on the sterling overhang as the major obstacle to restoring multilateral arrangements and reviving trade and growth in Europe. The existence of the sterling area was also seen to impede American exports to these areas. Therefore the US attempted to persuade Britain to repudiate its sterling balances or scale them down substantially, and in the meantime to closely regulate their releases. While London was not disposed to adopt the former suggestions, a tight sterling release regime accorded closely with Britain's own interests. The negotiation of this regime became, consequently, the principal issue in its economic relations with members of the sterling area among whom India, as the largest holder of sterling at the beginning of this period, was the most important.

STERLING BALANCES: FRAMING THE ISSUES

India's sterling balances amounted to about £1,022 million (Rs 1,363 crores) at the end of March 1945 and peaked at £1,300 million (Rs 1,733 crores) in April the following year. There was widespread hope in India at the time that these resources would form the basis upon which to carry out a programme of rapid industrialization. The Bank, and to some extent even the colonial government, were therefore anxious to reach an early settlement with the debtor country, Great Britain, on the utilization of these balances.

Signals from London and elsewhere were not reassuring. The US anxiety to move towards a multilateral trading system was well known, as indeed its view that Britain's large sterling balances posed the principal obstacle to it. Its dependence on American money, which was underlined by the lend-lease controversy and the 1946 loan agreement between the two countries, gave the US some leverage over Britain's policies. In the latter country too, many including Keynes urged cancelling or reducing these wartime debts. More sober counsels prevailed in the end and the risk of repudiation began to recede from 1946. But thanks to persistent American efforts to dismantle the sterling area and some confusion within Britain over how best to advance the international role of the sterling, the risk of inequitable arrangements to reduce or 'fund' these balances could not be fully discounted until the early 1950s.

There still remained the problem of regulating the use of these balances. Britain was obliged, under the Anglo-American financial agreement (which came into effect in July 1946 following its ratification by the US Congress), to complete within a year arrangements to deal with its debt and facilitate the pound's return to convertibility. India too, was concerned to finalize arrangements enabling its sterling resources to be used to promote economic development.

These pressures led to a series of exploratory meetings which, despite being marked by major disagreements between the two sides, culminated in an interim agreement signed in August 1947. Initially, the discussions focused on narrowing differences between India and Britain on the nature of the debt, the manner of dealing with it, and the rate at which India could draw upon its balances. Besides, with India's independence from British rule in sight, attention also centred on adjusting a portion of these assets against the value of British military stores in India and the external pension liabilities of the latter's government. The interest payable on the balances too, came up for consideration.

Briefly, the British delegation at these talks opened negotiations on the note that the balances represented war debts which should be scaled down and that India should not charge or earn any interest on the remainder. The Indian side predictably took the view that the country's sterling holdings represented payment for exports (including invisible exports) which could not be liquidated in the form of goods because of wartime conditions. India would have been better off had Britain financed its imports by raising loans in rupees. Not only had the method Britain adopted to finance imports from India intensified inflationary pressures in the colony, recourse to sterling credits represented an abuse of the Reserve Bank of India Act which obliged the institution to make unlimited purchases of that currency. India's sterling balances also arose from its membership of the empire dollar pool under whose arrangements it was required to surrender dollar earnings to Britain in exchange for sterling. Rather than partaking of the nature of an intergovernmental wartime debt on which no interest was payable, these resources (in the form of short-term sterling securities) belonged to the Reserve Bank which held them in its Issue and Banking Departments against their respective liabilities. The Indian negotiators at these talks also rejected suggestions that the debts should be scaled down. India was not bound by the Anglo-American agreement, nor would the interim government in Delhi countenance such proposals in any form. The Reserve Bank, they maintained, should also be left free to invest these resources in conformity with established central banking techniques. With little common ground emerging between the two sides, India broke off the talks in February 1947.

Exercised by the prospect of unregulated drawings by India—between May and July 1947 the colony's sterling balances fell by £41 million, among other things, to finance food imports—at a time when Britain's external payments position was deteriorating and yet the restoration of sterling convertibility under the Anglo-American agreement remained on the anvil, authorities in London were disposed to negotiate a temporary agreement.

With the impending political changes in India also dictating such a course, the two sides resumed talks in London in July 1947. These talks led to an interim agreement—efforts to arrive at a permanent settlement were put off until circumstances became more propitious—which was concluded on the eve of Britain's departure from India on 15 August 1947.

The 14 August agreement did not mandate a freeze of India's sterling assets. The same object was, however, largely achieved by splitting existing balances into a No. 1 account, which was a current account, and a blocked No. 2 account, out of which could only be made payments for purposes such as acquiring surplus military stores, discharging pension liabilities, and financing capital outflows from India to the rest of the sterling area. The current account was to comprise a working balance of £30 million and an additional release of convertible sterling for the remainder of the year of £35 million (of which £26 million had already been expended during the month ending 14 August). According to tacit agreements and letters exchanged between the two delegations, the Reserve Bank of India was also precluded from altering the pattern of its sterling investments in such a manner as to increase appreciably the interest it earned on them.

The August 1947 agreement was intended to last only until the end of the year and it became necessary to negotiate a fresh agreement early in 1948. By then, however, much had changed in the two countries. The brief flirtation with sterling convertibility in July–August 1947 ended within weeks in disaster, and with its officials mooting a fresh agreement on a 'definite dollar target for the current period', doubts even arose about Britain's willingness to acquiesce to India running dollar deficits of the amount (roughly £15 million) it had appeared prepared to tolerate in August 1947. India too, in the meantime, underwent a painful partition which, among other things, necessitated financial arrangements with the newly-created dominion of Pakistan.

The main issue in the 1948 negotiations was the size of sterling releases to India and of the latter's convertible component. With the sterling area's dollar and gold reserves down to £500 million against Britain's external liabilities of nearly eleven times that figure, the latter sought to press India to curtail imports while increasing exports to hard currency areas. India had used up more than double the 'dollar ration' of \$60 million Britain had had in mind in August 1947, and its expenditures drew adverse comment in Britain's financial press in 1947–48. The *Financial Times* commented in December 1947 in the context of Indian drawings that the sterling system was 'more a handicap than a help' in coping with Britain's payments crisis, while the *Banker* remarked in March 1948 on the large size of Britain's 'unrequited exports' to India. Arguing that Britain's position as a banker to

the commonwealth was inconsistent with the requirements of European recovery, the *New York Times* suggested blocking existing sterling balances. In what was a thinly disguised attempt to nail countries such as India to the cross of the US's strategic goals in Europe in the wake of the Marshall plan, the paper also advocated sterling loans from Britain to continental Europe. Against this background, and following a detailed inspection of India's dollar expenditures and of material concerning those aspects of its trade with the sterling area which had a bearing on the former, the British delegation threatened to impose a unilateral 'dollar ration' on the former colony. Although India had spent more dollars than earlier anticipated, its overall deficit was well within projected limits. India was also not unwilling to moderate its dollar expenditures to the extent possible. But the idea of a 'dollar ration' was anathema to its officials, as indeed it was to most other involuntary holders of sterling balances, and India threatened to leave the sterling area if Britain imposed such limits.

With differences persisting or widening, Britain preferred to negotiate another interim arrangement for 1948. Pruning India's dollar deficit to relieve the burden on the central dollar reserves of the sterling area remained Britain's principal objective, and its officials proposed an arrangement under which while an agreed dollar deficit was met from the central reserves, the balance would be financed by drawings on the International Monetary Fund. The initial British offer was a 'dollar ration' amounting to £5 million for the half year, with the authorities in London monitoring India's dollar expenditures on a continuous basis.

India's negotiators greeted both proposals with derision, and its government came closer in 1948 than at any other time before or since to considering alternatives to the sterling area. India, officials felt, could not be expected to help solve the sterling area's difficulties if the sterling system failed to address the country's relatively modest requirements. The latter had virtually no dollar reserve of its own and was precluded as a member of the sterling area from building one. India depended on London for dollars, and if these could not be secured from that source, there was little advantage to be had from continuing in the sterling area. In the forceful exchanges that followed the British proposal, this Indian view was put to its delegation in the plainest terms. With the British delegation (led by Jeremy Raisman, a former Finance Member in the Government of India) recognizing that Britain would have to pay a price to retain India in the sterling area, the half-year 'dollar ration' was raised to £10 million. In addition, £18 million were allowed to be unblocked from the No. 2 account. India, for its part, agreed to purchase dollars from the IMF to finance dollar deficits in excess of the agreed provisions, provided the charges

payable in gold against dollar drawings from the latter agency and repurchases from it were met out of the sterling area's reserves.

With short-term agreements proving inconvenient and uncertainty about the availability of dollars from year to year clouding the import and investment outlook in India, an Indian ministerial delegation led by the Finance Minister, Shanmukham Chetty, and comprising among others the Governor, C.D. Deshmukh, visited Britain in June 1948 in search of a longer, three-year agreement, and in anticipation of one, to settle issues such as the valuation of military stores and the pension annuity. Thanks to a highly restrictive import policy regime, India had meanwhile accumulated current sterling of about £83 million. While such excesses, which the Indians attributed to the uncertain outlook for import financing, underlined in their eyes the need for a longer agreement to smoothen the flow of imports, the British delegation cited the same development as proof of India's inability to absorb imports. At first the British Chancellor opposed a three-year agreement, and suggested that India should be content with the sterling already to its credit in the No. 1 account, for the year up to June 1949. He also ruled out fresh releases from the central reserves to cover the dollar deficit which he proposed should be met by drawings on the Fund. But in three weeks of intensive negotiations, the Indian side managed to wear down British resistance to a three-year agreement. It agreed, however, to smaller releases than before, with imports in the first year being financed out of existing balances in the No. 1 account. The draft on the sterling area's hard currency reserves was also to be limited to £15 million in the first year (i.e. July 1948 to June 1949), after which the position was to be reviewed. It was also agreed that should India's balances in the No. 1 account fall below £60 million at any time during the next two years, they could be reinforced to the extent of £40 million each year. Releases, it was further agreed through an unpublished letter, would be flexible from year to year and could, if necessary, be drawn in advance. Agreements were also reached about pricing and paying for military stores and pension liabilities.

The three-year agreement did not by any means signal the end of India's external financing problems. Within months of the agreement, the balance in India's No. 1 account fell to £31 million, and it was compelled despite large sterling holdings to open its drawing account with the Fund with a request for \$99.98 million, purchased in seven instalments in 1948 and 1949. Seeking to utilize the flexibility provision in the agreement, India decided to anticipate future releases. There were once again murmurs in the press about large Indian drawings, and suggestions for blocking the balances.

Fortunately, thinking in Whitehall ran along more pragmatic lines, and the British authorities did not object to the Indian request for advance drawings.

But they preferred to see India arrest the rapid liquidation of its current sterling holdings, and sought to this end to regulate the dollar ration and future sterling releases.

Recent developments, and India's continuing need to finance large import surpluses, brought home to its officials that they could not afford to be complacent nor depend on British government departments to fight India's battles. With India's sterling and dollar expenditures once again expected to figure prominently in negotiations between the two countries after Prime Minister Jawaharlal Nehru's visit to London in 1949, the Bank was asked by Delhi to assemble the basis upon which to rest India's case in these talks. This request resulted in a cogent forty-page note entitled 'India's Sterling Balances' by P.S. Narayan Prasad, Director of the Bank's newly-created Balance of Payments Division. Prasad's note underlined that the charges of excessive drawings levelled against India and the solutions advanced to deal with them reflected an insular approach based on examining the issue solely from the British point of view rather than in relation to the totality of considerations relevant to the problem. The drain on the central reserves, Prasad argued, owed largely to Britain's own external deficits. According to Britain's balance of payments statement for 1947, there was a net drain on the sterling area's gold and dollar reserves of \$1,023 million. Of this, Britain alone accounted for \$626 million, while between them India and Pakistan drew only \$55 million. India, the note pointed out, could not be expected to curtail its drawings when Britain's own deficit was so conspicuously large. The sterling area represented a cooperative pooling of dollar reserves of various countries. Contributions to it were made according to convenience, and drawings from it according to need. Given its past contributions to the pool, India could not be put in the dock if it drew a little more from the pool, in passing times of dire need, than it put in. The right to cover hard currency deficits went with the obligation to contribute dollars when in surplus. If this proposition was not accepted, Prasad maintained, it was better for India to leave the sterling area.

Prasad's note also pointed out that since Indian sterling balances were not liquidated entirely to finance exports from Britain, curtailing sterling releases would do little to assist European recovery. The effort to divert supposedly unrequited exports to rebuild Europe's productive capacity, he also argued, was intended to enable that continent to build a trade surplus with the eastern hemisphere and reduce its recourse to American aid.

By January 1949, it became evident that barring a miracle the three-year agreement would soon collapse and that fresh discussions and agreements would be necessary. But the meeting of the consultative committee of Indian and British representatives held in Delhi in February 1949 preferred not to

anticipate events, and discussed a variety of other issues. These included the effect of the Marshall plan on India, re-exports of Indian goods from Britain to the dollar area, and the effectiveness of exchange control and import licensing. There was also some debate about India's entitlement to the dollar assistance Britain received towards the sterling area's deficits.

By spring 1949, India's external payments position was beginning to get out of hand. It had virtually exhausted the second (flexible) sterling drawing of £40 million intended originally for the second year and its application to draw a further \$100 million from the IMF was encountering stiff American resistance. Recognizing the need to bring about a better fit between sterling releases and imports, John Matthai, who had meanwhile replaced Chetty as Finance Minister, revoked all Open General Licences (OGLs) for soft currency imports in June 1949 while pressing for a further release from the blocked account to finance imports in the pipeline. The latter request and those for sterling releases over the next two years formed the subject of talks between the two countries in London in July 1949. These talks, which were also framed by Britain's agreement with Egypt in March 1949 containing terms more generous than those offered to India in the June 1948 agreement, led to a fresh deal in whose making Governor Deshmukh played a prominent role. The July 1949 agreement provided for further releases of £50 million for 1949–50 and 1950–51, in addition to the 'anticipated' drawing of £80 million. A special release of £50 million was also secured to clear imports already in the pipeline. The obnoxious 'dollar ration' too, was done away with, and the two governments agreed not to renew the understanding reached through an exchange of letters in August 1947 on the maximum interest India could earn on its sterling balances. The Reserve Bank was now free in principle to invest these funds according to general central banking principles and its statutory obligations. However not all constraints on such investments were lifted, largely superfluous though these now were to Britain's needs. In a letter he addressed to the Governor of the Reserve Bank, B. Rama Rau, in October 1951, his Bank of England counterpart, Cameron Cobbold, dwelt on the expediency 'from the point of view of a central bank' of investing the Reserve Bank's funds in liquid assets and on the desirability of consulting his institution whilst taking investment decisions to minimize disturbances to the London market. The Reserve Bank was not inclined to demur to these suggestions since it had little to gain and much to lose from unstable conditions in London.

The Bank of England, which had not been taken into close confidence about the July 1949 agreement and which by now was beginning to turn its sights away from the sterling area and a little more firmly towards Europe

and the United States, found little to cheer in it. Cobbold pointed out to the Treasury that the agreement on releases would increase pressure on the sterling and make it difficult to convince the Americans that everything was being done to resolve the sterling overhang. On the contrary, it would provide ammunition to American critics to attack British policy, not without some justification, for seeking to promote exports to protected markets in the sterling area at the cost of those to hard currency markets. The Governor went as far as to suggest a review, in due course, of the new agreement if it could be done without 'inviting the charge of bad faith'.

The new deal was not the end of the problem of sterling balances which soon became hostage to fresh uncertainties besetting the future of the sterling. With Britain's overexposed external banking position still very much a cause for concern and with a devaluation of the sterling under active consideration in the summer of 1949, the Bank of England, among others, grew more attracted to radical plans to wipe the slate clean and make a fresh beginning with American aid. The Governor of the Bank of England was, according to that institution's official history, now of the view that unless Britain did something 'violent and ambitious', it would 'bleed to death'. 'I see no attraction in allowing the UK to starve in order to provide India with new railways', he is said to have remarked.³ The Bank of England worked on several plans with the sole object of persuading the Americans to take a 'big wad of old sterling off UK's back' in order to prepare the ground for a successful sterling devaluation.⁴ But little came of them since the Americans were not as keen yet to bolster UK reserves as London was to secure assistance from across the Atlantic. British proposals to encourage the restoration of sterling convertibility through American purchases of the currency also failed, understandably, to make any headway.

Seeing that the more radical plans remained on paper, Britain attempted to persuade the United States to take over and write down, with the owners' consent, a proportion of its debt and exchange the remainder for dollars. In short, the Treasury hoped, instead of channelling its aid directly to countries such as India, the United States would link its assistance to the resolution of the sterling balance problem. At talks held in Washington in August–September 1949, little support was forthcoming from the Americans or the Canadians for the British idea which, along with other proposals for dealing with sterling balances, was relegated for examination to a committee. But the sterling's

³ John Fforde, *The Bank of England and Public Policy, 1941–1958* (Cambridge, 1992), p. 269.

⁴ *Ibid.*

devaluation in September 1949 and past American advocacy of the measure led to fresh speculation about a new Washington plan on sterling balances. With the air in the US capital remaining thick over the next few months with proposals to extend dollar aid to south-east Asia partly in return for a voluntary reduction in recipients' claims on Britain, the Finance Ministry asked the Reserve Bank to conduct a detailed examination of the 'Philosophy of Sterling Balances'.

Though it was widely speculated that the British were considering or sponsoring all manner of proposals to deal with sterling balances and contemplating the possibility of reaching some agreement about them with the USA, few details were yet available. The Bank's Department of Research and Statistics therefore undertook a conjectural exercise whose conclusions were presented to the government in June 1950 in the form of a confidential paper entitled 'India's Sterling Balances and Dollar Aid Plans'. This note dealt with India's approach to the utilization of the balances, influences shaping Britain's attitude towards them, the American interest in the subject, and finally with the possible ways in which dollar aid could be linked to the resolution or mitigation of the problem.

On the first issue, the Bank cautioned against an excessively rapid liquidation of the balances and argued the wisdom of convincing Britain that India was more likely to restrain its drawings in its own interest than in response to external pressure. This, it argued, would create an identity of interest between the creditor and the debtor. On the second point the memorandum underlined the changing ownership of sterling balances since the war. Whereas countries like Australia, South Africa, and Malaya had, thanks to large capital imports, increased their balances, India and Pakistan had depleted theirs. With the latter's shares in the overall balances now appreciably smaller than in the past, these countries posed fewer problems and little potential threat to Britain's external finances. As for proposals to tie dollar aid to sterling balance agreements, the Bank counselled against schemes to adjust the balances in excess of the dollar aid received. Though unlikely, a plan which provided dollars against matching reductions in India's sterling holdings should not be objectionable since that would merely amount to the United States, rather than the central reserves of the sterling area, bearing the burden of converting outstanding sterling holdings. However, since such a plan offered no aid but merely the facility of convertibility, it would be necessary, the Bank advised the government, to ensure that the formal arrangements did not have an appearance far different from fact. And finally, any dollar aid greater than the corresponding downward adjustment in sterling balances would be in India's interest provided it came with no strings attached.

In the event, though vague ideas of 'funding' the sterling balances were mooted, little came of these and other similar proposals. India, for its part, was not disposed to grumble about the stalemate. Its most pressing financing needs were being met, there was no immediate threat of another fall in the sterling, and its officials harboured deep misgivings about plans to substitute dollar aid for sterling holdings.

However, the threat to India's sterling balances was not altogether past. An IMF staff report on European payments arrangements focused on the over-abundance of sterling as the principal obstacle to convertibility, and suggested that until the sterling overhang was eliminated or locked up, Britain would be unable to settle its current account balances in gold, abolish bilateral agreements, or (without the use of controls) expand substantially its exports to the dollar area. The weakness of the British external position, the report suggested, also hindered progress towards convertibility in Europe. The report considered three solutions: reducing the use of 'old sterling' for current transactions, reducing British capital exports, and channelling more aid to Britain. It recommended the first course.

J.V. Joshi, who was on deputation from the Reserve Bank as the Indian Executive Director at the Fund, was quick to perceive the implications of this recommendation for India. In a well-reasoned intervention at the meeting of the Fund Board convened to discuss this report, he rejected the argument that sterling area countries liquidated their inconvertible external assets at a rate which was beyond Britain's capacity to satisfy through exports of goods and services. A large part of these balances were blocked and were not available to be drawn upon at the will of the holder. Besides, the rate at which these balances were released were determined by prior agreement between Britain and the creditor country, and he wondered how mutually agreed releases could lead to the 'evil result' feared in the report. These balances, Joshi maintained, were the result of the immense privations India had undergone during the war. If the Fund recommended scaling down these debts to secure the sterling's convertibility, he declared, it would be guilty of adopting a partisan attitude for, in solving Britain's balance of payments problem, it would create fresh problems for countries such as India and Egypt. Describing the proposed solution as reflecting a 'perverted and unreasonable' partisanship, Joshi questioned the Fund's right to crucify India 'on the cross of convertibility'. Finally, he demanded that the Fund Mission to Paris should be instructed not to recommend a solution which entailed the reduction of the claims of countries such as India and Egypt. Joshi's timely intervention helped scotch the obnoxious suggestion which was deleted from the Fund's final recommendations.

THE SIX-YEAR AGREEMENT

Until 1949 India had, to quote the Governor, C.D. Deshmukh, spent its sterling balances 'as if there was no tomorrow'. These balances fell sharply from £1,254 million at the end of 1945 to £621 million at the end of 1949. More than half the fall was accounted for by the cost of the pension annuity that India bought from Britain, payment for surplus stores, the transfer to Pakistan of that country's share of sterling assets, and capital outflows. But thanks to substantial food, and capital and intermediate goods imports, India ran large trade deficits during these years, financed mainly by its sterling drawings. To some extent, no doubt, these expenditures were also motivated by fears for sterling stability and misgivings about Britain's commitment to honouring its debt.

With the pound sterling already devalued, the danger of repudiation having receded, and the steep drop in sterling balances, Indian officials launched a review of policy. The initiative for this review came from the Bank which urged the Finance Ministry early in 1950 to regulate sterling releases more closely. India's actions, the Bank argued, should not be swayed by the argument that one pound 'sterling in hand ... [was] worth two in the book'. With repudiation no longer a distinct danger, it was now in India's own interest to help the pound on the course towards convertibility. An inconvertible sterling forced India to limit purchases from hard currency markets and make them at much higher prices from the sterling area. Large releases unrelated to actual balance of payment requirements made sense only if India wished to secede from the sterling area. According to the Bank's estimates, drawings of £50 million per year would be far in excess of India's requirements and the country could, without much sacrifice, seek and spend releases of £40 million in 1951-52 and £30 million the following year.

The Bank's recommendations shaped the Indian position in the negotiations which culminated in February 1952 in an exchange of letters with the British government detailing a six-year (July 1951-June 1957) agreement on sterling balances. This agreement, whose substance was finalized after discussions between the Finance Minister, C.D. Deshmukh, and his British counterpart and presented to the Indian Parliament in December 1950, provided for a release of up to £35 million each year. Unutilized amounts could be carried forward to subsequent years and larger allocations allowed in some years after mutual consultations. The agreement also envisaged the immediate transfer of £310 million, representing the assets of the Reserve Bank's Issue Department, from the No. 2 account to the No. 1 account on the condition that it would not be drawn down except in consultation with the British government. The Indian negotiators also sought agreement to discontinue the

latter obligation at the end of six years. Their counterparts preferred to hold the matter over until this period had passed, but agreed to transfer any balance left in the No. 2 account at the end of six years to the No. 1 account. Britain also agreed to consult India before repurchasing sterling from the Fund so that it could explore the possibility of making simultaneous rupee repurchases from that institution.

The six-year agreement was, as Deshmukh pointed out in Parliament in December 1950, largely in tune with India's aspirations and interests. A large part of the balances now comprised India's currency reserve and could not be liquidated without amending the existing fractional reserve system. Though perhaps not generous, the annual sterling releases proposed in the agreement were adequate for India's immediate needs. Finally, the agreement paved the way for unblocking Indian balances.

An important issue figuring in the 1950 negotiations related to the Indian demand for paying a part of the blocked balances in gold. This arose following Britain agreeing to sell Pakistan gold to the value of £4 million to strengthen its independent reserve. Ceylon had also been allowed to retain out of the island's dollar earnings a substantial independent reserve of gold and dollars. At the Finance Ministry's instance, the Bank examined India's case for a similar agreement with Britain. India's gold reserves, the Bank pointed out, had remained largely unchanged for two decades while its external trade and domestic currency circulation had both increased substantially. There was a case therefore for strengthening India's gold holdings, not to the extent of £24–28 million as a mechanical application of the Pakistan precedent might imply since London was certain to balk at the demand, but by about half that amount. Britain, the Bank felt, was unlikely to let go of even the latter amount, but nothing would be lost by India pressing its case. Dollar balances were however another matter. Since India also ran a dollar deficit, the Bank advised the government, Britain would refuse to entertain a demand which struck directly at the root of the sterling area system.

Britain refused to help India strengthen its gold reserves. Gold sales to a sterling area country, G.R. Kamat of the Finance Ministry was informed in London by officials at the British treasury, was against the *raison d'être* of the sterling area mechanism. India, they further reminded Kamat, also ran large dollar deficits.

At a time when our need to husband our gold and dollar reserves is so critical, the UK would only view with alarm a suggestion that the Central Reserves be reduced by a further dispersal of gold to independent sterling area holdings

The Indian claim would have been difficult enough to meet in isolation, but the prospect of other members of the sterling area making similar demands made it impossible.

The Reserve Bank was aware that its case was weak on economic or technical grounds. The British treasury had been quick to point out that India's gold reserves were higher in relation to money supply and Fund quotas than those of most other countries. Recognizing the strength of the British case, the Deputy Governor, N. Sundaresan, and Narayan Prasad were reluctant to join a technical debate on the subject. Rama Rau and Kamat therefore stressed the political argument at their next meeting with British officials. India had been reticent in pressing for larger gold reserves because of Britain's delicate external position. Britain's decision to strengthen Pakistan's gold reserves amounted to rewarding the pursuit of liberal monetary policies and penalizing others, such as India, who had on the whole followed restrictive policies and ensured that there was no significant erosion in the gold backing for their domestic currency. Besides placing India in an embarrassing position, London's decision had created the impression that either Britain was 'definitely partial ... [towards] Pakistan or that the Indian authorities were not good negotiators'. Officials in London recognized the force of the Indian argument, but expectedly refused to budge from their stand that Britain's external position and the practices of the sterling area precluded the suggested course.

The six-year agreement was set to expire at the end of June 1957. With the expected disappearance of the No. 2 account and the new currency reserve provisions in India, no purpose would have been served by a successor agreement. This was, in the event, the British view which was conveyed to the Indian government a year before the 1951 agreement was due to come to an end. But Britain remained keen to ensure that no restrictions were imposed on the transfer of capital from India to the United Kingdom, and in order to allay investors' fears, sought a public and authoritative declaration from the Indian government to that effect. The Indian government was not inclined to demur. Following some preliminary exercises in the Finance Ministry and with the Prime Minister's approval, the government issued a press release announcing that the expiring agreement would not be renewed, and that the absence of a fresh agreement would neither affect India's right to draw upon its sterling balances nor those of British citizens in India to remit savings and repatriate investments. The decade-old controversy over India's sterling balances and its right to utilize them thus ended on a rather amicable note.

THE WASHINGTON BALANCES AND RESERVE DIVERSIFICATION

In one important respect, however, the course of the six-year agreement was far less smooth than the manner in which it came to an end. This agreement did not touch upon the balances of the India Supply Mission in Washington (hereafter ISM or mission balances), and not long after it was signed they became a source of misunderstanding between officials of the two countries.

Since the second world war, India had maintained a supply mission in the US capital. Until December 1947, this mission obtained its dollar requirements through the British Supply Mission at Washington and the UK payments office in Canada. Thereafter, India evolved independent procedures for financing the mission's expenditures involving quarterly dollar remittances from the reserves of the sterling area which foreshadowed estimated disbursements. But London objected to the arrangement because it meant locking up large dollar balances for several weeks when the 'sterling area's dollar position was very tight'. The Bank sympathized, and early in 1948 Delhi decided that the mission should not draw dollars from London without its approval. At the same time the Washington mission was given a working balance of \$4 million which was raised in successive stages to \$34 million to facilitate some flexibility in its operations, especially since limits were placed on India's dollar drawings from the sterling area's central reserves. In March 1951 these working balances were increased to \$50 million and to \$60–75 million in 1951–52. By 1953 they averaged \$80–90 million.

The earlier increases were necessitated by the rising prices of India's imports from the USA, and large food imports. But the size of the Washington balances also reflected to some extent India's experience with Britain's discriminatory 'dollar ration' policy. As B.K. Nehru (who handled the issue when differences between India and Britain over these balances came to a head in 1955) recalled, Britain so severely curtailed dollar drawings by India in 1948–49, that great harm was caused 'through the enforcement of too rigorous an exchange and import control with the hard currency area'. But Britain placed no such restrictions on the other countries (with the exception of Pakistan), which were left free to draw on the central dollar reserves.

We did not want to find ourselves ever again as helpless as we did in 1948–49 and gradually built up these balances as a safeguard against the recurrence of a situation in which the United Kingdom finding itself in difficulties would work to get out of them at our expense.

Apart from financing imports, the Washington balances were utilized to build India's credit in that country, assist its quest for foreign capital, and give its officials some exposure to the working of money markets in the USA. Besides in the longer run, these balances helped initiate India into the world of reserve diversification. The controversies over them in the mid-1950s, which are recounted below, also dovetailed rather neatly into discussions which India initiated in January 1957 to diversify its external portfolio. Although officials at the Finance Ministry were not averse, when it suited them, to point to the Washington balances as the first step towards reserve diversification even in 1955, there is no evidence that the increase in these balances during the early 1950s reflected India's lack of confidence in the sterling, or a desire yet to diversify its assets away from that currency. The mission's balances, which never exceeded £33 million were, after all, a bagatelle to India's aggregate sterling holdings of £542 million in September 1955; and as B.K. Nehru remarked, if India wished to diversify, 'decamping with \$20 million was hardly the way to do it. Transferring a couple of hundred million pounds from London to New York would have made sense.' But through the greater part of the fifties, the British continued to view with suspicion India's attempts to build up its dollar balances, and time and again applied pressure on its officials to reduce them.

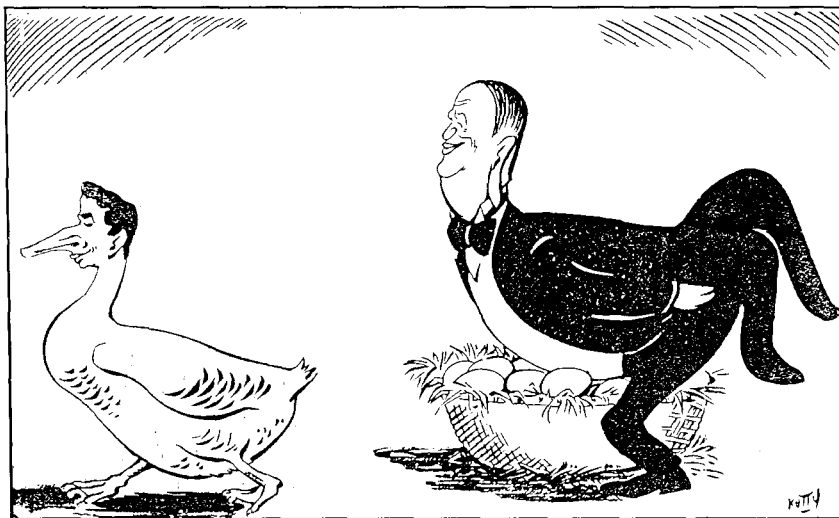
The seeds of distrust between India and Britain on the dollar balances question began sprouting freely in 1955. In September that year, Leonard Waight, Minister (Financial) at the British High Commission, confronted B.K. Nehru with a telegram from London which alleged that India had failed to keep its end of a purported agreement to pay off its debt to the Fund from the ISM balances and to keep the latter at a specified lower figure. Waight's bombshell was followed by a personal message from the British Chancellor of the Exchequer to his Indian counterpart, C.D. Deshmukh, in which he expressed concern over the erosion of the central reserves and the rise in the level of India's balances in the US which was 'much higher than is needed for a working balance'.

Britain could produce no evidence of any agreement by India to reduce its Washington balances, and its case rested entirely on treasury officials' recollections of discussions in Delhi in October 1953 between Deshmukh and senior officials of the British treasury. There was also some confusion in British minds over the precise meeting at which an agreement on India's dollar balances was purportedly reached. The records only showed that a limited understanding was reached in November 1953, after talks which Rama Rau and Ambegaokar held in London with British treasury officials, that

India would 'avoid making any dollar remittance from London during the closing months of a calendar year' to enable Britain to make payments on its Canadian and US loans.

Following this, India utilized its Washington balances to make Fund repurchases. But it drew on the central reserve to restore the balances during the early months of 1954. The latter move, British officials maintained, was contrary to the understanding. Though never actually made, accusations of bad faith hung in the air, while Indian officials objected to the self-righteous British attitude. For some weeks the issue clouded, if not relations between India and Britain, those between officials of the two countries. But as B.K. Nehru pointed out to Waight in October 1955, the only agreement between the officials of the two countries was that 'no extra burden would be thrown on the Central Reserves during the second half of a calendar year' and India had 'scrupulously kept' this promise. There was none given to reduce the balances nor was repayment to the Fund from India's Washington balances an implementation of that supposed promise. Nehru also drew Waight's attention to the fact that at \$93 million in

Hatching by Proxy



Mr. Deshmukh stated in Parliament that it was in India's interest to remain in the sterling area 'since all our eggs are in that basket'.

September 1955, these balances were not at a higher level than in October 1953 when Deshmukh allegedly made the broken promise.

The Indian dollar balances also figured prominently in discussions between Rama Rau and the British Chancellor in Istanbul in September 1955 and in those between Deshmukh and Edward Boyle the following month. Following these discussions, India agreed to reduce its Washington balances to \$75 million on the condition that Britain would not raise the subject again in bilateral negotiations. Deshmukh also raised with his British counterpart the possibility of India maintaining 'loan reserves' in the United States and Switzerland 'in the name of the Government of India' but as part of the central reserves of the sterling area, to enable it to build credit and raise loans in these markets. But little came of this suggestion.

It was not until the Suez crisis of 1956 that India began seriously to ponder the possibility of diversifying its exchange reserve, and even then gradually and with extreme caution. Not only did the Suez crisis provoke bitter anti-British sentiment in India, London's decision to block Egypt's sterling balances drew attention to the risk of India's assets also being frozen in the event of political differences developing between the two countries. T.T. Krishnamachari, who had long been 'very bearish of sterling', had meanwhile become Finance Minister, and ever since, officials in London expected him to 'create difficulties'. While the battering the sterling took in the wake of the crisis appeared to justify his fears, Britain's handling of the Egyptian balances issue underlined in Delhi's eyes the need for early steps to promote the diversification of India's reserves.

An increase in the Washington balances was the obvious means to achieve this object. Yet it was not until January 1957, i.e. well after the immediate crisis had passed, that B.K. Nehru raised the question with Waight. As Nehru confessed to Waight, politically the authorities in India were under pressure to diversify out of sterling, and mentioned to him a figure of \$110 million—\$10 million as working balance and \$100 million as a currency reserve. The British authorities rejected the plea and argued that there was no threat to the sterling and that acceding to the Indian request would encourage other sterling holders to advance similar proposals. The action proposed, the British Chancellor also pointed out to Krishnamachari, would not serve Indian interests if it triggered a stampede from the sterling, and its devaluation. The Reserve Bank too felt there was no immediate risk to the sterling, and advised caution. Krishnamachari's own inclination was to diversify out of sterling and 'take the consequences', but he was prevailed upon in the end to hold his hand.

Fears for the sterling did not altogether cease after the January 1957 discussions. But a number of factors contributed to easing them for the greater

part of the next decade. The progressive restoration of sterling convertibility from the late 1950s was no doubt an important factor, as was the steep reduction in India's reserves after 1956. It also became clear from the early 1960s that the dollar too, was not entirely invulnerable to speculation. Besides, India's increasing dependence during these years upon external assistance helped effectively to diversify its portfolio since such assistance came inevitably in a mix of currencies. The sterling part of India's drawings from the Fund increased during the 1960s, but the Bank and the government sought better reserve diversification from the early years of this decade by deciding to meet the bulk of the country's external obligations out of its sterling holdings.

One may note, in concluding this section, that Indian nervousness about the sterling revived in 1966, and the government once again sought the Bank's advice about persisting with the prevailing reserve arrangements and about ways to insulate the country's reserves from the risks of a devaluation of the British currency. The Bank's study suggested that the policy of making external payments predominantly in sterling had already led to a sizeable reduction in the proportion of Indian reserves held in that currency. More sterling would be liquidated to meet payments falling due in the near future. While the Reserve Bank would have liked to sell pound sterling forward, the Bank of England frowned upon such transactions. Indian sales were also likely to be too large to be put through the market. There was the additional risk, besides, of a rapid liquidation of dated sterling securities inflicting a capital loss on India.

Therefore the Bank judged that the balance of advantage lay in continuing to meet non-sterling commitments through sterling sales in the spot market. Even if India was left with Rs 100 to Rs 115 crores of sterling at the time of devaluation, the Bank pointed out to the government, those assets could be utilized to make payments to the sterling area. On the other hand, the Bank could also not do without a fairly large working balance in pounds sterling and this situation was likely to continue for some more time. In a long letter to S. Bhoothalingam, Secretary in the Finance Ministry, conveying to him the Bank's views on the sterling, the Governor, P.C. Bhattacharyya, pointed out that India had done a great deal to diversify from sterling without giving rise to any instability, and that it could now afford to take a more accommodative approach towards Britain's problem.

Fears for the sterling were confirmed in November 1967 when it was devalued by about 14 per cent. But sterling assets now comprised less than a sixth of its exchange reserves and the exchange losses India sustained were, at about Rs 7 crores (or 1.6 per cent of the total reserves), relatively negligible. The larger losses, amounting to Rs 14.75 crores, arose from forward purchase contracts. Sterling devaluation also appeared to the Bank to signal the onset

of a period of wider currency instability involving the US dollar as well. These fears, which too were soon confirmed by the partial closure of the US gold window in 1968, influenced the Bank's attitude towards proposals Britain mooted about the middle of the same year for a system of sterling guarantees. The principal British object in advancing these proposals was to dispel uncertainty about the sterling's future and restore its international standing. But the Bank found little to commend in the British plan, among other reasons because the guarantee proposed was in terms of another reserve currency, viz. the US dollar whose future too was not beyond doubt, rather than in gold.

THE RUPEE IN A CONVERTIBLE WORLD

With the rupee stable and India firmly a member of the sterling area, issues of exchange rate management did not greatly exercise the minds of officials at the Bank and the Government of India in the first decade following the end of the second world war. But these were not altogether absent in their deliberations, particularly during periods when the prospects for sterling convertibility appeared to brighten and suggestions abounded of widening the band on either side of the par value of a convertible sterling. Wider margins for the sterling were, in particular, anathema to the Bank and the government. Hence the Bank began to conduct studies of the relative advantages of pegging the rupee to the sterling or the dollar, and those of following an 'independent' exchange rate policy. Not yet definitive guides to policy, these exercises were intended to equip the Bank to anticipate and prepare responses to ideas emerging globally about exchange rate management.

Restoring convertibility of the major European currencies, particularly the sterling, was the principal objective of international economic policy in the 1950s. Early in this decade, Britain recognized the merits of so arranging the advance towards convertibility and freer trade as to ensure the cooperation of sterling area countries. The 1952 and 1953 commonwealth discussions centred on the forms which convertibility might take, and proposals were mooted to allow the sterling to fluctuate within a wider band around the par than that allowed by the Fund, as the means of taking 'the strain off the reserves and put[ting] it on the rate of exchange'.⁵ As a sequel to this, Britain was anxious in 1953 to obtain a stabilization loan either from the Fund or the United

⁵ Quoted in J. Keith Horsefield, *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation*, vol. I, *Chronicle* (Washington, 1969), p. 353.

States. Though there were rumblings within, the Fund did not altogether look askance at the wider margins plan nor was any legal difficulty anticipated in extending its assistance to a member with a fluctuating currency. But, according to a report from the Indian Executive Director at the Fund, W. R. Natu, the latter organization was not convinced that the sterling was yet ready to face the pressures of convertibility. A realistic plan to make the sterling convertible was thought to depend on assistance being made available to Britain jointly by the Fund and the United States. With American support not forthcoming, however, the 1953 sterling convertibility proposals failed to get off the ground.

Modified proposals reappeared in 1954 as part of the so-called Collective Approach, whose main thrust was to enable the main European currencies to fluctuate 3 to 5 per cent on either side of their individual dollar par. As discussions on the Collective Approach continued through much of 1953 and the early months of 1954, Britain was careful to keep members of the sterling area, including India, informed of these developments. By the summer of 1954, both Washington and the capitals of Europe saw feverish activity in the shape of preparations for convertibility, and there was a shared belief that economic factors were conducive to a stable return to convertibility.

Britain's approach to convertibility favoured *de facto* or limited convertibility for non-residents with a continuation of quantitative restrictions, controls on capital movements, and a degree of discrimination against dollar trade. While domestic anti-inflationary policies were to be persisted with, fluctuating exchange rates also formed a key aspect of the British proposal. These proposals, especially the ones pertaining to discrimination against dollar trade and the continuation of quantitative restrictions on current account transactions, were not to US liking. Nor was the latter willing yet to revise its trade policies in the direction desired by the Europeans.

With Britain pressing forward with convertibility proposals despite these hurdles and seeking Fund assistance for the purpose, attention at this institution began to focus on the likely size of Britain's financial requirements and those of the other European countries. Assessing Britain's financial needs was far from easy. Besides, there were fears that Britain's request for assistance would be followed by similar requests by other commonwealth countries, and that the total assistance necessitated by the move to convertibility might be beyond the Fund's resources. Hence in June 1954, Ivar Rooth, the Managing Director of the Fund, sought the views of P.S. Narayan Prasad, who had by now become the Indian Executive Director, on the likelihood of India requiring stabilization assistance should the sterling become convertible, and its possible size. While not wishing to foreclose this option, Prasad pointed out that India had to balance its opposition to a fluctuating rate against the disadvantages of

abandoning the rupee's link with the pound sterling, and that its authorities could not take a final view until they were in a position to evaluate the 'facts and prospects' at the time convertibility became 'an actual fact'. The Fund, he told Rooth, should not therefore

be surprised if we do come up at that time with a demand on [the] Fund's resources for the support of a different exchange policy, if we should choose to have one.

Meanwhile at the Bank, Joshi and B.K. Madan began examining the issues that would arise in the event of convertibility. Madan's note addressed the nature of the exchange rate regime which might arise, the question of the rupee's convertibility, and the likely implications of policy for India's obligations under Art. XIV or Art. VIII of the Fund's articles of agreement.

As regards the first, the presumption was against the rupee fluctuating with the sterling. Nor was Madan in favour of a freely floating rupee. The balance of advantage, according to him, pointed to severing the rupee's fixed link with the sterling and maintaining the status quo whereby it moved within a narrow band representing one per cent of its dollar par. While much more needed to be known about the probable form and content of sterling convertibility before India could determine its precise approach, he recommended telling the UK authorities in clear terms that India's complaisance in this matter could not be taken for granted. Madan's note also favoured the rupee being made de facto convertible along with the sterling, since otherwise the odds would weigh heavily against it. The third issue, according to Madan, involved matters of strategy. Rupee convertibility, he suggested, might have to be qualified or limited by the trade and exchange restrictions needed to buttress it, and India should canvass support to enable developing countries with weaker economies to continue to take advantage of Art. XIV of the IMF articles of agreement (pertaining to current account restrictions) even after their currencies became convertible, without violating Art. VIII.

A meeting of commonwealth finance ministers was convened to coincide with the annual Fund-[World]Bank meeting in Istanbul in September 1955 at which convertibility with wider margins was a major topic of discussion. Madan's note determined the Indian view at these meetings that since convertibility was still a distant possibility and its ancillary conditions were unknown, Delhi was not yet prepared to commit itself to the course it would adopt in its event. However, Rama Rau, who led the Indian delegation in the absence of the Finance Minister, C.D. Deshmukh, took the opportunity to inform the British Chancellor of the Exchequer that it would be 'politically next to impossible, at present, to permit the rupee to fluctuate with [the]

sterling' and that the final Indian response would depend on the circumstances in which the currency was made convertible within a wider band. Elaborating on the Indian view, Rama Rau pointed out that a wider band was not in the interests of the sterling area since it combined the disadvantages of exchange uncertainty for trade with those of speculative uncertainty. Since the sterling was under pressure, he said, the markets might decide to test the bottom of the 3 per cent band so severely and persistently as to force another devaluation. The Chancellor affirmed the British determination to defend the sterling and denied any intention to devalue, whereupon Rama Rau reminded him of the role of speculation in forcing the sterling's fall in 1949 and of the latter's effect on the value of India's sterling balances. India, he pointed out, would have to guard against the risk of a sterling devaluation in the future particularly as it was about to embark on a phase of rapid planned development. To Rama Rau, as to others at the Bank and in the government, wider margins were the first step to an eventual devaluation, and he pressed on his British interlocutors the necessity for drastic internal measures to bolster international confidence in the sterling prior to embarking on convertibility within permitted Fund margins.

Taken aback by the intensity of his opposition to a wider band, Leslie Rowan, head of the British treasury's overseas division, appealed to Rama Rau not to elaborate on his arguments at the formal conference of commonwealth ministers. The Governor heeded this plea, though not before making India's objections to wider bands explicit at the formal session and then turning to the British Chancellor to enquire whether he would like him to expand on them. Rama Rau reiterated the Indian view at meetings at Whitehall and the Bank of England when he visited London from Istanbul. Discussions in London did not focus directly on the Indian response, but the Governor of the Bank of England and his aides, and later the Chancellor and his officials, underlined that wider margins would enable Britain to deal more effectively with speculators. The Fund margin of one per cent decided at Bretton Woods, officials in London insisted, was an arbitrary figure lacking any theoretical basis. These discussions ended with London urging India not to rule out wider margins and Rama Rau seeking more concrete convertibility proposals from Britain.

As Rama Rau's talks with the Germans revealed, India was not alone in opposing wider margins. The German Finance Minister made little secret of his strong opposition to wider margins, while the head of its central bank echoed Indian fears that speculative activity would force the sterling down to the bottom of the band and render its defence impossible. The Germans also shared the Indian view that more effective stabilization measures should precede sterling convertibility, which would then 'automatically follow'.

Thanks to the Istanbul and London discussions, the British treasury delegation that arrived in Delhi in October 1955 was better prepared to deal with Indian objections to wider margins. If the rupee fluctuated with respect to the sterling, British officials argued, the value of India's sterling assets would be in a state of flux. A stable rupee-dollar rate and an unstable parity with the sterling, the British side also feared, would tempt India to move her reserves into dollars. Finally, since nearly 70 per cent of India's trade was invoiced in sterling, a variable rupee-sterling rate would create greater uncertainty in the minds of traders than a variable rupee-dollar rate.

The British treasury team made little immediate impression in India but secured agreement for Cyril Hawker, executive director at the Bank of England, to visit Bombay and Delhi for consultations with officials at the Bank and the Finance Ministry. In preparation for Hawker's visit, the government asked the Bank to examine the administrative and other arrangements needed to enable India to 'manage successfully a fully independent exchange policy'. P.J. Jeejeebhoy, Deputy Exchange Controller, who was entrusted the task at the Bank, concluded that India's ability to adopt an independent exchange rate policy was limited by the size of its exchange resources. Since its trade was mainly financed in sterling and to a certain extent in dollars, reliance upon these currencies could not be eschewed. The two alternatives before India were to continue to remain within the sterling area or link the rupee to the dollar.

Jeejeebhoy underlined the advantages to India of a continued link with the pound sterling. These included administrative and technical arrangements provided by British banks and the London forward market by which the business community was able to sell and buy foreign exchange, both spot and forward. He was apprehensive that the abdication of sterling area membership might mean a drastic revision in such arrangements at least for a temporary period. Besides, India would need substantial dollar reserves to pursue a policy which was independent of the sterling, and its ability to acquire them depended on whether Britain would treat India's sterling balances differently for convertibility purposes from the manner in which it treated the balances of countries continuing to adhere to the sterling. Even from a purely ways and means angle, Jeejeebhoy pointed out, India needed larger working balances of dollars than it currently possessed.

The difficulty of fixing the daily spot and forward rates was, according to Jeejeebhoy, another argument in favour of a continued link with the UK currency. The insignificant margin which prevailed between the buying and selling rates for spot and forward sterling had so far ensured the relatively smooth financing of foreign trade. If the pound varied within a 6 per cent band and the rupee varied within one per cent of the sterling par, changes in

procedure and practice would be necessitated. The Bank would have to fix the buying and selling rates for transactions based upon the sterling-dollar rates in London in order to maintain the cross rate between the rupee and the sterling within one per cent. Fixing daily rates would not be without inconvenience to the business community. Besides, the Bank would have to intervene in both the sterling and dollar markets, since the alternative of supporting only one market would introduce uncertainty and dislocation in the other. The resulting cost to the Bank of covering its transactions was another factor to be borne in mind in adopting a different exchange rate policy.

Jeejeebhoy's note strongly underlined the perils of an 'independent' exchange rate policy. Although not without disadvantages, the option of pegging to the dollar within a narrow band still remained, and this was in the event a recommendation which emanated from the Bank's research department after a study of the subject by V.V. Bhatt. Rama Rau took advantage of Hawker's visit to pencil in the outlines of a tentative scheme along these lines in the event of the sterling moving into a wider band. The rupee, Rama Rau elaborated, 'would remain pegged to gold and, therefore, to the dollar' and fluctuate against the sterling. The Bank, he proposed, should make no change in the existing intervention practice and operate only in sterling at rates fluctuating with the sterling-dollar rate, leaving banks free to deal in dollars against sterling in the London or New York markets.

Hawker made little secret of his dislike for Rama Rau's proposal. Although the latter was better than pegging to the dollar and operating only in dollars, it would still represent a break in the uniform sterling front, influence other countries to follow suit, and damage the international role of the sterling. Besides disadvantaging India's rupee and sterling trade, the plan would create technical difficulties for exchange markets. Although not insuperable, such difficulties would still necessitate the organization of a local market and the supply of cover facilities for spot and forward risks. Complications would also arise from the difference between the working hours of the London, New York, and Bombay exchange markets which could come in the way of Indian banks covering themselves completely against exchange fluctuations.

Hawker conveyed his objections to Rama Rau's proposal also to Deshmukh when he met him in December 1955. Deshmukh assured Hawker that should a fixed rupee-sterling rate be found, upon examination, to be to India's economic advantage, the political resistance to it could probably be overcome. In the meantime, he said, India would like to 'hold its horses'.

The British Chancellor made it clear in Istanbul that the buoyancy of the British economy argued for restrictive measures and that his government,

which still had an open mind on the timing and nature of sterling convertibility, did not wish to rush the decision. This announcement was partly intended to deflect attacks on the sterling by speculators expecting the currency to be made convertible with wider bands. Thereafter, thanks to the sharp fall in sterling area reserves from the second half of 1955, hopes of an early restoration of sterling convertibility quickly faded. It also soon became apparent that there would be no general move towards convertibility in Europe until the UK took the first step.

In fact by 1956, prospects of early sterling convertibility had given way to fears for the currency's stability. As rumours regarding the sterling gained momentum and the currency came under attack in the wake of the Suez crisis, officials at the Bank and in the government began considering India's options in the event of a sterling devaluation. Even as Commerce and Industry Minister, T.T. Krishnamachari was wont to raise alarms about the sterling's future, and in July 1955 he forced the Finance Ministry, and through it the Bank, to directly address the possibility of a fall in that currency. Although Britain's economy was in a state of disequilibrium, it did not appear to officials at Mint Road and North Block that there was any imminent threat of a sterling devaluation. While dangers could arise to the longer-run stability of the currency from differential productivity growth rates within Europe, its immediate troubles were felt to be the result of reversible short-term factors. Britain, the Bank and the Finance Ministry also felt, had several measures open to it before pondering a devaluation. The only practical course, Deshmukh suggested to TTK, was for India to remain a member of the sterling area but consistent with its rules build significant dollar balances. This had already been done and it was not possible to intensify the process without evoking valid protests from Britain. Rama Rau too felt there was no immediate prospect of a sterling devaluation and that Britain was both determined and well equipped to avoid such a step.

It was pointed out above that the run on Britain's reserves in the wake of the Suez crisis led to a half-hearted effort by India in January 1957 to explore diversification possibilities in consultation with the British authorities, and that despite Finance Minister T.T. Krishnamachari being in its favour, the exercise was abandoned no sooner it began. During the preceding months, however, Indian sterling balances began to fall rapidly as imports surged on the back of rising public and private investment. Such an outcome had been anticipated by some economists within the Bank even in 1955, but little notice was taken of their views at that time. As the drains intensified, the Bank drew the government's attention to the phenomenon in December 1956. Recent sales of sterling had been as high as £6 million each week, while

weekly sales during the twenty-eight weeks ending 28 October 1956 averaged about £4 million. The rapid outflow excited widespread comment in the financial press both at home and overseas, and the Reserve Bank warned the government that this rate of drain was unsustainable. As pointed out in chapter 2, the rapid fall in its sterling reserves during 1956–57 also led to the revision of India's currency cover provisions which were modified twice within a period of about twelve months.

The reduction in India's sterling balances was greeted with concern at the Bank of England, particularly in the wake of rumours of possible diversification by India out of sterling, and Hawker returned to Bombay in January 1957 for discussions with the Bank. He talked at length about the manner in which Britain had weathered the adverse effects on the sterling of the crises of the previous year and speculative attacks on the currency. The raid on the sterling, he confessed, 'was a direct consequence of a lack of confidence' in the currency. But London had mobilized its resources and managed successfully to defend the currency and signal its resolve not to be pressurized into a devaluation. Britain, Hawker reaffirmed, was determined to avoid another change in the sterling parity since it would deal a mortal blow to the currency's international role. The Bank of England official was however principally anxious about the speed at which India was dissipating its sterling reserves. While displaying no overt concern, he sought reassurance that India had not lost confidence in the sterling and that it would not face a crisis in meeting its foreign exchange commitments in the near future. Hawker also attempted to draw out Indian reactions to the blocking of Egypt's London balances, and added that there was no cause for a 'Commonwealth country to believe that such an action would ever be taken against it'. K.G. Ambegaokar, who was the Governor during these weeks, remained non-committal. While newspapers had speculated freely about India moving out of sterling in response to Britain's action against Egypt's balances, the Bank itself had not yet 'taken any serious view of the situation'.

It was not the case, however, that the Bank suffered no attacks of anxiety about the stability of the UK currency. Several officials at the Bank were convinced that fears about the sterling were a hardy perennial that needed persistent and careful study, and Pendharkar, S.D. Deshmukh, and Bhatt were entrusted the responsibility for forming a firm outlook on its prospects. Their study of the 1956 crisis convinced the Bank that devaluation was no solution to Britain's external problems. The latter's deficit was caused by a disturbance to normal trade rather than an imbalance in relative prices, and was accentuated by leads and lags in current account transactions and

speculative outflows of short-term capital. Britain's best course, the Bank believed, lay in taking bold steps to support the existing rate. Even though it judged a sterling devaluation to be improbable, the Bank continued to study the various courses of action open to India in the event of Britain deciding upon such a policy.

The prospects for the sterling took a turn for the worse from the mid-sixties. But having already diversified the country's reserves out of the endangered currency, the Bank could afford to face the future with a certain measure of equanimity. The prospects for its trade of a sterling devaluation and its aftermath were another matter altogether, but little would be gained by anticipating events in such matters. The devaluation of the pound sterling by some 14 per cent in November 1967 did turn thoughts within the Bank towards a possible response. Ceylon (20 per cent) and Nepal (24.74 per cent) decided to follow the sterling down. But its recent devaluation still conferred some advantage, so that while resolving to keep the situation under continuous watch and modifying some export duties, India decided not to respond to the sterling's devaluation by altering the exchange rate.

STERLING CONVERTIBILITY AND AFTER

A major move towards the restoration of multilateral payments arrangements after the end of the second world war was the announcement on 29 December 1958 of the resumption of external convertibility of fourteen west European currencies including the pound sterling. The departure from prevailing arrangements signalled by the agreement was less significant for the sterling than for the other currencies, since a measure of *de facto* convertibility of non-resident holdings had already been established in February 1955 when London decided to intervene in the market for transferable sterling. The December 1958 decision meant that Britain was now able formally to unify transferable, American, Canadian, and the so-called registered accounts into a single external account. Some current account restrictions remained in place both in Britain and in the other European countries, and these were proposed to be removed when conditions permitted, as part of the process of instituting the proposed European monetary arrangements.

The Bank first learnt of the convertibility decision officially on 24 December 1958 when Cobbold cabled the Governor, H.V.R. Iengar. This was followed by another message three days later detailing consequential changes in Britain's exchange control rules and procedures governing non-residents. The most gratifying feature of the new development, from the Indian point of view, was the burial of proposals for convertibility with wider margins. Telegrams from

London made clear that the sterling would be maintained within a narrow band of \$2.78 to \$2.82, and India could set at rest its fears about the consequences for the rupee of wider sterling margins, and put on hold plans to review its exchange rate policy.

India's response to the non-resident convertibility move was prompt, and it was among the sixteen countries which took immediate steps to adjust their exchange control regulations to the new conditions. In February 1961, ten European countries including the United Kingdom decided to abolish current account restrictions and assume full obligations under Art. VIII of the Fund's Articles of Agreement. The latter step had immediate practical implications for India since with the sterling becoming formally convertible, its sterling balances began to be counted by the Fund as part of the country's monetary reserves. India had borrowed from the IMF in 1957, and under Art. V, an increase in a borrower's monetary reserves could lead to an additional repurchase obligation which was independent of the repurchase programme agreed earlier. Although there was no immediate danger of this happening, India wanted to avoid having to alter repurchase obligations as a result of a notional increase in its monetary reserves. Hence the Bank and the government decided to keep a careful watch over India's monetary reserves position and, should it become necessary, consider replenishing its working balances within reasonable limits, in order to avoid new repurchase obligations.⁶

The restoration of convertibility, if anything, increased the Bank's interest in exchange rate management. The restoration of European convertibility was followed within a matter of years by greater uncertainty in currency markets and doubts over the long run stability of the sterling and now, also the dollar. Hence the Bank took a continuing interest in evaluating alternative scenarios and policy possibilities. The events leading to the rise in the price of gold in London from the Bretton Woods parity of \$35 per ounce to \$41, the gold rush of October 1960, and the revaluation of the Deutschmark, which the Bank had earlier dismissed as improbable, sparked off studies within the Bank on the possible consequences for India of a realignment of the exchange rates of the major international currencies. These studies also focused on India's response to the development, particularly should its export rivals such as Pakistan and Ceylon also take the opportunity to devalue their currencies.

The substance of the Bank's views was summarized in a note by Madan entitled 'Exchange Values of Currencies' which was based on the considerable preparatory work done then and earlier by Pendharkar, Deshmukh, and Bhatt.

⁶ Under Art. XI(c), working balances are not counted towards reserves.

Madan's note concluded that India had no alternative to following the sterling down if the latter was devalued. This consideration applied even more strongly if both the sterling and the dollar were devalued. European revaluation, on the other hand, would be in the nature of an overdue correction involving no questions of any possible response by India. Madan felt there was no need for India to match a Pakistani devaluation since the latter's existing export incentive schemes amounted to a de facto devaluation of its currency. While the same conclusion held true in Ceylon's case as well, India, Madan argued, might need to examine specific measures for the protection of some exporters' interests. But a more detailed evaluation of the question was not possible until more was known about the precise extent and coverage (including possible offsetting export duties) of the devaluations carried out by these countries. The Indian decision would depend, besides, on the availability of foreign assistance, the course of exports during the slack season, and its success in holding the domestic price line down.

In the end, little came of these exercises. The dollar steadied during the subsequent months, particularly after the so-called gold pool, comprising several European central banks and the Federal Reserve Bank of New York, was formed in November 1961 to coordinate intervention in the London gold market. By the end of 1961, the Bank had grown sanguine about the prospects for the dollar, and studies of international monetary and exchange rate conditions took a back seat which they did not vacate until the late 1960s.

THE BANK'S ROLE

Writing in 1985 on the occasion of the fiftieth year of the Reserve Bank, B.K. Madan referred to the institution's external financial initiatives as a major source of the considerable national and international stature it enjoyed during the early post-war years. In particular the former Deputy Governor had in mind the Bank's contribution to the formulation and exposition of India's views at the Bretton Woods and Savannah conferences and its handling of the related wartime issues of sterling balances and domestic inflation.

Madan himself was closely involved with the Bank's activities in these spheres. Yet his assessment is not far off the mark. The Bank's engagement with international financial issues derived from the independent expertise its newly established research department was building up in this area, which was already superior to that available, loosely speaking, in the 'third world', not to mention the Government of India. Besides, as the sole economic and

financial policy-making body accountable in some sense to a wider public body and with an elected Central Board whose members were sensitive to 'nationalist' aspirations, the Bank's views carried a legitimacy at this time denied to those of the colonial government.

After 1947, but more especially from the early fifties, a gap opened up between the Bank's technical expertise in international financial matters and its executive responsibilities, with the latter passing increasingly into the hands of an elected central government in Delhi. This process gained pace after C.D. Deshmukh, who as Governor was an Indian delegate to Bretton Woods and the head of the Indian delegation at Savannah, became Finance Minister. Thereafter, the Bank merely provided the technical analysis and policy advice upon which the government based its decisions, but rarely itself made the decisions. Although as Governor, Deshmukh played a major role in the sterling balances negotiations and his successor often represented the government's views to other governments and central banks, the Bank's role in financial and economic diplomacy generally, and in particular on matters covered in this chapter, became increasingly subordinated to that of the government. On the other hand, the Bank's expertise in these areas remained relatively unchallenged for much longer than in others. In addition, the practice of sending its officials as Indian executive directors to the Fund and the use the government made of the Governor's contacts with other governments, central banks, and international financial institutions meant that the Bank was not entirely divorced even during these years from the management of the country's external finances.