

APPENDIX G

Bilateral Rupee Payment Agreements

with C.J. Batliwalla

One of the more striking features of India's external economic relationships of the fifties and the sixties was the forging of trade, investment, and financial links between India and the centrally planned economies of eastern Europe. No narrative of developments in the country's external sector during these years can be complete without a brief survey of this relationship.

Until 1952 trade contact with east Europe was confined to agreements with Poland, Yugoslavia, Hungary, and Czechoslovakia. Commercial contacts with the Soviet Union and the other countries of eastern Europe were established in the 1950s. Thereafter, trade with the region increased rapidly, from \$9.2 million in 1952–53 to \$658 million in 1965–66, and from a mere 0.3 per cent to 14.2 per cent of India's foreign trade. These bilateral agreements were important because they were believed to give India access to new markets, and enabled it to import vitally required capital and defence goods, often on easy rupee payment terms.

India's policy on trade and financial relations with this region was determined largely on political grounds. Their rapid expansion under the impetus of bilateral rupee payment agreements evoked a certain amount of concern, notably over the contribution of such arrangements to enhancing India's access to capital goods. It was argued that rather than offering new and expanded markets, these agreements led directly or indirectly to a reduction in India's hard currency export receipts. Reports of switch trade or shunting—i.e. the diversion by socialist countries to world markets of imports from India paid for in rupees—also abounded. Alarmed by what appeared to him as a headlong push towards bilateral trading arrangements and the limited benefits to India therefrom, Iengar wrote to Jawaharlal Nehru alerting him to the dangers of such agreements. But Nehru brushed aside Iengar's reservations. In a two-page handwritten note, he instructed the Finance Ministry to ignore the Governor's views and declared that 'political compulsions far outweigh[ed] economic considerations in this relationship'.

Thereafter, the Prime Minister did not discuss the matter with the Governor, and the Bank was largely excluded from the arena of policy-making in this particular area. Nor did it take part in the negotiations except to advise the government about certain operational aspects of bilateral trade. But it fell to the Reserve Bank to administer the settlement of transactions under these agreements and maintain the accounts of India's trade with the region.

MECHANISM OF TRADE AND PAYMENT AGREEMENTS

Bilateral trade agreements with Yugoslavia, Czechoslovakia, Hungary, and Poland went back to 1948–49. The early agreements did not embody any special payment arrangements, and surpluses and deficits were settled in sterling. Agreements concluded between 1953 and 1958 accepted the rupee as the unit of account, but while every effort was to be made to balance trade, imbalances were expected to be settled in sterling or a convertible currency. These agreements were more an expression of intent than a means immediately to promote trade, but they also helped familiarize each country with the trading potential of the other. Though trade was bilateral, payment arrangements were not, and as the Reserve Bank of India noted in its *Report on Currency and Finance* for 1955–56, these agreements were 'essentially multilateral in character' in that outstanding balances were settled in sterling 'at the end of the agreement period or on demand'

India's experience with these early agreements was far from encouraging. Centrally planned economies did not display the same enthusiasm for importing from India as for exporting to it, and saw bilateral trade as a means of earning sterling for expenditure elsewhere. In 1958–59 a radical change was effected in payment arrangements. From now on payments for all transactions were to be effected in inconvertible rupees, and contracting countries agreed not to demand balancing payments in convertible currency and instead to hold rupee balances. Protocols were appended to earlier agreements deferring the convertibility of rupee balances and enabling central banks of partner countries to hold accounts with the Reserve Bank and some commercial banks. For its part, India agreed to provide overdrafts (called technical credits) on the partner country's rupee account to smoothen short-term imbalances. The object of these amendments was to ensure a balance in India's bilateral trade with the socialist countries, conserve foreign exchange, and enlarge its export markets. The value of the rupee was fixed in terms of gold for the purpose of these agreements, intergroup transfers of balances were generally disallowed, and no distinction was made between trade and transactions financed from aid.

East European countries maintained their accounts with the Reserve Bank. As part of this responsibility, the Bank administered these accounts and monitored the balancing aspects of the various accounts each country maintained with it. This work was handled in the then Chief Accountant's office and the Economic Department, with the latter entrusted with responsibility for compiling, collating, and presenting material for the Governor and the other departments dealing with banking relations of this group, and analysis and reviews for use by the government. The Economic Department was also the principal source of data for India's balance of payments with east Europe and undertook reviews at regular intervals of trade and financing arrangements with each bilateral partner. Over time, the intricacies of these arrangements increased with the growth of trade, aid, and the exchange of technical know-how. Besides, the Bank also tried to assess the impact of these arrangements on the Indian economy, and supplied data and material to help resolve disputes between contracting parties, notably over the interpretation of the 'gold clause' after the rupee devaluation of 1966. But the Bank itself was rarely involved directly in the negotiations.

It is necessary before getting any deeper into the working of these agreements to understand how trade transactions with rupee payment countries were operated and accounted. Each such country maintained four accounts with banks in India: a central clearing account, a special account in which were deposited credits extended as assistance to India, another similar account to which were credited debt repayments by India, and a current account. While the first three accounts were maintained with the Reserve Bank, the fourth was held with one or more commercial banks. India paid for normal imports by depositing inconvertible rupees in the first central account and for aid-financed imports by withdrawals from the second. Its trading partners financed their imports by making payments through their current accounts. Credits in the third account could be transferred to the current account through the central clearing account. Funds could be moved freely between these four accounts, but while transactions financed by technical credits were routed through the central clearing account, trade transactions were put through current accounts. Having to maintain this complex set of accounts, the Bank was obliged to engage in continuous liaison with its holders (especially the central banks of India's socialist trading partners) and with the Finance and Commerce Ministries. Information was often sketchier than the Bank wished and establishing the precise nature of a transaction was not always easy.

Temporary 'swing credits' were extended to a country which ran out of its rupee balances on the understanding that they would be repaid as soon as possible. On the other hand, should any country accumulate a large rupee

surplus, India imposed licensing restrictions on imports from that country to redress the imbalance. Originally, technical credits were a temporary form of trade credit extended by the Indian government to its rupee payment partners to boost exports in 1959 when there was a recession in the western demand for them. Though conceived as a 'once for all operation', it was converted in due course into a revolving credit or a semi-permanent overdraft facility for the duration of each agreement, on the reasoning that with trade financed in inconvertible rupees, exports to the socialist countries would otherwise be constrained by the size of India's imports from them. Upper limits were fixed separately for each individual country, except the USSR, credits to which had no upper limit, while withdrawals up to Rs one crore were free of any interest charges.

This credit facility was not invulnerable to abuse. In 1961 D.N. Maluste, Deputy Exchange Controller, drew the Finance Ministry's attention to one bilateral trading partner availing of technical credits to the hilt despite having large current account balances, possibly with a view to earning some additional return. On this occasion, the central bank of the concerned country represented that current account balances were intended to support the letters of credit opened by the bank against exports from India. Following this the Bank advised the government to ensure that no country used technical credits as a means of increasing its interest earnings. But little came of this suggestion as the Ministry of Commerce and Industry felt excessive credits were not the problem. The real problem, according to this ministry, was the opposite one of inadequate credits hampering bilateral trade. The Bank's more extensive review carried out in 1964 confirmed its earlier assessment. India's exports to eastern Europe did not suffer for want of funds or credit. Several countries continued to draw on interest-free technical credit to deposit in interest-earning commercial bank accounts. The review proposed more intensive scrutiny of outstanding credits, efforts to persuade debtor countries to repay their borrowing whenever they had sufficient balances in their current accounts, and in the meantime to charge higher rates of interest on technical credit. But to little immediate avail.

Thanks to its role in operating these arrangements, the Bank was privy to very detailed data on trade with the socialist countries and the manner in which it was balanced or financed. However, largely for strategic reasons, these data were never put out in a comprehensive or transparent form. Generally too, the working of these agreements have been shrouded in mystery. According to the summary position for four years (1960-61 to 1963-64) worked out by officials at the Bank, India ran substantial merchandise trade deficits with the Soviet bloc countries, which rose from Rs 13.1 crores in 1960-61 to Rs 45.5

crores in 1963–64. Invisible transactions were relatively small except in the first year, and these figures are also generally reflective of the position on the current account. Capital receipts registered a steady and perceptible increase from Rs 4.6 crores to Rs 42.5 crores during these years. Although these loans were made on concessional terms at nominal interest rates and carried longer amortization periods, east European credits were of much smaller magnitude than those extended by the west. The real significance of these flows lay not in their size but in the competition they injected between donor groups, and their success in forcing the major western countries to re-evaluate their aid programmes.

Combined current and capital account transactions with bilateral payment countries reflected nominal surpluses of Rs 1.4 crores in 1960–61 and Rs 1.5 crores in 1962–63. Against these may be set net drawings of technical credits of Rs 2.7 crores and Rs 3.4 crores respectively during these two years. In 1961–62, India ran a deficit of Rs 9.4 crores, which the socialist countries used partly to repay technical credits (Rs 5.6 crores) and partly to augment balances in their central and commercial accounts (Rs 3.8 crores). The 1963–64 payments outcome vindicated the Reserve Bank's suspicions: despite a deficit of Rs 11 crores in that year, net technical credits extended by India exceeded Rs 4 crores when repayment would have been the proper course. As a result, socialist countries' rupee balances in their commercial bank and Reserve Bank accounts improved by Rs 15 crores.

Merchandise imports under bilateral agreements increased faster than exports in the first half of the sixties. But this trend was interrupted in 1965–66, when the growth in imports levelled off and gave way to an export surplus. Thereafter, India's trade relations with the socialist countries suffered some uncertainty due to the 'gold clause' controversy arising from the devaluation of the rupee in June 1966. This controversy is discussed below. Although imports in 1968–69 and 1969–70 were again higher, from 1970–71 they stabilized at a lower level. To an extent, this reversal reflected the repayment and servicing of assistance drawn to finance the import surplus of the earlier period. But also, India was committed under the agreement to liquidate its export earnings from an individual country on imports of goods and services from it. In the early sixties, over half of India's imports from socialist countries comprised machinery or turnkey projects tied to aid. But by the beginning of the next decade, as the Bank informed the government, thanks to the difficulty of finding suitable products, licences issued for capital goods imports from the socialist bloc remained unutilized. In other cases, there were long delays between orders and shipment. The resulting imbalance often forced India to enhance technical credit limits to several socialist countries.

A major issue of contention arising from bilateral rupee trade agreements concerned the diversion of Indian exports from hard currency markets to the socialist countries and the reported re-export by them of their imports from India. With outlook in Delhi dominated by the country's balance of payments problems, the advantage of paying for capital goods imports in inconvertible rupees was thought to outweigh such losses. There was some concern voiced at the Bank, notably by the Division of Trade, about trade diversion when supplies of exportable goods were inelastic. But more detailed commodity studies suggested that there was no large reduction in India's exports to the rest of the world due to higher exports to the socialist world. If anything, there was some trade creation, particularly in the case of exports such as cashew nuts, tobacco, and iron and manganese ore, and some improvement as a result in India's terms of trade.

Raw hides and skins were believed to be an exception. While world demand was buoyant and Indian suppliers were constrained by a variety of factors from meeting it, some east European countries began pre-empting supplies by offering much higher prices. This benefited one section of the trade, but value addition and employment in the downstream activities suffered as many tanneries could not secure adequate supplies of raw hides and skins and were forced to close. Exports to hard currency markets too, suffered a setback.

Re-exports by the socialist countries of imports from India presented another aspect of the diversion problem. Sometimes, however, the evidence for shunting—as in the case of India's exports of oilcakes, the Soviet bloc's shares of which rose significantly through the 1960s despite shortfalls in domestic availability—was suggestive rather than conclusive. Apart from oilcakes, there were several complaints in the 1960s of re-exports of coffee, tea, spices, and hides and skins, and the Estimates Committee of Parliament too, examined the problem without coming to any definite conclusion. On a visit to Europe, V.G. Pendharkar, Manager of the Bank's office in London, came across Indian tea and cashew nuts consigned to Russia and Poland being offloaded at Hamburg and Bremen for re-consignment to US ports. The Indian government was aware of such practices, but little could be done about them in the absence of reliable quantitative information. In the meantime it preferred to turn a blind eye to shunting on the assumption that it did not account for any significant proportion of India's exports to the socialist bloc. Besides, many officials argued, India was not in a position to strike hard bargains in international markets to which its exports were not indispensable. India also depended on eastern Europe for essential supplies and, overall, trade with the region had been of benefit to it.

But elsewhere, particularly in the west, there was mounting scepticism about such arrangements. Western criticism of rupee trade was not entirely disinterested, and Britain, in particular, was concerned about the effects of such arrangements for its trade with India. Some of the concern was no doubt motivated by ideological and political considerations. There was also some fear that British suppliers eager to retain markets in India would be willing to accept inconvertible (or deferred convertible) rupees, and the London manager of the Reserve Bank was asked more than once about reports of such deals. The annual Art. XIV consultations with the Fund became occasions for some close questioning of India's motives and intentions about rupee settlements. The host country generally responded to the Fund's probing by emphasizing its preference for multilateral trade, and pointing out that in practically all bilateral agreements India had retained and exercised its right to buy from the cheapest market. India also urged the Fund to look more closely at the commercial policies of the stronger creditor nations to understand India's recourse to bilateral trading relations. As officials at the Bank also began to stress by the mid-sixties, while aid from both the west and from eastern Europe came in a tied form, repayments to the former took the form of free foreign exchange. In contrast, repayments to India's east European creditors were 'tied' to its exports to them. In that sense, loan and repayments arrangements with eastern Europe were marked by a greater symmetry than those with the west.

Our account of India's rupee trading arrangements in the 1950s and 1960s ends on a note of irony. As India's external debt servicing and repayment obligations began to appear onerous in the mid-1960s, officials in London and Germany considered accepting part of its repayment in inconvertible rupees to be used for expenditure within India. Similar suggestions had been mooted (in payment for exports of military hardware and capital equipment) after the Chinese aggression, but the Bank of England would not hear of them. To canvass the advantages of rupee payment arrangements but insist that they be kept within modest dimensions, one official argued in March 1963, was to admit like the 'barmaid, that the child is illegitimate but will not be a nuisance because it is tiny'. Though the new proposals were closer to P.L.480-type arrangements than to India's rupee trading agreements with eastern Europe, it is worth noting that many more officials, at least in London, were willing to countenance rupee payment to deal with the anticipated crisis in Indian external finances in 1965-66 than they were two years earlier.

Nothing ultimately came of such suggestions. But it is useful in concluding this appendix to draw attention to an innovative method aired in London of weaving together the two strands of India's external financial diplomacy

since the 1950s. Responding to fears that the western insistence on India repaying its debts might strengthen Soviet propaganda about the 'usurious terms' on which such loans were extended, some senior officials at the Bank of England reflected that the time had perhaps come to draw the USSR into Indian aid negotiations. The west, according to this view, had never been certain whether it gave aid to the developing world because of any 'moral imperative' or to give the 'Bolsheviks a black eye'. India may become a further cause of tensions between the west and Russia should the latter step in to fill the breach caused by a pause in the former's aid commitments. On the other hand, if aid commitments continued as before to India and the west gave similar assistance to the rest of the developing world, there was the risk of the resulting debt burden causing an 'almighty balance of payments freeze-up' between the 'north' and the 'south'. This would almost certainly give the Soviet Union a great propaganda and strategic advantage. Therefore, some officials suggested, 'careful thought' should be given to the possibility of using the Indian situation to

talk to the Russians about the subject of 'competitive aid', which is doing neither team of donors any good and ... is a rod in the pickle for the so-called beneficiaries. If this could lead to the opening up of perspectives, at the end of which ... Soviet bloc membership of the international institutions could be thought of as a real possibility, ... [that would] be one of the most significant steps forward in international economic relations since the war.

In the event, western concern over extending to India relief on its debt to consortium members when its repayment obligations to the socialist world were left untouched, extended beyond the Bank of England. Approached by Bhattacharyya in February 1966 to negotiate a postponement or refinancing of debt repayments to the original members of the consortium, the World Bank sought from India an explanation of 'why any relief thus secured without a corresponding relief from the Soviet Union and other east European countries would not work to the detriment of consortium members'.

DEVALUATION AND THE GOLD CLAUSE

The rupee was the unit of account in India's payment agreements with eastern Europe. Under the so-called gold clause found in many of these agreements, the exchange value of the rupee was fixed in terms of its gold content, thus effectively protecting holders of rupees governed by such agreements from devaluation. The Reserve Bank was not in the picture at the time these agreements were made, when little thought appears to have been given to the

You Said It

By LAXMAN



Don't sign the agreement on a rupee payment basis, Sir. We don't have any rupees either!

-ToI, 5 May 1961

significance of this clause. The devaluation of 1966 turned the spotlight on the gold clause. Not only did India discover now that it was on a sticky legal wicket, with the Soviet Union determined to dig in its heels and insist on the application of this clause to contracts between the two countries and the other countries waiting to see how this test case would be resolved, rupee trade between India and east Europe came to a virtual standstill immediately after the devaluation. This caused great concern in India because at the time of the devaluation, only a quarter of the trade planned for the 1966 calendar year had moved.

Under the gold clause, the agreed value of the rupee was defined in terms of gold, so that in the event of a devaluation of the rupee, adjustment would take the form of an additional payment in rupees. As exercises undertaken in the wake of the Russian demand for compensation revealed, the gold clause

worked to the detriment of the Indian exporter: while it was applicable to Russian exports to India, no similar protection was available to an Indian exporter exporting to Russia, since price contracts did not allow for domestic price increases arising from devaluation. Russian officials justified the asymmetry on the ground that contracts were expressed in a currency controlled by the Indian government. Had the arrangement been in roubles, they argued, the USSR would have stood ready to extend protection to India against a rouble devaluation. The Poles argued along similar lines or wanted to switch over to a third currency, while Bulgaria and Czechoslovakia proposed a form of double accounting.

Several rounds of negotiations were held between Indian officials and representatives of the socialist bloc over the latter half of 1966. The first priority in these talks was to revive or sustain trade flows, and understandings were reached to maintain pre-devaluation unit prices for all traditional items for the duration of the existing agreements. Further Indian shippers were permitted to mark up the rupee value of the 'unimplemented portion' of their contracts by 57.5 per cent in the case of all other countries and 47.5 per cent in the case of the Soviet Union. India also agreed to revise the value of imports from these countries by the full extent of the revaluation.

This agreement was not easy to implement in the case of goods already in the pipeline, with differences breaking out over the meaning of the term 'unimplemented'. Besides, the agreement related to current trade flows, and was silent on the revaluation of the various balances which the Soviet Union and the east European countries held in rupees. Discussions on the latter subject dragged on for several more years and merged with those over the extension or modification of rupee payment agreements with these countries.

The 1966 devaluation experience reinforced India's determination to incorporate a symmetric gold clause in future rupee payment agreements. This was easier said than done, with the Soviet Union and Poland, in particular, opposing any move to protect the receipts of Indian exporters in the event of another rupee devaluation. Disputes about the manner in which to overcome the problem continued for several more months and tended to take some of the gloss off bilateral payment agreements. The devaluation of sterling in 1967 added more confusion and uncertainty, but also highlighted the dangers of basing bilateral trade on third country currencies over whose parities neither of the contracting countries had any control. While this led India and the former Yugoslavia in the direction of settling imbalances in convertible currencies generally, the Soviet Union advanced solutions—such as double accounting or accounting for trade in roubles—which Indian negotiators found unacceptable. The former involved, in the Bank's view, an unworkable clearing

arrangement necessitating its acquiring a foreign exchange liability without the advantage of a forward cover or guarantee. As it happened, the negotiations over compensation in the immediate aftermath of the 1966 rupee devaluation and the failure of India and the Soviet Union to agree on symmetric ways to protect the interests of both countries foreshadowed future problems of fixing exchange parities in a world of relatively greater instability between the values of the rupee and of currencies such as the rouble whose exchange rates were administered rather than market-determined.

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