THE FOREIGN EXCHANGE SITUATION

Professor B. R. SHENOY

FORUM OF FREE ENTERPRISE
SOHRAB HOUSE, 235, D. NAOROJI ROAD, BOMBAY-1

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—Eugene Black

President, World Bank

PREFACE

This is the edited text of a lecture delivered under the auspices of the Forum of Free Enterprise, Bombay, on March 24, 1958. The Forum readily agreed to my suggestion to issue it as a pamphlet in view of the topical and widespread interest in the subject. Public concern over it has been enhanced by the jumps, since mid-March 1958, in the loss of reserves to above the weekly average of the past two years.

The main thesis of the lecture is that the prevailing foreign exchange crisis, like the scarcity of rupee finance, is the outcome of our (misguided) effort to cover the savings gap in the Plan by inflation, that the crisis cannot be overcome except through, firstly, a cessation of inflation, and, secondly, an adjustment in the exchange value of the rupee (to be determined preferably by "floating" the rupee) to allow for the effects of past inflation. The vast gap between the landed costs and market prices of import goods and between the internal and the external prices of gold, the low level of the surplus reserves now remaining, the more or less stagnant state of our exports at below the pre-war level, and the progress towards *de*

facto convertibility of sterling and other leading currencies of the world render devaluation inevitable. Devaluation, by itself, would have no lasting value if it was not preceded by elimination of over-investment as, otherwise, the rupee woud be soon over-valued again. If the U.S. recession should persist and spread, the necessity for devaluation will gain in urgency through its adverse effect on our exports.

The incidence of devaluation would be on the "black" market prices of import licences, on the enormous gains of the smugglers of gold, and on the subsidies to industrialists. As the experience of devaluation by 31 per cent in September 1949 showed, devaluation would not lead to a rise in import prices (nor to a fall in export prices). It would restore to the export trade the full amount of their rightful returns in rupees. A tightening of import restrictions as a "remedy" might turn out to be worse than the disease as, through curtailing the imports of raw materials, machinery and other essential goods, it would affect adversely production, employment and income.

B. R. SHENOY

University School of Social Sciences
Gujarat University
Ahmedabad-9

THE FOREIGN EXCHANGE SITUATION

The greatest single problem before the country to-day, on the mundane plane, is speedy economic growth. We mean by this an accelerated pace of capital formation; in concrete terms, more roads, more canals, more machinery and tools, and so on. Capital formation now (through foregoing current consumption) enables increased production of consumer goods to-morrow (by adding to the output per worker). Economic development is a function of invested savings.

I. DEMOCRATIC VS. COMMUNIST PLANNING

This is so in the free as well as the communist countries, as the economic process, like the engineering process, is the same everywhere. The difference lies in the method of acquiring investment resources. Under communism we have the direct method. The planners, having made an inventory of resources, acquire them for plan investment. Fewer consumer goods are allowed to be produced. As the community cannot consume

what has not been produced, increased investment and reduced consumption is the result. In China. among the first things the planners did was to put the entire nation, men and women, in one uniform of blue cloth, thereby reducing the clothes bill of the country in one simple step.

In a democratic society the method is indirect--the planners first get hold of the savings of the people and then acquire in the market the equivalent investment resources. Investment is limited by the amounts which the community is willing and able to save.

What does this difference mean to the common man? It means two things. Under democratic planning each individual is sovereign over the disposal of his income between spending and saving. He is also free, within the usual limits of his physical handicaps, to choose his own occupation and pursue it freely, within the limits of law. Neither of these freedoms is compatible with communist planning. The consumption of the communist citizen is controlled by rationing (necessitated by the reduced output of consumer goods) and the choice of his occupation is determined for him by Authority. In a democracy, when an individual has difficulties with his employer, he scans the "situations vacant" columns in the Press and, in due course, moves into another job. What will such an individual do under communism? There is only one

employer, the STATE. He learns to put up with the difficulties as the consequences of not doing so may be grave.

This basic issue is of relevance to the subject of our discussion because many of our difficulties, including the foreign exchange famine, are the direct outcome of a failure to appreciate adequately the limitations of planning in a democracy. The communist planners, by exercise of the control they have over the proddction and distribution of consumer goods, may make a plan first and, then, proceed to find the requisite savings (resources). The planners in a democracy must adjust the plan to the available savings, as they have no direct control over the latter. The Second Plan, following the communist precedent, was formulated without reference to the availability of savings.

II. FOREIGN EXCHANGE CRISIS AND ECONOMIC GROWTH

How serious is the foreign exchange crisis? The drain of reserves began in April 1956, with the commencement of the Second Plan, and, except for three scattered weeks, has continued since. The total loss of reserves during the past twd years amounted to Rs. 563 crores, including the I.M.F. loan of Rs. 95 crores. The Second Plan had contemplated a draft of Rs. 200 crores on the reserves during the whole

of the five year period. Since the beginning of 1958 the net loss of reserves has declined to Rs. 1.4 crores a week, the weekly average of the loss during the past two years being Rs. 5.4 crores. In the second half of the financial year, ordinarily, we have a seasonal surplus in payments due to the seasonal uptrend in exports. Our surplus reserves today are about Rs. 200 crores. This is below the danger line. Firstly, our payments deficits during the past decade varied from Rs. 160 crores to Rs. 280 crores. Secondly, the value of food imports in 1951-52 amounted to Rs. 228 crores and they are estimated to cost Rs. 150 crores in 1957-58. Thirdly, with our export earnings depending on *a* few major items, we need to hold **a** larger amount of reserves than countries whose exports are more diversified. Fourthly, the outstanding foreign exchange payments commitments of the country, as on 30 September 1957, amounted to Rs. 970 crores,[1] our total reserves at the time being Rs. 353 crores (excluding gold). Finally, we need some reserves as a war chest.

A note of the Planning Commission on the "Fall in Foreign Exchange Reserves" placed on the table of Lok Sabha on 20 March 1958 states that the drain of foreign exchange resources is "attributable

1. This, by itself, is no measure of the possible drain of resources as the amount of the licenses must be set against export receipts.

mainly to the attempt to carry out the Second Five Year Plan". This statement needs clarification. **A** programme of economic development need not, ipso *facto,* lead to a foreign exchange crisis. This is illustrated by the experience of many countries. During the First Plan, Indian national income rose at an annual rate of 3.5 per cent, which was higher than that of most democratic countries. But we had no payments difficulties during the period. Our current account balance of payments were in surplus in four out of the five years, the net deficit of the period being Rs. 30 crores. Total investments during the First Plan being limited to total savings and foreign aid, the activity of saving made available the necessary foreign exchange requirements of the Plan through increased exports or reduced imports. Intractable payments difficulties arise not from economic growth but from the futile attempt at such growth through inflationary finance.

III. LOW LEVEL OF **EXPORTS AND IMPORTS**

A characteristic feature of India's payments position is that, notwithstanding an 85 per cent increase in industrial production and a 30 per cent increase in agricultural production, the volume of Indian exports today is below its pre-war level. The index af the volume of exports during the five years ending 1955-56 was about 72 per cent of the exports in 1937-38. Depending as this estimate does on the grafting of one base year to another and on the

adjustment of the index for undivided India to the index for the Indian Union on a population basis, the margin of error in it may be large. But it would appear that post-war Indian exports have remained below the pre-war level. In this respect we are almost alone in the world. Until recently, Japan kept company with us. In recent month's, however, Japanese exports exceeded the pre-war level. In the United Kingdom, with an increase of 51 per cent in industrial production, exports were 73 per cent higher than before the war. The world total exports in 1956, at constant prices, was 71 per cent above that in 1937.

The low level of our exports (and the payments difficulties) are due, principally, to post-war inflation to finance increased consumption or increased investment. The relationship between inflation and low exports is easily seen. When investment is financed from savings, there would be present somewhere in the economy equivalent investment resources (the "saved up" physical counterparts of the savings) and investment would amount to the acquisition of these resources and their employment for capital formation. When investment is financed by inflation, there would not be present anywhere in the economy equivalent investment resources and more domestic investment would be initiated than would have been the case if inflation had not taken place. Ipso *facto*, less of the domestic output (investment goods or consumer goods) would be

now available for export. The demand for foreign exchange to meet the import content of the inflation financed investment would add to the strain on the foreign exchange market. This demand may cause a drain on the currency reserves.

The inflationary investment funds would, in due course, add to the money incomes of the community and enhance domestic consumption. At this stage cases of inflationary finance of investment merge into cases of direct inflationary finance of consumption. As the national product will not have risen in the meanwhile (and as, in a background of inflation, there would be a tendency to add to the pipe-line stocks), the increase in consumption would take place at the expense of exports or by increased imports. Imports being subject to restrictions, the pressure of the enhanced consumption demand would fall more on exports.

Inflation financed investment and consumption would, thus, cause reduced exports or increased imports. In either case there would ensue a scarcity of foreign exchange' leading to a draft on reserves. Persistent payments difficulties are an automatic reflex phenomenon of continued domestic inflation.

The extent of inflation in India since World War II is reflected in the jump in money supply from Rs. 309 crores in 1937 (including Pakistan) to

Rs. 1,976 crores in 1948. The volume of exports index declined during the period from 161 in 1937-38 to 92 in 1948-49 (1952-53=100). Exports have risen since, but they have remained, as we have seen, well below the pre-war level and the rise has compared poorly with the expansion of exports in the rest of the world. Payments difficulties in the post-war period have been endemic. The effort to keep balance of payments equilibrium has involved severe import and payments restrictions. When inflation ceased, as during the larger part of the First Plan period, exports tended to move up and payments tended to be in equilibrium. Foreign exchange difficulties re-appeared with the finance of economic development through credit creation in 1955-56. Our balance of payments on current account showed a reduced surplus during the year. In 1956-57 and after, inflationary finance gained momentum, budget deficits rising from Rs. 186 crores in 1956-57 to Rs. 380 crores in 1957-58. Exports as a result declined, imports shot up, and the loss of reserves amounted to Rs. 280 crores in 1956-57 and during 1957-58, as at 7 March 1958, Rs. 283 crores.

The increase in consumption, which follows inflationary finance, is reflected in the increase in the consumer goods bias of domestic production since 1955-56, the increase in the imports of consumer goods, and the increase in the imports of materials for the manufacture of consumer goods at home. In 1357, relatively to 1955, while the output of sugar

went up by 21 per cent, *Vanasputhi* by 16 per cent, cotton textiles by 5 per cent, footwear by 9 per cent, soap by 12 per cent, and cigarettes by 22 per cent, the output of iron and steel rose by 1 per cent, iron ore by 0.7 per cent, and coal by 14 per cent. Though the output of cement shows a rise of 25 per cent, this reflects, in part, the diversion (away from Plan investment) of savings into less essential urban property—a by-product of inflation. Excluding foodgrains, the imports of consumer goods rose from Rs. 62 crores in 1954-55 to Rs. 75 crores in 1955-56 and to Rs. 81 crores in 1956-57. The imports of "Materials chiefly for (the manufacture sf) Consumer Goods" rose from Rs. 35.8 crores in 1955-56 to Rs. 103.2 crores in 1956-57—a jump of 2.9 times.

Though our imports have remained at a higher level than our exports, they have been still at a low level relatively to the rest of the world and relatively to imports before the war. The annual average (111) of the volume of Indian imports during the five years ending 1955-56 was 85 per cent of that in 1937-38. The world total of imports in 1956, at constant prices, was 76 per cent above that in 1937. In times of import liberalisation, as since 1956-57, imports have shot up to above the pre-war level, the index of the volume of imports in 1956-57 being 137 and in the first quarter of 1957-58 155, as against 116 in 1955-56 and 130 in 1937-38 (1952-53 =100). India's payments problem in the post-

war period is, thus, primarily a problem of stepping up exports to pay for the import needs of the country. It is not a case of excessive imports. Exports being far too low, payments difficulties arise whenever imports are liberalised. Two decades of exchange restrictions and the recurring exigencies of payments have reduced non-essential imports to a minimum. Imports of consumer goods (excluding food) represented about 10 per cent of our total imports (including food) during the two years ending 1956-57. Most of them were essential consumer goods. The largest bulk of total imports represented raw materials and capital goods. Any further cut in imports might impinge upon the latter and react adversely on production, employment and income.

The low level of our exports is sometimes sought to be attributed, firstly, to a diversion of potential exports into economic development and, secondly, to the increased consumption of a growing population. Neither explanation is valid. Some diversion of potential exports into Plan investment may, no doubt, take place. But (if this is not balanced by increased exports elsewhere) imports should, then, fall to a level commensurate with the reduced exports, as we cannot successfully build economic development on payments deficits. The larger consumption needs of the increase in the numbers of our population should be met by adding to the national product. To eat into exports, without

reducing imports, in order to maintain a growing population would be to draw on currency reserves to finance increased consumption. We cannot expect to remain solvent for long under such conditions.

Some have attributed India's payments difficulties to our policy of import liberalisation in 1956, which, as we have seen, had led to a steep rise in our imports. This explanation may apply but in a formal sense. Behind the increased imports was the deeper functional cause, namely, the growing inflationary pressure of demand for imports. Liberalisation of imports enabled manifestation of the basic causal factor in an increased flow of imports. The pulling of the trigger may, no doubt, release the bullet and cause the death of the victim. But if the bullet of inflationary demand had not been there, the pulling of the trigger (liberalisation of imports) will not have stepped up imports. In the United Kingdom the progressive liberalisation of imports in recent years did not lead to an unmanageable jump in imports. The index of the volume of imports in 1955 and 1956 remained close to, or below, the index of the volume of exports. Such inflationary pressures and payments difficulties as did arise in 1957 were successfully tackled by a rise in the Bank rate to 7 per cent in September 1957 and other supporting measures as evidenced by the improvement in the gold and dollar reserves of the country and the reduction in the Bank Rate to 6 per cent on 20 March 1958.

The low levels of our exports and imports are the effect of three factors: firstly, restrictions on imports and payments, secondly, inflationary finance of investment, and, thirdly, a rigid exchange rate. With restrictions on imports and payments, increased imports to meet the inflationary demand for them was not possible. Inflation, therefore, ate into potential exports. Simultaneously, with the rigid exchange rate, the profitability of production for the foreign markets diminished (as rupee prices and costs rose with inflation) relatively to production for the home market, where inflation had put up the demand for both investment goods and consumer goods. Exports, therefore, failed to expand with the expansion of output. There was a switch-over of production for the home market. Import restrictions, through causing scarcity of supplies and driving prices up, facilitated this development.

In an artificially oriented model such as this, there would be always present an unsatisfied demand for import goods which, under the compulsion of the situation, would be met by, home-made substitutes. Any liberalisation of imports would, therefore, lead to increased imports, the excess over current needs being hoarded by the trade on the speculative anticipation that the resulting strain on payments would cause cuts on imports leading to windfall gains at the expense of consumers. The pressure for imports would receive added strength if import liberalisation was accompanied by over-

investment. This development is well illustrated by the jump in imports since 1956-57, when we had both import liberalisation and over-investment. The inflationary pressures being released through the import valve, exports declined but by a small margin in 1956-57, the index falling to 110 during the year from 115 in the preceding year. During the first quarter of 1957-58, the index of imports rising to 155 (from 137 in 1956-57), exports rose by two points to 112. Apparently, the shift of demand from home goods to import goods released more home goods for export.

IV. REMEDIAL MEASURES

The foregoing logic and our experience suggest that, in order to stop the drain of reserves, the first essential precondition is cessation of inflationary finance. The prevailing import restrictions may, then, keep the balance between export receipts and imports. But, though we have been talking of the "core" of the Plan, the budget for 1958-59 continues to be an inflation budget. Though the budget estimates for 1958-59 show an overall deficit of Rs. 199 crores, as in 1957-58, this may turn out to be an under-estimate. The budget estimates have grossly over-stated the (non-inflationary) capital receipts (including foreign aid).

Cessation of inflationary finance was not, by itself, sufficient to achieve lasting payments equilibrium. It would remove but one of the two factors

responsible for the prevailing foreign exchange crisis. The distorted pattern of our production and trade, as characterised by the low level of our exports in a back-ground of vastly expanded national output, will remain. The payments equilibrium will be precarious if this distortion is not rectified. Certain developments and the inherent factors of instability that have been built into the artificial pattern impart urgency to this problem.

Firstly, the main prop of the low level of our imports is the import and payments restrictions. An island of restrictions cannot for long survive in a world which has been rapidly progressing towards de facto convertibility. While the free-market premiums in terms of rupees are limited to the U.S. dollar, exchange control leakages have been generally restricted to the dollar trade, which is about 18 per cent of our total trade. If a premium should appear on sterling as well, exchange control leakages would apply to 70 per cent of our trade. Part of sterling exchange receipts also would be, then, diverted to the free markets while sterling requirements would continue to be acquired from the exchange control, so that the (official) payments gap will widen and render precarious the continuance of exchange control.

Secondly, cessation of inflation cannot correct the prevailing vast gap between the landed costs and market prices of import goods (for which free

internal markets exist) and between the internal and the external prices of gold, though it may prevent a widening of the gap. The range of the gap between landed costs and market prices is reflected in the prices which import licenses fetch in the "black" market. They vary from 30 per cent to 125 per cent of the face value of the licenses, depending upon commodities. In the case of luxury goods the prices may be of the order of 200-300 per cent. In the case of raw materials and machinery, generally, import licenses are issued in favour of their users, their tranferability after import is subject to restrictions, and most persons are able to obtain licenses to meet their requirements. There being no free internal markets for such goods, the import licenses for them command but low premiums. This is a case of the users of these goods being able to obtain them at landed costs and, therefore, receiving an indirect subsidy from the rest of the economy. The subsidy has continued without strain or much notice, probably, because the amount of it is a fraction of the national income (probably under $1\frac{1}{2}$ per cent).[1] The gap between the internal and the external prices of gold (at the prevailing price of Rs. 111 per tola) is as large as Rs. 48.50 per tola. These two gaps are a standing obstacle, the one, to a liberalisation of imports, and the other, to a liberalisation of payments.

(1) The imports of machinery, iron and steel, other metals, chemicals, dyes and colours, raw cotton and raw jute amounted to about Rs. 500 crores in 1956-57.

Thirdly, if the recession in the U.S. should persist and spread, our exports, which are already low, may be further depressed and accentuate the crisis.

The foregoing discussion indicates that the key to the situation is the rigid exchange rate. As inflation drove up rupee prices and costs, the exchange rate became unrealistic and acted as a hurdle to export production. The gap in the internal and the external prices of gold and between the landed costs and market prices of import goods, which appeared and grew with the progress of inflation, is a reflection of the unrealistic character of the exchange rate. Short of devaluation of the rupee it is not possible to correct these inherent imbalances in the economy. Nor can the threat to our payments equilibrium, which is held out by the progress of sterling and other currencies towards *de* facto convertibility, and to the expansion of exports, which the U.S. recession may cause, be met adequately otherwise than through an elimination of over-valuation. Though scope exists for the export promotion measures listed by the Export Promotion Committee, exports may not respond sufficiently in the absence of devaluation.

If the exchange rate had been left free, domestic inflation would not have shifted relative profitability in favour of production for the home market. This is well illustrated by French experience. Notwithstanding a jump of 35 times in the money supply,

the volume of French exports in 1956 was 207 per cent of the exports in 1937, French industrial production having risen, in the meanwhile, by 87 per cent. The expansion of exports was rendered possible by the flexibility of the exchange rate of the franc, which, in terms of the U.S. dollar, today ($ 1=Frs. 420) was 1/17th of its value in 1937 ($ 1=Frs. 25.14). In India, though money supply had expanded by over 7 times since 1937, the exchange value of the rupee had fallen only by 43 per cent, during the same interval, in terms of dollars and not at all in terms of sterling.

It is not possible to pre-determine, by the slide-rule method, the appropriate measure of devaluation. This is a difficult enough procedure under any circumstances. The fact that the rupee had been a sheltered currency for the past two decades adds to this difficulty. This suggests a floating rupee on the Canadian model, official interventions in the foreign exchange market being limited to prevent undue swings in either direction of the norm. Stabilisation should follow at the equilibrium rate, thus determined through trial and error. As domestic stabilisation progressed it should be possible, by degrees, to liberalise the restrictions on imports and payments. Cessation of over-investment and inflation, and exchange rate flexibility should facilitate this through a shift-over of production for exports. Import liberalisation, however, may be beset with certain difficulties. A lowering of the

barrier of import restrictions must affect adversely the high-cost high-price industries, producing substitute import goods, which have sprung up behind these barriers. In some of them trade liberalisation may have to be accompanied by protective import duties or direct subsidies.

V. EFFECTS OF DEVALUATION

It has been argued that devaluation may not increase our foreign exchange earnings, while it may raise the rupee costs of imports. This fear is based upon a mistaken analogy between the competitive exchange depreciations of the 1930's and the prevailing Indian case of an unrealistic exchange rate. The two situations are poles apart in essential respects. The logic and the conclusions of the one will not apply to the other. In the 1930's the buying power of nations and the international trade of the world were shrinking, unemployment was on the increase, stocks were accumulating with the producers and the dealers, and prices were on the decline, while, due to trade union activity, wage costs had assumed a high degree of rigidity. Under these conditions, competing producers were using every available device, including competitive currency depreciation, to somehow keep their hold on world markets. Currency depreciation, in such a context, offered but temporary and illusive gains as it was often attended by adverse turns in the terms of trade. The malady of the period was not

owing to exchange rate over-valuation. It was due to the complex factors responsible for the Great Depression. Currency depreciation, so far from remedying the situation, added to it yet another factor of instability.

The post-war Indian situation has little in common with this model. World production and world trade have been expanding. The purchasing power of nations, in the wake of growing real incomes, has been on the ascendant. Almost alone in the world India's international trade has lagged behind—while world trade today in terms of dollars, at constant prices, is about 75 per cent above pre-war, India's foreign trade is below the pre-war level—as we have seen, mainly as an outcome of the exchange rate handicap on exports and the diversion of (potential) export production to meet the demands of the home market, sustained by inflationary finance of development and the resulting inflationary expansion of consumption. An adjustment of an over-valued exchange rate in such a context should release forces leading to the restoration of a stable equilibrium. It cannot, as in the 'thirties, add to the forces of unsettlement.

In the prevailing Indian context, an adjustment of the exchange rate may not cause a significant reduction in the foreign exchange receipts per unit of exports. In the case of internationally traded commodities, ordinarily, there is a world

price, which is determined by world forces of supply and demand. The demand would not be affected merely because an essential exchange rate adjustment has taken place in India. The supply, however, may increase because India might now put on the world market larger supplies than she had been doing hitherto. In respect to commodities in which we are minor world suppliers, it is unlikely that this may cause a significantly adverse price effect in the background of a global expansion in real incomes and trade. Though the amount of trade expansion in the case of individual commodities would vary with the variations in the income elasticities of demand, expansion of real incomes must cause expansions of demand in the case of nearly all commodities. The question of India's share in the expanded world demand would be determined by the play of the forces of comparative costs of production. As hitherto India's share in world trade had been artificially held down by the hurdle of an unrealistic exchange rate, the presumption is that, with the removal of the hurdle, the other world suppliers of these commodities would have to yield place to India and be content with a lesser share of the expanding demand. This would be the case until India regained her due share (as determined by the theory of comparative costs) in world trade. This would apply generally to the minor lines of Indian exports which comprise a large variety of commodities and represent about 48 per cent of our total exports.

In the case of commodities, in which we are the largest suppliers in the world (e.g. jute manufactures in which we account for 53 per cent of world exports), we have some powers of control over world prices. We can exercise this power to ensure that world prices do not fall unduly with the exchange rate adjustment of the rupee. The situation may be also met by ,appropriate increases in the export duties following the devaluation of the rupee, so that the windfall gains of the jute manufacturers are appropriated, partly or wholly, by the State. The device of the export duty may be employed, too, to prevent a price decline, if this should happen in the case, of commodities the elasticity of demand for which is low. Thus, neither in the minor nor in the major lines of our exports should devaluation lead to an undue fall in the foreign exchange earnings per unit of exports. With the increase in exports, which should follow the increase in the rupee returns of the exporters. the foreign exchange earnings of the country should increase significantly, thereby leading to a liberalisation, and eventual removal, of restrictions on imports and payments.

Devaluation may not cause a rise in the rupee prices of import goods. As we have seen, rupee prices are not equal to external prices multiplied by the rate of exchange, plus the usual incidental costs; there exists a vast gap between landed costs, as thus determined, and market prices. The market

price is determined by the forces of demand, which depend on the state of inflation, and the supply situation, which is regulated by the import licensing policy. An adjustment of the exchange rate, therefore (as this will not influence either the demand or the supply), will not effect prices. The incidence of it will be on the gap between landed costs and market prices, as the exchange rate plays a part in determining landed costs. The margin of the gap will be now less and the price, which import licenses will command, will correspondingly decline. It will also reduce the gap between the internal and the external prices of gold, both expressed in rupees, as a lowering of the exchange value of the rupee would raise the rupee equivalent of the external price of gold.

In the case of import goods, which their users are able to acquire at landed costs, devaluation would reduce the amount of their subsidy by driving up landed costs. But the determination of the exchange value of a currency should not be governed by considerations of subsidies, which overvaluation may bring to certain privileged groups in the community. The aim of policy should be the attainment of an equilibrium rate which so stimulates exports and so retards imports as to maintain an even balance in the international payments of the country at *a* high and growing level of production and trade. Questions such as subsidising industrial expansion should not be allowed

to be mixed up with the principles of exchange rate determination. They should be tackled by other and more appropriate devices. An over-valued currency, moreover, if it subsidises industrialists, it penalises the export trade, necessitates undue import restrictions to maintain payments equilibrium, and hinders the growth of foreign trade. The real cost of the subsidy is, thus, excessive.

The experience following the devaluation of September 1949 supports the validity of the foregoing analysis. The economic model of the time did not conform to the model of the 'thirties. It had all the essential characteristics of the prevailing Indian model,—a drain of reserves, low level of exports and imports relatively to the national product, an exchange rate rendered unrealistic by inflation, large margins between landed costs and market prices of import goods, a wide gap between the internal and the external prices of gold, and an expanding world production and world trade. The devaluation of the rupee by 31 per cent, in such a back-ground, produced consequences indicated by our analysis. Export prices, so far from declining, rose from an index of 86 in 1948-49 to 91 in 1949-50 and the index of import prices, so far from rising, declined from 78 in 1948-49 to 77 in 1949-50. The terms of trade of the country consequently improved from 110 in 1948-49 to 118 in 1949-50 (1952-53=100). Though the rupee equivalent of the external price rose by 44 per cent as a result of devaluation, the

price of gold, after a nominal rise, soon fell to below the pre-devaluation level. Devaluation now may not be followed by a different set of consequences from that which logic suggests and experience has indicated.

VI. CONCLUSIONS

We may now bring together the main conclusions emerging from this discussion:

Firstly, our surplus reserves today (about Rs. 200 crores) are below the danger line, considering the range of our payments deficits and the value of our food imports in recent years, the weighted dependence of our export earnings on a few major lines of exports, the outstanding foreign exchange commitments, and the need of some reserves as a war chest.

Secondly, the drain of reserves is not attributable to economic development. It is the result of the (futile) attempt at economic development through inflationary finance.

Thirdly, the pattern of India's production and trade has been artificially oriented during the past decades. Post-war inflation, the rupee exchange rate being rigid, hindered the expansion of exports by rendering production for the home market relatively more profitable so that

exports have tended to stagnate at below the pre-war level notwithstanding the vast expansion of the national product. The low level of exports has necessitated import and payments restrictions for the maintenance of payments equilibrium. Domestic inflation, coupled with the rigid exchange rate, has led to a large gap between landed costs and market prices of import goods, which is a standing obstacle to import liberalisation, and between the internal and the external prices of gold, which is a standing obstacle to the liberalisation of payments.

Fourthly, the rapid progress of the world towards de facto convertibility would extend the leakages in our exchange control beyond the dollar trade, to which they are today restricted, and the U. S. recession, if it should persist and spread, may further reduce the level of our exports. Both factors add to the urgency of adopting measures for correcting the artificial pattern of production and trade.

Fifthly, a corrective to this situation lies in a substantial stepping up of exports. This cannot be achieved except through an appropriate devaluation of the rupee to allow for the over-valuation which has resulted from past inflation. Though this measure holds the key to the situation, devaluation, by itself, was of little lasting value if it was not preceded by a cessation of over-investment and inflation, as, otherwise, the rupee would be soon overvalued again. Cessation

of infiation without devaluation may provide temporary relief from the drain of reserves. It cannot correct the artificial pattern of production and trade. Experience and logic suggest that devaluation may not lead to a rise in the rupee prices of imports. Its incidence will be on the "black" market prices of import licenses, on the margin of profits of the gold smugglers, and on the subsidies received by certain privileged groups in the community. With the removal of the load of inflationary demand from the home market, it may be expected to lead to increased foreign exchange earnings, and, therefore, to an eventual removal of the import and payments restrictions.

Views expressed in this booklet do *not necessarily represent the views of the Forum of Free Enterprise.*

Free Enterprise was bow with man and shall survive as long as man survives.

—A. D. Shroff

HAVE YOU JOINED THE FORUM?

Annual Membership Fee is Rs. 10/-

6/M/58

Popular Press (Born.) Private Ltd., Bombay 7.