Monetary control measures and foreign exchange during the second plan

Money has two types of functions — static and dynamic. The static functions of money are the simple four — medium, measure, standard and store. It is the dynamic functions of money which have assumed greater importance in the modern world. Static functions of money only keep the economy functioning smoothly. "By its dynamic functions, money tends to exert a powerful influence on the price level, on the volume of production, trade and consumption and on the distribution of wealth." 1 The functions of money become dynamic at a time, when through monetary measures something more than the working of the exchange system in the economy is sought for. As for example in a period of depression, the Central Bank of a country may adopt easy and cheap money policies, which may influence trade and industries and consequently employment position in the country and ultimately lead to recovery. Similarly tight money policy in a period of inflation can

1. Dr. Paul Einzvig: How money is managed, p. 17.
stabilise prices. Monetary policies are generally adopted along with certain other economic measures and not in isolation.

In an underdeveloped country like India, the Government's spending out of created money for development purposes creates inflationary price rise. Additional money thus generated creates additional demand for goods whose supply increases rather slowly. The cure of such price rises has also been found in some monetary - which are more important - and non-monetary measures. The Fund Bank Review in an article entitled, 'Inflation and Growth' wrote, "Only in a stable economy can efforts be effectively directed to the kinds of long run investments which are needed for economic growth. It is, therefore, a matter of the most vital importance for governments to persevere in the measures that will end inflation and maintain stability. The measures themselves depend to some extent on the country concerned. But the avoidance of a government deficit, the encouragement of savings, and the control of bank credit will most certainly all be necessary". ¹

The planning authorities had apprehended that the plan financing would create inflationary conditions in the country and as such had in advance thought of controlling the same.

through fiscal and monetary measures. The Second Five Year Plan stated, "In a developing economy the basic trend of governmental operations in the fiscal and monetary field is inevitably expansionist. . . . The problem in the main is likely to be one of regulating inflationary pressure". 1

Monetary policy during the plan period was of controlled inflation. The planners could not avoid inflation, whereas they could not equally let it leave unchecked. The Reserve Bank of India is entrusted with the task of monetary management. It is from the actions of the Reserve Bank, that we can learn about the Monetary policy aimed at during the plan period. We, therefore, quote the Reserve Bank's publications to point out the Monetary policy followed during the Second Five Year plan.

"The Bank's recent policy may be described broadly as one of controlled expansion. while the need for expansion of credit and money supply commensurate with the rapid development and diversification is fully recognised by the Bank an excessive expansion of money supply would be inflationary and would ultimately jeopardize the financial stability of the economy. In the prevailing situation, with considerable inflationary potential, the direction of credit policy should be one of general restraint without jeopardy to the

1. Second Five Year Plan ; Planning Commission, p. 38.
functioning of the productive sector of the economy".

"The maintenance of monetary stability during the process of development thus becomes an objective of prime importance in the very interest of successful achievement of targets of development itself. In the task of ensuring development with stability, the keynote of monetary policy would have to continue to be one of general restraint simultaneously with expansion of institutional facilities for provision of credit to specific sectors in particular agriculture and small scale industry".  

It has been estimated that about one-third of the Indian economy is outside the monetary sector. This non-monetary sector of the economy covers the subsistence and near subsistence farmers. This non-monetary sector considerably limits the scope of monetary policy in the economy. Even then, the rest of the economy offers sufficient scope of monetary management. "Even if one-third of the economy is left out of account - though it would not be immune from monetary influence - two-thirds of the Indian economy offers a large enough area for the operation of monetary and fiscal policies".  

In the following pages, we shall study how the authorities directed each element of monetary policy during the Second Five Year Plan period.

**THE BANK RATE**

The changes in Bank rate have neither been frequent nor wide in India. From the inception of the Reserve Bank, till it was changed to 3\% per cent in November, 1951, the Bank Rate remained fixed at 3 per cent. In November, 1951, it was changed to 3\% per cent as an anti-inflationary measure. After this eventful first change, the Bank Rate remained fixed at this changed rate for some years. Thereafter, there occurred three changes in quick succession in November, 1956, February, 1957 and May, 1957.

Though the Bank Rate was raised from 3 to 3\% per cent in November, 1951, the rate of Bank advances against usance bills remained at 3 per cent until it was also raised to 3\% per cent in November, 1956. Thus the rate of advances against usance bills was brought at par with the Bank rate. The authorities did not feel like making a direct change in the Bank Rate thereafter. They wanted it rather to be brought through use of a 'fiscal measure with a monetary intent'.

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The effective borrowing rate of the scheduled banks, against usance bills was, however, further increased by \( \frac{1}{2} \) per cent with effect from February 1, 1957, as a result of the Government's raising of stamp duty on such bills. Simultaneously, the Bank increased its lending rate on advances against Government securities from 3\( \frac{1}{2} \) to 4 per cent. Further, with effect from May 16, 1957, Bank Rate itself was raised from 3\( \frac{1}{2} \) to 4 per cent; on the other hand the Government announced the lowering of the stamp duty on usance bills to 1/5th of 1 per cent so that the effective borrowing rate of the scheduled banks against usance bills came to 4\( \frac{1}{5} \) per cent.

The object of the Reserve Bank was to make credit costlier rather than restricting its availability.

In September, 1960, a system of varying lending rates which the Reserve Bank calls Slab rates—was introduced with Bank Rate remaining unaltered. The object of such a measure was to keep the inflationary pressure in check, which had become more intense in early 1960 – 61 (Reserve Bank of India Year : July, 1960 to June, 1961) and also to effect a small contraction of bank credit in the slack season of 1960 compared to that of the two previous years.

Reviewing the deteriorating inflationary condition in the country, the Reserve Bank expressed, "the need for a more stringent policy of credit restraint by the Bank".  

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The Bank therefore announced a set of credit policies — including varying lending rates — on September 21, 1960, to be effective from October 1, 1960. Under Reserve Bank's scheme of varying lending Rates, each scheduled bank was assigned a quota for the purpose of its borrowings at the Rate. The quota was fixed for each quarter and was to be equal to half of the average amount of statutory reserves required to be maintained by it during the previous quarter. Any borrowing above this amount but up to 200 per cent of the quota was to bear a rate of 1 per cent above the Reserve Bank's lending rate; borrowing in excess of 200 per cent of the quota was to bear a rate of 2 per cent above the Bank rate. The Reserve Bank also asked the scheduled banks to adhere, from October 1, 1960, to a minimum lending rate of 5 per cent on all advances, except those made to other banks and bank employees. This direction to the scheduled banks was given so that the higher cost of borrowing from the Reserve Bank was ultimately transmitted to the borrowers and thus the demand for bank credit lowered. "The system of slab rates combines the feature of direct limitation on borrowing and raising the cost of borrowing", said the Reserve Bank.¹

Along with the introduction of the slab rate system

by the Reserve Bank, the State Bank of India — the biggest commercial bank of the country — increased its lending rates to other banks from 4½ per cent to 6 per cent in the principal cities and to 5 per cent in other places. This additional support the Reserve Bank got for its innovated interest rate policy from the State Bank strengthened the efficacy of that policy.

The innovated bank Rate policy of the Reserve Bank, which it called slab rate system, was aimed at combating inflation. As various other anti-inflationary measures were taken simultaneously, it is very difficult to state as to how effective this particular measure proved in checking the inflationary price rises of the period. But at least it can be said, "that there has been a consistent and marked effort on the part of the Indian authorities to use the instrument of interest rate to check inflationary rise in prices".¹

VARIABLE CASH RESERVE

The Reserve Bank also exercises its control over the scheduled banks, through the instrument of variable cash reserve requirements for such banks. On account of large scale investments and currency expansion during the two Plans,

¹ S.N.N. Simha: Development with Stability, pp. 70 and 71.
the bank deposits had swelled up. Their liquidity position as well as lending capacity had considerably increased. The Reserve Bank, therefore, wanted to freeze, some portion of the increased deposits and curtail the capacity of the banks to lend, through the technique of variable cash reserves.

In the alternative, the Bank could increase the overall rates of reserve deposits of the scheduled banks. But under the variable reserve policy, the scheduled banks had to maintain reserve for deposits at an increasing rate, after the deposits had crossed a certain limit. But so long deposits were within the prescribed limit, the banks had to keep with the Reserve Bank a reserve at 2 per cent of time deposits and 5 per cent of demand deposits. After March 11, 1960, the scheduled banks were required to keep with the Reserve Bank additional reserve equal to 25 per cent of the addition to their existing demand and time deposits. In this additional reserve deposit, the usual reserve deposits of 5 per cent of demand liabilities and 2 per cent of time liabilities were also included.

The measure was further reinforced on May 5, 1960 and the Bank raised the limit of additional reserve deposits that the scheduled banks had to maintain with the Reserve Bank to 50 per cent of the additional deposits, that the banks could get after this date. These measures of the Bank further reduced the liquidity position of the banks.
The variable cash reserve requirements order of the Reserve Bank to the scheduled bank, caused much financial loss to them, as they had to keep a large portion of their increasing deposits with the Reserve Bank - the return on which was extremely meagre. "Also there were widespread complaints that the impounding of such a large percentage of additional deposits might be acting as a disincentive to the banking system to mobilise deposits".  

On November 11, the directive of May 5, 1960 regarding the maintenance of additional statutory reserves was relaxed. Further impounding of the increase in liabilities over the level as on November 11, was suspended; also about half of the reserves already impounded were released by reducing the additional reserve deposit required to 25 per cent of the increase since March 11, 1960. Ultimately additional reserve requirements were altogether revoked with effect from January 13, 1961.

OPEN MARKET OPERATION OF THE RESERVE BANK

The technique of open market operation is used by a Central Bank, with the object of providing the money market with additional resources at a time when the demand for them for trade and industrial purposes have gone up and the

commercial bank are unable to meet them from their existing resources. On the contrary, when an excessive liquidity in the money market is causing inflationary pressure, the Central Bank with the help of the other part of the open market operation, can relieve the money market of much of the excessive liquid resources.

The scope of open market operations is extremely limited in India. The people in this country, who are in a position to save do not invest much of their savings in government securities, nor do the commercial banks, who have a scope for more remunerative investments. Business corporations find them least attractive. Only such institutions like Life Insurance Corporation and Provident Fund Commissioner, who have to invest in them under law, do so. Dr. Madan wrote, "Open market operations, however, have tended to become increasingly a one way traffic (in India), with the constant concern of the Government and the Bank to sell more and more Government securities to reduce the gap in budgetary operations which has to be financed in the last resort by borrowing from the Reserve Bank . . . . . Open market operations are thus becoming primarily an ancillary to Government debt management".

1. Dr. B.K. Madan : The Role of Monetary Policy in a developing economy, p. 31.
SELECTIVE CREDIT CONTROL

Selective Credit Control was experienced in Britain when the banks were asked by the British Treasury to restrict their lending to the dealers selling on hire-purchase terms. The banks complied with the order of the Treasury and restricted their lending to the hire-purchase dealers. But the impact of such a policy on credit restriction was not very significant. As, "when the banks restricted their lending they (the hire-purchase companies) had to turn elsewhere to get their money".1 Though it was more expensive, they could get all the money they needed. The Treasury had therefore to undertake other measures to restrict the business of the hire-purchase companies. Whereas in Britain selective credit control measures have been used to restrict dealings in durable goods, in U.S.A. it has been used to curb dealings in stocks and shares.

In India, Selective Credit Control measures have been used to regulate the dealings in essential consumers' goods. It has been the policy of the Government - which policies the Reserve Bank implements - that the dealers of essential consumers' goods should not be permitted to hoard such goods with the help of bank advances. At the same time, it was also thought that genuine trade in such commodities should not

suffer on account of the shortages of credit. The shortage of credit causes hardships not only to the traders but also to the cultivators and ultimately to the consumers too. Selective credit control measures were undertaken during the Second Plan period to regulate the prices of food-grains, sugar, cloth and oil seeds. Such control was also used to regulate the prices of raw jute, jute manufactures and stocks and shares.

The power of Selective Credit Control was vested in the Reserve Bank under the Banking Companies Act of 1949. Under the Act, the Reserve Bank is authorised "to give directions to banking companies in regard to their lending policies; the purposes for which advances may or may not be made, the margins to be maintained and the rates of interest to be charged on advances". ¹

This power of Selective Credit Control, was not used by the Reserve Bank during the First Plan period. However, during the Second Plan period, it was used in a systematic way to control inflation. Dealings in various commodities were brought within its scope and left out, from time to time. But bank credit for food grain trade is even now subjected to Selective Credit Control.

In 1956 - 57, the agricultural production in the country had fallen very low and there was an increase in the

rate of bank advances against food-grains. Consequently there was hoarding of food-grains and a speculative rise in prices. In May, 1956, the Reserve Bank issued directives to the banks to restrict credit against paddy and rice. The credit control measures were combined with the use of moral suasion.

There was brief break in Selective Credit Control measures imposed on the dealings in paddy and rice from November 14, 1956 to February 9, 1957. From September 13, 1956, credit control was imposed on the dealings in other food-grains. Certain modifications in the directives of the Reserve Bank for the banks' advances against food grains were made in June, 1957. A new directive regarding bank advances to the dealers in sugar was issued. In the initial stages, the scheduled banks did not pay any heed to the Reserve Bank's directives but when the Governor of the Bank warned them of drastic steps it may take against them, the defaulting bankers complied with the Bank's directives.

A directive was issued by the Reserve Bank on July 10, 1959, under which the existing margin requirement of not less than 40 per cent in respect of all food-grain advances were to continue, but the margin in regard to advances against paddy and rice given to purchasing agents of the Government of Orissa and against wheat to the storage contractors working on behalf of the Punjab Government was to be only 25 per cent.
The Reserve Bank further asked the banks for the imposition of a minimum margin of 50 per cent in respect of scheduled banks' advances against ordinary shares.

A study of the Reserve Bank's Selective Credit Control measures reveals that the limits for credit varied from commodity to commodity, State to State and from time to time. In the case of certain commodities, the selective credit control has not been continuous. They were brought within such control whenever it was found necessary and were released from control when the need for it did not exist. However, the food-grains have remained within its fold almost continuously from the early Second Plan period.

The Selective Credit Control measures were not very effective on account of two reasons. In India as we know, dealers in food-grains and raw materials deal in a variety of other commodities and carry on many other trades. So they could get sufficient credit against the other commodities and for other trades and divert the same for hoarding of food grains and other essential consumers' goods, which were subjected to Selective Credit Control by the Reserve Bank for preventing rise in their prices. Secondly, though the warning of the Governor of the Reserve Bank had the desired effect on the erring scheduled banks to restrict their credit in 1957, it is doubtful whether this could have a lasting effect.

"The scheduled banks in the face of the steady increasing
operating costs, not to mention higher charges of interest they have to pay on deposits, have necessarily to utilise as large a portion as possible of their deposits in Advances. 1

The Selective Credit Control measures worked with a larger measure of success in 1960 - 61, that is in the last year of the Second Plan, because they were adopted in conjunction with general quantitative controls. The compliance by banks with the Selective Credit Control directives continued to be satisfactory during the year 1960 - 61. Advances against paddy and rice and wheat remained well within permitted levels; the peak of the adjusted level of advances against paddy and rice at \( \text{Rs.} 12.3 \) crores in March, 1961 was 35 per cent below the permitted level. In the case of 'other food grains', the advances had risen above the permitted levels in the last quarter of 1960, but the excess advances were temporary and relatively small. The advances against ground-nuts were also below the permitted levels except in the period November, 1960 - January, 1961. Advances against shares rose by only \( \text{Rs.} 61 \) lakhs over the year as against a rise of \( \text{Rs.} 11 \) crores in 1959 - 60, despite the buoyancy in the share - markets and the high level of new issue activity during the year.

In conclusion, we may say, that no component part of the monetary policy can be treated lightly in this country,

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1. Indian Finance: August 31, 1957, p. 400.
because it is not very effective. As the monetary policy itself as a whole has its limitations in an underdeveloped country like ours, all its components should be taken in use to get the maximum possible results, so that the technique of selective credit regulation, have to be given its due importance in the formulation of monetary policy. The techniques of credit regulation, however, have to be modified to suit the changing outlook of the economic scene, bearing in mind the needs of a developing economy.

THE FOREIGN EXCHANGE RESOURCES FOR THE SECOND FIVE YEAR PLAN

There is hardly any country in the world, other than Japan, which has been able to make economic development without foreign assistance. Most of the developed countries of today and those who are mid-way between developed and underdeveloped have been able to attain their present position, because they could get economic assistance from other countries.

It has been stated by Prof. Nurkse, that foreign assistance smoothens the process of economic development. In his words, "Foreign funds can certainly speed up the process (of economic development) and make it less arduous, less violently disruptive socially, and less likely to produce despotic form of government". It is therefore the duty of

1. Prof. Ragnar Nurkse: Capital formation in an underdeveloped economy, p. 141.
the prosperous nations of the world, to see that the under-developed nations quickly move into development. And for this they must liberally give economic assistance to such underdeveloped nations. The Prime Minister of Japan who could realise the indivisibility of the world into economic units pleaded for perpetuating this idea amongst the affluent nations of the world, while inaugurating the Annual meeting of the I.M.F., I.B.R.D., I.D.A. and I.F.C. Addressing the members of these organisations he said, "It is incumbent upon all of us (he meant the prosperous nations in particular) to make efforts to remove obstacles to free economic intercourse, to strengthen international co-operation and to go beyond our national borders, to contribute to the growth of the whole world and to the enhancement of the welfare of mankind". 1

There were critics of the Second Five Year Plan who argued that the Plan depended too much on foreign assistance. Out of the total Plan outlay of Rs. 4,800 crores in public sector they said the Plan expected to finance as much as Rs. 9,300 crores from foreign assistance. That is about 1/5th of the total public sector outlay, which in their opinion, was too much. We can on the contrary argue, that for a country

like India whose per capita income in 1956 was less than £300 per year, it was very difficult to raise all the Plan resources internally and as such foreign assistance was a must for the Second Plan. The nations of Western Europe whose total population is half of that of India, got in four years under the Marshall Aid Plan an assistance of £4,640 millions. Whereas, during the Second Five Year Plan, the total amount of foreign aid authorised was £25,883 million, which comes to about £1,990 million.

Though the planning authorities expected about 1/5th of the plan requirements in the public sector to be available from foreign resources, they were not sure whether such an amount of foreign assistance would be really forthcoming. According to the Planning Commission, estimates of foreign exchange earnings and requirements over a period of five years cannot be made with any great precision. There are

1. Authorised aid relates to aid that has been authorised during the period, but not necessarily for release during that period. Thus, for example, loans amounting in the aggregate to £2,803 millions or nearly £3 billions authorised by the U.S.S.R., Czechoslovakia and Yugoslavia during the Second Plan period were for projects not included during that period but figuring in the Third Plan programme. Similarly of the £11.1 billions of U.S.P.L. 480 aid, a considerable portion (approximately £5 billions) was intended for release during the Third Plan period. Dr. V.K.R.V. Rao and Dharma Narain: Foreign aid and India's Economic Development, p. 2.
many uncertainties. Amongst the uncertainties, the Plan had in view, the most important was the terms of trade. The terms of trade have been continuously adverse to the primary commodity producing countries of the world for the last few years. It was stated in the Plan that a ten per cent deterioration in the terms of trade could cause an adverse balance of trade for India to the extent of 1.80 crores.

The following table sets forth, the anticipated balance of payments position on current account during the Second Five Year Plan period.

<table>
<thead>
<tr>
<th>TABLE - 32</th>
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<tbody>
<tr>
<td><strong>INDIA’S ANTICIPATED BALANCE OF PAYMENTS ON CURRENT ACCOUNT</strong></td>
</tr>
<tr>
<td><strong>(1956-57 TO 1960-61)</strong>*</td>
</tr>
<tr>
<td>1) Exports</td>
</tr>
<tr>
<td>2) Imports</td>
</tr>
<tr>
<td>3) Trade Balance(1-2)</td>
</tr>
<tr>
<td>4) Invisible (Excluding official donation)</td>
</tr>
</tbody>
</table>


From the above table, it would appear that large part of the deficit was expected to occur in the second and the third year of the Plan. The hump in the 'middle' was expected on account of the increase in imports of steel machinery and equipment reaching the peak about the middle of the Plan.

The planners were quite aware of the effects of inflation on balance of payments deficits. It was stated in the Second Five Year plan, "The balance of payments is particularly sensitive to inflationary pressure. Rising domestic prices create new demand for imports and come in the way of exports". ¹ It has been a common experience that large scale development expenditure in an underdeveloped country gives rise to inflation. Inflationary condition in the country under such circumstances gives rise to increased demand for imported goods and upsets balance of payments position.

Mr. Graeme S. Dorrance, Chief of the Finance Division of the I.M.F. after having studied the effects of Inflation on Economic Development, came to the same conclusion. He writes, "Balance of payments difficulties are symptoms of the underlying stresses". ² By 'stresses' he means inflationary stresses.

¹. Planning Commission : Second Five Year Plan, p. 96.
Over the First Five Year Plan as a whole, a total amount of ₹.298 crores was received from external resources, to finance the plan. Of this amount, only ₹.204 crores could be utilised and we had an unutilised amount of ₹.94 crores\(^1\) at the end of the First Plan. The total commitments for the Second Plan were as follows: The U.S.S.R. promised ₹.63 crores for Bhilai Steel Plant. Allowing for a repayment of a part of this credit during the Second Plan period, the net available amount was worth ₹.43 crores. The Government of U.K. and its bankers promised an amount of ₹.43 crores. For investment programme in private sector foreign capital inflow of ₹.100 crores was expected. External assistance for public sector was estimated to be ₹.800 crores. If we deduct from this the three committed amounts of ₹.170 crores, a balance of ₹.630 crores was left uncovered for which arrangement had to be made\(^2\).

None of the prosperous nations of the world, who are generally the sources of external assistance to the developing nations frames any long term foreign assistance budget. It has, therefore, not been possible for the developing countries to anticipate regular foreign assistance for some years. This means that the developing nations cannot frame such long term development plans for which they may be

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assured of necessary finance from the developed nations of the world. India being no exception, it was not possible for her to estimate all the aids that she could get from different countries. The lump-sum assistance she hoped to receive was much dependent on the goodwill of the developed nations and India's power of persuasion.

In conclusion we can state that the amount of foreign assistance expected during the Second Five Year Plan was not too much in consideration to the poverty of the country and the need for its rapid development. But considering to the tendency of the developed countries of the world, it was considerably big. But with the mood of the developed nations changing and India's power to persuade increasing - due to her good performance on the economic front - there was nothing to feel pessimistic about the expected amount of foreign assistance.

THE FOREIGN EXCHANGE CRISIS

Within a few months, after the Plan was started, severe strain was felt on our balance of payments. Between April to June, 1956, there was a negative overall balance of payments of Rs. 60.2 crores on current account and in the next quarter the deficit was Rs. 69.3 crores. Whereas during the whole First Plan period, the overall balance of payments deficit on current account amounted to Rs. 126.8 crores only,
within one year of the Second Plan, it came to Rs. 221.3 crores. The anticipated amount of deficit for the year was Rs. 148 crores. The country had, therefore, to draw an amount of Rs. 219 crores from its foreign exchange reserves.

This unexpected increase in the deficit in our balance of payments in the first year of the plan caused considerable anxiety. This large deficit in our balance of payments was due to an increase in imports, particularly of capital goods and a fall in our exports on account of the Suez crisis. There was nothing to feel alarmed at this stage, but it was necessary for us to be cautious. At the end of March, 1957, we had foreign exchange worth Rs. 701.4 crores.

The continued pressure on the country's balance of payments position, necessitated the negotiation of a line of credit from the I.M.F. for Rs. 95 crores in the last quarter of 1956 - 57, of which Rs. 61 crores was utilised within this period. The balance of Rs. 34 crores which represented standby counterpart was drawn by June 12, 1957. Severe restrictions were put on the supply of foreign exchange for travels, health and education. The Government also cancelled the facilities regarding remittances to foreign countries by Money Order from June 27, 1957.

The half-hearted attempt of the Government to check the deteriorating balance of payments position in the first year of the plan, failed to achieve any results. The tide
of adverse balance of payments, thereafter, continued to move against the country at a greater speed. Between April to June, 1957, the deficit was ₹74.7 crores, but in the next quarter the adverse balance of payments was as high as ₹101.0 crores. This caused alarm in the country. There was already a suggestion before the National Development Council meeting that the plan expenditure targets be curtailed. At the end of June, 1957, we barely had foreign exchange reserve of ₹70 crores over and above the minimum of foreign exchange reserve to be maintained by the Issue Department of the Reserve Bank of India.

To tide over the crisis, the following were suggested:

1) **Prof. B.R. Shenoy** suggested devaluation of the rupee, which he regarded to be over valued.

2) **Prof. Gadgil** thought that the crisis was on account of our defective foreign exchange budgeting. **Prof. Gadgil** thought that the Government had no long term and clear cut policy about imports and as such had issued indiscriminate licences for imports, which had given rise to such a situation.

3) There were others, who pleaded for lowering the minimum amount of foreign exchange reserves to be maintained by the Reserve Bank. **This they thought would release the blocked foreign exchange in the Reserve Bank and help the country to tide over the foreign exchange shortages.**
4) It was also suggested that the country should approach the I.M.F. and other friendly countries for help. And, we should also curtail our imports and push up exports.

The overall balance of payments deficit for the second year of the Plan was Rs. 259.9 crores and the total for the first two years was Rs. 481.2 crores. This was much more than the anticipated deficit of Rs. 396 crores for the first two years.

It was suggested by Prof. Shenoy that the value of the Rupee be lowered because its real value had fallen. It was Prof. Shenoy's argument that due to the fall in the real value of the Rupee - but its exchange value having remained unchanged - India's post-war exports were only 72 per cent of the pre-war level, whereas, the imports were 98 per cent of the pre-war level. He, therefore, concluded, "It is acting as a drag on our exports and it so favours imports that it is not possible to defend the payments position of the country without payments and exchange restrictions". ¹

Regarding the fact that the Rupee is overvalued, Prof. Shenoy said, "the rupee exchange has been kept at a highly unrealistic rate". His views were based on a comparison of the price levels in U.K. and India on purchasing power

¹ Quoted by K.V. Gowda: The appreciation of the Indian Rupee, p. 231.
parity lines. "In 1957 as compared to 1937 money supply in India had risen to nearly 7½ times. The corresponding rise in the U.K. was 3½ times. During the same period, the internal cost of living in India had risen to over 3 times and in U.K. to 2.5 times." He, therefore, felt that the devaluation of the Rupee was necessary.

It is not known as to why Prof. Shenoy selected 1937 as the base year. The base years are changed from time to time and it should not be too remote from the date of consideration. The base year generally taken, at the time Prof. Shenoy made the comparison was 1953. If 1953 is taken to be the base year and the wholesale prices, 1957 in U.K. and U.S.A. are compared with those in India, the conclusion would be just the reverse. The following table would explain this.

<table>
<thead>
<tr>
<th></th>
<th>Wholesale price Index</th>
<th>Cost of Living * Index</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>1953</td>
<td>1957</td>
</tr>
<tr>
<td>India</td>
<td>100</td>
<td>103</td>
</tr>
<tr>
<td>U.K.</td>
<td>100</td>
<td>108</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>100</td>
<td>107</td>
</tr>
</tbody>
</table>

* Source: Reserve Bank of India Annual Report on Currency and Exchange for 1957 - 58:
Statement No. 1. Statistical Year Book (U.K. 1958), Section 159.

Wholesale prices in India rose by 3 per cent between 1953 to 1957, whereas they rose by 8 per cent in U.K. and 7 per cent in the U.S.A. Similarly, the cost of living rose more in U.S.A. and U.K. than in India.

The theory of Prof. Shenoy based on the reasoning that prices in India rose faster than that in U.K. and as such the Rupee was overvalued, therefore falls.

The increase in imports and fall in our exports was not on account of the overvaluation of the Rupee, it was rather on account of other factors like developmental investments, heavy food imports and the liberal issue of import licences. The fall in our export earnings was also on account of unfavourable terms of trade which have been common for all the primary goods producing countries of the world and the increased consumption demand for exportable goods which is also common in a developing nation under inflationary pressure.

There were some people who argued that India should devalue her currency, because the Rupee was showing signs of weakness in the foreign exchange markets and that our foreign exchange reserve was gradually declining.

Against such arguments for devaluation, we can state that if there was any sign of weakness in exchange value of the Rupee, it must have been in the black-market, because there are no free dealings in foreign exchange in India.
India's foreign exchange mechanism is controlled by the Government of India and the Reserve Bank of India and the sale and purchase of foreign exchange are done at the official rate with the permission of the authorities. Even if there was any sign of weakness in the black-market, it should not have caused any alarm, because the rate of exchange of a country's currency depends much on the faith of the foreign traders, who may feel or may not feel that the official rate can be maintained. In the former case, the rate is not likely to move downwards. It was stated by the Governor of the Reserve Bank of India Mr. K.V.R. Iyengar that there was no corelationship between the exchange value of the rupee and our foreign exchange reserve. The value of the Indian rupee in the foreign exchange markets was not dependent on the appreciation or depletion of our foreign exchange reserve. The main function of the foreign exchange reserves was to help a country to tide over its temporary balance of payments difficulties. In his words, "It is now almost universally accepted that the main purpose of foreign exchange reserves is to enable a country to tide over unfavourable turns in its balance of payments. On the other hand the strength of a currency depends on the inherent economic strength of a country and the way it conducts its economic and monetary affairs. If issues are not confused it would be clear that the rupee is as sound as it ever was".  

1. Quoted by Indian Finance, July 5, 1958, p. 49. Campaign for Confidence.
Devaluation would have rather worsened the situation as it would have made our imports costlier and would have hardly increased our earnings from exports, because the demand for our exports is not very elastic. It was also not possible, by devaluation, to reduce our imports to any appreciable extent as imports were already controlled through various import control rules and the bulk of the imports was tied to some development project or the other.

The real reasons for an exchange crisis as stated earlier can be summarised as follows: (i) Unplanned import licence policy of the Government. The Government had no long term import policy. The import policy was framed on ad hoc basis; (ii) As a consequence of the above, the Government issued liberally import licences during the first one and half years of the plan, particularly for capital goods and created the crisis; and (iii) The increase in food imports during this period due to bad harvests was another important cause for this imbalance.

It was, therefore, suggested by some people that imports should be severely curtailed. "Logically, this strain would be relieved if foreign exchange difficulties lead to a drastic curtailment of imports" wrote Prof. Gadgil.  

The Government took some steps in this direction and severely curtailed imports and in certain cases completely stopped the imports of particular type of goods. The imports of luxury goods, baby food etc. were totally stopped. Mr. Lal Bahadur Sastri, the then Minister of Commerce, was right when he said that the solution to the exchange crisis was not to be found in restrictions of imports only. He, therefore, raised the slogan 'Export or perish'. That is it was thought necessary to lay more emphasis on the expansion of exports rather than the curtailment of imports. Lowering of imports would have slowed down the progress of the plan. The Government took extra care to boost exports and granted many facilities to the exporters.

The other part of the solution to the crisis was external. The country could get external assistance in the following ways:

a) The deferring of payment for the maturing loans by the creditor governments.

b) Aid given by the foreign governments either individually or in a group.

c) The assistance received from the International organisations like I.M.F. and I.B.R.D.

In order to give us aid to tide over our foreign exchange difficulties, a number of countries met at Washington along with the I.B.R.D. and formed the Aid India Club in
August, 1958. The formation of the Aid India Club was justified on the following grounds:

1) That the success of India's Second Five Year Plan was very important to keep the biggest democracy of the world alive. This was a political consideration.

2) It was thought that these very difficulties proved that a basic change for the better was taking place in the economic sphere in India.

3) It was also said by Prof. Myrdal that balance of payments difficulties are very common to the developing nations.

Representatives of five nations and the I.B.R.D. met in Washington to examine the balance of payments situation of India. It was the I.B.R.D., which had realised the country's difficulties and brought these countries to a conference under its auspices for considering aid to India. "In 1958, the success of the Second Five Year Plan was threatened by an acute shortage of foreign exchange. India was using up its foreign exchange reserve at a dangerously rapid rate in order to maintain imports essential to the plan". The members of the Aid India Club agreed to a $350 millions aid to finance the foreign exchange requirements in the third year of the Second Five Year Plan.

The I.B.R.D. promised loans of $100 millions. The U.S.A.

promised to provide new credits from its Development Loan Fund amounting to $75 millions, which were repayable in Rupees and another $25 millions to be available by the middle of 1959. The U.K. promised $108 millions; West Germany $40 millions; Canada $17 millions and Japan $10 millions. Moreover the U.S.A. promised extension until 1967 for the repayment of principal and interest amounting to $55 millions that had become due on account of the $190 millions wheat loan of 1951 and supply of an additional $200 millions worth of surplus agricultural produce under P.L. 480 - which was to be repaid in rupees.

These nations also agreed to meet India's foreign exchange requirements for the rest of the plan period - 1959 to 1961 - and according to their calculations an assistance of $600 millions was required by India.

The total amount of foreign assistance received during the first two years of the second plan amounted to as much as Rs. 812 crores, of which Rs. 721 crores was in the form of loans and Rs. 91 crores as grants. While the amount utilised upto March, 1958 amounted to Rs. 402 crores, which included the I.M.F. loan of Rs. 95 crores. The balance of unutilised loans was Rs. 410 crores. The committee headed by Dr. Rao - appointed to enquire into the causes of large amount of foreign loan assistance remaining unutilised gave a finding that most of these loans were tied and they could be obtained, in many
cases, only after we had made some preliminary expenditure, which was not insignificant in most cases.

In the years - 1956 and 1957 - two major changes were made in the Reserve Bank of India Act, pertaining to the reserve requirements against currency issue. First of these was the Reserve Bank of India ( Amendment) Act 1956. The amendment provided for the substitution of the proportional reserve system by a minimum reserve of foreign currencies and gold in absolute amount viz., ₹400 crores in foreign securities and ₹115 crores in gold coins and bullion, at the international rate of ₹62.50 per tola instead of the existing valuation rate of ₹21 - 7 - 10 p. per tola.

The Act was further amended on October 31, 1957. The minimum of total reserves in gold and foreign securities was reduced to ₹200 crores, out of which ₹115 crores was to be in gold.

The amendments to the Reserve Bank of India Act on Gold and Foreign Exchange Reserve requirements had far reaching effects: (i) They freed a large amount of our foreign exchange resources, which were unnecessarily locked up in the Reserve Bank's vaults on account of the provisions of the Reserve Bank of India Act of 1934. (ii) The amendments to the Reserve Bank of India Act, also released a large amount of gold from the Bank's vaults to be used for developmental purposes. (iii) They gave too much liberty
to the Government to get notes issued by the Reserve Bank of India.

It is not possible to calculate exactly the amount of gold or foreign exchange that was released on account of the Amendments to the Reserve Bank of India Act of 1934, but it is certain that the amount was not insignificant.
TABLE - 32

BALANCE OF PAYMENTS DURING THE SECOND FIVE YEAR PLAN PERIOD

(Rupees crores)

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<td>Second Plan</td>
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<td>Estimates</td>
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<tr>
<td>1) Imports:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(a) Private</td>
<td>812</td>
<td>696</td>
<td>504</td>
<td>598</td>
<td>592</td>
<td>622</td>
<td>.</td>
</tr>
<tr>
<td>(b) Government</td>
<td>287</td>
<td>537</td>
<td>525</td>
<td>416</td>
<td>496</td>
<td>452</td>
<td>.</td>
</tr>
<tr>
<td>Total imports (a + b)</td>
<td>1,099</td>
<td>1,233</td>
<td>1,029</td>
<td>924</td>
<td>1,088</td>
<td>1,074</td>
<td>868</td>
</tr>
<tr>
<td>2) Exports f.o.b.</td>
<td>635</td>
<td>594</td>
<td>576</td>
<td>623</td>
<td>632</td>
<td>612</td>
<td>593</td>
</tr>
<tr>
<td>4) Non Monetary gold movement</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>+ 6</td>
<td>-</td>
<td>+ 1</td>
<td>-</td>
</tr>
<tr>
<td>5) Invisibles (net) other than official donations and similar official assistance</td>
<td>+111</td>
<td>+102</td>
<td>+83</td>
<td>+57</td>
<td>+33</td>
<td>+77</td>
<td>+51</td>
</tr>
<tr>
<td>6) Current Account Deficit excluding official donation</td>
<td>-353</td>
<td>-537</td>
<td>-370</td>
<td>-238</td>
<td>-423</td>
<td>-384</td>
<td>-224</td>
</tr>
<tr>
<td>7) Capital transactions other than assistance in (9) below</td>
<td>-36</td>
<td>-23</td>
<td>-16</td>
<td>-51</td>
<td>-25</td>
<td>-30</td>
<td>+24</td>
</tr>
<tr>
<td>8) Total Surplus (+)/Deficit (-)</td>
<td>-389</td>
<td>-560</td>
<td>-386</td>
<td>-289</td>
<td>-448</td>
<td>-414</td>
<td>-200</td>
</tr>
<tr>
<td>9) Foreign Assistance including net drawing from I.M.F.</td>
<td>+168</td>
<td>+300</td>
<td>+344</td>
<td>+273</td>
<td>+389</td>
<td>+295</td>
<td>+160</td>
</tr>
</tbody>
</table>

It would be clear from the previous table, that the amount of deficit in the balance of payments anticipated in the Plan was much lower than the actual deficit. Against an expected annual average deficit on current account of ₹224 crores, the real deficit reached an average of ₹384 crores. But for the timely help of the foreign friendly countries, the international organisations and the import restriction and export promotion measures taken at home, the country could not be saved from a bankruptcy of foreign exchange. The draft on our foreign exchange reserve for the first two years of the Plan was ₹481 crores against an anticipated amount of ₹200 crores for the entire Plan period. Against an annual expected foreign assistance of ₹160 crores, we actually got an average assistance of ₹295 crores per annum.

The various measures that the Government took bore fruits and in 1958 - 59, the total balance of payments deficit on current account was adverse to the extent of ₹370 crores as against an adverse balance of ₹537 crores in the previous year. The deficit on current account declined further in 1959 - 60 and was only ₹238 crores. However, in 1960 - 61, the deficit increased again to ₹423 crores. Imports of both capital and consumers' goods, which had declined significantly in the three years 1957 - 58 to 1959 - 60, again went up in 1960 - 61. Import of raw materials, which was sharply cut down in 1957 - 58 and 1958 - 59 was allowed to increase in the fourth year of the Plan and remained at that
level in 1960 - 61 also.

Private imports in the last year of the Plan were higher than those in 1959 - 60 though they were lower than those in the first two years of the Plan. In contrast to this Government imports rose by more than 80 per cent from ₹ 287 crores in 1956 - 57 to ₹ 537 crores in 1957 - 58 and were still higher in the last year of the Plan. These were the reasons because of which the balance of payments position of India deteriorated from ( - ) ₹ 238 crores in 1959 - 60 to ( - ) ₹ 423 crores in the last year of the Plan.

As the reserves had gradually reached a low level, special efforts were made to obtain additional foreign assistance and the country could manage to get considerable foreign assistance. As a result of such assistance, whereas, the Reserve Bank of India reserves and net drawings from the I.M.F. financed about 80 per cent of the current account deficit in 1956 - 57 and 55 per cent in 1957 - 58, they financed only 12 per cent of the deficit in 1958 - 59. It should be noted here that the I.M.F. assistance is meant to tide over temporary balance of payments difficulties. It gives short term loans for not more than five years and as such its aid cannot be helpful in correcting any long term disequilibrium in the balance of payments. "They interpreted 'temporary' to mean that a member drawing on the Fund should repay within a period of three to five years". 1

In 1959 - 60, there were net payments to the I.M.F. on account of the repayment of a part of the drawing in 1957, and yet the reserves had to be drawn upon to finance only 60 per cent of the current account deficit. In the last year of the Plan also, in spite of the inflow of foreign capital in India, we had to finance 14 per cent of balance of payments deficits on current account from our reserves.

In conclusion, we can say that foreign assistance in the form of loans, aids and private investments can make development of country less arduous and socially less violent, but ultimately the country must depend upon its internal resources for all development plans. External efforts can be of very little help for the developmental efforts of a developing country unless there are complementary efforts within the country.

As far as, India is concerned, all such aids, loans and investments can-not be a permanent feature. As we have already stated very few affluent nations of the world have any long term aid or loan programmes. "The Western effort (to assist India) although considerable has had about it an unmistakable air of provisional thinking and emergency measures". ¹ From the point of view of capital investments,

¹. Barbara Ward: India and the West, Foreign Aid, Scale and Need, p. 204.
this place is less profitable to the industrialists of rich countries. We have, therefore, to meet our external payments deficits from our own resources and have to be careful about our foreign trade policy and have to make out long term foreign exchange budgets.

The greatest drag on foreign exchange resources is caused by food imports. Unless we are self-sufficient in food, this drag on our foreign exchange resources cannot be stopped and consequently we will be under constant threats of foreign exchange shortages.