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The Monetary Crisis and Foundation for Reserve Bank of India (1890-1935)

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Abstract
The monetary policy of British India was highly controversial during the interwar period as it aimed to protect the budgetary obligations and private commerce. The currency stabilization policy was seen as a tool to protect the British economic interest while they ruled India. The currency came under serious pressure during the World War I and Great depression, the facets of Indian currency's dependence was exposed through the modified council bill system and Gold exchange standard. The much-needed currency reforms and banking system were conceded by the colonial administration after much wrangling for half a century.

Keywords: British India, Monetary System, Council Bill System, Gold Exchange Standard

JEL: N01, N10, N15

1. INTRODUCTION

There were a number of critical phases during the colonial regime from the establishment of the East Indian Company to the granting of independence. The colonial relationship as primarily observed by various nationalists was more about wealth transfer and pursuance of policies towards colonial economic interest which undoubtedly led to deprivation of national wealth (Gupta, 2002). The backdrop against which British India was administered had also been investigated and researched in great depth and several of the British policies were criticized for being pivoted around exploitation. The objective of this paper is to explore the financial facets and the monetary system of British administration in governing British India during the controversial currency crisis which led to the formation of Reserve Bank of India.

This Paper is structured as follows: the Section 2 outline the facets of British India's fiscal policy, the gold exchange system, home charges and the council bill system which acted as an alternative to gold standard. It is followed by a detailed analysis on currency crisis and different committee's recommendations in the Section 3. The impact of great depression on Indian monetary system is discussed in Section 4. Finally, Section 5 provides accounts on the establishment of Central banking system in British India.

2. BRITISH INDIA'S FISCAL POLICY - AN OVERVIEW

It is imperative to understand the revenue administration of the Colonial regime as all economic policies culminated in the augmentation of revenue for imperial power. The Tax system adopted in British India during the latter half of 19th century was regressive and income inelastic. A major portion of revenue, around 50%, was generated from Land tax and 24% from sale of opium and Salt. The slight expansion of economy during the subsequent period did not translate into revenue increase as the sources of revenue such as land and salt were inflexible. British India depended heavily on land tax for its revenue which did not show any notable improvement as the yield remained stagnant for an exceptionally long period. The other flexible sources such as customs, excise and income tax were yet to gain importance in revenue administration (Ambirajan, 1978).

Only after World War I, in order to counter the financial stringency, the government was forced to explore the other options of flexible sources. It is to be noted that the sustained campaign and resistance by landlords against land tax also necessitated the government to explore alternative sources of revenue. At the end of that decade, the combined share of customs, excise and income tax rose to 50%. The government however faced some impediments in levying tax on groups like the self-employed and industrial firms which were owned by Europeans and landlords. The burden of defense expenditure, pension payments and debt service (huge interest payments) accounted for the majority of the spending and only less than 25% went into investment (Gupta, 2002). The other major point of contention during that time was the large remittances made by the Government. It had adversely affected the spending on public goods and capacity to invest in much needed machinery and raw materials whereas during the same period the other countries like Ceylon, Philippines and Thailand spent two to three times that of British India. This underlines the influence of imperial concerns of administrative and political stability leaving too little scope for development.

The government revenue in proportion to GDP during the period 1920-30 was just 5% as compared to 19% in UK. The tax per head per unit of GDP was also the lowest compared to other colonies like Malaysia or even French Colonies at that time. The National Income rose from Rs 18 million to Rs 25.9 million during the period 1910 to 1930. But the increase in revenue over a period of time did not result in a significant rise in the Tax-GDP ratio. On the contrary, debt to GDP ratio rose to 40.6 in the year 1938. So, evidently debt service and administrative commitments override the investment and social development. The contention of our nationalist throughout the period was that the leakage of funds in the form of 'home charges' led to lower expenditure on needy sectors (Ambirajan, 1978).

2.1 THE GOLD EXCHANGE STANDARD

The foremost objective of monetary policy was to standardize the exchange rate and stabilize the export and import. An appreciation of currency affected the commercial interest of the exporter's often private commerce and depreciation resulted in deficit budget, therefore it became difficult to meet the sterling obligations. The currency reform of uniform silver weight was introduced in the year 1835. This led to silver standard and silver became the accepted means of currency across British India. There were two ways by which trade transaction took place between India and the rest of the world. One was by way of council bill sales and the other was minting of Silver bullion into coins which were procured as payment by Indian traders in London. Towards the last decade of the 19th century, silver supply increased across the world which led to a sharp decline in silver prices. The traders found that buying silver bullion in London and minting that into coins in India was profitable compared to Council bill redemption. Once the council bills came under severe threat, the government devalued the rupee which however strained the budget to a considerable extent. As the value of silver started to fall rapidly, free coinage of silver was suspended in 1893 (Tomlinson, 1979).

The Gold supply increased in the 1890s after discoveries in South Africa. The classical gold standard and claim for Gold circulation gained momentum amongst Indian Nationalists as this was seen as a sign of independence. The home charges represented a debt contracted in gold that was to be met by equating it to silver rupees which was vehemently opposed by our nationalists. To adapt to this different monetary condition, two committees examined the situation and submitted partially divergent reports. The Fowler committee advocated the adoption

of Gold Standard with Gold circulation whereas the Hershell Committee recommended Gold Standard without Gold Circulation. In 1898, the Gold Exchange standard was introduced, and the trade balance remained favorable up to 1913. However, it was occasionally disturbed due to heavy borrowings by British India. The demand for Indian goods was stronger during this period. The central bank of a borrowing country had to settle the remittances/payment in Gold at a fixed maximum rate as a standard trade practice. The international trade was carried out without use of Gold as currency or little flow of Gold from one country to another (Brunyate, 1926).

2.2 THE HOME CHARGES

Great Britain was on Gold Standard and the Indian currency was Silver. The Silver rupee coin was not convertible by law, but it can be exchanged at the rate of £1 per Rs 15 in 1898 as fixed by the Fowler committee. It is to be noted that the ultimate phenomenon of trade would not be different if one country operated on Gold standard and the other country had inconvertible currency. The Secretary of State issued a notification that sterling bills would be sold in exchange of currency but the conversion rate was considered to be very unfavorable to Indians and that the exchange of Gold for currency was entirely within the absolute discretion of the imperial power. The trade was favorable for India as there was a greater demand for Indian goods particularly raw materials. The Secretary of State had to remit 'Home Charges' in sterling annually in London. The Nationalist saw the home charge remittances as 'unilateral transfer of wealth' and 'expropriation of surplus 'but in Keynes perspective the creditor nation was heavily investing in its colony and it was characterized as reverse drain of wealth from England. The large remittance was considered as a case of imperial exploitation by the Nationalists but alternatively some of the British Economists considered the influx of capital into British India an example of local development fostered by the British. The Second Boer War (1899-1902) changed the situation rapidly as gold reserve fell to an all-time low and the Gold circulation was opposed tooth and nail by Treasury officials in London and the Indian Nationalists' demand became infeasible (Ambirajan, 1978).

2.3 THE COUNCIL BILL SYSTEM- AN ALTERNATIVE TO GOLD STANDARD

The Secretary of State offered to sell council bills in India. The bills were readily purchased by Exchange banks located in Calcutta, Bombay and Madras. The 'home charge' chargeable to Indian revenue was thus collected in Rupees. The Exchange banks would sell council bills to Indian exporters. The Indian exporters would buy council bills proportional to their receivables for goods exported by them to London. The exchange banks after discounting the bills drawn by the Indian exporters sent it to London for Sterling payment. The Indian Exporters would en-cash the council bill certificates in Rupees in our treasuries whereas Exchange Banks would be paid in Sterling in London through their head offices. As the balance of trade was favorable to India, there was a heavy demand for council bills since 1904. The sale of council bill became an effective strategy to prevent the gold flow into India which was the undeclared policy of the Secretary of State (Balachandran, 1993).

The price at which the council bill was bought and sold became an index for Sterling-Rupee exchange. The amount of council bills sold in any year was equivalent to the amount of Gold which could have been imported to India. But its effect on price level remained more or less the same as if the metal had flowed into India. The council bills collected by treasuries were again circulated back by the Secretary of State to Exchange banks by way of sale. Thus, to a greater extent it prevented gold movement into India as desired by the British. Throughout the period from 1893-1913 the trade was favorable to India, however the higher demand for Indian goods and large borrowings in terms of capital goods were considered as major disturbances in the trade balance. The council bill system played the role of Gold movement into India; however, it did not alter the price level. At the same time, it did not prevent private import of Gold and large volume of it went into personal consumption or was hoarded (Tomlinson, 1979).

3. WORLD WAR- I AND THE CURRENCY CRISIS

Immediately after World War-I the gold exchange standard faced a serious crisis and confidence in the Rupee started to erode. Great Britain's post war efforts were to stabilize the global financial health and its financial

relationship with the United States of America. The attempt to study the Indian perspective in isolation during the global crisis only places limitations on the understanding of the global interwar monetary reforms and stabilization plans attempted by the British. The British India had excessive appetite for Gold and during 1914-1919 alone she absorbed over 1/4th of the total Gold output despite restrictions. The substantial portion of trade surplus was converted into security bills and it grew steadily but such huge security holdings in sterling had eroded the confidence of Indians in the local currency and increasingly Indian households held their savings in gold and silver. During the war time, restrictions were imposed on import of Gold and Silver which slowly turned the Indians towards currency notes. But the demand for silver rupees did not subside to the expected levels and at one point in time convertibility became the critical financial problem (Gallagher and Seal, 1981).

The problem was no more an isolated financial trouble but required combined effort from America and Britain to iron the issue out. The British authorities on the one hand were satisfied that the growing demand for silver could prevent the Gold flow into India. It was apprehended that the demonetization of silver would flush out inferior silver metals from India and at the same time imposing Gold restriction had the potential to trigger another political and financial turmoil. Lionel Abraham, a veteran official in the India Office in London described the restriction of gold and silver demonetization attempts as 'Sin against Civilization'. The gold demand for Indian households was deferred after the Pittman Act was passed which enabled the US to export around 150 million ounces of Silver to India (Keynes, 1913). The two important committees which looked into the issue of monetary system were the Fowler Committee and the Babbington-Smith Committee

3.1 FOWLER COMMITTEE

The value of silver was eroding faster against gold, which led to decline in rupee value against the gold based currencies. British India had been importing about one fourth of the global silver production to meet its currency requirements. In 1892, the government ordered the Indian mints to stop the silver currency processing, and the Fowler committee recommended fixing the exchange rate at 15 rupees per British Sovereign. The Committee also drew attention of the government towards inadequate banking facilities and discount rate fluctuations. The Committee recommended for a Central bank to carry out the regulations more effectively and to expand and contract the supply of capital in times of pressure and slackness (Brunyate, 1926).

3.2 BABBINGTON-SMITH COMMITTEE

The Babbington- Smith committee examined the impact of war on the Indian Currency system. The committee primarily looked into the issue of probable gold flows into India, because the imperial interest was to prevent any undue gold drain into India which in turn would threaten Britain's ability to meet the trade balance issues with the US and various other countries. Cokayne, the Governor of the Bank of England stressed that any form of gold drain into India would raise the interest rate world over and also worsen the deflation in Europe. He recommended a total ban on gold import to India. The Government back in India was aware that any such drastic move would heighten the agitation as Nationalists were already revolting against the domination of British priorities in determining the Indian Financial System (Ambirajan, 1978).

The committee decided to revalue the rupee at a higher rate as it was believed that in India silver rupees were preferred over currency notes and it indirectly denoted the higher appetite for gold as well. Once the revaluation was done, convertibility could be achieved thus the demand for gold would be deferred. Though the imperial interest was to manage the currency problem without allowing gold inflow into India, it was evident from the discussion between India office and Treasury officials that the convertibility argument was relegated and the Inflation argument was projected instead. One dissent note came from Keynes that allowing gold flow into India would have had an anti-inflationary effect worldwide. His view was however not appreciated by the committee. The committee was in favor of high exchange rate and convertibility as it would preserve the role of Silver and prevent inflow of Gold. The high prices would reduce purchase by manufacturers and in turn the store value of Silver would increase. The committee was also of the view that by ensuring convertibility the choice of private savings would tilt towards non-gold assets. The British adopted a monetary policy based on the committee report and revaluation of rupee was done whenever the silver price rose (Coffman, 2010).

3.3 THE COUNTER- CYCLICAL ROLE OF BRITISH INDIA

Britain was keen to reconstruct her monetary system to the Sterling-Gold standard of the Pre-War level. To contain the post war political and social problems, it resorted to expansionist policies which affected the Gold-sterling ratio and deepened the domestic inflation. They persuaded US also to adopt expansionist policies to keep the inflation rate more or less at their level otherwise it warranted gold export to the US by Britain. The other option was to raise the Bank rate, but it was strongly opposed by the cabinet. The US was also aware of the benefits that Britain would derive in case of expansionary policies pursued in their country. Britain successfully rolled out an anti-inflationary package in India based on the Babbington-Smith Committee report, but they could not secure the cooperation of the US on this issue. This was the insight of Keynes that India performed a counter cyclical role in the world economy. After some time rupee started to fall, the Indian Government agreed to sell Gold reserve holdings in the domestic market to bring down the price of Gold so that the Gold demand could be met without much strain on the world market. This resulted in the immediate pick up in Gold sales in the domestic market and import fell and India emerged as a net exporter of Gold in 1921 (Gupta, 2002).

4. THE GREAT DEPRESSION AND RATIO CONTROVERSY

In 1925, the Sterling-Rupee ratio was fixed at £1: Rs 18 and it remained for the next one decade at this level. The depression across the world and the fall in commodity prices affected the demand for Indian staples in the British market which in turn depressed the internal prices. The discussion on major reforms to transfer the monetary control to an elected assembly aggravated the sentiments of investors and overseas rupee holders. They feared that the devaluation of Indian rupee was imminent and that also put pressure on the exchange rate. The options before the British Government were either build confidence in the future Indian monetary management or devalue the rupee to increase the competitiveness of Indian goods. The devaluation required additional revenue support from the British treasury as there was a commitment on annual home charges remittances and the debt service obligations also piled up by that time. The sterling public debt and the home charges were about £350million and £30 million respectively and the same had to be remitted to London annually. The priority of the British government was to ensure that the remittances were made annually without default. In case of a devaluation of the Rupee, the Government of India had to raise additional revenue or borrow to meet the commitment on sterling remittances and the other alternative was the shipping of Gold or Silver to be sold in London (Mukherjee, 1992).

The Indian political sentiment was in favor of full gold Standard and to live up to this expectation, the gold reserve had to be built up but the demand for silver in the world market was also low so both these options seemed politically and financially unacceptable. The remittance to be made from the reserve was considered to be a cash transfer affecting the money supply in India. Any contraction of money supply would definitely strain the central budget and the interest rate. All the options thus had the potential for a spiraling effect at home as well in London. The political situation was in turmoil towards the end of 1929; the colonial government was accused of pursuing monetary policies to advance its interest. These conflicts and frictions occurred at the time of a greater depression. The deteriorating political situation aggravated the flow of capital outside India. By the beginning of 1930, the Rupee Sterling ratio was clearly at risk. The government of India had to meet the remittances through the currency reserve. The inflated prices and loose money available for speculation is thought to have created the situation of deficit. The lower interest rate facilitated the cheap borrowing in India for its exports and exchange of sterling at a fixed rate later. But contraction of money supply could only aggravate the situation further by affecting land revenue, income tax and customs duty. Alternatively increasing the currency supply by way of issuing treasury bills could put the rupee exchange at risk (Mathur, 1988).

The political agitation civil disobedience caused the collapse of Indian sterling loan stock in London. The Indian office and the treasury together exerted pressure on the Secretary of State and succeeded in getting £50million credit to ease the remittance problem, the Chancellor of the Exchequer refused to consider any such proposal to transfer the burden on to the shoulders of British Taxpayers. As the proposal was turned down, the Treasury recommended to India office the devaluation of Indian Rupee without the support of the British commitment. But strangely the British Prime minister supported the idea of drawing credit as against the horrible

consequences in the event of devaluation. The problem got aggravated, the flow of capital out of India became heavy and the prospects for any new foreign loan became dismal. The exhaustion of reserve currency became imminent and default on commitment appeared inevitable. The officials at the India office London and the British policy makers attempted only to avoid further deterioration of Indian economy but had no intention of either mitigating or preventing the agony caused by depression. They began to demand the shipping of gold to London.

A Large amount of gold was shipped from India and sold in London. During 1931 to 1934, Rs 1893 million worth of gold was exported and the flow of gold continued for some more time. The bulk of gold export came from private savings of the Indian Population. The depreciation of Sterling made gold selling in London profitable and this probably caused easy movement of Gold from India to London. The outflow of Gold enabled the Government of India to meet the remittances and all its commitment in London. England and British India had different monetary standards and the risk was accentuated by the depreciation of silver and therefore the exchange rate represented a key factor in the risky financial environment. The question of monetary link between Sterling and rupee and the financial relationship between Britain and India were altered and saw a different dimension during 1900-1930 as the issues were rattled and dodged for nearly three decades by the India office at London and by the British Policy makers. The Royal commission on Indian currency and Finance was set up in 1920 recommended the creation of a Central Bank in 1926, but owing to differences and disagreements the idea was withdrawn. The guidelines presented by Dr Ambedkar to the Hilton Young Commission (also known as Royal Commission on Indian Currency and Finance) based on his research entitled the Problem of the Rupee – Its Origin and Its Solution were also taken into account for developing a framework for the Central banking system. The Reserve Bank finally came into existence after the enactment of 1935 Government of India Act (Mukherjee, 1992).

5. CONCLUSION

The Council bill system though prevented the flow of Gold into India effectively but at the same time such mechanisms did nothing to alter the price levels during that period. A large volume of Gold was imported for private consumption and a major part of it was hoarded and it was not added to the circulation of money. During the time of the great depression, when the commodity prices were tumbling down across the world, our nationalists agitated for the devaluation of Indian currency to provide impetus to export. As such all the countries were facing severe depression at that time, hence the demand for Indian goods could not have arisen. During the Pre-war period, British India had seen substantial growth and investment but World War I and Great depression did aggravate the financial stability across the world and the problem of the Indian currency should be viewed in a wider context not in isolation. The British Government at one point in time feared that the devaluation of the Indian currency and payment default by the Indian Government would crash the empires pound and financial reputation. After the crisis was over the concern of the foreign holders of rupees was buttressed by providing sufficient safeguards in the constitutional reforms enacted in the year 1935 and led to the establishment of a non-political Reserve Bank to act as a Central bank in India.

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