Monetary Policy and the Indian Economy During the Inter-War Years

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In this essay, Niall Murphy delves into the murky world of colonial monetary policy to determine whether Britain may have allowed India, the supposed jewel in its crown, to become tarnished for its own benefit. He recounts the problems India faced while trying to uphold the Gold Standard, and the negative consequence thereof. At a broader level, Murphy poses tough questions for those who attest that British rule was conducive to economic growth.

"Cecily, you will read your political economy in my absence. The chapter on the fall of the Rupee you may omit. It is somewhat too sensational. Even these metallic problems have their melodramatic side." (Wilde, 1895)

Introduction

Recent research in the field of development economics has become preoccupied with 'one-size-fits-all' answers to the 'big questions'; what role for trade, geography or institutions in explaining why some countries are rich and others are poor[1]? Often neglected in these studies is the role of short run government policies and their effect on development[2]. An historical example of the importance of short run government policy is Indian monetary policy during the interwar period; O'Rourke has gone as far as to ascribe the electoral success of the Indian National Congress in the late 1930s to the deflationary impact of monetary policy (2007, p.469). By examining the role of Indian monetary policy in the poor performance of the Indian economy between the wars through the lens of the principal-agent problem this essay aims to show how short run government policy can be a crucial ingredient in an economy's development and that neglecting this insight can lead to a misdiagnosis of an economy's binding constraints.

First this essay will consider the arguments of those who have highlighted the economic benefits of British imperialism. Second, the important role of India in the in-

1. For example see Acemoglu, Johnson and Robinson's (2001) attempt to attribute 500 years of divergence to the differing quality of institutions across the globe.

2. See Haussmann, Rodrik and Velasco (2005) for an alternative 'diagnostics' approach

ternational gold standard will be considered. The negative consequences of the high exchange rate for trade will then be examined followed by a discussion of how monetary policy was used to facilitate Indian debt remittances to Britain. Finally, there will be a brief comparative discussion of how the deflationary monetary policies pursued by the Indian authorities were incompatible with the Great Depression.

Economic performance in Imperial India

Niall Ferguson (2003: p.1) has argued that "while it is convenient for contemporary rulers in countries like Zimbabwe to blame their problems on the 'legacy of British rule', the reality is that British rule was on balance conducive to economic growth." Drawing on modern-day research in the field of development economics, he illustrates that enforced openness to trade could have been a force for convergence (Sachs & Warner, 1995) and that capital flows could have also acted as a channel for economic development (Clemens & Williamson, 2000). He also supports the proposition by Cain and Hopkins (1993) that Britain's "gentlemanly capitalism" placed a heavier emphasise on finance than British exports and extrapolates from this that British imperial policy offered "at least the opportunity of economic convergence," by creating macro institutions which conformed to a "London Consensus" emphasising property rights and liberal economic policies (Ferguson 2003, p.19). Writing on Indian finance, Sunderland (2013, p.213) argued that "the IO [India Office], the Bank of England, the Treasury and City institutions were well aware that they stood or fell together" and thus they were willing to extend "costly favours on the understanding that these would eventually be reciprocated." Thus on balance financial policy was largely favourable to India's interests.

Yet an interesting caveat to the pro-imperialism thesis is recognised by Ferguson himself; the case of India. Ferguson asks; "why was Indian economic performance so much worse than that of the Dominions?" While the world economy generally performed worse during the interwar years than in the years before the outbreak of the First World War, India fared particularly badly. As the figures below demonstrate, growth in real GDP per capita was demonstrably lower than in most other countries. Meanwhile, India's percentage share of the value of world trade (in gold dollars) fell from 3.75 per cent in 1913 to 2.5 per cent in 1937 (Tomlinson, 1979: p.30).

Growth in real GDP per capita (average annual rates of growth), 1913 – 1950							
	Western Europe	USA	Latin America	Japan	China	**India**	USSR
1913 – 1950	0.8	1.8	1.4	0.9	-0.8	**-0.3**	1.1
1921 – 1938	2	0.8	1.4	1.8	N/A	**-0.1**	N/A
1921 – 1929	3.5	3.3	2.6	2	N/A	**0.9**	N/A
1929 – 1938	0.7	-1.3	0.4	1.7	0	**-1**	4.9

Table 1: Maddison 2001: pp.104-111, pp.180-187

Ferguson offers "the insufficient scale of British interference in the Indian economy" by way of explanation (2003: pp.21-24). By not investing sufficiently in human capital, the Indian state failed to reap the potential benefits of imperialism. However this conclusion seems unsatisfactory; while many economists have written on the importance of education to development (Duflo, 2001; Psacharopoulos, 1995; Shultz, 2003), the lack of investment in education in other dominions and even in Britain itself did not hinder GDP growth in the same way as it did for India: between 1857 and 1947 Indian per capita GDP grew by just 19 per cent, compared with an increase in Britain of 134 per cent (Ferguson, 2003: p.21). This essay argues that, among the myriad possible reasons for the poor performance of the Indian economy under colonialism, one possible explanation for the inter-war years was that the agent (the India Office) pursued monetary policy objectives which benefitted two of her principals (HM Treasury, Bank of England) but not the other (the Secretary of State for India). Thus in the specific case of monetary policy in the inter war years, it was the excessive interference of the British government in Indian affairs, and not the lack thereof as Ferguson claims, which was one of the problems facing the Indian economy.

The role of India in the International Gold Standard

A key objective of monetary policy in British India was to stem the flow of gold into the country. Post-war British policymakers had made the decision to return to the gold-standard at the pre-war peg (Eichengreen, 1999, p.57). However, the absorption of gold by both France and Germany meant that the Bank of England (BoE) was constantly "under the harrow" according to its interwar governor Montagu Norman (ibid, p.65). As gold flowed to other central banks, the BoE was forced to raise interest rates in order to attract gold into England. This policy of monetary contraction was particularly problematic in a post-war era where structural rigidities in the economy meant that unemployment was high (Feinstein et al. 2008: pp.10-20). Meanwhile, officials in India were becoming increasingly aware that Indian gold absorption rose during a global boom and fell during a slump (Balachandran, 1996: pp. 38-42). Thus since the global economy was experiencing an expansion around the time that Britain was attempting to restore convertibility, policy instruments which could stem the flow of gold from India became desirable. Balachandran quotes Viceroy Willingdon; "for the first time … Indians are disgorging gold … we have sent … to London in the past 2 or 3 months … £25,000,000 sterling and I hope the process will continue!" (1996, p.181). While Niemeyer[3] stated that if "more gold can be loosened… in India … or elsewhere … and sent to a place where it will … tend to come into the hands of monetary authorities, the better for everyone including India." (1996, p.182). As the graph below demonstrates, from just before 1925[4] Indian net gold imports fell substantially and India eventually became a net gold exporter. This continued right up until 1932 when Britain left the gold standard.

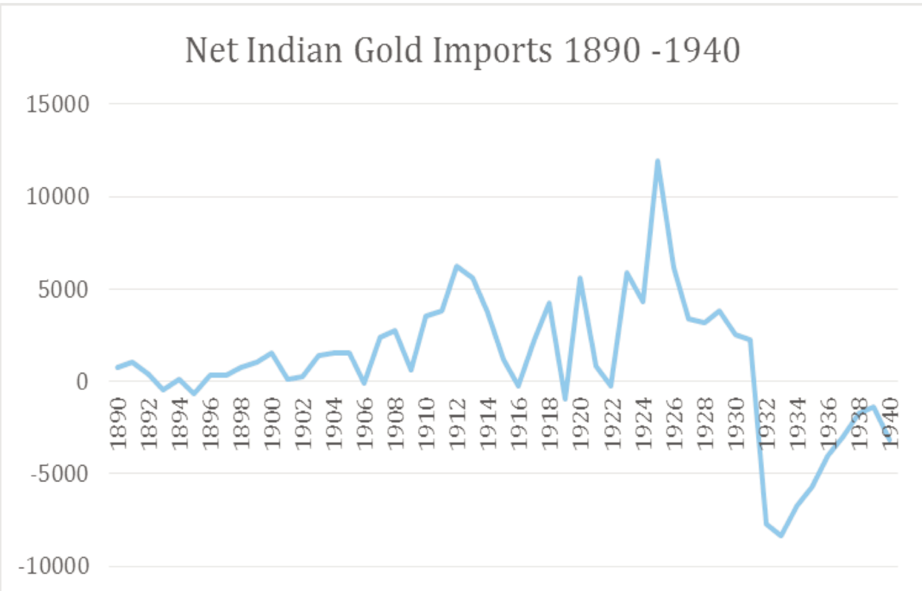

Figure 1: Reserve Bank of India 1954: p.970). Note: '000 standard ounces up to 1921 and '000 fine ounces thereafter.

3. An official at the BoE

4. When Britain returned to the Gold Standard

The exchange rate as an instrument for stemming the flow of gold; the Babington-Smith committee

In 1919 the world price of silver was rising. Since silver coin played a prominent role as a means of exchange in India, the intrinsic value of coin was rising, forcing the exchange rate to rise with it. The Babington-Smith committee was established to find an exchange rate to deal with the crisis. In his contributions to the committee, J.M. Keynes[5] advocated revaluing the rupee to 2 shillings (Rothermund 1993, p.77). Keynes' logic was that a high exchange rate would act as a bulwark against inflation. However if the "natural rate" continued to rise above 2 shillings, the peg should not follow it. Keynes reasoned that if silver became more valuable than the exchange rate, then some coin would be melted down and sold as bullion. This release of bullion onto the market would lower the price of silver causing it to fall back towards the exchange rate (ibid 1993, p.77). Thus, with Humean vigour, Keynes highlighted the self-adjusting nature of the price of silver. The majority report of the committee recommended that the rupee be pegged to gold at 2 shillings (so one gold pound sterling was equal to 10 rupees) justifying its decision on the basis of the need to protect the Indian economy from inflation. (Balachandran, 1996, p.83) The committee also recommended that a gold standard be set up in India (Tomlinson, 1979: p.69).

However, the IO persevered with an exchange rate of 2s 4d right until a dramatic fall in the price of silver forced it to change tact, while no attempt was made at establishing a gold standard in India. Why did the IO attempt to set such a high exchange rate, one which went far beyond the recommendations of the committee? One explanation could be Francis Lucas' evidence to proceedings where he pointed out that if India continued to demand more gold than the world could supply then the international trade and payments system would begin to breakdown. Lucas' solution was to encourage the use of silver in Indian monetary affairs (Balachandran 1993, pp.79-80). To make this possible, the government of India would fix the exchange rate at a level "high enough to offer parity valuation" which would enable the Indian government to offer up to $1.38 for an ounce of standard silver (ibid 1993, pp.79-80). Lucas viewed that a high price of the rupee against gold would encourage Western monetary agencies to sell silver to India (ibid 1993, pp.79-80). The high exchange rate preserved the role of silver as a token coin and would prevent India replacing silver with gold, something which would be contrary to the interests of the global economy. Furthermore, a revalued rupee would depress incomes in India and reduce demand for gold and possibly even encourage distress sales of gold; during the hearings, Gubbay confirmed that high prices strengthened the role of precious metals as a store of value (ibid, p.89). This emphasis on the importance of gold also explains why no gold standard was ever established. Viewed from this perspective, we can see that due

5. Considered an authority on Indian monetary affairs due largely to his celebrated publication "Indian Currency and Finance" (1913)

to a principal-agent problem, Indian monetary interests were placed second in line to those of the global payments system of which Britain played a key role.

The Exchange rate and trade

The downside of this policy was highlighted by the only Indian member of the committee, Dadiba Dalal, who protested that the exchange rate was too high and hurting Indian exports while stimulating British exports to India. (Rothermund 1993, p.77). Furthermore, the justification for using a high exchange rate to prevent inflation also seems unwarranted; while price inflation was clearly a problem in 1918-19 when prices rose faster than USA/UK prices, it was only 3 per cent in 1919-20 when the committee was in the middle of its deliberations; in the same year British prices rose by 20 per cent (Balachandran 1996, p.78).

At the Hilton-Young Commission[6], Sir Purushottamdas Thakurdas made a similar point to Dalal while advocating a 1s 4d rate. The Bombay cotton exporters had always advocated a cheap money policy as this would stimulate their exports and inflation which they figured would raise internal purchasing power (Rothermund 1993, p.78). Furthermore wages of workers in Bombay soared during the war and early post war years but had not fallen back in line with prices. Cotton producers argued for inflation to be used to lower real wages making the industry more competitive.

They also argued that if prices were too low that the burden of debt on agricultural classes was aggravated in a typical example of the debt deflation effect illustrated by Irving Fisher only a few years later (1931).

Growth of value of merchandise exports at constant prices (annual average rates)				
	1870 - 1913	1913 - 1929	1929 - 1950	1950 - 1973
Western Europe	3.23	0.21	-0.32	8.03
USA	4.86	3.33	1.68	6.27
USSR	N/A	-4.66	3.08	9.98
Latin America	3.4	3.89	1.46	4.1
China	2.59	2.9	0.06	2.74
India	**2.37**	**-1.02**	**-1.9**	**2.46**
World	3.35	0.89		7.88

Table 2:Value of Merchandise Exports

6. A currency commission created in 1925 to once again advise on the correct exchange rate for the rupee.

The chart above shows how merchandise exports declined dramatically during this period in India; more than any other region[7]. While there are any number of possible reasons for this, the figures add weight to the arguments of Indian exporters that the exchange rate was far too high and damaging their exports and the prospects of the Indian economy. If monetary policy was being formulated with the interests of the Indian economy in mind, then the exchange rate peg would most likely have been devalued.

The 'currency crisis' and the importance of debt repaymentsA

The events which occurred in the run up to Britain going off the Gold Standard are illustrative of the consequences of imperial monetary policy on the well-being of the Indian economy. In 1930, the world economy was heading into a deflationary spiral; there was a decline in demand for India's exports and there was a flight of capital from India; all of which put considerable pressure on the set exchange rate of 1s 6d. With the terms of trade turning against India, internal prices became depressed (Tomlinson, 1979b). At this point, a devaluation would have seemed a reasonable response, however such a move would require approval from London; in another illustration of the principal-agent problem, the main concern of London was payment of the home charges[8], all of which were paid for by Indian revenue raising and through sterling. Any rupee devaluation would make these obligations more expensive to pay. However with prices falling across the economy, and tax revenue falling with it, the Secretary of State for India was left with fewer and fewer options for meeting its obligations. To pay the debt due to London, the Secretary decided to remit money from the currency reserves; between April 1929 and March 1932 over £35 million of the debt was paid in this way[9]. The consequences of this was to contract the money supply in India which further lowered prices and raised the interest rate and so a vicious cycle was begun (Tomlinson, 1979b). Yet again, the Indian economy was being put to the sword so as to serve the interests of an agent with aims which had negative repercussions for the Indian economy.

Monetary policy and The Great Depression in India

This exchange rate policy continued into the Great Depression; the only devaluation respite came when sterling came off the Gold Standard and since the rupee was subsequently pegged to sterling at its previous rate, the real value of the currency had fallen. Yet despite that, during the great depression in India prices still fell by a factor of four or more (Roy 2011: p.98), while the table below demonstrates the dramatic fall in some of India's major export commodities.

7. With the exception of the USSR which decided to halt exports during the era for political reasons

Major Export Commodities (million rupees)							
	Raw cotton	Cotton Textiles	Raw jute	Jute products	Opium	Rice	Tea
1910 - 1919	349	136	184	330	53	217	161
1920 - 1929	692	116	493	493	20	309	260
1930 - 1939	327	46	274	274	NA	215	214

Table 3: Rothermund 1993: p.81

In contrast, Rothermund (1995: p.100) gives the example of Sweden; there the currency was devalued and no deflationary policy was pursued. Prices were stabilised by a constant money supply while the central bank provided credit to its banking system to maintain confidence in its credit system. Diaz Alejandro (1984) emphasises that many Latin American states adopted countercyclical policies to smooth the business cycle. Debt defaults, expansionary monetary policies and government works programs all helped stimulate domestic demand which as Bulmer-Thomas (2003) has pointed out, played a key role in allowing Latin American economies recover in the period 1932-39.

None of these options were available to the Indian government for reasons which have already been elaborated upon. Whether these policies would have been effective or not is a discussion for another day; the main point here is that these options were not even up for consideration to the Indian authorities due to the principal-agent problem.

Conclusion

This essay has demonstrated, by considering the pro-imperialism arguments, the important role of India in the international gold standard, the negative consequences of the high exchange rate for trade, the importance of Indian debt repayments in deciding monetary policy and finally, and the deflationary monetary policies pursued by the Indian authorities during the Great Depression in a comparative context, that monetary policy must be integrated into a wider narrative explaining the poor performance of the Indian economy during the interwar years. While Ferguson and other supporters of British economic policy in the colonies during the geriatric years of European imperialism have sought to explain the problems of the Indian economy using the 'bigger picture' approach of 'one-size-fits-all' development policies which sweep across vast swathes of time and space, this essay

8. The cost of running the IO and the current expenditure on the Indian military and civil service.

9. Approximately 1/3 of the total outstanding value of the debt according to Tomlinson (1979b)

has demonstrated the important role of short run government policy in explaining the poor performance of developing economies. This is an important lesson for development economists today as it reminds us that having multiple explanations is not necessarily a vice, that country and time specific examples are useful, that nuance is good and complexity important when we attempt to explain why some countries perform better than others.

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