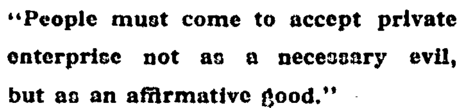
DEVALUATION OF THE RUPEE

CAUSES & CONSEQUENCES

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



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

—Eugene Black

DEVALUATION OF THE RUPEE

CAUSES & CONSEQUENCES

DEVALUATION BRINGS INDIA TO CROSSROADS*

BY

N. A. PALKHIVALA

The law of economics, which is no respecter of nations, had already devalued the rupee. This month the Government of India wisely and courageously faced the ineluctable reality and yielded with a grace to reason. Devaluation was desirable, inasmuch as **de jure** recognition of a longstanding **de facto** position is desirable. It was advisable in so far as international business, like internal trade, has a better chance of thriving under natural conditions than under artificially fixed rates.

However, devaluation can only lift India out of the quagmire in which the national economy had been floundering so long and put the nation at crossroads — the two roads which diverge in a wood. There ends the function of devaluation. It then depends upon the wisdom and character of the Government and of the people as to whether India will take the road of discipline, chosen by countries like France and Yugoslavia which have had an economic rebirth as a result of

---

**Based on a talk delivered under the auspices of the Forum of Free Enterprise in Bombay on June 27, 1966.*

devaluation, or whether India will take the road traversed by Indonesia which after devaluation found itself further enmeshed in the net of soaring prices.

No doubt, devaluation involves hardships — the hardship of the unceasing responsibility of every citizen not to lose sight of the larger national interest, and the hardship of the prime responsibility of the Government to see to it that it profits by its past mistakes and creates the conditions in which citizens' enterprise and work can yield the most fruitful results.

The United States has helped India to the extent of Rs. 3,000 crores during the last three Plans, as against Rs. 600 crores contributed by the rest of the world. There are 77 under-developed countries, but the aid given to India by the United States constitutes 18% of its total assistance to under-developed countries and is more than double the assistance it has given to any other country of the world. Likewise, India is by far the largest debtor of the World Bank, the assistance from the World Bank being in the amount of $ 735 million. That these creditors would favour devaluation is natural and understandable. But for India to put the blame squarely on the shoulders of the United States and the World Bank for devaluation shows that in spite of our economic distress we have not lost our sense of humour.

The task facing the country now is not to go into the causes of devaluation or to indulge in an exercise in ratiocination concerning the pros and cons of devaluation. The decision has been made — it is as irrevocable as a haircut. The task before the Government and the nation is now to concentrate on the measures which are essential to make the nation get the optimum benefits out of devaluation while reducing its disadvantages to the minimum:—

First, the private sector must hold the priceline as far as possible, even at the cost of making a dent in their existing profit margins.

Secondly, the highest priority should now be given to price stability. The physical targets of the Fourth Plan are much less important than the necessity of containing prices so that the rate of inflation does not exceed 6% per annum instead of the annual 15% inflation which has been witnessed during the last two years. We shall search in vain for a wiser maxim than that of Professor Colin Clark: "The economist or politician who offers to trade away price stability for an expected higher rate of economic growth may end up by finding that he has lost both."

Thirdly, production must be increased by freeing the economy from the heavy hand of the bureaucrats with their pen-and-pencil armies and permit-licence armouries. Stifling controls are the main cause of the stagnation in production. It is necessary to recall the finding of the Economic and Scientific Research Foundation that the rate of economic growth in India is the lowest in Asia, barring Indonesia. Workers must put extra effort before extra leisure and the Government must put consolidation before growthmanship. An exhortation to manufacturers and traders to hold the priceline is less important than vigorous and realistic steps to increase production: it is easier to increase the national product than to change the national character.

Fourthly, the people will have gone through the trials and tribulations following in the wake of devaluation in vain if the Central and State Governments do not give up their habit of living and planning beyond our means. Last year's deficit financing was to the extent of Rs. 435 crores!

Fifthly, the public sector with its Rs. 2,000 crore investment must be compelled to show good results. The present average return in the 60 Corporations in the public sector is 0.6% and even in the profitable running concerns the average return is only 3.6%. Hard economic realities and not soft ideological words must dictate further investments in the public sector.

Sixthly, the newly added surcharge of 10% on individuals and on companies should be removed. Then alone will industry be able to meet the higher cost entailed by devaluation. It is further imperative that depreciation should be allowed on fixed assets in respect of the additional amounts now required to repay foreign loans or unpaid prices.

Seventhly, the export drive must be intensified. Frequent changes in export duty are disastrous to our export trade. Those commodities whose exports used to secure more than 40% import entitlements would still be in need of assistance if the exports are even to be maintained at the present level.

DEVALUATION POINTS UP THE NEED FOR DISCIPLINE

BY

S. M.*

The country has not taken the devaluation as badly as those who, with the approach of the elections have begun working overtime to squeeze the utmost propaganda advantage from every decision of the Government would have us believe.

This is not to deny the uneasiness which prevails in certain Congress circles at the highest level. One Cabinet Minister, for example, warned Mrs. Gandhi that if she tried to push devaluation through she would have to get herself a new Cabinet. Mr. Kamaraj's own reservations have been well advertised but nothing like a revolt of any size has materialized and the Minister who forecast an orgy of resignations from the Cabinet has not allowed his own strong feelings to get the better of his instinct for survival.

* *The author is a well-known columnist.*

The essence of the opposition to devaluation is, of course, that it was imposed by foreign pressure. That there was pressure need not be denied. But the International Monetary Fund, from which it came was created precisely for regulating and giving advice on the par values of the currencies of its member-countries and has used such pressure as its authority gives it to get several other member-countries to accept measures of fiscal discipline. The only point to consider for any country under "pressure" from the IMF is whether the advice is in its own interest.

Presumably, the Government of India came to the decision that it was. No doubt its decision was influenced by the fact that selective devaluation had been already in operation in our export dealings for several years. Mr. Manubhai Shah, whom Press reports credit with a last-ditch stand within the Cabinet for the prestige of the rupee, was responsible oddly enough for the creation of an elaborate system of export incentives based on the recognition that the rupee was grossly overvalued.

We have thus been living with devaluation of a kind without securing the manifest benefits of making it official. For so long as the rupee's official value reflected far less than the true worth of foreign exchange, it was bound to be cheaper to buy abroad than to look for substitutes at home. The crippling effect this has had on domestic initiative to invent and to improvise in the industrial field has amounted to official discouragement of that policy of self-reliance that nobody is ever tired of preaching.

Other results of the overvalued rupee are the premium on smuggling and the drying up through normal banking channels of remittances home from Indians abroad. Naturally, there are disadvantages in devaluation such as the higher rupee cost of debt servicing and repayments but the struggle to maintain these advantages by an artificially valued rupee is on balance too heavy a price to pay for continued fiscal untidiness of

a sort which perpetuates the very distortions in the economy which in the first place were responsible for undermining the value of the rupee.

But devaluation can only offer a short-term corrective to those distortions and create the necessary climate for putting our economic house in order. It is not in itself a remedy unless accompanied by the long neglected disciplines of good management.

The first of these disciplines is that the Government cannot continue to take a share of the national cake larger than the proportionate increase in the gross national product. Whether the Government expenditure is a net increase through taxation or the conjuring up of non-existent resources through deficit financing, the result will be the same—pressure on costs leading to higher prices and a consequent deterioration of the ability to compete in foreign markets. If the Government at the Centre is ready to exercise restraint on its own spending and that of the States, it has not given very convincing evidence of it.

Secondly, the Government must abandon all measures which tend to restrict production. In the long term, the only answer to price stability is the elimination of shortages and a return to the self-regulating mechanism of market preference.

Thirdly, the first emphasis now must be to get the maximum out of installed capacities before locking up scarce resources in laying down new capacities though it may be accepted that there must be exceptions to this rule like power, fertilizers, steel, cement etc.

Fourthly, the Plan must wait at least for a year to be given a precise frame. The exercise of planning now is very much like whistling in the dark to keep up our spirits. The economic data on which to base future growth in the context of the lessons we have learnt from past failures will not be available for proper assessment for at least six months, probably longer. We must wait, for instance, to see how we come out of

the annual gamble with the monsoon and how much fertilizers and improved seeds have contributed by way of larger yields of food and cash crops.

We must also wait to see to what extent industrial output picks up with the promised liberalization of the imports of raw materials and maintenance spares.

It is only in the light of this knowledge that we can talk of the size of the Plan and the order of priorities that will best serve the immediate needs of pulling out of the present crisis.

The first need that devaluation imposes on us then is to restore some degree of stability to the economy and to discipline costs and prices. To attempt to draft a detailed Plan until this is done is not only a foolish exercise but is bound to involve us in fresh crises.

But some kind of a Plan frame will be needed for the forthcoming aid discussions with the World Bank. The obvious way out is to concentrate now on the national or the Central Plan and to postpone consideration of the projects at the State level. To persuade the States to do this will not be easy, but then this is exactly the kind of test that devaluation asks of the willingness in the political leadership to practise discipline and to enforce it. If that willingness is lacking, we have further devaluation of the rupee in store.

From this point of view, the proposal for separating the election to the Central and State legislatures, though now out of court, had much to commend it. A Central leadership which has secured the mandate of the people by its own exertions unaided by State parties would have a far better leverage against State Governments than in the electoral system now obtaining.

In any case, I am appalled to see the total ignorance of the parliamentary tradition that the critics of the earlier election proposal manifested. A Parliamentary government is not elected for a fixed term.

There is a limit on its term beyond which it cannot go but within the term a parliamentary government has the right to decide when it is convenient and profitable for it to seek a fresh mandate from the people.

In years to come we shall doubtless get unstable State Governments which will not last out the full five-year course. I do not see how such States can fall into the pattern of simultaneous countrywide elections. There is thus nothing extraordinary or improper in the upsetting of the pattern.

(Reproduced from "Hindustan Times" of June 22, 1966, with kind permission of the Editor.)

WHAT IS DEVALUATION?

BY

DR. KERSI D. DOODHA*

There is a considerable amount of confusion on devaluation. The general impression is that when one devalues one's currency, it affects the value of the currency both at home and abroad. Many people in our country unhesitatingly talk that the rupee has lost its purchasing power by 36.5 per cent. Or that the rupee after June 6, 1966, commands a real value which is equivalent to 63.5 paise.

This, of course, is a false notion of devaluation. When we devalue, what we in practice do is to bring about an equilibrium between the internal prices of goods and services, and those prevailing in foreign markets. The restoration of this equilibrium is desirable only when the balance of payments is showing signs of a fundamental disequilibrium. The notion of "a fundamental disequilibrium in the balance of payments" is the one that has been popularised by the International Monetary Fund in Article I of its Articles of Agreement. Though the Fund has never defined it,

---

* *The author is an economist in a commercial bank.*

a fundamental disequilibrium is said to have arisen when a country continues to experience a deficit on its basic international payments account and has increasingly to rely on foreign assistance to bridge the gap. Further, it may have recourse to measures which indirectly seek to promote exports and to reduce imports. The Fund would further argue that a fundamental disequilibrium has arisen, when a country which has borrowed from it is not in a position to repay the loan over a given period. Normally, the Fund has fixed a period of 3 years during which temporary disturbances in the balance of payments of a country should be set right. Since it is opposed to the adoption of restrictive measures, as they adversely affect international trade, it provides temporary lines of credit in requisite amounts. The member country in its turn is obliged as soon as the factor of a temporary disturbance has been overcome, to repay the credit by repurchasing its currency from the Fund.

Let us see what constitutes a temporary disequilibrium. For instance, one might say that a failure of monsoon in a given year would, other things being equal, lead to a disequilibrium between the forces of demand and supply of food. As a temporary palliative, therefore, a country might have to import foodgrains in quantities larger than it did prior to this natural calamity. Under the circumstances, it goes without saying that if total imports other than of food are not to be reduced, then a credit arrangement has to be made to import more foodgrains. For this temporary loan, a country can have recourse to the International Monetary Fund. Further, assuming in the following year that all goes well, and if food output once again rebounds to a relatively normal level of production, then the country no longer has to borrow in order to finance surplus imports of foodgrains, because these are no longer required. On the other hand, it may very well turn out, that this country having experienced an average period of prosperity, may seek to increase its exports to foreign countries. These higher

export earnings in their turn may be employed to repurchase its currency from the International Monetary Fund.

However, when a country borrows continuously from the Fund under the various arrangements that have been made by that body purely for the purpose of technically meeting the requirements of genuine borrowers, its intentions became suspect. Doubts are strengthened when inspite of these borrowings, the balance of payments does not reveal an equilibrium position. In that case, we may rightly assert that there is something definitely wrong with the management of that economy. Moreover, this suspicion is reinforced when one notes that repurchases in subsequent years are made repeatedly through renewals, so that repayments are not genuine but pure book-keeping entries. Such developments are thus presumed to have caused a fundamental disequilibrium.

Speaking in regard to the dollar, Harry G. Johnson has defined a fundamental disequilibrium as "the persistence of a substantial deficit for over five years, coexistent with an otherwise undesirably high level of unemployment and inspite of the battery of interventionist policies adopted to cope with it, and given also the variety of evidence that the competitive position of the United States has deteriorated." In such a case, the International Monetary Fund advises the member to bring about an equilibrium in the balance of payments through a change in the par value of its currency. If such a desired change either in the sense of an increase or a decrease in the value of one's currency is cumulatively undertaken up to 10 per cent over a period of years, then the Fund is merely to be informed about these changes and may not be consulted beforehand. However, should the warranted change in the par value exceed the cumulative change of over 10 per cent, then not only is that country advised by the Fund to alter its par value, but the rule

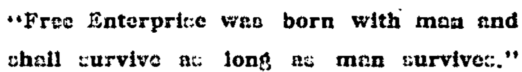
further demands that a notice of 72 hours be given to the Fund before any such change may be instituted.

The purpose in giving this orthodox advise of changing the par value is rooted in the conservative policy pursued by the Fund. It is normally assumed that inflationary conditions within a country are primarily responsible for the decline in exports, because the goods and services which that country could export are now priced out of the international markets. On the other hand, the very fact that prices have risen within the country, indicates that now it is cheaper to import from outside, rather than produce more quantity of goods and services within the country. Inflation, therefore, cuts two ways. It reduces exports and causes an encouragement of imports. In order, therefore, to avoid this excessive imports, it reduces the value of its currency in foreign markets, meaning thereby that now in terms of a foreign monetary unit the goods offered in the international market by a devaluing country are cheapened. Further, a unit of foreign currency after devaluation commands a larger value of the domestic currency than before. The cheapening of domestic goods, other things being equal, leads to an increase in exports because international buyers now find that their real purchasing power **vis a vis** the devalued currency has increased considerably. By the same token, when devaluation is undertaken, the import value of the goods rises so that we now have to pay more of our currency units per unit of import value formerly done. When the cost of imports rises, in terms of the law of demand and supply, some people will now find it dearer to import more than before. They will, therefore, cut their import requirements. A rise in exports and a cut in imports thus enables the devaluing country to bring about an equilibrium in its international payments position.

It may be observed that since the change in the par value of one's currency merely restores the monetary equilibrium, there is no change whatsoever in the

relative prices of the goods and services produced within the country except in these industries which rely upon imported items. The success of devaluation naturally depends upon the presence or absence of several conditions in the devaluing country. First of all, items entering into exports should be demand elastic, so that a fall in their prices would lead to a growth in their volume of exports. Second, the exportable items, traditional as well as newly added, should be available in sufficient quantities, so that their higher exports will not adversely affect their supplies within the country. Third, the supply situation further should be elastic because the higher demand for exports should be balanced against supplies coming from within the country. Otherwise, the totality of supplies within the system will go down and hence prices are likely to rise further. Fourth, the supply structure should be capable of generating substitutes for products that are currently being exported away. If the elasticity of substitution is zero, then once again there will be a pressure on prices. Finally, devaluation has to be undertaken in a climate of stable prices, for if inflationary conditions prevail, then the **expectation** of rising prices will neutralise the benefits of the measure.

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.



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

— A. D. Shroff

Have you joined the Forum?

The Forum of Free Enterprise is a non-political organisation, started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions, and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual membership fee is Rs. 10/- and Associate Membership fee is Rs. 5/- only. **Bona fide** students can get our booklets and leaflets by becoming Student Associates on payment of Rs. 2/- only.

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box No. 48-A, Bombay-1.

Published by M. R. PAI for the Forum of Free Enterprise, "Sohrab House", 235, Dr. Dadabhai Naoroji Road, Bombay-1, and printed by H. NARAYAN RAO at H. R. MOHAN & CO. (PRESS). 9-B, Cawasjee Patel Street, Bombay-1.

11/July/1966