INDIAN ECONOMIC CRISES

A Programme of Reform

PROF. B. R. SHENOY

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

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by

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PREFACE

The Indian economy is being helplessly squeezed by multiple economic crises—unending price inflation; persisting resources shortages and Budget deficits; balance of payments difficulties, which defy solution; failure of exports to move despite the manifold export-promotion incentives; drying up of liquid funds and fantastic interest rates with the capital market in a state of near paralysis; inadequacy of supplies to keep the wheels of production going; excess production capacities and threatened closures of production units; semi-stagnant agricultural production and continued dependence on heavy food imports; rising unemployment, especially in the sophisticated economic sectors; unforeseen and unmerited abundance to a thin upper crust of society in the context of growing mass indigence, which has spread to the erstwhile prosperous salaried middle classes; and increasing social and political tensions and instabilities.

It is most dangerous to blame all this, as we have been doing, on a succession of two bad monsoons, the treacherous Chinese attack on our northern frontiers and the three weeks of Indo-Pakistan war. This may

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* *Prof. Shenoy, eminent economist, is Director of the School of Social Sciences, Gujarat University, Ahmedabad. This booklet is based on a series of articles published in "Swarajya", Madras, and published with grateful thanks to the Editor.*

engender the belief that there is nothing basically wrong with the economy. The roots of the multiple crises go deeper and, chronologically, date well beyond these misfortunes, though they have, doubtless, added to our difficulties. The crises are the outcome of our own policies of the past 1½ decades.

Poverty is not insolvency. A poor people can remain a proud people. Inflationary finance and abject dependence on foreign aid, which bespeak of insolvency, are outcome of mismanagement; not poverty. Even a rich people may head for insolvency under continued mismanagement.

The theme of the following pages is that the prime factors operating behind most of our major economic ailments have been price acceleration, import licensing and other economic controls; and that inflationary finance has been the tap root of them all. Our analysis demonstrates, too, that, in recent years, inflationary finance has ensued wholly from the U.S. Embassy disbursements of PL 480 rupees with it. These rupees are but paper funds. The physical resources behind them, PL 480 foodgrains, have been all consumed; and their sale proceeds have been used up in Capital Budget payments. Drafts on these rupees must be, therefore, inflationary, though the government of India and USAID experts in New Delhi may refuse to own up the guilt.

It follows that the most essential first step, to redeem the economy from the prevailing chaos, is to put a stop to inflation. This demands that PL 480 deficit financing must cease forthwith. Though the 1966 amendment to Public Law 480 (which provides for dollar payments for PL 480 foodgrains) would achieve it, this amendment would come into full effect only in 1971. In the meanwhile, the PL 480 rupees with the U.S. Embassy, which have piled up to Rs. 744 crores, must be immobilised; preferably written off, as advocated by an American economist.

The second most essential reform is to abolish import licensing. This will remove the major cause of the colossal anti-social income shifts. A pre-condition for this reform is to replace the present arrangement of two prices for foreign exchange, an official price and a free-market price, by a single price which measures the real worth foreign exchange.

Experience elsewhere has demonstrated that these measures of monetary reform alone may help considerably to clear the mess and usher in accelerated progress. As economic growth is a function of the most effective investment of savings (including foreign aid), the economy may get a further push forward if our policies are oriented to stimulate the flow of savings and to ensure the most fruitful investment of resources. This will call for drastic cuts in taxation; matching cuts in government expenditures; denationalisation of Public Sector enterprises; and removal of economic controls, which clog the springs of production or obstruct the flow of output.

Two powerful factors stand in the way of the adoption of these reforms. First, the gains in money and power, which the prevailing policies yield in such overflowing abundance to the politicians and to administrators, may virtually vanish under the policies outlined above. Import licensing, in particular, is a veritable gold mine. It is exceedingly hard to let go the hold over it. Secondly, if the present policies must necessarily produce balance of payments difficulties, the Aid-India Consortium may be always relied on to bail us out. Having so heavily under-written Indian economic policies financially, U.S.A. cannot now disown its share of responsibility for the chaos, which these policies have produced. If aid must really aid economic development through the most-effective capital formation from aid funds, government-to-government aid must be replaced by the flow of capital through the capital markets of the aid-giving countries.

Ahmedabad

B. R. SHENOY

I

ANTI-SOCIAL INCOME SHIFTS

The biggest single problem confronting us, today, is the ruthless and also the colossal pace of income shifts from the already indigent masses, the lower ranks of office-workers and the erstwhile prosperous salaried middle classes, into the pockets of a vastly better-to-do minority. Large numbers of the latter receive, from these income shifts, windfalls of unmerited and unforeseen abundance. This is the root explanation of the *asuric* phenomenon of a steep rise in luxury living among the privileged upper-crust of the community,in the context of continued and growing mass misery. The more striking manifestations of this phenomenon include, at one end, the flaunting of income and wealth by the few, the enormous increase in status-symbol possessions and consumption, the overcrowding of holiday resorts and of expensive hotels, and the capacity loads of air-conditioned coaches and jet planes, spanning the land; and, at the other end, the forgone subsistence wants or accustomed conventional comforts of millions of families, harassed by the rising cost of living.

Affluent living from earned incomes, i.e., incomes representing a legitimate share of one's contribution to the Indian national product, need not necessarily make for social or political unsettlement. For *ipso facto,* such affluence would have for its counterpart more than proportionate additions to the incomes of the rest of the community. Affluence of this category is not robbery but co-sharing. The entrepreneurs would retain from the newly created incomes, say 15 to 20 per cent; and their collaborators, workers, farmers and the rest, would be paid 80 to 85 per cent.

It is basically different with much of the growing opulence which strikes the eye all around us today, more

generally in the urban areas and, in lesser measure, in the rural areas. This opulence is fed, almost wholly, by the anti-social income transfers referred to above. Quite naturally, in a social background in which the masses have been, traditionally, on the margin of subsistence, perverse income transfers, on any appreciable scale, must add to family budget pressures on a wide front and before long assume explosive dimensions.

These family budget pressures are doubtless a prime driving force behind Naxalbari, Gheraos, *Bundhs,* Dharnas, other manifestations of social tensions and instabilities now stalking the land. Political parties and professional agitators organising these phenomena are but immediate agents taking advantage of this inner human unrest, to serve their own personal or party ends. Not until these income shifts are stopped and everyone's income represents but an honest measure of his contribution to the Indian national product, may we reasonably look for social and political peace, an indispensable background for continued economic growth. Tear-gas bombs and President's rule are not lasting solutions of this problem. So long as the inner turmoil remains unrelieved, the outbursts may keep repeating.

The major instruments of these income transfers are price acceleration and—strange as it may seem—import licensing and other economic controls. These instruments have all sprung from, or are occasioned by, inflationary finance. The link between inflation and price acceleration functions as a lever of income transfers.

Price acceleration reduces the real incomes of wage-earners and salaried people, the largest bulk of the population; the counterpart of this income reduction is, first, the real resources acquired by the Government against created moneys and, secondly, the larger money receipts and real incomes which price acceleration brings to traders, businessmen and industrialists—a small fraction of the community. It is difficult to assess the quantum of

the total incomes which the masses are thus deprived of, involuntarily; but it must have some relationship to the amounts of the Budget deficits, which averaged Rs. 268 crores during the past 11 years.

The logical link between inflation and import licensing, and the way that import licences shift incomes are less obvious. Briefly, created moneys inflate money incomes. The larger money incomes, on the other hand, eat into potential exports and reduce the volume of exports; and, on the other, add to the demand for import goods. Reduced exports and larger imports upset the balance of payments position and accentuate foreign exchange scarcities. As a "remedy" to the latter, we impose more stringent import restrictions. This drives up the market prices of import licences.

The market prices of Private Sector import licences alone may be, currently, of an annual order of Rs. 550 crores. These large sums accrue to the beneficiaries of import licences, people in the upper-income groups; and they come out of the pockets of the users of import goods. Every time we purchase a commodity in the market with an import content, we perforce contribute to the unmerited affluence of the beneficiaries of import licences; and most commodities today have an import content, large or small. It follows that, whilst inflation continues, import licensing and the de-stabilising income shifts on a colossal scale must continue, too.

Other economic controls, which produce income shifts, include price controls and controls over the allocation and movement of foodgrains, oils and oilseeds and other essential supplies. These controls stem from inflation, being the "defences", which economic administrators put up in the belief that they may "protect" the community from the full impact of inflation. But they really give rise to corrupt incomes and unmerited monopoly gains to people in the upper-income groups, though some in the lower-income brackets may share as well these ill-gotten gains.

It is not anti-social income shifts alone that have emerged from inflation. Inflation is the tap-root of most of our major economic ailments. That foreign exchange scarcity, which is perhaps the worst of these ailments, springs from inflation is easily seen. Continuing inflation necessarily drives up the market prices of foreign exchange as it must of commodities in general. But under the influence of false theories, we refuse to recognise this price rise and insist in selling foreign exchange at a level fantastically below its market worth.

Quite naturally, the demand for the under-priced commodity, foreign exchange, exceeds the available supply of it. There is no solution to this self-created problem other than, first, to put a stop to inflation and, secondly, to charge the market price for foreign exchange. Import restrictions, exchange controls and allied measures, of which we have become so fond, are but quack remedies. Both logic and experience have demonstrated that, once the market in foreign exchange is released from the hamstrings of controls and official directives and it starts operations under the banner of freedom and truth, the recalcitrant balance of payments deficits may soon become a myth of the past.

Two powerful factors stand in the way of this logic and experience carrying conviction with those in power. First, import licensing is a veritable Alladin's lamp that brings unforeseen wealth on press-button effort; and the disposal of these titles to easy money, for which claimants are unlimited, brings power to the politicians of the party in office and other functionaries of the State. Secondly, the persisting balance of payments deficits are continually made good by the Aid-India Consortium. Though our balance of payments difficulties are the result of the divergence between the official and free-market prices of foreign exchange, they are "sold" to the members of the Consortium as being the outcome of "developmental" deficits in payments; and, apparently, the experts of the Consortium have no difficulty in accepting this description

of the deficits. If U.S. generosity had not kept on covering up the damage caused by misguided policies, the weight of this damage might have, in due course, compelled the adoption of more sensible policy measures.

We live in an age of breath-taking discoveries and progress in physical sciences, technology and medicine. But in economics we seem to be moving backward, as witness economists and administrators arguing in chorus that inflation is inevitable if we must have economic progress, and that import restrictions, exchange controls and dishonest pricing of foreign exchange are essential instrumentations for such progress—as though economic growth were a disease, not a healthful and invigorating enterprise.

II

IMPORTANCE OF ZERO INFLATION

In the foregoing discussion we saw that inflation was the tap-root of the perverse income shifts and of the recalcitrant balance of payments difficulties. Certain other ill-effects of inflation merit attention, too.

Physical restrictions on imports, one of the inflation-caused "defences" put up by economic administrators, denude the home market of import goods and drive up their prices. The more drastic the import cuts, the higher will be the price rise. This artificial rise in the prices of import goods has rendered profitable the establishment or expansion, at home, of industries to produce substitutes for the import goods concerned. Home production of these import substitutes would be uneconomic, in the absence of the artificial price rise. Much of the feverish industrial activity of the past two decades owes its origin to this factor.

The artificially induced acceleration of industrial production has involved mis-direction of investment resources—raw materials, labour capital and talent—on a

massive scale into the fabrication of high-cost and shoddy manufactures, to the comparative neglect, even starvation, of more productive traditional industries, especially agriculture and the mill sector of cotton textiles.

We may find it difficult to acknowledge readily the economic damage of this arrangement, as our thinking is vitiated by the mercantilist fallacy that, by producing import substitutes at home, we "save" equivalent foreign exchange. Import substitution may be, indeed, most welcome if it came naturally as part of the process of economic development. Pressurised import substitution may retard economic growth through resource wastages.

We have been forcibly diverting into indiscriminate industrialisation and into the so-called infrastructure industries an order of three-fourths of our investment resources. An abandonment of physical restrictions on imports and of the other artificial stimulants to uneconomic industries would, therefore, release significant amounts of capital and resources for use in agriculture and the traditional industries, where the additions to the national product for the same quantum of investment would be much larger than in the new industries. Indian national income might, then, very well increase at an annual rate of 8-10 per cent; and we might have, in addition, natural import substitution, too. By contrast, during the five years ending 1965-66, though we have had a great deal of import substitution, the actual rate of increase in the Indian national product has been about three per cent per annum.

Nor has import substitution at such tremendous cost helped to correct the balance of payments disequilibrium. Since, as we have seen, the latter results from inflation and currency over-valuation, so long as inflation continued and we fail to correct currency over-valuation, balance of payments disequlibrium may continue, too, aggressive import substitution or no. Persisting inflation and currency overvaluation have deeply eroded our ex-

ternal payments position such that we are compelled to cut the imports of plant replacements and materials, so essential to keep the economy going; and, despite the rigour of import curbs, we have to rely on foreign aid, more than ever, to take us out of the balance of payments mess.

Currency over-valuation, the result of inflation, has also led to considerable capital wastages through over-capitalisation, i.e., a more liberal building-up of block capital and labour-saving machinery than might happen ordinarily or would be socially justifiable from the employment standpoint. The rupee cost of machinery worth $ 10 million, at the official exchange rate, was Rs. 4.76 crores before June 1966, and is Rs. 7.50 crores today; at the free market rate, the same machinery would be worth currently about Rs. 10.09 crores. The incidence of interest and capital depreciation on a unit of output would correspondingly contrast under the three exchange rates. The free rate might compel capital economy; and over-capitalisation under it would be small or nil. The inducement to over-capitalise would be higher under the old official rate than under the present one. Militant trade unionism, itself fed by price inflation, has added to this tendency to over-capitalise.

Until so recently as March 1961, the confirmed official view was that some inflation was, to quote the *"Economic Survey,* 1960-61", "the very condition of economic advance" (p. 17). If we must have the latter, so the official experts argued, we must be prepared to suffer the former too. Latterly, however, Budget speeches have been reiterating the need to avoid inflation. In February 1965, the Finance Minister affirmed that "deficit financing" in all forms must be "necessarily reduced, and indeed eliminated". In the following year, he spoke of keeping "to our resolve of avoiding deficit financing". In March 1967, he was "determined to pursue sound financial policies"; and, in May of the same year, presenting the final Budget for 1967-68, he promised "to limit the outlay of

the Central Government strictly within the resources which can be mobilised in a non-inflationary manner".

This is a most-welcome forward step on the plane of ideas. But performance contrasts with precepts. Budget deficits of the past five years, which averaged Rs. 260 crores a year, were higher than the annual average deficit (Rs. 237 crores) of the preceding four years. In the first half of 1967-68 fiscal year, the Budget deficit, as measured by Government borrowings from the Reserve Bank and commercial banks, amounted to Rs. 135 crores. In the first half of the preceding two years, these borrowings averaged Rs. 130 crores.

Continued deficit financing at a high level is reflected in the data on price inflation. During the three years ending 1966-67, money supply rose by Rs. 1,202 crores, or by 32 per cent; and prices by 46 per cent, or by 15.3 per cent a year. This is a near-record rate of increase in the recent history of price inflation in India, this rate having been exceeded only in the early years of World War II. In the first half of 1967-68 fiscal year, prices rose by 9.5 per cent, or at a faster pace than during the corresponding periods of the preceding two years. This is a matter for serious concern, as prices have risen by over 100 per cent during the past decade and a half and are 8.4 times pre-war prices.

The decline in the General Index of prices by 3.4 per cent during the month ending 11 November 1967 seems to reflect the working of seasonal factors; it is not evidence of any basic improvement on the fiscal front, though official pronouncements seem to read too much into this price decline. The forecast, dated 5 December 1967, presented by the Finance Minister to the Consultative Committee of MPs for the Ministry of Finance, is that, contrary to the brave assurances of the Budget speeches of last March and May, deficit financing during the current year is "unavoidable". With expenditures remaining at a high level, the quantum of budget support from foreign

aid uncertain, and the anticipated shortfalls in Customs and Excise duties, the year may end, possibly, with a near-record Budget deficit.

It is difficult to think of a more tragic contrast between, on the one hand, our doings and, on the other, our policy precepts and the needs of the situation. If we must put out of action the pernicious levers of income transfers—price acceleration, import licensing and other measures of economic control—and redeem the economy from its dismal state, fiscal measures to ensure zero inflation must receive top priority. Other measures of reform may not produce any appreciable impact without this essential first step. Possibly, the alternative may be the demise of democracy.

III

PL 480 INFLATION

PL 480 finance has been a subject of sharp controversy since about January 1961. One view, held by the present writer, among others, is that the prevailing arrangement of outright payment in rupees for PL 480 foodgrains necessarily involves inflation. Even the non—PL 480 part of our Budget has been in deficit, the amount of this deficit, during the 11 years ending 1966-67, being Rs. 1,277 crores. Obviously, therefore, payments for PL 480 foodgrains are made in created moneys. As these moneys finance expenditures, under one head or another, they expand the monetary circulation as created moneys must.

The Reserve Bank of India, the Ministry of Finance and the USAID, New Delhi, hold the opposite view. The Reserve Bank experts assert that, under certain circumstances, PL 480 finance may be even deflationary! The Ministry of Finance and USAID, on the other hand, wish to maintain that the monetary impact of PL 480 finance is mostly neutral; and that, if PL 480 operations give rise to any net issues of inflationary moneys, this may apply only to the comparatively small amounts of U.S. uses of PL 480 rupees.

As the two views conflict head on, one of them must be incorrect. Exponents of both views agree that the monetary impact of PL 480 operations is not a matter of value judgment but severely one of accounting and economic analysis. This raises the hope of a successful resolution of the controversy.

The recent Seminar in New Delhi, organised by the Economics Research Centre, failed to arrive at an agreed answer to the question of whether PL 480 finance was inflationary. But it helped to define the core of the controversy: all were agreed that, if aggregate Budget receipts (and disbursements) from PL 480 operations amounted to simply the sale proceeds of PL 480 foodgrains, PL 480 finance was non-inflationary. The use of these sale proceeds to meet Government's bills would then but restore into circulation the moneys taken out of the pockets of the people in exchange for foodgrains. The monetary impact of the operation would be neutral.

If, on the other hand, aggregate Budget receipts (and disbursements) from PL 480 operations exceed the sale proceeds of PL 480 foodgrains, Budget outlays would not only restore into circulation the moneys taken out of the pockets of the people, against the sales of PL 480 foodgrains; these outlays would add to the monetary circulation an amount equal to the excess Budget receipts, i.e., the sum of PL 480 loans and grants. The net impact of these operations would be inflationary.

We shall now proceed to examine the evidence on whether Budget receipts from PL 480 finance are simply equal to the sale proceeds of PL 480 fodgrains, or are larger than this sum. Drawing our data from the *"Explanatory Memorandum on the Central Budget for* 1967-68" (p. 64) and from the papers presented to the New Delhi Seminar by the Ministry of Finance and USAID, we find that Budget receipts from PL 480 finance, in 1967-68, are as under:

(Crores of Rs.)

(1) Receipts from special securities, representing PL 480 imports, which remain-

	ed outstanding with the U.S. Embassy, as at the close of the year ...	135.00
(2)	Receipts from special securities, representing PL 480 imports, which were converted into PL 480 loans, during the year ...	150.00
(3)	Cheques received from the U.S. Embassy on account of PL 480 loans, during the year ...	150.00
	Total ...	435.00

It will not be disputed that the entire PL 480 receipts are disbursed into circulation. This is obvious from the fact that the Cash Balances of Government remained unchanged at Rs. 50.54 crores as between the beginning and the end of the year. Clearly, every *paisa* of Budget receipts during the year 1967-68 was issued into circulation, as, otherwise, the Cash Balances at the end of the year would have differed from that at the beginning of the year. As PL 480 foodgrain imports in 1967-68 are placed at Rs. 285 crores, PL 480 Budget receipts and disbursements (Rs. 435 crores) exceeded Budget support from these imports by Rs. 150 crores, the amount of PL 480 loans. It follows that PL 480 finance involved a net expansion of money by this sum. This is conclusive evidence that PL 480 finance is inflationary by the amount of the drafts on special securities.

It is unnecessary to proceed further before entering the conventional *quod erat demonstrandum* on our exercise. If official economists and technicians wish to object to this QED, the discussion should be on the third item of Budget receipts listed above, the first two items being non-controversial. The receipt of PL 480 loan cheques from the U.S. Embassy cannot be denied any more. The USAID paper, presented to the New Delhi Seminar by Dr. Samuel A. Costanzo, has stated that PL 480 loans and grants are made by cheques drawn on the U.S. Embassy account with the Reserve Bank. To maintain that PL 480 finance is non-inflationary they have to establish that these cheques

are torn, burnt or otherwise destroyed; and that they do not figure at all in Budget receipts. And to maintain that drafts on Rs. 744 crores of PL 480 rupees, now with the U.S. Embassy, are not inflationary, they have to prove in addition that these rupees are not money but a variant of monetary *Maya*.

When the amount of PL 480 cheques is large, it may drive up the Cash Balances well beyond the immediate disbursement needs of Government; and the Ministry of Finance may, then, direct the Reserve Bank to utilise the excess Balances to redeem treasury bills. Such use of idle funds, however, applies to all Budget receipts, not to PL 480 loan cheques alone. It is part of our tradition of good management of Budget funds—to use temporary surplus moneys for reducing short-term indebtedness, rather than pay interest on the latter while receiving no returns on the surplus moneys. It has nothing to do with the question of the monetary impact of PL 480 finance; interim uses of temporary surplus funds to cancel short-term debt do not render inflationary finance non-inflationary.

Disproof of the official contention that PL 480 finance is non-inflationary may be established also by use of the *reduction ad absurdum* technique. Dividing Budget operations into two parts (Budget receipts from the sales of PL 480 foodgrains and total PL 480 disbursements, for one part, and non-PL 480 receipts and payments, for the other part) we find that, during the three years ending 1966-67, non-PL 480 operations showed a surplus of Rs. 95 crores. If PL 480 finance was non-inflationary (i.e., if PL 480 disbursements amounted to no more than Budget receipts from the sales of PL 480 foodgrains, as official experts asset) we should have had, during this period, an overall Budget surplus of Rs. 95 crores; and price stability, too. Budget statistics, however, show a deficit of Rs. 859 crores, in PL 480 operations of this period and an overall deficit of Rs. 764 crores; and prices rose, as we have seen, at a near-record pace of over 15 per cent, per year. The official thesis, therefore, is unsustain-

able. These data, on the other hand, fully support our conclusion: (i) that PL 480 finance is inflationary; (ii) that the amount of PL 480 inflation is measured by the amount of the liquidation of special securities; and (iii) that, during the past three years, inflation in India has wholly ensued from U.S. Embassy disbursements of PL 480 rupees with it.

IV

A PROGRAMME OF REFORM

The foregoing review of the Indian economic situation has indicated that the biggest single problem confronting us, today, is the ruthless pace of income shifts from the already indigent masses, the lower ranks of office workers and the erstwhile prosperous salaried middle classes into the pockets of a vastly better-to-do minority. We saw, too, that in the context of a semi-stagnant economy, with the masses on the margin of subsistence, these income shifts have intensified family budget pressures on a wide front; and that, if we fail to adopt corrective measures soon enough, we may run the risk of even a demise of democracy.

Our analysis has demonstrated that the major instruments of these perverse income transfers have been price acceleration, import licensing and other economic controls; and that these instruments, in turn, have emerged from inflationary finance. Most of the major economic ailments, harassing us, have also their roots in price inflation.

A correct diagnosis is half the remedy in that it suggests the measures of reform to redeem the economy from its present predicament; and to place it firmly along the right road to progress. The first essential step is, clearly, to put a stop to inflation. In the absence of this reform, other corrective measures may not produce any noticeable impact.

To put a stop to inflation, the Central Budget must be balanced. We have seen that, during the past three years,

Budget deficits have ensued wholly from the U.S. Embassy disbursements of the PL 480 rupees with it. The non-PL 480 part of the Budget was in surplus during this period, by Rs. 95 crores; so that, if PL 480 deficit financing had not taken place (i.e. if PL 480 disbursements had not exceeded the sale proceeds of PL 480 imports), the Central Budget might have showed a surplus of Rs. 95 crores, in place of a deficit of Rs. 764 crores, causing near-record price inflation. It is a most unwelcome thought that the Food for Freedom Programme has been the sole cause of it.

The responsibility for PL 480 inflation is not that of Government of India alone. Every financial transaction must have two willing partners to it. When the Government receives cheques on account of PL 480 loans and grants they will be spent; as these loans and grants are financed from created moneys, this expenditure must be inflationary. There is nothing that Government of India can do unilaterally to prevent, or correct, this inflation.

This complex situation merits the urgent attention of the Governments of India and U.S.A. The unused PL 480 rupees with the U.S. Embassy amounted to, as on 30 September 1967, Rs. 744 crores, or 15 per cent of the moneys in circulation. These rupees are but paper funds. The physical resources behind them, PL 480 foodgrains, have been all consumed; and their sale proceeds have been all used up in Capital Budget payments. It does not enhance our credit—neither of the Indian nor of the U.S. experts—to mobilise our ingenuity to try to maintain that the use of these paper funds is non-inflationary. Neither party likes to own up the guilt.

As part of his dollar defence programme, President Johnson directed the USAID Administrator, on 12 January 1968, to cut by at least $100 million aid payments in dollars, through larger drafts on U.S.-owned PL 480 funds. This decision is most unfortunate. It may well undermine the monetary systems first of India, the largest beneficiary of PL 480 aid, to be followed by Pakistan and other countries. If PL 480 inflation must stop, the U.S.-

owned counterpart funds, which represent created moneys, must be abolished. This may be achieved in one of two ways: by providing that PL 480 foodgrains should be paid for, instead of in rupees, in U.S. dollars; or by offering these foodgrains on long-term loan, like the Wheat Loan, 1951, loan repayments being spread over, say, 30-40 years.

The 1966 amendment to PL 480 has adopted the former alternative. In the context of an acute scarcity of foreign exchange, it may appear too harsh, at first sight, to insist on dollar payments. But it is not sound policy to feed oneself on borrowed funds, more especially when our yields of foodgrains, per acre, are about the lowest in the world, and a little capital investment may step up the yields by more than our needs. We may borrow fertilizers and other inputs. In ordinary times, it is a good restraint to pay for our food. This may conduce to increased domestic production. A poor people, *ipso facto,* will be short of everything, including foreign exchange. This is no excuse for begging for food. A poor people are not an insolvent people. Insolvency, of which inflation and balance of payments difficulties are outward manifestations, is an outcome of mismanagement. In the absence of mismanagement, there may be no need to beg for food continually; as our *per capita* income has been rising albeit slowly, we should be able to buy at least our food.

Under the 1966 amendment to PL 480, dollar payments will be stepped up by 20 per cent each year, so that it comes into full effect in 1971. In the meanwhile, PL 480 deficit financing might well continue at even a higher pace than hitherto, if drafts on PL 480 rupees replace, as directed by the U.S. President, aid dollars. This may be disastrous, as it may cause uncontrolled inflation. Urgent action is, therefore, called for to immobilise forthwith U.S.-owned PL 480 rupees. Some American economists would even write off these paper funds. This would be creditable economic statesmanship.

The third essential measure of reform is to put a stop to the income shifts, which ensue from import licensing.

To achieve this, the values of import licences must be reduced to zero. It is easy to see that this demands abolition of the system of two prices for foreign exchange, an official price and a free market price. As the latter contrasts with the former, it is impossible to prevent importers and other buyers of foreign exchange from acquiring foreign exchange from the official market in amounts larger than their actual needs, for disposing of the excess purchases on the free markets; it is impossible, too, to prevent exporters and other sellers of foreign exchange from disposing of some of their foreign exchange earnings in the free markets. This diversion of foreign exchange from the official markets to the free markets will render balance of payments difficulties inevitable so long as duel pricing of foreign exchange continued; and there will be no escape from import licensing. And under restrictive import licensing, import licences will command unearned market values and anti-social income shifts will abide.

It follows that, to be able to remove physical restrictions on imports, dual pricing of foreign exchange must first cease. But dual pricing will prevail if (under the influence of false theories) we insist in selling foreign exchange, in the official market, at price well below its real worth. This underlines the importance of adopting an equilibrium exchange rate. It is not possible to arrive at the latter by any slide-rule technique. The most practical way of doing so may be to let the rupee float for a while. Free market pressures and supports would, then, reveal its truthful and correct value.

Those measures of monetary reform—balancing the Budget, paying for PL 480 foodgrains in U.S. dollars, freezing PL 480 rupees with the U.S. Embassy and selling foreign exchange at its market worth—will provide the economy with a background of monetary stability. Experience in other countries has shown that monetary reforms alone may make for leaps forward in economic and social advance (through protecting, instead of undermining, the sanctity of economic contracts and through stimulating

savings and investment) in economies which have been bedevilled by price instabilities and foreign exchange uncertainties. This progress may receive a further push forward if monetary reforms are followed by fiscal and economic reforms designed, first, to stimulate the flow of savings and, secondly, to ensure that domestic savings and foreign aid are most fruitfully employed.

One can only list these latter policy reforms here. First, to stimulate savings, taxation must be drastically reduced, as the marginal rate of saving by tax-payers contrasts with the savings, if any, by the State through Revenue surpluses. The income-tax structure best suited to developing economies is a flat-rate tax on incomes above an exemption limit. Secondly, as a corollary to drastic cuts in Revenue collections, the consumption expenditures of the State must be scaled down to match, as, otherwise, deficit financing might mount higher. Thirdly, every effort must be made to denationalise Public Sector enterprises, which, currently, absorb over 70 per cent of investment resources, to the neglect, even starvation, of agriculture and other high-yielding sectors of the economy. Finally, price controls and other economic controls, which hinder the most effective use of investment resources, must be abolished.

The prevailing policies have eaten into savings and misdirected investments. Official estimates place the current rate of saving at 6.4 per cent of the Indian national income, as against 8.2 per cent in 1966-67 and 10.3 per cent in 1965-66. If we squeezed the water of inflationary finance from these statistics the decline in the rate of saving may be even more depressing. The decline in saving and in the quantum of foreign aid largely explain the fantastic interest rates, the slump in share values, the low level of fresh investments and perhaps also the recession in the capital goods industries.

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
(1899-1965)
Founder-President,
Forum of Free Enterprise.

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