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Chapter V

INDIA'S STERLING BALANCES

The growth in the sterling balances of the Reserve Bank of India since December 1941 when the existing series ("Foreign Funds") began, is shown in the table at the end of this section.

Enormous as these figures became they would have been still higher had it not been for the repatriation of Indian Government sterling debt amounting to about £157 million (nominal); the calling of the four loans (£66 million); the advance of £30 million to meet Indian Railway Annuities; and purchases by the Reserve Bank of India for cancellation (about £46 million); in all just on £300 million. These reductions, particulars of which follow later, affected the sterling balances from time to time up to the Spring of 1943, after which further offsets could not be found.

The question of India's sterling balances was considered by a Standing Committee of the War Cabinet appointed on 4th August 1943, with the Chancellor of the Exchequer in the Chair. An extract from a Report of this Committee dated 19th July 1944 (I.F.(44)12) may be quoted as showing clearly the nature of the problem.

The Defence

The Defence Expenditure Plan

"The Plan which governs the incidence of military expenditure as between India and the United Kingdom, as settled in February 1940, has broadly the effect of leaving India to bear local defence costs arising in India, and His Majesty's Government to bear the full costs of Indian Forces employed outside India, subject to a contribution by India representing the normal cost of any such forces as were in India before the war. More specifically it has led, as the war has developed, to the following results. The figures quoted give the cumulative sums involved in the four years 1940-41 to 1943-44.

The Government of India have met -

	£ million
(i) the cost of all the forces required for the local defence of India (i.e., in practice, up to the present, all military and air forces, European and Indian, in India and the Royal Indian Navy, including the capital costs in connection with them	565½
(ii) the "normal" cost of certain troops earmarked before the war for external defence, approximating to about a division, subject to the free provision of equipment furnished from overseas	10
(iii) one crore of rupees as a non-recurring contribution towards the "extra" cost of such external defence troops under active service conditions outside India	¾
(iv) one-quarter of the "modernisation" costs referred to in (v) below	8½
	584¾

His Majesty's Government have borne -

(v) under the agreed Chatfield arrangements, three-quarters of the capital cost of various "modernisation" measures in India	25½

....

	£ million
(vi) the cost of all munitions and stores produced in India (including the capital cost of extending facilities) which are treated as a debit against His Majesty's Government in the first instance, subject to an adjustment by Indian acceptance of a charge in respect of all stores produced in India which are required by the troops referred to under (i) above	462½
(vii) the pay and allowances of India's troops serving overseas, less deductions in respect of item (ii) above	42
(viii) the cost of other services rendered by India mainly in connection with overseas operations, namely, custody and maintenance of prisoners of war, transportation of personnel, provision of store and supply depots, war hospitals, cash, roads and buildings, and various measures of a joint character	163
(ix) the cost of the equipment (aircraft, weapons, &c.) supplied from overseas for the Indian forces, both inside and outside India, apart from motor transport and lend-lease or mutual aid items	Unknown

It will be seen from the above that there is an important element of non-reciprocity in our financial arrangements with India. His Majesty's Government supplies India without charge with all the imports from whatever source (with the exception of Lend-Lease supplies and motor transport) which she requires for the expansion forces...... On the other hand, defence stores (item (vi) above) sent from India have all been charged to the United Kingdom since the Plan is merely concerned with the allocation of expenditure required for the defence of India in a sense which may have been appropriate in 1939, but is now affected by factors, referred to in the next paragraph, that have developed subsequently. Anything contributed by India to the common war effort outside India has to be paid for in the same way as ordinary exports. The cost of the goods supplied by India under item (vi) above has risen enormously, partly because their volume has exceeded expectations, and partly because the inflation in India has raised prices so much that over a wide range of goods and services the purchasing power of the rupee has fallen much below that of the sterling equivalent, 1s.6d., at which the rupees are acquired for sterling.

Possibility of modifying the Plan

When the Plan was drawn up, the war was remote from India's frontiers, but subsequently India herself has been directly threatened by both Germany and Japan. The exports of defence stores for which the United Kingdom pays India have, therefore, contributed directly to the defence of India herself, and, since her security is now more immediately bound up with the success of the war effort of the United Nations, there is a prima facie case for contending that the change in circumstances justifies a broader interpretation of India's obligations and a revision of the financial arrangements. In any case, the Chancellor of the Exchequer always reserved the right to raise the question of a further contribution from India. From India's side, on the other hand, it would be contended that the Plan has already operated more unfavourably than was expected, owing to the prolonged retention in India of very large forces, both British and Indian. On broader grounds, too, India would probably contend that she has paid a very heavy price for so poor a country in the shape of deprivation and starvation. The figures above show that the only adjustment of the Plan which would have an appreciable effect on the magnitude of the problem to be faced eventually would be a completely new arrangement on mutual aid lines. It does not seem to us that there is any hope of getting this accepted by India. More modest proposals of modification, directed to getting India to bear a greater contribution of the external costs of her Forces, which would, in the opinion of the Committee, be in themselves entirely justifiable, would nevertheless encounter grave political difficulty in India, and, since it would almost inevitably be regarded as a final settlement of the whole problem, might well spoil the prospect of some adjustment on broader lines later. The Committee therefore recommend that it is not wise or practicable to try to modify the Plan at precisely this moment.

Sterling Balances

The future growth of the balances cannot be either estimated or prevented, and we must rely upon effecting a settlement in respect of India's abnormal balances at a more propitious time. Meanwhile nothing should be done to prejudice this ultimate settlement."

The Bank of England do not appear to have been consulted when the original arrangement was made between H.M.G. and the Government of India; nor did they come into the picture until the beginning of 1942, when the sterling balances were some £200 million. The India Office were supplying the Bank with quarterly forecasts of net receipts or payments between the accounts of the Reserve Bank of India and the Secretary of State at the Bank of England, and the Governor noticed that no less than £43 million was expected to be paid to the Reserve Bank in March for war expenditure. The Governor enquired whether a continuation of payments on this scale was to be expected, and was told that in the following 15 months payments might average £22 million a month.

The Bank's attitude from this time on until the Report of the War Cabinet Committee in July 1944 (which in effect confirmed the Bank's view) was that a new agreement should be made, based on the principles laid down by President Roosevelt that there should be "equality of sacrifice" among the Allies, and that no nation should make a profit at the expense of its partners in the war. The Governor, however, was content in replying to the India Office (22nd July 1942) merely to mention that "a reduced scale of payments to India on war account would leave us with a less troublesome prospect in the post-war years." The contrast between India and Canada was very much in the Bank's mind. Canada - in far less immediate danger than India - was about to make a generous gift of $1,000 million towards the cost of the war.

The next stage was reached with the arrival in London of the Indian Finance Member, Sir Jeremy Raisman, in July. He and Sir Theodor Gregory, Economic Adviser to the Government of India, held discussions with the Treasury, but little or no progress towards a solution was made. This was not surprising as the Finance Member's brief contained such phrases as the following:

Pointing out that the greater part of the expenditure by the U.K. was on stores, it stated that the only way to reduce this was "either for H.M.G. not to get stores from India, or for India to follow the Canadian example and give them away. The former is presumably impossible and the latter is politically and economically out of the question.

The problem of sterling accumulation could only be really solved by India staying out of the war. If H.M.G. wants to use India either as a source of war supplies, or as a source of man-power, or as an arsenal, or as a battle ground, or even to deny India to the enemy, then by and large H.M.G. must pay for it, and the greater India's war effort, the more H.M.G. must pay. India is just not in the mood to give anything away as yet, and until that mood changes sterling will accumulate. This conclusion is quite inescapable and transcends all purely Treasury considerations. The days are past when India can with impunity be coerced against her will in almost anything. Her nuisance value is enormous."

The Indian representatives emphasised that this was the Viceroy's view also and that in addition the Indians were far from happy about the future value in hard currencies of sterling, and anxious concerning its convertibility. India might demand more gold. The Board of the Reserve Bank was pressing for more repatriation.

On Reverse Lend-Lease it appeared doubtful whether such a plan could effectively be applied to India, and Sir Jeremy Raisman's brief asserted that "... Apart from any question of principle the political condition of India at present would, in any case, render it imperative that the Government of India should always be able to state with confidence that the amount of Reverse Lend-Lease India is paying has never exceeded the benefits of Lend-Lease which she has received."

At a meeting between the Treasury and the Bank on 27th July it was stated that Lord Keynes had suggested making it clear to India that her sterling balances would not in fact be at her free disposal. Everybody else, however, felt that the one thing to avoid was to increase the doubts in Indian minds about the usefulness of sterling, and that in any event India should be told that her sterling balances would remain free for her use, subject to the Exchange Control Regulations.

Sir Jeremy Raisman seems to have seen the Governor on 29th July, but there is no record of the interview.

Suggestions considered during this visit included the establishment of a Development and Reconstruction Fund, and a proposal that the pensioners of the Indian Government paid in sterling should have their pensions secured by the Indian Government transferring to the U.K., out of their sterling balances, a sum equal to the capitalised value of the annuity required to pay the pensions.*

The last-named proposal began to be discussed again by the Treasury in January 1943. The average period of the annual payments under the plan was said to be about 28 years, and as this would be the same as the term of the 3% Savings Bonds then on tap, the U.K. would pay 3%. The capital sum would be between £125 and £150 million. The Bank favoured some such arrangement; in the Governor's opinion a strong argument in its favour was that due payment to Indian sterling pensioners would be assured throughout their lives, no matter what government might come into power in India.

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*The sale of private assets was also briefly considered at the Bank but rejected for many reasons. They would be most difficult to value; could only be sold to the Indian Government, who would not be able to manage them efficiently; and would create a complication with Canada, who had been assured that private assets in other Empire countries would not be sold.

The Bank, however, considered that this operation could not take place until April or May since the Indian sterling holdings were not yet sufficiently large. In connection with the sterling balances it was always necessary to bear in mind the statutory requirement of a 40% cover in gold or sterling for the Reserve Bank's Note Issue. As the Indian Government had agreed that this meant that a working margin of 10% would also have to be kept, in practice 50% of the Note Issue had to be covered.† In the event the idea was dropped.**

In the middle of February, in connection with some correspondence between the Treasury and the India Office, the Bank began to take a stronger line. Mr.Cobbold (15.2.43) wrote to the Treasury:-

"..... Before trying to tackle the detailed points is it not necessary to consider again the possibility of revising financial arrangements with India on "equal sacrifice" lines? Looking ahead and bearing in mind the possibility of war in the Far East going on after peace in Europe, with perhaps the main base in India, the dimensions of possible United Nations expenditure in India seem enormous and likely to produce an absolutely insoluble financial problem. Are we and the Americans really going to allow India to be indefinitely enriched and to be the single exception from the principle of "equal sacrifice"?

Must we not adopt the position that if the war goes on for any length of time and more especially if the Far Eastern theatre becomes more important we shall have to revise our financial arrangements with India, with American help if necessary. Should not our present tactics be to find such palliatives as may be necessary to keep India quiet until the

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†Correspondence between Mr.Kershaw and the India Office in November and December 1941 suggests that the Bank did not feel that this formula provided India with adequate external reserves to meet possible post-war capital movements.

**H.M.T. were apparently unwilling to pay so high a rate of interest. The lower the rate the greater would be the amount of sterling to be cancelled. But the Indian Government were, it seems, not ready to accept as low a rate of interest as the U.K. desired.

time comes for a frontal attack on the whole position, and in the meanwhile to avoid any step which would prejudice longer term issues?"

And again on 24th February.

"..... There seems to me everything to be said for keeping to and pressing the major issue of "equal sacrifice" and refusing to make any move on the various points raised (all of which would involve prejudice to long term issues to India's benefit and to our detriment) until you are clearer about the major issue. I should include in the refusal any commitment at this stage about a Development and Reconstruction Fund: there seems no good reason to give India any pledge that she will be able to convert her swollen sterling balances into goods in priority over other claimants who have taken a real share of the burden ...."

Early in 1944 another idea for stopping or reducing the growth in the sterling balances was put forward from the Treasury. This was the expedient of borrowing in rupees by the U.K. Government, and was favoured by the Bank. But apparently the Treasury later decided against incurring external debt where not absolutely necessary, and probably did not wish to establish a credit rating abroad (which had been avoided in the case of Canada). They may also have felt that any such borrowing might prejudice the eventual settlement with India, which already looked sufficiently complicated.

Indian Sterling Loans

A repatriation of sterling securities was first proposed in December 1940, the six dated stocks dealt with by the Vesting Order of 7th February 1941 being specified.

It was arranged that the counterpart in rupees would be provided by allotting to the Reserve Bank (Issue Department) the equivalent value in rupee securities created ad hoc. These could be gradually sold on the market and would also be reduced as the proceeds of borrowing from the public became available. There had been a limit of 25% on the Reserve Bank's holding of Government of India rupee securities, but this was removed.

At the end of 1940 India's sterling balances were £142 million, already a demand for more gold was threatened, and it was said that a number of members of the Central Board of the Reserve

Bank would be associated with such a claim.

The Bank favoured the vesting, which they assured the Reserve Bank could be carried through in one operation, though three separate ones had been originally suggested as more convenient for the U.K. The Governor, incidentally, asked the Reserve Bank whether it would be politically possible for them to revalue their gold at the same time and thus extinguish some 40 crores of repatriated debt, with the consequent avoidance of the creation of its counterpart in rupee securities. Not unexpectedly the Reserve Bank replied that they would be unwilling to raise the question at that time.

Vesting applied, of course, to residents in the U.K. only. Government of India dealt with holders in India. Residents in Burma could surrender their holdings for payment in rupees. British Insurance Companies operating in India, and certain other holders, were allowed the option of taking rupee securities. Residents in other parts of the sterling area were allowed to surrender stocks on the same terms as U.K. residents. But no holdings from outside the sterling area were accepted otherwise sterling would have been provided against securities blocked under Regulation 3A.*

*Some consideration was given to granting the facility and blocking the resultant sterling, but the proposal was soon dropped.

In the case of Trusts the residence of the (income) beneficiary was the determinant. Some trouble arose in cases where some of the beneficiaries were resident and others non-resident. In practice holdings were accepted if one beneficiary was a resident of the U.K.

After the vesting under the February 1941 Order there remained three Indian Government sterling loans outstanding, namely India 3½% Stock, redeemable on or after 5th January 1931; India 3% Stock, redeemable on or after 5th October 1948; and India 2½% Stock, redeemable on or after 5th October 1926.

Objections to vesting the 3 per cents, not redeemable until 1948, were natural enough while there was outstanding a large amount of callable 3½% loan. Compulsory requisition could hardly be defended in such circumstances. Lord Keynes wrote (in Nov.1941)-

"Surely there is no case here for employing the vesting machinery at all, since the Government of India have outstanding a loan of suitable amount, which they are entitled to repay at notice at any time. If, in such circumstances, the vesting machinery was used to take up another issue, which they had no right to repay, leaving the 3½ per centa outstanding, bondholders as a class would have, I should have thought, a very strong and justifiable grievance. If the Market value of the 3½ per cents was much below par that might possibly make a difference, but they are not"

When the question of vesting was raised again in the autumn of 1941, the price of the 3½% loan was near par. The India Office and the Bank thought there would be little risk in dealing with all three loans at once; the total nominal amount was about £150 mn. and Indian sterling balances at this time (October) about £160 mn. The 3½% loan itself was about £65 mn. and the question was whether Indian sterling balances could be assumed to be sufficient to deal with it in a year's time, as well as the other two in the near future. The Indian Government believed the risk to be negligible, as their sterling balances continued to rise (£206 mn. at the end of 1941).

Notice was accordingly given to repay the 3½% loan on 5th January 1943. The other two loans were vested under an Order of 23rd December 1941 and paid for on 22nd March 1942.

The question of dealing with the Indian Railway Annuities first arose in March 1942 when the India Office suggested the possibility of vesting them. An alternative proposed by the Treasury was that the Government of India should place in the hands of the Trustees a lump sum sufficient with the interest thereon to continue to pay the Annuities. This, however, would have involved an alteration of contractual rights. The Bank (L.2.4.42) thought there was every reason to avoid vesting and considered that the simplest method would be for the British Government to assume the contractual liability to the Annuitants in place of the Indian Government, in return for an appropriate capital payment. If this were done it would not be necessary to disturb the functions or existing investments of the Trustees. This idea was accepted.

The next point to be decided was the interest rate to be applied. The Treasury placed the weighted average life of the capital element in the Annuities at between five and six years. In view of the fact that in 1940 a five year conversion loan had been issued at 2%, and the credit of the British Government had since improved, the Treasury first thought that the Annuities should be capitalised at 2%. The Bank, however, pointed out that except in one case the comparison was rather with the 2½% National Defence Bonds 1944-48 and that 2½% might be fairer. On 19th Mey the Bank suggested 2¼% as a justifiable compromise, and the transaction went through at this rate at the end of September 1942. The Government of India paid £30,054,250, and the Treasury undertook to make available to India sums equal to the instalments of the Railway Annuities as and when they fell due. The agreement did not in any way alter the contractual relationship between the Government of India and the Annuitants, or the liability of the Government of India for the payment of the Annuities. The Annuities dealt with were ~~as follows~~ the following:-

East Indian Rly.	Classes,	A,B,C & D	£1,143,913:18:10
Eastern Bengal Rly.	"	A and B	116,850:14: 9
Scinde, Punjaub and Delhi Rly.	"	" " "	371,361: 3: 7
Great Indian Peninsula Rly.	"	" " "	1,268,516: -: 7
Madras Rly.	"	" " "	488,381: 5: 7
			£3,389,023: 3: 4

Railway Debentures

It was also proposed to repay or vest various Indian Railway Debentures. Some of these were not obligations of or guaranteed by the Indian Government, and were therefore unsuitable to be dealt with, because of the undertaking givento Canada to which reference has already been made. Some delay occurred in selecting the Stocks to be vested or called, partly because of the variation in prices which took place, and partly because the Treasury until the autumn were considering the desirability or otherwise of a South African vesting operation end did not wish either to prejudice the other. Inthe autumn, however, the Indian Government became rather impatient of delay and it was arranged that the following Stocks should be vested on 15th January 1942:- 1943?

to UK holders

Vesting Order of 15th January 1942: Payment/12th March 1943

Vested		Vesting Price (With allowance of 2½% 15 Jan-12 Mar)
Irredeemable		
E.Indian Rly.4½% Deb.Stock	£1,419,150	£112: 8: 8
Great Indian Peninsula Rly. 4% Deb.Stock	2,662,450	104: 8: -
E.Bengal Rly.4% Deb.Stock	339,166	104: 8: -
S.Indian Rly.4½% Deb.Stock	413,350	112: 8: 8
Redeemable		
Bengal & N.W.Rly.5% Deb.Stock 1945	2,440,000	102:17:11
Bengal-Nagpur Rly.4% Deb.Stock 1944	1,876,000	102: 2:10
S.Indian Rly.4% Deb.Stock 1945	2,172,748	102: 2:10
Callable		
Burma Rlys.3% Deb.Stock	1,223,550	88: 6:10
E.Indian Rly.3% New Deb.Stock	7,625,750	92:12: 1 (ex int.due 4.2.43)
Nominal	£20,172,164	

Notice was also given for three other Stocks to be repaid on 4th February 1944.

Redeemed at par on 4th February 1944

Bombay, Baroda & Central Indian Rly.3½% Deb.Stock	£955,500
East Indian Rly.3½% Deb.Stock	6,801,000
Great Indian Peninsula Rly.3½% Deb.Stock	3,368,000
	£11,124,500

U.K.STERLING LIABILITIES TO INDIA

(comprising Indian Railway Annuities Loan, deposits, advances, bills, British Government securities if held for banking offices in India and U.K.sterling securities if held with the Secretary of State)

£ millions

	Total	Sterling Loans to H.M.G.	Reserve Bank of India Holdings (a)	Silver Redemption Reserve	Funds with Commercial Banks (net) (b)
At 31st December 1941	235.5	-	221.0	7.5	7.0
" 31st March 1942	227.8	-	211.5	7.5	8.8
" 30th June "	284.0	-	261.8	7.5	14.7
" 30th September "	347.6	30.1	281.2	7.5	28.8
" 31st December "	429.0	30.1	360.9	7.6	30.4
" 31st March 1943	447.9	29.3	385.5	7.5	25.6
" 30th June "	549.6	28.6	484.0	7.5	29.5
" 30th September "	634.1	27.9	567.0	7.5	31.7
" 31st December "	705.9	27.3	642.6	7.5	28.5
" 31st March 1944	774.4	26.6	710.2	7.5	30.1
" 30th June "	824.5	25.9	752.7	7.5	38.4
" 30th September "	922.2	25.2	851.3	7.5	38.2
" 31st December "	998.1	24.5	934.1	7.6	31.9
" 31st March 1945	1,083.1	23.8	1,025.7	7.5	26.1
" 30th June "	1,131.0	23.1	1,067.5	7.5	32.9
" 30th September "	1,226.8	22.3	1,156.6	7.5	40.4
" 31st December "	1,310.9	21.6	1,252.2	7.5	29.6
" 31st March 1946	1,352.4	20.9	1,295.9	7.5	28.1
" 30th June "	1,330.5	20.2	1,272.0	7.6	30.7
" 30th September "	1,291.1	19.4	1,238.8	7.6	25.3
" 31st December "	1,268.9	18.7	1,217.9	7.7	24.6

(a) Includes comparatively small amounts held on Government and Private Accounts in the Drawing Office.

(b) Including certain official accounts.

Statistics Office,
18th May 1950.
R.H.J./565.

Figures in £ millions.

INDIAN GOVERNMENT AND RAILWAY STOCKS

Date of Vesting Order	Stock	Nominal Amount acquired under U.K. and Govt. of India Orders against payment in sterling to 30.6.1945		Flat cost to 30.6.1945		If called subsequent to vesting - Amount redeemed	
7th February 1941	India, Government of, 5% 1942/47 (Called 15.6.1942)	4.6		4.8			.2
	do. 4½% 1950/55	28.5		31.4			
	do. 4½% 1958/68	10.7		12.1			
	do. 4% 1948/53	7.3		7.8			
	do. 3½% 1954/59	5.7		5.9			
	do. 3% 1949/52	6.3	63.1	6.3	68.3		
23rd December 1941	do. 3% 1948	64.8		58.8			
	do. 2½%	10.4	75.2	8.1	66.9		
15th January 1943	Bengal & North Western Rly. 5% Special Deb.Stock (Called 1.11.1945)	2.4		2.5		(outstanding for redemption)	.01
	Bengal Nagpur Rly.Co.Ltd. 4% Deb.Stock (Called 1.1.1944)	1.8		1.8			.2
	Burma Railways 3% Deb.Stock	1.2		1.0			
	East Indian Rly.Irred.4½% Deb.Stock	1.4		1.6			
	East Indian Rly.3% New Deb.Stock	7.1		6.5			
	Eastern Bengal Rly.Irred.4% Deb.Stock	0.3		0.4			
	Great Indian Peninsula Rly.Irred. 4% Deb.Stock	2.6		2.7			
	South Indian Rly.Perpetual 4½% Deb.Stock	0.4		0.5			
	South Indian Rly.Co.Ltd. 4% Reg. Deb.Stock (Called 1.7.1945)	2.0	19.2	2.1	19.1		.03
			157.5		154.3		

STERLING LOANS CALLED - NOT THE SUBJECT OF VESTING ORDERS

		Amount Redeemed
India, Government of, 3½% Stock	called 5th January 1943	57.2
Great Indian Peninsula Rly. 3½% Deb.Stock	called 4th February 1944	2.7
Bombay Baroda & Central India Rly. 3½% Deb.Stock	called 4th February 1944	.7
East Indian Rly.3½% Deb.Stock	called 4th February 1944	5.4

PURCHASES BY RESERVE BANK OF INDIA IN LONDON FOR CANCELLATION

Government of India Stocks	42.3	nominal
Indian Railway Debenture Stocks (all liabilities of Government of India)	3.5	"
	45.8	"

(Cost not easily available: probably much the same as nominal, since premiums & discounts likely to cancel out)