R.C. DUTT LECTURES
ON POLITICAL ECONOMY, 1978

I. S. GULATI

INTERNATIONAL MONETARY DEVELOPMENT AND THE THIRD WORLD: A Proposal to Redress the Balance

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Romesh Chunder Dutt Lectures on Political Economy

On 12 and 13 February 1979, Professor I. S. Gulati, Fellow in the Centre for Development Studies, Trivandrum, delivered the Fourth R. C. Dutt Lectures at our Centre. These Lectures as well as the Sakharam Ganesh Deuskar Lectures on Indian History have been instituted at this Centre with the purpose of involving it in the study of affairs in which public and academic scrutiny of long range as well as purely contemporary time dimension is carried out on national and international issues.

Professor Gulati focuses attention on aspects of the wider context of the international monetary scene. He seeks to identify the concerns of the developing world and endeavours to draw lessons from the past in charting out the courses of future action for developing countries. He believes that the developing world cannot go on waiting for a world trading system which ensures it equitable terms for its exports. He suggests that the establishment of an integrated commodities fund may lead to some sort of coming together of the developing countries, including the oil-exporting countries, if they choose to join. In his opinion, that alone will restrain, if not altogether eliminate, the urge to keep the monetary reserves in the deposits of the developed world. One hopes that there will be informed discussion of Professor Gulati's proposals.

BARUN DE
Director, Centre for Studies in Social Sciences, Calcutta

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IQBAL GULATI

Introduction

ROMESH CHUNDER DUTT was not only a great economic historian but also a keen participant in the economic policy debates of his times. Thus he not only wrote but also made history. Permit me to begin my lectures by a reference, in some detail, to one of Romesh Chunder's contributions of the latter type because it bears on the subject of my lectures.

Of the major economic policy issues of his day, probably one of the most important was concerned with the revaluation of the Indian rupee vis-à-vis the pound sterling. The exchange rate for the rupee had been on the decline during the last quarter of the nineteenth century. From 23.125*d.* in 1871–72, the exchange rate for the rupee declined to 19.75*d.* in 1878–79. Then it remained steady at that level for six years. From 1884–85 it started declining again and reached 14.20*d.* in 1893–94.

The sharp decline in the rupee's external value, a period of twenty-five years, saw the growth of a strong body of opinion arguing for measures not just to stop the fall in the rupee's external value but to raise it somewhat. British civil servants in India were greatly concerned at the decline in the sterling value of their remittances back home. So were British traders who were remitting profits back to the United Kingdom. The government itself was concerned because in order to pay for the home charges fixed in sterling, it would have to enhance taxes within India.

By 1893 the pressure from these quarters was very strong. As a result, the Herschell Committee recommended in May 1893 that (a) the external value of the rupee should be raised a little and fixed at 16*d.*; and (b) the coinage of rupees should be suspended to support the new exchange rate.

Romesh Chunder describes how subsequently, at the recommendation of the Fowler Committee, the government decided to establish a Gold Reserve in 1899, 'to make it available for foreign remittances when a fall in exchange made such help necessary', and how the reserve had to be expanded within seven months from two million sterling to seven million.

Romesh Chunder's principal objection to artificially raising the external value of the rupee derived, inter alia, from his belief that it would dislocate export trade and injure industry. To put it in his own words, spoken in evidence before the Fowler Committee:

> On that point I should premise that my information is second hand, because I am not personally engaged in manufacture or trade. But I have consulted men engaged in trade, and they tell me that the raising of the value of the Indian rupee artificially dislocates trade and has injured manufacture.

Whether or not Romesh Chunder's argument was generally valid, given the price elasticities of demand for various items of export interest to India at that point of time, may well be a matter for debate. But that this argument was made is in itself significant. Also, it should not be overlooked that Romesh Chunder employed this argument to demolish the view that if the external value of the rupee fell the government would have to raise additional taxation to pay a given amount of home charges, fixed in sterling. To the extent that the decline in the external value of the rupee increased the incidence of home charges in terms of rupees, the solution, according to Romesh Chunder, lay in reducing the charges and not in raising taxes within India.[1]

From the point of view of my lectures, what is significant is that the concern voiced by Romesh Chunder, some eighty to ninety years ago, with respect to the external valuation of the rupee is of relevance even today in the wider context of the international monetary developments.

It is not inappropriate, therefore, that in a series of lectures dedicated to the memory of that eminent scholar I should speak on recent international monetary developments with a view both to identifying areas of concern to the developing countries, including India, and to locating possible ways and means of meeting these concerns.

I have devoted my first lecture to reviewing the major international monetary developments over the past thirty-five years or so, that is, since the end of World War II, both to highlight the principal aspects of the current international monetary scene and to identify the concerns of the developing world. In my second lecture, I have indulged in a sort of speculative exercise about the options, if any, open to the developing countries in tackling their concerns and for protecting their interests. While I certainly feel that the developing countries can, and should, draw lessons from the past in charting out their course of future action, I entertain no great illusion that the suggestions I have to offer will be readily acceptable. I would consider my present effort worthwhile if these lectures evoke enough interest in the issues that seem to me to demand attention on the part of the thinkers and policy makers in this and other developing countries.

LECTURE ONE

A Review of Developments Since World War II

LET ME start with a word of caution: I have used the term 'world monetary system' in a very narrow sense. For my limited purpose, the world comprises countries agreeing to become members of the monetary arrangements that were decided upon at Bretton Woods at the end of World War II and the successive arrangements since 1973.

Par value system

The Bretton Woods arrangements envisaged the establishment of an institution, controlled largely by the industrialized countries, with a view to overseeing the working of a system of stable exchange rates. This institution was to be known as the International Monetary Fund (IMF). Each of the member countries of the IMF undertook to set and maintain the par value of its currency in terms of gold or the U.S. dollar. Thus, until such time as the par value of a currency was changed, its relationship with other currencies, that is, its exchange rates with other currencies, remained fixed and stable. It was not that the par value of a currency could not be changed altogether; but the change was to be resorted to in exceptional circumstances when the balance of payments of a country was in 'fundamental disequilibrium', a term whose implications, however, were never quite spelt out.[1]

The duty or obligation to maintain their par values meant that countries with a balance of payments surplus should, instead of allowing the par value of their currencies to appreciate, be willing to accumulate reserves and that countries with a balance of payments deficit should, instead of allowing the par value of their currencies to depreciate, be willing to decumulate their reserves.

Thus the 'deficit' country should either have reserves of its own, which means that it should have been a 'surplus' country sometime in the past and accumulated reserves instead of allowing its currency to appreciate; or it should have access to another source of reserves, a source that could be drawn upon for the settlement of the overall balance of payments deficits of countries. The underlying assumption here is that normal inter-country lending and borrowing during any year are already reflected in the deficit or surplus of the overall balance of payments of every country. Thus the greater the 'normal' lending by the surplus countries to the deficit countries, the less the need for the latter countries to settle their balance of payments.

Sources of reserves

What sort of reserves did the Bretton Woods arrangements propose to draw upon for the settlement of the deficits of the member countries? Of course, every country could draw upon its own reserves to finance the deficit in its overall balance of payments. We spoke above about the willingness of a deficit country to decumulate its reserves to maintain the par value of its currency. The problem, however, arose because the more a country dipped into its own reserves to finance its deficit in any one year, the less would be left to it for the subsequent years. Under the gold standard, the gold-losing deficit country was supposed to gain in competitiveness against the gold-gaining surplus countries. Therefore, the former country would dip into its gold reserves in the assurance that that itself would set in motion the process by which its deficit would disappear and a surplus emerge.

When the Bretton Woods System was being hammered out, it was far from anyone's thoughts to go back to a gold standard pure and simple, mainly because the annual gold supplies were never expected to be sufficient to meet the full reserve needs of the world monetary system adequately. Gold was nevertheless given the role of the ultimate or basic reserve asset in that the currencies of the member countries, including the U.S. dollar, were to be denominated in gold. Evidently, it was still considered necessary to lend the national currencies, more so the most important among them, the gold backing to make them internationally acceptable.

The system provided explicitly for the creation of a pool of national currencies in the hands of the IMF for the settlement of balance of payments, presumably over and above the reserves that each country itself may hold. The quota of each member country was fixed on the basis of its relative economic size, and one-quarter thereof was to be subscribed by the country in gold while the other three-quarters were to be contributed in its own currency. The Fund would thus be in a position to sell, when necessary, the currencies held by it of the surplus countries against the currencies of the deficit countries. A deficit country's eligibility to purchase currencies of surplus countries was, however, tied to its quota. Also, such purchases were subject to conditions which varied directly with the ratio of these purchases to the quota. These conditions were over and above the obligation of a deficit country to repurchase, within a period of three to five years, the excess of its currency which the Fund had thus come to possess.

Whatever else one may say about the Bretton Woods arrangements, particularly now with the benefit of hindsight gained from the circumstances leading to its collapse, one can safely say that in its conception the system sought, perhaps somewhat simplemindedly, to provide for a multilateral mechanism for the settlement of overall balance of payments by making the surpluses of one set of countries available, at least temporarily, to cover deficits of another set of countries. Evidently, it was thought that the quotas, totalling only $9 billion at the start, would contribute sufficient amounts of surplus currencies to match the deficits for the short period within which the deficit countries were obliged to repurchase the excess of their own currencies from the Fund.

It is very doubtful whether it was at all then envisaged that the resources thus provided to the Fund would have to be supplemented by other methods, on any large scale. Though it was not unknown in 1943–44 that the national currencies of a few countries could, and already did, serve as monetary reserves of other countries (on the eve of World War II, in 1938, as much as 17 per cent of the monetary reserves of countries other than the U.K. and the U.S.A. was comprised of foreign exchange), the Bretton Woods Agreement did not possibly envisage the continuation of that practice on a much larger scale.

Role of dollar

The role that the U.S. dollar actually came to play subsequently in the international monetary system as the major source of additional monetary reserves was certainly not provided for in the Bretton Woods Agreement. To provide for that would have required making, at that time, the major assumption that the strongly surplus U.S. balance of payments would soon get converted into a deficit so that in the process the U.S.A. would start incurring net liquid liabilities abroad, liabilities that the monetary authorities of the other countries would be glad to hold as part of their monetary reserves. Actually, the U.S. liquid liabilities abroad started expanding right in the early fifties, so that by the end of that decade they had more than doubled, from $8.9 billion to $19.4 billion.

It is likely that U.S.A. itself was not quite prepared to play, or at least conceive of itself playing, the role of a major generator of monetary reserves; a role that would have required it to run corresponding deficits in its overall balance of payments. It was then a country with a strong surplus balance of payments on current account whereas the economies of the rest of the industrialized countries lay ravaged by war. The latter were then in urgent need of support from the U.S.A. in the form of credits which would enable them to finance the imports they required in excess of whatever exports they could then generate.

It is doubtful if even the British anticipated such a development. They must have been worried then that the surplus countries like the U.S.A. might just go on accumulating balances and leave it to the deficit countries to sort things out for themselves. The whole emphasis of the Keynes Plan for the establishment of an International Clearing Union was therefore to ensure that the settlement of the balance of payments between countries took place through a system under which the burden of adjustment to a situation of imbalance did not fall entirely on the deficit countries.

As events actually unfolded themselves, the U.S.A. started running deficits in its overall balance of payments quite early in the day, not only with a view to meeting its international commitments—military, political and economic—as a superpower, but also to enable U.S. multinationals to buy and make investments abroad. The U.S.A. carried on with this policy rather easily for quite some years before any questions were raised. The U.S. decision to incur liquid liabilities abroad—liabilities which the outside monetary authorities were willing, indeed keen, to hold by way of their foreign exchange reserves—is, however, quite significant.

Concern with liquidity

Herbert Grubel has attempted to explain this actual development in terms of the failure of the Bretton Woods System to provide for the creation of adequate international liquidity.

The United States emerged from the Second World War with an overwhelmingly dominant economy in terms of production capacity and national wealth including reserves of monetary gold. In the eyes of the rest of the world dollar holdings were more desirable than gold, since they were more readily exchangeable into the metal and brought interest to their holders. During the 1950's U.S. balance of payments deficits were welcomed as a source from which the reconstructed nations of Western Europe could replenish their depleted stocks of international reserves.[2]

Grubel almost makes it appear that the U.S.A. performed a great service to the world by running balance of payments deficits and generating dollar reserves for the other Western countries to hold.

The U.S. had thus, without formal international agreement, taken on the role of a World Banker and helped to sustain an efficient monetary system.[3]

That a monetary system in which a substantial part of world liquidity is met by the accumulation of the short-term obligations of one or a few reserve-currency countries cannot be considered efficient has been pointed out by Robert Triffin in several of his writings.[4] Such a monetary system is basically wrong because it makes the system highly dependent on the decisions of a few individual countries. Unfortunately, excessive concern with the liquidity requirements of the world monetary system has led many economists to ignore not only 'the highly erratic and unpredictable factor' arising from the dependence on a few individual countries for the creation and acceptance of world liquidity but also the severely regressive distribution of transfer of resources that it entails. By allowing the national currencies of one or two countries to perform the reserve-currency role, the world monetary system is clearly allowing the reserve-currency countries to become net recipients of current resources or to gain command over future resources from the rest of the world.[5]

While the question of distribution of the transfer of resources entailed in a system of reserve creation is extremely important, I consider the concern with meeting the liquidity requirements of a world monetary system somewhat overdone for quite an independent reason.

Attempt at undervaluation

Basically, countries which are accumulating reserves are trying to prevent the external value of their currencies from rising. A persistent situation in which the same set of countries is continuously accumulating reserves shows a clear tendency on their part to keep their currencies undervalued. This can be ascribed very largely to a sort of pathological concern with either building up their monetary reserves for their own sake or maintaining the competitiveness of their goods in the world market and thereby the aggregate domestic demand. It is more likely to be the latter than the former. All the same, I call this concern pathological because the building of reserves is not a costless activity. Every dollar added by Japan or Germany to its reserves involves an equivalent resource-transfer to the U.S.A. in the form of either the former's current goods and services or the ownership of its assets. Perhaps my use of the word 'pathological' is inappropriate. I may be taking too narrow a view of the trade-off by not taking into account the gains, present or future, and possibly intangible, that Japan or Germany expects to realize in the process.

Ordinarily, if one set of countries is trying to keep the external values of its currencies depressed and another set of countries finds that its currencies are thereby forced to remain overvalued, the second set should be worried because its competitive position is thereby adversely affected in the world market. But this need not be the case with any particular country in the second group so long as its new issues of short-dated liabilities continue to be generally accepted abroad as reserves.[6]

A stage could always come, however, when the countries in the first set become worried that they are accu-