UNIT 7 FINANCIAL MANAGEMENT AND THE PROBLEM OF RUPEES

Structure

7.0 OBJECTIVES

This unit would enable you to understand:

- The contribution of Ambedkar in the field of financial management and solving the problems of the Indian rupee;
- The role of financial management in solving the problem of currency in circulation; and
- The problems of the Indian rupee before India's independence and how were they solved.

7.1 INTRODUCTION

In this unit we will discuss Ambedkar contribution in the financial management and solving the problems of the Indian rupee and what the problems of the Indian rupee before India's independence and how were they solved. When an economy has multiple standards of medium of exchange, the currency loses its primary quality of general and ready acceptability because such a system creates plurality in fluctuations in relative values of currencies. Even if a country adopts a single standard of medium of exchange in metallic currency, the problem cannot be solved because the supply would be insufficient to meet the demand. These facts, especially in the Indian context, were highlighted for the first time by Ambedkar, who was the first Indian to obtain a doctorate degree in economics.

Ambedkar was one of the first generation economists of the early 20th century. He was a leading monetary economist with degrees from Columbia University in U.S.A. and the London School of Economics. He authored the following books on economics:

1) *Administration and Finance of the East India Company (1915)*
2) *The Problem of Rupee: Its Origin and Its Solution (1923)*
3) *The Evolution of Provincial Finance in British India:A Study in the Provincial Decentralisation of Imperial Finance (1925)*

In these books, Ambedkar advocates price stability through conservative and automotive monetary management. In this matter, he criticised Keynes who supported Gold Exchange Standard (GES) while Ambedkar favoured Gold Standard (GS). GES is a monetary system under which the currency of one country is converted into bills of exchange of another country whose currency is convertible into gold at a stable exchange rate. Under this system, the country maintains its currency parity with gold without gold reserve. GS is a monetary system in which the standard unit of currency is a fixed quantity of gold and the country maintains gold reserve.

The differences between the two monetary systems are summarized in the table:

Gold Exchange Standard (GES)	Gold Standard (GS)
The currency of one country is converted into bills of exchange of another country whose currency is convertible into gold at a stable exchange rate.	The standard unit of currency is a fixed quantity of gold
The country maintains its currency parity with gold without gold reserve. The government manipulates the coinage to keep it at par with the value of gold.	The country maintains gold reserve

The problem of rupee is directly associated with the problem of inflation. A rise in inflation reduces real wages of workers belonging to the earning class. Therefore the rupee should be stabilised which is only possible when the purchasing power of rupee is stabilised because devaluation of currency results in distributional effects and inflation. Stability in purchasing power of the rupee can be achieved only when financial management supports Automatic Monetary Policy (AMP). Ambedkar was in its favour.

In his doctoral thesis in the London School of Economics, he argued that gold exchange standard does not have stability in India. He emphasized that India cannot afford gold exchange standard because it increases inflation and reduces real wages of the earning class. In his thesis he proved statistically that Indian rupee had lost its value and hence purchasing power of the rupee was falling. He suggested having circular flow of money along with regulated government deficit in India. More attention should be given to price stability rather than to exchange rate stability. The exchange standard requires to be managed, which can be done either by the government or by an independent authority. However, the chance of mismanagement is greater by government because the issue of government money is authorised and conducted by men who are never answerable in case of bad judgment. Ambedkar was in favour of an independent centralised regulating authority to undertake financial management. This view laid down the foundation for the establishment of the Reserve Bank of India.

7.2 FINANCIAL MANAGEMENT AND RUPEE

Financial management is concerned with managing money through planning, controlling, organising and directing the financial activities of an organisation. Funds flows are directed according to plan. The basic functions of financial management, according to Nobanee (2015) include the following:

- estimating capital requirement
- determining capital composition
- finding sources of funds and their investment
- managing cash and disposal of surplus
- maximising sales and minimising cost.

The rupee is the name of the currency of India, Nepal, Indonesia, Sri Lanka, Mauritius, Pakistan, Seychelles and Maldives. According to Kapoor (2002), the earliest coins in the world were issued in ancient India. Rupiya was introduced in 900 B.C. Sher Shah Suri (1540-1545) issued silver coins weighing 178 grains which were called Rupiya. The Indian rupee is a descendent of the rupiya. The origin of rupiya is from the Sanskrit word for silver coin, rupya (Turner, 1985).

The Indian rupee suffered from many problems. Ambedkar's experiences related to financial management helped him in proposing solutions to these problems. Ambedkar favoured the need of an autonomous monetary institution to control the value of rupee associated with exchange rate. Ambedkar's view was instrumental in establishing the RBI. It was established on 1 April 1935 via the Reserve Bank of India Act, 1934. The central office of the Reserve Bank of India was initially in Calcutta but was permanently moved to Mumbai in 1937. Ambedkar also helped establish the Finance Commission of India in 1951 to strengthen the centre-state relations.

7.3 AMBEDKAR ON FINANCIAL MANAGEMENT AND RUPEE

Ambedkar was a monetary economist. He obtained a doctorate from London School of Economics in 1923 under the supervision of Prof. Edwin Canaan. His thesis, "The Problem of the Rupee: Its Origin and Solution" was on the problems of the rupee, and was published in book form in 1923. In his thesis, Ambedkar examined the causes for the rupee's fall in value (Sorade 2013).

The main focus of his thesis in London School of Economics (LSE) was on managing Indian monetary affairs. Unlike J.M. Keynes who favoured the gold exchange standard, Ambedkar favoured the gold standard. He looked into the problems of the rupee at a time when there was a clash between the colonial administration and Indian business entrepreneurs over the value of rupee. Indian businessmen blamed the colonial administration for maintaining an overvalued exchange rate of the Indian currency to support British exporters who sold goods in India. The Congress supported Indian entrepreneurs and demanded devaluation in the Indian currency. Eventually, London agreed to set up the Hilton Young Commission to look into the matter. When this commission, then known as the Royal Commission on Indian Currency and Finance, came to India, each of its members was holding the book, The Problem of Rupee: Its Origin and Its Solution, that Ambedkar wrote in 1923.

In his book, Ambedkar raised the following basic questions:

- Should India stabilise its exchange?
- What should be the ratio at which India should stabilise its exchange?

Ambedkar argued in favour of limited devaluation of rupee, somewhere in between the then prevailing exchange rate and the point of agreement between the Congress and British colonial administration. He said that this limited devaluation would help both the business class as well as the earning class. A devaluation of currency increases inflation. A steep devaluation results in steep inflation which reduces real wages of the earning class. Ambedkar, in his statement to the Royal Commission said:

> The more important point is, supposing that there is a gain arising from low exchange, where does this gain arise? It is held by most businessmen that it is a gain to the export trade and so many people have blindly believed in it that it must be said to have become an article of faith common to all that a low exchange is a source of gain to the nation as a whole. Now if it realized that low exchange means high internal prices, it will at once become clear that this gain is not a gain coming to the nation from outside, but is a gain from one class at the cost of another class in the country.

Ambedkar posited the following facts before the commission to reform the Indian currency:

- Coinage of Indian rupee should be stopped absolutely by closing the mints.
- Minting of gold coin should be opened for the coinage of a suitable gold coin.
- Ratio between the gold coin and rupee should be fixed.
- Both the rupee and gold should not be convertible to each other but they may be circulated as unlimited legal tender at a ratio fixed by law.

Problems of Rupee

i) *Double Standard in Mughal Period*

The Indian money consisted of both gold and silver in the mid-eighteenth century. Hindu emperors supported gold coins while Muslim emperors favoured silver ones (*Princep 1834*). For example, in south India, a silver coin, pagoda, was used as a medium of exchange. Hence both the gold mohur and the silver rupee were in circulation without any fixed exchange ratio between them. Further, different kingdoms in India decided the minting quality of coins, hence metallic contents differed considerably across kingdoms. As a result, the currency lost its primary quality of general and ready acceptability.

A common medium of exchange between the coins in circulation being absent, plurality of medium of exchange created problems in trade. It encouraged barter trading in the markets. The society suffered from diseased money which drove away good money. Consequently Indian economy suffered significantly.

The value of the coin circulated in the Mughal period depended on the fluctuation in the value of metals. When the value of gold increased more than its value when the coin was minted, the circulation of the gold coin got reduced because people would store gold coins at home instead of using them. Similarly, when the value of silver increased more than its value at the time of fixation of the proportion of gold and silver, the circulation of the silver coin got reduced because people would store the silver coins at home instead of using them. This fluctuation in the relative value became a continual problem for trade. Traders started demanding circulation of monometallic coins in place of bimetallic ones.

ii) *From Double Standard to Silver Currency*

In 1833 an Imperial system of administration was set up by an Act of parliament which centralized all legislative and executive authorities over India. It replaced local coinage by imperial coinage. Therefore, a common currency, as a sole legal tender, was introduced in India by an Act of the Imperial government (XVII of 1835), which is also known as the Currency Act of 1835. According to this act, no gold coin was permitted as a legal tender of payment in any of the territories of the East India Company. This was a turning point in India's monetary reforms because monometallic silver, 180 grains in weight, became the sole legal tender throughout the country.

Adoption of silver coinage decreased the revenue collected through seignorage (tax collected on total price of a coin including metal contents and production cost). It created a commercial problem in trade, which was demanding credit that could not be met by silver coinage due to insufficiency of supply of silver.

iii) *Free Banking System*

In the nineteenth century, India followed the free banking system in which every bank was empowered to issue notes. However, notes issued by the Presidency Bank enjoyed more acceptance by the Government for revenue repayment. In 1920, by the Banking Act XLVII, three Presidency Banks were amalgamated into one bank, called the Imperial Bank of India. No discretion was left to the Government regarding paper currency. The Government was empowered to regulate silver mining. According to law, Rs. 979 only could be issued against 1000 to lakh of silver coins. The Indian Paper Currency Law was able to control the volume of issue of notes. Banks were empowered to invest Rs. 4.00 crore in 1861, Rs. 6.00 crore in 1871 and Rs. 8.00 crore in 1890. Denominations of 10, 20, 50, 100, 500and 1000 notes were being issued in 1861. However, even the lowest denomination (Rs. 10) was too large to displace the metallic currency. Perhaps this was the reason why the paper currency could not have as much share as silver coins in total circulated currency (i.e. silver coins plus paper currency). A 5- rupee note was issued for the first time in 1871.

iv) *Lack of Universal Encashability*

The country was divided into different circles for issuing paper currencies. Paper currencies were encashable only in the circle office from where they were issued. They were not encashable in another circle. Thus the Indian paper currency lacked universal encashability despite being legal tender.

v) *Irregular Supply of Money*

Both the demand and the supply of money should be kept equal, to keep a check on prices. But in any economy, the demand for money can never be pre-determined because it depends on the population, trade and seasonal variations (for example, demand is slack in summer and brisk in autumn). Only money supply can be adjusted according to the fluctuation in the demand for money.

Financial management involves managing circulation of both metallic and paper money. But the Indian Paper Currency Act did not permit an increase in supply beyond a limit. Paper notes became inelastic in nature. The demand for money, therefore, increased substantially, more than the supply because the purchasing medium of exchange is a function of both money and credit. It resulted in more demand for metallic money than for paper currency because the supply of the latter was restricted and inelastic.

vi) ***No Cheque System***

Credit was given in cash, not by cheque. This created a shortage of liquidity in banks.

vii) ***No Connection Between Treasury and Banking Operation***

The government treasury operated independently without any connection with the banking operation.

viii) ***Inelastic Credit Media***

Amount of credit in operation was limited due to unavailability of cheque system and limited paper currency. This severely affected purchasing power.

ix) ***Low Profit Margin to Businessmen***

Businessmen dependent on banking operations for borrowing capital were subjected to seasonal fluctuations. Their profit margins could be wiped out because of the fluctuations. A sudden rise or fall in the rate of discount resulted in under trading or over trading. This increased business risk.

x) ***Rupee-Sterling Exchange Variation***

Both the Indian silver rupee and England's gold were made of different metals which were subject to vary in value over a period of time. However, the exchange rate was almost steady up to 1873 at the ratio of 1 to 15.5, but after that, the value of the Indian rupee fell substantially because of demonetization of silver in the international market and less production of silver. It affected trade between the two countries. India paid a higher amount of gold to England due to appreciation of gold value. Consequently British administration in India increased taxes to raise revenue.

xi) ***Switching over to Gold Standard***

India was following the silver standard while most of the prominent countries were following the gold standard. Under the prevalent system, the Government was to pay in rupees in return for gold, in every case, and gold for rupees only in case of foreign remittances (Lindsay Committee 1898). The Government of India had two reserves of currencies-paper currency reserve and gold standard reserve. The difference between the two is summarized in the following table:

Paper currency reserve	Gold standard reserve
Held fully in rupees.	Held partly in gold and partly in rupee
Was in the possession of the Government of India located in India.	Was in the possession of the secretary of state located in London
The Government of India was empowered to sell "Reverse Council" to sell when there was a want of gold.	The secretary of state was empowered"Council Bill" when there was a want of rupee

The paper currency reserve was held fully in rupees while gold standard reserve was held partly in gold and partly in rupee. The gold reserve was in the possession of the secretary of state located in London and the rupee reserve was in the possession of the Government of India located in India. The secretary of state was empowered to sell "Council Bill" when there was a want of rupee and the Government of India was empowered to sell "Reverse Council" when there was a want of gold. The basic points of the Indian currency system can be cited below.

- The gold sovereign was a full legal tender.
- The silver rupee was also a full legal tender.
- The Government of India undertook to give rupees for sovereigns but did not undertake to give sovereigns for rupees, that is, rupee was an inconvertible currency, unlimited in issue.

7.4 LET US SUM UP

In this unit you have learned how B. R. Ambedkar looked into the problems of the rupee at a time when there was a clash between the colonial administration and Indian entrepreneurs and businessmen over the value of rupee. The Indian rupee was suffering from a number of problems.

1) Double standard of both gold and gold exchange was adopted by British administration in India.
2) Every bank was empowered to issue notes at its liberty.
3) Paper currencies were encashable only in circle offices from where they were issued.
4) Paper notes were almost inelastic in nature.
5) The cheque system was not popular.
6) The value of Indian currency was highly volatile.

In such a situation, Ambedkar's experiences related to financial management helped him in proposing solutions to these problems.

He strongly supported gold standard in which the standard unit of currency is a fixed quantity of gold and the country maintains a gold reserve. He emphasized that India could not afford gold exchange standard because it increases inflation and reduces real wages of the earning class. More attention should be given to price stability rather than exchange rate stability. He favoured setting up of an autonomous monetary institution to control the value of rupee associated with exchange rate, which later came to be called the Reserve Bank of India.

7.5 QUESTIONS TO CHECK YOUR PROGRESS

1) What do you understand by the plurality in standards of medium of exchange of currency?
2) Who was the first Indian to get a Ph.D. degree in economics?
3) Name some books on economics written by B.R. Ambedkar.

4) What is the difference between gold exchange standard and gold standard?

5) What do you understand by financial management?

6) Who established the finance commission of India?

7) Who was Edwin Canaan?

8) What problems were being faced by Indian currency before independence?

SUGGESTED READINGS

Jadhav, N. "Neglected Economic Thought of Babasaheb Ambedkar," Economic and Political Weekly, Vol. 26, No. 15, 13 April 1991, pp-980-982.

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