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Recd 20/6/66

18 June 1966

My dear Masani,

I enclose copy of a note on devaluation of the rupee which I wrote for press reporters whom I met yesterday. I thought that you may like to look into it.

With kind regards,

Yours sincerely,

B R Shenoy

(B.R.SHENOY)

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Encl: 1

Statement made at the Press
Conference on 17-6-66

DEVALUATION OF THE RUPEE

Devaluation is, doubtless, a most welcome measure, though by far the best course to adopt would have been to float the rupee, as this would have completely eliminated the harassive balance of payments headache of the past two decades. The extent of devaluation might seem heavy at first sight. But the new rate chosen still leaves behind an ominous measure of over-valuation. It is unfortunate, too, that in the case of about 56 per cent of our exports, the scaling down of the hurdle of currency over-valuation should be accompanied by the erection of fresh barriers of export duties, which cancel one-fourth to one-third of the benefits of devaluation in the case of the major earners of foreign exchange.

2. The purpose of devaluation is three-fold: first, to eliminate the black (free) market in foreign exchange; second, to restore to exporters the full rupee worth of their foreign exchange earnings; and, third, to shift production back to the overseas markets from production for the home market and so to step up our exports.

3. The adequacy and achievements of devaluation have to be assessed in terms of these three purposes. If the black (free) market in foreign exchange is not eliminated, our balance of payments difficulties might remain endemic, rendering chronic our dependence on foreign aid for the external viability of the economy.

4. The mechanics of how this would happen is easily stated. Currently, the rupee fetches about 8d. in the free market; the new official parity is 11.43d. As currently, exporters would, therefore, continue to sell, to the extent possible, their export receipts in the free market, getting Rs.30 for every £1; among other ways, they do this through under-invoicing exports. On the other hand, those who need foreign exchange would try to purchase all and more of their requirements from the official market; they do this through over-invoicing imports. The sale of foreign exchange in the free market and the purchase of foreign exchange in the official market must necessarily run up a deficit in the official market. It is little use trying to argue, as we have been doing, that this deficit is a "developmental deficit", reflecting the foreign exchange finance of developmental projects. It is -- in logic and in fact --a perverse deficit which must ensue when two markets exist for the same commodity, the price in one being higher than in the other.

5. When U.K. devalued in September 1949, the rate chosen was the equilibrium rate which eliminated the free market in transferable sterling and U.K. was, in due course, able to free sterling from controls on current transactions. We, on the other hand, devalued less than sufficiently with the result that exchange controls, import restrictions and the need for foreign aid persisted, a second devaluation being now forced on us as the end result. This history will be, doubtless, repeated as the new rate leaves behind considerable over-valuation.

6. Take now the second and third objectives of devaluation. During the past two decades, with every rise in costs and prices, the result of inflation, the rupee has been more and more over-valued. In consequence, exporters got for the same output less and less rupees on exports; and more and more rupees on sales in the domestic market. This, coupled with our aggressive policies of indiscriminate import substitution, has led to enormous shifts of resources and production from export industries into industries catering to the needs of the home market.

7. This production shift is the tap root of our balance of payments difficulties; it explains the stagnation of our exports at a low level in the context of the rising national product. The rising national product calls for more and more imports to keep the wheels of production moving; with exports remaining low, the gap between foreign exchange earnings and foreign exchange needs necessarily widens. In the context of continuing inflation, export promotion measures could do little more than provide short-lived first-aid relief.

8. There is no escape from India's balance of payments difficulties without producing a shift-back of production from the home market to the overseas markets. And this shift back cannot come about in full measure unless exporters receive the full rupee worth of their foreign exchange earnings as, otherwise, they would continue to cater unduly for the home market. When devaluation is

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incomplete, the shift-back will be incomplete, too, and the balance of payments difficulties will persist.

9. This analysis shows that the export duties,on 12 important items of exports, may prove to be a spanner thrown into the corrective mechanism of devaluation. They deprive the export industries concerned part of the benefits of devaluation. In the case of jute exports, for instance, the net gain in rupees would be 57.6 per cent less the sum of the export duties of 36.4 per cent and the loss of the tax credit certificates of 2 to 5 per cent. This explains the poor response of jute shares to devaluation. For the first four days following devaluation jute share values remained virtually unchanged. On 14 June the jute share index was up by 4 per cent to 48.4 (1959-60=100). The same factors explain the poor response of tea (plantation) prices to devaluation.

10. The export duties, therefore, would hinder the shift-back in production and the solution of our balance of payments difficulties.

11. The devaluation discussion has thrown up some old fallacies. What is logical and necessary under devaluation is a rise in the prices of export goods. Since our exports are but 4 per cent of the national product, this price rise should produce next to no impact on the prices of consumer goods or the general prices index. Any general price rise should be assigned to budgetary causes, not to devaluation. Price data confirm ~~to~~ this logic.

12. Devaluation cannot push down the external prices of our exports as these are determined by the prevailing conditions in the external markets. The flavour of Indian tea remains the same after devaluation; so are the income and demand for tea abroad unaffected by devaluation. External prices of tea should fall only if our exports should exceed the secular increase in the demand ~~o~~for tea.

13. It is incorrect to suppose that, because we do not today have excess export goods, there is no room for devaluation. Increased exports emerge when, first, producers divert their output from the home market to the external market under the inducement of higher rupee receipts; and, secondly, when this inducement leads to increased production for exports.

14. To complain that the World Bank forced us to devalue is to miss the realism of human affairs. India is the largest single debtor of the Bank, our total loans from it being $735 million, Japan coming next with $664 million. The Bank has also played the role of a friendly and sympathetic broker in getting us loans from the Aid-India Consortium, which it organized. It now finds that there is little hope of our ability to meet our external debts without increased exports and that exports cannot increase without devaluation. Quite naturally the Bank felt compelled to use the lever of aid to see that we devalue. An over-sensitive people should not indulge in over-borrowing.

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B.R.SHENOY
17 June 1966