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By K. N. CHAUDHURI

I Introductory: Problems of General Approach and Methodology

This paper stems from a dissatisfaction with the present state of historical writings on India's international economy in the nineteenth century. While the task of reducing the mass of literature available on the subject to a coherent and meaningful survey is a difficult and perhaps not a very fruitful exercise, it is rather easier to understand why such writings on Indian economic history in general and trade history in particular have remained confused and often internally contradictory.

There are three fundamental reasons. In the first place Indian historians have been excessively concerned with qualitative evidence as opposed to quantitative and empirical observation of data. Secondly, the selective method of presenting evidence, as implied by the above point, has been inspired by a corresponding preoccupation with welfare postulates in the place of a positive approach. Instead of asking how does the existence of a drain of wealth affect India's balance of payments and national income, Indian historians have traditionally inquired how does the drain impoverish the Indian people. Finally, the general reluctance to apply the tools of economic analysis in the study of India's economic history has inevitably resulted in a confusion of the main issues involved in matters of both interpretation and methodology. It is difficult to understand how otherwise respected historians in the field of Indian studies could have shown such a surprising degree of lack of understanding involving the simplest terminology of international trade theory.

Apart from this, the most serious methodological failure can be ascribed to the general readiness to accept the concept of a particular problem which has gained wide currency at the popular level and the tendency to work forward from a position so established without examining carefully whether such concepts have any real validity or

[1] A version of this paper was read at the XXVIIth International Congress of Orientalists, Ann Arbor, Michigan, in August 1967.

relevance to the economy in question. An example of this can be found in the attitude adopted by the so-called nationalist historians towards the entire subject of India's foreign trade. This trade, it was vaguely felt, was nothing but an instrument in the hands of the Imperial power for the economic exploitation of India and therefore intuitively considered to be harmful to the true interests of the nation. R. C. Dutt, for instance, dramatically stated that 'the richest country on earth stoops to levy this annual contribution from the poorest. . . . The contribution does not benefit British commerce and trade, while it drains the life-blood of India in a continuous flow'.[2] But even he realized that a country which derived a large proportion of its total national income from foreign trade was in a different position from the one which was not fundamentally dependent on exports and imports to maintain its standard of living.[3] However, Dutt chose not to draw the obvious conclusion: the necessity of estimating the role of foreign trade in India's national economy. Such an investigation might have led to the awkward conclusion that by the end of the nineteenth century the total value of India's external trade was perhaps only a very small percentage of her total national income.

The importance of international trade to the economy of Britain was obviously a strong determinant of the attitude of the British economists towards trade; the Indian nationalist historians unconciously absorbed this preoccupation which provided them with a unique opportunity to build up a political case against British rule in India without the trouble of inquiring first whether such an approach was really relevant to the Indian situation. Thus a major weakness in our understanding of the part played by international trade in India's economy has stemmed from a neglect of the dynamic changes which occurred along the given functional relationships of this trade during the nineteenth century as a whole.

It was generally recognized that in the first three decades of the century certain structural changes took place in India's international economy as a result of her political and commerical connexions with Great Britain. But the usual tendency has been to treat these changes as once-for-all and then to proceed estimating their effects on India taking the whole of the nineteenth century as a homogeneous time period. It does not need much elaboration to point out that this type of static approach is likely to result in a seriously distorted view of the actual course of Indian economic development. The purpose of this

[2] R. C. Dutt, *The Economic History of India in the Victorian Age*, London, 1906, p. xiv.
[3] *Ibid.*, p. 535.

paper is to review briefly some of the established notions of India's nineteenth century external economy and suggest some possible alternative lines of investigation.

At the centre of all discussions regarding the structural changes in India's overseas trade has been the controversy surrounding the famous theory of an economic drain from India. Almost equally important, but conducted at a lesser analytical depth, was the question associated with the effects of competitive imports on India's international specialization pattern. The third and final point that gave rise to much public debate in the closing years of the century concerned the effects of foreign trade on India's domestic economy operating through monetary factors and the price level. For the sake of convenience we shall take the second point first and then go on to a discussion of the drain theory and the currency controversy.

II Competitive Imports

The contemporary views regarding the effects of the rising volume of imports in India's foreign trade covered practically all the major aspects of the theory of international trade. More specifically such discussions were concerned with (i) the pure theory, that is the question as to what factors determined the composition and volume of traded goods; (ii) commercial policy in terms of 'welfare' economics; and (iii) the wider question of the relationship between trade and domestic employment and income.

In order to understand the significance of the contemporary preoccupation with the problem, it is necessary to say a few words about the nature of India's foreign trade during the pre-British or pre-Industrial Revolution period. Traditionally, the main characteristic of trade between India and Europe was a one-way flow of goods. India exported much more than she imported, leading to a corresponding reverse flow of treasure to correct the imbalance. There were complexities introduced through monetary fluctuations which led to bimetallic movements of treasure to and from India but such factors did not fundamentally change the general picture. The classical explanation of this unbalanced structure of trade was to emphasize the rigidity of consumer tastes with its assumption of a very low price elasticity of demand which inhibited the growth of imported goods from Europe. It is conceivable, however, that the imbalance was due to a wide disparity in the structure of prices and the costs of production in

Europe and Asia.[4] By the early nineteenth century technological revolution in Britain, with sharply decreasing costs and rising productivity, had radically changed the potential relationship underlying the trade between India and Europe. The manufacturing industries in Europe were now in a position for the first time in their history of overcoming the barrier imposed by the disparity in the levels of prices. The result could be seen in the rapid substitution of British cotton goods in the international market for India's export products followed by a rising flood of imports into India itself.

Between 1828 and 1840, for example, the value of cotton piece goods exported from India fell by 48 per cent while the imports of cotton yarn and cotton goods increased by 80 and 55 per cent respectively.[5] The rate of expansion in imports which followed the opening of the Indian trade to private European traders in 1814 proved much faster than the corresponding increase in exports from India.[6] Thus an increasing proportion of total export earnings was being currently spent on imports. Since Britain supplied between 65 and 70 per cent of the total value of imports, it is reasonable to conclude that manufactured goods came to play an increasingly dominant role in the composition of India's imports.

One must, however, note that although most of these were products of advanced industrial technology, some categories of imports—such as iron and steel and cotton yarn—had a different role from the finished consumer goods. The effect of these two imports obviously would be what is known as the import multiplier, or in other words they would serve as inputs to Indian domestic industries leading to some employment and income generation, assuming that the decreased cost of the inputs off-sets the contracting effect of the substitution of foreign imports for the domestically-produced raw and semi-finished industrial material.[7] The imports of machinery, tools, and implements, in so far as they raised the efficiency of production, must also be distinguished from other goods. However, these were the more complex aspects of the question to which the contemporary observers paid little attention.

[4] Cf. K. N. Chaudhuri, 'The East India Company and the export of treasure in the early seventeenth century', in *Economic History Review*, 2nd series, 16, 1963, p. 27.

[5] Cf. K. N. Chaudhuri, 'India's foreign trade and the cessation of the East India Company's trading activities', in *Economic History Review*, 2nd series 19, 1966, p. 347.

[6] See G. A. Prinsep, *Remarks on the External Commerce and Exchange of Bengal*, London, 1823.

[7] On this point see Morris D. Morris, 'Towards a reinterpretation of nineteenth century Indian economic history', *Journal of Economic History*, 23, 1963, p. 613.

Their main concern lay in gauging the effects of those imports which directly competed with the Indian domestic products.

The crude view of the competitive effect of the cheap imported textiles from Britain was that it led to the complete destruction of the Indian handloom weavers. The famous quotation given by Marx that the bones of the Indian weavers bleached the plains of India was only one example of the general run of sentiment. In 1840, for example, in the questions formulated by the Parliamentary Committee appointed to consider the trading relations between India and Britain, it was automatically assumed that the competitive position of the British cotton industry had led to a drastic reduction in the size of the Indian domestic industry. But opinion differed whether such an effect was good or bad. Charles Trevelyan and Montgomery Martin took the view that institutional rigidities such as caste and occupational structure had prevented the displaced handloom weavers from turning to alternative employment, while Andrew Sym stated that they were absorbed by agriculture.[8] John Crawfurd in his sketch of Indian economy in 1837 thought that the law of comparative costs justified India's increasing specialization in agricultural products.[9]

These reassuring appeals to theory did not entirely satisfy public conscience and in the 1880s there was much public unease in India that the effect of a policy of partial free trade had been to restrict employment opportunities, such views being reflected in the well-known observation of the Famine Commission of 1880 that one of the chief causes of poverty in India was to be found in the fact that agriculture formed almost the sole occupation of the mass of the population.[10] Modern writers have made much of the suggestion that the construction of the railways in India in the second half of the century accentuated the decline of the handicrafts by extending the market for imported goods and destroyed employment opportunities by economizing the use of labour.[11]

In the absence of detailed empirical studies, it is difficult to make precise statements about the effects of competitive imports. We may,

[8] *Select Committee on the East India Company's Relief*, *Parliamentary Papers*, 1840, VII (353), QQ. 1310, 3915–20.

[9] John Crawfurd, *Sketch of the commercial resources and monetary and mercantile system of British India*, London 1837, p. 26.

[10] *Report of the Indian Famine Commission*, 1880, p. 1.

[11] L. J. Jenks, *The migration of British capital to 1875*, London and New York, reprint 1963, p. 227; D. Thorner, 'The pattern of railway development in India', *Far Eastern Quarterly*, 14, 1955, p. 214; P. Ray, *India's Foreign Trade since 1870*, London 1934, p. 37.

however, distinguish two different types of problems posed by the increasing level of imports into India during the nineteenth century. One relates to the problem of aggregate effect and the other to the relative real wages earned by the various factors of production. Professor Kindleberger has put forward the general proposition that imports can stimulate or retard economic growth, depending on the capacity of a particular economy to transform itself and make the best use of its resources. In an underdeveloped economy, however, where the factors employed in import-competing industries already operate at a subsistence level, the effect of an inability to move into other occupations may be to destroy them altogether through the competition of imports. The general effect then is to encourage an unbalanced growth of the economy through its reliance on agriculture, which ultimately leads to trade acting as a depressor through the operation of the diminishing marginal returns and the deterioration in the terms of trade. On the other hand, if rising imports are a function of increasing exports, income and saving, they might lead to various secondary effects which encourage economic growth.[12]

Obviously, the case of India cannot be explained merely by one or two simplified models. In the first place, it is by no means clear what was the precise degree of contradiction in the textile industry. The general expansion in India's economy in the nineteenth century brought about by the construction of railways and the extension of agriculture, together with the rapid development of the cotton mills in the 1870s and '80s, might actually have increased the size of the textile industry proportionately from what it had been in pre-British days. Secondly, a rising secular trend in the volume of imports can be scarcely maintained if the contraction in the income of the factors engaged previously in the import-competing industries is equal to the increment brought about by expanding exports. One must assume either that some effective transformation took place or that the degree of contraction was not quite as severe as it was taken to be. While no one denies that in the short-run the imports of cheaper machine-made textiles must have produced a painful dislocation, it is difficult to imagine in view of the size of the Indian textile industry at a later time that some sort of adjustment did not take place in either direction to offset the initial reduction in the level of non-agricultural employment.

It may be argued that this was precisely what the nationalist

[12] Charles Kindleberger, 'Foreign trade and economic growth', in *Economic History Review*, 14, 1961, p. 289; *Foreign Trade and the National Economy*, New Haven and London, 1962, p. 104.

historians were objecting to, namely, the so-called ruralization of India and its inhibiting effects, since agriculture was subject to diminishing marginal returns while industrial expansion was capable of constant returns to scale.[13] The answer to this objection must depend on formulating the right kind of 'deductive-hypothetical' questions, or in other words estimating what would have happened in the absence of competitive imports. Even admitting that the initial effects of the imports were detrimental to the welfare of labour engaged in the Indian handicrafts, it must be remembered that labour was already the more abundant factor and was probably earning a lesser share of real wages relative to other factors. It has been theoretically demonstrated that the effect of trade is to lower the return to the more scarce factor and in this light it may be interesting to investigate the impact of competitive imports on capital rather than labour in India.[14] There was at least one nineteenth-century observer who thought that the increase in trade and competition brought about by the opening of roads and the construction of railroads had lowered the rates of profits and therefore return to capital.[15] It is hypothetically possible to argue that the competition created by trade lowered the interest rates in India in at least that sector of the capital market which had been previously financing the production of handicrafts, and to relate the effect of such changes to the establishment of the machine textile industry in the sub-continent in the mid-nineteenth century. In this case the role of competitive imports would fit one of Kindleberger's models where imports stimulate economic growth by inducing technological innovations.[16]

One final word may be added on the commercial policy adopted by the British Government in India. A modern British economic historian has condemned this policy as being utterly selfish and the group-reaction from the Indian side has also been to deplore universally the destructive influence of partial free trade on one sector of the Indian economy. We do not propose to go into this question in detail, but it is worth noting here that the effect of the adoption of a particular commercial policy is not always the same for all countries. For example, the response of the various European countries to the supply of cheap

[13] Cf. Bipan Chandra, *The Rise and Growth of Economic Nationalism in India*, New Delhi, 1966, p. 58.

[14] Stolper and Samuelson, 'Protection and Real Wages', in *Review of Economic Studies*, 1941, also printed in *Readings in the theory of International Trade*, The American Economic Association, London, 1961.

[15] J. M. Campbell, *District Gazette Nasik*, 1880, pp. 142–4.

[16] Kindleberger, *op. cit.*, *Economic History Review*, 2nd series, 14, 1961.

imported wheat was different in each case. In England the policy of free trade led to the destruction of agriculture. In Germany and France a protective policy was adopted and largely preserved the traditional character of agriculture, while in Denmark the effect of cheaper cereal imports was economically the most satisfactory in the form of a switch to the more efficient and intensive dairy and animal farming.[17]

III FOREIGN TRADE AND THE THEORY OF ECONOMIC DRAIN

More than anything else the concept of an economic drain was the most influential factor in shaping the attitude of Indian historians towards India's foreign trade since the latter was the obvious channel through which the drain was effected. The exponents of the drain theory can be divided into two groups, the vulgar theorists arguing simply that the British rule in India was primarily exploitative and those who attempted to build up a more elaborate argument based on statistical calculations to show how the drain actually operated. In the former category were public writers such as Robert Knight, one-time editor of the *Indian Economist*, who asserted in 1869 that India's double misfortune was in being at once a poor country and a country governed by strangers whose administration was not only very costly but marked by all the evils of absenteeism.[18] Such sentiments were reflected at many levels; Major-General F. Marriot, for example, thought in 1874 that the effect of British rule in India was to make everything more costly since basically a poor country was governed by one of the richest which had no notion of public economy.[19] The real exponents of the drain, however, were not concerned with vague ideas of the exploitative character of British government in India; they were trying to present a rigorous statistical proof that foreign trade acted to depress the total national income and levels of employment in India. Thus the essence of the drain theory was to establish a causal link between the changes in the domestic economy on the one hand and foreign trade on the other by using a crude concept of 'gains from trade'. There were also other writers who were concerned

[17] Kindleberger, 'Group Behaviour and International Trade', *Journal of Political Economy*, 59, 1951. For the tariff question, see S. B. Saul, *Studies in British Overseas Trade*, Liverpool, 1960, p. 198.

[18] *The Indian Economist*, 11 October 1869, p. 80.

[19] W. F. Marriot, 'Indian Political Economy and Finance', India Office Library, *East India Tracts*, Vol. 503.

less with questions of welfare and more with the positive aspects of the drain. In other words, this latter group of observers tried to isolate the effects of the drain on India's balance of payments and the mechanism of adjustment.

Historically, the discussions on the problems of drain falls into two periods. Most of the early nineteenth-century discussions were concerned with the balance of payments problems but towards the end of the century the latter issue faded into the background and the main public concern was with the income effect of the drain. There was practically no discussion of the drain theory from Indian writers before Naoroji began his investigations in 1865. The most widely held definition of the concept of a drain was that of an export surplus in India's current account for which there was no corresponding entry on the debit side of the balance of payments whether in the form of import of merchandise, treasure, or securities. From this proposition and the statistical demonstration provided by a comparison between India's total exports and imports the protagonists of the drain went on to show how India was impoverished by the growing export surplus year by year throughout the nineteenth century. For the sake of getting the problem of definition out of the way, we might note that India's active merchandise balance of trade was liquidated by the following off-setting items: (i) the Government of India's foreign obligations arising out of administrative charges incurred in Britain or other parts of the Empire; (ii) invisible service charges such as freight and banking; (iii) remittance of retained profits by foreign entrepreneurs and the savings of British civil servants in India; (iv) payment of interest on foreign borrowings.

During the first half of the nineteenth century the main edge to the whole question was provided by the problem whether the current expansion in India's foreign trade, particularly her export earnings, was sufficient to cover the £3½ million required by the government and some of the other payments plus a reasonable level of merchandise imports. A detailed investigation of India's foreign trade during this period shows that there was indeed matter for concern, and that the Parliamentary Committees were right to investigate thoroughly the whole process of adjustment in international balance of payments disequilibrium which in India's case was likely to be introduced through the presence of a unilateral transfer of funds.[20] The two questions most frequently put before the various witnesses were, first, whether there was likely to be any difficulty in remitting the £3½

[20] Cf. K. N. Chaudhuri, *op. cit.*, *Economic History Review*, 2nd series, 19, 1966.

million on the government's account through the normal channels of trade and secondly, if the exports in any particular year fell short of the necessary sterling exchange requirements, how would trade react? The contemporary thinkers approached the questions from two directions: as an adjustment process following an autonomous dis-equilibrium in the balance of payment and secondly in terms of the specific factors which kept the balance of payments in current surplus. The answers given by the Indian monetary experts on the first problem were essentially the same as those developed by Ricardo and John Stuart Mill who used price discrepancies in the surplus and deficit countries operating through the fluctuations in rates of exchange, export of bullion and the resultant fall in domestic prices in relation to those abroad to explain the mechanism of adjustment.

However, the question as to what factors kept the balance of payments in permanent surplus, as was required in the Indian case, was more difficult to answer and indeed was not attempted in theoretical terms. Instead, the Select Committee of 1840 raised the question whether India had the necessary capacity to pay the so-called 'tribute' and whether or not such payments impoverished the country. The question was put to Horsley Palmer who was himself connected with an Indian business house and had been the governor of the Bank of England. Palmer's reply was that the power of production in India was so great and the commodities themselves so valuable that there was never likely to be any difficulty in making the required payments through the commercial products of the country. As to the second part of the question, Palmer answered that the degree of impoverishment was substantially reduced if the remittances were made in the produce of the country because 'the money levied in the shape of tax upon the population of India is re-expended in the production of India for which a demand arises in Europe and therefore, though the drain to a certain extent does exist, still it is so small as not materially to affect the prosperity of the country'.[21]

It is not difficult to see that even in the 1830s and '40s the classical thinking on the Indian drain problem comprised two distinct components: the income effect and the monetary effects associated with a short-term disturbance in the balance of payments. It was natural in the circumstances that the latter should have received much more attention than the former, because the 1830s were a period of acute trade fluctuations in India, which produced certain immediate effects

[21] *S.C. on the East India Company's Relief, Parliamentary Papers*, 1840, VII, QQ. 1441–44; see also the evidence of Charles Trevelyan, *ibid.*, p. v.

on the Indian domestic economy. The most important of these was the sudden drop in India's exports, combined with a sharp increase in the level of remittances which in 1831–32 and 1832–33 caused a net export of treasure from India. The monetary effects of the deflationary situation were observed by Charles Trevelyan, who stated that the contraction in the domestic supply of currency was such as to cause a marked fall in the prices of commodities and increase the burden of taxation to a grievous extent. But he also noted that this was essentially a short-term disturbance which was corrected by a large inflow of bullion in the years following the depression.[22] The expansion in the value and volume of India's exports and the relative absence of any serious balance of payment crisis (1847–48 was an exception) to some extent diverted attention from the monetary aspects of India's unilateral transfer of funds and stilled some of these earlier fears.[23] The appearance of Naoroji's *Poverty of India* in 1876 reopened the discussion at a different level, which was then continued by Naoroji himself and the others right down to the First World War.

Naoroji's thinking on the theoretical issues arising out of the drain problem was extremely confused and largely coloured by political feelings. Again, he was essentially concerned with welfare analysis and adopted two crude methods to prove his case. One was to give extensive quotation from the observations of British administrators in India to show how the drain had impoverished the country, and the other was to make a rough calculation of the actual extent of the drain. By taking the total value of exports and imports of India from 1835 to 1872 he concluded that Britain had kept back £500 million for her own benefit. He admitted that certain items such as the interest payments on railway loans could not properly be considered part of the drain and therefore have to be deducted from the above sum. But even so a substantial balance still remained unaccounted for, which explained the current financial and economic exhaustion of India. Naoroji did not stop at this point, but went on to argue that the 'normal' foreign trade of a country usually showed an import surplus which he called the profits of exports, and therefore according to his reasoning there was a secondary burden on India through the loss of this profit on exports remitted home through an import surplus. It is quite clear that Naoroji did not distinguish the difference between

[22] *S.C. on the East India Company's Relief*, *Parliamentary Papers*, 1840, VII, QQ. 1441–44; see also the evidence of Charles Trevelyan, *ibid.*, p. v.

[23] For figures of exports and imports for this period, see T. Took and W. Newmarch *A History of Prices*, London, 1857, Appendix XXIII, pp. 712–36; F. J. Atkinson, 'Silver prices in India', in *Journal of the Royal Statistical Society*, 1897.

the f.o.b. valuation of exports and c.i.f. of imports and failed to take account of capital flows and invisible payments in balance of payments account.

Further inconsistencies appeared in Naoroji's calculations as he went on elaborating the theory, which will be too tedious to go into here.[24] However, since his arguments have been described by an Indian historian as foreshadowing the concept of the investment multiplier, it is worth mentioning that he paid little attention to the income effects of exports as, for example, represented by the heavy net imports of monetary silver.[25] His reasoning on this point was that the import of bullion was necessary for purely currency purposes, that it was insignificant in per capita terms, and that anyhow most of it did not remain in British India but went to the Native Princely States.

The substance of Naoroji's arguments was repeated by R. C. Dutt in more eloquent language. According to Dutt one-fourth of the total annual revenue of India was remitted out of the country and he concluded that

> when taxes are raised and spent in a country, the money circulates among the people, fructifies trades, industries, and agriculture and in one shape or other reaches the mass of the people. But when the taxes raised in a country are remitted out of it, the money is lost to the country for ever, it does not stimulate her trades or industries.[26]

The most able answer to these allegations of an economic impoverishment of India operating through the export surplus was provided by Sir Theodore Morison who made a careful analysis of the various items on India's total international obligations and came to the conclusion that the only possible item which could properly be called a drain was the payment of Home Charges, all other items being payments for services or import of capital which had contributed in one way or the other to India's economic development.[27] It may be argued that this way of looking at India's international balance-sheet might reduce the total extent of the drain, but after all Naoroji and Dutt were basically objecting to the payment of the political charges which, according to the latter, constituted a serious depressor in the

[24] For Naoroji's various writings, see *Povery and Un-British Rule in India*, new Edition, Delhi, 1962; for a general discussion of the drain controversy, see J. R. Mclane, 'The drain of wealth and Indian Nationalism at the turn of the century', in Tapan Raychaudhuri, *Contributions to Indian Economic History*, Calcutta, 1963, Vol. II.

[25] Bipan Chandra, *op. cit.*, p. 661.

[26] Dutt, *op. cit.*, p. xiv.

[27] Sir Theodore Morison, *The Economic Transition in India*, London, 1911, ch. 8, ix.

economy. It is obvious that the final answer to the whole controversy must depend on making some sort of estimates of the total value of India's foreign trade in her national income and determining whether the exports were a 'leading', 'balancing', or 'lagging' sector.[28] It is conceivable also that this proportion did not remain constant over the nineteenth century as a whole, and that the problem of remittances or the drain was much more critical in the first half of the century when the stimulus to overall economic development in the sub-continent was probably less than in the later period relative to the size of the out-flow of funds. Some idea of the relationship between the rate of increase in Indian exports and imports and the size of the debt payments can be gathered from the modern studies of India's balance of payment. In the accompanying table we have set out the index number of export and import values between 1898 and 1914 and shown the proportions of imports, total invisible and debt payment, and the Home Charges in the total export values which are also given as percentages of estimated agricultural output. It will be seen that though the share of exports in total value of agricultural production was rising during the period, the proportion of debt payments was falling, while the Home Charges constituted only an insignificant part of the total exports. It is also significant that the imports of merchandise tended to absorb a greater share of the export proceeds. The only conclusion one can derive from these figures is that the proportion of invisible and debt servicing charges in the current account of the balance of payment could not have been much more than five per cent of India's national income in this period.

While statistical computations provide the most convincing and reliable demonstration of the insignificance of the drain controversy, at least in the context of the later nineteenth-century developments, there is also another way of testing such a conclusion, namely, by looking at the problem through the use of the analytical techniques recently developed in the theory of balance of payment adjustment, particularly the branch of the theory termed the 'absorption approach'. We have already referred to the classical explanation of the adjustment process to a balance of payment disequilibrium, expressed mainly in terms of the quantity theory of money. The modern counterpart of this theory is derived from the Keynsian revolution which emphasizes the role of the foreign trade multiplier which, under certain assumptions of the state of elasticities of demand, tends to bring about adjustments through the fluctuations in the levels of income and employment.

[28] Kindleberger, *op. cit.*, p. 195.

The 'absorption approach' is essentially an extension and refinement of the latter theory incorporating also the modern monetary theories.

Index of exports, imports, and treasure; percentages of imports, invisible and debt payments, and Home Charges in the total export values; exports as percentages of total estimated agricultural output, 1898–1914.

Year	1	2	3	4 per cent	5 per cent	6 per cent	7 per cent
1898–99	100	100	100	56	33	1·9	
1899–00	97	103	124	59	34	1·8	
1900–01	95	112	99	61	30	1·7	13·8
1901–02	111	121	87	59	35	0·6	16·6
1902–03	115	116	151	56	30	1·6	14·7
1903–04	136	127	225	50	28	1·1	18·5
1904–05	140	144	219	55	29	1·0	19·3
1905–06	143	169	154	64	33	0·8	20·3
1906–07	157	166	370	60	22	0·9	19·4
1907–08	157	193	351	70	23	1·0	25·6
1008–09	136	179	156	75	25	1·4	18·4
1909–10	166	172	297	59	34	1·0	19·3
1910–11	186	189	310	58	27	1.0	21·8
1911–12	202	201	410	56	24	0·9	25·4
1912–13	218	230	488	60	23	0·8	27·4
1913–14	221	264	346	69	21	0·8	29·7

Column 1: Index number of export values
Column 2: Index number of import values
Column 3: Index number of net import of treasure
Column 4: Value of imports as percentages of exports
Column 5: Total invisible and debt charges as percentage of exports
Column 6: Home Charges as percentage of exports
Column 7: Value of exports as percentage of estimated agricultural output in India

Sources: Y. S. Pandit, *India's Balance of Indebtedness 1898–1913*, Oxford, 1937; K. M. Mukherji, *Levels of Economic Activity and Public Expenditure in India*, Bombay, 1963, Table 3, column 6.

The Keynsian approach starts with the hypothesis that an increase in the level of exports leads to increasing income in the export sector of the economy without, however, providing a corresponding supply of domestically produced goods, while imports constitute a leakage from the circular flow of income by diverting expenditure away from domestic goods. It follows from this that a rise in exports without a corresponding increase in imports results in increased activity in the country with the trade surplus in a period subsequent to the initial rise, some of which will eventually be spent on imported goods.[29] In the case of a deficit or import surplus the process operates in the reverse direction. The modern theory starts from the same premises but it extends the analysis to include the total aggregate receipts (which include exports or other foreign payments) and total disbursements (which again include imports) by the residents of the country concerned and to see how a possible deficit or surplus in the aggregate accounts can be corrected under full employment or inflationary conditions. The possible alternatives open to the policy-makers are either to reduce the domestic expenditure or to divert expenditure from domestic or foreign goods.[30]

If we now go back to the Indian situation, we can see that a 'flow' type of disturbance made it necessary to keep the balance of trade permanently in surplus. So far as the Government of India's own foreign obligations were concerned, the authorities adopted a very simple method; through budgetary policy they created surplus funds which were then placed to the credit of the foreign importers of Indian products through the government's foreign exchange operations and the transfer was thus automatically effected through exports. This was an 'expenditure reducing' operation and was the source of a major confusion in the thinking of Naoroji and Dutt. The latter considered that the entire amount of the exports, equivalent to the payment of Home Charges and financed out of taxation, was a net abstraction from the economy, whereas it is quite clear that some sort of value—added concept must be used here. In this connexion the point made by Horsely Palmer was vitally significant, since the effect of financing exports through taxation is to divert resources to the export industries and increase the income of the factors engaged in the production of export goods. If there is some spare capacity in the economy it allows the existing level of employment to be maintained, even if it does not lead to actual growth which might have followed an autonomous increase in exports. In the absence of spare capacity an inflationary situation might develop, leading to rather different results and therefore this assumption is crucial to our analysis of Indian economy. In his lectures on Naoroji, Professor B. N. Ganguli

[29] For a discussion of the theoretical problems and the bibliography see H. G. Johnson, *International trade and Economic Growth*, London, 1958, Part II; R. C. O. Matthews, *A Study in Trade Cycle History*, Cambridge, 1954, ch. I and 9.

[30] Professor Johnson's discussion of the problem is confined to the correction of a possible deficit since the emergence of a balance of payment surplus does not normally raise pressing problems of policy, Johnson, *op. cit.*

derived the following equation: $Y - T = (C + I) + (X - M)$ where Y is national income, T is tribute, C consumption, I investment, X exports and M imports. The effect of an increase in T, according to him, is to lead to a reduction in Y, an increase in export surplus, and the squeezing of domestic consumption and investment.[31] Obviously, this is true only if we assume that the increase in T is unaccompanied by changes in Y, which under the Indian condition of expanding net export surplus (that is, the import of monetary silver) and capital import is an unrealistic assumption. In fact it can be argued that a policy of taxation encouraging the export industries allows unutilized capacity or resources to be brought into employment and if accompanied by a rise in productivity, it may even lead to a net rise in national income.

In India's case we know that both the budgetary policy of the government and an autonomous rise in foreign demand for her exports were operating simultaneously. It is also not difficult to show that during much of the nineteenth century there was some excess capacity in India in the form of under-employed labour and waste land. The combination of the latter situation may seem a paradox and indeed such a possibility is excluded under classical theory of international trade. But Professor Hla Myint has convincingly argued that the pattern of economic development in the nineteenth century in the case of countries engaged in the production of primary commodities has been strongly influenced by a combination of under-employed labour, surplus resources, and the stimulus provided by expanding trade. This type of situation was observed by Adam Smith and led to the development of his theory of 'vent for surplus' or trade arising out of a highly 'skewed' resource base.[32] The existence of surplus labour is explained by the fact that in a subsistence economy, owing to the lack of efficient transportation, the consequent limitation of the market, and absence of specialization in production, there is little incentive to maximize potential output. The introduction of trade and the construction of social overhead capital with foreign entre-prenurial skill change the pattern of consumer tastes as well as the supply functions often leading to an absolute and proportional increase in output. That this kind of situation was common in India was observed by Sir Thomas Munro as early as 1797 when he noted that one of the chief difficulties in raising the level of agricultural income

[31] B. N. Ganguli, *Dadabhai Naoroji and the Drain Theory*, Bombay, 1965, p. 16.

[32] Kindleberger, *op. cit.*, H. Myint, 'The "Clasical Theory" of International Trade and the Underdeveloped Countries', in *Economic Journal*, 1958, pp. 317–37.

in the Salem district was due to the limitation of the markets and the high cost of transporting produce outside the district.[33]

To return to the problem of the drain, it can be argued on the basis of the preceding discussion that even if it is admitted that the existence of the unilateral transfer slowed down the rate of growth in India which might otherwise have been expected from the rate of expansion in the value of exports, it is by no means true that it acted as a net depressor in the Indian economy, as was stated in the politically irresistible language of Naoroji and Dutt. We do not of course wish to minimize the benefit to Britain provided by her expanding balance of payment surplus with India but, as Professor Saul has shown, export of capital from Britain and her growing demand for imports stimulated the general expansion in the level of world trade by acting as a 'leading' sector from which India benefited indirectly.[34]

IV Foreign Trade and Monetary Problems

While the questions relating to the competition of imported manufactured goods and the unilateral transfer of funds aroused the deepest emotions in India, the discussions centring upon the relationship between foreign trade and India's monetary problems were more impersonal, technical, and illuminated by little understanding. The complexity of the Indian currency system baffled observers both in India and Britain. An example of this was the famous 'silver scandal' which caused the youthful John Maynard Keynes to remark in 1912 that such misunderstandings would continue to arise in the future so long as the relations of the House of Commons to India combined in a high degree of responsibility and ignorance.[35] An exhaustive discussion of India's financial and currency problems is outside the scope of this paper, which will therefore make only some brief concluding remarks on the monetary aspects of India's international economy.

In the nineteenth century the money supply in India consisted of (i) copper and silver coins freely coinable at the government mints; (ii) gold mohurs of limited legal tender; (iii) paper currency backed by metallic reserves; (iv) bank deposits of the western type; (v) native internal bills of exchange; and (vi) the credit created by Indian bankers and money-lenders. Of these the metallic currency was

[33] Sir Thomas Munro, 'Condition of Salem', in *Selections from his Minutes and other Official Writings*, edited by Alexander J. Arbuthnot, London, 1881, Vol. I.

[34] Saul, *op. cit.*, ch. 5.

[35] J. M. Keynes, *Indian currency and finance*, London, 1913.

naturally the most important, and since India did not produce any silver, it had to be obtained through foreign trade. In such circumstances any instability in Indian monetary system was likely to arise out of her international financial position and, as we have already seen, the operation of the 'gold standard' mechanism following a deterioration in her balance of payments in 1831–33 led to a severe crisis in the internal economy. The Select Committee investigating the remittance problem was clearly puzzled by the degree of dislocation and analysed the factors responsible for the deflation as follows:

> The causes of these results is to be found principally in the great consumption of the precious metals which takes place in India . . . It is to be remembered too, that in India a temporary deficiency of metallic currency is not supplied, as in this country, by an issue of paper. An export of treasure is a net diminution of the circulating medium; and while the habits of the people remain what they are, and the monetary system what it is, any considerable export of treasure must produce embarrassments similar to those which have been described by Mr Trevelyan.[36]

The absence of any financial institution in the country with some of the functions of a modern central bank clearly made the whole system highly vulnerable, since a temporary balance of payment crisis could not be corrected by appropriate monetary measures. But in actual fact the frequency of such financial upheavals was not very great, and it was not until the final quarter of the century that the Indian currency system came under sustained pressure. As was to be expected the origin of the disturbance was external and its effects were transmitted to India through the prolonged rise in the bimetallic ratio from the 1870s and the consequent fall in rupee-sterling exchange rates. Since India was obliged to pay large sums fixed in terms of sterling, the government finance was gravely threatened and private trade reduced to a chronic state of uncertainty. The most serious implication for India's export economy was the possibility of a deterioration in her terms of trade which the presence of the transfer problem made almost certain, although it must be realized that there was also a fall in the gold price of India's imports simultaneously with the depreciation of the exchange rate. One of the side-effects of the latter phenomena was to provide in effect partial protection to the newly-established cotton and jute mills in India which might otherwise have been in serious difficulty, though here again it has been argued that at least the cotton industry was secure against the competition of

[36] *S.C. on the East India Company's Relief*, *Parliamentary Papers*, 1840, VII, p. v.

cheapening foreign imports by concentrating on a very specialized section of the market.[37]

By the 1890s the failure to secure an international agreement on bimetallism led the government to take drastic measures and in 1893 on the recommendation of the Hereschell Committee the Indian mints were closed to free coinage and the value of the rupee divorced from the market price of silver, the sterling exchange of the rupee being arbitrarily fixed at 1s. 4d. The reasoning behind these measures was that they would enable the government to bring about an improvement in the rates of exchange and India's terms of trade by contracting the supply of currency in India, although no formal theoretical explanation was offered of how the reduction in the money supply in India would affect international demand for rupees. In fact these measures were initially unsuccessful, and it was not until 1898 that the exchange rate touched the official par. Thereafter, the way was left clear for the gradual and reluctant adoption of the Gold Exchange Standard which ultimately provided India with one of the most perfect mechanisms regulating the supply and demand for foreign exchange. The essence of the system depended on the government's obligation to maintain the fixed rates of exchange in terms of gold to rupees within the gold export and import points, any abnormal fluctuations being smoothed out through official intervention out of the gold reserves in London and silver in India.

On the Indian side the initial criticisms took three forms: first, that raising the exchange in terms of silver would restrict India's growing textile trade with silver-using countries such as China; secondly, that a possible fall in internal prices would harm the cultivators and make their position as leading debtors in the economy an onerous one, and, finally, an irrational feeling that the Indian finances were being adjusted not in her true interests but in those of her British administrators and foreign investors who had savings and profits to remit home. Time was to show that these fears were unfounded. The prices in China adjusted themselves in terms of gold and India's exports to China continued to grow.[38] Similarly, in India a sustained rise in internal prices set in during the closing years of the century.[39]

However, the most serious criticism of the Indian currency system was made by a British economist, namely Keynes himself, who pointed

[37] See Saul, *op. cit.*; Ray, *op. cit.*, p. 183.

[38] *Report of the Indian Tariff Board* (*Cotton Textile Industry Enquiry, 1927*), Bombay, 1927, Vol. I, Report, p. 95.

[39] Cf. K. L. Datta, *Report on Rise of Prices and Wages in India*, Calcutta, 1914, Vol. I.

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out that in the absence of widespread use of bank deposits and cheques the effect of the closure of the mints was to make the supply of money within the country absolutely inelastic. The only way that an increase could be brought about in the money supply was through the purchase of the Secretary of State's Council Bills in London which were then cashed out of the reserves held by the government in India. The effect of this was to accentuate the existing situation where the seasonal demand for money required for moving the crops at harvest time led to a sudden and steep rise in the rates of discount. It also made the Indian money market unduly dependent on the London market and subject to marginal fluctuations in the rates of interest and premium on gold price. The final question then arises whether this inflexibility of the money market with its accompanying high interest rates did not retard India's industrial growth in the early years of the present century. But to answer which would really be an exercise in the application of the theory of capital and therefore beyond the objective of this paper.