FROM DEPENDENT CURRENCY TO CENTRAL BANKING IN CEYLON

AN ANALYSIS OF MONETARY EXPERIENCE
1825—1957

BY

H. A. de S. GUNASEKERA

THE LONDON SCHOOL OF ECONOMICS
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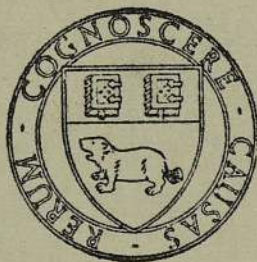

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PREFACE

In recent years there has been an increasing interest in the economic problems of underdeveloped areas. However, specialized studies in this field are still far from adequate. Ceylon is a well known example of an underdeveloped export economy. But there is little published work relating either to the economic development of the island or to the evolution of its monetary institutions. The present work attempts to analyse the monetary experience of Ceylon from 1825 to 1957 against the background of its economic development. Although it is mainly concerned with an analysis of the working of monetary institutions, enough economic history has been included to enable monetary developments to be seen in their proper historical background.

For the greater part of our period Ceylon was a British Colony. British capital was invested in the plantations—first coffee, then tea and rubber. A corollary of her colonial status was the dependence of her economic life on the world markets for her exports. Specialization on export production implied also a dependence on countries abroad for her requirements of food and manufactured goods.

The monetary arrangements which developed in this colonial setting were necessarily adjuncts of the country's export economy. Whether the money supply was provided by private traders or by banks or by a currency board (the form of currency issue which was to become typical of colonial territories) or by a central bank, the structure of the country's economy imposed a rigid pattern upon the behaviour of money and credit. The present study discusses the basic factors which influenced monetary organization in an underdeveloped export economy. It is concerned with the monetary consequences of economic and political dependence. When the country was granted independence in 1948 steps were taken to establish a central bank. The Currency Board system was considered inconsistent with her status as a free nation. Yet the operations of the Central Bank were conditioned and circumscribed by the 'economic dependence' of the country. The latter part of this study is concerned with the special problems of central banking in an underdeveloped export economy.

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For advice on the establishment of a central bank the government of Ceylon preferred to go to the Federal Reserve System of the United States rather than to the Bank of England. Thus, while all the formative influences on Ceylon's monetary and banking institutions had been British, her central bank, both in its powers and in its structure, resembles those that have been recently set up on the basis of American advice in a number of underdeveloped countries.

For the period up to 1903 I have been able to make use of the Ceylon files in the Public Record Office, London. This material throws a flood of light on the factors which influenced official policy towards Ceylon's currency and banking questions. For the latter part of this study, however, I have had to rely almost wholly on published sources.

The study is substantially based on a thesis submitted to the University of London for the degree of Ph.D. It has been revised and rewritten for publication. At the London School of Economics I was fortunate in having Professor R. S. Sayers and Mr. J. S. G. Wilson (now Professor of Economics in the University of Hull) as my supervisors. To them I am deeply grateful for valuable advice and much stimulating criticism. For the shortcomings that remain in spite of their patient and generous assistance I alone am responsible.

I am indebted to the officials and staff of the following libraries for their unfailing co-operation in the preparation of this work: The British Library of Political and Economic Science, the British Museum Reading Room and Newspaper Library and the Royal Commonwealth Society Library. To the officials at the Public Record Office, London, I owe a special debt for helping me to find my way in a maze of unpublished documents.

I am thankful to the Vice-Chancellor of the University of Ceylon and to the University Council for giving me leave from my teaching duties and to the London School of Economics for the award of a Leverhulme Research Studentship, as well as for an additional financial grant which enabled me to complete my research in London.

H. A. de S. G.

University of Ceylon
15 May 1961

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NOTE ON SOURCES

1. The main sources of information for the early part of this study, until 1903, are the Colonial Office papers kept at the Public Record Office in London. These consist mainly of the correspondence between the Secretary of State for the Colonies and the Governor of Ceylon, and are known as 'Despatches'. These documents are indexed in the Catalogues of the Public Record Office as the 'CO 54' series. The series also contains correspondence between the Colonial Office and other departments. The footnote references give the official number of the Despatch, its date and the number of the volume in the series. The number of the Despatch is prefixed with either 'G' or 'S' according as to whether the Despatch is sent by the Governor or by the Secretary of State. Thus, 'G 5 of 10 October 1827, CO 54/99' means 'Despatch No. 5 dated 10 October 1827 from the Governor of Ceylon to the Secretary of State for the Colonies contained in volume 99 of the CO 54 series'.

2. Often the Secretary of State's Despatches are not available in the CO 54 series. Copies are found, however, in the Register of Despatches: CO 55 series.

3. Official papers of some of the other Colonies have also been consulted, especially those of Mauritius, Prince Edward Island, New Zealand and Jamaica.

4. Official correspondence and Reports of Commissions have sometimes been published as 'Sessional Papers' in Ceylon. The footnote references give the number and year of the Sessional Paper, using the abbreviation S.P., which is also used in the Sources to the tables and in the Bibliography. Similarly, British Parliamentary Papers are quoted as 'B.P.P.'

5. The banks' annual reports and other information relating to annual general meetings, as well as banks' balance-sheet figures, have been obtained from the relevant issues of the *Bankers' Magazine*, London.

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CHAPTER I

INTRODUCTORY

The history of a country's monetary and banking institutions is but one aspect of its economic history. The monetary structure of a country and its economic and productive organization are interdependent. While the smooth functioning of the economic system depends closely on the existence of suitable monetary arrangements, the latter are to a large extent conditioned by the characteristics of the economies they are intended to serve. If one or the other gets out of step, there arise monetary problems and sometimes controversy, which it is the task of the monetary historian to chronicle.

This work examines the evolution and the behaviour of the currency and banking system of Ceylon from 1825 to 1957 against the background of its economic development. Such a task requires both a narrative of monetary events and an analysis of their effects on the economic system. More important, however, it entails a discussion of the effects of economic changes and economic fluctuations upon the monetary system itself. Writers on monetary history are often apt to concentrate their attention on one aspect at the expense of the other. In order to guard against such a narrowing of one's perspective it is necessary to devote a fair amount of space in this study to an account of changes in the spheres of production, trade and prices. The absence of any published work on the modern economic history of Ceylon makes such an account all the more necessary. Monetary history is significant only in so far as it is complementary to the analysis of economic change. Any other approach comes dangerously close to numismatics.

For most of the period with which this study is concerned Ceylon was a colony of Great Britain. There is a fundamental similarity in the monetary organization and problems of nearly all the British colonies. This similarity stems from the similarity of economic background. The investment of British capital in a narrow range of plantation crops, the growth of a

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British planting and commercial community virtually separate and distinct from the inhabitants of the colony, and finally the emergence of a native land-owning capitalist class are familiar characteristics of nearly all colonial countries. In addition there was the unifying influence of the Colonial Office whose task it was to exercise a broad control over colonial administrations. Whether the problems were those of Australia, New Zealand, Hongkong, Singapore, Mauritius, or Ceylon, it was the same persons in the Colonial Office who applied their minds to them.

The evolution of Ceylon's monetary and banking institutions and the behaviour of its supply of money and credit were influenced by three main factors. First, there was the influence of the policies of her great neighbour India. Since for most of our period the currency unit of the island was the rupee, the monetary history of Ceylon is closely interwoven with that of India. Secondly, the policies and the decisions of the home government in regard to the monetary organization of the Colony exercised an important, though not often decisive, influence. But transcending them both was the influence of the economic background.

The period 1825 to 1957 may be divided into four phases according to the form of the currency organization that prevailed:

1. A long period of makeshift arrangements starting with the British occupation of the maritime provinces and continuing until 1855.
2. The era of the exchange banks, 1856 to 1884. During this period currency notes were issued by the exchange banks.
3. The Currency Board system, 1884 to 1949. During this period the note issue was in the hands of a Currency Board sponsored by the government. The system lasted until shortly after the country attained independence, when steps were taken to establish a central bank.
4. The beginnings of central banking, 1949 to 1957.

While the effects of Indian monetary events and of the policies of the home government (the Colonial Office and the Treasury) have been given their due share of attention, it is hoped to show

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in the course of our analysis that in each of these periods the dominant influence on the supply and availability of money is to be found within the economy itself in its productive organization.

The Early British Period

Perhaps the one continuous thread which runs through the entire monetary history of Ceylon is its affinity with that of the neighbouring sub-continent of India. Separated from the mainland by a narrow stretch of sea, barely twenty-two miles at its narrowest point, Ceylon's political and economic life, no less than her social and cultural life, has been bound up with that of India. From very early times the coins that circulated there found their way to the island mainly in exchange for what produce she was able to offer to traders from the opposite coast. In addition, every invading army brought over coins that were current on the mainland. Except for occasional attempts by the local kings to strike their own coins, the coins of Ceylon were those that circulated in South India—the puranas, the Roman 'aurei' and 'solidi', the star pagoda, the 'fanam' and a variety of rupee coin.[1] While the Portuguese rulers of Ceylon in the sixteenth and seventeenth centuries were for the most part content with the currency system as they found it, and managed their affairs with the help of a medley of coins of European and Indian origin, the Dutch introduced new coins into the island—silver ducatoons and rix dollars, copper stuivers and 'doit' which circulated alongside star pagodas, rupees and 'fanams'.[2] The basis of the currency system under the Dutch was the South Indian 'fanam' which was a fixed fraction (one-twelfth) of the rix dollar and a varying multiple of the copper stuiver. Ceylon was attached to the currency area of the mainland through the copper 'fanam' whose equivalent in stuivers was varied from time to time according to the value of the 'fanam' in South India.[3] The numerous

[1] For an account of the early currency of Ceylon consult H. W. Codrington: *Ceylon Coins and Currency*, 1924; B. R. Shenoy: *Ceylon Currency and Banking* 1941, Ch. 1.

[2] Portuguese rule over parts of Ceylon extended from 1505 to 1656 and Dutch rule from 1656 until 1796 when the British East India Company established its rule over the entire maritime provinces of Ceylon. The capture of the Hill Kingdom of Kandy in 1815 completed the British conquest of the island.

[3] Cf. Robert Chalmers: *History of Currency in the British Colonies*, 1893, p. 350.

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other coins were rated against one another according to their metallic contents.

When the British East India Company took over the maritime provinces of Ceylon from the Dutch in 1796, the country had been practically denuded of metallic currency except for a small quantity of copper stuivers.[4] Coin had been driven out of circulation by depreciated paper money in the form of 'kas nooten' and 'credit brieven' denominated in rix dollars which had by then become merely a fictitious unit of account.[5] This paper money, the first to be issued in Ceylon, was an embarr[illegible]ing legacy from the Dutch. Sir Frederick North, the first British Governor of Ceylon, decided to withdraw it as soon as circumstances permitted. Early in 1800 the Dutch paper began gradually to be withdrawn and British rix dollar notes took its place. Owing to 'the great inconvenience of circulating copper money', in March of that year North issued notes to the value of 30,000 rix dollars. These notes were exchangeable into specie at the Government Treasury. The readiness with which these notes were accepted induced North to make a further issue of 45,000 rix dollars in the following year. In the meantime the metallic circulation was increased. Copper stuivers were coined both at the Royal Mint and locally and 'the want of some circulating medium less cumbersome than copper' was met by the coinage of silver rix dollars to the value of about £8,000. These coins, whose intrinsic value was 1s. 8d. per rix dollar, passed current at 2s. 1d. The exchange value of both paper currency and coin was maintained by the sale of bills on Madras and London at the rate of $3\frac{3}{4}$ rix dollars per star pagoda and $9\frac{3}{8}$ rix dollars to the pound sterling.

The ensuing years found the government in financial difficulties. The expenses of administration as well as the war against the Kingdom of Kandy caused continual revenue deficits. When the proceeds of bills on the British Treasury and an increase in the government's debenture debt proved insufficient, recourse was had to an increased issue of paper

[4] Copper coins remained in the island as they were not current on the opposite coast.

[5] Cf. A. Bertolacci: *A View of the Agricultural, Commercial, and Financial Interests of Ceylon*, 1817, p. 102. (This work as well as the same author's *Views of Ceylon* are extremely useful sources of information on the economic history of the early British period.)

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currency. By 1812 the note circulation had risen to nearly 2 million rix dollars. Currency inflation and the discontinuance of the sale of bills on London and Madras at fixed rates[6] led to both a depreciation of the exchanges and an export of specie. In July 1812, according to Bertolacci, the exchange had fallen to about 70 fanams per star pagoda and the circulation consisted of about 1·9 million rix dollars in notes and about 100,000 rix dollars in copper coin.[7] In the same year, although the Lords of the Treasury were 'in general, unwilling to sanction either the establishment or the increase of government paper in circulation',[8] Governor Brownrigg secured permission for an increase of about five or six lakhs of rupees [*sic*] on pointing out to the Secretary of State that 'the circulating medium not only will bear but does require a considerable increase by a new issue of current notes'.[9] The Treasury insisted, however, that the amount issued 'be so restricted as in no case to exceed the amount of balances in the Treasury and in the Cutcherries'.[10]

The exchanges began to recover after 1812 due both to a rigid economy in government expenditure as well as to an improvement in trade and production. By 1819 the exchange rate had risen to 54 fanams per star pagoda. The rise in the exchanges and an increase in economic activity led also to an increase in the metallic currency. The government imported 200,000 rix dollars worth of copper coin in 1815, and 400,000 rix dollars struck at the Royal Mint were imported in 1812. At the same time coin flowed in from India in the normal course of trade. In 1823, the Madras quarter-rupee and rupee, both countermarked with a crown, were issued as 'current and lawful money of the island' at the rate of 1⅓ rix dollars per rupee.

Thus, in the early years of British rule there was neither a monetary standard nor a settled system of currency issue. The monetary circulation was dominated by the exigencies of the government's financial requirements, nearly every issue of

[6] The practice was stopped in 1805. Thereafter bills were sold by auction to the highest bidders.

[7] Bertolacci: *A View of the Agricultural, Commercial, and Financial Interests of Ceylon*, 1817, p. 104.

[8] CO 55/62: S 2 of 23 Jan. 1813.

[9] CO 54/44: G 13 of 12 June 1812.

[10] Cf. Shenoy: *Ceylon Currency and Banking*, 1941, pp. 43–46.

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paper money being designed to meet budgetary deficits. The metallic circulation was determined by the ebb and flow of trade, with the government intervening whenever there was a serious deficiency of coin.

The Rise of the Plantations

For many years after 1796 the island remained merely a military and naval outpost constituting a considerable drain on the British Exchequer.

> 'It must be borne in mind,' wrote Lord Torrington[11] in 1847, 'that till within the last ten or twelve years, Ceylon presented few of those characteristics which belong to an enterprising British colony. It was taken possession of originally as a position of importance from a military point of view, which it would have been perilous to our Indian possessions to have left for the occupation of France, and from that time to the present it has been regarded more as a military station of great salubrity than as a rich territorial possession of the Crown.'[12]

Perhaps the makeshift monetary arrangements of this period adequately met the needs of such a military station. They were, however, clearly unsuitable when the island's trade and production increased. As early as 1812, Brownrigg had written of the 'great inconvenience' caused to merchants by the scarcity of currency.[13] Yet until 1841, when the first Bank of Ceylon was established, both merchants and producers were left to their own devices to secure their requirements of currency. Meanwhile, the country was well on the way to becoming an 'enterprising colony'.

Hitherto her cinnamon, spices, gems, elephants and pearls had been the island's chief exports. By the middle of the century, however, British planters had transformed the island into a 'coffee economy'. Thousands of acres of land were granted by succeeding governors to planters, at first without charge and later at a nominal price. The rise of the coffee plantations is perhaps the most significant event in the country's economic history. It represents the first large-scale impact of Western capitalism on the slow moving, feudal, economic

[11] Lord Torrington was Governor of Ceylon from 1846 to 1850.
[12] CO 54/236: G 20 of 8 June 1847.
[13] CO 54/44: G 13 of 12 June 1812.

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organization. It carved out a sector of the economy in which capitalist relationships and business methods prevailed. It created a class of wage-earners drawn almost wholly from India and a local professional and capitalist class whose fortunes and interests were closely connected with the plantation industry. A contemporary observer provides the following graphic description of the effect of the coffee plantations on the economic life of that period:

> 'The pioneer planter introduces into regions all but unknown to man, a host of contractors, who in their turn bring in a train of pedlars, tavern-keepers and others eager to profit by the expenditure about to take place. To the contractors succeed the Malabar coolies, the working bees of the colony, who plant and cultivate the coffee and at a subsequent period reap the crop. Each of these coolies consumes monthly a bushel of rice, a quantity of salt and other condiments and occasionally cloth, arrack, etc., the import, transport and purchase of which find employment for the merchant, the retail dealer, the carrier and their servants; and again the wants of these functionaries raise around them a race of shopkeepers, domestics and others, who but for the success of coffee planting, would have been unable to find equally profitable employment. . . . Then again, when plantations become productive, how many different agencies are called into operation. . . . Colombo stores in their best days gave occupation to thousands of the industrious poor natives and enabled them to support an expenditure for food, clothing and other necessities, the supply of which further furnished profitable employment to the shopkeeper, merchant, seaman, etc.'[14]

The growth of the coffee industry created an 'export economy' in Ceylon and coffee exports became the chief source of the national income. It gave rise to a large number of occupations which were directly or indirectly sustained by export incomes. The country's prosperity hinged on the price of coffee in London. Towards the end of the century coffee was replaced by tea, rubber and the products of the coconut palm as the island's main source of income.

But the impact of foreign capital investment was lopsided. For it attacked and undermined the existing pre-capitalist, feudal, social and economic organization, but did not destroy it. Capital investment was confined largely to the plantation

[14] J. Ferguson: *Ceylon in 1903*, 1903, p. 88.

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industry and to avenues complementary to it. The economy, therefore, was a dual one falling broadly into two sectors—an estate and commercial sector on the one hand, and a rural sector on the other. While the former was based on the plantations, the latter continued to rest mainly on the small-scale cultivation of paddy lands combined with a few handicrafts. Owing to the very nature of the political and economic organization the monetary and credit problems of the rural sector received little official attention. Our historical account is, therefore, of necessity confined to the estate and commercial sector.

The period from the rise of coffee to the present day possesses an essential unity in that the basic economic structure remains unchanged; the country is still an underdeveloped export economy. The size of her national income continues to depend overwhelmingly on the prices fetched by her export commodities in foreign markets. The economy, therefore, has reacted violently to fluctuations of trade and economic activity abroad.

An analysis of the country's monetary experience is concerned essentially with such questions as the adequacy of monetary institutions, the doctrines and opinions which were responsible for such institutional arrangements, the role of the banks, the factors influencing the supply of money and credit, the influence of the monetary factor on economic fluctuations, and on economic development and the significance of central banking. In short, it is concerned with the monetary problems of a colonial export economy in the process of development and change. As such the present study might be of some use in the understanding of the special problems of money and banking in underdeveloped export economies, particularly in those countries which are still Colonies or have only recently emerged from colonial dependence.

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CHAPTER II

THE HISTORY OF THE CURRENCY AND THE BEGINNINGS OF BANKING

In 1802 Ceylon ceased to be under the control of the British East India Company. It was thereafter administered directly by the Crown through the Secretary of State for the Colonies. In Britain the regulation of the currency had always been one of the most jealously guarded prerogatives of the state. The same principle was most scrupulously followed in the Colonies. Colonial currency legislation was usually the result of decisions made by the British Treasury and the Colonial Office in consultation with the Governor of the Colony concerned. As might be expected, the Lords Commissioners of the Treasury had an overriding voice in currency questions. Once a decision was arrived at it received royal sanction by an Order-in-Council and was then communicated to the Governor, who issued a Proclamation enforcing it in the Colony.[1]

The Treasury Minute of 1825

The Treasury Minute of 1825 has left its mark on the evolution of nearly all colonial currencies.[2] Its purpose was 'to introduce a fixed and uniform medium of exchange for all transactions connected with the public service, in place of the various, fluctuating and anomalous currencies which have been created under the pressure of temporary emergency, or with views of local and peculiar expediency'. The Treasury Minute intended that the British shilling should become the chief circulating medium in the Colonies. In the words of Chalmers, the pioneer historian of Colonial currencies, 'the shilling was to circulate wherever the British drum was heard'. The immediate cause of the Treasury Minute, however, was not

[1] While legislation relating to the coinage required an Order-in-Council, other monetary laws could be introduced in the colonial legislatures. But the procedure was the same—Treasury approval was necessary before such laws could receive royal sanction.

[2] Cf. Chalmers: *A History of Currency in the British Colonies*, 1893, p. 23. The Treasury Minute of 11 Feb. 1825 is reproduced in Appendix B, p. 417.

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the grand vision of welding the Empire into one single currency area, but the practical difficulty of paying the Imperial troops in a variety of coin of fluctuating and uncertain value in terms of sterling.[3]

The currency of Ceylon, according to the Treasury Minute, was 'very various' and consisted of 'rix-dollars coined in England for its use, of many coins of India, of Spanish dollars, and of paper rix dollars'. Accordingly, the Order-in-Council of 23 March 1825 was enforced in Ceylon by Regulation 8, dated 4 July, of the same year.[4] British silver was made legal tender and the accounts of the Colony were thereafter to be kept in pounds, shillings and pence. All military and civil disbursements of the Governor were to be made as far as possible in sterling. In order to prevent the export of the silver coin, sterling bills were sold by the government, drawn on 'the agent of the island in England' at the rate of £103 per £100 bill—the premium of 3 per cent. being intended to cover the expense and risk of shipping coin to England.[5] These bills were available for British silver money or for silver or paper rix dollars at the rate of 1s. 6d. per rix dollar.[6]

If, however, a sum in excess of what was paid into the Treasury in British silver or in rix dollars was required for public expenditure, the Governor was authorized to sell sterling bills against Spanish dollars, rupees or any other coin. Such coins were to be issued by the Treasury at a sterling value calculated on the basis of their silver contents—an ounce of silver being priced at 5s. 2d. Thus, the Spanish dollar was equivalent to 4s. 5d., the Bengal sicca rupee[7] to 2s. 1d. and the rupees of Madras and Bombay to 1s. 11d. each. Pending the arrival of British silver, the Governor's proclamation ordered

[3] Cf. Chalmers: *ibid.*, p. 417; The Colonial Office Despatch of 14 March 1825 to the Governor enclosing the Treasury Minute, however, says: 'The object of His Majesty's Government in making the arrangements referred to in these papers is twofold. First, for establishing an unobjectionable and unvarying medium for the payment of the troops, and secondly for establishing a uniform currency in the whole of His Majesty's foreign possessions founded upon and having reference to the United Kingdom.' CO 54/88.

[4] Supplement to Ceylon Government Gazette, 2 July 1825. On the same day the rupee and quarter-rupee of Madras were demonetized.

[5] Cf. Treasury Minute: Chalmers: *History of Currency in the British Colonies*, 1893, p. 418. Experience having shown that 3 per cent. was too high a premium, the rate was reduced to 1½ per cent. in September 1827. Chalmers, pp. 26 and 355.

[6] Secretary of State Despatch of 14 March 1825: CO 54/88.

[7] From the Arabic *sikka*—a coining die.

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that these coins should remain current at the rates mentioned above.

The price of silver on which these rates were based, however, overvalued the various silver coins to the extent of about 3⅓ per cent.[8] The gold price of silver in the market was no more than 5s. per standard ounce. It thus became more profitable to export shillings rather than rupees or Spanish dollars in making payments abroad, and to import these coins rather than shillings whenever the trade balance was favourable. And when sterling bills were purchased at the Treasury it was British silver rather than the overvalued coins which were tendered.[9] Thus the shilling could remain in circulation only so long as the British Treasury was prepared to make continual shipments of the coin to Ceylon.[10] But this was precisely what the Lords of the Treasury wished to avoid. In 1833 the over-valuation of the various silver coins was corrected. The sterling value of the Spanish dollar was reduced to 4s. 2d., of the sicca rupee to 2s. and the Madras and Bombay rupee to 1s. 10d. each.[11]

The Rupee Currencies

When the stage seemed clear for the successful operation of the Treasury scheme, the policy of keeping the island supplied with British silver seems to have been abandoned. In connexion with Governor Sir Robert Horton's request for an annual supply of £10,000 in silver, the Treasury replied, 'My Lords do not deem the circulation of British silver monies an object of sufficient moment to incur the charge of remitting an annual supply.'[12] They considered that 'the admission of Indian and foreign coins to pass current in Ceylon sufficiently provide for a circulating medium of such intrinsic value'. They did not propose to make further remittances of British coin to the island. In effect, they recognized the total failure of the scheme of 1825.

The Treasury Minute, however, produced an unexpected result. Although it failed to establish a sterling currency in

[8] The price of 5s. 2d. per standard ounce was based on the bimetallic ratio of 1601.

[9] This was the familiar phenomenon known as 'Gresham's Law'. For a fuller description of this episode cf. Shenoy: *Ceylon Currency and Banking*, 1941, pp. 48–51.

[10] Cf. CO 54/88: G 108 of 20 December 1832: 'a continued drain thus takes place to meet which a remittance of £10,000 per annum is at present necessary'.

[11] Treasury letter dated 22 June 1833: CO 54/132.

[12] *Ibid.*

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Ceylon, it set in motion a train of events which once again brought Ceylon into the Indian currency area by making the Indian rupee and its subsidiary coin almost the only coined money in the island.

For centuries the coins of India had formed a considerable part of the island's circulating medium. The intimate economic and political links between the two countries had seen to that. The pull of the Indian currency became stronger and more substantial when, with the development of the coffee industry, immigrant labour from India was recruited to work on the plantations and when imports of rice and other foodstuffs from India continued to increase.

The sale of sterling bills in Ceylon against the tender of Indian rupees made Colombo a part of the Indian exchange market. If the rupee was to circulate internally at a fixed sterling value, it was impossible for the authorities to avoid the consequences of fluctuations in its external value. For example, with the sicca rupee valued at 2s., a £100 bill could be bought for Rs. 1015, which gave an effective rupee–sterling rate of roughly 1s. 11½d. per rupee. When the exchange in Calcutta fell below this figure by more than the cost of sending rupees to Colombo, rupees flowed in to take advantage of the more favourable rate of exchange.[13] Similarly, if the Calcutta exchange rose above 1s. 11½d. per rupee by more than the cost of sending rupees to Calcutta, there was an outflow of rupees from Ceylon. Up to 1836 there was a brisk demand for the government's bills, and between 1825 and 1833 over £1½ millions worth were sold. However, in the latter half of 1836 the demand suddenly declined. The cause was the rise in the Indian exchanges—the exchange rate in Calcutta then stood at about 2s. 2d. per rupee. It was now cheaper to buy sterling in India rather than in Ceylon, and the island began to be drained rapidly of its rupee currency. The government was in the unfortunate position of having to sell its bills in India at the unfavourable rates ruling there, while disbursing the proceeds locally at 1s. 10d. per rupee. But the rupees thus imported found their way back to India in settlement of the continual deficit in the balance of trade during these years.

[13] *Mutatis mutandis*, the same argument applies to the Bombay and Madras rupees.

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The Governor, Sir Robert Horton, believed that the export of coin could be stopped by raising the sterling equivalent of the rupee. On 26 September 1836 he issued a Minute stating that the 'Company's Rupee'[14] would, as from that date, be valued at 2s. sterling. The Minute proved powerless to arrest the outflow of specie. But it set up once and for all the 'Company's Rupee' as the country's monetary medium.

Since the price of silver was 5s. per standard ounce the 'Company's Rupee' had been overvalued by over 7½ per cent. by the Governor's Minute. The rupee thus drove all other coins—sicca rupees, shillings and rix dollars—out of circulation. Years later, when favourable trade balances required the import of specie, it was the 'Company's Rupee' which was imported.

While the legal currency of the island was British silver, the currency in actual circulation continued to be the rupee and its sub-divisions. Accounts were kept in pounds, shillings and pence while payments were made in rupees and annas at the 'fictitious par' of 2s. to the rupee. Writing in 1866 to the Secretary of State for the Colonies, Sir Hercules Robinson, then Governor of Ceylon, stated:

> 'For the last 30 years the rupee of India has for all practical purposes been the sole measure of property here. It now constitutes, with its sub-divisions, the real metallic currency of the colony. Accounts are kept and all monetary transactions are described in the denomination of British sterling, but debts so contracted are discharged in rupees at the rate of 2s. per rupee. For this practice, there is not, as far as I am aware, any legal authority.'[15]

The 'legal authority' was the Governor's Minute of 1836 which, in fact, was illegal, for the Governor had no power to make independent decisions regarding currency matters. When a discharged government official demanded payment in sovereigns,[16] which was the only lawful means of payment, Sir

[14] By Act XVII of 1835 the 'Company's Rupee' weighing 180 grains, $\frac{11}{12}$ fine, was declared the standard rupee in British India. In 1862 the 'Government Rupee' of the same weight and fineness replaced it. Cf. Chalmers: *A History of Currency in the British Colonies*, 1893, p. 338.

[15] S.P. 1 of 1869.

[16] By Order-in-Council of 16 October 1852, the sovereign was declared legal tender in Ceylon. Thereafter, the shilling was legal tender only for sums not exceeding forty shillings.

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Hercules Robinson decided that it was time the currency arrangements of the island were given a secure legal basis. It was with this object in view that he commenced a correspondence with the Secretary of State for the Colonies which resulted finally in the Order-in-Council of 1869. It declared that the 'Company's Rupee' and its subdivisions (the ½-rupee, ¼-rupee, and ⅛-rupee) should be the only legal tender in the colony, from and after the first day of January 1872.[17] After much discussion and public agitation, which included the formation of a 'Decimal Coinage Association', Ceylon changed over to decimal sub-divisions of the rupee as from the same date.[18] Accounts of the Colony were thereafter kept in rupees and cents.[19]

The legislation which adopted the rupee as the monetary unit was more than thirty years overdue.[20] For nearly eighty years thereafter Ceylon's monetary system continued to be attached to that of India and shared its varied fortunes. Only rarely did Ceylon develop special problems of its own.

The Paper Currency

The history of the paper currency is in many respects more absorbing than that of the metallic circulation. While the latter shows merely an absence of policy after the failure of the Treasury scheme of 1825, the history of the paper currency was influenced by a definite and settled policy on the part of the authorities. The first half of the nineteenth century has been called 'the golden age of English monetary controversy'.[21] The debate centring round the suspension of cash payments during the Napoleonic Wars was soon followed by the controversy between the Currency School and the Banking School

[17] Ceylon Government Gazette, 26 August 1871.

[18] Cf. Fernando, *Ceylon Currency, British Period*, 1939, p. 9.

[19] Ceylon Government Gazette, 26 August 1871: Proclamation dated 23 August 1871.

[20] In 1847, a Commission appointed by the Secretary of State for the Colonies had remarked: 'It appears to us that as Ceylon is for all commercial purposes a part of India, the simplest and most effectual mode of remedying the present anomalous state of affairs would be to establish in that island the Indian in place of the British currency.' Cf. S.P. 1 of 1869. This suggestion, however, was not acted upon; cf. Treasury letter of 4 March 1854: 'My Lords will not deny that some advantage and convenience may attend the assimilation of the currency and circulating medium of Ceylon to that of the East India Company's possessions which has virtually been effected by Sir R. W. Horton's Minute.' CO 54/138.

[21] Sir T. E. G. Gregory: *Select Statutes, Documents and Reports relating to British Banking, 1832–1928*, 1929, Vol. I, Introduction, p. i.

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regarding the renewal of the Bank of England's Charter in 1844. Questions such as the proper authority for the issue of paper currency, the principles which should regulate the issue of such currency, and the role of the banks in the monetary mechanism of the country were then subjects of heated discussion. It was inevitable, therefore, that when the authorities in England turned their minds to questions of colonial currency, the ideas then dominant should have influenced their decisions. Thus, the changing attitudes of the Treasury and of the Colonial Office bear unmistakably the stamp of the divergent ideas of the Currency School and Banking School theorists.

The quantity of rix dollar notes in circulation, which amounted to nearly RD 2½ million in 1820, had been reduced to about RD 1½ million in 1825. The decision to introduce British silver into circulation required that there should be a further contraction of the paper money. Governor Sir Edward Barnes was therefore required to cancel all rix dollar notes received at the Treasury in exchange for sterling bills.[22] Any disposable surplus revenue of the government was also to be utilized for retiring the notes in circulation.

The Governor, however, persuaded the authorities to agree to a circulation of £100,000 in notes. He emphasized that the withdrawal of the whole of the note circulation at that stage would cause grave inconvenience both to the government and to the public.[23] But his request to issue notes in denominations of ten shillings and five shillings to replace the rix dollar notes of small denominations (which comprised nearly one-half of the total circulation) was refused.[24] The Lords of the Treasury were of opinion that notes of a smaller denomination than £1 would discourage the circulation of British silver money.[25] Barnes made several abortive attempts to induce the Colonial Office and the Treasury to agree to the issue of small notes. In his Despatch to the Colonial Office dated 10 October 1827, he argued that

> 'the monied transactions of this country, and particularly of this island, can in no way be assimilated to those of England.

[22] Treasury Minute of 11 Feb. 1825; Chalmers, *A History of Currency in the British Colonies*, 1893, p. 423.
[23] CO 54/89: G 77 of 26 July 1825.
[24] CO 55/69: S 2 of 23 March 1826.
[25] CO 55/70: S of 2 April 1827.

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> The large majority of the inhabitants here are extremely poor. Articles of provisions are much cheaper, and monied transactions generally carried on in smaller descriptions of currency; consequently a Paper Currency consisting only in Notes of fifty pounds down to one is inconvenient and inapplicable to the purposes of this island. . .'[26]

On that date the paper circulation consisted of about fifty thousand pounds in notes of large denominations of sterling, and of about fifty thousand pounds in five- and two-rix dollar notes. The Treasury, however, insisted on the withdrawal of the small notes, and undertook to make periodical remittances of silver for this purpose. Between 1830 and 1832 the quantity of paper money called in and cancelled amounted to £23,431, which slightly exceeded the amount of specie which had been received from England. A Proclamation issued in June 1831 demonetized the rix dollar notes.

In December 1832, Sir R. W. Horton, who had succeeded Barnes, wrote to the Colonial Office asking for instructions regarding the amount of paper he was at liberty to retain. The amount of notes then stood at £87,000. He suggested that a maximum might be fixed at £100,000.[27]

The Treasury again took the opportunity of setting out its views on the paper currency. The Lords of the Treasury could not consider 'the Promissory Notes of the Colonial Government in circulation and which were issued in payment of the ordinary services of the Colony, in any other light than as a debt incurred for purposes which ought to have been provided for out of the current revenues'. The inconvenience to the government of having to maintain the value of these notes by selling bills at a fixed rate, or by keeping a reserve of coin against them, 'greatly outweighed whatever advantage might be obtained by continuing them in circulation'. On no account were further issues to be made. On the other hand, the Governor was required to continue the policy of cancelling the paper currency by utilizing specie received from England and, whenever possible, the Colony's surplus revenues. However, these instructions were qualified by the option given to the Governor of retaining the notes,

[26] CO 54/99: G 5 of 10 October 1827.
[27] CO 54/118: G 108 of 20 December 1832.

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'if the state of the balances in the colonial chest should be such as not to admit of those notes being withdrawn, without interfering materially with the means of defraying the regular current expenditure of the Government'.[28]

At this stage the authorities appear to have reconciled themselves to the circulation of the remaining Treasury notes. They were more concerned that there should be no further increase in their amount. In March 1835, the Secretary of State, giving permission for the retention of the notes already in circulation wrote to Horton as follows:

> 'As the paper remaining in the circulation does not much exceed the general average of the balances in the public chests, I refrain from pressing you to cancel the remainder of the notes. . .'

He added that the amount of paper may not be increased and that the payment of notes in specie should not on any account be discontinued.[29]

Four years later the Governor, Stuart Mackenzie, again brought up the question of an increase in the currency. He argued that no inconvenience could possibly arise from suiting the issue of paper money to the wants of the community, so long as the holder was entitled to exchange his paper for silver upon demand—a view, however, which was not shared by the Lords of the Treasury who merely reiterated their earlier opinions on the question.[30]

Small Notes

Mackenzie also sought permission for the issue of ten shilling and five shilling notes. The absence of a coin 'of an intermediate value between the sovereign or one pound note and the half-crown or rupee' was a cause of great inconvenience to the public, especially 'in the remoter parts of the interior where many of the coffee plantations are in process of formation'. In these areas money-changers were demanding fourpence to sixpence as commission on the silver given in exchange

[28] CO 54/133 and CO 55/75: Treasury Letter enclosed in S 18 of 24 July 1833.
[29] CO 55/75: S 22 of 21 March 1835.
[30] CO 54/173: G 29 of 11 November 1839; G 11 of 16 December 1839; CO 54/184: Treasury Letter of 4 March 1840.

for pound notes.[31] The Treasury, however, continued to doubt the 'expediency' of the issue of small notes. They again recommended that any increase in the paper currency should be distinctly prohibited. With a view to ensuring that their instructions were followed, the Governor was required to submit periodic returns of the amount of notes in circulation.[32] Governor Colin Campbell's request similar to Horton's, to increase the note issue to £100,000, was refused as it would raise the 'floating debt of the island'.[33]

Clearly, the development of the coffee plantations had increased the urgency of the need for small notes. In 1847, soon after the rush into coffee planting, we find Lord Torrington again emphasizing the necessity for issuing ten shilling notes. A 'Memorandum on the Monetary System of Ceylon' enclosed by him in his Despatch to the Colonial Office, dated 11 November, states:

> 'Since that period, (*i.e.* Mackenzie's despatch of 1839) great anxiety has on several occasions been expressed by the agents and proprietors of the coffee estates, the greater proportion of which have been opened since that period, that they might have the advantage of an issue of notes for smaller sums than £1 sterling. The difficulties and risk of carrying large quantities of copper coin upon men's backs to the remote estates in the mountain districts is very great, and yet it is indispensable for the payment of labour whose monthly wages never amount to £1 sterling. Indeed, the charge for delivering coin at Kandy before it is even carried further into the mountains is 1 per cent, and the sums thus transmitted by the local banks monthly are very considerable during the busy season.'[34]

The Lords of the Treasury were consistently opposed not merely to the circulation of small notes, but to the existence of any government paper currency at all. It was only their reluctance to send specie from England for the retirement of the notes that induced them in 1835 to agree to a maximum note circulation of £87,000. The constant pleadings of suc-

[31] CO 54/173: G 29 of 11 November 1839.

[32] CO 54/175: Treasury Letter to Colonial Office of 4 March 1839; CO 54/173: Treasury Letter enclosed in S 43 of 18 March 1840.

[33] CO 54/190: G 19 of 15 December 1841.

[34] Monetary System of Ceylon: Memorandum enclosed in CO 54/240: G 153 of 11 November 1847. The memorandum was the work of Mr. W. M. Bernard, Colonial Treasurer.

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ceeding Governors could in no way influence the Treasury's opinion.

Against the background of the state of monetary opinion in England at that time, this attitude does not seem as illogical as it does today. The issue of paper money was no function of the government. Its responsibility was confined to the issue of metallic currency. In the eyes of the Treasury, therefore, the government notes in Ceylon were merely a part of the government debt which it was inadvisable to increase for purposes of meeting current expenditure. Nothing was more reprehensible than a budget deficit. The Treasury did not realize that, provided an equivalent value of coin was kept in the government's vaults, an increase in the note issue could not logically be considered as an increase in the government debt. In other words, on its own argument, there was no objection to notes replacing coin.

What was necessary, however, was not so much an increase in the currency (although that was urgent enough), but an increase of hand-to-hand currency. Neither coin nor notes of large denominations were suitable for the payment of wages on the coffee estates. Coin was inconvenient and expensive to transport, while the pound note often exceeded the monthly wages of an estate worker. The low level of incomes and prices required notes of small denominations. The popularity of the old rix dollar notes had demonstrated that the community had no special preference for coin, which was, in fact, mainly required for purposes of remittance to India.

Further light is thrown on the Treasury's attitude by comments they made on Torrington's suggestion that the issue of ten shilling notes should be sanctioned. In turning down this proposal which had the support of the Secretary of State for the Colonies, Earl Grey, the Treasury argued: 'The case of Ceylon too is peculiar and renders a constant circulation in coins to a large amount unavoidable.' It was felt that the Indian workers on the estates had to be paid in rupee coin to carry back with them when they returned to the mainland during the slack season. According to the Treasury, 'to give these people notes exchangeable in Colombo . . . would be a great hardship'.[35]

[35] CO 54/240. The comments were made when Earl Grey drew up a scheme for a government note issue in Ceylon and sent it for Treasury approval. Grey

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The Treasury's aversion to small notes is understandable. In England itself, the small note did not present an impressive history.[36] Their prolific issue by the country banks during the Bank Restriction period had been embarrassing, while the crisis of 1825 had been attributed partly to the over-issue of small notes by the country banks. In 1826, Parliament had decreed the recall of all bank notes of denominations below £5, including the one pound notes of the Bank of England.[37]

Though the policy with regard to the government's paper currency can be understood by reference to the contemporary English scene, the failure of the authorities to provide the island with some arrangements amounting to a 'monetary system' seems inexplicable. The country's trade and production was daily increasing. By 1847 a sizeable coffee industry had been established. The quantity of coffee exports rose from 1·7 million pounds in 1827 to 19·5 million pounds in 1847. Yet in 1833 the Treasury ceased to send coin from England. The monetary circulation depended almost entirely on private imports of coin from India, except for the small quantity of government notes, which were reluctantly allowed to circulate. This state of affairs continued until the establishment of banks in the island completely altered the picture.

The Banks

From the early years of the century banks were being set up in the Colonies. As in the case of the banks in Britain, their business rested largely on their right to issue bank notes. These banks were welcomed by the colonists who were starved of a circulating medium in the midst of abundant resources awaiting development.

By 1840, the Treasury, the Board of Trade and the Colonial Office between them had evolved a set of Regulations for the Colonial banks. In that year the Colonial Office sent out a circular for the guidance of the Governors of the Colonies containing 'Regulations for the Incorporation of Banking

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was agreeable to the issue of 10s. notes. In view of the success of the small rix dollar issues this further Treasury comment seems strange: 'The issue of notes for as small an amount as 10 shillings will only tend to throw the bulk of the island community into the extortionate hands of money changers.'

[36] Cf. A. E. Feavearyear: *The Pound Sterling*, 1931, pp. 171 and 218–26.

[37] 7 Geo. IV. C. 6.

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Companies in the Colonies.'[38] These Regulations had to be complied with before a bank could be granted a local Act of Incorporation. The same conditions applied when a colonial bank was granted the privilege of a Royal Charter. Compared with the uncontrolled state of commercial banking in Britain, the Colonial Banking Regulations appear a veritable strait-jacket. The Regulations laid down stringent conditions regarding the amount of subscribed and paid-up capital of a bank. It was required that the debts and engagements of the company should not 'exceed at any time thrice the amount of the paid-up capital, with the addition of the amount of such deposits as may be made with the company's establishments by individuals in specie or government paper'. The shareholders were liable 'to the extent of twice the amount of their subscribed shares' in the event of a bank's failure. Conditions relating to the transfer of a bank's shares and an increase in its share capital were also set out.

The most significant part of the Regulations is that relating to the issue of bank notes and the conduct of general banking operations. While the circular of 1840 made no distinction between 'promissory notes' and other debts of the company, a revised version of 1846 required that 'the total amount of promissory notes payable on demand should not exceed the amount of the capital stock of the company'. To this an important addition was subsequently made: 'a reserve of specie always to be maintained equal to one-third of the amount of notes at any time in circulation'.[39]

Regarding banking operations, the Regulations required:

(i) That the Company shall not hold shares in its own stock nor make advances on the security of those shares.

(ii) That the discounts or advances by the Company, on securities, bearing the name of any director or officer thereof, as drawer, acceptor, or endorser, shall not at any time exceed one-third of the total advances and discounts of the bank.

(iii) That the Company shall not advance money on the security of lands or houses or ships, or on pledge of merchandise, nor hold lands or houses except for the transaction of its business,

[38] Chalmers, *A History of Currency iu the British Colonies*, 1893, Appendix B, pp. 429–434, reproduces the Regulations in full.

[39] *Ibid.*, p. 433, footnote.

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nor own ships or be engaged in trade except as dealers in bullion or bills of exchange; but shall confine its transactions to discounting commercial paper and negotiable securities and other legitimate banking business.

These principles formed the framework within which British colonial banks have operated for over a century. Royal Charters and Acts of Incorporation have now disappeared but the rigid rules relating to the proper sphere of banking operations or the proper type of banking security have hardly been affected by the passage of years. Chalmers' words written in 1893 still remain true:

'The influence of the Regulations of 1840–46 has ranged from Canada and the West Indies, to Australasia and the Eastern colonies, and even if all the provisions are scarcely abreast of modern theory, yet it may be urged on their behalf that they have withstood the rigorous tests of practical experience throughout half a century, and in every quarter of the globe.'

Beginnings of Banking in Ceylon

The student of Ceylon's banking history has to make his way through a territory almost bare of statistical or other signposts. In the circumstances he may be excused if he grasps eagerly at what few there are. Mr. H. D. Andree, the accountant of the Chartered Mercantile Bank in Colombo, has left us an intimate and delightfully practical account of early banking in Ceylon.[40] To this source, the account which follows is much indebted.

For nearly half a century after the British occupation, Ceylon was without the services of a bank. For those who wished to make remittances to Europe a limited quantity of sterling bills were available. Besides the government's bills, there were bills drawn by the missionary bodies on their parent organizations in Britain. Certain merchant houses also used to sell sterling bills at six months' sight.

Ceylon's exchange problem has always been that of meeting

[40] H. D. Andree: "The Progress of Banking in Ceylon", dated April 1864 in *Ferguson's Ceylon Directory 1876–78*, pp. 82–88. A photostat copy of this article is available in the British Library of Political and Economic Science, London School of Economics.

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her trade deficit with India out of her receipts of sterling from her exports. She had to convert sterling into rupees. The only bankers were the 'Chettiars' or 'Chetties' from South India, who combined a substantial volume of money-lending with their main business as traders. The Chettiar utilized his connexions with the mainland for arranging remittances to and from India. He was prepared to supply rupees in Ceylon which he imported from across the Palk Strait at a minimum of cost. Being the only dealers in rupees the Chettiars were able to choose the bills they discounted. They showed a marked preference for government bills. The merchant houses which required cash were compelled to convert their sterling bills into rupee bills before the Chettiars would negotiate them. For this purpose, the merchant houses established agencies in the Presidency towns of India, against whom they drew rupee bills. The sterling bills were posted to those agencies to be discounted in India. The alternative method of obtaining rupees was to discount the sterling bills in London, ship bullion to India with the proceeds, buy rupees in India and ship them to Ceylon. This involved a long delay and the merchants much preferred to obtain their rupees from the Chettiars. As Andree points out,

> 'Judging from the fact that the entire grain trade was in the hands of the Chetties, and that coffee-planting was in its infancy, the exports consisting principally of cinnamon, coconut oil and coir, we may conclude that they (*i.e.* the Chetties) met all the requirements of the merchants and that importations of specie were but rarely required.'[41]

In the early years of the British occupation, therefore, the absence of banks was not an insuperable difficulty. But the island's economy was being rapidly transformed. By 1840, over 40,000 acres of land were under coffee and 'the mountain ranges on all sides of Kandy became rapidly covered with plantations.'[42] Land was available at next to nothing,[43] and

[41] H. D. Andree: "The Progress of Banking in Ceylon", dated April 1864 in *Ferguson's Ceylon Directory 1876–78*, p. 87.

[42] Sir James Emerson Tennent: *Ceylon: an Account of the Island*, etc., 2nd ed., 1859, Vol. II, p. 230.

[43] Until 1833 the government made free grants of land; thereafter at an 'upset price' of 5s. an acre.

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credit was necessary to bring the land into production. The growth of trade and economic activity created a parallel growth in the demand for banking services. The gap in the country's economic organization became glaringly apparent. The demand naturally arose in the export and foreign trade sector, and the demand was for what has now come to be known as 'exchange banking'. The planters needed banks in order to remit their capital from abroad, to discount the bills of exchange which they drew against the export of their produce, to provide them with cash advances in rupees for the payment of wages, and to sell them sterling drafts when they wished to remit their earnings home. If, in addition, with the tremendous prospects opening out before them the planters were inclined occasionally to look to banks to provide them with capital to bring land into production, it was nothing unusual in the history of colonial expansion. The commercial community which was fast developing alongside the plantation sector needed similar banking services. There arose, too, an increased demand for sterling and rupee drafts to pay for the growing volume of imports—manufactured goods from Britain and rice and foodstuffs from India. This demand soon outstripped the meagre resources of the Chettiar firms.

Ceylon's first bank—the Bank of Ceylon—commenced business on 1 June 1841, having obtained a Royal Charter in that year. 'In spite of the increasing trade of the island', states its prospectus, 'and the progressive cultivation of its natural products, there is no bank whatever, whether public or private, in existence; and it is this great want which the promoters propose to satisfy.' The bank was to be established for the purpose of 'advancing money on securities, granting cash credits, receiving deposits, issuing notes, and other banking business connected with money transactions'. Soon after its inception the bank was caught up in the wild speculation and crash of the 'coffee mania'. In the words of Emerson Tennent,

> 'The Governor and the Council, the Military, the Judges, the Clergy and one half the Civil Servants penetrated the hills and became purchasers of crown lands. The East India Company's officers crowded to Ceylon to invest their savings and capitalists from England arrived by every packet. . . . Five millions sterling

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are said to have been sunk within less than as many years [*sic*] but this estimate is probably exaggerated. The rush for land was only paralleled by the movement towards the mines of California and Australia, but with this painful difference, that the enthusiasts in Ceylon, instead of thronging to disinter, were hurrying to bury their gold.'[44]

The commercial crisis of 1845 to 1847 in Britain precipitated a collapse in Ceylon. The average price of plantation coffee fell from 68s. per cwt. in 1844 to 43s. in 1847. Estates were forced on to the market and sold for a mere song. Those that could not be sold were abandoned and for nearly three years 'enterprise seemed paralysed'. The Bank of Ceylon was heavily involved in the crisis. It had made large advances to planters on the security of their crops, land and buildings.[45] When the crash came the security became worthless and the bank had lost £68,000 out of its nominal capital.

That the bank was unsoundly and injudiciously managed is beyond question. No doubt it interpreted its tasks of 'advancing money on securities' and 'other banking business connected with money matters' rather liberally. But at bottom the bank was just not strong enough to withstand the shock of the coffee crisis. It was the first and only chartered bank in the country. Its operations were confined exclusively to the island and it had not the time to accumulate resources against bad debts or bad times.

In the meantime, the Western Bank of India, established in 1843 with its head office in Bombay, had moved its headquarters to London and changed its name to the 'Oriental Bank'. It opened a branch in Colombo in 1845. Both because of its wider network of operations and because it steered clear of large loans to the coffee planters, it survived the crisis

[44] Tennent, *Ceylon: an Account of the Island*, etc., 2nd ed., 1859, Vol. II, p. 231.
[45] J. Ferguson, *Review of the Agricultural and Planting Industries of Ceylon*, 1888, p. 11. This type of advance was known as a 'Block Debt' and was the cause of many a bank failure at the time. The *Economist* in its issue of 21 October 1843 says: 'the term block debt includes the whole fixtures, appurtenances, and even growing crop. . . . Advances upon factories, plantations, growing crops, etc. have proved a source of . . . serious loss, even to commercial agency houses, whose whole business has been to watch them. Transactions of this kind are of a nature altogether contrary to proper banking business, which, from its very nature ought to be confined to securities available within short periods, and not to those which involve funds for a long or indefinite time.' The practice is condemned as a 'vicious system'. 'Banks in our Colonies.'

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of 1847.[46] In that year it took over the assets and liabilities of the floundering Bank of Ceylon and obtained a Royal Charter. The two banks were merged in 1851 to form the 'Oriental Bank Corporation' with an initial capital of £2,500,000. The bank soon bestrode Eastern banking like a colossus, and its name became as familiar as 'a household word to most businessmen throughout the world'.[47] Branches were soon opened in Kandy and Galle.

Attracted by the scope for banking business in the island, the Oriental Bank Corporation was followed by the Mercantile Bank of India, London and China, which established a branch in Colombo in 1854. After an initial period of hostility and rate cutting by these two institutions, they settled down to more peaceful ways and established what Andree has aptly called an 'entente cordiale' which implied, above all, concerted action in fixing of exchange rates and rates of interest.

The Role of the Banks

In 1844 the Government passed an ordinance making it lawful for banks to issue 'promissory notes for any sum amounting to one pound or upwards' in Ceylon, subject to a fee of 3s. 6d. per half year on every £100 of notes in circulation, and an annual licence fee of £20 for each office up to three in the island.[48] Chartered banks were issued licences free. Neither the Bank of Ceylon nor the Oriental Bank were slow to utilize this privilege.

After 1844, therefore, there were the notes of the banks circulating alongside the Treasury notes. Bank notes, however, suffered under a handicap in that they were not accepted by the government in the payment of taxes and other dues. Government notes enjoyed greater credit and were even held by the banks as part of their cash reserves. Since only a limited quantity was available these notes often commanded a premium in terms of bank notes.[49] The volume of paper

[46] 'Upon the whole the management of the Bank of Ceylon has not been so judicious and fortunate as that of the "Oriental". The connexion of the latter with its sister banks in India and other parts to the eastward gave it considerable advantage in its exchange transactions.' Cf. Memorandum on the Monetary System of Ceylon, *loc. cit.*

[47] Andree, *loc. cit.*, p. 84.

[48] Ordinance No. 23 of 1844.

[49] CO 54/236: G 47 of 8 July 1847.

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currency in the hands of the public on 30 September 1847 was as follows: [50]

Government notes	£43,310
Bank of Ceylon notes	£14,340
Oriental Bank notes	£16,800
Total	£74,450

In conformity with the wishes of the Treasury and the Colonial Office, the government notes had been steadily reduced from about £85,000 in 1840 to about £44,000 in 1847.[51] The total circulation of government notes and bank notes together in 1847 was less than the amount of government notes alone in 1841, and Lord Torrington, the Governor, remarked that 'the whole circulation of the island, and I believe, the capital of the banks, is not really sufficient for its mercantile wants'.[52] The deficiency was partly met by the growth of the cheque habit: The establishment of banks had 'facilitated the transaction of business without the introduction of money'.[53] On 1 March 1848, the deposits of the Oriental Bank amounted to £280,455, and £100,000 of its total capital of £900,000 was reserved exclusively for use in Ceylon.[54] About £42,000 had been invested in bills of exchange and about £55,000 in loans and cash credits. Torrington was able to write to the Secretary of State on 1 May 1848 that 'the Oriental Bank has afforded many advantages not only to the mercantile community, but to the mass of European residents'. Special reference was made to its role in 'facilitating the negotiation of bills drawn against produce shipped to England'.

The banks had also relieved the government, to a large extent, of the task of importing specie. In the same despatch of 1 May 1848, Torrington wrote that the establishment of the banks had facilitated

> 'the operations of the exchanges, by regulating the introduction of specie without any expense to government, which had formerly been much embarrassed and had frequently incurred no little expense owing to the irregularity and uncertainty with which these essential matters were conducted in the absence of any duly authorized institution for regulating the general monetary transactions.'

[50] Memorandum on the Monetary System of Ceylon, *loc. cit.*
[51] CO 54/236: G 47 of 8 July 1847.
[52] CO 54/240: G 153 of 11 November 1847.
[53] CO 54/248: G 86 of 1 May 1848. [54] *Ibid.*

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In order to appreciate fully the importance of regular imports of specie, it is necessary to refer briefly to the pattern of the island's trade and payments. The bulk of her exports were to Great Britain, while the bulk of her imports were from India. Ceylon had therefore to settle her trade deficit with India by converting sterling bills into rupees. The Indian traders who imported rice, cloth and foodstuffs from India preferred

> 'both the risk and the trouble of carrying the specie with them rather than take bills which are only payable at the distance perhaps of 30 or 40 miles from the coast and for the cashing of which they may have to pay at the place where rupees are required at the rate of 2 to 5 per cent. or even more to some extortionate moneylender'.[55]

In addition, Indian rupees had to be imported to meet the needs of the domestic circulation. There was continual influx and efflux of specie between India and Ceylon. The labour force on the coffee estates, consisting almost entirely of immigrants from South India, were paid in Indian rupee coin, at least a part of which they carried back with them when they returned home during the slack season on the estates.[56]

Table 1 below shows the imports and exports of specie during the decade 1837–1847.

TABLE 1

IMPORTS AND EXPORTS OF SPECIE, 1837–1847

Year	*Imports* £	*Exports* £
1837	39,057	9,774
1838	48,840	16,057
1839	230,492	15,222
1840	174,948	4,930
1841	110,796	2,690
1842	172,312	13,026
1843	314,387	830
1844	517,795	13,448
1845	441,157	17,096
1846	381,847	87,402
1847	454,974	198,568

Source: Ceylon Blue Books.

[55] Memorandum on the Monetary System of Ceylon, *loc. cit.*

[56] Cf. *ibid.*: 'Scarcely less than £10,000 a month is remitted to the coffee districts by each of the local banks during the period of picking and preparing the coffee, and little, if any, of this large amount ever returns to Colombo.'

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The table does not include the specie exported to India by traders or that taken away by the Indian workers. The exports and imports recorded in the Customs Returns were almost wholly those of the banks. As can be seen, the rush into coffee in the early forties of the century was accompanied by increasing imports of specie.

Government Notes or Bank Notes?

The existence of the government notes was a constant source of anxiety to the local Treasury. Although there was no separate reserve maintained against them, the notes had to be encashed at the Treasury on demand. At most times the coin in its vaults was barely a fraction of the outstanding issues.[57] Only a year before Torrington's arrival the Oriental Bank had caused considerable uneasiness by asking the Treasury to redeem £15,000 of its notes. An awkward situation was avoided only by the timely arrival of a ship from Bombay carrying bullion for the bank.[58]

The banks were naturally anxious to see the last of the government notes. To them the presence of these notes appeared as an unwarranted infringement of their rights. Their counterparts in other countries had the field to themselves and there appeared no reason why their own activities should be thus restricted. In 1847 the Oriental Bank offered to deposit security with the government in the form of East India Company paper in return for the privilege of keeping the government's cash balances and of being given a monopoly of the note issue. It was suggested that the government notes should be withdrawn from circulation and replaced by the notes of the Oriental Bank. Torrington, who was already much alarmed by the state of the island's Treasury, was anxious to be relieved of the burden of the government notes. In June 1847 he wrote to the Secretary of State that 'the two Banks which are in operation in this colony would probably be able to furnish in a short period all the advantages which could be expected from the circulation of the paper currency and thus relieve the Government from the necessity of issuing its own notes'. He suggested that the entire government paper currency should be

[57] CO 54/248: G 86 of 1 May 1848.
[58] CO 54/240: G 153 of 11 November 1847.

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redeemed as soon as the coin accumulated in the Treasury permitted such a step.[59]

But, in contrast to previous communications from that quarter, the Secretary of State replied that he did not consider a government paper currency necessarily objectionable. He instructed Torrington 'to take no steps without further orders for withdrawing the notes then in circulation and to use the utmost caution to prevent any discredit being thrown upon them or any doubt as to their being continued in use'.[60] There had been a complete reversal of policy in the Colonial Office.

Earl Grey, who then held office as Secretary of State for the Colonies, was an ardent believer in the principle of a government issue of paper currency. In the English currency controversies of this period he was a vigorous defender of the Bank Charter Act of 1844. In February 1847 he had sent a lengthy despatch to the Governor of New Zealand advocating the issue of paper currency by the government. He believed that

> 'the discussions that have taken place in recent years, and more especially the proceedings of Parliament upon the occasion of the last renewal of the Bank Charter, have . . . in the judgment of those whose authority is of most weight in this subject, finally settled the principles upon which a paper currency ought to be regulated'.[61]

He now enclosed a copy of this letter to Torrington and proceeded to take the preliminary steps towards the establishment of a properly regulated government paper currency in Ceylon.

Earl Grey proposed that a special department of the Colonial Treasury, to be called the Currency Department, should be set up. It was to maintain a reserve of £14,000 in specie against a note circulation of £40,000, and

> 'no notes will be issued by the Currency Department except in exchange for specie received from the Government or from individuals or in exchange for debentures received from the former; and coin in the Currency Department shall never be suffered to fall below the minimum reserve of £15,000'.[62]

[59] CO 54/236: G 20 of 8 June 1847. [60] *Ibid.*: S 66 of 6 August 1847.
[61] Earl Grey to Governor Grey of New Zealand: CO 406/6: 2 February 1847.
[62] Earl Grey's draft despatch 'A' in CO 54/240.

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He wished to limit the circulation of the existing banks and to prohibit the establishment of new banks of issue.

Earl Grey's advocacy of a government issue was based on three main considerations. To start with, he was an uncompromising adherent of the ideas of the Currency School. The principle of a centralized issue had only recently been adopted in England, and in his letter to the Governor of New Zealand he set out the arguments that were being used in support of Peel's Act of 1844.

> 'I consider,' he wrote, 'that the business of banking or of dealing in money and that of issuing paper money, have not merely no necessary, but no proper connection with each other. The former is a branch of commercial business which should be left like every other to private enterprise; but to issue money, that is, to furnish the authorized medium of exchange is one of the peculiar and not the least important functions of the government.'

A metallic currency was not liable to 'injurious fluctuations' because it was regulated by the influence of the exchanges 'of which the operation is too powerful to be counteracted by law'. In order to unite the 'advantages of cheapness and convenience which belong to a paper currency' with the 'steadiness and uniformity of value' of a metallic currency, 'one of the former description ought to be so regulated that the amount in circulation should vary according to the laws which govern the latter'. Paper money beyond a fixed amount should be issued only in exchange for the precious metals and should always be redeemable in the precious metals. This was undiluted Currency School theory.

In addition, Grey was impressed by the 'cheapness' of a paper currency, which would lead to 'an important saving in the capital of the community'. But perhaps what weighed with him most was the poor record of some of the issuing banks in the colonies. In June 1848, the Colonial Office wrote to the Treasury,

> 'In view of the calamitous results of bank failures in Calcutta and the West Indies Lord Grey is more than ever indisposed to encourage the issue of paper money in the colonies under any authority except that of the respective governments.' [63]

[63] Earl Grey's letter to Treasury: CO 54/248: 5 June 1848.

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Grey's proposal was sent to the Treasury for its comments. Charles Trevelyan, Assistant Secretary to the Treasury, was in sympathy with the ideas underlying it. On 9 March 1848, Trevelyan wrote to Grey: 'Your Lordship is already aware that I concur with you on the advantage of a properly limited and regulated government paper currency.'[64] He agreed that the circulation of the existing banks in Ceylon should be limited and the establishment of new banks issuing notes prohibited 'according to the plan adopted in regard to country banks on the occasion of the last renewal of the Bank of England Charter'. But Trevelyan advised that they should proceed cautiously owing to the extreme novelty and difficulty of the whole plan. He suggested that the experiment should be tried on a small scale in order 'to accustom people to the advantages of the plan and the proper mode of working it . . . and it will be easy to extend our operations when the proper time arrives'.[65] In other words, while he approved the plan in principle Trevelyan was not prepared to run along at the pace set by Grey.

As the months went by Treasury opinion hardened and Trevelyan himself withdrew his support for Grey's scheme. He became convinced that if Grey's instructions were sent out to Ceylon there would be a 'financial imbroglio and breakdown'. He argued that the plan was 'so complex, so foreign to the experience of the Colonial Government and so inconsistent with the Indian habits and with the peculiar circumstances and necessities of the trade and monetary circulation of Ceylon'. He took the view that a large metallic circulation was necessary in Ceylon particularly in order to meet the needs of the Indian estate workers.[66] To pay them in notes would 'throw them into the extortionate hands of money-changers'. Grey agreed that there was 'a good deal of force' in Trevelyan's objections to his scheme and decided to give it up. But in his final letter to Trevelyan on this subject he wrote: 'You must not, however, suppose that the idea of economising capital in Ceylon by the issue of well-regulated government paper, including 10s. notes, has been given up. I shall hereafter again bring forward this proposal.'[67]

[64] CO 54/240: Trevelyan to Grey: 9 March 1848. [65] *Ibid.*
[66] Treasury comments on Grey's draft currency proposals: CO 54/240.
[67] Grey to Trevelyan: 30 June 1848: *ibid.*

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The establishment of a government paper currency came only thirty-six years later, in 1884. It was the result of a calamity foreseen by Earl Grey, the failure of an issuing bank. But when it came it embodied most of the features of Earl Grey's scheme of 1847.

In the next few years the policy of the home government underwent a sea-change. The policy of cancelling the government notes was once again resumed and its newest advocate was Trevelyan himself. The notes outstanding had been reduced to only £22,391 at the beginning of 1855.[68] In the meantime there had arrived at the Treasury a man who had already made a name for himself in Britain as a champion of the issue of currency notes by the banks.

James Wilson, M.P., became First Secretary to the Treasury in 1852. He came with a wide background of experience in economic and financial matters. He was a founder and a director of the Chartered Bank of India, Australia and China, besides being the founder and first editor of the *Economist*. He was a principal participant on the side of the Banking School in the monetary controversies which centred round the Bank Charter Act of 1844 and had published in 1847 a major work on finance entitled *Capital, Currency, and Banking*.[69]

With James Wilson advising the Colonial Office in currency matters, events began to move faster. Early in 1852 the directors of the Oriental Bank Corporation addressed a memorial to the Governor of Ceylon, stating that the government notes were in bad credit, often circulating at a discount of five to ten per cent. in terms of coin. They urged that these notes should be withdrawn and the Oriental Bank be given a monopoly of the note issue, a request which in 1847 had evoked Earl Grey's forthright views on the question of a paper currency.[70] The Treasury rejected the proposal as it was opposed to a single bank being given the exclusive privilege of issuing notes.[71] It was opposed by the members of the Executive Committee in Ceylon as being likely to discourage other banks from establishing themselves in the island. It was felt that the Oriental Bank already 'had too strong a command over the money

[68] CO 54/315: G 23 of 19 June 1855.
[69] The essays in this work appeared originally in the *Economist* of 1845 and 1847.
[70] CO 54/289.
[71] CO 54/294; Treasury letter to Colonial Office: 23 October 1852.

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market'.[72] There was no objection, however, to the Oriental Bank's notes being declared legal tender and to the bank managing the government's Treasury business.

However, Wilson was considering afresh the whole question of paper currency in the colonies. He was faced with similar problems elsewhere, particularly in Mauritius, New Zealand and in Prince Edward Island. On 21 February 1855, Wilson addressed a letter to the Colonial Office, urging that, 'the circulation be placed with the proper safeguards under the management of banks of issue'.[73]

The Treasury's attitude, as represented by James Wilson, derived support from the experience with government issues in New Zealand and Mauritius. In the former, a state issue had been established at the instance of Earl Grey in 1848, but the House of Representatives had requested that 'it be allowed to lapse in the natural course of events' on the ground that government issues were 'injurious to free commercial enterprise'. Up to 1854, the New Zealand government had incurred a net loss of £625.

The working of the government paper currency in the island of Mauritius merely served to strengthen the Treasury view. Government issues had proved equally unprofitable in that colony. On these grounds a proposal for a state issue in Prince Edward Island had been turned down by the Treasury in 1854.[74]

Wilson's argument was at bottom a case for free enterprise as against inept and arbitrary management by the state. The Treasury Minute on the proposed issue of government notes in Prince Edward Island which is referred to in Wilson's letter speaks of 'objections of the most serious nature to a government undertaking such functions, especially in small communities'. Even the small profit that might be derived by the government from its circulation was no compensation for the loss and inconvenience suffered by the community when the state tried to do what the banks could have done

> 'with greater efficiency and benefit to the trade of the island. So, as in any other branch of trade which might be undertaken

[72] CO 54/289: G 69 of 7 April 1852.
[73] CO 54/319: Treasury letter to Colonial Office: 21 February 1855.
[74] CO 54/84: Treasury letter to Colonial Office: 13 Jan. 1854.

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by a government, the real profit derived by the community would be less than if undertaken by private enterprise. It would be the same as regards the profits derived from the circulation of notes.'[75]

The Minute argues further that the moment the government issues notes not merely against bullion but also against securities, it trespasses on the field of the bankers and undertakes the risks inherent in banking business without the specialized knowledge necessary for the efficient conduct of such business. Then, in the true style of the Banking School, the letter goes on to discuss the influence of bank operations on the state of the circulation. When the banks have too large a reserve they increase their discounts and advances or buy securities, 'and by this means, through the operation of the exchanges, the surplus bullion is exported'. Similarly, bankers, by restricting their accommodation, are able to restore the country's stock of bullion. 'It is through the aid of the banking operations, that is, the advances made to the public in discounting bills, etc., the extent to which they are made from time to time and the rate at which they are made, that the exchanges are most easily affected and the circulation maintained in its proper amount.' It is then argued that the Issue Department of the Bank of England is being constantly influenced by the policy followed by the Banking Department, thus helping a proper circulation to be maintained.

Thus, the ideas of the Banking School which suffered a partial eclipse by the enactment of the Bank Charter Act of 1844, exercised a considerable influence on colonial currency policies in the middle of the nineteenth century. In Wilson's letter of February 1855, we have almost an echo of the banking principle when it states that the business of note issue

'being intimately connected with the commercial dealings of the country, can only be satisfactorily managed by banks, which necessarily regulated their issues by the state of trade from time to time and have the opportunity of expanding or contracting the circulation according to its fluctuations'.

Apart from these theoretical considerations, there was the fact that it seemed difficult to reconcile a state issue with the

[75] CO 54/84: Treasury letter to Colonial Office: 13 Jan. 1854.

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privilege of note issue granted to the banks by Royal Charter under safeguards which appeared more than adequate to the Treasury. It was an anomalous situation. A decision had to be made one way or the other. The Oriental Bank was chafing under the unwarranted competition of the government notes and had made several appeals to the authorities. This aspect of the question was referred to by the Governor Sir Henry Ward in his address to the Legislative Council, announcing the decision to withdraw the Treasury notes.

> 'The decision come to by His Majesty's Government with regard to the withdrawal of the Treasury Notes now in circulation rests not merely upon the grounds stated in a prior letter,[76] namely that a large circulation of government notes payable on demand must lead to risk of embarrassment in times of financial difficulty, while it is of doubtful advantage in times of prosperity, but upon the fact that it is difficult to conciliate such a circulation with the just expectations of private banks of issue already established or that may hereafter be established by Royal Charter or by Colonial Ordinances upon conditions that are deemed indispensable to the public security.'

Strangely enough, Wilson appears to have been misinformed about monetary conditions in Ceylon. He believed that the arguments adduced in the case of Prince Edward Island applied 'ten-fold in the case of Ceylon', because the Ceylon government's notes were inconvertible. This is a surprising error, especially as one of the earlier objections to these notes was that they might embarrass the Treasury if presented for conversion either by the public or the banks. He accepted the statement in the Oriental Bank Corporation memorial that government notes were at a discount of 5 to 10 per cent. because of the lack of public confidence in them. However, Governor Ward, while agreeing with the wisdom of the step recommended by the Treasury, felt constrained to point out that the memorial was not 'a full and candid statement of the true position'.[77] After consultation with the senior officials of the government, he assured the Secretary of State that paper in general was at a discount owing to the pressing demand for

[76] CO 54/294: Treasury letter to Colonial Office: 23 October 1852, signed by Charles Trevelyan; also CO 54/242: Treasury letter: 31 Aug. 1847.
[77] Proceedings of the Ceylon Legislative Council, 1856.

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silver in the outlying parts of the country. Oriental Bank notes, too, were at a discount 'at any place other than the place of issue'. The discount on paper represented merely the cost of transport of silver. In fact, the government notes enjoyed an advantage in this respect because they could be cashed at provincial Treasuries (Kachcheris) whenever funds were available.[78] The local Legislative Council, in its reply to the Governor's Address on 5 July 1855, remarked that it

> 'perceived with regret that the Letter of the Treasury dated 21 February 1855 . . . has been written in the belief that a state of affairs prevailed in Ceylon in respect of the management of its paper money by the local government which has not now, and never has had, any existence'.[79]

In December 1855, Sir Henry Ward announced the withdrawal of the remaining Treasury notes,[80] declaring that the 'promissory notes payable on demand by any Chartered Bank would be accepted at the Treasury and at all Kachcheris in the settlement of taxes and other dues'.[81] In order to safeguard the government against the failure of a bank, the colonial treasurer was required to encash all bank notes held by government above a minimum sum.

The Governor's announcement left the Oriental Bank in sole possession of the field, since the Mercantile Bank was not 'a Chartered Bank'. When the latter obtained a Charter in 1859 the privilege of issue continued to be shared by the two institutions until 1884 when after the failure of the Oriental Bank Corporation a government paper currency was reintroduced.

[78] CO 54/315: G 23 of 19 June 1855.
[79] Proceedings of Ceylon Legislative Council, 5 July 1855.
[80] The amount of Treasury notes in circulation in 1855 was estimated at £22,391: CO 54/315; G 23 of 19 June 1855.
[81] Ceylon Government Gazette, 28 December 1855.

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CHAPTER III

THE ERA OF THE EXCHANGE BANKS

The economy took several years to recover from the coffee crisis of 1847. But by 1855 it had entered a period of sober expansion. The planters had taken to heart the lessons of the previous period.

> 'It is no exaggeration,' wrote Sir Emerson Tennent in 1857, 'that there is not a single well established principle which now guides the management of estates, and the conduct of their proprietors, that was not preceded by a directly opposite policy prior to 1845. . . . Expenditure has been reduced within the bounds of discretion . . . and although the extravagant prices and still more extravagant expectations of that period have been dissipated, coffee planting at the present day promises to be as sound an investment as moderate enterprise can hope for.'[1]

While in 1855 the estimated area under coffee was only 85,600 acres, the figure had risen to nearly 250,000 in 1875. As can be seen from Table 2, the quantity of coffee exported almost doubled during these two decades while its value increased almost fourfold.

In the wake of this development of coffee plantations, the country was undergoing an economic revolution. New roads and bridges were built and the traditional isolation of the villages was broken down. Railways were opened connecting the planting districts in the central hills to Colombo and the coastal districts. In 1867 the Colombo–Kandy Railway was opened and in the next few years the line was extended to Nawalapitiya (1873) and Nanu Oya (1880). The plantation district of Matale was connected to Kandy in 1880, while a coast line to Kalutara was completed in 1879.

It was left to the banks not merely to supply the credit requirements of the economy during this period of economic expansion, but also to supply its medium of circulation. It is indeed remarkable that the considerable economic develop-

[1] James Emerson Tennent: *Ceylon: an Account of the Island, etc.*, 1859, Vol. II, p. 231.

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ment of the colony prior to 1856 was carried through in spite of the absence of a suitable monetary system. Prior to 1856, the money supply consisted of Treasury notes, bank notes,[2] Indian rupees, and its subsidiary coinage. The volume of Treasury notes diminished steadily and never was above the limit of £37,000. They were legal tender, convertible at the

TABLE 2

THE COFFEE INDUSTRY, 1855–1875

Year	*Acres thousands*	*Quantity of Coffee Exported cwts thousand*	*Value* £ thousand*	*Value of Total Exports £ thousand*
1855	85·6	506·5	1125·3	1974·8
1865	160·0	927·4	2343·5	3565·1
1875	249·6	924·3	4506·9	5375·4

* In the Ceylon Blue Books coffee exports were valued at a conventional 'average price' which was adjusted from time to time. The price per cwt between 1855 and 1875 was as follows:

	Plantation Coffee s. per cwt	*Peasant Coffee s. per cwt*
1855	44	33
1856	46	39
1857	51	43
1858	53	39
1859–1872	54	40
1873	88	80
1874	90	76
1875	100	80

Source: Ceylon Blue Books.

Treasury into specie and were accepted by the Government in payment of revenue. The notes of the Oriental Bank, and after 1854 those of the Mercantile Bank, were also in general circulation.[3] They were, however, not accepted at the Treasury or the government Kachcheris. The volume of bank notes depended on the ability of the two banks to keep their notes in circulation. The banks' notes were more in demand in the towns where the banks had branches. Elsewhere they were generally at a discount. The amount of Indian rupees that circulated was unknown; large quantities entered and left the island annually. The banks had to maintain a reserve of specie equal to one-third of their note circulation. The

[2] From 1841 when the first Bank of Ceylon was set up.

[3] On 31.12.55, the amount of Treasury notes outstanding was £12,258 and the note circulation of the two banks was £63,478 (Ceylon Blue Books).

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reserve consisted mainly of Indian rupees, as sovereigns—though they were legal tender—were not in circulation.

Table 3 below gives the figures of the exports and imports of specie during the period 1847–1855 as recorded in the Customs Returns.

TABLE 3

EXPORTS AND IMPORTS OF SPECIE, 1847–1855

Year	*Exports* £	*Imports* £	*Year*	*Exports* £	*Imports* £
1847	198,567	454,973	1852	197,739	641,095
1848	512,040	359,956	1853	1,824,619	2,346,040
1849	302,434	418,741	1854	682,807	1,371,975
1850	272,612	452,382	1855	297,368	930,419
1851	727,311	1,004,967			

Source: Ceylon Blue Books.

It will be seen that the figures for imports of specie far exceed those for exports except for the year 1848. One might be tempted to conclude that considerable additions were being made from year to year to the amount of specie in circulation—that Ceylon, in fact, was a 'sink for the precious metals'. Such a conclusion, however, would be erroneous. For while the imports of specie were usually made by the banks and were, therefore, recorded in the Customs Returns, the total outflow of specie was an unknown quantity. What is included in the table is merely a fraction of the specie which annually left the island. It is mainly a record of the specie exports of the banks. It excludes what was sent out by the Indian traders 'in payment for rice and cloth',[4] and also what was taken away by the thousands of Indian labourers when they commenced their annual homeward migration during the slack season on the coffee estates.

Whatever the merits or demerits of the decision to withdraw the Treasury notes in 1855, it at least made the monetary system less complicated for the general public. Now there were only two types of money—bank notes and coin. Bank notes, which constituted the bulk of the circulation, were being accepted by the government in payment of revenues and taxes. The banks were now able to meet the increasing demands of the circulation untrammelled either by government competition or by irksome restrictions on the acceptability of

[4] The phrase occurs regularly in the Ceylon Blue Books.

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their notes. The Mercantile Bank of India, London and China was reconstituted as a chartered bank in 1859, adding the prefix 'Chartered' to its name. Thereafter its notes enjoyed the same status as those of the Oriental Bank. Except for the brief intrusion of the Asiatic Banking Corporation which opened a branch in Colombo in 1865, but went into liquidation a year later, the Oriental and Chartered Mercantile banks were responsible for the country's note circulation until 1884. The Bank of Madras, which opened a branch in Colombo in 1867, was not a chartered bank,[5] and did not issue notes, for by Ordinance No. 2 of 1861 the right of note issue was confined to chartered banks and could be extended to other banks only by special proclamation. Nevertheless this bank came to play an increasingly important part in the country's monetary arrangements.

The Business of the Banks

The banks were established in the island to meet the needs of a rapidly developing export economy. It was the plantations and their attendant commercial life which brought them to the island, and it was this same sector of the economy that they continued to serve. The two chartered banks were bound generally by the Colonial Banking Regulations most of the provisions of which were written into their Charters. Clause II of the Regulations of 1841 prohibited the chartered banks from advancing money on the security of fixed property or 'on the pledge of merchandise' or 'to engage in trade except as dealers in bullion or bills of exchange'. Their transactions were to be confined to 'discounting commercial paper and negotiable securities and other legitimate banking business'.

It is apparent from their advertisements in the local newspapers and periodicals that after the brief but hectic career of the first Bank of Ceylon, its successors hardly ever intended to transgress those limits in their day-to-day business. The nature of their business remained almost unchanged as the

[5] The Bank of Madras was founded under the Indian Presidency Banks Act of 1861. During this period two other banks 'came and passed away': the Bank of Hindustan opened in Colombo on 4 July 1864 and closed in November 1866; the Royal Bank of India opened on 13 March 1865 and closed on the last day of 1866. Cf. Ferguson's *Ceylon Directory and Handbook 1876–78*: H. D. Andree, *The Progress of Banking in Ceylon*, dated April 1864.

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years went by. They never stepped out of the narrow field they had carved out for themselves immediately after their arrival.

The following is a list of their main lines of business apart from the acceptance of fixed deposits and demand deposits at interest:

Exchange

The banks

(i) discounted bills of exchange drawn against the export of produce;
(ii) issued drafts on nearly any part of the world in which there was a bank or banker;
(iii) issued letters of credit.

Loans and Discounts

The banks

(i) advanced money on cash credit account or as fixed loans for a period not exceeding six months, but more usually for a period of four months or less.
The security accepted for such loans consisted of:
(*a*) goods not of a perishable nature protected by fire insurance;
(*b*) life assurance policies;
(*c*) bills of lading with insurance policies attached;
(*d*) promissory notes bearing two names with not more than two months to run and representing *bona fide* commercial transactions.
(ii) discounted private bills and promissory notes payable in Ceylon[6] bearing at least two approved names unconnected with each other in general partnership, or bearing one name if accompanied by the deposit of adequate collateral left in the custody of the bank.

The Bank of Madras did the same type of business, but by its Act of Incorporation it was precluded from dealing in foreign exchange. In this respect its business was confined to the issue and purchase of drafts on India.

[6] H. D. Andree, *loc. cit.*, p. 89. 'The discounting of local promissory notes is singularly free from danger—a proof of the ability and integrity of borrowers.' The rate of interest on these discounts ranged from 10 to 12 per cent. till about 1875. The rate then fell to between 8 and 10 per cent.

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Year after year, the banks' advertisements carried the same monotonous announcements. There is no substantial difference, for example, between the Oriental Bank's advertisement of 1855 and that of 1883. The same is true of the Chartered Mercantile Bank and the Bank of Madras after 1861.

The most striking characteristic of the banks' business as listed above is its strictly short-term character. The usance of bills of exchange was not more than six months. Advances on cash credit account, similarly, had an upper limit of six months while promissory notes had 'not more than four months to run'. It can, of course, be argued that these short-term loans and advances were 'in effect' long-term loans in that they were renewable. But the essential point about the banks' loans was that they constituted short-term credit which could be utilized only for purposes of working capital. This became the rule wherever the British banker went.

A second characteristic of the banks' business was that it was heavily weighted in favour of foreign trade. Besides bills of exchange, drafts and letters of credit which had their origin in foreign trade, the banks lent against bills of lading and 'goods shipped for importation into Ceylon'. Usually 'goods not of a perishable nature' would be export produce awaiting shipment, while *bona fide* commercial transactions, in the context of the economy, was a phrase synonymous with export or import transactions. In fact, as Andree points out:

> 'The two banks established in the island are strictly and avowedly banks of exchange. The distinguishing principle of their business is to deal in foreign bills of exchange, the other branches of business being considered merely accessory. . . . Thus the entire capital of the banks may be said to be devoted to exchange business being constantly employed in going backwards and forwards between the different branches and their Head Office, while a portion of their deposits is lent out to customers upon promissory notes and the balance held as reserve.'[7]

Besides the ingrained preference of the British banker for the short-term self-liquidating loan, the banks in the island had special reason to insist on short-term maturities, though such liquidity would, in fact, have been of little avail in a crisis. Unlike his counterpart in Britain, the local bank manager did

[7] Cf. H. D. Andree, *loc. cit.*, p. 87.

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not have a fine range of extremely liquid assets in which to keep a second line of defence against a possible run on the bank. There was neither a call loan market, nor a discount market, nor a 'lender of last resort'. In case of need, Indian rupees might take more than a week to arrive from the mainland, and it was not certain that cash would always be readily available at the Indian branches.

Exchange Business

Dealing in exchange was the least risky and the most profitable line of business for the banks. In normal times they were almost certain of getting their funds back on the maturity of the bills. It was profitable because of the substantial margins they maintained between their buying and selling rates. Andree, again, has left us an intimate account of the banks' exchange business in the middle years of the nineteenth century.[8] As the country's exports to Great Britain and elsewhere in Europe invariably exceeded its imports from these countries the banks generally were left with surplus sterling. They wished to convert such sterling partly into Indian silver rupees to meet the needs of the domestic circulation and partly into Indian exchange in order to meet the demand for remittances to India, which supplied the bulk of the island's imports. At first, the banks resorted to what Andree calls a *wheel of exchange*. Supplies of cash were obtained by a circuitous method: sterling bills were sent to London for rediscount; silver bullion was bought with the proceeds; this was shipped to India, converted into rupees at the mints and then shipped across to Ceylon. The whole process took at least two months and involved the locking up of the banks' capital and a diminution of their profits.

'But now,' writes Andree, 'the telegraph and steam communication with Australia have revolutionised all that, and reduced the system to one of extreme simplicity.' The new method of working the exchanges was apparently the happy result of a rise in the Indian exchange rate in December 1863 when the rupee rose as high as 2s. 3d. and sterling was quoted in Colombo at a discount of nearly 10 per cent. As a result the 'wheel of exchange' became very costly and the banks fell back 'upon the simpler and more agreeable method of "simul-

[8] Cf. H. D. Andree, *loc. cit.*, pp. 85–93.

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taneous operations"', which was the name given to 'the system of buying and selling bills at the same time'. With the help of the steamship and the telegraph the banks were able to buy and sell exchange in different markets. To start with, sterling was sold mainly to the banks' Australian correspondents who developed an avid appetite for it after the gold discoveries in the eighteen-fifties.[9] They bought sterling bills and sent gold direct to Ceylon or to India where it was used to purchase rupees for import into Ceylon. This process was helped by the establishment of steam communication between the Australian ports and Ceylon in the sixties. Whenever the rate of exchange was favourable rupees were obtained from Bombay or Calcutta by drawing against sterling bills which were on their way to London for rediscount. Rupees could be had from India in this manner within less than a fortnight. Needless to say, these operations increased the rate of turnover of the banks' funds and 'set free the local capital of the banks, to use it either in discounts, or to divert it by means of their sister offices into other countries where it can be usefully employed'.

Although the sovereign had been legal tender in Ceylon since 1852, it was not in circulation. Sovereigns were usually at a premium as an article of merchandise, and there was always an apprehension that the sovereign would become 'a drug in the market'. What the banks needed were rupees, and for these they were necessarily dependent on their Indian branches. Ceylon was thereby linked to the Indian money market and conditions there invariably affected the situation in Ceylon. The availability of rupees in Ceylon depended on the ease or tightness of money in the Indian market.[10] Thus, monetary conditions in Ceylon were intimately connected with those in two centres—London, where the banks had their head offices and India, with whom the country had a common monetary standard.

The Rate of Exchange

It was seen in the last chapter how the adoption of the Indian rupee as the monetary unit in Ceylon resulted from the close

[9] The Blue Books of this period refer to the influx of Australian sovereigns to take advantage of the favourable rate for sterling prevailing in Ceylon.

[10] H. D. Andree, *loc. cit.*, quotes an instance in 1863 when the Ceylon branches had to ship rupees 'though not in any large quantity' to relieve the stringency in India.

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connexion between exchange rates in this country and the mainland. With a separate monetary unit, a fall in the rupee–sterling rate in India would have led normally to a rise in the value of Ceylon's currency in relation to the Indian rupee. But with an identical currency the price of sterling in the two countries could not differ by more than the cost of transporting silver rupees in either direction. Ceylon's rate of exchange, therefore, was determined by the vagaries of the Indian exchange. Whatever the state of her balance of payments, the price of sterling in Ceylon kept step with its price in the Indian monetary centres.

In 1835, by the Coinage Act of that year, India had adopted a silver standard and Ceylon had been drawn in as a part of this system only a year later by Sir Robert Horton's Minute of 1836. The par value of the Indian rupee was set by the gold price of silver. With silver at 5s. per standard ounce the par value of the rupee was 1s. 11d. Since Ceylon's currency was nominally sterling, the exchange quotations were in terms of a discount or premium—a 3 per cent. discount meant that the banks bought a six months bill of £100 for £97, that is Rs. 970. A fall in the rupee–sterling rate in India led to a reduction in the discount or an increase of the premium on sterling, while a rise in the rupee–sterling rate had the opposite effect. Up to the 1870's sterling was at a discount ranging from 2 per cent. to 8 per cent. After 1870, the rate in Ceylon fell in step with the fall in the Indian exchanges. From May 1873, after the rupee had been adopted as the legal currency unit of the island, sterling exchange was quoted in rupees. Since rupees had to be imported from India the rates in Colombo were generally slightly higher than those in India.[11]

The Banks and the Money Supply

The home government never viewed with favour a monopoly of the note issue or of banking business.[12] Yet during this entire period what actually prevailed was a duopoly, and competition was restricted by agreements regarding terms and rates

[11] Cf. H. D. Andree, *loc. cit.*, p. 89: 'Our rates are generally so based, as to leave sufficient margin over those of the Presidency towns, to cover the expense of transit.'

[12] Cf. Wilson's Treasury letter to the Colonial Office, 21 Feb. 1855. CO 54/319.

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of business. The Oriental Bank towered above its rival—the Chartered Mercantile—with a note issue at most times nearly thrice as large. The chartered banks were subject to the rigorous conditions laid down in their Charters based on the Colonial Banking Regulations and the authorities were satisfied that these constituted a sufficient guarantee that the business of issuing notes would be judiciously conducted. The banks' specie reserve which had to amount to at least one-third of their note issue was checked and certified monthly by the Colonial Treasurer. Their reserves were invariably above the required minimum. They were in fact a reserve, not only against the note circulation but also against the banks' deposit liabilities. It was possible, therefore, for a bank to satisfy the legal requirements regarding reserves and thus appear perfectly sound while all its deposits were tied up in bad debts. The difficulty would not have been solved by earmarking the reserve as a backing for the notes, as the ability of the banks to meet a demand for cash would have depended on the saleability of their other assets or on their ability to obtain cash from their overseas branches. It is not possible in practice to separate the business of note issue from the other activities of a bank. The Currency School sought to achieve this when they argued for the separation of the two departments of the Bank of England. But as experience proved it was not possible for the Issue Department to be sound while the Banking Department was under pressure.

During the period 1856–1884, the money supply of the country consisted of three different elements:

(*a*) bank notes;
(*b*) demand deposits held by the public;
(*c*) Indian rupees and subsidiary coins.

If we ignore the export and import of specie on private account, the total money supply depended solely on the rate at which the banks were acquiring assets in Ceylon.[13] An increase (decrease) in the banks' assets led either to an increase (decrease) in the note issue or of the volume of demand deposits or both.

Given the general lending policy of the banks and their rates

[13] I.e., a change in (*a*) and/or (*b*).

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of interest, the money supply depended on the supply or availability of the assets which the banks wished to acquire. As has been seen, these assets consisted primarily of sterling bills and of short-term credits to the plantation and commercial sectors of the economy. The chief determinant of the money supply, therefore, was the value of exports which determined both the volume of sterling bills available and the demand for short-term loans in the form of cash credits or of advances against the discount of promissory notes. An increase in the value of exports sooner or later led to an increase in imports which caused a further expansion of the money supply. By and large, the broad limits of the volume of bank lending and of the note circulation were set by conditions in the export sector of the economy.

Both the Oriental and the Chartered Mercantile had branches spread over several territories. By the terms of its Charter, the Oriental Bank could conduct business in territories 'east of the Cape of Good Hope'. Accordingly, it had branches at one time or another in India, Australia, New Zealand, South Africa, China, Mauritius, Hongkong, the Straits Settlements and Ceylon. The Chartered Mercantile had branches in India, China, Mauritius, the Straits Settlements and Ceylon. Like most 'imperial banks'[14] they each had, besides their head offices in London, a branch in Edinburgh. Fixed deposits were collected in Britain for investment abroad. The high rates of interest prevailing in the overseas countries enabled the 'imperial' banks to offer higher rates than could the domestic banks. To match these sterling deposits they held a certain proportion of their assets in British government paper.

While the banks operated over a wide field, they formed at the same time an integral part of the London money market, whose resources were always available to them. This fact introduced a considerable flexibility into the banking arrangements of the countries which they served. It placed at the disposal of a country a vast pool of banking capital, and no country had to rely entirely on its own resources. Funds could be moved from place to place or country to country according

[14] The term is due to A. S. J. Baster, who in his book, *The Imperial Banks*, gives an account in detail of the history of the chartered banks.

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to the varying demands of business, and if the need arose, the banks' capital could be augmented by borrowing in the London market.

In 1855, in advocating the withdrawal of the Treasury notes, James Wilson had argued that the business of note issue was intimately connected with the needs of business. The system that prevailed in Ceylon in the thirty years that followed established so close a connexion between the 'needs of business' and the note issue that Wilson himself would have been surprised. Never before or since has the money supply of the country been so sensitive to the demands of the plantation and foreign trade sector of the economy. The word 'business' in this context meant the estates and the few commercial firms which were European-owned. For the most part the rest of the economy lived in a different world, where money was scarce and bank credit was all but unknown.[15]

The extreme sensitivity of the bank note circulation to the needs and condition of the planting industry can be seen from the accompanying diagram (Chart I). The series of the monthly figures of note circulation for the period of 1856–1884 is subject to two types of variations. In the first place there was the seasonal ebb and flow in the demand for money. The note issue was at its highest during the months of November, December and January which was the busy season in the coffee industry, and at its lowest in May, June and July which was the slack season for coffee, and the Indian labourers returned to the mainland carrying their earnings with them in the form of Indian rupees.[16] Chart I shows the seasonal fluctuations in the amount of the note circulation.[17]

Besides the seasonal variations there were the cyclical changes in the currency supply. These corresponded closely

[15] It would be an exaggeration to state that the banks never lent to native businessmen. But this class of business was only a small proportion of the total both because of the absence of a large class of native capitalists and because the latter seldom were able to satisfy the security requirements imposed by the banks. Other than the planters the banks' best customers were the Chetties, who were 'bankers' to most Ceylonese.

[16] The labour force at crop time was almost twice as large as during the rest of the year.

[17] That is, seasonal deviations from the trend. The trend has been calculated by applying a twelve-month moving average to the monthly series of note circulation 1856–1884.

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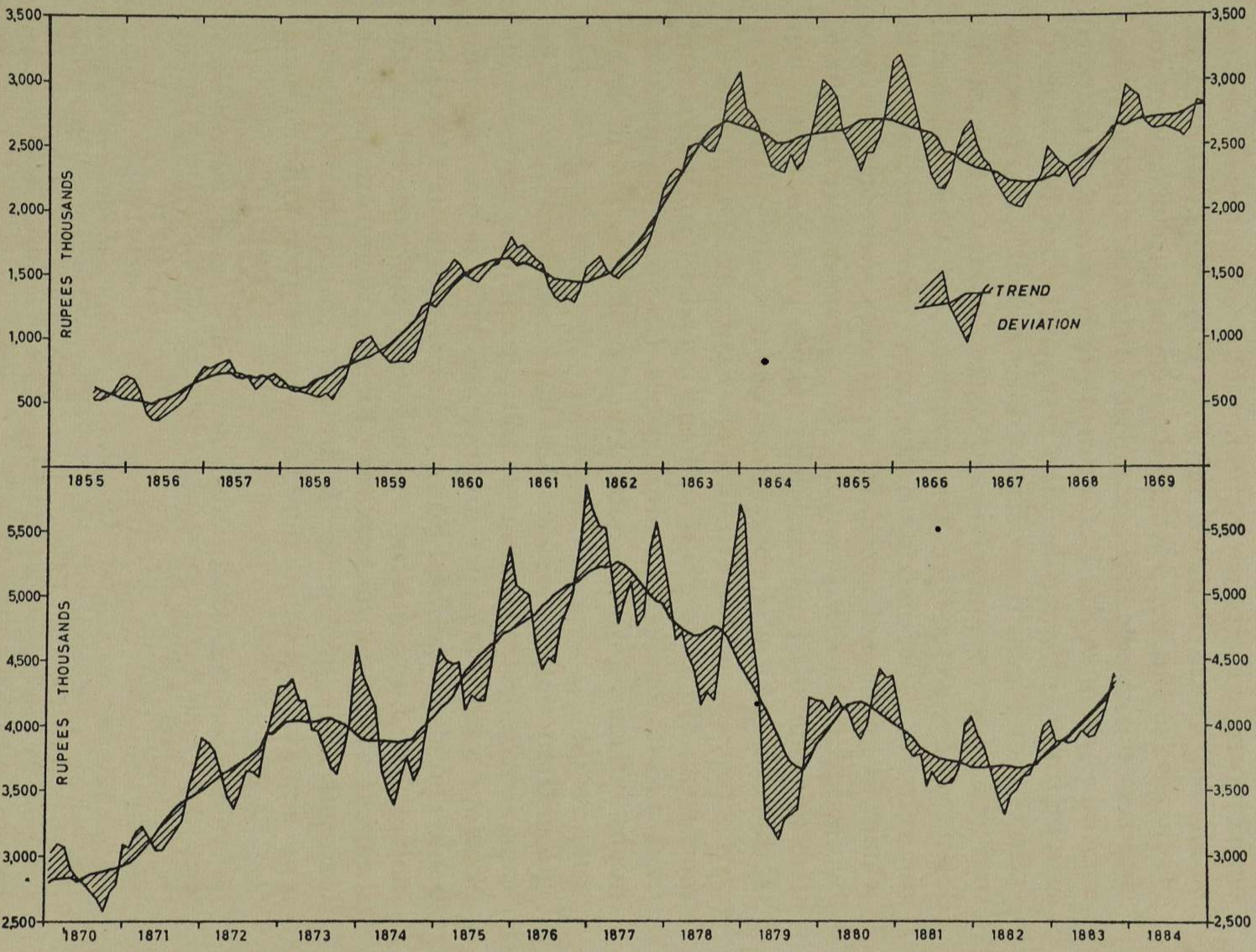
CHART I. BANK NOTE CIRCULATION, 1855–1883

Figures in pounds up to 1871 have been converted into rupees at 2s. per rupee



Sources: *Monthly Statements of Banks; Ceylon Government Gazette*

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with the ups and down of the international trade cycle.[18] When Ceylon was transformed into an export economy by the development of the coffee plantations, her fortunes were tied to conditions which prevailed in the United Kingdom and in other parts of the world where she sold her produce. Ceylon shared in the commercial crises, if not the financial panics, that overtook American and European markets with unfailing regularity during this period. The rise and fall of the value of coffee exports which accompanied these cycles of prosperity and depression are marked by ups and downs in the note circulation. The average monthly circulation of bank notes and the value of coffee exports during these years are set out in Table 4. Although an exact correspondence between the two series is unlikely owing to the numerous factors which determine the total monetary circulation, parallel movements of the value of coffee exports and of the supply of money are only to be expected. In this period, through its effect on the supply of sterling bills and the demand for bank accommodation, the value of coffee exports was the most important single influence on the total volume of money and bank credit.

The 'Imperial' character of the banks which in many ways was a source of strength and stability, introduced certain complicating factors into the situation. The broad lines of the banks' policies were laid down by their head offices, and the managers and directors in London had to look to their balance sheets as a whole in determining theirs. If, for instance, the Oriental Bank was incurring losses in certain branches the tendency was to restrict credit at all points irrespective of local

[18] Fluctuations in the note circulation (corrected for seasonal changes) correspond closely with fluctuations in the condition of the British economy, as is evident from the following table:

Turning-point in the British Trade Cycle		*Note Circulation in Ceylon*	
Trough	*Peak*	*Trough*	*Peak*
1855	1857	1855/56	1857
1858	1860	1858	1860
1862	1866	1862	1865/66
1868	1873	1868	1873
1879	1883	1874	1877
		1879	1883

Cf. W. W. Rostow: *British Economy of the Nineteenth Century*, Oxford, 1948, p. 33. and Chart I.

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Table 4

COFFEE EXPORTS AND BANK NOTE CIRCULATION 1856–1883

Year	*Estimated Value of Coffee Exports** £	*Average Monthly Circulation* £
1856	981,723	53,890
1857	1,496,645	73,491
1858	1,337,122	65,744
1859	1,467,497	98,344
1860	1,574,033	156,934
1861	1,656,733	150,368
1862	1,545,284	167,504
1863	2,126,222	258,242
1864	1,744,793	259,631
1865	2,345,532	269,363
1866	2,247,038	260,853
1867	2,240,668	223,483
1868	2,566,758	245,751
1869	2,593,996	271,102
1870	2,647,818	285,459
1871	2,480,399	328,592
1872	1,853,713	374,075
1873	4,220,252	404,761
		Rs.
1874	3,216,651	3,779,234
1875	4,506,902	4,538,326
1876	3,424,624	4,931,951
1877	4,976,022	5,229,269
1878	3,395,249	4,718,484
1879	4,029,229	3,843,597
1880	3,333,739	4,176,716
1881	2,137,326	3,760,001
1882	1,803,151	3,675,874
1883	1,358,536	4,095,838

Sources: Ceylon Government Gazette; Ceylon Blue Books.*

* Export figures show marked year-to-year fluctuations owing to part of one year's crops being held over and exported in the following year. Also, coffee production tended to fluctuate, with good and bad years alternating.

differences in economic conditions.[19] Similarly, an overall increase in liquidity encouraged the banks to ease credit conditions at all their branches in order to maximize their profits. Banking policy, therefore, tended to magnify the effects of cyclical fluctuations in economic activity. The available evidence suggests that such a 'banking accelerator' operated in

[19] Annual Reports of Oriental Bank, 1864, and of Mercantile Bank, 1866.

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1866 and in the eighteen-eighties when the Oriental Bank was making desperate attempts to cut its losses.[20]

A further consequence of the banks' connexions with the London money market was that they transmitted to their overseas branches the shocks of the financial crises in the metropolis. The Overend, Gurney crisis of 1866, for example, was reflected in an acute stringency of credit in Ceylon, and ten years later the failure of the City of Glasgow Bank affected considerably the Oriental Bank Corporation.[21]

Exports and Imports of Specie

A country usually gains specie when its balance of payments is favourable and exports specie when the balance of payments is adverse. In the case of countries with 'imperial banks' with head offices in London and branches in many countries, the connexion between balances of payments and specie movements is more remote. When such a country is experiencing an adverse balance, the demand for foreign currency can be met out of the banks' assets abroad. In the case of Ceylon, a deficit in the balance of payments could be met out of the banks' assets in India or London. Similarly, an acquisition of sterling during a period of favourable trade balance would usually lead to an increase in the holdings of sterling of the banks, rather than to an import of specie. The branches of the Imperial banks in the various territories were in no sense conducted as separate units. They resembled in most respects a network of branch banks within the same country. The settlement of balance-of-payments surpluses or deficits did not necessarily require the movement of specie.

Table 5 below shows the exports and imports of specie as recorded in the Customs Returns, together with the value of the total merchandise exports for the years 1856 to 1882.

The table exhibits two characteristics. Firstly, imports of

[20] The total advances of the OBC by 1883 had been reduced by nearly half the amount at which they stood in 1878 'made up of the contraction of ordinary current business consequent on the falling off in the produce on which all business is founded, partly by actual realisations from debtors or by sales of property': Report to Special General Meeting of OBC, October 1883.

[21] The OBC held £11,000 worth of bills under letters of credit of the City of Glasgow Bank. Cf. Annual Report of Oriental Bank for 1877.

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specie invariably exceeded exports of specie.[22] As in the earlier years, this phenomenon is explained by the fact that the bulk of the exports of specie (by private traders and Chettiars) and the large quantities of coin taken away by Indian workers returning home were not recorded in the Customs Returns.

TABLE 5

EXPORTS AND IMPORTS OF SPECIE, 1856–1882

Year	*Exports of Merchandise*	*Imports of Specie*	*Exports of Specie*
		£ thousand	
1856	1460	1040	203
1857	2253	1160	335
1858	1923	1415	405
1859	2160	1159	364
1860	2238	1182	312
1861	2285	1371	421
1862	2206	1510	288
1863	3179	1842	408
1864	2662	1771	450
1865	3069	1723	496
1866	3070	1443	516
1867	3339	892	191
1868	3474	999	312
1869	3332	1227	299
1870	3753	540	49
1871	3554	855	82
1872	3089	845	53
1873	5378	924	61
1874	4203	962	188
1875	5284	1158	94
1876	4304	962	204
1877	5705	761	25
1878	4328	565	110
1879	4874	876	86
1880	4727	570	15
1881	3343	373	49
1882	3369	455	4

Source: Ceylon Blue Books.

Secondly, the value of specie imports and the value of merchandise exports show a close positive correlation. In periods of rising export prices the banks were called upon to meet an

[22] Imports of specie show a considerable decline after 1866. It is likely that the development of steam navigation and the establishment of the electric telegraph enabled the banks to operate with a smaller reserve of cash. In addition, after 1873 the banks showed an increasing reluctance to hold silver owing to the continual fall in its gold value.

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increased demand for currency as well as for credit. The banks, therefore, imported specie to add to their reserves. When the coffee season was over part of the silver imported by the banks was usually absorbed into the domestic circulation while part of it found its way back to India. If at the end of the season the banks had redundant specie they returned it to India for use at another of their branches. In good years therefore both exports and imports of specie tended to increase. Similarly, during periods of bad trade the banks imported less specie and less was sent back to India.

In other words, specie movements were governed by the 'needs of trade' and were, in fact, the obverse of fluctuations in the note circulation discussed earlier. The banks were not passive agents whose deposit and note liabilities depended on the inflow or outflow of specie. On the other hand, they imported specie when they wished to increase the volume of their liabilities. The banks were able to obtain specie from their Indian branches by drawing against sterling bills which were sold in Madras, Bombay or Calcutta. Contrary to the classical theory, the principal role of specie movements in Ceylon was not that of a final balancing item in the country's international accounts. On the other hand, specie movements were the necessary accompaniment of seasonal and cyclical changes in trade activity.

The Troubles of the Exchange Banks

This chapter has been called The Era of the Exchange Banks because it deals with a period during which these banks played an important and strategic role in the island's economy. Apart from being responsible for the currency supply, they aided the remarkable economic development of the second half of the nineteenth century by meeting the demand for short-term credit generated by this process.

Once the government had withdrawn from the business of note issue, it began to make use of the banks to an increasing extent. Government revenues were collected and payments were made in most provincial towns and special 'Shroff's departments' had been established in the 'Kachcheris' to undertake this work. In 1864 the work was handed over to the banks. The government's cash balances at Badulla, Nuwara

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Eliya and Jaffna were transferred to the Oriental Bank against the deposit of £16,000 in Consols as security.[23] The Chartered Mercantile was entrusted with the collections at Matale. The business in Galle was shared between the two banks. From 1857 the practice had developed of lending government surplus balances to the banks. But in every case the banks had to deposit security, for those were the days when casualties amongst Eastern banks were heavy. By 1866, the two banks had been recognized as bankers to the government—balances up to £100,000 being left with them without security.[24]

While the Chartered Mercantile Bank confined itself to the main towns of Colombo, Kandy and Galle, the Oriental covered the planting districts with a network of branches unmatched since by any other exchange bank. By 1878, branches or agencies of the Oriental were open in Colombo, Kandy, Jaffna, Galle, Badulla, Nuwara Eliya, Dimbulla and Haldummulla.

Both banks survived the trials of the eighteen-sixties which was a severe testing time for the Eastern exchange banks, many of them being eliminated by 'this crisis of unparalleled severity and duration'.[25] The following figures of the dividends of the two banks suggest that they were able to withstand the crisis and the commercial stagnation that followed without much diminution of their profits. Indeed they gained out of the crisis in that many of their rivals were eliminated.[26]

The troubles of the Eastern banks began in the seventies. Before the turn of the century both the Oriental and the Chartered Mercantile (as originally constituted) had disappeared from the scene. The banks had hardly tided over the prolonged depression of trade after 1866 when a new problem faced them. This new problem was the extreme instability of the Eastern exchanges owing to the fall in the gold price of silver. The price of a standard ounce of silver

[23] Cf. CO 54/394: G 251 and 252 of 14 Nov. 1864.

[24] CO 54/328: G 18 of 27 Jan. 1857; CO 54/329: G 133 of 24 July 1857; CO 54/335: G 51 of 15 June 1858.

[25] Cf. Annual Reports of OBC and CMB for 1866 and 1867.

[26] Cf. Annual Report of OBC for 1867: 'The lessened competition in Indian banking has enabled them to pay a dividend equal to that of 1866'. Cf. also 'Banking in India and China' by J. W. Maclellan in *Bankers' Magazine*, LV, 1893: 'During 1867 there were seven banks transacting exchange business in Bombay and Calcutta; in the previous year there had been 24 in the former and 22 in the latter city'.

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which had remained more or less stationary for several centuries suddenly began to drop steeply and fluctuated violently from day to day. The causes of this 'silver crisis' and its effect on the Indian and Ceylon currencies are considered in a later chapter. Its effect on the Eastern banks was extremely

TABLE 6

DIVIDENDS OF THE BANKS, 1860–1870

	1860	*1861*	*1862*	*1863*	*1864*	*1865*	*1866*	*1867*	*1868*	*1869*	*1870*
					per cent.						
Oriental Bank Corporation	16	14	15	19	16	10	12	12	12	12	12
Chartered Mercantile Bank	10	10	10	15	10	13½	10	6	6	8	6

unsettling and often fatal. The currencies of the territories in which these banks operated were more often than not on a silver standard; India, Mauritius, China, Hongkong, the Straits Settlements, all had the silver rupee or the silver dollar as their monetary unit. The fluctuations in the price of silver introduced chaos into the Eastern exchange markets and inflicted heavy losses on the banks.[27] It converted the business of dealing in exchange into a mere gamble. Table 7 shows the fluctuations in the price of silver and the movements in the rupee–sterling rate between 1872 and 1885.

More troublesome than the fall in the exchanges over a period were the short-run fluctuations which made it almost impossible for banks to enter into exchange contracts without risk of serious loss.

The Indian rupee contained 165 grains of fine silver. A standard ounce of silver was equivalent to 444 grains of fine silver.[28] The value of the silver in the rupee was therefore equal to $\frac{165}{444}$ or nearly $\frac{3}{8}$ of the London price of an ounce of silver. A change of roughly 2½d. in the price of silver tended to produce a change of 1d. in the rupee–sterling rate.

It was not merely the banks' day-to-day exchange business which was affected by the fall in the Eastern exchanges. The banks' capital as well as a large proportion of their deposits

[27] Cf. Evidence of an Eastern banker, D. Maclean, before the Royal Commission on Gold and Silver 1888. 'We live from hand to mouth' (Q. 5041 and Answer); also evidence of J. K. Bythell (Q. 1905 and Answer).

[28] I.e. 0·925 × 480 grains = 444 grains.

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Table 7

THE PRICE OF SILVER AND THE RUPEE (STERLING RATE), 1872–1885

Year	*Average Price of Silver in London* *pence per oz.*	*Average Exchange Rate of Rupee* *pence*
1872–73	60 5/16	22·75
1873–74	59 1/4	22·35
1874–75	58 5/16	22·15
1875–76	56 7/8	21·63
1876–77	52 3/4	20·51
1877–78	54 13/16	20·79
1878–79	52 9/16	19·79
1879–80	51 1/4	19·96
1880–81	52 1/4	19·95
1881–82	51 11/16	19·89
1882–83	51 5/8	19·53
1883–84	50 9/16	19·53
1884–85	50 5/8	19·31

Source: Committee appointed to inquire into Indian Currency: Report, 1898.

were in sterling. On the other hand they had made considerable investments in Indian government paper. The depreciation of the exchanges implied a loss on that portion of the banks' capital and sterling deposits employed in the East. Substantial sums had to be set apart out of earnings to meet the losses on the silver securities and sterling deposits. After 1878, the dividends of the two exchange banks in Ceylon were considerably lower than those of the halcyon days of the previous two decades. As can be seen from the following table, on many occasions the banks were unable to declare a dividend.

In addition to the vagaries of the exchanges there was yet another circumstance which led to a diminution of the banks' earning capacity. In the long run, the improvement of means

Table 8

HALF-YEARLY DIVIDENDS OF THE CHARTERED MERCANTILE AND ORIENTAL BANKS, 1876–1884

	1876		*1877*		*1878*		*1879*		*1880*		*1881*		*1882*		*1883*		*1884*
	i	ii	i	ii	i	ii	i	ii	i	ii	i	ii	i	ii	i	ii	i
	per cent.																
Chartered Mercantile Bank	8	8	8	8	6	0	4	6	5	5	5	0	5	0	5	5	5
Oriental Bank Corporation	10	10	10	10	5	0	4	4	4	4	4	4	4	4	0	0	–

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of communication must necessarily be advantageous to overseas banks with branches in several countries. It facilitates control by the head office as well as the movement of funds between branches. But the immediate effects proved uncomfortable for the Eastern banks. The shortening of the distance between Europe and the East after the opening of the Suez Canal rendered the customary six months' usance of the bills of exchange superfluous, and four months' usance increasingly became the rule. Furthermore, the development of telegraphic communication 'completely revolutionized the banking practice as well as the trade of the East'.[29] Telegraphic transfers to a large extent superseded 'the old system of bills at long usance'. A bank in Bombay or Calcutta which sold a telegraphic transfer to a customer had to lay down money in London almost immediately, whereas if it discounted a six month bill it was engaging in credit creation in addition to the sale of exchange. There was, in other words, a considerable reduction in one of the most lucrative lines of the banks' business—the discounting of bills of exchange.

On top of all these developments, there was the stagnation in trade and the low prices of Eastern produce which ruled during this period. Of all the Eastern products none contributed to the troubles of the exchange banks in Ceylon more than coffee—the staple export of the island and the mainstay of its economy. Since the fate of at least one of the exchange banks in Ceylon was closely tied up with the coffee plantations, it is necessary at this stage to turn aside to discuss the phenomenal decline of this local industry.

The Coffee Slump and the Leaf Disease

As early as 1869, at the height of the development of the coffee plantations, an unknown fungus, which was afterwards termed *Hemileia vastatrix*, was found to attack the tender coffee leaves, 'the orange-coloured spots on the leaves multiplying and increasing in size up to July and August'.[30] But its effects were hardly felt owing to the rapid extension of the cultivated area and the equally rapid rise in coffee prices. As a contemporary planter put it: 'All the time the leaf disease got

[29] Cf. *Statist:* 15 April 1882: "The Indian Banks."

[30] J. Ferguson: *Review of the Planting and Agricultural Industries of Ceylon*, 1888, p. 14.

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worse and worse, and men got madder and madder, and prices got higher and higher and crops got smaller and smaller.'[31] The average annual coffee exports for the five-year period 1866–1870 were 964,330 cwt valued at £2,485,280. In the period 1871–1875, 856,570 cwt were valued at £3,155,922, while in the next five years 743,098 cwt fetched £3,599,486—over £400,000 more for 100,000 cwt less produce. The average price of plantation coffee, which was 54s. per cwt in 1869, rose to 107 shillings in 1877. The depression started in 1879. The Governor, Sir James Longden, in his opening address to the Legislative Council in 1880 regretted that he was 'unable to congratulate the Council on an unchecked continuance of the prosperity which notably distinguished the five years ending with 1878'. He argued that all countries were subject to such vicissitudes, and Ceylon, 'intimately connected as she was with Europe through her extensive and valuable trade could hardly escape sharing in the great depression which had affected the entire commercial world'. But the depression, he said, 'is now slowly passing away'.

Contrary to his expectations the depression continued for three disastrous years. At the same time as coffee prices were tumbling, the leaf disease wrought havoc amongst the plantations. Only 453,758 cwt were exported during the season 1880–81 and the next season's crop 'was the smallest ever known',[32] about 260,000 cwt being exported with 200,000 acres under cultivation—'below what was shipped forty years earlier from less than one-fourth the area'.[33]

The drastic fall in coffee crops due to the spread of the leaf disease saw the wholesale abandonment of estates. Government revenues fell and every branch of trade and industry was affected. In the words of the contemporary whom we quoted earlier: 'All around me there seemed to be an expectation of disaster . . . the crisis was acute, the colony was practically in a state of paralysis.'[34]

The severity of the depression is well illustrated in Table 9,

[31] R. W. Jenkins: *Ceylon in the Fifties and the Eighties*, 1886, pp. 55–56.
[32] Governor Sir Arthur Gordon's address to the Legislative Council, 6 December 1883.
[33] J. Ferguson: *Review of the Planting and Agricultural Industries of Ceylon*, 1888, p. 16.
[34] R. W. Jenkins: *ibid.*, p. 37.

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which sets out the more relevant statistics for the period 1878–1883.

The total value of exports fell from Rs. 47 million in 1878 to Rs. 35 million in 1883 while the value of coffee exports declined by nearly Rs. 20 million during the same period. The effect

TABLE 9
COFFEE EXPORTS, 1878–1883

Year	*Value of Total Exports Rs. thousand*	*Value of Coffee Exports Rs. thousand*	*Quantity of Coffee Exported Cwts thousand*	*Average Price of Plantation Coffee s.*	*Average Monthly Circulation of Bank Notes Rs.*
1878	47,339	33,953	631·6	107	4,718,484
1879	51,995	40,292	779·7	107	3,843,597
1880	50,426	33,337	656·6	104	4,176,716
1881	35,655	21,373	436·9	100	3,760,001
1882	36,339·8	17,984	464·7	81	3,675,874
1883	35,213·5	13,521	305·4	81	4,095,838

Sources: Ceylon Blue Books; Ceylon Government Gazettes.

of the fall in coffee prices was aggravated by the decline in the quantity of coffee exports due to the leaf disease. The average monthly circulation of notes fell by over 25 per cent. between 1878 and 1882.

The Failure of the Oriental Bank Corporation

Almost at the end of the long depression there occurred 'the heaviest colonial bank failure that has ever yet been recorded'.[35] On 3 May 1884, the Oriental Bank Corporation suspended payment. The slow but unmitigated decay of this gigantic organization, whose branches were spread over three continents, is one of the most astounding events in the history of eastern banking. For years its name had been the very embodiment of credit and at the height of the prosperity it dwarfed all its competitors both by the scale of its operations and the size of its dividends. At the time of its failure it had, besides its head office in London, 7 branches, 5 agencies and 27 sub-agencies. The course of the bank's decline is indicated in Table 10 below which shows a steady fall since 1876 in all its lines of business. Between 1876 and 1883 its deposits were almost halved and its holdings of bills of exchange fell from

[35] *Bankers' Magazine:* June 1884, p. 613.

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£5·6 million to £1·7 million. The note circulation alone remained fairly steady.

The earliest signs that all was not well with the Corporation were in 1877 when 'losses of an exceptional character'[36] forced

Table 10

BUSINESS OF THE ORIENTAL BANK, 1876–1883

Year	*Deposits £ million*	*Bills £ million*	*Notes £ million*	*Reserve £ thousand*
1876	11·7	5·6	·77	500
1877	12·0	5·2	·71	325
1878	11·9	6·2	·77	13
1879	8·9	2·2	·66	13
1880	8·2	2·3	·60	13
1881	8·7	2·5	·65	13
1882	8·2	2·6	·73	13
1883	6·6	1·7	·76	13

Source: Annual Balance Sheets of Bank.

ts directors to draw upon its reserve to the extent of £175,000 in order to pay its customary dividend of 10 per cent. The next year it paid only one half-yearly dividend. It 'passed' its dividend at the annual general meeting and appropriated the balance of £325,000 in its reserve fund to meet losses incurred through bad debts, depreciation of its rupee securities and losses in the exchange business. As much as £187,567 was set off against a revaluation of rupee paper at the rate of 1s. 8d. to the rupee, and the return of sterling deposits in the East. A further loss of over £91,000 was incurred owing to the depreciation of the bank's holding of the bonds of the Chilean government. The next year saw a further loss of £39,000 on the Chilean bonds and only a 4 per cent. dividend was declared.[37] The transfer that year of its South African business to the Bank of Africa was a frank admission of the bank's difficulties and since then it 'steadily lost caste'[38] and began to lose deposits and business. The shares of the bank which sold at £43 in 1877 were being quoted at £22 two years later.

During the next five years the bank's difficulties increased. Both the price of silver and the price of rupee paper continued

[36] Annual Report of OBC for 1877.

[37] All figures relating to the bank's business are obtained from the Reports to the Annual General Meetings and to the half-yearly meetings 1877 to 1884.

[38] *Economist*, 10 May 1884.

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to decline while the commercial depression deepened. Ceylon, where the Corporation had perhaps its largest volume of business, was afflicted by the coffee blight while the island of Mauritius where too the bank did extensive business was struck by a series of 'natural calamities'. For several successive years the sugar crops of Mauritius were affected by cyclones, drought and bad harvests.

These disasters inevitably left the bank with a heavy load of 'bad and doubtful debts' and outright losses. Planters in Ceylon who seemed solvent at the beginning of a coffee season were 'reduced from affluence to embarrassment by no error or fault of their own, but through the mysterious ravages of a microscopic fungus'.[39] The advances made to the planters were beyond recovery and the bank was compelled to take over the estates and await better times in which to realize their security. It was the same story with the sugar estates in Mauritius. On many occasions 'when the bank's managers had confidence in the debtor time and needful assistance was given'.[40] In the words of the chairman's report of June 1883, 'had the two islands had none but the ordinary vicissitudes of seasons and markets to contend with, all would still be going well. But we know what cruel and unexpected calamities fell upon both, and as the fortunes and credit of each were based upon a single staple, when that gave way, all seemed to go with it. Men reputed wealthy were found to possess little but their estates to fall back upon, and the bank's agents, to prevent a total loss, had to possess themselves of the estates.' As a result of this policy, by December 1882 the bank found itself in possession of 'landed property' valued in its balance sheet at £280,824. In the same year, £104,800 was lost on the realization of some of its securities in Ceylon.[41] But the bulk of these properties the bank had to hold over as it was almost valueless. These assets had to be prevented from deteriorating and large sums were invested in 'liberal and judicious outlay on buildings,

[39] Governor Sir Arthur Gordon's address to the Legislative Council, 6 Dec. 1883.

[40] Report of Chairman to Shareholders, June 1883. Evidence of the bank's activities is provided by the following editorial comment in the *Ceylon Observer*, 3 May 1884, after the suspension: 'The case of concerns which for years back lived only because it was in the interest of the OBC to keep them in existence is, we fear, hopeless'.

[41] *Ibid.*

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machinery, etc.' and on the upkeep of the estates. On the Ceylon estates, new crops—tea, cinchona and cocoa—had to be introduced. With the best will in the world the local managers could hardly be expected to cope with such unfamiliar operations. But to the last, the bank's directors were optimistic and 'only patience', they said, 'is required for working out a good result'.[42]

In their report of October 1883, the directors gave the shareholders the assurance that the figure at which the Mauritius and Ceylon assets stood in the bank's books 'could reasonably be expected to be realized'. Next April's report, however, was an eye-opener. The bank had over £2 million locked up in Ceylon and Mauritius and, as if to fill its cup of misfortune, there was a substantial fraud at the Mauritius branch.[43] The directors proposed to write off one-half of the bank's capital 'to cover once and for all the entire depreciation of the fixed capital abroad in silver currency countries as well as possible further depreciation of the now unproductive assets'.[44] The directors thought it fit to point out that such a reduction in capital did not affect the real value of the bank's shares or their earning capacity.

But the market thought otherwise. The price of the bank's shares slumped to less than £7 and when the news of the meeting was published there was a rush to withdraw deposits both at home and at several overseas branches. Within two weeks, on 3 May 1884, the directors issued a circular suspending payment. The pioneer of Eastern exchange banking had ended its long and remarkable career.

Misfortune and mismanagement were equally responsible for the bank's failure. Of misfortune, it had more than its fair share in Mauritius and in Ceylon. The whole 'coffee economy' of Ceylon virtually rested on the finance provided by the Oriental Bank, and the very size of its commitments made it difficult for it to restrict its credits without precipitating a collapse. The directors' judgment was at fault in continuing to prop up unsound and bankrupt concerns in the hope of a turn of

[42] Chairman's Report at Annual General Meeting, 24 April 1884.
[43] *Ibid.*
[44] In accordance with the terms of its Charter, a special bill was introduced in Parliament to sanction this procedure.

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the tide.[45] Perhaps the most conspicuous example of mismanagement was its huge advances at ridiculously low rates of interest to the Ceylon Company Ltd., at one time amounting to over £500,000—when for years the Company had been insolvent. The bank's advances policy was reckless, and the practice of making cash credit advances was carried to fantastic extremes.[46]

As early as 1878, when the Eastern banks were first beginning to feel the effects of the depreciation of silver, the directors of the Oriental Bank threw caution to the winds in drawing on its reserves to maintain its customary dividend. The whole of the reserve fund was exhausted the following year. The directors clung on to the very last to their rupee paper, speculating on a rise in the price of silver,[47] and it was foolhardy to have touched the highly risky Chilean bonds.

At the height of the crisis in the bank's affairs, its chairman assured the shareholders that 'The managers did not lend money on the security of estates'.[48] This was substantially true. Like most Eastern banks, the Oriental gave advances or cash credits on the security of crops, often taking a mortgage over the estate as collateral security. When coffee crops began to wither away and one after another planters were driven to bankruptcy the bank took possession of the land. The practice of taking land as collateral was nothing unusual in Eastern banking, and the failure of the Oriental Bank could hardly be attributed to it.

The End of an Era

In Ceylon, the failure of the Oriental Bank coincided with the end of the coffee era. It saw also the end of the bank note

[45] Cf. *Bankers' Magazine*, May 1884. Also, *Ceylon Observer*, 12 June 1884. 'What right had the Directors to virtually saddle the bank with 20,000 acres of land in the island of Ceylon. . . . What right, whatever, had the Directors to advance to such a company at all beyond the value of the crops in sight or beyond discounting for the company in the ordinary way of business?'

[46] Cf. Letter in *Ceylon Observer*, 3 May 1844: 'I was opposed to the OBC system of advances, which instead of being confined to crop . . . when its quantity was ascertained, commenced advancing at the commencement of the year, long before the appearance of the blossom on the trees to give some indication of the probable crop'. Also, editorial comment in *Ceylon Observer*, 12 June 1884: 'the cash credit system would have been excellent if kept within bounds. But the advances were recklessly extravagant, and one by one estates became the property of the bank and had to be supported.'

[47] It was believed that the directors of the bank 'held bimetallic theories'. Cf. *Bankers' Magazine*, June 1884, p. 233.

[48] Chairman's Report at Annual General Meeting, April 1883.

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issues. Following upon the failure of the Oriental Bank a government paper currency was introduced to take the place of the bank note currency. The last few years of the nineteenth century, however, mark the end of an era in more senses than one. The whole chartered-bank system had now become obsolete since the coveted privilege of limited liability had been extended to any banking company registered under the Act of 1862. Both the Treasury and the banks found the system had outlived its usefulness.[49]

The United Kingdom government therefore introduced a Chartered Banks (Colonial) Bill in Parliament in 1880 whose object was to relieve the Treasury of its duties with regard to chartered banks and 'to leave the said Banking Companies the uncontrolled management of their own concerns'. But the Bill could not be passed before the dissolution of Parliament that year.

The Treasury then formulated a model Charter which was much less cumbersome than the old Royal Charter, and banks whose Charters expired were given the option of accepting the model Charter or registering under the Companies Act of 1862. The Oriental Bank had accepted the model Charter and so did the Chartered Mercantile Bank.

The New Oriental Bank Corporation which attempted to build upon the ruins of the OBC was registered under the Act of 1862. It commenced business in Ceylon in 1885 but went into voluntary liquidation in 1892. The National Bank of India, one of the first Eastern banks to register under the Act of 1862, opened a branch in Colombo in 1881. The Chartered Mercantile Bank, which had struggled on in spite of innumerable difficulties, finally succumbed in 1892. It was reconstituted with an enhanced capital and commenced business as the Mercantile Bank of India Limited on 3 February 1893. Before the turn of the century there were two additions to the number of banks in the island. The Chartered Bank of India, Australia and China, one of the oldest of the chartered banks, opened a branch in Colombo in 1893.[50] In the same year the Hongkong

[49] Cf. Hamilton: Memorandum on Chartered Banks (Colonial Office Library): 'The Charters of Incorporation impose on the executive government duties and responsibilities which it cannot suitably or conscientiously undertake'.

[50] Cf. Sir Compton Mackenzie: *Realms of Silver*, 1954, for the history of this bank.

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and Shanghai Banking Corporation with its head office in Hongkong entered the field. Thus, at the end of the century there were five banks in the island—four exchange banks and the Bank of Madras. Of the former the Mercantile Bank and the National Bank were registered under the Companies Act of 1862. The Chartered Bank continued to operate under a modified Royal Charter. The Hongkong and Shanghai had been set up by a special ordinance of the Hongkong government and the Bank of Madras was governed by the Indian Presidency Banks Act of 1861.

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CHAPTER IV

A GOVERNMENT PAPER CURRENCY

The Suspension of the Oriental Bank in Ceylon

On the morning of 3 May 1884, outside the gates of the Oriental Bank's office in Queen Street, Colombo, there was the following laconic announcement:

> 'A telegram has been received this morning advising me to suspend, and I have accordingly done so.
>
> '(Signed) James Anderson,
> 'Manager.'

According to a contemporary newspaper, by mid-morning 'the streets of the Fort were one blaze of excitement. Groups of anxious Chetties and native traders were hurrying into the Fort from every direction and collecting in a noisy mob outside the bank premises. By 11 o'clock, the Fort was full of natives from the Pettah[1] and all parts of Colombo, and it required the efforts of a strong body of police to keep Queen Street free for traffic'.[2] A run developed on the Chartered Mercantile and the Bank of Madras, 'the cashiers of which had as much as they could do in paying out silver to the anxious throngs'.[3] The panic soon spread to the outstation towns and then throughout the villages. The failure brought all business to a standstill. Nearly three-quarters of the currency notes in circulation were those of the Oriental Bank, amounting to over three million rupees.[4] The bank conducted the overwhelming part of the banking business in the island, and it kept the bulk of the government's cash balances.[5] The stoppage of the bank,

[1] The Pettah was the habitat of the 'native' and Indian traders, while the Fort was overwhelmingly the 'European' quarter.

[2] *Ceylon Observer:* 3 May 1884; Editorial. [3] *ibid.*, 3 May 1884.

[4] The total note circulation at the end of April 1884, was as follows:

Oriental Bank	Rs. 3,423,635
Chartered Mercantile Bank	945,889
Total	4,369,524

Source: Ceylon Government Gazette, 1884.

[5] The government's deposits with the Oriental Bank amounted to Rs. 626,369; it held also Rs. 176,126-worth of the bank's notes.

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therefore, threatened a complete collapse of the economic life of the country. Food riots were feared as the traders would not sell rice for anything but silver, and the country was threatened with famine as rice could not be imported from India without silver to pay for it.[6]

It was a grave situation and quick action was needed. Everyone looked to the government for a solution. The Governor, Sir Arthur Gordon, hastened to Colombo from Kandy. When he arrived there on 5 May he was met by deputations from the Ceylon Chamber of Commerce,[7] the Bank of Madras and the Chartered Mercantile Bank. They urged on him that only a government guarantee of the Oriental Bank's notes could allay the panic. They argued that such a guarantee was unlikely to entail a loss to the government as the currency notes, according to the terms of the bank's Royal Charter, formed a first charge upon its assets. The Governor was in a quandary. According to the Royal Instructions he was not empowered to take any steps affecting the currency without the prior approval of the Secretary of State for the Colonies.[8] However, even telegraphic communication would have meant a delay of at least three days, and a telegram was barely adequate to convey to the authorities the gravity of the situation. At the same time, had he delayed to act the situation might very well have got out of hand. On the same evening, the Governor with the advice of his Executive Council announced that he 'had

[6] Cf. *Ceylon Observer,* 5 May 1884, editorial: 'Some apprehension has been expressed of rioting and looting of rice shops.' also, *ibid.*: 'If credit is gone and no attempt is made to restore it, who can compel merchants to engage in the unprofitable trade of supplying the people of Ceylon with their staple food?' Cf. also Governor's Despatch No. 87 of 5 May 1884: Referring to the dangers inherent in a system of bank issue he writes, 'We shall again be brought face to face with the fact on the one hand of people being unable to buy food, and on the other with that of Chetties, who are the principal rice-dealers in the country, trooping to the Solicitor-General for leave to use firearms in defence of their stores'. CO 54/553 and S.P.1 of 1886.

[7] As a result of the crisis, the *Ceylon Observer* published the correspondence which had taken place in 1856 between the Governor and the Chamber of Commerce in which the latter raised serious objections to the issue of notes by the banks. They felt that the reserve was insufficient because 'the bullion exposed monthly is not a *bona fide* reserve kept up to meet the requirements of the note circulation only, but is, in fact, the reserve against all liabilities payable on demand'. Cf. *Ceylon Weekly Observer:* 12 May 1884, p. 409.

[8] Cf. Comment of Colonial Office on Governor's G 174 of 9 May 1884, where it is referred to as 'a class of business which by the Royal Instructions and by special circular despatch of 18 Aug. 1875 [is] expressly reserved for the decision of the Home Government. . . . The decision should be taken by those on whom the responsibility lies.' CO 54/553.

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decided that the note issue in Ceylon of the Oriental Bank Corporation should be guaranteed by the Ceylon Government'.[9] The Governor's decision was welcomed on all sides.[10] The news of the guarantee soon allayed the panic, and within a few days the notes of the Oriental Bank were in general circulation, though sometimes at a slight discount. The banks, after an initial reluctance freely to accept these notes, soon co-operated fully with the government.[11] To meet the abnormal demand for silver they immediately imported a million rupees from India. This was augmented by the silver in the vaults of the Oriental Bank which had been seized on the Governor's instructions.[12] A total collapse of the country's circulating medium was thus narrowly averted. On 24 May, Gordon was able to write to the Secretary of State: 'The success of the steps taken have more than equalled my most sanguine expectations'.[13] Two weeks later he reported that 'public confidence had been completely restored'.[14]

In the meantime, however, the home government reacted unfavourably to the Governor's *fait accompli*.[15] The initial reaction at the Colonial Office was that the guarantee was a mischievous proceeding which transferred to the general taxpayer a burden which should legitimately be borne by the holders of the notes. They saw no reason why the note holders should have been placed in a more advantageous position than the other creditors of the bank. In any case, they felt, the Governor was too precipitate in his action. There was an alternative course of action open to him. He might have called a meeting of the bank managers, principal residents and heads of mercantile houses and invited them to continue to

[9] Cf. Governor's letter to the Chamber of Commerce and the Bank of Madras on 5 May 1884, published in the *Ceylon Observer* of that date.

[10] Cf. The comment in the *Ceylon Observer*, 12 May 1884: 'It is a matter for sincere congratulation that we have at the head of affairs in Ceylon at the present time a man of Sir Arthur Gordon's character who can take a decided step without having to refer to the Colonial Office and obtain their sanction.'

[11] The National Bank of India and the Bank of Madras (neither of which issued notes) eased the situation by granting advances against the hypothecation of deposits held with the Oriental Bank. This facility was available only to those who were not debtors to the defunct bank. Cf. *Ceylon Weekly Observer*, 10 May 1884.

[12] CO 54/553: G 190 of 19 May 1884.

[13] *Ibid.*: G 200, 24 May 1884. [14] *Ibid.*: G 221 of 8 June 1884.

[15] Cf. S.P. 1 of 1886 which contains the correspondence between the Governor, the Secretary of State and the Treasury relating to this episode.

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receive Oriental Bank notes at least for a time, until specie arrived from India.[16] He should have telegraphed for instructions. Instead of which, in the one communication to the Secretary of State prior to the guarantee he appeared to conceal what he had in mind. Nevertheless, the Secretary of State, while he did not condone the Governor's action, was not prepared to censure it. He appreciated the difficult circumstances in which the Governor had to act and the consequences that might have followed from inaction.[17] When the incident was referred to the Treasury,[18] however, the Governor received none of the sympathy shown him at the Colonial Office. Nevertheless, apart from stating that 'My Lords are not prepared to approve of the guarantee as it was given', the Treasury advanced no arguments other than those that had been considered and dismissed by the Secretary of State, Lord Derby.[19] Yet 'in deference to their Lordships' wider information on such matters' Lord Derby wrote to the Governor that he was not able 'entirely to endorse the Governor's action'.

But his action was endorsed in Ceylon both by the Executive and Legislative Councils. The former sent a memorandum to the Colonial Office arguing that only the Governor's bold step had saved the government and the country from bankruptcy and civil commotion. They suggested that the Lords of the Treasury being so far removed from the scene of events were not in a position to assess the nature of the emergency. The Legislative Council presented to the Governor an address of appreciation of his conduct.

Hardly had the panic and excitement of the bank failure died down before the Governor decided on the next step. In the

[16] In the Straits Settlements, the other banks agreed to cash all OBC notes that were presented. But the issue of the Oriental Bank was less than one-tenth of the total circulation there.

[17] Cf. CO 54/553: the Minutes of various officials at the Colonial Office on Gordon's Despatch No. 174 of 7 May 1884: (i) 'The failure of the OBC might be as ruinous there, as the failure of the Bank of England here.' (ii) 'I am rather inclined to think that it may have been fortunate that Sir Arthur Gordon did not give us a chance of vetoing his proposal to guarantee.' (iii) 'If his prompt action has saved the colony from great trouble and disturbance I am not inclined to find fault with its irregularity' (Lord Derby). The published correspondence (S.P. 1 of 1886) does not indicate the sympathy and understanding with which the Governor's action was viewed by the Secretary of State. A previous writer (B. W. Fernando: *Ceylon Currency*, p. 27) has therefore been led to attribute to the Secretary of State views which were, in fact, those of the Treasury.

[18] CO 54/553: Letter to Treasury from Colonial Office, 3 July 1884.

[19] Lord Derby's Minute on CO 54/553: G 174 of 9 May 1884.

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same despatch to the Secretary of State in which he detailed the events which followed the crisis he suggested that a government paper currency should be substituted for the issues of private banks. He believed that only such an arrangement could 'thoroughly and permanently restore full confidence in the colony'.[20] There was a strong demand amongst the planters and the business community for a government note issue. This demand was echoed by the local Press soon after the crisis.[21] The Bank of Madras was in favour of a state issue[22] while the Chartered Mercantile was not perturbed about having to surrender its right of issue.

Barely a week after the crisis—on 10 May—the Governor sent a draft Currency Ordinance to the Secretary of State.[23] In his covering despatch he made a cogent case for a government note issue 'which would command an almost absolute confidence amongst the native people'. He implored the Secretary of State not to risk the repetition of such a disaster as that which had befallen the colony, for the sake of 'a pedantic adherence to general rules laid down some thirty years ago'. The reference was to James Wilson's famous Minute of 1855 which had led to the decision to withdraw the Treasury notes in that year. He argued that the circumstances had changed, and doubted whether Wilson would have expressed himself in the same terms had he written his Minute after his experience as Finance Minister in India.[24] One argument, in particular, which had weighed with the Treasury in 1854, namely the fear that banks would not care to set themselves up in the colony if they were denied the right of note issue, no longer applied as

[20] Lord Derby's Minute on CO 54/553: G 174 of 9 May 1884.

[21] Cf. Editorial in *Ceylon Observer*, 7 May 1884: 'The Colony cannot afford such another experiment as that which has ended so disastrously in the case of the OBC.' Cf. also letter to *Ceylon Observer*, 9 May 1884, by 'an authority on banking': 'The natives of Ceylon will never put their faith in a note again . . . unless it bears the signature of government.'

[22] CO 54/553: G 175 of 10 May 1884. [23] *Ibid.*

[24] Cf. *ibid.*: 'When the late Mr. Wilson wrote the memo . . . he was entirely ignorant of the feelings and the prejudices of Orientals and of the modes of influencing and governing them successfully. He was at that time penetrated by Western ideas and by them only, and contemplated a moral atmosphere essentially English in its character and which is to a great extent reproduced in Australia and North America. But I greatly doubt whether, if Mr. Wilson had been called on to rewrite the memo when a few years afterwards he was Finance Minister in India, he would have expressed himself in the same unreserved manner when contemplating the case of a note issue by the Government of a Crown Colony in Asia.'

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there were now three banks in the island. Finally, he argued that the profits of a government issue would accrue to the residents of the country and might 'irrigate a province', whereas the profits of a joint stock bank would 'enrich shareholders not in Ceylon, but in England'.[25] Lord Derby sent the Governor's draft Ordinance to the Lords of the Treasury for their advice stating that he agreed with the Governor 'in his main contention that a government note issue is desirable'. He was careful to emphasize that the chief concern of the home government ought to be to provide the colony with a sound system of currency. Gordon's source-of-revenue argument he felt was a side issue. The Treasury, however, saw no reason to alter its traditional policy of opposition to state note issues in the Colonies which 'had been adopted when My Lords were advised by two officers of great authority on questions of currency—the late Mr. James Wilson and the late Mr. Arbuthnot.[26] 'Neither the failure of a bank in Ceylon, nor the perhaps exaggerated alarm of a Governor not specially versed in economic subjects would justify the reversal of a policy founded on approved authority'.[27] They would, in fact, have withheld their sanction to the proposed measure except that the principle of ultimate state liability for bank issues had already been admitted and, in future, both the public and the banks would expect the government to assume responsibility for the issues of the failed banks. It was for this reason alone that the Lords of the Treasury reluctantly agreed to the establishment of a government paper currency in Ceylon.[28]

[25] CO 54/553: G 175 of 10 May 1884.

[26] George Arbuthnot was then Assistant Secretary to the Treasury. He was the author of the pamphlet, "Sir Robert Peel's Act of 1844 . . . Vindicated" (1857), which is an important contribution to the Currency School–Banking School debate.

[27] Cf. Treasury letter to Lord Derby, 28 August 1884: CO 54/556; also S.P. 1 of 1886.

[28] The events in Ceylon appear to have wrought a change in the attitude of the Colonial Office and of the Treasury towards state issues of paper money in the Colonies. Cf. Treasury document No. 11503 dated 26.8.1884 (Public Record Office): 'This precedent makes me change my view, and if henceforth Colonial Governments are to make themselves answerable for the note issues of private companies . . . it will be better that Government should undertake the issues themselves'. When the question of extending the privilege of note issue of the banks in Hong Kong was considered in November 1884, the Treasury wrote to the Colonial Office: 'Having regard to the grave public inconvenience recently of Ceylon by the discrediting of the notes issued by the OBC, my Lords are not prepared to assent to any extension of the existing privilege. . . . On the contrary, my Lords now think that the time has come for adopting such measures as may be

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What is most surprising in this entire episode is that the Treasury, when called upon to express an opinion on the fundamental question of paper money in the Colonies, chose to fall back on arguments and policies which might have been suspected to be obsolete. There was no re-examination of the problem in the light of subsequent experience both in the United Kingdom and in the Colonies.

In England, the Bank of England's virtual monopoly of note issue had become an accepted fact and few indeed would have questioned it. India had adopted a government paper currency system based on the British model and, ironically, James Wilson had been its prime mover.[29] The government paper currency in Mauritius which had been decried by Wilson was working satisfactorily. On the other hand, frequent failures amongst the chartered banks had shown that the Colonial Banking Regulations were not a sufficient guarantee of sound banking. The collapse of the Oriental Bank was really the culmination of a series of failures amongst colonial chartered banks, and should have convincingly demonstrated the fallacies inherent in the Treasury attitude. Yet not even the serious difficulties of the Eastern banks which were referred to in the last chapter appear to have raised any doubts in the minds of the Treasury or of the Colonial Office regarding the soundness of the system of bank issue.

While the draft Ordinance was being considered by the home government, the Governor was repeatedly urging upon the Secretary of State the necessity for an early decision as the public could not be left indefinitely in suspense as to the manner in which the 'guarantee' was to be implemented. The banks were large holders of Oriental Bank notes which they found difficult to keep in circulation. The confidence that was being precariously maintained by the efforts of the Governor could not last much longer.[30] On 10 December 1884, to the general

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considered desirable for vesting in the Colonial Government the exclusive right of issuing notes. . . . The detailed arrangements for establishing a state issue in the Colony of Ceylon . . . can probably be adapted without much modification for establishing a State issue of notes in Hong Kong.' (Treasury letter to Colonial Office, November 1884: No. 18072/84; Public Record Office: T.1 8130B.)

[29] Cf. Wilson's Minute on a Paper Currency for India: B.P.P. 1860, Vol. XLIX.

[30] In August 1884 Norwell & Co., the contractors engaged in building the Railway to Nanu Oya, precipitated a minor crisis by demanding to be paid in silver as the workmen were refusing to accept OBC notes: Cf. CO 54/556.

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relief of all concerned, Ordinance No. 32 of 1884 (the Paper Currency Ordinance of 1884) was passed by the Legislative Council. Except for six amending ordinances from time to time it remained the basis of the island's currency system for well over half a century.

The Origins of the Paper Currency Ordinance

The establishment of a government note issue in Ceylon was a departure from settled policy. The only colony which had hitherto had a state issue was Mauritius where government paper currency had been in circulation since 1849. On the failure of the Mauritius Bank—one of the two note-issuing banks in that colony—in 1847, Earl Grey, who was then Secretary of State for the Colonies, was able to put into practice his decided views on the question of colonial currencies which were referred to in an earlier chapter. The Mauritius Ordinance No. 9 of 1849 of which Earl Grey was the principal architect, set up a Government Currency Board empowered to issue notes in denominations of ten rupees and five rupees. In the words of Grey's Despatch to the Governor of Mauritius, 'after the issue of £300,000 under the foregoing instructions[31] no further issues of paper are to be made by the Commissioners of Currency except in exchange for specie, and of the specie so received one half shall be retained by them, and the other half transferred to the Colonial Treasury to be invested in such a manner as shall be directed by the Lords Commissioners of the Treasury'. The Currency Board was 'to exchange notes for specie and vice-versa'.[32] Earl Grey's scheme was in all essentials similar to what is now called the Currency Board system.

If Earl Grey was the father of this system, its more remote ancestors were the theorists of the Currency School. Like the Bank Charter Act of 1844 it sought to establish a system whereby the note issue behaved exactly as would a metallic currency, notes being issued only in exchange for specie. It embodied one of the basic ideas of the Currency School in

[31] The reference here is to the transition arrangements after the lapse of the banks' issue; £300,000 was to be advanced to the banks which had agreed to put the government notes into circulation. The Board was to hold a 50 per cent. reserve of coin against this issue. Cf. Earl Grey's Despatch: CO 168/33: No. 210 of 25 October 1847 to the Governor of Mauritius.

[32] *Ibid.*

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separating the business of note issue from the business of banking. An important change in the Mauritius Ordinance of 1849 was made in 1864 when it enabled up to a maximum of one-half of the investment portion of the currency reserve to be held in debentures of the Government of Mauritius or in Mauritius Registered Stock. These provisions were re-enacted in Ordinance No. 28 of 1876 which also made the Indian silver rupee the sole legal tender in the Colony.

When the Colonial Office and the Treasury had to provide Ceylon with a currency ordinance they naturally turned to the Mauritius Ordinance of 1876, and the Governor's draft was amended to conform with it. There was, however, a significant difference between the arrangements in the two Colonies. The provision for the investment of a portion of the currency reserve in the securities of the Colony itself was omitted in the Ceylon Ordinance, on the suggestion of the Treasury. The Treasury objection was based on the grounds that in an emergency domestic securities would be unsaleable on the spot.[33] The Commissioners could therefore invest in British government securities, Indian government securities or in those of any British colony other than Ceylon. The Governor in his draft had suggested that the entire invested portion of the reserve should be held in Indian government securities. But Lord Derby and the officials at the Colonial Office felt that such securities were particularly liable to depreciation at times of panic, famine and other local difficulties. It was therefore agreed that not more than one-half of the securities in the reserve should consist of Government of India stock 'except with the sanction of the Secretary of State for the Colonies', although logically the currency reserve should have been held in India since the note issue was convertible into Indian rupees. With the rupee–sterling exchange falling, the remittance of funds to London for investment would have involved an exchange loss to the Currency Commissioners. But it was argued that this was only a paper loss since it would be 'recouped whenever they had occasion to sell bills on England'.[34]

[33] Cf. Treasury Letter to Colonial Office, 28 August 1884, S.P. 1 of 1886. 'An emergency making realisation necessary practically means a panic, and in a panic securities will be unsaleable on the spot'.

[34] Cf. Comments of Colonial Office on Governor's Despatch: CO 54/553: No. 175 of 10 May 1884.

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The Paper Currency Ordinance of 1884

The Paper Currency Ordinance of Ceylon may be regarded as the first example in the monetary history of the British Colonies of what has now come to be called the '100 per cent. reserve system'. The following were the main provisions of the Ordinance: It set up a Board of Commissioners of Currency consisting of the Colonial Secretary, the Treasurer and the Auditor-General. This Board was empowered to issue currency notes in denominations of 5, 10, 50, 100 and 1000 rupee notes in exchange for silver rupees of India. The notes were legal tender for the amounts expressed thereon, and were convertible on demand into Indian silver rupees at the Commissioners' Office in Colombo. After 31 March 1885, the notes of the Oriental Bank Corporation 'ceased to be recognized as money'. Between 15 February 1885 and 31 March 1885 the Currency Commissioners accepted in exchange for government notes the notes of the OBC.

Once again the traditional prejudice against notes of small denominations had asserted itself. Governor Gordon, like several of his predecessors, had realized the usefulness of small notes in an economy in which most transactions were for small sums. In his draft he had provided for the issue of 2½-rupee notes.[35] Both the Colonial Office and the Treasury vetoed it on the grounds that small notes would drive silver out of circulation and thus render the monetary system more vulnerable in times of panic.[36] This argument drew support from the experience of 1884. It was felt that had more silver been in circulation the run on the banks would have been less severe.[37] But the crisis had also shown that rupee coins were not a popular circulating medium owing to their unwieldiness.[38]

The Commissioners were required to retain in silver coin a reserve of one-half at least of the amount of currency notes in

[35] Gordon refers to the 'demand for small notes among the natives': CO 54/556; G 286 of 28 July 1884; also S.P. 1 of 1886.

[36] Cf. Treasury Letter to Colonial Office: CO 54/556: 28 August 1884: 'small notes are used by the less educated classes and those classes are specially liable to panic'; also S.P. 1 of 1886.

[37] Colonial Office Letter to Treasury enclosing Despatch No. 175 of 10 May 1884: CO 54/553.

[38] Cf. CO 54/553: Colonial Office minute on Governor's Despatch No. 174: 'Owing to the inconvenience from bulk of a rupee currency the notes of the two banks are universally used throughout the country and but very little coin'.

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circulation. The reserve was to be verified from time to time by a Board of Survey under instructions from the Governor. A sum not exceeding the value of one-half of the currency notes in circulation was to be invested in Indian government securities and securities of the government of the United Kingdom or of the government of any British colony other than Ceylon. There was a proviso, that 'not more than one-half of such a sum shall be invested in Indian Government securities except with the sanction of the Secretary of State'.

If, at any time, the specie held by the Commissioners fell below one-half of the notes in circulation, it was not obligatory on them to sell and realize any of the securities they held unless and until the amount of specie fell below one-third of the notes in circulation. But no addition could be made to the security portion of the reserve until the specie reserve amounted to at least one-half of the notes in circulation.[39]

The dividends, interest or other income from the investments was to be credited to the general revenue of the island excepting an amount equal to 1 per cent. of the investments, which was to be set apart annually in a Depreciation Fund. Appropriations to this Fund could be discontinued by the Governor, with the sanction of the Secretary of State, when it appeared to him that the reasons for such appropriation no longer existed. These sums were to be invested 'in such manner as the Governor with the sanction of the Secretary of State may direct'.

Finally, the accounts of the profits of the circulation 'and of the charges and expenses incidental thereto', were required to be published annually in the Government Gazette as also a monthly statement showing the amount of notes in circulation, the amount of the specie reserve and the cost price and market values of the securities held by the Commissioners. These remain our only sources of information regarding the working of the 'Currency Board system' in Ceylon.

The Working of the Paper Currency Ordinance

A full evaluation of the new monetary system can be undertaken only after we have seen it at work during its entire lifetime. The period, in effect, extends from 1885 to 1949, in

[39] Ordinance No. 32 of 1884: para. 14.

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which year the Monetary Law Act set up a central bank and changed the entire system of note issue. As will be seen in a subsequent chapter, the Currency Ordinance of 1941 merely gave legal sanction to practices which had developed out of the earlier arrangements.

At this stage, however, it is useful to describe the mechanics of the new system. Legally, any member of the public was entitled to convert Indian rupees into notes and vice-versa. But the public had long been used to obtaining their notes from the banks and it was natural that this arrangement should have continued, even after the disappearance of the bank note currency.[40] The banks, once they ceased to be issuers of currency, adopted the role of intermediaries between the public and the Currency Commissioners. Besides the banks, the only other persons who went to the Currency Commissioners for cash were the Chetties. It would appear, however, that they seldom found it necessary to obtain notes in exchange for coin. Given the security holdings of the Board, the amount of notes in circulation varied with the amount of Indian silver rupees offered to the Commissioners.

Mr. B. R. Shenoy in his account in 1941 of the working of the Currency Board system suggests that 'the chief part in this movement of specie was played by the banks or rather the Bank of Madras, through whom the exchange banks found it convenient to operate'.[41] The available evidence, however, indicates that for many years after the inception of the new monetary system each bank was responsible for its own exports and imports of specie—they did not operate through the Bank of Madras. The arrangements described by Mr. Shenoy developed only some time after 1903—probably after the first world war.[42]

[40] Cf. Evidence of George Van Hoff, Clerk to the Currency Commissioners, before the Currency Commission of 1903: S.P. 5 of 1903, p. 18:—*Question:* In practice the notes are mostly issued to the banks? *Answer:* Yes. *Question:* The notes brought into circulation are mostly through the agency of the banks? *Answer:* Almost wholly so.

[41] B. R. Shenoy: *Ceylon Currency and Banking*, 1941, p. 153.

[42] The evidence before the Currency Commission of 1894 and 1903 (see Chap. V) supports this view. The bank managers who gave evidence referred over and over again to their own exports and imports of specie. Nowhere do they refer to the 'leading role' of the Bank of Madras. Cf. for example the evidence of J. M. Skinner, manager of the Mercantile Bank of India, before the Silver Currency Commission of 1894: 'Most of the specie imported into Ceylon comes to the banks. . . . The banks would only import sufficient specie to balance exports and

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Some time after 1903 the task of dealing with the Currency Commissioners and supplying the rupee requirements of the other banks was assumed more and more by the Bank of Madras, and its successor the Imperial Bank of India. It is probable that the practice developed during and after the first world war. As will be seen in a later chapter, during that war one-rupee notes were issued for the first time in Ceylon and the silver rupee began gradually to disappear from circulation. With currency notes as the sole circulating medium, the exchange banks preferred to obtain them from the Bank of Madras rather than import silver merely in order to transfer it to the Currency Commissioners.

The arrangements which developed were a result of Ceylon's pattern of trade. The exchange banks financed the trade between Ceylon and the United Kingdom which bought the bulk of the island's exports. They discounted sterling bills drawn against the export of Ceylon produce. Since Ceylon's imports from the United Kingdom fell far short of her exports to that country, the branches of the exchange banks invariably found themselves in possession of surplus sterling which they wished to convert into domestic currency. In other words, the measure of their requirements of rupees was the amount of sterling bills they had bought.[43] At one stage they solved this exchange problem by engaging in what are called 'simultaneous operations'. They sold their surplus sterling through their branches in India and imported rupees.[44] Through the agency of the Bank of Madras, however, they were able to obtain rupees cheaper and more conveniently.

Ceylon had a habitual deficit in her trade with India so that there was usually a surplus demand for Indian exchange which was largely concentrated at the Bank of Madras. This bank

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imports. . . . Banks now get rupees from India and pay for them by instructing the Indian banks to sell drafts on London on their account, or order for silver, government paper, etc., from London.' S.P. 6 of 1894. Evidence of Robert Wilson, *ibid.*, p. 34: '*Question:* Prior to 1901, when the Ordinance making gold legal tender was introduced, all the silver was imported by the banks? *Answer:* Practically, I should say.' See also *ibid.*, p. 17.

[43] Cf. Ceylon Currency Commission: S.P. 6 of 1894, p. B9:—Evidence of J. M. Skinner, Manager, Mercantile Bank of India, Colombo: 'The banks would not bring into the island more rupees than they required; the measure of their requirements would be the amount of sterling bills they had bought. The banks would only import sufficient specie to balance exports and imports.'

[44] Cf. Chap. III.

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was well equipped to deal in Indian exchange. It had a wide network of branches in South India and occupied a dominant position in the Indian money market. Bills drawn by Indian merchants on importers in Ceylon were sent to it for collection. Similarly, there was a large demand for drafts on India to settle the adverse trade balance with that country. The Bank of Madras, therefore, found itself in possession of rupees in Ceylon which it wanted to transfer to India, while the exchange banks had surplus sterling which they wished to convert into rupees in Ceylon. The rupee surplus of the Bank of Madras and the sterling surplus of the exchange banks could be set off one against the other if the exchange banks could supply the Bank of Madras with rupee credits in India. This they were able to do by buying India Council bills or bar silver in London with the proceeds of their sterling bills or, more usually, by turning over sterling to their Indian branches in exchange for rupee credits in India. The Bank of Madras then supplied the exchange banks with rupees in Ceylon for a small commission governed by the cost of importing silver rupees from India. Since the Bank of Madras was thus relieved to a large extent of the cost of shipping specie to India it was in a position to supply the exchange banks with cash at a price considerably lower than what it would have cost them to import rupees themselves. The exchange banks, therefore, found it convenient to go to the Bank of Madras rather than to the Currency Commissioners whenever they wanted to increase or diminish their own holdings of currency notes. In the absence of this arrangement, the exchange banks would have been continually importing rupees while the Bank of Madras would have been exporting them. These two opposite flows of specie were set off against each other by the Bank of Madras and it became necessary to ship rupees only in so far as the two streams were unequal.

Broadly speaking, the Bank of Madras would need to import specie if the demand for rupees of the exchange banks exceeded the demand for remittances to India. Similarly, specie would be exported if the amount of sterling which the exchange banks wished to dispose of fell short of the demand for remittances to India. Thus the net movement of rupees in either direction was determined by the value of the sterling bills which the banks discounted. And this quantity was a function

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of the state of the country's trade. At times of rising export prices there was a brisk demand for money and increasing quantities of sterling bills were offered to the exchange banks, which, therefore, required more and more cash in Ceylon. At such a time the Bank of Madras was confronted with an excess demand for rupees which was met by importing coin from India and exchanging it for notes at the Currency Board.

On the other hand, during a period of falling export prices, the situation was exactly the reverse. The exchange banks found business dull and the value of sterling bills offered to them lower. At such times the outward stream of specie exceeded the inward stream and the Bank of Madras was faced with a demand for Indian remittances greater than what the exchange banks were offering to it in India. The Bank therefore met this excess demand by exporting Indian rupees which it obtained from the Currency Board in exchange for notes. The currency circulation was thus contracted.

The emergence of the Bank of Madras (and later the Imperial Bank of India) as a dealer in rupees was fundamentally due to the fact that at all times Ceylon had to make heavy payments to India, from which country she obtained the bulk of her articles of everyday consumption. The Bank of Madras performed the function of setting off these debits in the island's balance of payments against the credits acquired by trade with the United Kingdom and the rest of the world. Its role as a 'clearing house' for exchange was considerably facilitated by the fact that from 1885, in which year the Colombo Bankers' Clearing House was established, the exchange banks maintained accounts with the Bank of Madras for purposes of inter-bank clearing. The primacy of the Bank of Madras in Ceylon was a natural corollary of its position in the Indian money market where, until the establishment of the Reserve Bank of India, the three Presidency Banks undertook numerous central banking functions.

Apart from the purely mechanical business of issuing and redeeming notes—which business was considerably simplified by its having to deal mainly with one bank—the only other function of the Currency Board was to maintain the requirements of the Currency Ordinance regarding the silver and investment portions of the reserve. When Indian rupee coins

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were issued in exchange for notes, it led to a fall in the ratio of coin to total notes in circulation—'the coin reserve'. However, as long as the coin reserve remained above one-third of the note circulation, the Board was not obliged to take any action. If it fell below that level it had to take steps to sell a part of its security holdings in order that the ratio might be restored. On the other hand, when the reserve rose above 50 per cent., the excess could be invested either in the London money market or in India. During the early years of the Currency Board system the procedure adopted when the Commissioners wished to invest in London was somewhat roundabout. The excess coin was transferred to the Colonial Treasury, and the Governor, through the Secretary of State for the Colonies, requested the Crown Agents for the Colonies to buy securities on behalf of the Board. The Crown Agents recouped themselves by drawing a bill on the Colonial Treasury and selling it in the London market. The bill was usually bought by one of the exchange banks wishing to obtain rupees in Ceylon.[45] This practice was soon discontinued and it became the rule for the Commissioners to remit funds to London through one of the exchange banks. When the Board wished to invest in Indian securities funds were remitted through the Bank of Madras.

As it turned out, during the whole period 1885 to 1914 additions were made to the stock of sterling securities only at somewhat long intervals. On no occasion did the Commissioners sell sterling securities during this period. They operated entirely on the rupee securities for the purpose of adjusting the coin reserve. That the rupee portion of the investment reserve should have been its more flexible component was only natural since the Commissioners dealt in Indian rupees. It was quicker and cheaper for the Commissioners to remit surplus funds to India or to obtain funds by selling Indian securities

[45] The official correspondence between the Governor, the Secretary of State and the Crown Agents relating to these transactions has been 'destroyed under Statute'. The indexes to the correspondence, however, refer to it. Governor's Despatch No. 30 of 1887 requested the Secretary of State to instruct the Crown Agents to invest Rs. 300,000 and to draw upon the Colonial Treasury for funds. Cf. *Public Record Office Index*, 12981. Again, Despatch No. 30 of 14 January 1888 refers to an investment of Rs. 88,000. The bill on the Colonial Treasury realized £6,183 12s. 8d. Cf. *Index*, 15393. The Indexes for the years after 1888 contain no record of similar correspondence.

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rather than to adopt the more roundabout course of buying and selling sterling securities. Indeed, as the authorities were fully aware when the Currency Ordinance was being drafted, it was illogical to hold a part of the currency reserve in sterling securities when the Commissioners dealt in Indian rupees. This arrangement was justified solely on the grounds of safety. The Currency Commissioners considered the sterling portion of the reserve a kind of nest-egg. Its value was not likely to depreciate heavily and it brought in a steady income to the Board. The prices of Indian securities, on the other hand, were much more volatile. But this was compensated by the greater simplicity and convenience of buying and selling them.[46] In particular, the Commissioners could invest even temporary surpluses in India as they could be brought back without delay in case of need. It would not have been worth while to make such temporary investment in London.

Chart II shows the monthly surplus or deficit of the coin reserve expressed as a percentage of the total circulation for the period 1888 to 1913. The diagram reveals two important characteristics of the coin reserve. In the first place, the coin reserve was usually below the minimum of one-half of the total circulation though comfortably above the level of one-third, at which point it would have been necessary for the Commissioners to sell securities.[47] Secondly, the coin reserve usually rose, often above 50 per cent., towards the end of each year, while it fell away in the middle months of the year. This seasonal movement of the reserve was sufficiently regular for the Commissioners to anticipate it. Clearly it was the intention of the framers of the Currency Ordinance that the normal reserve should be 50 per cent. The question arose, therefore, whether it was in accord with the spirit of the Ordinance for the Commissioners to invest a surplus reserve which accrued at the end of a year when it was almost certain that the reserve would soon ebb away. This question was broached by the Currency Commissioners in 1896.[48] It was argued that to

[46] Fluctuations in the prices of securities held in the reserve did not directly affect the note issue, as the securities were valued at cost price in the Board's accounts. It was the function of the Depreciation Fund to provide for a possible depreciation of the securities.

[47] The reserve was augmented by the sale of securities only in years of bad trade such as 1894, 1898, 1902, 1908.

[48] Cf. S.P. 34 of 1896.

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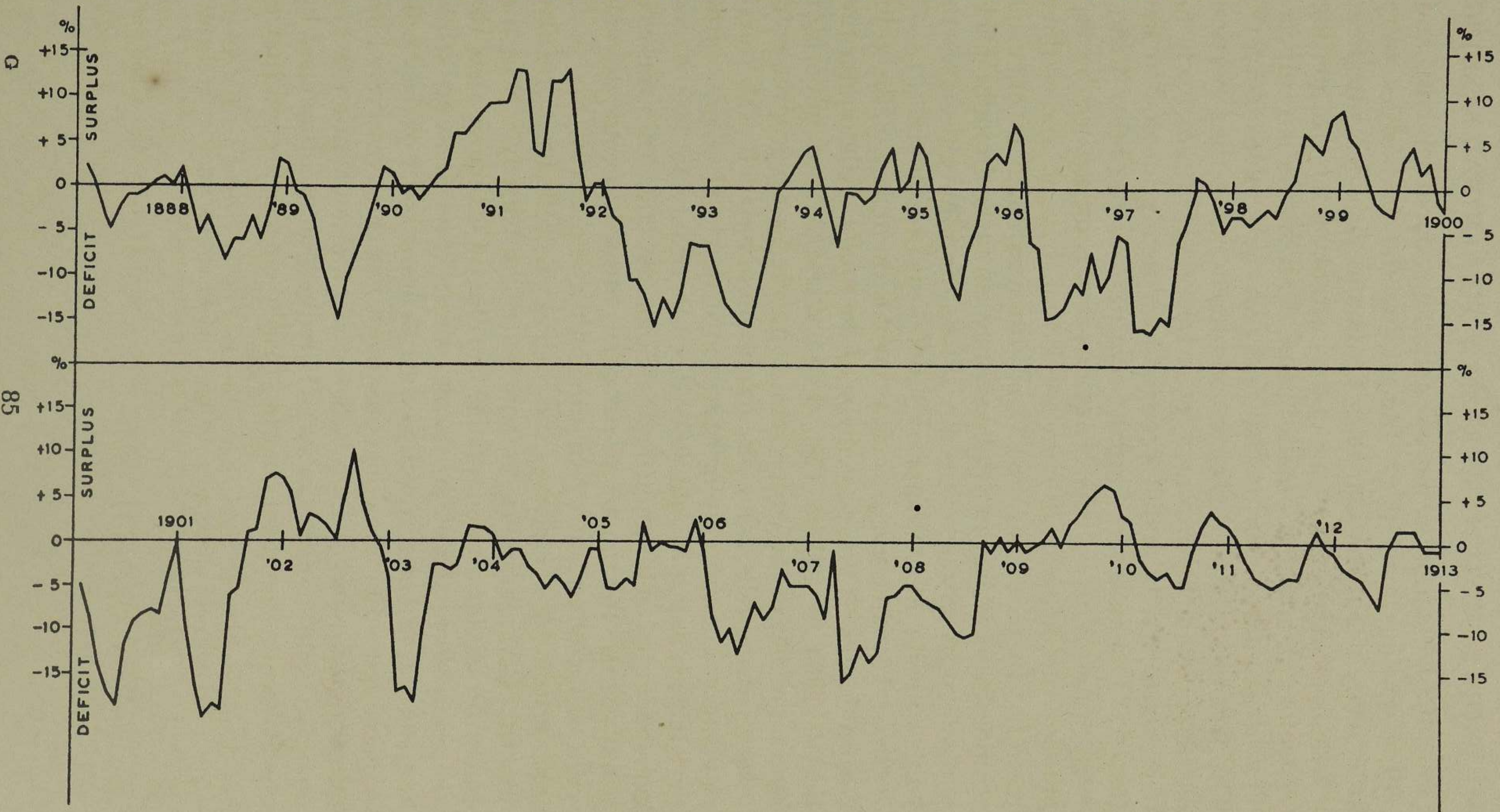
Chart II. SURPLUS OR DEFICIT OF COIN RESERVE, 1888–1913



Source: Monthly Statements of Currency Commissioners.

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all intents and purposes the effective coin reserve was one-third and that such a reserve was adequate in view of 'the ease and convenience of realizing Indian securities'. The Governor wrote to the Secretary of State recommending a change in the Ordinance. But the Treasury and the Colonial Office saw no reason for such a change. And the Commissioners continued to invest temporary surpluses whenever they were available. Only in a very superficial sense can it be said that the Commissioners attempted to maintain the requirements of the law. This practice continued until 1917 when the Ordinance was amended and the law was made to conform with the practice.

The function of the Currency Board was not to manage the currency, but to manage the currency reserve. As long as the reserve remained below 50 per cent. but above the bare minimum of one-third, the expansion and contraction of the note circulation represented merely an automatic response to the influx and efflux of coin from the vaults of the Currency Board. When coin was offered to the Board the note circulation expanded by an equivalent amount and when notes were presented for conversion into coin the circulation fell by an equal quantity. As we have seen, since for most of the time the coin reserve was below 50 per cent., the circulation was generally determined by the import or export of specie by the banks. To this extent the system resembled a gold standard, without of course, the 'rules of the game'.

An Element of Elasticity

The system, however, worked less rigidly on occasion, when the coin reserve was above one-half and the Commissioners were at liberty to buy investments. They could issue notes up to twice the value of any excess specie they held. Assume, for instance, that there is an excess reserve of 10 per cent. against a note circulation of Rs. 100. Then the balance sheet of the Board will be as follows:

Liabilities		*Assets*	
Notes in circulation	100	Coin in Vault	60
		Securities	40
			100

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Now the Board can buy securities until the reserve has fallen to 50 per cent. To do this it can buy foreign exchange from a bank and pay for it with its own notes. A coin reserve of 60 enables the Board to have in circulation Rs. 120 in currency notes. It can, therefore, buy Rs. 20 worth of securities, and the note circulation will have increased by a similar amount. The next step depends on the bank which sold the foreign exchange to the Commissioners. It might be in a position to sell the exchange by drawing on its balances abroad, that is by issuing drafts either on its head office in London or on one of the Indian branches. In which case there will be no further change in the currency supply. On the other hand it is possible that the increase of the note issue through the purchase of securities by the Currency Board might be offset by the bank's converting the notes so issued into specie in order to meet the additional demand for foreign exchange.[49] In that event both the note issue and the coin reserve will fall by Rs. 20, and the balance sheet will be as follows:

Liabilities		*Assets*	
Notes in circulation	100	Coin in Vault	40
		Securities	60
			100

The coin reserve will be below one-half but above one-third and no further action will be needed.

The banks, therefore, were able to play a crucial role in the currency mechanism. To the extent that the banks were willing to sell foreign exchange to the Board, without at the same time demanding payment in coin, they were able to impart a certain degree of elasticity to the system and the amount of currency was not entirely dependent on the ebb and flow of specie. The crucial question, then, is what determined the bank's behaviour? A full discussion of this question must, however, be postponed until a larger slice in the life of the Currency Board system in Ceylon has been examined.

The extent to which the investment of the surplus coin reserve lent elasticity to the currency system may be illustrated from Table 11, which details the changes in the note circulation

[49] This is the extreme case. *Mutatis mutandis*, the same will hold true if only a part of the increased issue is returned to the Commissioners.

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and in the coin reserve, on the occasions that the Currency Commissioners invested in securities. It will be seen that whenever securities were bought the increase in the note circulation was greater than the increase in the coin reserve.[50] For instance, at the end of September 1888 there was a surplus of ½ per cent. in the coin reserve. During the next month further coin was being brought to the Board to be exchanged for notes. The Commissioners then increased their holdings of Indian government securities by Rs. 70,000. The note issue rose by Rs. 210,000, which was balanced by the increase of Rs. 70,000 lakhs in the investment portion of the reserve and an increase of Rs. 140,000 in the coin reserve.

Similarly, in March 1899 the note circulation increased by Rs. 302,000 lakhs although the increment in the coin reserve was only Rs. 100,000. The difference was accounted for by the addition of Rs. 202,000 worth of securities. On many occasions the note circulation increased in spite of a fall in the coin reserve.[51] In every case the explanation is to be found in the investment of surplus coin by the Currency Board in Indian or sterling securities. The clearest example of the expansion of the note issue in this manner is provided by the figures for September 1898. In that month there was no change at all in the coin reserve, and the increase in the note circulation by Rs. 192,000 lakhs was due entirely to the remittance of funds to India for investment.

One is, of course, not justified in assuming that the periodical investment of coin surpluses conformed to any plan of 'monetary management'. As Chart II shows, a surplus in the coin reserve when it did emerge usually came between October and January, which was the busy season in the island. The import of silver by the banks was greatest at this time of the year. Offered to the Currency Board, it led to a rise in the coin reserve often to above the minimum of 50 per cent. When the Commissioners took steps to invest a part of the coin surplus by buying foreign exchange from a bank, they did so at a time when the banks themselves were importing rupees in order to obtain more notes for circulation. Thus the banks were only

[50] Or, as in March 1888, January 1889, October 1899, January 1905, June 1906, May 1910, November 1912 and January 1913, the note issue fell by less than the fall in the coin reserve.

[51] E.g. in September 1892, October 1895, December 1906, November 1911.

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Table 11

PURCHASE OF INVESTMENTS BY THE CURRENCY BOARD
1888–1913

Lakhs of Rupees
(1 *lakh* = *Rs.* 100,000)

Date	*Change in Note Circulation*	*Change in Coin Reserve*	*Change in Security Reserve*
31.3.88	– 1·62	– 2·48	+ 0·89
31.10.88	+ 2·10	+ 1·40	+ 0·70
31.12.88	+ 2·90	+ 2·50	+ 0·40
31.1.89	– 1·50	– 2·50	+ 1·00
31.12.89	+ 5·25	+ 2·25	+ 3·00
30.9.92	+ 5·40	– 4.60	+ 10·00
31.10.92	+ 1·06	– 3·60	+ 4.44
30.9.95	+ 6·45	+ 4·04	+ 2·45
31.10.95	+ 0·40	– 2·64	+ 3·00
31.12.96	+ 6·58	+ 1·66	+ 9·92
28.2.97	– 5·90	– 5·93	+ 0·30
28.2.98	+ 0·14	+ 0·10	+ 0·35
30.4.98	+ 6·88	+ 4·00	+ 2·88
30.9.98	+ 1·92	—	+ 1·92
31.3.99	+ 3·02	+ 1·00	+ 2·02
31.10.99	– 0·30	– 2·30	+ 2·00
31·1·1900	– 3·03	– 5·90	+ 2·87
30.11.1900	+ 5·45	– 1·67	+ 7·12
30.9.03	+ 14.80	– 0·20	+ 15·00
31.10.03	+ 7·90	– 1·59	+ 9·50
30·11·03	+ 11·13	+ 3·13	+ 8·00
31.12.04	+ 1·57	– 0·41	+ 1·98
31.1.05	– 2·78	– 3·77	+ 0·99
30.6.06	– 0·92	– 2·77	+ 1·84
31.8.06	+ 2·29	+ 0·29	+ 2·00
31.9.06	+ 9·36	+ 4·45	+ 4·91
30.11.06	+ 15·66	+ 13·07	+ 2·60
30.12.06	+ 5·93	– 5·73	+ 11·66
30.4.10	+ 11·32	+ 8·09	+ 3·24
31.5.10	– 2·76	– 5·02	+ 2·26
31.7.10	+ 5·83	+ 3·89	+ 1·94
31.8.10	+ 11·88	+ 9·88	+ 2·00
31.9.10	+ 16·20	+ 11·32	+ 4·88
30.11.11	+ 4·63	– 0·35	+ 4·63
30.11.12	– 3·53	– 6·05	+ 2·52
31.1.13	– 5·48	– 7·85	+ 2·37
31.8.13	+ 33·60	+ 17·70	+ 15·90
30.9.13	+ 8·77	+ 3·90	+ 4·83
31.10.13	+ 11·96	+ 1·40	+ 11·00

Source: Ceylon Government Gazettes; Monthly Statements of the Commissioners of Currency.

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too ready to obtain rupees by selling foreign exchange to the Commissioners. And the currency supply acquired elasticity just at the time when the demand for it was at its highest. It is worth noting that this elasticity was in the main due to the ability of the Currency Board to invest temporary surpluses, which was made possible only by the 'ease and convenience' of realizing Indian securities.

The above remarks on the behaviour of the currency might be illustrated by examining the currency figures for 1889 reproduced in Table 12. At the beginning of the year the coin

TABLE 12

CURRENCY MOVEMENTS IN 1889

Month	*Change in Circulation*	*Change in Coin Reserve*	*Change in Security Reserve*	*Percentage Coin Reserve*
		Lakhs of rupees		
January	− 1·50	− 2·50	+ 1·00	48·5
February	−4·10	−4·09	—	44·5
March	+ 2·00	+ 2·00	—	46·5
April	− 2·50	− 2·50	—	43·8
May	− 1·00	− 1·00	—	41·8
June	+ 1·30	+ 1·30	—	44·1
July	—	—	—	44·1
August	+ 1·50	+ 1·50	—	46·5
September	− 1·70	− 1·70	—	43·9
October	+ 3·00	+ 3·00	—	47·5
November	+ 7·20	+ 7·20	—	52·9
December	+ 5·25	+ 2·25	+ 3·00	52·7

Source: Ceylon Government Gazette; Monthly Statements of the Commissioners of Currency.

reserve had been reduced to 48·5 per cent. from 51·9 per cent. at which it had stood at the end of the previous year. One lakh of rupees was invested in Indian government securities in January. As a result, although 2½ lakhs of notes were presented at the Board for conversion into specie the circulation fell by only 1½ lakhs. Thereafter until November the circulation varied with the amount of coin in the reserve, which began to rise steadily after June. The influx of coin had raised the coin reserve to 52·9 per cent. by November and the Commissioners again added to the circulation by buying securities. In December, therefore, the note circulation registered a rise of 5¼ lakhs although the coin reserve rose by only 2¼ lakhs. The remittance of 3 lakhs of rupees to India for investment was

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responsible for the additional increase of 3 lakhs in the circulation.

It would, however, be misleading to stress this slight element of elasticity inherent in the system. In the first place, it depended upon whether the coin reserve was already in surplus. It was available, that is, when specie was flowing into the country in the wake of a rising volume of trade. It was not available as a method of compensating a fall in the circulation at a time when specie was flowing out. As we have seen, surpluses in the coin reserve were far from frequent, and when they did occur it was usually during the last three months of the year.[52] Secondly, in years of bad trade such as 1893, 1901, 1905, 1907 and 1908, the coin reserve was invariably below 50 per cent. and when the reserve was being drained away, the Commissioners, far from investing abroad, had to sell securities in order to prevent the coin reserve from falling below the bare minimum of one-third. The elasticity referred to thus depended on two factors—whether there was a surplus in the coin reserve, and whether the banks were willing to draw on their balances abroad in order to enable the Commissioners to invest abroad without depleting the coin reserve. In the final analysis, both these factors depended on whether the banks were wishing to import funds and as such were governed by the state of the country's trade.

Mr. Shenoy, in his account of the pre-1914 system, uses the term 'secondary expansion' for the increase in the circulation discussed above.[53] The term is somewhat misleading in that it suggests an analogy with the 'secondary expansion' of credit by commercial banks, on the strength of increased cash reserves. However, a bank is able to create credit while the Currency Board cannot 'create' money. It can only exchange local currency for foreign currency, and the 'secondary expansion' is dependent on the availability of foreign currency. If the banks are unable or unwilling to supply it, the Board has to part with coin in order to acquire securities abroad. In other words, it is in fact the banking system which imparts the elasticity referred to.[54]

Probably influenced by this confusion regarding the powers

[52] Cf. Chart II. [53] Shenoy: *op. cit.*, pp. 152–58.
[54] This question is discussed at greater length in a subsequent chapter.

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of the Currency Board, Mr. Shenoy is led to make the following comment on the system: 'Another feature of the system before the Great War I was that the coin portion of the reserve was more usually below 50 per cent. than above it, so that the device of issuing notes against the purchase of securities was not frequently open to the Currency Commissioners. . . . Currency movements before 1914, then, notwithstanding the proportional reserve system of issue, behaved more or less as if it were on a fixed fiduciary issue basis. The rise or fall in the volume of money was measured by the quantity of inflow or outflow of rupees.'[55] Again, the term 'proportional reserve system' is inaccurate, as the Currency Board could only hold coin and foreign securities. The import of securities was merely a more profitable substitute for the import of coin. It is important to distinguish between an issue of currency against foreign securities and an issue against domestic securities. In the latter case, there is no foreign exchange problem involved. The term 'proportional reserve system' is usually associated with the practice of issuing notes against domestic securities.

The foregoing analysis of the working of the Paper Currency Ordinance throws into relief the important role played by the banks. They were responsible for the expansion and contraction of the note issue because they were the biggest exporters and importers of specie and all but monopolized dealings with the Currency Commissioners. The fact that remittances abroad for the purpose of buying investments for the currency reserve were made through the banks enabled them at times to obtain currency without the actual import of specie. The currency system was thereby rendered somewhat elastic.

How far, it might be asked, did the system introduced by the Paper Currency Ordinance differ from the system of issue by the banks which it superseded? There were several obvious differences. For example, the profits of the note issue now accrued to the general revenue of the country, whereas under the previous system they 'enriched shareholders abroad'. Secondly, the later arrangements were considerably safer in

[55] These as well as other scattered passages in Shenoy's account suggest that the purchase of securities was deliberately used as a 'device' for increasing the circulation. Such discretionary devices were contrary to the spirit of the Paper Currency Ordinance. The more likely explanation is that the Commissioners were keen on investing coin surpluses in order to increase the profits of the Board.

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that the Currency Board held a reserve of specie equal to at least one-third of the circulation. The rest of the currency reserve was held in gilt-edged securities. Every note was backed by its equivalent in coin or by securities which could be readily converted into coin. On the other hand, under the earlier system the reserve of specie which the banks were required to maintain constituted the banks' working balance for their general banking business as well. For the rest, the notes were backed by the sum total of the banks' assets which were of varying degrees of liquidity and soundness. In short, the Currency Board system established a system which the framers of the Bank Charter Act tried, but failed, to achieve—a complete separation of the business of note issue and the business of banking.

Yet the obvious differences between the two systems must not be allowed to obscure their underlying similarity; while in the earlier system the banks issued their notes against the specie they imported, under the Paper Currency Ordinance they obtained notes from the Currency Board by handing over their imports of specie. In both cases, the amount of the circulation depended on the actions of the banks.

Safety and soundness were the hall-marks of the Currency Board system. By tying the note circulation to the amount of the coin reserve the system made it impossible for an inflation or a depreciation of the currency to originate locally. The next chapter deals with a depreciation of the exchange and a rapid increase in the monetary circulation brought about by a depreciation of the money metal itself. That depreciation was on a scale never before experienced in the history of metallic currency.

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CHAPTER V

THE VICISSITUDES OF THE RUPEE 1885–1914

The failure of the Oriental Bank and the introduction of a government paper currency came at a time when the country was just emerging from the long years of depression which had overhung the economy since 1878. If the extinction of the coffee industry during these years is the most startling episode in the country's economic history, the rapid growth of the tea industry in the years which followed is no less remarkable.[1] The dark clouds were lifting and the future seemed bright. A planter writing in 1886 exclaimed, 'Le Roi est mort, vive le Roi', which, paraphrased, meant 'King Coffee is Dead, Long Live Tea'.[2]

During a brief interlude after the collapse of coffee, cocoa and cinchona were tried out. But tea proved the produce from which Ceylon was 'to gain new life for herself'.[3] Tea had been cultivated on a purely experimental scale from about 1867. After 1874, however, the acreage under the crop increased rapidly and even at the height of the 'great depression' in the late eighties, tea plantations were being opened out. Abandoned coffee estates were turned over to tea and new lands were cleared and planted. Unlike coffee, which was confined to the hill districts of the island, tea thrived even at a few feet above sea-level. As a result, parts of the low country which had hitherto been out of the main current of the island's economic life began to share in the growth of the plantation economy. Table 13 shows the tremendous strides made by the industry between 1878 and 1900. Within the short space of a decade between 1880 and 1890 the acreage under tea rose from a little over 9000 acres to over 200,000 acres, while the value of tea exports rose from about 1½ lakhs of rupees to more than Rs. 22 million.

[1] Cf. J. Ferguson: *The Rise of the Planting Enterprise and Trade in Ceylon Tea*, 1900, p. 2.
[2] R. W. Jenkins: *Ceylon in the Fifties and the Eighties*, 1886, p. 18.
[3] *Ibid.*, p. 58.

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With the rush into tea, there was again the danger of the island's economy being based on a single export crop. But the introduction of rubber at the turn of the century and the development of a considerable export trade in the products of the

TABLE 13

THE TEA INDUSTRY, 1878–1900

Year	*Area under Tea acres*	*Quantity of Tea Exported lb*	*Value of Tea Exports Rs*
1878	4,700	19,607	20,900
1880	9,274	162,575	150,641
1885	102,000	4,372,721	2,842,269
1890	220,000	45,799,518	22,899,759
1895	305,000	98,581,060	49,290,530
1900	384,000	149,264,602	53,735,257

Source: Ceylon Blue Books.

coconut palm led to the emergence of an export economy resting on three staple agricultural industries, tea, rubber and coconut. To this day the economy of the country conforms to the basic pattern which was evolved in these years. Tea did not loom as large in the economy as coffee did. For instance, in 1897 tea contributed only 56 per cent. to the total value of exports. Rubber contributed 15½ per cent. and coconut products 4 per cent. Twenty years previously the value of

TABLE 14

VALUES OF THREE MAIN EXPORTS, 1885–1915

Year	(1) *Value of Total Exports Rs. million*	(2) *Value of Tea Exports Rs. million*	(3) *Percentage of (2) of (1)*	(4) *Value of Rubber Exports Rs.*	(5) *Percentage of (4) of (1)*	(6) *Value of Coconut Product Exports Rs. million*	(7) *Percentage of (6) of (1)*
1885	33·8	2·8	8·3	—	—	5·5	16·6
1890	50·2	22·9	44·7	—	—	7·4	14·8
1895	77·5	49·3	63·5	1,290	—	10·5	13·6
1900	90·9	53·7	59·0	12,882	—	16·4	17·9
1905	102·2	59·6	58·3	221,000	—	22·5	22·0
1910	166·2	84·1	50·5	28 mill.	16·9	35·0	21·2
1915	265·7	122·5	46·0	83 mill.	31·4	40·9	15·5

Source: Ceylon Blue Books.

coffee exports alone amounted to 81 per cent. of the total.[4] Table 14 sets out the values and the relative importance of the three main exports between 1885 and 1915 at five-yearly intervals. It shows that exports of rubber were negligible until

[4] Governor's address to the Legislative Council, 7 Nov. 1898.

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the beginning of the present century, while the relative importance of the exports of coconut products increased somewhat.

The Paper Currency Ordinance gave the island a monetary system which was proof against panics. It ensured that a repetition of 1884 was almost impossible. Yet in the years that followed monetary problems claimed the attention of both the government and the public more than it ever did before. The rise of the tea industry took place against the background of a continuous depreciation of the exchanges. In fact, many claimed that the two were closely connected. Ceylon, along with India, was on a silver standard. As the Indian exchanges declined owing to the fall in the gold value of silver, the rupee–sterling rate in Ceylon merely kept pace.[5] And when in 1893, after the exchange value of the rupee had been all but halved, and the government of India decided to abandon the silver standard, Ceylon could do no more than accept the change, though not without much indignation and several protests. When finally India stumbled along towards a gold-exchange standard Ceylon kept her company. In fact, this 'currency companionship' lasted well into the middle of the next century. The monetary history of Ceylon is largely a story of the repercussions of currency changes in India.

Of these changes none caused more resentment in Ceylon than the Indian decision to abandon the silver standard in 1893.[6] This episode and the events which led up to it have been so extensively treated by writers on Indian currency problems, that only a brief recapitulation of the salient facts is necessary here.[7] Forces on both the demand and supply sides of the market contributed to the great fall in the price of silver. New sources of supply were being discovered just at the time when the countries of Europe were taking steps to abandon silver for gold.

Germany and the countries of the Latin Monetary Union went on gold in the 1870's and the United States soon followed suit. The world's unwanted silver found a market only in the

[5] Cf. Chap. III.

[6] The action of the government of India was described by a Ceylon planter as follows: 'To speak plainly, such statesmanship is as immoral as it is high-handed—some authorities have called it criminal.' Cf. S.P. 6, 1894: App. C, p. 26.

[7] Cf. Indian Currency Committee 1893 (Herschell Report); Indian Currency Committee 1898–9 (Fowler Report). An excellent résumé of the history of silver currencies during this period is provided by D. H. Leavens: *Silver Money*, 1939.

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silver standard countries of the East, particularly India, China and Japan. The price of a standard ounce of silver which had averaged $60\frac{5}{16}$d. in 1872–73 fell to $39\frac{1}{16}$d. in 1892–93, and the average rate for the rupee fell from 1s. $10\frac{1}{2}$d. to 1s. $2\frac{1}{2}$d. during the same period.[8] The government of India was particularly affected, as more and more rupees had to be raised by taxation in order to remit the 'home charges'. It became virtually impossible for the government to frame its annual budget, as exchange fluctuations upset its best laid plans. For years the government had pinned its faith on bimetallism, but by 1893 it had become clear that no solution could be found along those lines. The failure of the International Monetary Conference in that year and the impending repeal of the Sherman Silver Purchase Act in the United States threatened to reduce the price of silver still further. The government of India therefore sought the approval of the home government to stop the free minting of silver to reduce the rupee circulation, and to take steps towards the introduction of a gold standard. The government's proposals were referred to a committee under the chairmanship of Lord Herschell. The Herschell Committee broadly endorsed the proposals of the government. It recommended the following measures:

(*a*) The closure of the Indian mints to the free coinage of silver.
(*b*) The use of the mints for coining rupees on behalf of the government, which was to pay out rupees for gold at the rate of 15 rupees per sovereign. The Committee also accepted the proposal of the government of India to contract the circulation with the object of raising the exchange value of the rupee.

The new currency policy was initiated on 26 June 1893, with the closure of the mints. Like their counterparts in India, it was the 'export interests' in Ceylon, especially of the tea planters, that led the outcry against this step, which they described as an attempt to give an 'artificial value' to the rupee. As early as November 1892 Mr. T. N. Christie, a prominent planter in Ceylon, wrote to the Secretary of State for the Colonies contending that the low value of the rupee was beneficial to the producing interests, and that any attempt by the government of India to tamper with the currency would

[8] Cf. Indian Currency Committee 1898: Appendices, p. 144.

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inflict 'a ruinous loss' on the island. He concluded that 'Ceylon will resist any such proposal.'[9] Before the Herschell Committee itself, the case of the tea planters of Ceylon was put by Mr. H. K. Rutherford, chairman of the Ceylon Tea Plantations Company, and by Mr. Martin Leake, secretary of the Ceylon Association in London.[10] They argued that 'the prosperity of the whole of Ceylon is bound up with her staple products'[11] and that a rise in exchange would render tea cultivation in the island unprofitable. Tea prices, they argued, were gold prices, since Ceylon and Indian teas found their main markets in the United Kingdom. A rise in exchange reduced the rupee receipts of the producers, while it gave a bounty to their Chinese rivals whose currency was on a silver bullion standard. They asserted that it was the low exchange which had enabled the country to recover from the effects of the collapse of coffee. But the Herschell Committee were as unimpressed by the arguments of these witnesses as they were by those of the tea planters in Darjeeling.[12] In any case, it was no part of the Committee's duty 'to advise what action should be taken by the Colonial governments (i.e. Ceylon and Mauritius), which had the Indian rupee as their monetary standard'. It was open to Ceylon either to establish a currency of her own and thus to sever her link with the Indian monetary system, or 'to acquiesce in the action of India'.[13]

The Silver Currency Commission

Since their complaints went unheeded by the Herschell Committee, the 'producing interests' of Ceylon prevailed upon the Governor to appoint a commission locally to review the problems created by the currency changes in India. On 6 October 1893, a Commission[14] was appointed under the chair-

[9] Indian Currency Committee 1893: Minutes of Evidence. Appendix II, p. 221.

[10] The Ceylon Association in London had passed a resolution deprecating any alteration in the silver currency of India: *ibid.*, p. 109, Q. 2427–8.

[11] Answer to Q. 2451, Evidence of Messrs. Rutherford and Leake: *ibid.*, pp. 109–13.

[12] Cf. Indian Currency Committee 1893, Report of, para. 119.

[13] *Ibid.*, para. 129.

[14] Besides the chairman, the Commission consisted of Messrs. F. R. Saunders (Colonial Treasurer); R. Reid (Principal Collector of Customs); W. W. Mitchell (businessman); Giles Walker (chairman, Planters' Association of Ceylon); G. A. Talbot (general manager, Ceylon Tea Plantations, Ltd.); T. N. Christie (planter); D. Noble (Agent, Bank of Madras); F. W. Bois (businessman).

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manship of Mr. J. A. Swettenham,[15] Auditor-General of Ceylon, to consider and report as to:

(i) The probable effect in Ceylon of the recent action of the Indian government in putting an artificial value on the rupee.
(ii) The measures which it may be expedient to take to protect the interests of the Colony under the altered nature of the currency.

The Commission submitted its Report on 16 February 1894. An overwhelming number of witnesses before this Commission were of opinion that the action of the government of India was detrimental to the interests of Ceylon.[16] The argument in its simplest terms is best expressed in the words of one of the witnesses:

'For 40 lb of tea fetching 6d. per lb the producer received 240d. That is, £1. Remitted to Ceylon at 1s. 4d. gives the planter 15 rupees, of which he pays 10 rupees for the costs of production and pockets Rs. 5.00 for himself. With the rupee following the fortune of silver, however, he would be in a different position. The rupee with silver at 32d. is worth about 1s. 0½d. or say 1s. The £1 paid for the 40 lb of tea would, therefore, bring him Rs. 20.00 of which he would pay Rs. 10.00 for the cost of production and this would leave him Rs. 10.00 instead of Rs. 5.00 profit.'[17]

In this manner, the action of the Indian government affected adversely all those who produced for export—the British estate owners and the large number of native 'landed proprietors' both large and small who earned their incomes from exports.[18] The Commission, too, expressed the view that the divorce of the exchange value of the rupee from its bullion or intrinsic value was 'not advantageous to the general interests of Ceylon'.[19]

The evidence given before the Swettenham Commission as

[15] Later Sir Alexander Swettenham.

[16] Twenty-eight out of the thirty-eight persons who gave written evidence to the Commission held this view. Five considered it too early to form an opinion, while four thought the step was advantageous to Ceylon.

[17] Evidence of Mr. H. H. Capper, editor, *Times of Ceylon*: S.P. 6 of 1894, p. c12.

[18] Besides the three main exports, there were such minor exports as cinnamon, cardamoms, arecanuts, plumbago. These were largely owned by Ceylonese.

[19] S.P. 6 of 1894, para. 25. The Commission made two important provisos which are discussed at a later stage in this chapter.

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well as the Report itself, is suffused with an enthusiasm for the economic prosperity of the preceding years. The dominant voices before the Commission were those of businessmen and planters who were then riding on a wave of prosperity. In the words of the Report, 'All the statistics which are generally held to be indices of a country's progress pointed to a general increase of prosperity.'[20] The value of total exports had risen from Rs. 33·8 million in 1885 to Rs. 61·1 million in 1892, while the value of tea exports alone had increased from Rs. 2·8 million to Rs. 32·5 million. Similarly, total imports had increased from Rs. 40·8 million to Rs. 62·8 million and government revenue had risen from Rs. 12·6 million to Rs. 18·5 million.[21]

The view of the Commission was that 'a bullion silver currency coupled with a falling exchange has been for the benefit of the greatest number; in other words, the sum of the advantages has preponderated over the sum of the disadvantages.' In the entire field of applied economics there is no more difficult problem than that of deciding whether a particular event or economic measure is beneficial to the community as a whole. Rising prices are generally to the advantage of entrepreneurs and businessmen while they affect the fixed-income earners adversely. The different classes of society are differently affected by a fall in the exchanges, just as they are by a change in the internal purchasing power of money. Attempts to sum up those different effects is necessarily arbitrary and invariably biased.

In discussing the Report of the Swettenham Commission it is useful to proceed with the help of a hypothetical outline of the train of events during this period. Ceylon's exports found their chief markets in the United Kingdom, and their prices, therefore, were gold prices. Given the sterling price, say of tea, the amount that the producers received in Ceylon depended upon the rate of exchange. The lower the sterling value of the rupee, the greater the rupee receipts. The 'exporters' may be divided into two groups: (i) proprietors resident in Britain or shareholders in sterling companies; and (ii) shareholders in rupee companies or individual proprietors resident in Ceylon, including the large number of small Ceylonese proprietors.

To the former group the depreciation of the rupee meant that

[20] S.P. 6 of 1894, para. 46. [21] Ceylon Blue Books.

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a smaller part of the sterling proceeds of their exports had to be utilized for the purpose of meeting production costs in Ceylon. In other words, a fall in exchange was equivalent to a fall in the costs of production.[22] Thus the depreciation of the rupee increased their sterling profits. In the case of the second group, the exchange affected the entire sterling price of the exports since the sterling receipts were usually remitted to Ceylon.[23] For both groups, exchange depreciation led to increased profits.

The rise in income of the exporters normally leads to new investment on the one hand, and increased consumption on the other.[24] The amount of new investment is a function both of the level of incomes and of the rate of profits earned. Increased investment gives rise to an increased demand for productive services. To the extent that supplies are inelastic, prices and costs of production rise while the volume of employment increases. This initial increase in incomes and employment leads to further increases according to the multiplier principle. The expansion starting in the export sector is diffused throughout the economy. For the purpose of analysing the effects of the increased consumption expenditure, consumer goods may be conveniently divided into four classes: A, B, C and D, of which A and B are imported:

A. Imports from gold standard countries, chiefly from the United Kingdom.
B. Imports from silver standard countries, chiefly from India.
C. Export commodities which are also consumed at home.
D. Consumer goods and services produced at home solely (or mainly) for home consumption.

In the case of imports of both A and B goods, since the demand from Ceylon is only a small fraction of the total demand for

[22] Cf. Indian Currency Committee 1893: Minutes of Evidence, p. 110. Evidence of Messrs. H. K. Rutherford and Martin Leake: 'When the rupee was at par the sterling value of the labourer's wage was 8d., and at the present moment it is equivalent to 5d.' (Question 2449.)

[23] Cf. Indian Currency Committee 1898: Minutes of Evidence, p. 141. Statement of Mr. Henry Bois, a Ceylon planter and chairman, Ceylon Chamber of Commerce (Question 1259).

[24] The profits of those resident abroad need not necessarily be invested in Ceylon. But British 'foreign investment' in Ceylon is likely to increase through a 'ploughing back' of profits. The increase in consumption referred to is that of proprietors resident in Ceylon.

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these commodities, prices are unlikely to be significantly affected by an increase of domestic demand. However, the price level of A goods coming from gold standard countries is affected by a fall in the rupee–sterling rate. With a given sterling price, the price in Ceylon is raised in proportion to the fall in the exchanges. The price level of B goods, on the other hand, being expressed in silver currencies, is not directly influenced by the depreciation of the rupee–sterling rate. The prices of consumer goods produced at home, D goods, are not directly influenced by the exchanges at all. The effect of increased consumer expenditure on these prices will depend on the elasticity of supply of these goods while their costs of production will be affected by the exchanges to the extent that imported materials are used in their production. To sum up, then, the fall in the exchanges, by increasing the profits of the exporters, leads to increased investment and increased consumption. The effect on the price level of domestic goods and services depends on their elasticities of supply while the effect on the prices of imported goods depends on whether they are produced in gold or silver standard countries.

The factor which sets the whole expansionary process in motion is the rise in the profits of the exporters. In other words, the causal factor is the stimulus to exports provided by exchange depreciation. The effects of exchange depreciation on exports was a widely discussed question towards the end of the last century. Then, as now, there were two mutually opposed attitudes to it. One approach made much of the stimulus to exports, arguing that the advantages to be derived from the rising volume of exports and the increased money receipts outweighed any disadvantages that might result from the enhanced cost of imports.[25] Others, while granting that exchange depreciation offered a bounty to the exporters, pointed out that it was a purely 'transitory stimulus' which disappeared once domestic costs of production adjusted themselves to the new rate of exchange.[26] Assuming such a process of cost adjustment, the interests of exporters lay not so much in a low rate of exchange as in a falling rate of exchange. In any

[25] Cf. Indian Currency Committee 1893, Report, para. 27, and J. S. Nicholson: "Effects of the Depreciation of Silver, with Special Reference to the Indian Currency Experiment", *Economic Journal*, March 1894, p. 59.
[26] Cf. Indian Currency Committee 1893, Report, para. 27.

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case, there was no gain to the community as a whole. Exporters gained at the expense of the rest of the community. The Herschell Committee accepted the latter position in rejecting the arguments of the export interests. The Swettenham Commission, however, took the opposite point of view. The first view was one which found its most vigorous advocates amongst the exporters themselves, while the latter was the one which was generally accepted in academic circles.[27]

The advantage to the exporters, then, was based on the rigidity of domestic costs. The lag of costs behind prices is a familiar phenomenon of inflation even in modern developed economies. The lags were far greater in backward economies such as India, China and Ceylon in the late nineteenth century. The evidence before the Swettenham Commission on this point warrants the conclusion that the rate of wages paid both to immigrant estate workers and to other unskilled workers had remained static over the previous twenty years. 'Three days labour for a rupee' appears to have been the more or less fixed rate of wages.[28]

[27] Alfred Marshall's evidence before the Indian Currency Committee of 1898 may be taken as representative of the academic view, on this question. Referring to the bounty on exports, Marshall said: 'Now, if one says that the export trade of a country is coterminous with the undertakers of business enterprise who are generally employers, and that anything that benefits the employers is a bounty on the export industry, then the proposition may be conceded.' On the alleged advantage enjoyed by China which had a silver bullion currency while India had an 'artificial standard', he remarked: 'If the Chinese currency is depreciated, a smaller part of the value of these goods [i.e. those received in payment for exports] will have gone to the employees and to the creditors in China with whom the capitalist tea growers have relations; but that is a distribution within the country. It is the gain of one class at the expense of another. . . . It is, however, quite natural that capitalist employers in a country in which currency is not depreciating should look with envy on the position of those who can pay wages and other dues in a depreciating currency, and therefore retain for themselves a larger share of the price which they got for their goods whether sold in home or foreign markets.' Indian Currency Committee 1898, Minutes of Evidence, p. 177, Q. 11792.

[28] Cf. S.P. 6 of 1894, paras. 19–21. Cf. also *ibid.*, Appendix C., Evidence of Messrs. D. S. Pace, W. Cantrell, T. Smith, W. Jenkins, W. McKenzie, F. Beven; and *ibid.*, p. 26: Letter of Mr. J. H. Starey.

Mr. T. N. Christie, the spokesman of the Ceylon planters, giving evidence before the Indian Currency Committee of 1898, put the position very lucidly thus:—'The prices of products that we grow, especially tea, are practically gold prices; they are based on their London selling value, and for a given sterling sum the producer received, with a fall in exchange, a larger number of rupees.' He found that his expenses practically rose not at all, and yet he received an augmented number of rupees and consequently benefited in proportion to the extra number of rupees that he received. . . . 'During the last 20 years or the last 24 years when the rupee has been falling, the rate of wages has not varied. The rate of wages paid today is the same as the rate that was paid when I was out there (24 years ago).

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The Purchasing Power of the Rupee

The experience of these years shows hardly any evidence of the adjustment of domestic costs of production to a lowered exchange value of the currency as postulated by theory. Broadly speaking, this rigidity of costs is to be explained by the sluggish response of a backward economy to monetary stimuli, by the influence of custom and tradition, and by the perfectly elastic supply of Indian immigrant labour. According to the Swettenham Commission the purchasing power of the rupee had slightly diminished between 1873 and 1893.[29] But, they said,

> 'The slight tendency towards increasing wages, and a more general tendency towards increasing prices, bears no actual proportion to the progressive decline in the gold value of silver, and it can hardly be attributed thereto.'[30]

As for the readjustment of wages and prices, it was uncertain, remote and likely to be postponed for an indefinite period of time.[31] In fact, the planters contended that there was no depreciation of the rupee at all, or that it had depreciated only in terms of gold but not in terms of its purchasing power over commodities.[32]

That there had been no readjustment of wages and prices to the lower exchange value of the rupee is amply borne out by the evidence given before the Swettenham Commission. On the other hand, as regards the effect of the fall in the exchanges on

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When employers have been extremely prosperous . . . some benefit, of course, filtered through to the labourers.' Indian Currency Committee 1898, Minutes of Evidence, p. 165; Answer to Q. 4504.

[29] S.P. 6 of 1894; para. 21. [30] *Ibid.*, para. 26. [31] *Ibid.*, para. 26.

[32] A leading planter in Ceylon, Mr. J. H. Starey, in a Paper submitted to the Commission, stated as follows: 'Judging from past experience in Ceylon, the value of the rupee outside Ceylon (whether it rise or fall) is not likely to have much effect upon the cost of living. Its fall in relation to gold has not increased the cost of living to any material extent.' (S.P. VI of 1894, Appendix C.) Perhaps the best statement of this view was provided by Mr T. N. Christie in his evidence before the Indian Currency Committee of 1898. When asked whether there had been any readjustment of prices, salaries and wages in Ceylon to the altered value of the rupee, he replied: 'There has been no readjustment or practically none because no adjustment was required. The local purchasing power of the rupee, the local cost of living, has practically remained the same. . . .' When the Chairman, Sir Henry Fowler, referred to the payment of wages in a 'depreciated currency', Christie emphasized that the currency had not depreciated locally and went on to add, 'I would rather maintain that it has not depreciated at all. It has proved a very stable measure of value except in relation to gold.'

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the domestic cost of living, the evidence of the planters must be accepted with some reservation. As interested parties, there was perhaps an unconscious attempt on their part to minimize the extent to which the purchasing power of the rupee had depreciated. Unfortunately, it is not possible to measure the extent of the price changes during this period as there are neither index numbers nor adequate price statistics. Nor is it possible to separate the effects of exchange depreciation from the long-run economic changes both in Ceylon and in Great Britain. However, an examination of the evidence given before the Swettenham Commission and the statistics collected by it, suggest that the purchasing power of the rupee had more than 'slightly diminished'.

Ceylon's imports of consumer goods from the United Kingdom (A goods) comprised only a small proportion of her total imports.[33] They consisted largely of manufactured goods such as textiles, millinery, haberdashery, foodstuffs such as butter, jams, bacon and cheese, wines and spirits. These goods were largely consumed by the British planting and commercial community and to a certain extent by the 'native' upper middle class. Though their prices rose somewhat, the increase seems to have been much less than one would expect. In other words, the prices of A goods rose by a smaller proportion than the fall in the exchange. The explanation is to be found in the fact that during this period sterling prices were falling, mainly owing to improvements in techniques of production and to a reduction in freights by land and sea.[34] Several witnesses referred to a deterioration in the quality of the articles imported, and to that extent the fall in the purchasing power of the rupee was concealed.[35] Nearly two-thirds of Ceylon's imports, however,

[33] In 1892, imports from the United Kingdom formed 28·6 per cent. of total imports.

[34] Cf. S.P. 6 of 1894, Appendix B, p. 2: Evidence of W. Jenkins, manager of Messrs. Cargill & Co.; general merchants and largest importers of consumer goods from U.K.: (*a*) 'At present, speaking generally, ten rupees will purchase fewer commodities than ten years ago.' (*b*) The local increase of prices, due to a falling exchange, has been counterbalanced to some extent by the fall in gold prices. *Ibid.*: Stanley Bois of Bois Bros. & Co., Agents for BISN: 'Freight charges are now lower than before.'

[35] Cf. *ibid.*, J. A. Mann, Merchant: 'Qualities have been falling generally. People also do not get in Ceylon the same quality they got twenty years ago.' *Ibid.*: J. H. Renton, planter and merchant: 'There has been a reduction of 8 to 12 per cent. in the quality of cotton goods and an increase in price of 5 to 10 per cent.'

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came from India (B goods). They comprised the bulk of the people's food and clothing and a large range of articles of everyday use. The most important influence on the cost of living of the mass of the population was the price of B goods. Those prices, as we have seen, were not affected directly by the depreciation of the rupee, but they were affected indirectly to the extent that the internal price level in India rose owing to the fall of the rupee. According to the data collected by the Swettenham Commission, the prices 'of the necessaries of life' had increased from between 20 to 50 per cent.[36]

The evidence leaves no doubt that the depreciation of the exchanges by nearly 40 per cent. which occurred between 1873 and 1893 was accompanied by a considerable fall in the real value of the rupee. That the real value of the rupee did not fall more than it did, is to be explained by the fact that Ceylon obtained most of her imports from India. Since the two countries had the same monetary unit, the prices of these imports were not affected directly by a fall in the rupee–sterling rate. The planters' claim that the rupee had not depreciated at all was certainly an overstatement.

Exchange Depreciation and the Tea Industry

On the other hand, the claim that exchange depreciation was advantageous to the producing interests is irrefutable. The proprietors of tea estates resident in Britain, in particular, reaped the advantage of lowered production costs while they were not materially affected by the lower purchasing power of the rupee, since the bulk of their incomes were spent at home. However, it would not be correct to regard exchange depreciation as anything more than a contributory factor in the rise of the tea industry itself. In other words, while it enhanced the profits to be derived from investment in tea, it was not a necessary or indispensable condition for the rise of the tea industry.

From 1880, which year may be regarded as the beginning of

[36] In reply to the query whether these prices had risen or not during the previous twenty years: fifteen Revenue Officers thought that prices in most cases had risen from 20 to 50 per cent.; four did not find any considerable increase in their districts; one said that prices had remained steady, and one that there had been greater fluctuations depending on the traders. It is noteworthy that in those districts where no increase was reported, the reason adduced was the improvement in the means of transport.

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the tea era in Ceylon, until the end of 1885, the price of tea in the London market was rising, while there was only a fractional fall in the average exchange rate of the rupee. It was during this period that the foundations of the industry were laid, and the expansion in the area planted was most rapid. Table 15 below summarizes the relevant statistics for the years 1880 to 1885.

TABLE 15

EXCHANGE RATES, LONDON TEA PRICES AND TEA CULTIVATION, 1880–1885

Year	(1) *Price of Tea pence per lb*	(2) *Exchange Rate pence per rupee*	(3) *Price of Tea cents per lb*	(4) *Total Acreage under Tea*	*Annual increases of* (4)
1880	10·50	20·0	54	13,500	—
1881	11·75	19·9	59	22,000	8,500
1882	12·75	19·5	65·4	32,000	10,000
1883	15·25	19·5	78	70,000	38,000
1884	14·75	19·3	76	102,000	32,000
1885	15·25	18·2	83·5	150,000	48,000

Sources: Ceylon Blue Books; *Statist.*

It is seen that between 1880 and 1885 the London price of tea rose by nearly 50 per cent. while the exchanges fell by less than 2d. per rupee, from 1s. 8d. to 1s. 6⅖d. During these same years the area under tea cultivation rose from 13,500 acres to 150,000 acres—an annual rate of 28,250 acres. The cost of production of tea at this time hardly exceeded 7d. per pound,[37] so that throughout these years the producers were left with a sizeable margin of profits. The high profits enabled a rapid extension of the area under cultivation. The influence of the fall in the exchanges was negligible. By reducing the costs of production (expressed in sterling) or by increasing the rupee receipts of the estate owners, exchange depreciation merely presented them with a 'windfall profit'.

In contrast with the previous five years, from 1887 to 1892 tea prices declined. This was accompanied by a rise in the rate of exchange from 1888 to 1890 which was most marked in 1890. Thereafter the exchanges resumed their downward trend.

Table 16 sets out statistics of exchange rates and tea prices. It also shows changes in the value of tea exports and in the area under cultivation.

[37] Cf. H. K. Rutherford: *Planters' Notebook*, 1887, p. 37.

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In 1892, the average London price of tea at 9½d. was a penny lower than in 1880. But the rupee price had risen from 54 cents to 63 cents during the same period. If production was profitable at 10½d. in 1880 it can safely be assumed that it was equally profitable at 9½d. in 1892, irrespective of the fall in exchange. For in the meantime many factors had contributed to a fall in the costs of production of tea. As the planters gained more experience they improved their techniques of cultivation

TABLE 16

EXCHANGE RATES, TEA PRICES AND TEA CULTIVATION, 1886–1892

Year	*Average Exchange Rate pence*	*Average London Price of Tea pence*	*Equivalent cents*	*Area under Tea acres*	*Increase per Year acres*
1886	17·4	13·3	76	170,000	130,000
1887	16·1	13·0	81	183,000	13,000
1888	16·4	11·5	70½	200,000	17,000
1889	16·6	10·8	65	205,000	5,000
1890	18·1	10·8	59½	220,000	15,000
1891	16·8	10·0	60	250,000	30,000
1892	15·1	9·5	63	260,000	12,000

Sources: Ceylon Blue Books; *Statist.*

and manufacture. Better varieties of seed were used and suitable manures were developed. Several processes of manufacture which were initially carried out by hand were soon mechanized.[38] Railway development, new roads, the extension of the Colombo Harbour, and the reduction of freights—all went to reduce the 'laying down cost' of tea in London, while the lowering of the import duty in the United Kingdom had the same effect. A further development which reduced costs was the tendency towards amalgamation of several separately owned estates under a single joint stock company. There was, in addition, a remarkable expansion in the demand for Ceylon and Indian tea, chiefly in the United Kingdom. Of the many factors which affected the tea industry during this period the change-over of the British public from coffee to tea was not the least important. Not only did the British become addicted to tea, but they soon learnt to prefer the Ceylon and

[38] For an account of the cost-reducing methods adopted during these years, cf.: H. K. Rutherford: *Tea Cultivation and Preparation in Ceylon*, 1885; "Plucking, Pruning and Preparation of Tea", *Ceylon Observer*, 1897; C. S. Armstrong: *Tea Cultivation*, 1887; J. A. Henderson: *Account of Tea Cultivation in Ceylon*, 1893.

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Indian teas to those from China. As a result, by 1890 China tea had been almost driven out of the British market.

The chief determinant of the production costs of tea was the yield of green leaf per acre. Taking the average yield for Ceylon at 350 lb per acre and adding a charge of 1½d. per pound for freight, insurance, loss of weight and handling charges, the average cost of a pound of tea delivered in London was about 36 cents or 6d. per pound, with exchange at 1s. 4d.[39] That the industry was not working on a small margin of profit is proved by developments from 1887 to 1890. During these years the average price of tea in London fell from 13·3d. to 10·8d., while the downward trend of the rate of exchange was reversed. The exchange rate rose from about 1s. 4d. in 1887 to a little over 1s. 6d. in 1890, and the rupee price of tea fell from 76 cents to 60 cents. Yet the area under cultivation continued to increase. It rose from 183,000 acres in 1887 to 220,000 acres in 1890. The fall in price merely slowed down the rate of increase.

Over the period as a whole, the London price of tea fell by 9½ per cent. between 1880 and 1892, while the exchanges fell by about 25 per cent. Thus in spite of the fall in the sterling price producers received 10 cents more in 1892 than they did in 1880. Taking into account the fall in costs during this period, it cannot be said that their increment of profits was a necessary condition for the survival or the progress of the industry. The high level of profits of the estate owners merely made for a faster rate of capital investment than would have been otherwise possible.

Ceylon, in fact, was experiencing during this period a vast investment boom. Contrary to the generally held view, the depreciation of the exchanges was no hindrance to the investment of British capital in the island. The Swettenham Commissioners remarked:

> 'The evidence we have is conclusive that the fall (in the exchange) has not prevented the introduction of all necessary English capital, and it is stated that there is more capital offering for investment on reasonable terms than has ever been the case before.'[40]

[39] T. C. Owen: *Ceylon Tea Planters' Manual*, 1886.
[40] Report of the Silver Currency Commission, 1893: S.P. 6 of 1894, para. 24.

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Part of the explanation is provided by the Commissioners themselves when they refer to arrangements being made for the repayment of sterling loans in sterling value. Equally important perhaps was the fact that the British investor was fortunately able to reap the benefits of a falling exchange without incurring its disadvantages. Tea was sold in London and the proceeds accrued there. The question of a remittance of profits did not arise. He was merely concerned with obtaining funds in Ceylon for meeting the expenses, and this he was able to do at a lower sterling cost as a result of the fall in exchange. Similarly, when estates or tea shares changed hands the transaction took place in London and the rate of exchange was immaterial. The possibility of the estates having to be sold in Ceylon and the proceeds brought back was only a remote one at a time when investment in tea offered such handsome prospects of profit.[41]

Exchange Depreciation and Foreign Trade

The statistics of this period support the view that exchange depreciation acts as a stimulus to exports. It is, of course, possible to argue that the remarkable increase in the value of tea exports between 1885 and 1892 took place in spite of the disturbing influence of exchange fluctuations. But on this question there is no reason to reject the evidence of the exporters themselves, who were unanimous in their view that they benefited from the depreciation of the exchange. It is, however, important to remember that the trend of the exchange was consistently downwards, so that the exporters could reasonably assume that the exchange would not move adversely before a transaction was completed. It was possible in the circumstances for exchange risks to be transferred to the bankers, who covered themselves by buying or selling forward.[42] The day-to-day fluctuations of the exchanges were not of an order beyond the resources of the exchange banks, though they sometimes caused the banks considerable difficulty.

[41] Indian Currency Committee 1898: Memorandum of T. N. Christie, 'It is the reasonable prospect of profit which causes the flow of capital, and stability of exchange *per se* comes as a minor factor.'

[42] For a first-hand account of the finance of the Indian and China trades during these years, cf. Royal Commission on Gold and Silver (1888): Minutes of Evidence: Questions 1897–1908. Also *ibid.*, evidence of manager, Hong Kong and Shanghai Banking Corporation, Questions 4986–5025.

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If exporters are benefited by a fall in the exchange, on the same reasoning importers are likely to be adversely affected, for the rupee price of any article with a given gold price is increased in proportion to a fall in exchange. Yet none of the importers who appeared before the Swettenham Commission complained of the adverse influence of a falling or low exchange. On the other hand, they emphasized that their own prosperity as importers depended on the fortunes of the export trade. As one witness put it: 'The bulk of my business depends on producers. If their prosperity depended on a rupee at 1s. 2½d. I should prefer that rate. The lower exchange would suit our business better.'[43]

Between 1885 and 1892 the value of total imports increased from Rs. 40·8 million to Rs. 62·8 million, while the gold value rose from £3·4 million to £3·9 million. The value of imports of rice from India increased from Rs. 18·6 million to Rs. 23·9 million, and the quantity imported rose from 5,734,129 bushels to 7,364,436 bushels. Total imports from India increased from Rs. 28 million to Rs. 40·2 million. Clearly, the influence of the increase in prices was more than offset by the expansion of incomes. Although the rupee purchased less than before, the community as a whole had more rupees to spend, and the latter influence was more important than the former. The great disadvantage of this process was its unequal incidence on the different classes.

Effect on Various Classes

The Swettenham Commission considered the effects of exchange depreciation on the following groups:

(1) Merchants and traders.
(2) Producers and inhabitants generally.
(3) The government.
(4) The English Civil Service.

On this question, the theme which recurs over and over again in their Report is the overwhelming importance of the 'produc-

[43] S.P. 6 of 1894: App. B, p. 3, Evidence of J. A. Mann. Cf. also evidence of W. Jenkins of Cargill & Co.: 'The fall in exchange has not been adverse to our interests. Our business is now more valuable than ever it was. . . . We revalue our goods according to the rate of exchange.' And Report of the Silver Currency Commission, 1893, para. 16.

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ing interests'. Enough has been said of the advantages derived by them as well as by the 'English merchants and traders' whose business was dependent on them. They enjoyed a rise in income and profits which far outweighed the fall in the purchasing power of the rupee, both internally and externally. As the Report pointed out,

> 'the value of 15 exports has more than doubled (measured in rupees) in the last fifteen years—measured in gold the increment is sixty per cent. This denotes a general progressive increase of prosperity amongst the producing classes and those depending on them.'[44]

Both 'European' and 'native' producers together with 'those whose business was directly dependent upon their spending power' were obvious beneficiaries.

On the other hand, of the inhabitants generally, neither the 'ordinary wage earner of Ceylon' nor the Indian immigrant workers derived any direct benefit from the fall in exchange. But the Commission emphasized that 'the latter derived an indirect advantage through the prosperity of the employer which enabled him to offer employment to a larger number of immigrants'.[45] In fact, to the bulk of the population who were not producers, the expansion in employment which the investment boom produced was the only visible gain. From the historian's point of view, what was occurring was merely a second stage in the process of economic evolution which had started with the coffee era—a growth in the relative importance of the export sector of the economy at the expense of the traditional rural economy. Not only was there an expansion of employment in the estates but also in all fields which felt directly or indirectly the economic growth that was taking place.

As is inevitable during a period of inflation, fixed income earners, far from sharing in the general prosperity, suffered to the extent of the depreciation of rupee. Of this group, only the English Civil Service presented a case before the Commission,[46] though there is evidence that others, too, were feeling

[44] Report of the Silver Currency Commission, 1893: S.P. 6 of 1894, para. 15.
[45] *Ibid.*, para. 21.
[46] S.P. 6 of 1894: App. D, p. 26, Statement submitted to Committee by the English Civil Servants.

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the effects of the rising cost of living.[47] The complaint of the English Civil Service was that the cost of their regular remittances home increased with every fall in the rupee.[48] While the Commission sympathized with their difficulties, it felt that 'such grievances and hardships cannot be allowed to influence the currency policy of the country'. The English Civil Service, however, were able to obtain substantial privileges from the government to offset the increased cost of remittances.[49]

Finally, in dealing with the effects of the depreciation on the government, the Commission again emphasized the dependence of government revenue upon the prosperity of the export industries. As Table 17 shows, government revenues rose with the increasing value of exports. Between 1885 and 1892 the value of exports had almost doubled while the government revenue had risen by 50 per cent.[50]

TABLE 17

EXPORT VALUES AND GOVERNMENT REVENUE, 1885–1892

Year	*Value of Exports Rs. million*	*Government Revenue Rs. million*
1885	33·8	12·4
1886	33·6	12·4
1887	38·4	12·7
1888	39·3	13·4
1889	46·1	15·4
1890	50·2	15·3
1891	58·3	16·2
1892	61·1	18·6

Source: Ceylon Blue Books.

The government nevertheless experienced also the adverse effects of exchange depreciation. For instance, the Governor in his opening address to the Legislative Council on 14 September 1892, remarked that 'the year which has passed since the

[47] Cf. evidence of W. Jenkins: S.P. 6 of 1894: App. B, p. 2: 'Our clerical employees desire to have higher salaries now than they had before. Tailors and labourers remain on the same pay as formerly. We have increased the pay of our European employees on account of the fall in exchange.'

[48] E.g. for support of wife and children, education of the latter, expenditure at home while on leave, investment at home, payment of insurance premiums.

[49] Cf. S.P. 2 of 1894: Report of a Sub-Committee of the Legislative Council of Ceylon on the Question of Compensation to Public Servants for Fall in Exchange.

[50] This direct variation of export values and government revenues is all the more remarkable in that the only significant export tax was the duty on the export of elephants! The correlation is due to the determining influence of the value of exports on total national income.

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opening of the last session has been a year of plenty, of progress, and of prosperity'. However, he went on to add:

> 'But I should be wanting in my duty if I omitted to remind you of a circumstance which to a certain extent renders misleading the returns of revenue and trade which I have referred to. It is true that those returns record sums of rupees in increasing numbers, but unfortunately the value in gold of each one of those rupees has been becoming less from day to day. . . . The government has to meet in gold or its equivalent large and increasing liabilities.' [51]

But the connexion between the prosperity of the export industries and its own revenues was sufficiently obvious. The government did not on a single occasion advocate 'an artificial value' for the rupee. On this question the Commission wrote:

> 'The greatly increased number of rupees required to meet these obligations is beyond question a very serious matter; but so far the satisfactory increase in the revenue has enabled the finances of the colony to bear the enhanced claims without embarrassment. The Commission is of opinion that the prosperity of the producing interest is the main cause of the satisfactory condition of all items of colonial revenue, and if that prosperity were materially checked by a change in currency which also effected a saving to government in its gold obligations, the direct saving so effected might not be a sufficient compensation for the probable shrinkage in revenue.' [52]

The government itself made no representations to the Commission. But it is clear on which side its sympathies lay by the terms of reference of the Commission, which referred to the 'artificial value' placed on the rupee by the Indian government, and of steps to 'protect the interests of the Colony'.[53] In fact, the contrast between the attitude of the government of India and that of the Ceylon government is significant. Although export industries such as tea, jute and indigo were important items in India's total national product, the Indian economy was not dominated by them. India was much less dependent on exports than Ceylon was. And the planters in Ceylon exercised an influence on the counsels of government in proportion to the economic importance of what they produced.

[51] Proceedings of Ceylon Legislative Council, 1892.
[52] S.P. 6 of 1894, para. 22. [53] *Ibid.*, p. 7.

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While the revenue of the Indian government was inelastic, that of the Ceylon government was extremely sensitive to the value of the country's exports. Ceylon's 'home charges' had not so far exceeded 17 per cent. of the government revenue, while India's usually amounted to about one-third of the revenue. The different attitudes of the two governments were due to differences between the economic structures of the two countries.

A Separate Currency?

Although they considered 'the artificial value' of the rupee harmful to the interests of the export economy, the Swettenham Commissioners did not recommend that Ceylon should sever her link with the Indian monetary system. They were convinced that 'the risks inseparable from such a change are as great as, if not greater than, those which may be expected from inaction at the present time.'[54]

For the first time since the adoption of the Indian rupee as the country's monetary unit, the introduction of a separate coinage in Ceylon was widely discussed. Of the witnesses who appeared before the Currency Commission, eight were in favour of a separate currency unit in Ceylon. Twenty-two witnesses, while admitting that the effects of the Indian decision were unfavourable, were not prepared to recommend any action independent of India.[55]

In their decision to recommend no change in the island's monetary system the Commissioners were influenced by all the old considerations which made the Indian rupee in Ceylon a part of 'the natural order of things'.[56] As many witnesses pointed out, a separate monetary unit would have hampered the island's import trade with India since payments were still largely made by the shipment of rupees. By raising the cost of remittances to India it would have led to a rise in the price of imports. Then again, it was a great convenience to the immigrant Indian worker to be able to take home his earnings without the intervention of moneychangers.[57] But these were not overwhelming reasons for continuing the currency connexion.

[54] S.P. 6 of 1894: Report, para. 46.
[55] *Ibid.*, App. C. 25; Abstract of Written Replies to Questions.
[56] Cf. Chap. II. [57] S.P. 6 of 1894: Report, para. 36.

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The fundamental objection, however, to Ceylon's having a silver bullion currency of her own (which they called the 'shekel') is discussed by the Commissioners when they go on to consider whether another silver coin such as the Mexican dollar or the Japanese yen might not be introduced into Ceylon.[58] Adherence to a silver bullion standard implied a depreciation of Ceylon's rate of exchange with India. Such depreciation would necessarily have had a far greater effect on prices and the cost of living than the country had experienced through the depreciation of the rupee–sterling rate. Nearly every article of mass consumption in Ceylon was imported from India. It would have directly affected the profits of the planters in two ways. In the first place, a rise in the wages of Indian estate workers could scarcely have been avoided. The inducement for them to emigrate was the relatively better wages paid in Ceylon which enabled them often to save and take home with them a certain portion of their income. A depreciation of the rupee–shekel rate would have reduced the rupee equivalent of their wages. This fall in the relative level of wages in South India and Ceylon would have led to a rise in the Ceylon wage-rates or to a diminution in the supply of immigrant labour. Secondly, the rice which was issued to the workers in the estates would have cost more. In other words, the general readjustment of wages and salaries which would have followed the introduction of a bullion currency depreciated in relation to the Indian rupee 'would to that extent neutralize the profit hitherto reaped from a fall in exchange'.[59] The domestic price and wage structure was only partially affected by the fall in the gold value of the rupee over the years. But the traditional rigidity of wages and costs could not have withstood so immediate and so powerful an influence as a depreciation of the Ceylon currency relatively to that of India. Once India had abandoned the silver standard, Ceylon had little to gain by adhering to it. While the receipts of exporters might have been higher in terms of domestic currency, a unit of such currency would have purchased less goods both from India and from other gold standard countries.

[58] S.P. 6 of 1894: Report, para. 39.

[59] *Ibid.*, Report, para. 39.

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The Attitude of the Colonial Office

In the official correspondence between the Governor and the Secretary of State there is remarkably little reference to the depreciation of the rupee. The one aspect of the problem which engaged their attention was its effect on the salaries of British officials serving in the island.[60]

When the Report of the Indian Currency Committee was published, the Secretary of State wrote to the Governor:

> 'I should hope that the moderation of the views of the (Indian) Currency Committee will have disarmed any agitation which may at one time have seemed likely to arise for the severance of Ceylon from the Indian currency system. . . . I should anticipate that the balance of advantage is against such a change.'[61]

He pointed out that the question of the future of the Ceylon currency must be decided in accordance with the interests of the country as a whole and not in accordance with the interests of any particular class. It was doubtful whether the country as a whole gained any advantage from the low exchange, and the producers were most unlikely to benefit from a silver currency circulating at its bullion value in the future. The despatch concluded by casting doubts on the claim that the 'growth of the great tea industry was in any way connected with the low exchange'. On the other hand, 'the industry increased very rapidly during the years 1888–1890 in the face of rising exchange'. This last point was probably an echo of the views of the Indian Currency Committee of 1893, which stated that 'The progress of the export trade has been less with a rapidly falling than with a steady exchange'.[62] As the Swettenham Commission was quick to point out, it was not reasonable to expect an immediate increase in the quantity or value of exports. Since agricultural products took a few years to develop, the effect of any given fall in exchange must be looked for in the trade returns of three or four years later.[63] However, the Secretary of State was prepared to await the verdict of the

[60] Cf. CO 54/604: G 62 of 20.9.1892. CO 54/608: G 197 of 13.5.1893. CO 54/613: G 58 of 25.2.1894. CO 54/639: G 289 of 20.8.1897.

[61] Secretary of State's Despatch to the Governor: CO 54/612: 7 July 1893.

[62] Report of Indian Currency Committee 1893, para. 27.

[63] Report of Swettenham Commission, S.P. 6 of 1894, para. 32. This problem was the subject of an extended controversy in the pages of the *Economist* of 1898, *passim*.

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Ceylon Committee; and when, in spite of the different opinions expressed in their Report, the Swettenham Commission agreed that the 'balance of advantage' was against a change in the currency, the Colonial Office was obviously relieved. 'The thoroughness and care with which the Report was drawn up' was acknowledged; but for the time being, in the words of the Colonial Office official Minute, the Swettenham Report as well as the whole currency question was 'put by'.

The Fowler Committee

For the moment the evil day seemed postponed. The new currency policy adopted by India in 1893 did not succeed in maintaining a high rate of exchange permanently. On the contrary, except for a temporary rise soon after the closure of the mints, the rupee–sterling rate continued its downward trend. The average rate for 1895 was only slightly above 1s. 1d. per rupee. Thus, although tea prices were falling in the London market, this fall was counteracted by the falling exchange with the result that the producers received increasing rupee prices for their exports, and the extension of the tea plantations continued. The area under cultivation rose from 262,000 acres in 1892 to 305,000 acres in 1895, and the value of tea exports rose from Rs. 32·5 million to Rs. 49·3 million. But during 1896 the exchange started to rise and by 1898 it was hovering around the level of 1s. 3d. without actually reaching 1s. 4d., which rate the government of India wished to stabilize. The uncertainty of the currency policy of the government and the erratic fluctuations in exchange which had been a marked feature of the period since the closure of the mints, were having their unsettling effects on Indian economic life and there was a widespread demand for ending the policy of drift. The government of India, therefore, wished to take steps towards the establishment of a gold standard in India, which had been the goal envisaged by the Herschell Committee. In order to raise the exchange value of the rupee to 1s. 4d., the government proposed to contract the circulation by melting some part of the existing silver rupee.[64] The government's proposals were

[64] Correspondence respecting proposals on currency made by the government of India: B.P.P. 1898, LXI, Letter from government of India to Secretary of State, 3 March 1898, paras. 9–11.

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referred to a Committee under the Chairmanship of Sir Henry Fowler.

Meanwhile, tea prices were falling and the rise of the exchange was reducing the rupee equivalent of these prices. Table 18 shows tea prices and the average rate of exchange for the years 1893 to 1898. Although prices fell somewhat from 1893 to 1895, the rate of exchange fell at a faster rate so that the rupee proceeds of the exporters increased. On the other hand, from 1896 to 1898 both prices and exchange worked in the same direction. The average rupee receipts on a pound of tea fell from 65 cents in 1895 to 48½ cents in 1898.

TABLE 18

EXCHANGE RATES AND TEA PRICES, 1893–1898

Year	*Average Price of Tea in London pence*	*Rate of Exchange pence per rupee*	*Rupee Equivalent of London Price cents*
1893	9	15·1	60
1894	8½	13·5	63
1895	8¾	13·4	65
1896	8	14·6	55
1897	7⅞	15·5	51
1898	7⅞	16·3	48½

Sources: Economist; Statist.

During the whole of 1897 and the first half of 1898 trade was depressed and grave forebodings were in the air that if speedy relief were not afforded the tea industry would meet the same fate as its predecessor.[65] The restrictive currency policy initiated in India made money scarce and banks' rates of interest on short-term loans and discounts rose to between 12 and 15 per cent.[66]

Cries were again raised against the 'artificial rupee', and the new currency proposals of the government of India only served to increase the fear and alarm of the 'producing interests' in Ceylon. The Planters' Association, through the Governor, sought to have T. N. Christie appointed to the Indian

[65] Cf. Governor's address at opening of Session of Legislative Council, 1898: 'During the last year or two there has been a great depression in that great industry and respectable men amongst us have unmistakably suggested, if they have not positively asserted, that tea can no longer be profitably cultivated in several districts of the Colony and that before the end of the year many estates will be abandoned and the capital expended on them sacrificed.' (Proceedings of Legislative Council, 1898.)

[66] CO 54/645: Memorial of Ceylon Planters' Association to Secretary of State, para. 8.

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Currency Committee to represent the interests of the silver-using Colonies. But the Secretary of State for India, looking for a representative who had knowledge of the Far Eastern Colonies as well, preferred to appoint Sir Alfred Dent.[67]

The Fowler Committee had before it three memorials relating to Ceylon[68]—one from the Planters' Association, one from the Ceylon Association in London, and a third from 'certain inhabitants representing the general community of the island, embracing all classes'. The general tenor of all three documents was the same. They emphasized that 'the producing interests of Ceylon are overwhelmingly more important than any other',[69] and declared that the continued prosperity of the island was at stake. They complained of dear money and the positive bounty conferred on Ceylon's rival in the tea trade, China. It was felt that 'any tampering with the currency must be injurious to the trade of the colony, upon the prosperity of which all revenue, public and private, is dependent.'[70]

T. N. Christie, Martin Leake and Henry Bois[71] gave evidence before the Fowler Committee on behalf of Ceylon. The arguments of 1893 were now reiterated with greater vehemence and greater assurance. Christie, in a memorandum to the Committee, claimed that the experience of Ceylon was an 'index of the results of high and low, natural and artificial, exchange'.

> 'The prosperity of all classes in Ceylon,' he added, 'advanced with falling exchange, and with the artificial rise and scarcity of currency there was a great check; the margin of profit has most seriously gone down, in some cases disappeared. . . . The price of tea, its staple product, has gone down and verified the predictions of the Silver Currency Commission. . . . Prosperity has waned and European and natives alike feel the baneful effects of the present currency position.'

With silver at less than 30d. per ounce, even Christie hesitated to recommend the introduction of a bullion currency, which

[67] CO 54/645: Governor's telegram to Secretary of State for the Colonies, 5 April 1898.

[68] These papers are printed in Indian Currency Committee 1898: Memoranda, pp. 89–95.

[69] Inhabitants' Memorial, para. 8.

[70] *Ibid.*, para. 9.

[71] Chairman, Ceylon Chamber of Commerce, and member of the Ceylon Legislative Council.

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would have been 'too revolutionary'. He suggested the reopening of the mints with a heavy seignorage and the imposition of an import duty on silver.[72]

The Fowler Committee had no doubts that 'the rise in the international exchange temporarily diminished the profits of the producers of tea, just as the previous fall had temporarily increased them'.[73] But it felt that the permanent interests of the tea growers would be 'promoted rather than injured when their operations are carried on under the same standard of value as exists in the countries to which their produce is exported'. In the long run the advantages of a stable exchange provided by such a standard would more than offset any temporary stimulus afforded by a depreciating exchange.

The Committee therefore endorsed the policy of 1893 and the government of India made arrangements to establish a gold standard in India. The sovereign was declared legal tender in India and Ceylon followed suit.[74] By the end of the century the outcries of the 'silver interests' were hardly audible, although the price of tea continued to fall. As Keynes put it, 'time has dealt satisfactorily with their main grounds of criticism'.[75]

To the planters, exchange depreciation appeared as a cushion against price fluctuations. This was a dangerous doctrine. While they were prepared to reap the profits of a depreciating exchange they would not accept the consequences of falling prices. They saw nothing anomalous in an increase in their rupee receipts while the price of tea in London was falling.

The main ground of complaint was that an 'artificial value' had been placed on the rupee by the closure of the mints. This view seemed orthodox enough on the face of it. For it was the currently accepted doctrine that the exchange value of a currency should correspond with the value of the metal contained in the standard coin. This was the basis of the theory of the gold standard. The value of the pound sterling could not differ by more than a small margin from the value or purchasing power of the gold contained in a sovereign. This

[72] Indian Currency Committee 1898: Minutes of Evidence, pp. 163–84 and Part II, pp. 140–46.
[73] Indian Currency Committee 1898: Report, para. 27.
[74] Cf. Chap. VI.
[75] Cf. J. M. Keynes: *Indian Currency and Finance*, 1913, p. 2.

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whole theory, however, was based on what has been called the price specie-flow mechanism. In other words, it assumed the adjustment of internal prices and costs to changes in the value of gold. It was precisely this adjustment which did not take place in the case of the fall in the gold value of the rupee. The profits that accrued to the exporters were admittedly due to this rigidity of the domestic cost structure. In the absence of this process of adjustment there was no sense in identifying the 'natural or appropriate' exchange value of a currency with its bullion value.

In retrospect, the fears of the planters seem exaggerated. Both 1897 and 1898 were no doubt bad years, but the tide turned before long and the effects of the depression made hardly any impression on the government's revenue.[76] The arguments for a low exchange were reduced almost to absurdity in the next few years when tea prices fell as low as 6d., and the intrinsic value of the silver contained in the rupee fell to less than a shilling.

A balanced summing up of the events of these years was provided by Sir West Ridgeway, Governor of Ceylon from 1896 to 1903. Long after the controversy he wrote, in a review of his period of administration in Ceylon:

> 'When I arrived in the island early in 1896, the tea planting industry was in a very prosperous and promising condition. The average price in London was over 8d. per lb. and the utmost activity prevailed in the island in planting up additional areas. It was expected that the action of the Indian Government in raising the rupee to an artificial value of 16d. and maintaining it at that level from the beginning of 1898, would materially increase the cost of production and result in a serious check to tea investment in India and Ceylon. Such a check did partially occur, but nevertheless cultivation continued to increase.'[77]

Monetary Fluctuations

The developments we have reviewed present several features of interest. The experience of these years showed the special

[76] Address of Governor, opening of Legislative Council, 7 Nov. 1898:—'1897 was a chequered year. . . . Our staple industry in particular was depressed and yet, as you see, the prosperity of the masses was little affected and our revenue continued to expand.'

[77] Sir J. West Ridgeway: *Administration of the Affairs of Ceylon*, 1903, p. 71.

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effects of exchange depreciation in a backward export economy. In the process, the export industries received more than a 'transitory stimulus' owing to the failure of the structure of domestic costs to adjust itself to changes in the external value of the currency. The accompanying expansion of incomes as well as the rapid pace of investment in the plantation sector of the economy generated an inflation of considerable proportions.

TABLE 19

EXPORT VALUES AND MONEY SUPPLY, 1885–1900

Year	*Average Monthly Currency Circulation*	*Average Monthly Bank Clearings*	*Export Values*
		Rs. million	
1885	3·8	4·3	33·8
1886	4·3	4·6	33·6
1887	4·4	5·5	38·4
1888	5·1	6·2	39·3
1889	6·4	6·4	46·1
1890	6·3	7·0	50·2
1891	7·5	8·2	58·3
1892	7·8	8·4	61·1
1893	7·6	10·8	68·0
1894	7·4	11·1	71·2
1895	8·5	14·3	77·5
1896	9·2	14·3	67·9
1897	9·4	16·0	75·8
1898	9·5	14·2	84·1
1899	12·1	16·2	101·1
1900	13·1	16·6	106·0

Sources: Ceylon Blue Books; A. M. Ferguson: *Ceylon Directory;* Monthly Statements of the Commissioners of Currency.

Indeed, inflation seems inseparable from a period of rapid economic development, and in Ceylon as elsewhere, the impact of this process was unequally felt. The benefits to some were direct and palpable, to others they were remote and problematical.

From the point of view of this study, however, an important aspect of these events is the behaviour of the currency circulation. Between 1885 and 1900 the average monthly circulation of currency increased from Rs. 3·8 million to Rs. 13·1 million—an unprecedented rate of expansion. Table 19 shows the average currency circulation and the average value of bank clearings during this period. The fourth column contains the

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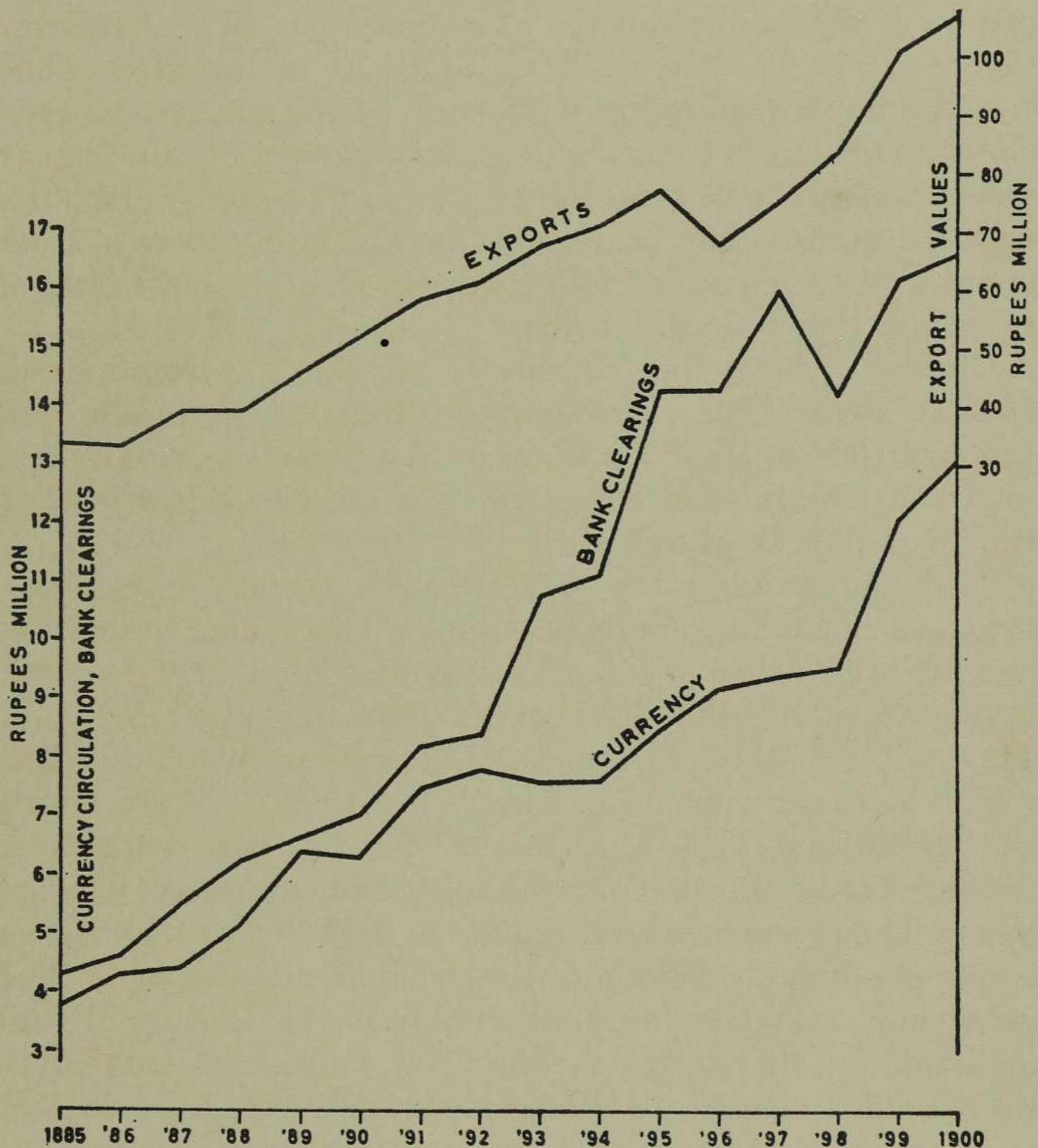
value of exports. The figures are set out in the accompanying Chart III.

The close correspondence between the three series is readily explained in the light of our account of the working of the Currency Board system in the previous chapter. The cause

CHART III. CURRENCY CIRCULATION, BANK CLEARINGS AND EXPORT VALUES, 1885–1900



of the currency expansion was the increase in the value of exports. A rise in the export values created an increasing demand for discounts and accommodation in the export sector of the economy. To the extent that import values increased there was an additional demand for credit. At the same time

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more cash was required in circulation to support the increased level of prices and economic activity. To meet this demand the banks imported silver from India which was exchanged for notes at the Currency Board's office. Part of the silver flowed back to India in payment for the increased imports from that country only to be brought back again by the banks as long as the increase in exports continued. On the other hand, when export values declined the banks had excess cash. They returned notes to the Currency Commissioners in exchange for silver which they exported to India to be invested. The correlation between export values and bank clearings was even closer than that between the currency circulation and export values. As we have seen, the banks had most of their dealings with the export sector of the economy. The turnover of bank credit was, therefore, highly sensitive to changes in the level of economic activity in this sector.

Chart IV shows the monthly circulation of currency from 1896 to 1898. The circulation fell from Rs. 11·5 million in January 1897 to Rs. 8·7 million in March 1897 but recovered to Rs. 10·2 million in December. It touched a low level of Rs. 7·4 million in March 1898.

The contraction from 1896 to 1898 was the direct consequence of Indian monetary policy. The Indian authorities had intensified their policy of contracting the circulation with a view to raising the exchange value of the rupee to 1s. 4d. Thus, while in 1892–93 over Rs. 12·5 millions worth of silver rupees had been coined in India, only Rs. 94,595 were coined in 1894–95, and Rs. 499,219 in 1897–98.[78] At the same time, the Secretary of State for India was restricting his sales of Council bills. The money market in India was tight, since the exchange banks were unable to lay down sufficient funds in India. The stringency was inevitably transferred to Ceylon. Not only did the banks refrain from importing silver, but they exported over Rs. 4 million of it between December 1896 and March 1898,[79]

[78] Indian Currency Committee 1898: Tables and Appendices, p. 148.

[79] Cf. *Statist*, 6 March 1897: 'The stringency in the Indian money market has seriously affected the tea industry in Ceylon, and no doubt other industries as well. It appears that the head offices of the banks in India have been drawing currency from Ceylon. As a consequence banks have not been able to lend as usual and business has been brought almost to a standstill. More particularly, the natives are suffering, as the native money-lenders cannot borrow freely from the banks.'

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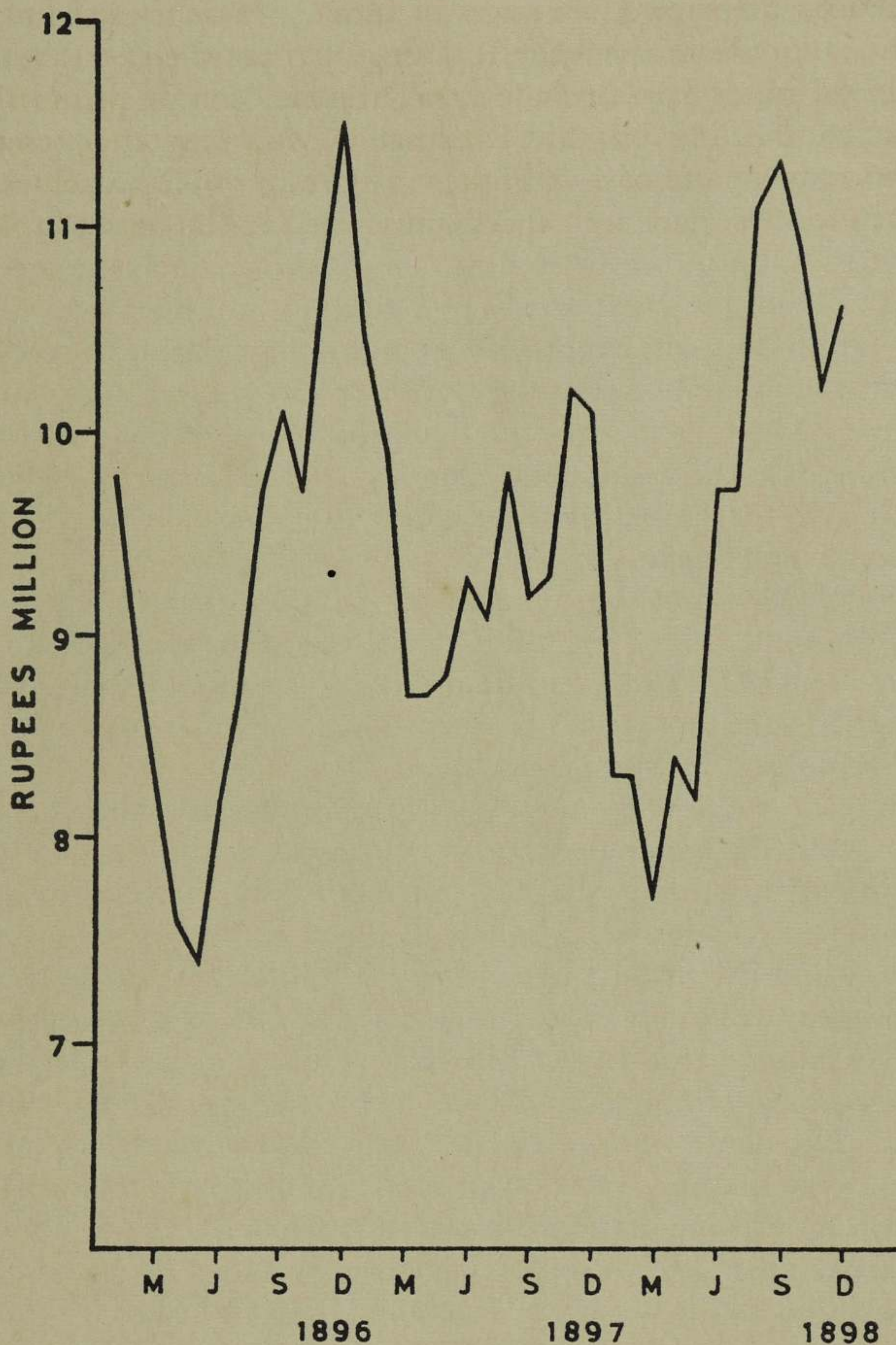
CHART IV. MONTHLY FIGURES
OF CURRENCY CIRCULATION, 1896–1898



a policy which evoked loud complaints from the Ceylon witnesses before the Fowler Committee.

After the closure of the mints in 1893, the supply of rupees in India ceased to be governed by the availability and price of silver. It became the product of administrative decision de-

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pending particularly on the sales of Council bills by the India Office. The currency circulation in Ceylon, therefore, depended on the supply of rupees in India. It depended finally on the amount of rupees the Indian government chose to mint. Since the rupee had become a token coin, 'a note printed on silver', the holding of Indian rupees in Ceylon's currency reserve ceased to have any basis in logic. The results of the attempt to substitute sovereigns for rupees is discussed in the next chapter.

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CHAPTER VI

THE CURRENCY BOARD SYSTEM, 1900–1918

A Scarcity of Silver

When the sovereign and the half-sovereign were declared legal tender in India, the question naturally arose whether these coins should not enjoy a similar status in Ceylon. In India, the issue of rupees in exchange for sovereigns was part of the mechanism by which the government hoped to maintain a gold standard. As long as rupees were issued against sovereigns at the rate of 15 rupees per sovereign, the rupee–sterling rate could not rise above 1s. 4d. per rupee by more than the cost of transporting gold to India. Since the task of maintaining the gold value of the rupee was the responsibility of the government of India, a similar arrangement was not essential in Ceylon.

Nevertheless, the Governor of Ceylon, Sir West Ridgeway, was impressed by the advantages of a gold currency as well as by the anomaly of holding token coin as part of the currency reserve. He therefore sought the approval of the Secretary of State to modify the Paper Currency Ordinance in order to enable the Currency Commissioners to hold at least a part of the reserve in coin 'with an intrinsic value and small bulk, rather than in coin with an artificial value and large bulk'.[1] The Secretary of State while seeing no objection to this proposal, pointed out that it would be necessary at the same time to declare the sovereign legal tender in Ceylon as the Currency Commissioners would otherwise be unable to pay out gold in exchange for notes.[2] As a result, the sovereign (but not the half-sovereign)[3] was declared legal tender in Ceylon by Order-

[1] G 40 of 30 Jan. 1900: S.P. 5 of 1903. [2] S 424 of 30 Nov. 1900: *ibid.*

[3] Section 6 of the Paper Currency Ordinance of 1844 was amended by Ordinance No. 13 of 1901 to read as follows: 'such notes shall be called currency notes and shall be payable only at the office of the Commissioners in Colombo. The holders of currency notes shall be entitled to obtain on demand at the office of the Commissioners, in exchange for such notes, either silver rupees of India or gold coin which is legal tender in Ceylon under any order of His Majesty the King in Council, but no other coin'. The following was added to Section 8: 'The Commissioners may also issue such notes in exchange for the amount thereof in gold coin which is legal tender in Ceylon, under any Order of His Majesty the King in Council'.

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in-Council dated 26 September 1901, and Section 2 of the 'Paper Currency Ordinance of 1884' was amended by Ordinance No. 13 of 1901, making it obligatory for the Currency Commissioners to issue notes against the tender of sovereigns at the rate of 15 rupees per sovereign. Notes were to be redeemed either in gold or in silver at the option of the Commissioners. At the time of the enactment of the new Ordinance it was feared that gold might not be offered in appreciable quantities. But in the event the influx of gold 'was as embarrassing as it was unexpected'.[4]

In a previous chapter we have seen that the banks were primarily responsible for the import of silver into the island. It was the only means available to them of laying down funds in Ceylon. The banks now found that the sovereign served their purpose much better. Owing to the greater value of sovereigns, bulk for bulk, it cost from $\frac{1}{16}$ to $\frac{1}{8}$ per cent. less to import a given amount in sovereigns rather than in rupees.[5] The banks therefore practically discontinued the import of rupee coin and imported sovereigns instead. The whole demand for rupee coin, both as a medium of circulation and as a means of remittance to India was thus thrown on the Currency Commissioners. In the two previous years silver had been lodged with the Commissioners at the rate of over Rs. 5 million a year; in 1902 only Rs. 145,000 were tendered by the banks and except for Rs. 15,000 in June no silver was lodged. On the other hand, during 1902 the banks tendered nearly Rs. 8 million in sovereigns.[6] Thus at the end of November 1901 there were Rs. 5·25 million in silver and Rs. 7 lakhs in sovereigns in the currency reserve. At the end of 1902, the silver reserve had fallen to 17 lakhs while the gold reserve stood at Rs. 6·17 million.[7] Thus the rupee coins which were flowing back to India either on the persons of immigrant workers returning to their homes or in buggalows and other native vessels in payment for imports of rice and other foodstuffs and necessities, were not being replaced. The customary 'circular flow' of rupees was interrupted and the country was faced with

[4] Sir J. West Ridgeway: *Administration of the Affairs of Ceylon*, 1903, p. 10.
[5] Cf. S.P. 5 of 1903, pp. 23–26 and 42: Evidence of the Agents of the Exchange Banks, Messrs. F. Benett, J. Stewart and R. Wilson.
[6] Indian Currency Committee 1898: Report, para. 10.
[7] *Ibid.*, para. 7.

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a shortage of hand-to-hand currency. The Commissioners' stock of silver was being rapidly drained away.

To meet the difficulty the Commissioners exercised their option of redeeming notes in gold. After May 1902 silver was not issued to the banks at all, and later even members of the public were given only a part of their requirements in silver.[8]

This was, however, no solution to the problem. Apart from the subsidiary coinage, the silver rupee was the only means of payment available for small transactions. Its scarcity was causing great inconvenience and money-changers were increasing their charges for changing notes into silver.[9]

As early as April 1902 the Governor sought the approval of the Secretary of State for the Colonies to a modification of the Currency Ordinance which would enable the Commissioners to refuse to issue notes against sovereigns if the necessity arose.[9] As the scarcity of silver increased this proposal was renewed, but the Secretary of State was unwilling to agree to such a measure 'until further experience had been gained of the present system'.[10] In his opinion, the refusal of the Commissioners to issue silver against notes was a sufficient corrective. Nor did he consider it wrong in principle that the government should import rupees in order to meet the demand for silver if the banks were unwilling to do so.[11]

However, for the government to have undertaken the import of rupees would have been illogical. It would have led to an increase in the cost of currency, with the banks importing gold in order to obtain notes and the Commissioners exporting gold in order to obtain silver. There was no sense in requiring the Currency Commissioners to redeem in silver the notes which they issued against gold. It was obviously simpler for the banks or the Commissioners to import silver direct.

Meanwhile, by November 1902, in spite of imports of silver by the government, the amount of rupee coin in the reserve had fallen to Rs. 2 million. In view of the Secretary of State's reluctance to take any further action, the Governor appointed a Commission, 'composed principally of bankers and merchants', under the chairmanship of the Hon. Mr. A. G.

[8] Indian Currency Committee 1898 p. 17: Evidence of Mr. G. Van Hoff, Clerk to the Currency Commissioners.

[9] G 108 of 31 March 1903: S.P. 27 of 1903, p. 3.

[10] S 363 of 12 Sept. 1902. [11] G 108, *loc. cit.*

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Lascelles, Attorney General, to inquire into the problem and make its recommendations.[12]

Having heard evidence from a varied section of the public the Commission concluded that the shortage of silver was directly due to the working of Ordinance No. 13 of 1901. However, they did not wish to recommend the repeal of the Ordinance without having given the sovereign a fair trial.[13] There were two other courses open.[14] A solution which was frequently advocated by witnesses before the Commission was the minting of a separate Ceylon rupee. It was, however, felt that such a step should not be taken without the benefit of expert advice. In any case, it seemed too far-reaching a solution to the immediate difficulty. The Commission nevertheless recommended that this question should be investigated by 'competent authorities outside the island'.[15]

The other course available was that which had been advocated by the Governor. The Commission in endorsing his proposal suggested the substitution of the following for Section 2 of the Paper Currency Ordinance (as amended by Ordinance No. 13 of 1901):

> 'The Commissioners shall, on the demand of any person, issue currency notes in exchange for the amount thereof in silver rupees of India.
>
> 'The Commissioners may also issue such notes in exchange for the amount thereof in gold coin which is legal tender in the colony under any Order of His Majesty the King in Council, but the Commissioners may decline to do so whenever it is inexpedient in their judgment to increase the amount of gold coin held as reserve under this Ordinance.'[16]

The Report of the Currency Commission was communicated to the Secretary of State. He, however, preferred to repeal the Ordinance of 1901 altogether. He pointed out that when he had agreed to the legislation which was now proving so troublesome he had done so merely on the grounds of convenience—the sovereign being an easier coin to store than the silver rupee. If experience showed that 'the balance of convenience was on the other side' he did not consider 'that the policy need

[12] The other members of the Commission were Messrs. E. Roslin, F. W. Bois, W. T. Highton, D. R. Marshall, P. Freudenberg, S. Spicer and R. A. Brohier.
[13] Report of the Currency Commission: S.P. 5 of 1903, para. 23.
[14] *Ibid.*, para. 25. [15] *Ibid.*, paras. 47–50. [16] *Ibid.*, para. 53.

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be upheld'.[17] Moreover, experience had proved the sovereign unsuitable as a medium of circulation. If, however, the Governor still felt that the sovereign ought to be retained, the Secretary of State was prepared to agree to the amendment suggested in the Report of the Currency Commission.[18]

The Secretary of State's Despatch of 11 August 1903 in which he stated his case for the repeal of the Ordinance, together with the related correspondence, was referred to the Currency Commission. They were called upon to advise which of the two alternatives referred to should be adopted, namely whether to amend Ordinance No. 13 of 1901 as had been suggested by the Commission or to repeal it altogether as had been recommended by the Secretary of State. When the Commission once again expressed its view that it was premature to demonetize the sovereign, the Governor caused an Ordinance to be introduced in the Legislative Council embodying the amendment that had been suggested earlier.[19]

As a measure of administrative convenience, the Commissioners of Currency announced that £200,000 would be the upper limit to its holdings of sovereigns. Gradually the banks resumed the import of silver; within a few months the circulation returned to normal.

The Report and the Minutes of Evidence given before the Currency Commission of 1902–3 provide us with much information regarding Ceylon's state of monetary development at the turn of the century. Two important monetary questions came up for discussion—the suitability of the sovereign as a medium of circulation and the possibility of minting a separate Ceylon rupee.

The Sovereign and the Rupee

The sovereign was declared legal tender in Ceylon not because it was likely to be immediately popular as a circulating medium, but because it was considered desirable to hold a coin of 'intrinsic value' in the currency reserve. The wholly unexpected behaviour of the banks, however, created a situation in which it was hoped that the sovereign might take the

[17] S 290 of 11 Aug. 1903: S.P. 27 of 1903, p. 7. [18] *Ibid.*
[19] S.P. 27 of 1903, p. 11: Colonial Secretary's letter to Mr. Lascelles, 16 Sept. 1903.

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place of the rupee coin. Considering the disparity between the values of the two coins, clearly the sovereign could not be a substitute for the rupee. The rupee coin was indispensable for all cash transactions as long as there were no currency notes of lower denomination than five rupees. As the Secretary of State was informed during the very early stages of the silver scarcity,

> 'for certain very considerable and important purposes, silver is absolutely essential, and cannot by any means be adequately replaced by gold. The payment of agricultural labourers and artisans, the conduct of petty transactions—in fact, the entire minor business of the Colony—can be effected by silver alone; gold owing to its much higher unit of value being absolutely unsuitable for the purpose'.[20]

There was hardly any section of the community which was not likely to be inconvenienced by the shortage of silver. To the estates and the bigger business establishments coin was essential for the payment of wages. Planters, in particular, had regularly to provide themselves with silver in order to pay their Indian labour.

All the bank managers were emphatic that the sovereign was unlikely 'to come into general use among natives very much',[21] and one of them put it somewhat expressively when he said that gold was asked for 'by a native, if he wants to give a bangle to his wife'.[22] The demand for gold consisted almost wholly of the demand for purposes of making jewellery. Although there is some evidence that during the later stages of the silver scarcity the circulation of sovereigns increased slightly, the coin was clearly unsuited to the prevailing structure of incomes and prices.[23] As the Commission expressed it:

> 'The members of the community who chiefly require coins are poor, and their weekly wages do not amount to anything approaching the value of a sovereign. In the great mass of the population in the island, therefore, the sovereign can never be of any use as a medium of circulation'.[24]

[20] G 260 of 12 June 1902.

[21] Evidence of Mr. F. Benett, Acting Agent, Chartered Bank; S.P. 5 of 1903, p. 38.

[22] Evidence of Mr. W. B. Patterson, Proprietor of Hatton Bank (a private bank in the planting district of Hatton): S.P. 5 of 1903, p. 37.

[23] Report of the Currency Commission: *loc. cit.*, para. 19.

[24] Second Report of the Currency Commission: S.P. 27 of 1903, paras. 14 and 15.

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Nor could the sovereign replace the rupee as a means of remittance to India. A Chetty rice dealer in his evidence before the Currency Commission stated unequivocally: 'What we want is silver.' The importers of rice and other foodstuffs had to buy their requirements from hundreds of small producers on the opposite coast, and each transaction amounted to no more than a few rupees. Although the sovereign was legal tender in India, it was not popular as a medium of circulation there for the same reasons that it was found unsuitable in Ceylon. Asked why he did not pay for some of his rice imports by shipping gold, the same witness said: 'The country from which we get the rice is a very poor country, and gold coins would be of no value.'[25] If sovereigns were taken across they had to be exchanged for rupees at a discount at one of the South Indian towns. Indeed, the shipment of rupee coin by native vessels was the cheapest method of remittance to most parts of South India, costing only about two rupees per bag of Rs. 2000—a charge of one-tenth of one per cent. The Chetties, who usually remitted in this way, did not consider it necessary to insure their funds against loss or theft.[26]

For the same reason that the sovereign could not be used as a means of remittance it was an unsuitable coin for the Indian worker to take back with him even if his savings amounted to as much.

Ultimately, the only sound reason for keeping sovereigns in the reserve was that they were full-bodied coins. Both the purchasing power of the rupee as well as its supply depended on the currency policy of the government of India. Experience had shown that the interests of other countries in which the Indian rupee circulated was unlikely to have much influence on the determination of Indian monetary policy. Gold was likely to be much more stable in value than silver. Gold was becoming 'the common denominator of the world's currencies' and there was no reason why Ceylon should lag behind in the course of currency evolution. The idea that a gold reserve should be available as a kind of treasure chest even though gold coin might not be in general circulation was basically sound, and indeed was widely adopted in later years. At bottom the question was whether the country should adopt a

[25] Evidence of S.S. Alagappa Chetty: S.P. 5 of 1903, p. 35. [26] *Ibid.*

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gold standard or some form of rupee standard, and the Governor, the Currency Commission and the members of the public who appeared before it were reluctant to abandon gold altogether. Considering the chequered history of the rupee and the transitional character of the Indian currency system, their reluctance is not surprising.

A Ceylon Rupee?

It was undoubtedly the experience of the previous decades which had led to the emergence of a definite body of opinion in favour of a separate monetary unit in Ceylon. In 1893 and the ensuing years the minting of a separate 'bullion currency' appeared merely as a desperate means of escape from the consequences of the Indian action. It was agreed on all sides that such a step would be prejudicial to the intimate commercial intercourse between the two countries.

But in the inquiry of ten years later one notices a change of emphasis. It was beginning to be felt that the Indian rupee coin was not quite as important as it was once thought to be. Trade and immigration could continue to take place in the absence of the rupee coin. No doubt a considerable proportion of the remittances to India was still being made by 'the primitive but economical method' of shipping coin by native vessel. The cost of remittances to India would thus be increased if the Indian rupee were demonetized. Nevertheless, the development of both banking and the system of communication in India was making for the greater use of bank drafts and postal orders as a means of remittance. 'Coast advances' (advances by estates to leaders of labour groups for the purpose of recruiting labour in South India) were generally taken across in bank drafts. The immigrant labourer himself was increasingly making use of the post office when he wished to make remittances and only wanted rupee coin when he was actually returning home.[27] The Chetty moneylenders and bankers also provided means of remittance by issuing 'hundis' (or demand drafts) on their branches or correspondents in many of the South Indian towns and villages. It was not

[27] According to the Shroff of the Bank of Madras: 'When coolies return to their coast they do not carry much silver. They buy bank drafts or Indian government notes' (evidence of S. S. Alagappa Chetty: S.P. 5 of 1903, p. 39).

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unusual for kanganies or for small traders to remit funds by means of these 'Chetty drafts'.

Briefly then, although it was convenient to have the Indian rupee coin in circulation, it was not considered indispensable. On the other hand, the general view was that this convenience could be obtained at too high a price. When the chief circulating medium of the country had to be imported, it made monetary conditions in the island dependent to an unusual degree on conditions obtaining abroad. And if the machinery for the regular import of coin for some reason refused to function, the country was faced with a currency crisis. If Ceylon had a coin of her own, it would not be exported to India and would presumably be held by the Currency Commissioners or the banks whenever there was a fall in the currency holdings of the public. It would no longer be necessary for rupees to move to and fro between Ceylon and India. It is significant that objections to the minting of a separate Ceylon rupee came from a Chetty trader and from the Shroff of the Bank of Madras[28]—both parties being primarily interested in the Indo-Ceylon trade. Clearly, the country was in a transitional stage between the widespread use of the rupee both as a medium of circulation and a means of remittance and the almost complete disappearance of the rupee coin which took place during and after the first world war.

However, although public opinion in Ceylon favoured a separate monetary unit and the Governor requested that the desirability of such a measure should be referred to 'competent authorities outside the island', neither the Secretary of State for the Colonies nor the Lords of the Treasury saw any reason for interfering with an arrangement which had 'completely satisfied the requirements of the colony until gold was made legal tender'.[29] When the proposal was referred to the Treasury, they merely echoed what they had been saying since the Indian rupee first came into general circulation in Ceylon:

> 'Regard being had to the intimate commercial connection between Ceylon and India, My Lords are of opinion that it is a matter of the first importance that the rupee of the government of

[28] Evidence of I. Sockanathan, and of Alagappa Chetty: S.P. 5 of 1903, pp. 42–46.
[29] S 290 of 11 Aug. 1903, para. 14: S.P. 27 of 1903, p. 7.

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India should be retained as the principal circulating medium in the Colony'.[30]

In view of the great demand for small notes in an earlier period, it seems strange that the one measure which might have relieved the shortage of silver hardly received any consideration. Those witnesses who were asked whether they favoured the issue of notes of small denomination were strongly opposed to the idea,[31] and the bankers were among them.[32] No very strong reason was given for these views. One witness referred to 'the bad experience with small notes on the continent of Europe',[33] while another merely asserted that there 'were too many small notes in circulation now in Colombo'.[34] However, within a decade, when the country was once again faced with a shortage of rupees during the first world war, it was the issue of small notes that provided a solution. Indeed, the small notes proved so popular that rupee coin almost disappeared from circulation, and imperceptibly there occurred a change in the very nature of the system of currency issue. The evolution of this exchange standard is considered in a later chapter.

A Nondescript Standard

The currency system which emerged as a result of the amendments to the Paper Currency Ordinance at the beginning of the century was a nondescript one. Until the enactment of the Gold Ordinance of 1901, currency notes were issued only against Indian rupee coin, and notes were redeemable in that coin alone. That system may therefore be described as 'a rupee standard'. After 1901, the system became at least partially a gold standard since notes were issued against the tender of sovereigns and were redeemed in either sovereigns or silver rupees. The Amendment of 1903 complicated the system by empowering the Currency Commissioners to refuse to issue notes against sovereigns whenever it seemed inadvisable to add to the gold portion of the currency reserve.

The various amendments to the Paper Currency Ordinance of 1884 did not fit into a preconceived scheme of currency

[30] Treasury Letter to Colonial Office, 31 July 1903: *ibid.*, p. 8.
[31] Report of the Currency Commission: S.P. 5 of 1903, para. 31.
[32] Evidence of Mr. J. Stewart, Manager, Mercantile Bank: *ibid.*, p. 43.
[33] Evidence of Sir W. W. Mitchell: *ibid.*, p. 30.
[34] Evidence of Mr. F. Benett, Acting Agent, Chartered Bank: *ibid.*, p. 39.

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regulation. They were merely *ad hoc* solutions to practical problems. In fact, some aspects of the currency arrangements were hardly logical. The Currency Commissioners could, for instance, decide whether to redeem notes in sovereigns or in rupees. Similarly, although they were required at all times to issue notes against silver rupees, they were entitled to refuse to accept gold. This amounted to discrimination against the sovereign and, on the face of it, appears to have made the system of currency issue uncertain. In practice, however, these arrangements worked satisfactorily. The effect of the Ordinance of 1901 was to induce the banks to import sovereigns; the effect of the Ordinance of 1903 was to induce the banks not to import too many of them. The two pieces of legislation represented the desire of the government to hold sovereigns in the reserve, while at the same time ensuring an adequate supply of silver for purposes of circulation.

However one may describe this system, it was clearly not an 'exchange standard'. The distinguishing feature of such a system is the issue and redemption of notes against foreign exchange. An early example of such a standard was the 'Lindsay Scheme' considered by the Indian Currency Committee of 1898. From the beginning of the century India was moving towards a gold exchange standard. A similar standard had been suggested for the Straits Settlements in 1903[35] and about the same time exchange standards were being adopted in certain South American countries.[36] Thus, although the idea of 'exchange standards' was very much 'in the air',[37] there was no suggestion that Ceylon should adopt such a standard in any of its forms. In fact, monetary conditions in the island were not suited to the adoption of an exchange standard; since the silver rupee was an essential and significant part of the monetary circulation of the country it was necessary to ensure the regular importation of this coin. This was most conveniently done under the existing arrangements which more or less forced the banking system to import coin. An exchange standard could develop only when it was no longer necessary to import silver rupees from India.

[35] Cf. J. O. Anthonisz: *Currency Reform in the Straits Settlements*, 1915.
[36] Cf. E. W. Kemmerer: *Modern Currency Reforms*, 1916.
[37] Cf. J. M. Keynes: *Indian Currency and Finance*, 1912, p. 35.

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Mr. B. R. Shenoy, in his account of the Currency Board system, suggests that the 'beginnings of an exchange standard' are to be found in the currency practices of the pre-1914 period. In support of this view he quotes several instances—in September, October and November 1903 and again in August, September and October 1913—when the 'Commissioners issued notes against exchange.'[38] However, an examination of the monthly statements of the Currency Commissioners for these dates does not support Mr. Shenoy's account. The statement for September 1903, for instance, shows that the currency circulation increased by Rs. 1,500,000 during the month. This is balanced by an item in the investment portion of the reserve which reads: 'By amount remitted to the Crown Agents for investment in sterling securities, Rs. 1,500,000'. In October, this figure was reduced to Rs. 350,000. The funds that were remitted in the previous month had now been invested in sterling securities, while an additional Rs. 350,000 had been remitted. In November, a further Rs. 200,000 was remitted to the Crown Agents and the sum awaiting investment stood at Rs. 500,000.

In a previous chapter it was seen how the note circulation often increased when the Currency Commissioners invested their surplus reserves of coin.[39] Such instances had occurred frequently ever since the very inception of the Currency Board system in Ceylon and no special significance can be attached to the figures quoted above. The monthly statements specifically state that the funds were *remitted* to the Crown Agents. They were presumably held by the Crown Agents, who not unnaturally awaited favourable opportunities for the investment of the Colony's funds. The sums referred to were certainly not *deposited* with the Crown Agents in exchange for notes in Ceylon. Only in the latter case could one claim that notes had been issued 'against exchange'. The same objection applies to the instances quoted in the three months of 1913 when the investment portion of the currency reserve included sums of Rs. 795,020, Rs. 845,150 and Rs. 1,341,500, respectively, 'to be invested in sterling securities'. They merely represented funds awaiting investment. There is no evidence that these

[38] Cf. Shenoy: *Ceylon Currency and Banking*, 1941, pp. 157–61.
[39] Chap. IV above.

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funds were not remitted to the Crown Agents in the usual way.

Mr. Shenoy's interpretation of the monthly statements of the Currency Commissioners is unwarranted. It is significant that he restricts himself to currency statistics after 1900. Perhaps a perusal of the pre-1900 statistics would have saved Mr. Shenoy from this pitfall. In fact, the issue of notes against exchange was first resorted to during the first world war. The practice became increasingly common during the inter-war period. By 1939 it had almost completely superseded the import of coin as a method of currency expansion. At the same time notes began to be redeemed in exchange. These developments are discussed in Chapter IX.

The Rubber Industry

Compared with the previous two decades which gave rise to problems which required the appointment of two Currency Commissions, the period from 1903 until the outbreak of the first world war was comparatively uneventful. Yet this period is not uninteresting for the student of monetary history for it illustrates the theme which has been repeatedly stressed in earlier chapters—namely, that the fluctuations in the note issue were largely determined by conditions in the export sector of the economy. The remainder of this chapter is again concerned with developments in the export sector, the changes in the currency circulation, and their interconnection.

With the average price of tea at 8d. per pound in 1899, the century ended on a note of fair prosperity.[40] From the commencement of the new century the export sector ceased to be dependent on the tea industry alone. The products of the coconut palm, mainly coconut oil, copra and desiccated coconut, began to assume an increasing importance in the export trade of the island. In 1896 coconut products amounted to only 14½ per cent. of the total value of exports; by 1903 the figure had risen to 26 per cent.[41] More phenomenal than the growth of the export trade in coconut products was the rise of the rubber industry. Just as the last two decades of the previous century had been dominated by the tea industry, so the first decade of

[40] Report on the Ceylon Blue Book, 1900.
[41] Report on the Ceylon Blue Book, 1903.

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the present century was dominated by the rise of the rubber plantations.

By 1900, the tea era had drawn to a close, and the area under the crop remained more or less stationary for several years, although tea still accounted for over half the value of the country's exports.[42] The economic stagnation that might have ensued owing to the exhaustion of this outlet for capital investment was, however, fortunately avoided. The Report on the Blue Book for 1902 noted that 'Para rubber is rapidly taking its place as one of the most important of the cultivations in the island', and the Report for the next year stated that the cultivation of rubber was proving a highly profitable industry.

Table 20 sets out statistics showing the growth of the rubber industry between 1901 and 1910. In 1901, the island's exports of rubber amounted to only 7392 pounds. From that year the expansion of the industry went on apace. The estimated area under rubber rose from 25,000 acres in 1904 to 203,000 acres in 1910.[43] In 1904 the country exported 75,712 pounds of rubber valued at Rs. 221,120. The next year both the value and the quantity exported more than doubled. In 1906 there was a boom in rubber which lasted until August of the following year, which again led to a doubling of both the quantity and the value of the commodity exported. The expansion of the industry received a slight set-back in 1908 but there was renewed activity from the middle of 1909 which continued till almost the end of the following year. This was the historic rubber boom which was stimulated by 'the lightning spread of the British, American and Continental motor car business',[44] when investors on the London Stock Exchange went 'rubber mad'. The price of rubber in the London market reached a record level of 12s. 10d. in April 1910 and rubber shares in London rose to premiums of 1000 and 2000 per cent. The boom began to subside after April, but the catastrophic slump which generally follows such booms did not come, as demand

[42] Cf. Report on the Ceylon Blue Book, 1900: 'Tea planting does not secure the profits that it once did'.

[43] The account of the development of the rubber industry is based on the series of Reports on the Ceylon Blue Book for the years 1900 to 1910. References to individual Reports are omitted.

[44] Cf. *Economist*, 22 Jan. 1910, p. 160.

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was sustained by the steady expansion of the motor car industry. Prices remained at low but remunerative levels right up to the outbreak of the first world war.

Table 20

DEVELOPMENT OF THE RUBBER INDUSTRY, 1901–1910

Year	*Estimated Acreage under Rubber* *	*Quantity Exported* † *lb*	*Value of Exports* † *Rs.*
1901	—	7,392	11,986
1902	—	21,168	39,392
1903	—	43,568	84,784
1904	25,000	75,712	221,120
1905	40,000	156,912	557,945
1906	100,000	414,960	1,527,539
1907	150,000	794,416	2,932,119
1908	180,000	1,146,656	3,606,873
1909	184,000	1,741,488	7,204,899
1910	203,000	3,802,624	19,634,006

Sources: * A. M. Ferguson, *Ceylon Directory;* † Ceylon Blue Books.

These developments no doubt gave a somewhat broader base to the economy of the country whose future no longer depended precariously on the vicissitudes of a single export. It was possible, therefore, for the fall in the price of one commodity to be offset by the rise in the price of another. For instance, in the early years of the present century the fall in tea prices and the slackening in the pace of investment in tea was counteracted by the favourable prices ruling for rubber and coconut products. But, by and large, in the course of trade fluctuations prices of agricultural commodities tend to rise and fall together, though the amplitude of price fluctuations varies from commodity to commodity. Later experience showed that rubber prices were much more volatile than tea prices and, to that extent, the rubber industry introduced a greater degree of instability into the economic system.

The Export Industries and the Currency Supply

Table 21 sets out the annual figures of currency circulation, bank clearings and the value of exports for the years 1900–1910. The statistics exhibit the marked correlation between the three sets of figures which we are led to expect from our previous analysis. Chart V shows the fluctuations in the currency circulation during 1900 to 1914 with the seasonal

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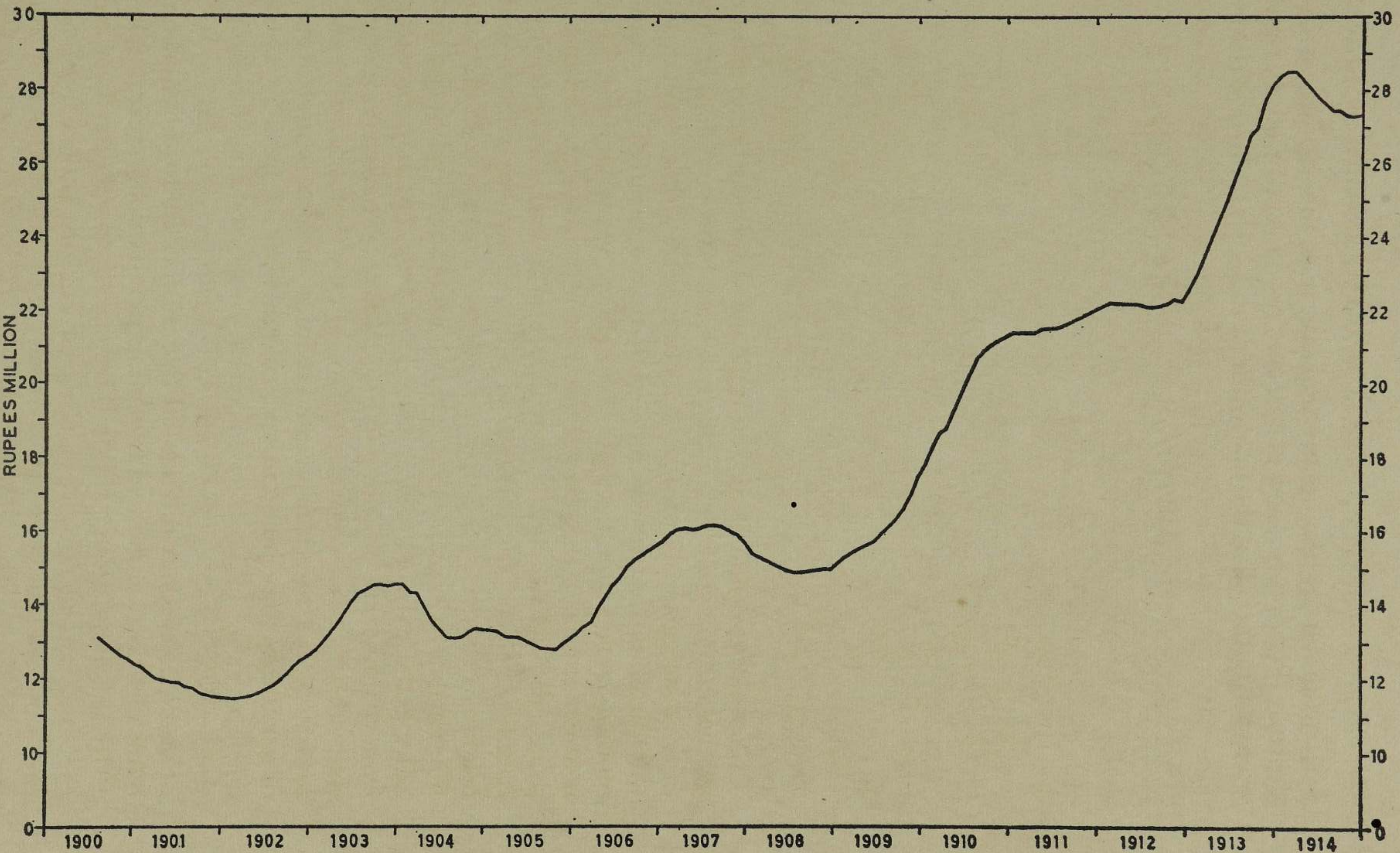
CHART V. MONTHLY CURRENCY CIRCULATION, 1900–1914

With seasonal movements eliminated



Source: Statements of Currency Commissioners

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movements eliminated.[45] The average circulation rose from Rs. 13·1 million in July 1900 to Rs. 25·1 million in June 1913.[46] But there were considerable ups and downs within this rising

TABLE 21

EXPORT VALUES, CURRENCY CIRCULATION, AND BANK CLEARINGS, 1900–1910

	Export Values	*Average Monthly Currency Circulation*	*Average Monthly Bank Clearings*
		Rs. million	
1900	90·9	13·1	16·6
1901	86·0	11·8	16·7
1902	96·7	11·7	16·7
1903	100·9	14·3	18·3
1904	99·9	13·1	19·0
1905	100·9	13·1	21·8
1906	108·2	14·7	25·8
1907	127·1	16·1	30·4
1908	127·0	14·5	28·1
1909	145·1	15·7	37·4
1910	160·7	20·0	60·0

Sources: Ceylon Blue Books; Weekly Returns of Colombo Bankers' Clearing House; Monthly Statements of the Commissioners of Currency.

trend. The currency movements may be separated into seven separate phases as follows:

(*a*) June 1900–March 1902;
(*b*) March 1902–December 1903;
(*c*) December 1903–December 1905;
(*d*) December 1905–April 1907;
(*e*) April 1907–December 1908;
(*f*) December 1908–April 1910;
(*g*) April 1910–January 1914.

The falling trend of the circulation up to March 1902 accompanied the decline in tea prices, which fell from an average of 7·20d.[47] in 1900 to an average of 6·86d. in 1901. As compared with 1900, the value of tea exports declined by Rs. 6·1 million, while total exports fell by Rs. 4·9 million. The depression was aggravated by a slump in plumbago prices. In

[45] This has been done by calculating a twelve-month moving average of the figures of currency circulation.
[46] The references are to the moving averages.
[47] All statistics of export values and prices are from the Ceylon Blue Books of the relevant years.

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the second half of 1902 the tea market began to revive and the average price was 7d. per pound in 1902 and 7¼d. per pound in 1903. The revival in tea prices combined with an expanding demand for the products of the coconut palm to make the year 1903 'a prosperous one for Ceylon trade'.[48] The value of exports rose from Rs. 96·7 million in 1902 to Rs. 100·9 million in 1903. But the following year the trend was again downward. Tea averaged 7·17d. per pound as against 7·5d. the previous year. The value of exports declined to Rs. 99 million. 1905 was a year of mild depression in the tea industry, which was, however, offset by the growing value of rubber exports. The value of total exports was higher than in the previous year, while the circulation showed a declining trend up to July and then started rising.

From the beginning of 1906, the economy was again on the upswing. The value of tea exports was Rs. 61·4 million in 1906 as compared to Rs. 59·5 million in 1905, while the average price increased to 7·25d. in 1906 and 8·25d. in 1907. Total exports rose from Rs. 100·9 million in 1905 to Rs. 108·2 million in 1906. The average currency circulation increased from Rs. 12·96 million in December 1905 to Rs. 16·11 million in September 1907.

As can be seen from Table 20, the value of rubber exports had been increasing rapidly from year to year since 1904; it was Rs. 1·5 million in 1906 and Rs. 2·9 million in 1907 as against Rs. 0·5 million in 1905. The currency expansion in 1906 and 1907[49] was almost entirely due to the boom in the rubber industry which together with high prices for both tea and coconut products combined to make 1907 'a year of unprecedented prosperity'.[50]

However, during the last four months of the year, rubber prices began to recede and the extension of rubber cultivation practically ceased. The value of tea exports declined somewhat in 1908 but the value of total exports remained near the previous year's level owing to the increased quantities of rubber exports. The average circulation fell from Rs. 16·1 million in September 1907 to Rs. 14·9 million in December 1908. The total value of bank clearings fell from Rs. 365 million in 1907 to Rs. 336 million in 1908.

[48] Report on Ceylon Blue Book, 1903, p. 3.
[49] Cf. Chart I. [50] Report on Ceylon Blue Book, 1907.

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But the setback to rubber was only temporary. Almost from the beginning of 1908 the price of rubber in the London market started rising. The rate of currency expansion rose sharply. The average circulation increased from Rs. 14·9 million in January 1909 to Rs. 18·7 million in April and Rs. 21·4 million in December 1910. The increased economic activity generated by the rubber boom was reflected to an even greater extent in the value of bank clearings, which rose from Rs. 336·1 million in 1908 to Rs. 405·5 million in 1909 and Rs. 720·5 million in 1910.[51]

As mentioned earlier, although the rubber boom tapered off after April 1910, the economy settled down to a period of steady expansion. The value of exports continued to increase, while rubber soon displaced 'coconut products' as the island's second most important export industry. The figures of currency circulation for the years 1911 to 1914 reflect the more moderate level of economic activity which followed the rubber boom and lasted until the outbreak of the war. The average circulation rose from Rs. 21·4 million at the end of 1910 to Rs. 28·5 million in February 1914. Table 22 summarizes the relevant statistics.

TABLE 22

EXPORT TRADE AND CURRENCY CIRCULATION, 1910–1914

Year	*Total Exports of Ceylon Produce*	*Value of Tea Exports*	*Value of Rubber Exports*	*Value of Coconut Product Exports*	*Average Monthly Currency Circulation*	*Total Bank Clearings*
			Rs. million			
1910	160·7	79·2	19·6	41·2	20·02	720·5
1911	170·1	84·9	28·3	38·0	21·53	494·8
1912	190·9	83·8	52·1	32·4	22·17	522·6
1913	232·9	87·7	61·2	51·4	25·41	571·2
1914	210·7	89·7	57·2	49·1	27·71	n.a.

Sources: Ceylon Blue Books; A. M. Ferguson: *Ceylon Directory*; Monthly Statements of the Commissioners of Currency

The First World War

During the early months of the war, conditions in the export industries were unsettled both by the loss of markets on the continent of Europe and by a serious shortage of shipping. But tea and rubber were essential to the Allied war effort, and by the end of 1914 'normal conditions had been for the most

[51] A. M. Ferguson, *Ceylon Directory*, 1911.

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part restored'.[52] The value of exports continued to rise until 1918 when there was a setback due to shortage of shipping space and the cessation of war demand. Of the island's three major exports, 'coconut products' suffered most during the war from the shortage of freight. The depression thus created in the coconut industry was the cause of considerable distress in the coastal districts of the island.[53] Table 23 sets out the figures of the value of exports during the war years.

TABLE 23

EXPORT VALUES, 1914–1918

Year	*Value of Tea Exports*	*Value of Rubber Exports*	*Value of Coconut Product Exports*	*Total Exports*
			Rs. million	
1914	89·7	57·2	51·4	218·3
1915	122·5	79·0	42·9	273·4
1916	105·3	103·5	42·2	297·5
1917	95·7	131·0	33·9	304·1
1918	83·2	62·2	35·5	211·3

Source: Ceylon Blue Books.

The country's imports were more affected by the war than her exports. The shortage of freight and scarcity of supplies led to a reduction in quantity of almost all imports. In spite of the considerable rise of prices that took place, the value of total imports fell from Rs. 186·1 million in 1913 to Rs. 172·3 million in 1914 and to Rs. 163·6 million in 1915. The figure rose to Rs. 211·5 million in the next year but relapsed to Rs. 184·1 million in 1917 and to Rs. 177·7 million in 1918. The rise in prices of imported foodstuffs especially was a marked feature of the war years and a cause of great hardship to the mass of the population.[54]

Indian Currency History

An analysis of Ceylon's currency experience during these years must necessarily begin with an account of developments in India. In an earlier chapter we have seen how the island's currency system depended on two important factors—the ability of the exchange banks to lay down funds in India, and the ability of the Bank of Madras to import silver rupees from India.

[52] Report on Ceylon Blue Book, 1914.
[53] Cf. *ibid.*, 1917, 1918. [54] *Ibid.*, 1918.

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The exchange banks both in India and in Ceylon employed their funds mainly in advances to exporters and in the purchase of sterling bills drawn against the export of domestic produce. They were able to bring back their funds to India in two ways. In the first place they bought bills of exchange arising out of India's imports. Since India had normally a large surplus of exports over imports, the import bills were usually insufficient to absorb all the funds which were awaiting transfer to India. The exchange banks, therefore, regularly bought the Council bills issued by the India Office. These bills, whose original purpose was merely to enable the transfer of the Indian home charges, thus came to play an important role in India's currency mechanism. The government of India released rupees in India against the payment of sterling in London. The smooth functioning of this machinery depended firstly on the need of the government of India to transfer funds to London and secondly on the ability of the currency authority in India to meet the demands for metallic currency (sovereigns, half-sovereigns and rupee coins) which invariably accompanied an increase in the note circulation.

The immediate effect of the outbreak of war was a weakening of the exchange, but when the first shock had passed away the currency mechanism worked smoothly. Towards the end of 1916, however, difficulties began to emerge. Shortages of supply and of shipping led to a contraction of Indian imports while there was a considerable increase in exports generated by the war. In addition, the British government had to make large disbursements in India, which was the base for military operations in Asia, Africa and the Middle East. As a result, the normal pre-war position was reversed. It was now the British government which had to make remittances to India. These developments created a heavy additional demand for Indian currency. The disappearance of the free market in gold in London and the shortage of silver made it more and more difficult for the Indian authorities to meet this demand. It became apparent that the continuance of unlimited sales of Council bills would endanger the convertibility of the note issue. In December 1916, therefore, the Secretary of State for India decided to restrict the sales of Council bills. At the same time arrangements were made to ensure that the available

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funds were utilized for purposes of financing essential war exports.

During the following year the situation was complicated by the rise in the price of silver. The increased demand for silver for currency purposes and a falling-off of production in Mexico combined to drive up the price of silver. In 1915, the highest price of silver in the London market was 27¼d. per standard ounce. In December 1916 the price had risen to 37d. and in August 1917 it touched 43d., at which price the rupee ceased to be a token coin. At an exchange rate of 1s. 4d. per rupee silver currency could not be issued except at a loss. The continued rise of silver necessitated a revision of the rate at which Council bills were sold. In September 1917 the Secretary of State announced that the price of Council bills in the future would be based on the price at which silver could be bought. The rate was raised from 1s. 4½d. to 1s. 5d. on 28 August 1917 and to 1s. 6d. on 12 April 1918.

Currency Difficulties

Except for a run on the Post Office Savings Bank which soon subsided, the outbreak of the war created no serious currency problems in Ceylon. Temporarily, the arrangements by which the native businessmen and traders obtained credit was affected, with the Chetties pressing for repayment of their loans and the banks on their part restricting accommodation to the Chetties.[55] Conditions, however, soon returned to normal.

TABLE 24

EXPORT VALUES AND CURRENCY CIRCULATION, 1914–1918

Year	*Value of Exports*	*Average Monthly Circulation*
	Rs million	
1914	218·3	27·65
1915	273·4	26·95
1916	297·5	28·18
1917	304·1	39·08
1918	211·3	37·52

Sources: Ceylon Blue Books; Monthly Statements of the Commissioners of Currency.

Table 24 shows the value of exports during the war years 1914–1918, and the average monthly currency circulation.

[55] Cf. *Ceylon Observer*, 1 Sept. 1914.

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Chart VI shows the monthly figures of the currency circulation during these years.

The most striking feature of Table 24 is that the close correspondence between the two series which we have noticed for earlier periods does not appear during 1915. Although the value of exports rose from Rs. 218·3 million in 1914 to Rs. 273·4 million in 1915, the average circulation fell from Rs. 27·65 million to Rs. 26·95 million. As can be seen from Chart VI, the trend of the circulation was downwards throughout 1914 and 1915. The departure from the normal behaviour of the currency circulation is attributable to developments in India. Owing to the uncertainty regarding the future of the exchanges, the exchange banks curtailed their purchases of Council bills in the two years 1914–15 and 1915–16. The total of Council bills sold by the Secretary of State fell from Rs. 31·2 million in 1913–14 to Rs. 7·2 million in 1914–15 and then recovered somewhat to Rs. 20·8 million in 1915–16.[56] At the same time the flow of the precious metals into India was slackening and metallic currency was in short supply.[57] The scarcity of rupee coin in India naturally curtailed the amounts available for import into Ceylon. During the first year-and-a-half of the war, the exchange banks in Ceylon were content to get by with smaller supplies of currency. It was not until February 1916 that the purchase of large quantities of silver by the Secretary of State increased the supply of rupee coin.[58]

The effects of this intervention of the Indian government were almost immediately transmitted to Ceylon. The exchange banks from the beginning of 1916 were able to import silver and the circulation started to rise rapidly, keeping in step with the increase in the value of exports. The sharp rise in the circulation from March 1916 is seen in Chart VI.

By the end of the year, however, the Secretary of State had restricted his weekly offers of Council bills, while the volume of

[56] Committee . . . to Enquire into Indian Exchange and Currency, 1919: Minutes of Evidence, Vol. II; Appendix, p. 8.

[57] The total imports of silver into India were as follows:

1912–13	107·2	million standard ounces valued at	Rs. 205·4 million
1913–14	79·8	,, ,, ,, ,,	Rs. 152·1 million
1914–15	64·2	,, ,, ,, ,,	Rs. 111·0 million
1915–16	39·8	,, ,, ,, ,,	Rs. 66·7 million

[58] In 1916–17 silver imports increased to 117 million standard ounces of which nearly 110 million ounces were imported by the government.

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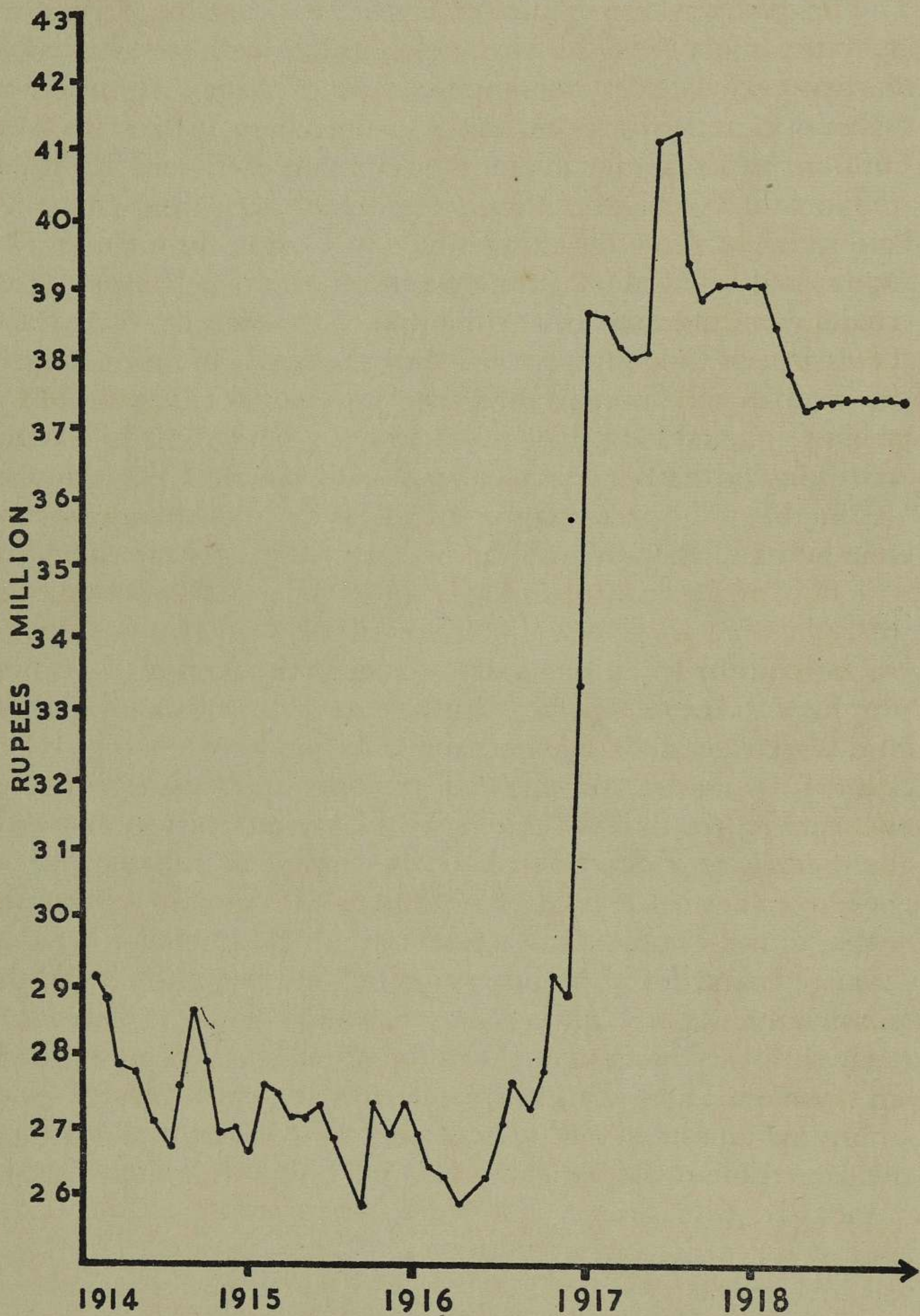
Chart VI. CURRENCY CIRCULATION, 1914–1918



Source: Monthly Statements of Commissioners of Currency

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import bills available to be taken up by the exchange banks was also scarce owing to the fall in the value of India's imports. The exchange banks found themselves unable to transfer sufficient funds to India with which to finance the rising value of exports. The precise methods of exchange control and rationing that this situation occasioned need not concern us here. For our purposes it is sufficient to note that it created in Ceylon what might be called an 'exchange deadlock'. The exchange banks were able to lay down funds in Ceylon by turning over rupee credits in India to the Bank of Madras. These rupee credits were the proceeds of the sale of the bills drawn against the export of Ceylon produce. As a result of the reduction in the supply of Council bills, the exchange banks found it impossible to convert their purchases of sterling bills into rupee credits in India in sufficient quantities, and the Bank of Madras was unable to import rupee coin. The mechanism of currency issue had stalled owing to the 'inconvertibility' of sterling.

Amendment of the Currency Ordinance

The failure of the currency mechanism created a new problem. Owing to the shortage of rupees, the exchange banks were unable to meet in full the funds necessary to finance the exports of tea, rubber and plumbago which were essential to the war effort. The expansion of the currency could no longer be allowed to depend on the availability of rupee coin from India.

When the problem first emerged in December 1916, the government relieved the pressure on the exchange banks by transferring Rs. 1·5 million of its surplus balances to London through the exchange banks for investment in Treasury bills.[59] This was no more than a stop-gap, for the demand for funds continued unabated and the exchange banks again appealed to the government for assistance. The Colonial Secretary then authorized the issue of Rs. 3 million in notes to the banks against its equivalent in sterling drafts on London. The sum was invested in Treasury bills.[60] Thus during December there was a total increase of Rs. 4·5 million in the note circulation. This procedure, however, infringed Section 2 of the Paper Currency Ordinance which debarred an addition to the

[59] *Ceylon Hansard*, 1916, p. 12: Speech of Colonial Secretary. [60] *Ibid.*

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investment portion of the reserve as long as the coin reserve was below 50 per cent. of the total note circulation.[61]

Early in January of the following year the problem reappeared, and the government undertook to issue to the exchange banks Rs. 6 million in notes against gold deposited in London. Since the Currency Ordinance did not specifically require that the metallic portion of the reserve should be held in Ceylon, this was a perfectly legitimate arrangement. However, owing to the desire of the Bank of England to conserve its gold stocks and the absence of a free market in gold in London, the exchange banks were not in a position to deposit gold in London to the credit of the Currency Commissioners, who therefore had to be content with credits at the Bank of England. The statement of the Currency Commissioners for January 1917 thus carried an item 'Cash held in London—Rs. 6,000,000' as part of the coin reserve.

Once again, the Currency Ordinance had been infringed. The Ordinance required that the coin reserve should be held in Indian rupees or any other coin which was legal tender in the island. It was illegitimate, therefore, to reckon 'credits at the Bank of England' as part of the reserve of coin.

But the demand for currency continued to increase. The only course open to the government was to amend the Currency Ordinance, and this was done in February 1917. A Bill was introduced in the Legislative Council with the object of resolving the deadlock. The preamble to the draft Ordinance states that its object was

> 'partly to empower the government to issue currency notes for a less denomination than Rs. 5 (section 2), partly to authorize, as an emergency measure, the issue of currency notes against credits in the Bank of England as an equivalent for gold (section 4), and partly to suspend the operation of the proviso to section 17 of the Paper Currency Ordinance 1884 (section 5)':

In introducing the Bill the Colonial Secretary argued that the proviso to Section 2 of the Paper Currency Ordinance erred 'on the side of excessive caution'. In the circumstances

[61] *Ceylon Hansard*, 1916: 'Before the issue of these additional notes, the notes in circulation amounted to Rs. 30,327,000, the reserve consisting of Rs. 15,165,000 odd in coin and Rs. 15,161,000 in investments—the orthodox amount being 50 per cent. of each. That proportion was upset by the issue of these notes and the act constituted a breach of the proviso to Section 2 of the Ordinance.'

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then prevailing it was practically impossible to adhere to its requirements.[62]

Although authority to issue notes of lower denomination than Rs. 5 was sought at the same time, it was not solely an emergency measure. In an earlier period successive Governors had pleaded with the Colonial Office to issue small notes.

Governor Gordon's draft Currency Ordinance had made provision for the issue of two-and-a-half-rupee notes, and both the Treasury and the Colonial Office agreed in rejecting the proposal. But now small notes were essential owing to the scarcity of rupee coin, and the government was convinced that, apart from the emergency, small notes would become generally popular. It was proposed to issue in the first instance two-rupee notes. One-rupee notes were to follow 'if the result of the issue of two-rupee notes showed' that 'a note for one rupee would be generally acceptable and useful'.[63] Events more than justified the government's judgment. The public accepted two-rupee notes with such readiness that one-rupee notes soon followed. Small notes proved themselves so popular that the Indian rupee coin gradually went out of circulation. By the late twenties it had become something of a curiosity, accepted only with reluctance owing to its bulkiness.

The passage of Ordinance No. 1 of 1917 removed the brake on the expansion of currency which had been in operation in one way or another almost since the outbreak of the war. The banks could now obtain currency by depositing sterling in London. The exigencies of the war had led Ceylon to adopt a partial sterling exchange standard.[64] Yet only once more during the duration of the war were the Currency Commissioners called upon to issue currency against the deposit of sterling in England. This was in June 1917 when the note circulation increased by Rs. 3·05 million. This was offset by a credit of Rs. 1,850,336 in England, an increase of Rs. 1·15 million in Indian securities and an addition of Rs. 50,000 in coin to the currency reserve. Thereafter the trend of the circulation was downward until several months after the conclusion of hostilities. The small increments in the circulation

[62] *Ceylon Hansard*, 1917. [63] *Ibid.*

[64] A full sterling exchange standard involves also the redemption of notes with exchange.

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that sometimes occurred were the result of the import of coin.

The amendment to the Currency Ordinance was only a partial solution to the monetary difficulties that arose as a result of the war. The currency circulation rose steeply from Rs. 27 million in June 1916 to Rs. 41·2 million in June 1917. Nevertheless, the banks were short of funds to take up all the export bills that were offered to them. They resorted to a policy of 'rationing' the available funds, giving priority to the demand for finance arising out of exports essential to the war effort. The exchange banks allowed exporters of tea, rubber, coconut and other produce to draw funds barely sufficient to cover their costs of production, the balance being credited to them in London.[65] At the same time, the situation was eased by the government agreeing to accept the payment of export duties in sterling.[65]

This turn of events was no doubt unwelcome to the estate owners, who were thus prevented from using their profits for improving their estates or extending cultivation. To the British estate owners it represented merely a restriction of capital investment and a forced accumulation of profits. The Ceylonese owners, however, were more directly affected in that they had to receive part of their sale proceeds in the form of bills on London that were of no immediate use to them. These sums were in effect a loan to the United Kingdom. It is recorded that 'the native estate owners were going round hawking their bills anywhere in the attempt to get people to buy them'.[66] A perhaps unintended consequence of this situation was that it prevented the money supply from increasing as much as it might have done; since it restricted the level of domestic expenditure its effect was anti-inflationary.

The reluctance of the exchange banks to finance the whole of the country's exports needs some explanation. The cause of this reluctance was the instability of the Indian exchanges. We have seen how the rise in the price of silver led to an appreciation of the rupee exchange and a restriction of the sale of Council bills. Both the insufficiency of Council bills and the

[65] Report on Ceylon Blue Book, 1917.

[66] Committee . . . to Enquire into Indian Exchange and Currency 1919: Minutes of Evidence, Vol. II, Q. 2406: Evidence of Mr. E. Rosling of the Ceylon Association in London.

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ever present risk of an appreciation of the Indian exchanges made the banks chary of buying the sterling bills which were drawn against the island's exports. If, for instance, a bank bought sterling bills and in the meantime the exchange appreciated it would be incurring an exchange loss. Apart from the loss in exchange the scarcity of Council bills rendered it difficult for the bank to get its funds back again to India or to Ceylon. Normally, the banks covered themselves by buying Council bills or import bills at the same rate, but such cover was not freely available. An 'overbuying guarantee' given by the Secretary of State for India 'in order to encourage the exchange banks to buy export bills in excess of their purchases in the other direction', while it prevented an actual famine of funds, did not induce the exchange banks to buy sterling as readily as they might have done had normal cover been available.[67]

The inability of the exchange banks to lay down sufficient funds in India affected also the finance of Ceylon's imports from India. As was seen in an earlier chapter, the rupee exchange necessary to pay for the imports from India was provided by the exchange banks and by the Bank of Madras. The process depended on the ability of the exchange banks to convert a portion of their purchases of sterling bills into rupees in India. When the ability of the exchange banks to do so was restricted, neither they nor the Bank of Madras were able to meet fully the demand for rupee drafts to pay for the imports of rice, foodstuffs and other necessities from India. The problem became acute in the middle of 1917 and once again the government had to intervene. The Currency Commissioners transferred a part of their gold holdings to the Bank of Madras and arranged with that bank for the issue of drafts up to the amount transferred. This was, however, only a temporary measure. In August, the government of India agreed to place 10 lakhs of rupees weekly to the credit of the Ceylon government. This credit was to be utilized only for the purchase of food by importers approved by the Principal Collector of Customs. The 10 lakhs of rupees were to be paid partly by the remittance weekly to India of 2 lakhs of silver. The balance of 8 lakhs was to be paid weekly

[67] Report of Committee . . . to Enquire into Indian Exchange and Currency 1919, para. 21.

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in sterling to the Secretary of State for India in London.[68] But by the end of September it was found that the drawings on India had not been so large as had been anticipated. It was therefore decided that the arrangements for the weekly credits should remain in abeyance until the Ceylon government's balances were exhausted. The arrangements were renewed in February 1918 when the government's balance in India became low. It again fell into abeyance in April 1918.

The problem of providing finance for the exports of tea was partially resolved when at the end of 1917 the export of Ceylon tea was taken over by the Food Controller in the United Kingdom who appointed a Local Tea Commissioner. The finance was provided by a special allocation of Council bills to the value of Rs. 4 million to the exchange banks. When these credits proved insufficient a further allotment of bills was issued to the government of Ceylon to be divided amongst the exchange banks. A weekly allotment of 13 lakhs was earmarked for Ceylon and was paid for by the Crown Agents for the Colonies out of the island's balances in London. The problem was further complicated when the government had to undertake the purchase of coconut oil on behalf of the British Ministry of Munitions. The government advanced Rs. 6·8 million for this purpose. The advance was repaid in weekly instalments of 2 lakhs each placed to the credit of the Ceylon government in Madras.

By April 1918, however, the exchange banks had sufficient funds in India, and the Secretary of State for India informed the Ceylon government that the special allotments of Council bills would cease at the end of that month. By special request three further allocations of Rs. 1·3 million each were allowed for the purchase of tea and coconut oil. In October 1918, owing to the fall in exports after the cessation of hostilities, it was found no longer necessary to buy special Council drafts and the exchange banks were thereafter able to cope with the ordinary demands of trade.[69]

[68] Report on Ceylon Blue Book, 1917.
[69] Report on Ceylon Blue Book, 1918.

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CHAPTER VII

THE INTER-WAR YEARS, 1919–1939: ECONOMIC FLUCTUATIONS

The years between the two wars have come to be regarded as being amongst 'the saddest, the most exciting and most formative in human history'.[1] They were years of dislocation as well as years of experiment. While Ceylon inevitably shared the dislocation in the countries which were her major markets, she was almost completely free of the experimentation in economic affairs which was a characteristic feature of the policies of economically advanced countries.

Nowhere is this absence of new policies more apparent than in the field of monetary organization. The Currency Board system had withstood the strain of the first world war remarkably well. When the Paper Currency Ordinance was amended to enable the issue of currency against credits at the Bank of England, and when the shortage of silver rupees was met by the issue of one-rupee and two-rupee notes, the currency system required no further attention. Thus it was, that while many European countries were faced with a breakdown of their monetary systems in the early post-war years, Ceylon, like most British colonies with a similar system of currency issue, was not confronted with any special monetary problems. Similarly, while the economic collapse of the nineteen-thirties led in many countries to the abandonment of traditional monetary standards and traditional monetary practices, the Currency Board system in Ceylon continued to function unaffected by this upheaval. The monetary history of the island during the inter-war years, therefore, is once again a narrative of the behaviour of the currency supply against the background of economic fluctuations. Since these fluctuations were both more prolonged and more violent than ever before, they make possible a closer examination of the response of the monetary system to changing economic conditions.

[1] W. Arthur Lewis: *Economic Survey, 1919–1939*, 1949, p. 28.

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On the basis of fluctuations in the value of exports, the period may be divided into four distinct phases as follows:

1. The post-war boom and slump, 1919–1921.
2. Revival and prosperity, 1922–1929.
3. The great depression, 1930–1932.
4. Recovery and recession, 1933–1938.

It is convenient to treat each of these phases separately.

1919–1921

The cessation of hostilities in August 1918 was soon followed by a 'boom of astonishing dimensions' [2] both in Europe and the United States. As a result, there was a soaring demand for the island's exports. The average price of tea rose from 46 cents in 1918 to 56·8 cents in 1919. The prices of rubber and of coconut products, which had been severely depressed owing to the shortage of shipping space during 1918, now registered a sharp rise. The average price of rubber was Rs. 1.00 per pound in 1919 while the prices of coconut products reached 'abnormal levels'.[3]

Table 25 sets out the main export statistics for the years 1918–1921. It is seen that the increase in the total value of exports by as much as Rs. 142 million in 1919 was due primarily to the increase in the value of rubber and coconut products exported.

TABLE 25

EXPORT STATISTICS, 1918–1921

	Value of Total Exports Rs. million	*Tea*		*Rubber*		*Value of Coconut Product Exports Rs. million*
		Value Rs. million	*Quantity lb million*	*Value Rs. million*	*Quantity lb million*	
1918	211·3	83·6	180·8	62·2	41·3	35·5
1919	353·8	116·5	208·5	132·2	100·8	86·3
1920	268·5	80·7	184·8	90·0	88·6	70·1
1921	248·1	112·7	161·6	51·6	88·1	71·3

Source: Ceylon Blue Books.

The post-war boom, however, was short-lived. Beginning in the second half of 1920 'there was a great depression in the tea and rubber industries'.[4] The average price of tea fell to 43·7 cents per pound in 1920 and the average price of rubber

[2] W. Arthur Lewis: *Economic Survey, 1919–1939*, 1949, p. 18.
[3] Report on Ceylon Blue Book, 1919.
[4] Annual General Report of Ceylon, 1920, p. 1.

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to 70 cents per pound. Many tea and rubber estates went out of production. There was unemployment amongst planters both Ceylonese and European and many Indian estate workers were repatriated. The European-owned estates adopted a scheme of voluntary crop restriction for some time, and scrap rubber was burnt on the estates.[5] The depression continued well into the second half of 1921 when the tea industry began to revive. Rubber, however, remained depressed for nearly a year longer.[6]

Exchange Fluctuations

An important influence on trade and economic conditions generally during these years was the fluctuation in the rupee–sterling rate of exchange. It was seen in the last chapter how the Indian rupee broke loose from its moorings owing to the increase in the price of silver during and after the war. From the beginning of 1917 the rupee–sterling rate was periodically revised by the Secretary of State for India in step with fluctuations in the price of silver. The rate for India Council bills (telegraphic transfers) was raised to 1s. 8d. on 13 May 1919 and to 2s. 5d. on 12 December 1919. On 2 January 1920, the government of India having accepted the recommendations of the Babington Smith Committee,[7] fixed the value of the rupee at 2s. gold. The adoption of the new ratio, however, coincided with a keen demand for sterling remittances and a slackening demand for Indian exports. Reverse Councils were sold at rates varying between 2s. $3\frac{29}{32}$d. to 2s. $10\frac{27}{32}$d. The attempt to hold the rate at 2s. gold proved unsuccessful, and from 24 June 1920, the government of India tried to maintain a rate of 2s. sterling. But owing to the heavy balance-of-payments deficits consequent on the trade depression, this course had to be abandoned, and the exchange was allowed to fall until March 1921, when it touched a low rate of 1s. $2\frac{7}{8}$d. sterling. Thereafter, both owing to the policy of currency contraction followed by the government of India and to the improvement in world economic conditions which led to an increase in Indian exports,

[5] Annual General Report of Ceylon, 1920, p. 1.

[6] The average price of tea in 1921 was 70 cents. As can be seen in Table 26, Indian prices began improving after July. The average price of rubber was 43 cents in 1921 and 53 cents in 1922. The table shows the average London prices during the period 1919–1921.

[7] Cf. Report of Royal Commission on Indian Currency and Finance (Hilton Young Commission), 1926, para. 8.

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the exchanges began to recover. The rate remained around 1s. 3d. during 1922, touched 1s. 4d. sterling in January 1923 and showed a tendency to rise. In October 1924, it rose to 1s. 6d. sterling. When the pound was relinked to gold in April 1925, the rupee became equivalent to 1s. 6d. gold, which rate the Hilton Young Commission decided to stabilize in 1926. When Britain left the gold standard in September 1931, rupee once again became equal to 1s. 6d. sterling. The rate of exchange in Colombo followed the rates ruling in the Indian monetary centres.

Table 26 shows the monthly movements in the rate of exchange and the fluctuations in the London prices of tea and rubber from April 1919 to December 1921. It is seen that the period of rising exchange from May 1919 to February 1920 coincided roughly with the post-war boom and the period of low or falling exchange rates coincided with the subsequent depression. In other words, after the breakdown of India's gold exchange standard, there was a system of free exchanges in operation, although the system was not the result of deliberate policy. Exchange fluctuations tended to damp down the effects of the fluctuation of export prices during the boom and depression. During the boom the rupee equivalent of the high export prices was reduced by the rise in exchange, while during the depression exchange depreciation raised the rupee receipts of the exporters.[8]

At the same time, exchange variations affected both the import trade and the cost of living. Owing to the absence of reliable price statistics it is not possible to make a quantitative estimate of these effects. The only evidence available is contained in the scattered references to them in the government's annual general reports for these years. The Report for 1919, for example, records that 'the upward tendency of prices has continued, and the increased cost of living has led to a general increase in wages'.[9] During the depression of the following year, the fall in exchange raised the rupee price of imports. The Report for 1920 states that 'the prices of imported commodities continued to rise and the tendency was assisted by the

[8] Evidence of Mr. E. Rosling of the Ceylon Association in London before the Committee . . . to enquire into Indian Exchange and Currency, 1919 (Babington Smith Committee): Q.2399. Cmd. 528 of 1920.

[9] Report on the Blue Book, 1919, p. 2.

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TABLE 26

EXCHANGE FLUCTUATIONS AND EXPORT PRICES, APRIL 1919 to DECEMBER 1921

	1919			*1920*			*1921*		
Month	*Ex-rate pence*	*Tea pence per lb*	*Rubber pence per lb*	*Ex-rate pence*	*Tea pence per lb*	*Rubber pence per lb*	*Ex-rate pence*	*Tea pence per lb*	*Rubber pence per lb*
January	—	—	—	$25\frac{29}{32}$	$14\frac{1}{2}$	33	$17\frac{7}{16}$	$5\frac{3}{8}$	$11\frac{1}{4}$
February	—	—	—	$32\frac{13}{16}$	$14\frac{7}{8}$	$32\frac{3}{4}$	$15\frac{5}{16}$	$4\frac{3}{4}$	11
March	—	—	—	$29\frac{1}{4}$	$14\frac{1}{4}$	$29\frac{1}{2}$	$15\frac{1}{2}$	$5\frac{7}{16}$	$10\frac{1}{2}$
April	$17\frac{31}{32}$	16	$23\frac{1}{4}$	$27\frac{3}{4}$	14	$26\frac{1}{2}$	$15\frac{11}{16}$	$6\frac{1}{4}$	$9\frac{3}{4}$
May	$19\frac{3}{4}$	$11\frac{1}{4}$	$22\frac{1}{2}$	$25\frac{2}{3}$	$10\frac{3}{8}$	$23\frac{7}{8}$	$15\frac{7}{16}$	$6\frac{1}{16}$	$8\frac{1}{2}$
June	$19\frac{31}{32}$	$9\frac{1}{2}$	$20\frac{1}{2}$	$23\frac{5}{8}$	7	$23\frac{3}{4}$	$15\frac{1}{2}$	$5\frac{7}{8}$	$7\frac{1}{2}$
July	$19\frac{31}{32}$	14	21	$22\frac{9}{16}$	$6\frac{13}{16}$	$21\frac{3}{4}$	$15\frac{3}{8}$	$5\frac{11}{16}$	$8\frac{1}{4}$
August	$21\frac{15}{32}$	13	$22\frac{3}{4}$	$22\frac{11}{16}$	$5\frac{9}{16}$	21	$16\frac{1}{16}$	$6\frac{1}{8}$	$8\frac{1}{4}$
September	$23\frac{7}{32}$	$15\frac{7}{8}$	$26\frac{1}{2}$	$22\frac{5}{16}$	$5\frac{1}{4}$	$18\frac{1}{8}$	$17\frac{3}{16}$	$7\frac{1}{4}$	$8\frac{1}{2}$
October	$24\frac{9}{32}$	17	$27\frac{3}{4}$	$20\frac{3}{16}$	$4\frac{5}{8}$	$15\frac{1}{4}$	$17\frac{1}{16}$	$7\frac{5}{16}$	$9\frac{1}{2}$
November	$25\frac{1}{8}$	$18\frac{1}{8}$	$29\frac{1}{2}$	$19\frac{5}{8}$	$5\frac{9}{16}$	$12\frac{3}{4}$	$16\frac{1}{4}$	$9\frac{1}{2}$	$10\frac{1}{2}$
December	$27\frac{7}{8}$	$15\frac{1}{4}$	31	$17\frac{3}{8}$	$4\frac{15}{16}$	11	$15\frac{15}{16}$	$10\frac{3}{4}$	$11\frac{3}{8}$

Sources: Ex-rates: *Statist*, November 1922; Tea prices: Calculated from *Statist* Weekly Tabular Appendix; Rubber prices: *Bulletin of the Rubber Growers' Association*, London.

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great fluctuations in the rate of exchange'.[10] The next year's Report again refers to the continuance of a very high domestic price-level in spite of the depression in the export industries. It is noted that the low exchange, although it kept prices high, 'gave material assistance to estates and exporters'.[11] In fact, two separate influences affected the relative prices of exports and imports during the depression of 1920–21. In the first place, there was the deterioration in the terms of trade which was due to the relatively greater decline in the world prices of primary products as compared with the prices of manufactured goods. Secondly, there was the further rise in the rupee prices of imports owing to the fall in the exchanges. Some indication of the combined effect of these two factors may be obtained by examining the changes in the quantity and value of imports during each of these years. In 1919 the total quantity of imports was 1·09 million tons valued at Rs. 239 million. In 1920, however, 0·89 million tons of imports cost Rs. 321·3 million. The following year, after the depression had led to a fall in import prices, 0·72 million tons of imports were valued at Rs. 260·9 million. In other words, the average price of a ton of imports rose from Rs. 233 in 1919 to Rs. 361 in 1920 and to Rs. 362 in 1921.[12] As a result of the fall in national income and the considerable deterioration in the terms of trade, the country's balance of visible trade, which showed a surplus of Rs. 127·8 million in 1919, turned into a deficit of Rs. 52·8 million in 1920. In 1921, owing to the large fall in the value of imports, the deficit was reduced to Rs. 4·3 million.[13]

The currency circulation which had remained around Rs. 37·3 million since May 1918 rose by stages to Rs. 49·7 million in January 1920 at the height of the boom. During the depression the circulation began to shrink. By April 1921 it had declined to Rs. 45·7 million, at which level it remained until April of the following year when a further return of currency brought the circulation down to Rs. 39·2 million. The severity of the currency contraction and especially its continuance throughout 1921 and the first quarter of 1922 when the worst of the depression had passed away, is to be explained by

[10] Annual General Report, 1920, p. 1. [11] *Ibid.*, 1921, p. 1.

[12] Data from the Administration Reports of the Controller of Customs and Shipping, 1919–1921: Appendix II.

[13] Ceylon Blue Books.

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the deflationary policy of the Indian monetary authorities during these years and the consequent tightness of the Indian money market.[14]

Revival and Prosperity

The tea industry was the first to recover from the depression, prices began to improve in the latter months of 1921. The average price of tea rose from 75 cents per pound in 1921 to 85 cents in 1922, to Rs. 1.02 in 1923 and Rs. 1.05 in 1924. Prices then dropped slightly but the market continued firm for the next three years with the average price between 98 cents and 94 cents per pound. Coconut products, too, enjoyed a buoyant market though prices remained below the levels reached in the boom of 1918–19. The revival of the rubber industry had to await the introduction of the Stevenson scheme in 1922. The restriction of supplies, together with the rising level of economic activity in Europe and America, led to a considerable advance of prices during the next few years. The average price rose from 53 cents per pound in 1922 to 88 cents in 1923. After a drop to 77 cents in the following year, it reached a peak of Rs. 1.73 in 1925. After the break of the rubber boom in that year, prices crawled slowly downwards until the early months of 1928 when they began their great tumble. The total value of exports rose from Rs. 297·8 million in 1922 to Rs. 503·3 million in 1926. Export values declined during the next two years mainly owing to the fall in the value of rubber exports and then rose slightly during the feverish boom year of 1929. Table 27 summarizes the more important export statistics of these years. The table has been extended to include the years of the great depression which is discussed in the next section.

The prosperity in the export industries was transmitted in varying degrees to the rest of the economy. The value of imports rose from Rs. 288 million in 1923 to Rs. 429 million in 1929. Similarly, government revenue rose from Rs. 93·7 million to Rs. 134·1 million during the same period, and government expenditure from Rs. 85·6 million to Rs. 152·1 million.

The currency circulation kept in step with the fluctuations in the value of exports. From Rs. 39·2 million in April 1922, it

[14] Royal Commission on Indian Currency and Finance 1926: Minutes of Evidence, Vol. II, p. 18.

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rose by stages to a peak of Rs. 62·8 million in November 1926, and remained around that level till the end of 1927. In the first quarter of the following year there was a total decline of Rs. 5 million, bringing the circulation down to Rs. 57·4 million in March 1928. There were no major changes thereafter until 1931 when the great depression was well under way.

TABLE 27

EXPORT STATISTICS, 1922–1932

Year	*Total Exports Rs. million*	*Tea*		*Rubber*		*Value of Coconut Product Exports Rs. million*
		Value of Exports Rs. million	*Average Price cents*	*Value of Exports Rs. million*	*Average Price cents*	
1922	297·8	146·0	85	57·0	53	63·9
1923	351·0	185·7	102	73·6	88	54·7
1924	385·4	215·0	104	63·7	77	68·8
1925	492·5	199·7	96	170·0	173	73·9
1926	503·3	213·2	98	170·1	121	72·6
1927	447·7	213·7	94	119·1	95	68·7
1928	392·6	199·7	85	74·0	55	56·6
1929	407·4	205·1	81	86·6	52	56·1
1930	310·2	182·0	75	47·0	27	41·2
1931	226·7	138·7	57	19·8	14	31·7
1932	170·3	107·7	42	13·2	11	29·9

Sources: Ceylon Blue Books; Annual General Reports.

The Great Depression

Studies concerned with events in the major industrial countries are accustomed to date the onset of the great depression from the autumn of 1929, after the stock market crash in Wall Street. Yet most raw material prices had reached a peak at least two-and-a-half years earlier, in the latter months of 1926.[15] In Ceylon, tea prices began to decline early in 1927 while rubber prices started falling in 1925. Although there was no sudden collapse, prices had fallen sufficiently to reduce the value of total exports by nearly Rs. 100 million between 1926 and 1929. More than two-thirds of this decline was due to the fall in the value of rubber exports.

[15] Cf. H. V. Hodson: *Slump and Recovery, 1929–1937*, 1938, p. 53: 'To open the tale of the world depression with the stock-market crash in New York in October 1929 is like starting the story of a flood at the moment when the last sod in the dyke gave way. The boom of 1928–9 concealed underlying deflationary tendencies, and its collapse merely allowed these to exercise their forces unchecked. The fall in commodity prices proceeded with only intermittent relief from 1925 onwards.' Also H. Clay (ed.), *Inter-war Years and Other Papers . . . of H. D. Henderson*, 1955, pp. 49–52.

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The major collapse of prices came with the decline of economic activity in Europe and America in the early thirties. There was a ruinous slump in the rubber industry, and prices in the London market had fallen as low as 2½d. per pound by September 1931. In January 1928 it was announced that restriction would be abandoned at the end of October. The announcement led to only a slight fall in market prices. From April, however, there was a pronounced downward trend. From an average of 1s. 7⅜d. in January, the London price had fallen to 5⅝d. in December. The average price for 1928 at the local sales was 55 cents per pound. There was a brief recovery at the beginning of 1929 when the price rose from 43 cents in January to 67 cents at the end of February. Thereafter the decline continued with but slight interruption. The average price was 52 cents in 1929 but the last sale of the year realized only 38 cents per pound. In October 1930, the price reached 14½ cents per pound. The average price was 14 cents in 1931 and 11 cents in 1932, just one-eighth of the price in 1923, and about one-fifteenth of the average of 1925.

The decline in tea, on the other hand, was of much smaller proportions. The average price fell from 94 cents in 1927 to 85 cents in 1928 and 81 cents in the following year. At the end of 1929 the price fell to 59 cents per pound, but revived slightly in 1930 when the average was 72 cents. It fell to 57 cents in 1931 and 42 cents in 1932. Thus the average in 1932 was well over one-third of its level in 1923 and 1924 when tea prices were at their highest for the decade.

In the absence of estimates of national income, the value of exports is the best available index of income changes. On the assumption that the value of exports constituted 40 per cent. of the national income, Table 28 provides some indication of the contraction of income which occurred between 1926 and 1932. The last column represents national real income on the assumption that the index of import prices is a fairly satisfactory measure of the overall purchasing power of the rupee.[16]

These estimates suggest that the national money income in 1932 was about one-third of its peak level of 1926, while the

[16] It must be emphasized that the figures are at best very rough approximations. Apart from inaccuracies in the figures for exports and the assumption of a constant ratio between export values and national income, no reliance can be placed on the index of import prices. The basis of its computation is not known.

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national real income was about 70 per cent. of the 1926 level. The deflation of money incomes was counteracted to a certain extent by the fall in import prices—especially by the fall in the prices of food imports from India.

TABLE 28

INCOME FLUCTUATIONS, 1926–1932

	National Money Income (approximate) Rs. million	*Index of Import Prices 1926 = 100*	*National Real Income (approximate) Rs. million*
1926	1258	100	1258
1927	1119	98	1145
1928	982	94·5	1040
1929	1019	91·3	1120
1930	776	75	1031
1931	538	60·5	890
1932	434	54·6	795

Sources: Ceylon Blue Books; Ceylon Ministry of Finance: The Economic and Social Development of Ceylon, 1926–1950 (for import price index).

In developed capitalist economies the most marked feature of the depression was an increase in unemployment. In these economies, booms are associated with increasing employment and rising wage-rates while depressions are accompanied by wage declines and unemployment. In a backward economy, however, whatever employment statistics exist are never a satisfactory index of the impact of boom and slump on the economic life of the country.

The economy of Ceylon has been broadly divided into three sectors—the estate sector, the urban sector and the rural sector. Only the estate and urban sectors provided regular employment on a wage or salary basis. The bulk of the wage-earners consisted of the immigrant Indian workers on the estates. The plantations had an elastic supply of labour. During a period of prosperity the arrivals of Indian immigrants exceeded departures, while during a downswing the reverse took place. The number of Indian workers on the estates rose from 498,839 in 1926 to 543,459 in 1930. At the end of 1933 the number had fallen to 459,822. Over 83,000 workers had returned to India between 1930 and 1933.

Table 29 shows the number of Indian workers on the estates and the quantities of tea and rubber exported during the years 1926–1933. It is seen that in spite of the downward trend in

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export prices, employment on the estates continued to increase until 1930. The quantities exported, both of tea and of rubber, increased until 1929. There was a large increase in rubber exports in 1929 and 1930, attributable largely to the removal of restriction. Tea exports fell somewhat during these years,

TABLE 29

CEYLON ESTATE SECTOR: NUMBER OF INDIAN WORKERS AND QUANTITY OF TEA AND RUBBER EXPORTS, 1926–1933

Year	*Number of Indian Workers*	*Quantity of Exports*	
		Tea	*Rubber*
		lb million	
1926	498,839	217	132
1927	526,654	227	125
1928	538,387	237	128
1929	541,351	252	181
1930	543,459	243	171
1931	497,410	244	138
1932	470,157	253	111
1933	459,822	216	142

Sources: Statistical Abstract of Ceylon 1950; Ceylon Blue Books.

but regained their 1929 level in the following year. On the whole, the fall in prices had little effect on production and employment in the tea industry. Although prices were low, the industry continued to earn profits throughout the depression years.[17] In contrast, there was a considerable decline in the acreage of rubber actually tapped. The contraction of production occurred between 1930 and 1932. From 181 million pounds in 1929, rubber exports fell to 111 million pounds in 1932. The fall in the total of estate employment was therefore largely caused by the decline in rubber production, and it is worth remarking that the tea industry was able to absorb some of those thrown out of work on the rubber estates.[18]

[17] An Index of Profits published in 'Government of Ceylon Post-War Development Proposals', moved as follows:

	Tea	*Rubber*	
1926	89·3	466·2	
1927	88·9	176·2	
1928	81·0	87·0	(1924 = 100)
1929	83·7	131·1	
1930	64·5	− 1·9	
1931	42·3	−15·2	
1932	19·3	−16·2	

[18] Administration Report of Controller of Indian Immigrant Labour, 1930.

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Just as the bulk of the unemployed amongst the Indian workers went back to India, the small number of Ceylonese estate workers went back to their villages. Unlike the Indians, the majority of the Ceylonese workers did not live on the estates but in the neighbouring villages. In many ways they still formed part of the village economy in which they often owned some tiny fragment of land (usually in common with other members of the family). The villages were able to absorb those of their members who lost their jobs on the estates without any outward signs of difficulty.

Although the estates did not rely to an appreciable extent on Ceylonese labour, the fall in export incomes affected the rural sector directly since a fair proportion of the wages paid out on the estates was spent in the neighbouring villages—usually on rice and vegetables.[19] By and large, the impact of the depression on the rural sector was an aggravation of its permanent state of underemployment, and a fall in the prices of its produce.[20]

Unemployment was most conspicuous in the urban sector of the economy.[21] Some information is available regarding conditions in the main town of Colombo. As there were hardly any industries, employment in the towns was confined largely to trade, transport and government services. The Ceylon Employers' Federation estimated that in 1931 about 10 per cent. of the total number of employees working in firms belonging to that association had been discontinued—that is, about 25,000 persons.[22] Referring to the same year, the Chairman of the Colombo Municipal Council remarked 'the problem of unemployment on a quite unprecedented scale (was) rapidly assuming alarming dimensions'.[23] In that year 7,500 persons were registered with the Council's Charity Commissioner for unemployment relief. Relief works, started in September 1931, gave employment to about 2000 persons at a nominal wage.[24]

[19] Similarly, the rural economy was dependent on the export incomes of the 'small-holders' of tea and rubber.

[20] The most important product of the rural economy was paddy. According to the Ceylon Blue Books, the price of country rice in Colombo town fell from Rs. 5.90 per bushel in 1926 to Rs. 3.50 in 1933.

[21] Cf. Administration Report of the Controller of Labour, 1931, para. 257: 'Unemployment has shown itself largely in the towns.'

[22] 'Unemployment in Ceylon': S.P. 7 of 1937, para. 5.

[23] Report of the Chairman of the Colombo Municipal Council, 1937. S.P. 28 of 1937, para. 6.

[24] S.P. 7 of 1937, para. 5.

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The government's financial policy only served to increase unemployment. As Table 30 shows, with the onset of the depression, government revenue began to shrink,[25] and in all but one of the depression years revenue fell short of expenditure. The budget deficits were, of course, not due to deliberate policy but to the inevitable rigidity of certain items of expenditure. Government attempts to balance its budget in fact led to a contraction of expenditure on public works from Rs. 24·11 million in 1928–29 to Rs. 4·92 million in 1932–33. Similarly, the total number employed in government departments was reduced from 69,287 in 1930 to 60,553 in 1933.[26]

TABLE 30

GOVERNMENT REVENUE AND EXPENDITURE

1928–29 to 1931–32

	Revenue	*Expenditure* *Rs. million*	*Surplus* (+) *or Deficit* (−)
1928–29	107·818	125·896	− 18·078
1929–30	103·507	110·275	− 6·768
1930–31	101·767	100·296	+ 1·471
1931–32	84·843	96·870	− 12·027

Source: S.P. 20 of 1934.

On the basis of the foregoing account, it is possible to make certain tentative generalizations regarding the effect of a depression on the volume of employment. Owing to the inelasticity of the supply of agricultural products, the effect of the depression on prices, wages and other incomes will be greater than its effect on employment. This does not, of course, exclude the possibility of a catastrophic slump in prices, such as that which affected the rubber industry in the thirties, from creating a substantial volume of unemployment. On the other hand, in the urban sector unemployment is likely to be more marked as, unlike in the agricultural industries, employers in the towns are under no compulsion to maintain output. Finally, in the rural sector, the effect of the depression is likely to be a fall in produce prices and an increase in underemployment. Similarly, during an upswing generated by a rise in export prices the opposite train of consequences seems likely. In the estate sector, the increase in employment will be small in comparison with the rise in prices and incomes. Employment

[25] 'Poor Relief in Ceylon': S.P. 20 of 1934, para. 106. [26] S.P. 7 of 1937.

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and wages will increase in the urban sector of the economy. The rural sector will experience both a rise in prices and an increase in employment opportunities in that sector itself and in the towns. In other words, there will be a drift of the population from the rural sector to the urban sector—a movement which is reversed during a depression.

Recovery and Recession

After the events dealt with earlier, the concluding years of the inter-war period seem dull and uneventful. With the economic recovery in the main industrial countries in the latter months of 1933, the demand for exports began to revive. The average price of tea rose from 39½ cents per pound in January 1932 to 76 cents in August. The average price for the year was 54 cents as against 42 cents in 1932. The price of sheet rubber rose from 9½ cents per pound in January 1933 to 19¾ cents at the end of the year. Except for a slight recession in 1935, export prices rose steadily, reaching a peak during the rearmament boom of 1936–37. The average price of tea in 1937 was 76 cents per pound and that of rubber 50 cents. Table 31 sets out the main export statistics for the period 1933–1939. The recovery of the thirties, as this table shows,

TABLE 31

EXPORT STATISTICS, 1933–1939

Year	*Value of Exports Rs. million*	*Tea*		*Rubber*	
		Quantity lb million	*Average Price cents*	*Quantity lb million*	*Average Price cents*
1933	177·35	118	54	23	15
1934	183·3	145	66	57	31
1935	245·4	146	64	38	30
1936	235·6	153	67	47	41
1937	252·2	171	76	77	50
1938	316·5	172	70	45	37
1939	268·1	188	77	68	47

Sources: Ceylon Blue Books.

was extremely mild. The value of total exports in the boom year 1937 was only slightly higher than in 1935. The yearly average of tea prices for the six-year period 1933–1939 was only 66 cents as compared with an average of 96 cents during 1923–1928. The yearly average of rubber prices was 48 cents as against a little over one rupee in the corresponding years of

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the previous decade. Even this moderate level of prices was secured only by the operation of international restriction schemes for both commodities.

From the second half of 1937, however, commodity prices began to be affected by the world recession and markets remained stagnant owing to the gathering gloom of the world political situation. As usual, tea was least affected by the slump, but the price of rubber fell in 1938 to 37 cents per pound. It was only after the outbreak of the second world war in September 1939 that export prices began to revive.

The Balance of Payments

In order to understand the significance and causes of the changes in the currency circulation which accompanied fluctuations in export values, it is necessary to digress somewhat and discuss the country's balance of payments as a whole, of which the value of exports is the most important component. The wide swings in the value of exports which have been outlined in the previous pages were the direct and most obvious effects of the international trade cycle. Fluctuations in economic activity abroad were transmitted to the domestic economy through their effects on the demand for exports.

Like most countries which have been developed through the investment of overseas capital, Ceylon normally has an export surplus—that is, a favourable balance of trade. The surplus increases in times of good trade and diminishes during periods of bad trade. In a severe depression such as that of the thirties, the trade balance often becomes negative or unfavourable. The habitual trade surplus is largely taken up in payment of dividends and interest on overseas capital, and in payment for invisible imports. The balance of payments accounts may be broken up into the following constituent elements:

A. The balance of merchandise trade.
B. The balance of 'invisible items', which includes profits, interest and other remittances to or from the country.
C. The balance on capital account.

Items A and B together comprise the balance of payments on current account and may be positive or negative (favourable

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or unfavourable), according as the receipts from abroad exceed payments abroad or vice-versa. Since merchandise trade is by far the largest single item in Ceylon's current account it is a reasonable assumption that her total balance on current account moves in the same direction as her balance of trade.

Capital movements may be classified into three separate categories:

(i) Autonomous capital movements
(ii) Accommodating capital movements, and
(iii) Changes in the country's international currency reserves.

Autonomous capital movements are those which take place irrespective of the state of the balance of payments and may be generally considered to be motivated by considerations of the long-term profitability of investment.[27] Accommodating capital movements, on the other hand, are closely connected with the state of the balance of payments. As the term implies, they are in the nature of temporary accommodation made available at a time of a shortage or surplus of foreign exchange. Although it may not always be possible to distinguish between the two types of capital movements, the distinction is worth making from an analytical point of view.[28] In the case of Ceylon, accommodating capital movements consisted almost entirely of changes in the foreign assets of the local banking system. The third item in the capital account—the international currency reserve—was held during this period by the Board of Commissioners of Currency.

It will be noticed that no mention has been made of the familiar category of 'equilibrating capital movements' which play an important role in the balance of payments of many economically developed countries. Such capital movements usually take place between countries with developed short-term money markets in response to interest-rate differentials or fractional changes in the rates of exchange. There is hardly

[27] The investment of part of the government's surplus funds abroad constituted a frequent outward movement of capital on long term. This was a matter of policy rather than profitability.

[28] For a discussion of the difficulties involved, see N. Kaldor: "A Note on the International Impact of Cyclical Movements", in E. Lundberg and A. D. Knox (eds.), *The Business Cycle in the Postwar World*, 1955.

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any scope for equilibrating movements of capital in the case of economies which have no short-term money markets.

Reliable statistics of the balance of payments are not available for the inter-war years, so that the balance of merchandise trade must serve as a rough guide to the extent of fluctuations in the country's foreign receipts and disbursements. Table 32 sets out the balance of trade for the years 1923–1939. The last column carries the annual change in the currency circulation.

TABLE 32

BALANCE OF TRADE AND CURRENCY CIRCULATION 1923–1939

Year	*Exports*	*Imports*	*Balance of Trade*	*Change in Currency Circulation*
	Rs million			
1923	351·03	287·95	+ 63·08	+3·50
1924	385·35	302·73	+ 82·62	+5·29
1925	492·49	351·33	+141·16	+9·98
1926	503·26	395·25	+108·02	+4·78
1927	447·74	406·66	+ 41·08	+0·27
1928	392·59	412·12	− 19·53	−5·05
1929	407·37	429·30	− 21·93	−0·13
1930	310·17	324·36	− 14·91	−0·08
1931	226·71	218·70	− 3·40	−5·37
1932	170·31	196·20	− 23·00	+0·13
1933	177·35	183·20	+ 23·50	+0·10
1934	263·30	217·00	+ 46·30	+2·03
1935	253·11	227·50	+ 25·61	+0·15
1936	268·47	214·34	+ 53·13	+0·10
1937	330·55	242·60	+ 87·95	+4·07
1938	283·74	235·50	+ 48·24	−3·30
1939	328·11	242·37	+ 85·74	+8·10

Sources: Ceylon Blue Books; Monthly Statements of the Commissioners of Currency.

As the table shows, the balance of trade was favourable from 1923 till 1927, the years of high export prices—the surplus being largest during the boom year of 1925. From 1928 to 1932 there was an adverse balance of trade. The largest deficit occurred in 1932 when the value of exports declined to nearly one-third of its value in 1926 while the value of imports had fallen by only one-half. Similarly, during the period of recovery from 1933 to 1937 there were favourable balances of trade. In 1938, owing to the recession of export prices in that year, the size of the surplus was reduced. These movements in

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the balance of trade were accompanied by roughly parallel changes in the quantity of currency in circulation.

Two related questions arise in connexion with fluctuations in the balance of trade and in the balance of payments. Firstly, how were these surpluses and deficits adjusted?[29] And secondly, what role was played in the process of adjustment by changes in the currency circulation?

The classical theory of the process of adjustment of the balance of payments was an extension into the field of international economics of the traditional quantity theory of money. Generally referred to as the 'price specie-flow theory', it received its best known expositions in the work of David Hume and John Stuart Mill.[30] In that theory changes in price-levels caused by changes in the quantity of money were directly responsible for restoring balance-of-payments equilibrium. It was argued that a deficit in the balance of payments led to a loss of gold by the deficit country (A) and a gain of gold by the surplus country or countries (B). Under the gold standard, the quantity of money (currency and bank deposits) declined in the former and increased in the latter, thus leading to a fall in prices in A and a rise in prices in B. A's exports were stimulated and its imports were discouraged. Country B, which gained gold, experienced the opposite train of events. The movement of gold and the price changes continued until the deficit was eliminated.

Early in the present century doubts began to be expressed regarding the validity of this explanation. The existence of gold flows and price movements of the type postulated by this theory was not confirmed by inductive studies.[31] As Professor Taussig, himself an exponent of the classical theory, pointed out in the course of his analysis of the British balance of payments before 1914, the adjustment seemed to take place much more smoothly and quickly than 'the theoretic analysis previses'.[32] Subsequent work has shown that the weaknesses of the classical explanation lay partly in its adherence to the 'quantity theory' explanation

[29] Cf. Ricardo's dictum: 'No country can long import, unless it also exports, or can long export unless it also imports.' (*The Works and Correspondence of David Ricardo*, Piero Sraffa (ed.), Vol. I, p. 263.)

[30] Cf. Hume: *Essays, Moral, Political and Literary*, 1875 ed., Vol. I, pp. 330–45; Mill: *Principles of Political Economy*, Ashley ed., 1848, Bk. III, Chap. 21.

[31] Cf. the studies by Taussig, Viner, Beach and Andrew.

[32] Cf. Taussig: *International Trade*, 1928, pp. 239–40 and 260–61.

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of the determination of prices and partly in its neglect of the income changes which invariably accompany balance-of-payments fluctuations.[33] This latter defect made the theory wholly unreal in its application to cyclical fluctuations.

The price specie-flow theory raises two problems. The first concerns the validity of the quantity theory of money and the second the response of demand to price changes.[34] For the purpose of analysing the influence of changes in the quantity of money on prices, it is necessary to consider separately the three groups of commodities—export goods, imported goods and domestic goods. The three categories are, of course, not mutually exclusive. Thus the export commodities tea and coconut are also consumed at home, while some commodities such as rice and foodstuffs are partly imported and partly home-produced. However, this fact makes no difference to our analysis, as long as the distinction remains broadly true.

As regards export prices, it is evident from our account of economic fluctuations so far that the price and quantity of exports are largely governed by the level of economic activity in the major consuming countries. Cyclical changes in export prices are due therefore to changes in foreign demand and are only remotely influenced by the level of domestic costs of production. In fact, it is unrealistic to speak of a separate local price for commodities such as tea and rubber which are traded in international markets. These commodities have a 'world price level'. The price of Ceylon tea, making allowances for quality, can hardly differ from the price of Indian tea. And the price of rubber in Colombo cannot differ from that in London, New York or Singapore by more than the cost of transport of the commodity in one direction, and the cost of remittance of the sale proceeds in the other. If the structure of costs in Ceylon is out of alignment with that in other producing countries, it will manifest itself in a change in the profitability of production at a given world price rather than in a change in the price itself or in the quantity demanded.

[33] This new approach was largely a by-product of the 'Keynesian revolution'. Cf. for example, Sir H. R. F. Harrod: *International Economics* (1945 ed.), Chaps. IV and VI; also P. Barrett Whale, "Working of the Pre-war Gold Standard", *Economica*, 1937; reprinted in T. S. Ashton and R. S. Sayers (eds.): *Papers in English Monetary History* (1954); T. C. Chang, *Cyclical Movements in the Balance of Payments* (1951).

[34] I.e. the price elasticity of demand.

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Granted that the level of export prices is governed by conditions of world demand, it follows that the changes in the quantity of money which accompanied the fluctuations in the balance of payments did not contribute to the adjustment process through their effect on export prices. As far as export prices were concerned, their role was purely passive. Similarly, since import prices are determined abroad and since Ceylon buys only a very small proportion of the total world production of 'import goods' it may safely be assumed that the supply of money within the country did not influence their price-level, except in so far as it influenced their domestic costs of distribution.

A change in the price-level of domestic goods may take place in two ways—through changes in the level of monetary demand for these commodities and through changes in the prices of imported substitutes. In the latter case, as we have seen, the quantity of money is irrelevant, while a change in monetary demand depends on a prior change in incomes. The determining factor is not the quantity of money but the level of incomes. All this does not imply that changes in the quantity of money are unimportant. On the contrary, every period of rising prices has been accompanied by an increase in the quantity of money, just as falling prices have been accompanied by a decline in monetary circulation. Clearly, prices cannot increase significantly unless the money supply is also increasing. But it suggests that, over a wide range of the economy, a change in the money supply is a symptom and not a cause of price fluctuations. It is significant, therefore, only in so far as it exercises an independent influence on the level of incomes.

The Terms of Trade

The question remains if a rise or fall in the price-levels of the three groups of commodities, whether caused by changes in the quantity of money or otherwise, plays a significant part in the adjustment of cyclical disequilibria in the balance of payments. This problem is closely akin to that concerning the influence of changes in the terms of trade and the two are conveniently discussed together.

Contrary to the classical assumption that prices moved in

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opposite directions in the surplus country and in the deficit country, prices in nearly all countries rise and fall together during cyclical fluctuations. However, there were wide differences in the degree of price fluctuations as between different commodities and between different countries. One of the most obvious empirical facts about the trade cycle is that the prices of primary products fluctuate much more violently than do the prices of manufactured goods. Thus during an upswing the rise in Ceylon's export prices was greater than the rise in her import prices, while in a downswing the reverse was true. In other words, her terms of trade improved during a boom and deteriorated during a slump. The approximate movements in the country's terms of trade during the period 1926–1939 are shown in Table 33. From a height of 99 in 1926 the terms of trade fell to 61 at the bottom of the slump in 1932. During the recovery years the terms of trade gradually improved and reached a level of 118 in 1937. The figure fell to 97 owing to the recession of the following year but recovered to 113 in 1939.

Table 33

TERMS OF TRADE, 1926–1939

(1934–38 = 100)

Year	*Index of Export Prices*	*Index of Import Prices*	*Terms of Trade*
1926	193	194	99
1927	169	190	89
1928	141	183	77
1929	127	177	72
1930	105	145	72
1931	75	117	64
1932	65	106	61
1933	71	98	73
1934	86	101	85
1935	95	104	91
1936	103	97	106
1937	116	99	118
1938	99	102	97
1939	114	101	113

Source: Ceylon. Ministry of Finance: Economic and Social Development of Ceylon. Table 2.

It might be argued that the changes in the relative price-levels of exports and imports represented by changes in the terms of trade performed the same function as the changes in

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absolute price-levels postulated in the classical theory. To do so, would be to misunderstand the whole nature of the price specie-flow theory of adjustment. The very essence of this theory is the assumption of a degree of substitutability between the three types of commodities—export goods, imports and domestic goods. The surplus country's (B's) exports were supposed to fall when their prices rose because the deficit country (A) was substituting domestic goods for imports from country B. Again, B's imports were assumed to increase because she substituted imports for domestic goods; and conversely, A's imports declined because she substituted domestic goods for imports.

Whatever their validity in economically developed countries, these assumptions are inadmissible in the case of an underdeveloped economy. It is clear that in such economies the elasticities of substitution between the three groups of commodities must be extremely small. Thus, in Ceylon, at least in the short run, it is not possible for domestic goods to be substituted for imports to any significant extent owing to the limited range of production within the country. For the same reason the primary products which are exported cannot displace domestic goods in the home market. It is, of course, possible for cheaper imports to displace domestic goods. But it is unlikely that the factor will be of importance during a period of rising incomes.

Since export goods and domestic goods are not substitutes for one another, changes in the relative price level of these two groups cannot influence the quantities demanded. As regards the change in the relative price-levels of exports and imports, in a country in which a high proportion of the national income is earned in export production and a high proportion of it is spent on imports, the significance of such cyclical shifts in the terms of trade lies not so much in their 'substitution effect' as on their 'income effect'. In other words, movements in the terms of trade represent changes in national real income.[35]

If neither changes in relative price-levels nor changes in

[35] National real income can change owing to changes in the terms of trade and changes in the volume of output. Owing to the low elasticity of supply of agricultural output, the former assumes added importance.

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absolute price levels play a significant role in the adjustment of cyclical fluctuations in the balance of payments, an explanation must be sought in the other factor which determines demand, namely income changes. It is now generally recognized that the process of adjustment of the balance of payments is only one aspect of the process of income change. The theory may be briefly summarized as follows:

> Let the value of exports increase by x. The further effects of this initial impulse depends on how the increased income is utilized. If it is assumed that each increment of income is spent on domestic goods and on imports, according to the theory of the multiplier money income will rise to the point where the increase in imports is equal to the original increase in exports. Since at each stage a part of the increment of income will be saved, the expansion in money income will stop short of this level, and there will be a surplus in the balance of payments on current account. If $\frac{x}{2}$ is spent on consumption goods, $\frac{x}{4}$ on imports and $\frac{x}{4}$ is saved, the following result emerges:
>
> Increase of national income $= 2x$
> Increase of expenditure on domestic goods $= x$
> Increase of expenditure on imports $= \frac{x}{2}$
> Increase of saving $= \frac{x}{2}$

Since exports have increased by x while imports have increased by only $\frac{x}{2}$ there will be a surplus on current account equal to $\frac{x}{2}$. In the absence of capital movements, this surplus will appear in the first instance as an increase in the foreign assets of the local banking system matched by an increase in its domestic deposits. To the extent that the banks turn over their foreign assets to the Currency Board, or import specie, the currency circulation will increase by a like amount. In the case of a decline in exports exactly the opposite train of events will occur. Incomes fall by $2x$, and imports by $\frac{x}{2}$ and there will be a balance-of-payments deficit equal to $\frac{x}{2}$ which will lead to a decline in bank deposits, or currency, or both. If accommodating capital movements take place, the decline in the total money supply will be re-

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duced. The precise effect of a rise or fall in exports on the amount of currency in circulation is thus seen to depend on the reaction of the banking system to a change in the size of its foreign assets. The 'income theory' of adjustment provides an explanation of changes in the value of imports and of changes in the money supply. According to this theory, changes in the money supply are a result of variations in export values and not a cause of them.

During a period of boom, when the value of exports is rising from year to year, this process leads to a lag of imports behind exports, a favourable balance of trade and an increase in the money supply. Similarly, a period of falling export prices causes an adverse balance of payments and a decline in the money supply. Thus during the five years 1923 to 1927 exports exceeded imports by a total of Rs. 435·96 million, while the currency circulation increased by Rs. 23·82 million. It follows that this net surplus must have been matched by an increase in some or all of the debit items in the balance of payments—that is, in invisible imports, remittance of interest and dividends abroad or an increase in the foreign assets of the banking system (accommodating capital movements). Similarly, during the downswing from 1920 to 1933, the cumulative trade deficit was Rs. 41·31 million and the decline in the currency circulation was Rs. 5·58 million, the balance being offset by an equal and opposite change in the total of other items in the international accounts. From our analysis so far the conclusion emerges that changes in the currency circulation, as well as changes in the volume of bank deposits, both depend on the balance of payments and the behaviour of the banking system. Further analysis of this problem, therefore, must await the discussion of the structure of the banking system which is undertaken in the next chapter.

Before concluding our discussion of the manner in which fluctuations in the balance of payments were adjusted, reference must be made to a most striking aspect of the whole process. During the depression of the thirties many countries, especially those highly dependent on raw material exports, were faced with exchange problems. And many of them had to resort to expedients such as exchange depreciation, exchange control, import restrictions and default on their foreign

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obligations.[36] The reasons for the absence of exchange difficulties in Ceylon lay partly in the nature of her monetary system and partly in the structure of her balance of payments. Under the Currency Board system the note issue was backed entirely by foreign assets and there was no danger of the inconvertibility of the currency. The monetary authority could always supply sterling or Indian currency in exchange for its notes. At the same time, since a large proportion of their deposits was created in the process of acquiring foreign assets, these same assets were available in the event of a balance-of-payments deficit.[37] Secondly, unlike in the case of most countries which were faced with such problems, equilibrium in Ceylon's balance of payments was not dependent on a large import of long-term capital. The cessation of overseas lending by the capital exporting countries, therefore, hardly affected her balance of payments. Although the real burden of interest payments on her sterling debt was increased by the adverse movements in her terms of trade, its transfer abroad presented no serious difficulty as it constituted only a small proportion of her total of foreign receipts.[38]

[36] For an account of foreign exchange problems during the inter-war years, cf.: League of Nations: International Currency Experience, 1944; M. Gilbert: *Currency Depreciation and Monetary Policy*, 1939; P. T. Ellsworth: *Chile, an Economy in Transition*, 1945.

[37] Cf. Chap. VIII.

[38] For example, in the financial year 1931–32 the interest payments on the sterling debt were Rs. 10 million. Exports in that year amounted to Rs. 232 million.

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CHAPTER VIII

THE INTER-WAR YEARS: THE BANKING SYSTEM

For Eastern exchange banking as a whole the inter-war period was a troublesome one. The major unsettling influence in the earlier years was the instability of the Indian exchanges which, together with the lack of adequate cover facilities, made the banks reluctant to employ their funds fully in the discounting of sterling bills both in India and in Ceylon.[1] When at length the rupee–sterling rate was stabilized in 1926 at 1s. 6d. sterling to the rupee, instability was replaced by uncertainty owing to the persistent demand for a lower rate by a wide and influential section of Indian businessmen, politicians and economists.[2]

The increasing competition for exchange banking business during these years did nothing to improve matters from the point of view of the banks themselves. Competition was intensified both by the rise of new banks and by the entry of two of the British 'Big Five' banks into a field which had hitherto been the special preserve of the Eastern exchange banks. In 1923 Lloyds Bank entered India through its purchase of the private banking business of Cox and Company, while the National Provincial acquired Grindlay and Company, a firm of army agents, in the following year. The British commercial banks, with their wide network of branches throughout the United Kingdom, were able to compete very effectively for the import

[1] Cf. Chap. IX.

[2] This was the famous 'ratio' controversy. Cf. the Minority Report of Royal Commission on Indian Currency and Finance, 1926. The effects of the uncertainty regarding the exchange value of the rupee was frequently referred to by the chairmen of the exchange banks. For example, the chairman of the National Bank of India remarked in 1927, 'No doubt the uncertainty regarding the future of the rupee exchange made banks reluctant to employ London funds in India in order to relieve the stringency in the money market there' (Report of the Annual General Meeting 1925 in *Bankers' Magazine*, 1925, p. 782). In the same year the chairman of the Chartered Bank said, 'The uncertainty as to the fixed ratio of the rupee resulted in trade bills being held back, and this caused unemployment of funds laid down by banks to meet ordinary trade requirements' (*ibid.*, p. 784).

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bills arising out of the Indian trade which formed an important part of the business of the exchange banks.[3]

After 1925 Eastern trade began to experience what one bank chairman described as 'a want of real vitality and push'.[4] Intense competition for a declining volume of business whittled down exchange margins to an extremely fine point, 'differences in exchange being now reckoned in 64ths or even worse as compared with the fair and reasonable differences which prevailed in happier days'.[5] After the banks had weathered the depression of the thirties, a new and formidable competitor appeared in the form of the Imperial Bank of India, divested of the restrictions on its foreign exchange operations after the establishment of the Reserve Bank of India in 1935.

Of the new exchange banks the most important was the Eastern Bank whose branch in Colombo was opened in 1920. Its appearance coincided with a considerable narrowing of exchange margins in Colombo and was no doubt partly responsible for it.[6] The P. & O. Banking Corporation was the only other new exchange bank to open an office in Colombo during this period. In 1927 the Chartered Bank acquired three-quarters of the shares of this institution. The absorption was completed in 1938 and its business was merged completely with that of the parent bank in that year. A number of Indian banks opened offices in Colombo during the thirties. The Indian Bank came in 1932, the City Bank in 1934, the Travancore National and Quilon Bank in 1936, and the Oriental Bank and the Nadar Bank in 1937. Of these, only the Indian Bank remained in 1939.

The Bank of Colombo

The first major indigenous bank in Ceylon, the Bank of Colombo, commenced business on 8 January 1917. It was

[3] Cf. Sir Compton Mackenzie: *Realms of Silver; One Hundred Years of Banking in the East*, 1954, p. 260.

[4] Chairman's speech at annual general meeting of Chartered Bank, 1928: *Bankers' Magazine*, March 1928.

[5] *Ibid.*

[6] Cf. T. L. Villiers: *Mercantile Lore*, 1940, p. 25: 'The advent of the Eastern Bank revolutionized the existing methods of exchange banking in Colombo, where for many years, owing to an agreement or understanding amongst the exchange banks, little competition existed in rates, the margin between buying and selling being very wide and providing a very handsome profit. . . . A difference of $\frac{3}{4}$ on simultaneous transactions between 3-months paper and the banks T.T. rate being usual as against the pre-competition days at $1\frac{1}{2}$d and 2d.'

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established under the provisions of Ordinance No. 2 of 1897 (The Ceylon Banking Companies Ordinance) with an authorized capital of Rs. 2 million of which Rs. 500,000 was paid up. Shares were not offered for public subscription, but it was arranged to have them taken up privately. There were ten original shareholders of the bank. The prime mover in this venture was a prominent businessman of Colombo, Mr. O. B. Wijesekera.

Although the paid-up capital was nominally Rs. 500,000, only Rs. 150,000 was actually available to the bank when it opened for business. The balance of Rs. 350,000 was received on the understanding that it would be re-lent to the subscribers against the security of their shares in the bank. After a somewhat chequered career the bank suspended payment on 8 June 1921. The reasons for the failure of the Bank of Colombo are not far to seek. It appeared on the scene at a time when the business of Eastern banking had become particularly difficult owing to the outbreak of the first world war. Confidence in small banking enterprises had been sapped by a wave of bank failures amongst indigenous banks in India. Nor did the manner in which the bank's capital was raised inspire public confidence. The Banking Ordinance expressly forbade the investment of any part of the funds of a bank in the purchase of its own shares. Yet the bulk of the bank's capital was locked up in advances to its shareholders against the security of its own shares.[7] Moreover, the bank was overstaffed and the staff was overpaid,[8] while none of the directors had any previous experience of banking.

It would have been remarkable if, with all the goodwill in the world, a bank started under such auspices had survived. The bank's resources were obviously inadequate either to compete with the powerful institutions already in the field or to tide over the initial period of stagnation which a new institution was bound to encounter.[9] At one stage the bank's total deposits amounted to Rs. 900,000. Of this Rs. 100,000 was held in

[7] Cf. S.P. 23 of 1934: Report of the Ceylon Banking Commission, Vol. II, Evidence of Mr. O. B. Wijesekera, general manager of the Bank.

[8] *Ibid.*, p. 390.

[9] *Ibid.* No government funds were deposited with the bank. A proposal to do so was vetoed by the Legislative Council in June 1921 shortly before the bank's suspension.

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cash, Rs. 200,000 had been lent to the public, while Rs. 600,000 had been borrowed by the shareholders.

In addition, the bank was involved in an unsavoury business over the proceeds of a sweep ticket and its appears also to have suffered through malicious propaganda in a local newspaper. It is significant that neither the commencement of the bank nor its suspension received more than a bare mention in the local press.

In sum, inadequate capital, bad management, and hostile propaganda, any one of which could be damaging enough in itself, may be said to have been responsible for the bank's failure. However, the Bank of Colombo apparently tried to fill an important gap in the credit structure of the country. According to its founder the 'chief object in starting the bank was to provide credit facilities for Ceylonese'.[10] It was unfortunate that the Ceylonese were confined to the shareholders.

The Banking System

During nearly the whole of the inter-war period the banking system of the island consisted of the branches of about ten banks, all of which had their head offices abroad. The banks may be divided into three groups: (i) the exchange banks, (ii) the Indian joint stock banks, and (iii) the Imperial Bank of India which, owing to its size and importance, it is convenient to discuss separately from the other Indian banks.

(i) The group of exchange banks consisted, first, of the Mercantile Bank of India, the Chartered Bank of India, Australia and China, the National Bank of India, and the Hong Kong and Shanghai Banking Corporation. All of them had opened offices in Ceylon in the nineteenth century. All except the last were incorporated in London and had their head offices there. The Hong Kong and Shanghai Banking Corporation was incorporated by Ordinance of the Legislative Council of Hong Kong. But the difference is only superficial, since the bulk of its shares were held by residents in the United Kingdom, as in the case of the other exchange banks. In addition, there were two newcomers, the Eastern Bank[11] and the P. & O. Banking Corporation. Messrs. Thomas Cook and Son

[10] Cf. S.P. 23 of 1934.
[11] The Eastern Bank is now a wholly owned subsidiary of the Chartered Bank.

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(Bankers) Ltd. and the American Express Company did a small volume of banking business, principally in connexion with tourist traffic. The Mercantile Bank had two branches, one in Kandy and one in Galle. The National Bank had branches in Kandy, Galle and Nuwara Eliya and the Hong Kong and Shanghai Corporation one in Galle.

Of the six banks, five may be called 'Anglo-Indian' or Eastern banks. The Mercantile, the National, the Eastern and the P. & O. Bank had the bulk of their business in the East, especially in India and Ceylon. The Hong Kong and Shanghai Bank had a larger volume of Far Eastern business, while the interests of the Chartered Bank were about equally divided between the East and the Far Eastern and 'South East Asian' countries.

(ii) The three Indian banks were branches of banks with their head offices in South India—the Indian Bank, the Calicut Bank, and the Bank of Chettinad. Their business was mainly with the Indian community in the island and was largely connected with the trade between South India and Ceylon.

(iii) In 1921 the business of the branch of the Bank of Madras in Colombo was transferred to the Imperial Bank of India, which was formed by the amalgamation of the three Presidency Banks. The bank's activities were governed by the Imperial Bank of India Act of 1920. The Act imposed several restrictions on the kind of business the bank could undertake. In order to eliminate the risks arising out of exchange fluctuations, it was not allowed to buy bills payable out of India. Under the Act it could not lend against the security of its own shares or against immovable property as primary security; nor could it make loans for periods longer than six months, or lend to any individual or firm at any one time an amount exceeding Rs. 2 million, except against certain specified securities. The business of the bank, therefore, was confined to the discount or collection of rupee bills arising out of the Indo-Ceylon trade and to short-term advances. Such advances were often made against promissory notes with two signatures with a mortgage over 'immovable property' as collateral security.[12]

[12] Cf. Report of the Ceylon Banking Commission, Vol. I, para. 121: S.P. 22 of 1934. In this way the bank overcame the statutory prohibition of loans against the primary security of immovable property.

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In an earlier discussion on the position of the Bank of Madras in the banking structure of the country it was seen how this bank played an important role both in the finance of trade between India and Ceylon and in 'offsetting' the island's normal trade surplus with the United Kingdom and the rest of the world against her invariable trade deficit with India. The practice had then developed for the exchange banks to deal with the Bank of Madras rather than with the Currency Commissioners whenever they wished to obtain or return currency notes. Like the Presidency banks in India, the Bank of Madras was the source of temporary accommodation for the rest of the banking system. It conducted the Bankers' Clearing House, and the other banks maintained balances with it for settling adverse balances at the clearing. These functions continued to be performed by the Imperial Bank of India.

The Business of the Banks

The attempt to describe the business of the banking system during this period is handicapped by the same absence of statistics which has prevailed since the beginnings of banking in Ceylon.[13] The published balance sheets of the exchange banks relate to their business in all the countries in which they operate, while those of the Indian banks and of the Imperial Bank of India included their business in Ceylon with their Indian business. It is, therefore, impossible for us to know either the volume of their business or the manner in which their assets in Ceylon were distributed. One has to confine oneself to a general and necessarily superficial account of their activities. The main source of information for the account which follows is the Report of the Ceylon Banking Commission and the evidence given before it. All the banks kept current accounts and accepted fixed deposits.[14] Interest at the rate of 2 per cent. used to be paid on current accounts provided the daily balance exceeded Rs. 100,000. Fixed deposits received from 2 per cent. to 4 per cent., depending on the period of the loan. During the depression and the ensuing period of 'cheap money',

[13] The government of Ceylon first began collecting banking statistics in 1939. Figures are available in greater detail after 1943. After the establishment of the Central Bank, monthly statistics began to be published in the Bank's *Bulletin*.

[14] The Eastern Bank and the P. & O. Bank also opened savings accounts on which interest was paid at the rate of 4 per cent. per annum.

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however, interest rates were reduced all round. The rate for fixed deposits varied between $\frac{1}{2}$ per cent. and $1\frac{1}{2}$ per cent., while current accounts earned $\frac{1}{2}$ to 1 per cent. on minimum monthly balances and later no interest at all. The government maintained accounts with all the exchange banks and with the Imperial Bank of India. The latter held the government's chief account.

The assets of the banks consisted of the following principal items:

1. Cash, bullion and money at call.
2. Investments and Treasury bills.
3. Bills of exchange.
4. Advances.

Bills of exchange and advances were the most profitable assets and the banks held as much of them as was available, consistent with their canons of liquidity. Hence the proportion of bills of exchange to the total deposits of a bank tended to increase during periods of active trade and to decline during a slump. The proportion of investments in government securities and Treasury bills changed in a compensatory manner, falling during a boom and rising during a slump.[15] The exchange banks looked upon the finance of exports and imports as their 'legitimate spheres' of activity.[16] Although in India the Imperial Bank's business was largely concerned with domestic trade and production, it cannot be said that in Ceylon its activities differed substantially from that of the exchange banks, except that it did not discount foreign bills of exchange. The proportion of its advances was probably somewhat higher than that of the exchange banks.

In order to describe the role of the banks in the finance of exports, it is necessary to refer briefly to the organization of the export trade during this period. Nearly 80 per cent. of the tea and about 45 to 50 per cent. of the rubber output of the island was produced by British-owned companies whose management had been entrusted to a small number of Agency Houses. Part of the output of these companies was shipped direct to London

[15] Until 1937 these investments consisted largely of Indian and British government securities.

[16] Chairman's speech at Annual General Meeting of the National Bank of India, 4 April 1933; *Bankers' Magazine*, May 1933.

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where it was offered for sale at the weekly auctions. In the case of such direct exports, where the head office of the estate company was in London, there was no necessity for equivalent remittances to be made to Ceylon and the transactions were conducted without the intervention of the banking system.

Direct shipments were most important in the tea trade, for Mincing Lane was the world's tea market. They were less important in the case of rubber, of which the United States was the principal importing country. They were almost insignificant in the case of coconut products, and of the other minor exports such as plumbago, cinnamon and cocoa.

There were organized markets in tea and rubber and auctions were held in Colombo under the supervision of the Ceylon Chamber of Commerce. The principal participants in the auctions were the brokers on the one hand and the shippers on the other. The brokers acted on behalf of the Agency Houses and other large producers. The shippers bought the produce at the auctions, usually on direct orders from overseas. They recouped themselves by drawing bills of exchange on the overseas buyers. These bills were negotiated with the exchange banks, the rate of discount being governed by rates ruling in London. Whenever the banks required a quick turnover of their resources they rediscounted the bills in the London market.

No regular sales of the other export commodities were held. Shippers usually bought the produce through a chain of middlemen or through the brokers. In the case of many commodities the final processing and packing was undertaken by them. As before, the banks financed the export of these commodities by discounting the bills of exchange drawn by the shippers.

The further details of the procedure involved in the finance of exports by the banks centre round the cardinal fact that the export trade of the island was the virtual monopoly of a few British and foreign firms. The bulk of the produce broking was in the hands of members of the Colombo Brokers' Association which consisted of six European firms. Although there were a few Ceylonese brokers outside this association the amount of business they handled was relatively small. Similarly, a few European firms, some of which had been established

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over a hundred years earlier, almost at the very beginning of the British plantations in Ceylon, were the principal shippers of export produce. The brokers, the shippers, as well as the exchange banks and the Imperial Bank of India, were members of the Ceylon Chamber of Commerce.

The fact that the various parties connected with the export trade were all members of a small, long established and closely knit community made for a large degree of informality in their business relationships. This informality is evident in the manner in which the banks bought the shippers' bills or extended credit to them. The banks often did not insist on confirmed letters of credit before purchasing bills, nor did they always require shipping documents to be attached to them. Even when such documents were taken they were released to the overseas importers on acceptance of the bills.

Apart from their purchase of bills, the banks financed the export trade through their loans, overdrafts and cash credits mainly to brokers and shippers. A seller, whether he was a producer himself or a middleman, required credit for working-capital purposes long before his goods were sold in the market. Short-term advances were often provided by the brokers or shippers, usually against some form of security. Such advances were deducted out of the sale proceeds of the goods. The brokers and shippers financed themselves by borrowing from the banks, often on their personal security and sometimes against the hypothecation of produce awaiting shipment or on the security of movable or immovable property, share certificates or other marketable assets.

The banks also allowed advances to exporters on trust receipts—that is, letters of lien over the produce purchased with the bank advances. The goods were to be held 'in trust,' by the exporters until the shipment was made. Shipping documents were then given to the banks to enable them to collect payment from the importers abroad. This method of lending, however, was not very common owing to certain defects in the law and was in any case exceptional as far as the European shippers were concerned.

Credit was required not only for the purchase and shipment of export commodities, but also for their production. To a large extent the working-capital requirements of the British-

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owned estates were provided primarily by the Agency Houses, who were kept in funds by the head offices of the estate companies in London. Further credit was readily available to them at the banks, often without any tangible security. In rare instances a loan would be secured by a mortgage over the estate. The large Ceylonese estates also enjoyed credit facilities from the banks, but the large number of small estates and smallholders had to rely primarily on the Chettiar money-lenders whose activities are referred to later in this chapter.

In contrast to the monopolistic organization of the export trade, the import business was handled by a large number of firms and individuals. In the nineteenth century and, to a lesser extent, right up to the early twenties, the Agency Houses and certain other European firms did the bulk of the wholesale business in piece goods, general merchandise, engineering materials, and other manufactured goods, most of which were indented for on behalf of Ceylonese and Indian traders on a commission basis. From the late twenties more and more of this business was undertaken directly by Indians and Ceylonese. The import of rice and other foodstuffs had all along been in the hands of Chettiar and other Indian traders. On the whole, the proportion of the import trade in the hands of Ceylonese was negligibly small, though increasing slowly over the years.

The banks opened letters of credit for importers and accepted bills on their behalf. Owing to the less compact organization of the import trade the availability of the banks' facilities varied considerably from one customer to another. For instance, in dealing with the old-established firms the banks seldom required any margin to be deposited against letters of credit, while a smaller firm would often be required to deposit as much as 50 per cent. of their value, or to secure them by the deposit of suitable security such as lien over the firm's stock in trade, or a mortgage over immovable property. When an importer in Ceylon was unknown to the overseas seller or his credit standing was not sufficiently high, bills of exchange were drawn on D/P terms and the bill of lading and other documents which entitled the importer to take delivery of the goods were released only on payment of the bill. In such cases, importers often secured bank credit by hypothecating the goods to a bank

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and signing a trust receipt, the loan being repaid after the goods were disposed of. Broadly speaking, bank lending was geared to trade rather than to production, and to foreign trade rather than to internal trade. The exchange banks were not generally interested in a loan unless it was likely to lead to an exchange transaction in the very near future. Except for credit extended to the larger estates either directly or through the Agency Houses, the banks lent primarily to importers and to the brokers and shippers in the export business. Thus the banks were prepared to lend to an exporter with a firm order, say, for coconut oil, in order to enable him to buy the produce in the market, but they seldom afforded similar facilities to the coconut miller who produced the oil. Similarly, the interest of the banks in financing imports ceased the moment the goods were received by the wholesalers. Very rarely did the several middlemen who intervened between the despatch of the commodities from the wholesaler's warehouses and its sale to the final consumer in the towns and villages, have access to bank credit. Once again Chettiars and other money-lenders had to provide the necessary finance.

Besides bills and short-term loans the banks' other assets in Ceylon consisted of inter-bank call loans and of deposits with the Imperial Bank of India. There was no market in short-term money. Not until 1937 were there securities of the government of Ceylon which the banks could invest in, for ever since the beginning of British rule in the island it had been the practice for the government to raise all its loans in the United Kingdom. The first rupee loan was issued in 1937 and the banks have since held perhaps the largest portion of the government's rupee debt.

Statistics of the banks' assets in Ceylon became available for the first time in 1939. These figures are set out in Table 34 together with the proportion of each type of asset to the total deposits in Ceylon.

The composition of the portfolios of the banking system is the best index of its contribution to the economic life of the country. Table 34 above shows that apart from the banks' cash balances only about 25 per cent. of their total deposits were invested in Ceylon, of which nearly 6 per cent. consisted of government securities; the proportion of domestic assests is, therefore, likely

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to have been below 25 per cent. before 1937. The rest of the deposits were invested in overseas assets, the bulk of them in India and in the United Kingdom.[17]

TABLE 34

DOMESTIC ASSETS OF THE BANKING SYSTEM
31 DECEMBER, 1939

	Rs. million	*Percentage of Total Deposits*
Ceylon Currency	9·183	5·6
Balances in Local Banks	5·710	3·5
Advances in Ceylon	29·333	18·0
Bills Discounted	2·026	1·2
Ceylon Governmental Securities	9·668	5·9
Other Local Investments	2·434	1·5
Total Deposits in Ceylon	162·828	—

Source: Government of Ceylon: Post-war Development Proposals, 1945.

Two explanations might be offered of the very high proportion of overseas assets in the portfolios of the banks. In the first place, the balance of payments of an export economy was likely to be subject to wide fluctuations. In times of bad trade, therefore, the banks were usually faced with a heavy demand for foreign exchange which they met by drawing on their overseas assets. In other words, a high proportion of overseas assets was equivalent to a high cash ratio, which in practice rendered the banking system invulnerable to exchange crises. A 75 per cent. reserve of foreign assets can hardly be justified on such grounds. It seems far from logical to hold large external reserves year in, year out, to guard against possible balance-of-payments difficulties, which when they did occur were never so serious as they were in the exceptional circumstances of the great depression. A central reserve of foreign exchange, preferably in the hands of a central bank, or a much smaller proportion of foreign assets, would have been adequate to tide over most periods of depression.[18] The more reasonable explanation seems to lie in the lending policies of the banks. In other words, it might be argued that there were no satisfactory outlets for the banks' funds in Ceylon. The most obvious instance of this deficiency is to be found in the absence of

[17] The banks probably invested the larger part of their 'surplus' Ceylon deposits in India. Such investment did not involve an exchange risk.
[18] Cf. Chap. VII.

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securities issued by the Ceylon government a circumstance which in the hundred years before 1937 must have been indirectly responsible for a considerable volume of capital exports from the island. A more important factor which restricted the volume of the banks' local assets, however, was the narrow segment of the economy to which they confined themselves—the finance of foreign trade. While such a policy involved little risk and good profits, it was not wholly in the interests of the domestic economy.

The Chettiars

Apart from their finance of foreign trade, perhaps the most important outlet for the banks' funds in Ceylon were the short-term loans that they made to the Chettiars. In the early years of the nineteenth century the Chettiars had been the main suppliers of money to the merchants of Colombo.[19] With the coming of the exchange banks and the Bank of Madras the Chettiars lost their dominant position and the European businessmen ceased to depend on them. Nevertheless, the Chettiars continued to be the main source of credit for Ceylonese agriculturists and businessmen.

The Natukottai Chettiars, to give them their full name, hailed from the South Indian district of Chettinad. For several centuries they had specialized in trade and money-lending and their activities had spread as far afield as Burma, Malaya and Indo-China. By the beginning of the nineteenth century they had become an important element in Ceylon's commercial life—especially in the import of rice from India and Burma. Until about the beginning of the present century their principal interest in Ceylon was in trade rather than in money-lending.[20]

In 1933 there were 556 Chettiar firms in the island of which 200 were in Colombo and its suburbs. According to the Natukottai Chettiars' Association there were '50 per cent. more' prior to the depression. Most of these firms had their 'supreme head offices' in India and were branches of firms with interests in other parts of Southern Asia. By the nineteen-twenties the

[19] Cf. Andree: "The Progress of Banking in Ceylon", A. M. Ferguson's *Ceylon Directory 1876–78*.
[20] Ceylon Banking Commission, Vol. II, p. 488: S.P. 23 of 1934.

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main business of the Chettiars was money-lending and pawn-broking, but most of them carried on business as importers, piece-goods merchants and estate suppliers, or even retailers and grocers. Amongst the banks and European commercial circles the Chettiars enjoyed a high reputation for honesty and integrity.[21]

The Chettiars' capital consisted of their own funds, of loans from 'friends and relations' in India, and of short-term loans from the banks. Each Chettiar firm had a 'credit limit' with one or more of the banks, and the Chettiars were never known to default on their obligations. Prompt repayment of bank loans was facilitated by the practice of the Chettiars of providing one another with temporary loans. The banks advanced to the Chettiars on promissory notes with two signatures. No security was demanded; but the loans had to be guaranteed by the banks' *shroff*.[22] The loans were usually for one or two months but were normally renewable. The rate of interest was 'the Chetty rate', 2 to 3 per cent. above the Imperial Bank's rate for loans against government securities. The bulk of the 'Chetty loans' was provided by the Imperial Bank, which was in many respects best qualified to undertake such business. Many of the Chettiar firms had their head offices in South India. The bank's Madras office, because of its close contact with the indigenous sector of the money market, was able to form an overall estimate of the credit worthiness of a particular firm. Moreover, owing to the statutory prohibition on the purchase of foreign bills, the bank had considerable funds available for investment in local advances. It has been estimated that prior to the depression the Imperial Bank had invested about Rs. 15 million in advances to Chettiars, while the exchange banks had lent them at least a million rupees each.[23]

For most Ceylonese the Chettiars were the only source of credit, whether on long term or short term. They made loans for the purchase and development of estates as well as for trade, production and consumption. Since the availability of bank credit was restricted and there were no other credit institutions,

[21] Ceylon Banking Commission Report, Vol. II: Minutes of Evidence, p. 488: S.P. 23 of 1934.

[22] Report of the Ceylon Banking Commission, para. 112. S.P. 22 of 1934.

[23] Ceylon Banking Commission Report, Vol. II. Memoranda and Evidence, p. 316: Evidence of Mr. J. Tyagaraja.

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it must be recognized that whatever Ceylonese enterprise existed was largely indebted to the assistance provided by the Chettiars. Ceylonese exporters and importers, retailers and small 'boutique-keepers', estate-owners, coconut-millers and arrack-renters, all of them at one time or another had to obtain accommodation from the Chettiars. The Chettiars were in fact responsible for the thin trickle of credit which found its way to internal trade and production. They lent on mortgages over land and buildings, on promissory notes, with or without other security, and sometimes on post-dated cheques. With regard to the part they played in financing indigenous trade and agriculture, there is no reason to dispute the following claims in the Memorandum of the Natukottai Chettiars' Association to the Ceylon Banking Commission:

> 'With the exception of a few Ceylonese who had facilities for obtaining credit from the local banks the bulk of the Ceylonese had to resort to the Chettiar money-lender in order to be financed in their various undertakings. The Chettiar went forward boldly to the rescue of Ceylonese applicants for loans of money. He lent both on mortgages as well as otherwise. In view of the admitted fact that the law of title to land in Ceylon is highly complicated, it is really commendable that the Chettiars invested so freely in the mortgage of Ceylon lands. Large acreages of Ceylon jungle and waste land have been opened up and cultivated with coconut with the aid of money borrowed from the Chettiar community. Several industrial and commercial undertakings have been freely financed by them and the petty trader and retailer had to depend entirely upon the Chettiar for financial assistance. A noteworthy feature of all these transactions is that money became available to the Ceylonese borrower at a moment's notice in any part of the day or night, without his being obliged to go through the formalities which a borrower had to experience elsewhere.'[24]

In fact, the Chettiars went forward 'too boldly'. Their main fault was their very liberality with credit, irrespective of the purpose for which accommodation was required or the ability of the borrower to repay the loan. Their favourite form of investment was in mortgages over land and house property. Titles to land were notoriously defective. Yet they did not hesitate to take second or even third mortgages over land. If

[24] Ceylon Banking Commission Report, Vol. II, p. 67.

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the Chettiar was ready to accommodate the genuine business-man, he was also ready to accommodate the speculator and the spendthrift. He lent as readily to the exporter of desiccated coconut as to the impecunious land owner trying to raise a dowry for his daughter. When the commercial banks left the task of financing Ceylonese business to the Chettiars, they were unwittingly encouraging the growth of an unsound credit structure.

Witnesses before the Ceylon Banking Commission differed in their evidence regarding the rates of interest charged by the Chettiars. The figure varied from 10 per cent. to 200 per cent. and some witnesses were loud in their condemnation of the Chettiars, whom they described as 'Shylocks' and 'blood-suckers'. The range of interest rates was not entirely a wild exaggeration, although the Chettiars themselves claimed that their average rate was about 13½ per cent.;[25] for the Chettiars' rates varied from borrower to borrower. The Chettiars were loath to refuse an application for credit however unsound it was. Instead—and this was the least satisfactory part of their business—they sought to protect themselves by extracting a rate of interest which their harassed customer could not reasonably be expected to pay. Nor is there reason to reject entirely the allegation often made that some of them resorted to dubious practices and charged usurious rates. For instance, the Charity Commissioner of the Colombo Municipal Council, in his Administration Report for 1934, remarked that 'hundreds of independent testimonies are to hand to substantiate the fact that his [the Chettiar's] notes are invariably made out for much larger sums than actually paid out by him'. He quotes a case 'which he is able to vouch for personally' where Rs. 540 was deducted beforehand, as interest, from a loan of Rs. 1500—that is, at the rate of 36 per cent. per annum. But only the legal rate of interest of 18 per cent, was marked on the note. In the meantime, the principal was being liquidated in monthly instalments so that the effective rate of interest was much over 36 per cent. In fact, the practice of collecting a loan in monthly, weekly, or even daily instalments appears to have been a common practice. All the time interest was charged on the full amount of the loan. The most glaring defect in the organiza-

[25] Evidence of Ceylon Natukottai Chettiars' Association: *loc. cit.*

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tion of credit was that its availability and its price were unrelated to the needs of the borrowers or to the returns which such credit could yield. During the boom years of the twenties the machinery worked all right, but the first signs of depression exposed its utter weakness.

The Chettiars were not mere intermediaries between the banks and Ceylonese borrowers. The Memorandum of the Natukottai Chettiars' Association submitted to the Banking Commission shows that the bulk of their capital consisted of their own funds or of loans from 'friends and relations' in India. In the pre-depression year 1925 their capital was composed roughly as follows:

Own capital	Rs. 85 million
Loans from friends and relations	Rs. 40 million
Short-term loans from the banks	Rs. 25 million
Total	Rs. 150 million

By 1934, however, their capital had been reduced to Rs. 100 million, of which Rs. 46 million consisted of investments in 'business and properties', and Rs. 54 million of investments in pawnbroking loans, mortgages, and short-term advances on promissory notes. About Rs. 26 million of their own capital had been withdrawn and remitted to India and Rs. 24 million in bank loans had been repaid.

The fall in the Chettiars' assets was part of the general contraction of credit after 1925. From about the middle of that year the banks adopted a more restrictive credit policy. In June a leading Chettiar firm [26] collapsed, dragging down several smaller ones with it, and the banks' accommodation to the Chettiars thereafter was considerably reduced. By the beginning of 1934 there were hardly any 'Chetty loans' outstanding. The Chettiars, for their part, faced with the restrictive policy of the banks on the one hand, and the depreciation of the 'properties' against which they had advanced on the other, began to call in their loans and foreclose on their mortgages, reducing many Ceylonese businessmen and agriculturalists to bankruptcy.

[26] The Chettiar firm of A.R.S.R.M. (It was usual for a firm to be known by the initials of its partners.)

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Nevertheless, the almost complete disappearance of Chettiar banking during and after the depression left a void in the credit structure of the country. It heightened the demand for a national bank which could meet the credit needs of the Ceylonese. It was this demand which led to the appointment of the Ceylon Banking Commission in 1934. The remainder of this chapter is concerned with its Report and the evidence given before the Commission. It also deals with the establishment of the Bank of Ceylon which was the direct result of the Commission's recommendations.

The Ceylon Banking Commission

At a certain stage in the history of every colonial country there grows up an indigenous capitalist class increasingly anxious not only to take over political responsibility, but also to play a larger role in the economic life of the country. In Ceylon that stage came soon after the first great war. In the political field it was marked by constitutional changes of a far-reaching nature culminating in the Donoughmore Constitution of 1931 which handed over to a Ceylonese Board of Ministers a considerable measure of control over the country's internal administration.

Corresponding ambitions in the economic field, however, were faced with numerous difficulties. Of these not the least important was the absence or insufficiency of financial institutions capable of furthering the process of economic development by a class of native capitalists. As early as 1920 attention had been focused on the inadequacy of credit facilities for agriculture and a committee had been appointed to examine the problem.[27] The cry for greater credit facilities for Ceylonese receded during the boom years of the twenties, only to emerge even louder than before during and after the great depression.

The depression brought home forcibly the danger of the country's dependence on her export industries and heightened the desire to diversify her economy. In the field of long-term credit, the State Mortgage Bank was established in 1934 for the purpose of providing credit for agriculture.

In April 1934, as a result of a motion passed in the State Council of Ceylon, a Commission under the chairmanship of the

[27] S.P. 8 of 1920: Report on State Banks for Agriculturists.

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well-known Indian banker Sir Sorabji Pochkhanawala was appointed

> 'to inquire into and report upon the existing conditions of banking and credit, and to consider the steps, if any, that are feasible and desirable in respect of the provision of banking and credit facilities for (*a*) agriculture, (*b*) industry, (*c*) trade; and also to make recommendations regarding the desirability of establishing a state-aided bank and sound local banks.'

The Commission's Report and Minutes of Evidence were published in December 1934.

The Report of the Ceylon Banking Commission is an invaluable document. It embodies an exhaustive analysis of every aspect of credit in Ceylon, ranging from the organized credit institutions such as the commercial banks and the State Mortgage Bank, to the Chettiars, pawnbrokers, 'boutique-keepers', and Afghan money-lenders who were the main suppliers of credit to the Ceylonese population. One of the major questions considered by the Commission was the role of the existing commercial banking system and it is with this question that we are primarily concerned.

We have already seen that the provision of short-term credit to foreign trade was the principal activity of the commercial banks. Nearly every Ceylonese witness who gave evidence before the Commission, however, complained that even in this sphere the resources of the banks were not freely available to them. Some went so far as to allege that the banks discriminated between their European and Ceylonese clients.[28]

The banks' own arrangements for dealings with their limited number of Ceylonese customers no doubt left room for such complaints. The exchange banks as well as the Imperial Bank of India are known to have operated two departments—one dealing with 'Europeans' and the other with non-European clients.[29] The latter department was under the immediate control of the bank's *shroff*, while the former was in charge of the manager or agent. Thus although in theory 'every bank manager can be approached directly by a client or by anyone who cares to see him either by interview or by

[28] Ceylon Banking Commission Report: Vol. I, para. 108.

[29] Ceylon Banking Commission Report: Vol. II, p. 317, Memorandum of J. Tyagaraja.

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correspondence',[30] in fact it was the usual practice for Ceylonese and Chetty business to be handled by the *shroff*. Since non-European business was invariably referred to the *shroff*, there was not much to be gained, in any case, by approaching the manager direct.

A bank *shroff* was a gentleman of some financial and social standing. His duties included the custody of the bank's cash. The bulk of the 'native' or non-European business had to be guaranteed or at least recommended by him.[31] For the responsibilities that the *shroff* assumed both as regards the cash department and the liability for the loans guaranteed by him, he was required to offer security to the bank in cash and in property. In return for his guarantee the *shroff* collected a commission both from his bank and from its customer. The bank usually paid him one-tenth of the interest received on a transaction while the commission paid by the customer varied. The intervention of the *shroff* thus raised the cost of credit to the borrower. The evidence is that the Ceylonese, like the Chettiars, had to pay the Chetty rate of interest, which was at least 2 per cent. higher than the normal rate at which credit was available to Europeans.[32]

The banks were no doubt justified in employing someone capable of reporting on the credit-worthiness of their clients. But the system lent itself to several abuses. The customer depended on the goodwill of the *shroff* who was able to pick the bank's customers according to the commission they were prepared to pay. He could often be tempted to recommend an unsound proposal while turning down a deserving one, purely for reasons of personal gain. The *shroff's* commission was an unwarranted, if not illegitimate, levy which should never have been imposed on the banks' borrowers. The *shroff* perhaps relieved the European bank manager of the nuisance of handling non-European business. But the existence of such an intermediary had the unfortunate effect of isolating the foreign banking system from the Ceylonese business-

[30] Ceylon Banking Commission Report: Vol. II, p. 317, Memorandum of J. Tyagaraja.

[31] The *shroff's* guarantee was given by his initialling the relevant page of the bank's ledger in the case of an overdraft or the promissory note in the case of an advance.

[32] *Ibid.*, p. 327: Evidence of Mr. R. Sri. Pathmanathan on behalf of the Low-Country Products Association.

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men. It made it impossible for the banks ever to develop an intimate banker–customer relationship between themselves and the Ceylonese which would have dispelled some of their innate doubts regarding the credit-worthiness of Ceylonese clients and widened the scope for the banks' activities, and thus increased their general usefulness. As it happened, it is no exaggeration to say that the banks were as foreign (in every sense of the word) to the island in 1934 as they were, say, sixty years earlier.

The allegation of discrimination by the banks on purely racial grounds seems unjustified if only for the reason that the banks had several Ceylonese customers who had access to bank credit on the same terms as Europeans. Moreover, a bank, like any other profit-seeking institution, might be presumed to have been willing to take up any sound business proposition. Although deliberate racial discrimination was unlikely, there was, in fact, inequality of treatment. The most obvious evidence of it was the *shroff* system itself. At bottom this inequality was the result of historical factors. As we have seen, for over a century the island's industry and trade had been dominated by British capital. British firms and individuals had easy access to credit because their connexions with the banking system were intimate and longstanding. Ceylonese, on the other hand, were newcomers and, in the eyes of the banks, 'small men', often with little capital of their own.[33] Their credit standing, therefore, was relatively low. 'Small men' and newcomers. irrespective of race, invariably experienced difficulty in obtaining credit. In other words, indigenous capitalism was still weak and immature. There were very few firms organized as joint stock companies or partnerships. The banks often had difficulty in ascertaining the financial standing of Ceylonese customers, as few of them possessed audited balance-sheets or books of accounts.

Historically, as John Stuart Mill observed, the colonies were not 'countries with a productive capital of their own, . . . [but places] where England finds it convenient to carry on the production of sugar, coffee, and a few other tropical commodities.'[34] England found it convenient to produce coffee, and

[33] Ceylon Banking Commission Report: Vol. II, p. 433: Q. 'Do you discriminate on making advances on shipping then?'; *Answer:* 'No, a small man will have some difficulty.' (Evidence on behalf of Colombo Exchange Banks' Association.)

[34] J. S. Mill: *Principles of Political Economy*, Ashley ed., 1909, pp. 635–6.

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later tea and rubber, in Ceylon. The banks were established to meet the demand for credit and remittance facilities which that system of production created. In other words, the banking system was essentially an adjunct of the process of investment of British capital in the colony. On the whole it proved incapable of adjusting itself to the additional demands made upon it.

The deficiencies of the legal system as it applied to credit agencies, which the banks complained of, is merely one more instance of the alien environment in which the banks had to operate.[35] Their traditions and practices were necessarily attuned to the English Commercial Law, whereas Ceylon's legal system was based primarily on the Roman-Dutch Law. The land law of the island was extremely complicated. Together with the absence of a system of primogeniture this gave rise to doubtful titles of possession and a system of joint ownership which made land unsuitable as security for bank loans. Similarly, according to the law in Ceylon a mortgagee could not take possession of mortgaged property without recourse to the Courts. The state of the law enabled a debtor to delay the issue of a decree by entering numerous frivolous pleas. Then again, the law relating to trust receipts and advances against lien upon produce was unsatisfactory from the lender's point of view. It does not seem likely, however, that the deficiencies of the law were an important factor in restricting the flow of bank credit. The banks were unconcerned about the legal position until the nineteen-twenties. If the state of the law had in fact hampered their activities, it is reasonable to assume that some attempt would have been made to have the law revised. The fact was that the banks preferred to specialize in the finance of foreign trade. For years this sector of the economy had been in the hands of Europeans. When Ceylonese businessmen entered this field, the conservatism of the bankers made them reluctant to cater for this new source of demand.

The failure of foreign banks to integrate themselves fully with the internal economy has been a common phenomenon in countries which have been the field of capital investment by

[35] For an account of the deficiencies in the legal machinery, cf. Ceylon Banking Commission Report: Vol. I, Ch. IX; also 'Second Interim Report of the Commission to Inquire into the Law relating to Mortgage, Credit Facilities and the Protection of Lands of Agriculturists'. S.P. 5 of 1945.

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overseas countries. The problem arises especially in those areas where foreign capitalism has been superimposed over an indigenous pre-capitalist economy.[36] Almost identical complaints regarding the exchange banks were made before the Indian Central Banking Inquiry Committee of 1931.[37] It remains the fundamental banking problem in most colonial areas and underdeveloped territories.[38]

The virtual isolation of the banking system from the indigenous economy had the effect of making credit almost unobtainable by the bulk of the Ceylonese except at prohibitive rates of interest. The Chettiars were able to borrow at an average of 8 per cent. from the banks and lend at rates varying from 13 per cent. to over 100 per cent. The rural sector of the economy, which contained the bulk of the indigenous population, was completely outside the pale of the banking system and had to rely on Chettiars, native money-lenders and 'boutique-keepers' who charged exorbitant rates of interest. Small village agriculturists were perpetually in debt to the 'boutique-keepers' to whom they were often compelled to sell their crop in advance. The more helpless and poverty-stricken the borrower, the higher the rate of interest he had to pay. The existence of such a system of credit side by side with a modern banking system was merely a counterpart of the lop-sided economic development of the country.

The Proposal for a State-aided Bank

The inquiry of the Banking Commission showed conclusively that there were serious deficiencies in the structure of credit in the island. The absence of indigenous commercial banks to cater for the special demands of Ceylonese entrepreneurs and businessmen was perhaps the most obvious of them. The Commission felt that no country of the size and importance of Ceylon should be without a bank of its own. Nearly every witness who appeared before it endorsed the proposal for a state-aided bank. The only opposition to it came from the

[36] Thus the problem arose in India, Ceylon and many of the British colonies, but not in Australia and New Zealand, where the indigenous economy did not survive the introduction of capitalist economy.

[37] Indian Central Banking Inquiry Committee, 1931: Majority Report, paras. 436–46.

[38] For an account of the position in the British African colonies, cf. W. T. Newlyn and D. C. Rowan: *Money and Banking in British Colonial Africa*, 1954.

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Ceylon Chamber of Commerce, while the bankers themselves were not convinced of the need for an additional bank sponsored by the government; in their view the existing banks were capable of meeting all legitimate demands for credit.[39]

The Chamber of Commerce felt that the scope for the operations of a national bank 'would be extremely limited and insufficient to justify its existence'.[40] Apart from their objection to 'state intervention', they advanced the astounding proposition that

> 'the establishment of any institution which has as a primary object the lending of money is psychologically and fundamentally undesirable in any country in which debt does not appear to cause a certain section of the people any embarrassment or even a sense of obligation'.[41]

The absurdity of this statement calls for no comment. It would be difficult to find a more frivolous and irresponsible argument against the extension of banking facilities than that advanced by this body of responsible businessmen.

The overwhelming weight of evidence before the Commission was that 'the establishment of an indigenous bank with powerful resources at its back would place Ceylonese and non-Ceylonese borrowers on a footing of equal advantage'.[42] The narrow sector of the economy for which the existing banks avowedly catered, the conservatism and rigidity of their policies, and their inevitable isolation from the indigenous business community left ample scope for new banking institutions.

The Commission recommended a state-aided bank for several reasons. If the new bank was to compete effectively with the existing banks and offer comparable services, it was essential that it should be equipped with a large capital which it would have been impossible to raise entirely by public subscription; moreover, state participation would not only encourage the public to subscribe to its capital but also increase the public's confidence in the institution.

[39] Ceylon Banking Commission Report: Vol. II, p. 484. Evidence of Mr. Ian Stewart, Agent of the Imperial Bank of India: *Q.* 'Do you think there are enough banking facilities in the country?' Mr. Stewart: 'Yes'. Cf. also *ibid.*, p. 434: Evidence of Colombo Exchange Banks' Association.

[40] *Ibid.*, p. 58, Memorandum of Ceylon Chamber of Commerce.

[41] *Ibid.* [42] *Ibid.*, Vol. I, para. 279.

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The new bank was to be established in Colombo. For meeting the needs of other parts of the country, the Commission favoured a chain of local banks connected with the bank in Colombo, but with separate directorates. Such a structure, it was felt, would be able to cater more adequately for the varying requirements of different districts, rather than would a system of branch banks. However, it had no objection to the latter arrangement 'should local banks fall short of expectations'.[43] An extensive system of co-operative credit societies and of land mortgage banks, the latter affiliated to the State Mortgage Bank, was suggested for the purpose of supplying rural credit on long and short term.

The Commission drew up a constitution for the bank, enumerating also the types of business it could undertake. The authorized capital of the bank was to be Rs. 10 million divided into 80,000 cumulative preference shares of Rs. 100 each and 80,000 ordinary shares of Rs. 25 each. The preference shares were to be subscribed by the government. The powers and functions of the proposed bank differed in two important respects from those normally associated with British commercial banks. The bank was empowered to lend against 'immovable property', which was generally unacceptable as security to British commercial banks, whether at home or overseas.[44] More far-reaching in its implications was the recommendation that the bank should be allowed 'to underwrite, subscribe, and invest in shares of joint stock banks and other companies registered in Ceylon'.[45]

These departures from the canons of orthodoxy were designed to meet two very real problems. Admittedly, one of the factors inhibiting a wider diffusion of commercial bank credit was the scarcity of the conventional type of banking security. Goods in process of production, movable property, such as a firm's stock in trade, share certificates, insurance

[43] Ceylon Banking Commission Report: Vol. I, para. 362.

[44] The total amount lent against immovable property was not to exceed 25 per cent. of the paid-up capital and reserve of the bank. The advances were not to exceed 50 per cent. of the value of the security. Such advances could be made only if the yield of the property was equal to at least $1\frac{1}{2}$ times the interest on the proposed loan (*ibid.*, para. 351).

[45] *Ibid.*, para. 351; the maximum permissible was 50 per cent. of the subscribed capital of joint stock banks and 25 per cent. of the subscribed capital of other commercial and industrial institutions.

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policies, and government securities—all these types of security presupposed a minimum level of economic development. Since such assets were necessarily scarce in an underdeveloped economy it was logical that some attempt should be made to lend against the security of land. The problem in Ceylon was twofold. First, there was the problem of raising long-term capital for the further development of the economy along capitalist lines. Secondly, there was the subsidiary problem of providing short-term credit to existing enterprises and to new ones that might be established. In the absence of a developed economic structure, commercial banking in the orthodox British tradition was bound to be confined to a very small sector of the economy. The Banking Commission had grasped this essential fact. It therefore sought to make the new bank not merely a source of short-term commercial credit but also an instrument of capital development. This was the rationale of its proposal that the bank should invest in the shares of joint stock companies. The suggestion itself was by no means a novel one. Even in Britain in the early years of the Industrial Revolution the country banks had provided trade and industry with long-term funds. Historical factors rendered such assistance largely unnecessary in Britain. But in the nineteen-thirties there was a large section of informed opinion which favoured a closer connexion between British industry and British banking in order to meet the competition of continental industry.[46] On the continent itself, the banking system had in one way or another co-operated in the provision of long-term capital for industry.[47] In the context of her underdeveloped economy, some such co-operation between banking and industry seemed necessary in Ceylon. The power of the proposed bank to invest, within limits, in the shares of joint stock companies was obviously intended to overcome the absence of a market in long-term capital. The habit of investment in the shares of joint stock companies, as indeed joint stock companies themselves, had not developed amongst the Ceylon public. Since there existed neither an organized Stock Exchange nor

[46] A. T. K. Grant: *Study of the Capital Market in Post-war Britain*, 1937, pp. 183–9, and pp. 201–5; also Sir Henry Clay: "The Financing of Industrial Enterprise" (*Transactions of the Manchester Statistical Society*, 1931–32).

[47] Cf. P. B. Whale: "English and Continental Banking", *Journal of the Institute of Bankers*, June 1931.

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any other specialized institutions such as underwriters and issuing houses, the problem of raising capital for new business was a formidable one. In the past any Ceylonese venturing into business, whether into trade, agriculture, or industry, had to depend on his own resources or to borrow from a Chettiar or other money-lender.

On 14 March 1935, a motion was unanimously carried in the State Council of Ceylon, urging 'the immediate establishment, under the provisions of the Joint Stock Banking Ordinance of 1897, of a State-aided Bank in Ceylon, generally on the lines indicated in Chapter VI of the Report of the Banking Commission.'[48] A draft of the Memorandum and Articles of Association of the Bank of Ceylon, together with the Commission's Report, was sent to the Secretary of State for the Colonies in May of the same year. The proposals were referred by him to an expert committee of London bankers consisting of Sir John Caulcutt (Deputy Chairman of Barclays D., C. & O. Branch); Mr. R. A. Wilson (General Manager of Lloyds Bank), and Mr. Crawford Gordon (London Manager of the Canadian Bank of Commerce). The London committee expressed 'apprehension for the future of any deposit bank founded upon the conditions set out in the Report'.[49] Briefly, they objected to three provisions in the proposed constitution of the bank:

(*a*) The heavy initial proportion of its preferred capital.
(*b*) The proposal to advance money against the security of immovable property.
(*c*) The proposal to invest part of the bank's funds in the shares of joint stock companies.

These provisions, it was argued, 'were not sound from the point of view of well tried and accepted principles of banking'.[50]

The first objection, which related to the capital structure of the bank, was a narrowly technical one. The committee felt that with four-fifths of its capital in the form of preference shares, the bank would be tempted to engage in hazardous transactions in order to enhance its earnings. On the other

[48] Ceylon Hansard, 1935.
[49] S.P. 1 of 1937, p. 30: Correspondence relating to the Establishment of a State-aided Bank: Experts' Report dated 6 November 1935.
[50] *Ibid.*, p. 32.

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hand, should it elect to be cautious, it could very well damage its prestige by having to pass its preference dividend. Either course was equally undesirable. The objection was a sound one provided one granted the assumption that those in charge of the bank might mismanage its affairs. On the other hand, it is unlikely that failure to pay its preference dividend in the early years of its life would have had the dire results imagined by the committee. In any case, the structure of the bank's capital was a matter of detaïl which could have been settled once the decision to set up the bank had been made.

The second and third objections were more fundamental. As was to be expected from a group of bankers firmly wedded to the British tradition in commercial banking, the committee took the view that it was 'fundamentally unsound' for the bank to invest in the shares of joint stock companies. It was argued that a clear distinction should be drawn between deposit banking and investment banking. It was improper for an institution whose liabilities consisted of deposits withdrawable on demand to hold any portion of its resources immobilized in illiquid assets.

For the same reasons the committee frowned on the suggestion that the bank should lend against the security of immovable property. In an agricultural country land was likely to be the security most frequently offered, and the tendency would generally be towards the grant of long-term credits. Owing to the wide fluctuations in land values, such security would be most difficult to realize during a time of depression when the bank needed to increase its liquidity.

The Board of Ministers, though itself not convinced of the soundness of the views of the expert committee, were prepared to delete the offending provisions rather than abandon a project which had aroused a great deal of public enthusiasm. Accordingly, the Board submitted a modified draft to the Secretary of State which was again referred to the committee in London.[51]

While the committee had originally taken the position that they were unable to recommend the establishment of an institution whose powers and functions were inconsistent with 'well

[51] S.P. 1 of 1937, pp. 41–46: Board of Ministers' Memorandum on the proposed State-aided Bank.

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tried and accepted principles of banking', they now reported that they were 'not convinced that there is sufficient demand for a new deposit bank, confined in its scope to legitimate deposit banking functions, to enable it to operate on a profit-earning basis'.[52] They therefore opposed the scheme and recommended that it should, in any case, be deferred until the deficiencies in the commercial law referred to earlier had been remedied. It was suggested, however, that special institutions for the provision of agricultural and industrial credit might be established.[53] The London committee in effect rejected entirely the Report of the Banking Commission. It is not clear from the published correspondence why, if the committee was opposed to the establishment even of a deposit bank along conventional lines, it did not say so in the first instance. In the circumstances, the disquisition on the dangers of confusing deposit banking with investment financing seem somewhat beside the point.

The Bank of Ceylon

The Board of Ministers made a last and successful effort. In July 1937 the Financial Secretary, Mr. H. J. Huxham, and the Minister of Labour, Industry and Commerce, Mr. G. C. S. Corea, took advantage of their presence in London to broach the subject afresh with the Secretary of State. They were able to discuss the question with the London committee, which eventually agreed to recommend the setting up of an ordinary deposit bank.[54] The committee drafted the Memorandum and Articles of the Bank of Ceylon Limited, which were forwarded to the Governor by the Secretary of State in July 1937, with the intimation that the establishment of a bank along such lines would receive his sanction.

The new scheme retained the principle of substantial state participation in the bank's capital, which was to consist of 15,000 convertible preference shares of Rs. 100 each, bearing a non-cumulative dividend of 6 per cent., and of 60,000

[52] S.P. 1 of 1937, pp. 47–52: Report signed by Messrs. Caulcutt and Wilson, Mr. Gordon being no longer available.

[53] This suggestion was implemented in 1946 with the establishment of the Agricultural and Industrial Credit Corporation.

[54] S.P. 28 of 1937: Further Correspondence relating to a State-aided Bank, pp. 4–6.

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ordinary shares of the same face value. The preference shares were to be taken up by the government at a premium of 100 per cent. The amount of the premium was to be divided equally between a published reserve fund and an unpublished contingency fund.[55] In addition, the bank was to receive an outright gift of Rs. 275,000 to enable it to meet the initial expenses of formation and registration and an interest-free fixed deposit of Rs. 100,000 for each of the first five branches it might open in Ceylon, or alternatively an annual contribution of Rs. 3000 for ten years. As long as the government continued to hold at least one-quarter of the shares of the bank it could exercise a considerable influence on its policies. Of the six members of the board of directors, two were to be nominated by the governor. The Financial Secretary was to be an ex-officio member of the board, though without voting rights. The appointment of the general manager, assistant general manager, secretary and accountant of the bank, as well as the election of the chairman of the board of directors had to receive the governor's sanction.[56]

The kind of institution envisaged by the London committee was a far cry from the bold and unorthodox proposals of the Banking Commission. Not only was its business confined to that of an ordinary commercial bank, but its powers even in this field were limited by several restrictions written into the Ordinance establishing it. For example, as regards the advances policy of the bank, the committee insisted that the period of a loan should not exceed six months except in the case of seasonal loans, which might be allowed to run for twelve months. No loan exceeding Rs. 10,000 could be granted without security and no loans could be made against the primary security of 'fixed' or immovable property of any kind or nature whatsoever. There was no objection to such property being accepted as collateral security. Not more than 50 per cent. of the bank's deposits could be invested in advances. Similarly, no foreign exchange business other than in Indian currency was to be undertaken within the first three years of the bank's establishment. The only bills of exchange which the bank could hold were those which had been endorsed by the payee.

[55] S.P. 28 of 1937: pp. 7–33. [56] *Ibid.*, pp. 7–33.

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The draft proposals of the committee, with certain minor amendments, were embodied in Ordinance No. 53 of 1938. The face value of the preference shares as well as of the ordinary shares was reduced to Rs. 50 and the number of shares of each kind was doubled. Government control over the affairs of the bank was made contingent upon its holding one-fifth of the issued capital of the bank and not one-fourth as suggested by the committee. For otherwise government control would have lapsed when the whole of the authorized capital was issued and paid up, since the proportion of government capital would then have fallen below one-quarter. The authority to invite application and allot shares was given to the Minister for Labour, Industry, and Commerce in order 'to ensure that shares were not alloted to non-Ceylonese or to persons who might be interested in having the bank run on lines contrary to those intended'.[57] The bill was passed by the State Council in March 1938 and received the Royal Assent in November of the same year. The bank commenced business in August 1939. Within a month the Governor gave permission to the bank to undertake exchange dealings in sterling This power was of little use, however, since the Ordinance enabled the bank to hold only bills endorsed by the payee. Thus export bills had to be sent abroad for endorsement before the bank could discount them. This disability was removed by Ordinance No. 45 of 1939, which left the type of bill which was eligible for discount by the bank to the discretion of the board of directors.

The bank's deposits, which were Rs. 4·76 million at the end of September 1939, rose to Rs. 18·23 million in September of the following year. The composition of its assets on that date was as follows:

Cash	Rs. 4·928 million
Treasury Bills and Government Securities	Rs. 15·130 million
Advances, including Bills of Exchange	Rs. 1·060 million
Other Assets	Rs. 0·478 million

It is seen that the proportion of advances and bills of exchange in its portfolio was still negligible. The development and expansion of the Bank of Ceylon occurred during and after the second world war.

[57] Speech of the Financial Secretary in Debate on Bank of Ceylon Ordinance: Ceylon Hansard, 15 Feb. 1938, p. 469.

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CHAPTER IX

TOWARDS AN EXCHANGE STANDARD

The Money Supply

The behaviour of the currency supply during the inter-war years broadly conformed to the familiar pattern of expansion and contraction in sympathy with the fortunes of the export industries. Thus during the post-war boom the circulation rose from Rs. 37·3 million in May 1918 to Rs. 49·4 million in January 1920. In the ensuing depression it fell by stages to Rs. 39·2 million in April 1922. Then again, during the boom in the export industries which commenced in the latter half of 1923, the circulation reached a peak of Rs. 62·8 million in January 1927. Similarly, during the years of the great depression, the circulation declined precipitously, reaching a low level of Rs. 41·8 million in October 1931. In the wake of the recovery of the thirties it rose to Rs. 48·5 million in August 1938. In the following month there was a drop of Rs. 3 million in the circulation, which then remained around Rs. 45·2 million until September 1939, when the outbreak of the second world war led once more to several years of currency expansion.

In our earlier discussion of fluctuations in the amount of currency in circulation, the crucial role played by the banking system has been repeatedly stressed. It was suggested that an increase or decrease in the volume of currency represented merely one aspect of the adjustment of the banks' portfolios to changes in the demand for money. It was also suggested that a substantial part of a surplus or a deficit in the balance of payments on current account was likely to have been met by accommodating movements of capital by means of the banking system. A favourable balance on current account was largely adjusted by an increase in the banks' holdings of foreign assets. Changes in the currency reserve were a mere residual. In other words, the banks obtained more currency from the Currency Board when they had to finance an increase in the value of foreign trade. Similarly, they returned currency

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when it was redundant. Table 35 shows the average monthly currency circulation, the average monthly bank clearings and the value of total exports, during the inter-war years. As in earlier years, the three variables show the close correlation which our analysis leads us to expect.

The question arises, what influence did banking policy itself exercise on the total supply of money? When the country's foreign receipts exceed or fall short of its foreign disbursements there is obviously an equivalent increase or decrease in the

TABLE 35

CURRENCY CIRCULATION, BANK CLEARINGS AND EXPORT VALUES, 1919–1939

Year	*Value of Exports*	*Currency Circulation*	*Bank Clearings*
		Rs. million	
1919	367·05	39·20	69·73
1920	276·29	48·80	90·00
1921	256·60	46·34	77·37
1922	297·75	40·90	82·74
1923	351·03	40·07	100·00
1924	385·35	44·52	107·46
1925	492·45	50·56	114·87
1926	503·26	59·51	131·64
1927	447·74	62·56	132·48
1928	392·55	58·06	131·52
1929	407·37	57·35	129·43
1930	310·17	57·23	103·18
1931	215·30	45·40	75·32
1932	173·20	41·89	62·45
1933	200·19	42·01	59·36
1934	263·30	42·66	71·23
1935	253·11	44·14	71·17
1936	268·47	44·31	79·46
1937	330·55	46·70	89·93
1938	285·74	47·36	87·02
1939	328·56	47·70	98·97

Sources: Monthly Statements of the Commissioners of Currency; Ceylon Blue Books; Weekly Returns of Colombo Bankers' Clearing House.

amount of bank deposits on the one hand and the amount of the banks' foreign assets on the other. This may be called the 'primary change' in the money supply. At the same time there is likely to occur a 'secondary change' in bank deposits through an increase or decrease in the banks' domestic assets. How far, in other words, was this secondary change significant?

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To consider first a favourable balance of payments, the increase in the value of exports which normally gives rise to it requires an increased volume of bank credit. To this extent, a secondary increase is necessary, and the banks would be neglecting an essential function if they failed to meet such an increase in the demand for bank credit. If, however, owing to their increased liquidity they granted credit for speculative or other non-essential purposes, such action would be clearly inflationary. Similarly, if during a period of falling export prices the banks caused a secondary contraction of credit over and above that justified by the decline in export incomes, their action would have an independent deflationary effect. The absence of banking statistics precludes anything but mere conjecture in our attempt to understand the influence of banking policy on the money supply. However, since the banks' advances during these years were only a very small proportion of their total deposits, the secondary contraction is likely to have been quantitatively insignificant.[1]

The behaviour of the banks in the great depression merits further attention. The evidence is that in this episode the banks adopted a contractionary policy. It was seen in the last chapter how nearly Rs. 25 million lent by the Chettiars alone were called in by the banks. Many witnesses before the Banking Commission of 1934 testified to the banks' restrictive policy. The steep fall in the average of bank clearings between 1929 and 1933 reflects the contraction of bank credit which occurred in these years.

At the same time the banks themselves suffered from excess liquidity. As early as April 1927 the Imperial Bank of India referred to the dull trade conditions which brought about 'a glut of money in the market and rendered it extremely difficult for the bank to find remunerative employment for its resources'.[2] The same complaint was repeated in nearly every half-yearly report of the Imperial Bank from 1929 to 1933.[3] Similarly, at its annual general meeting in March 1930, the chairman of the Chartered Bank stated that 'in some cases funds which had been laid down for the financing of the export

[1] Cf. Chap. VIII.

[2] Report for half-year ending April 1927.

[3] Cf. Report for half-year ending April 1930: 'Government issue of Treasury bills assisted the bank in the employment of funds not required for trade finance.'

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trade have not been fully required'. In the same year the National Bank of India had assets consisting of cash, bullion, investments, and bills of exchange equal to £24·239 million, against deposit liabilities amounting to £31·467 million—'a position of liquidity that cannot be denied'.[4] The next year's report again referred to 'a very liquid position'. In 1932, having drawn attention to the liquid position of the bank, the chairman remarked, 'We would prefer less liquidity in the figures, which would indicate improved trade and the finance required for the same.'[5] Again, in 1933 he referred to 'the paucity of satisfactory outlets for the profitable investment of funds'.[6] The chairman of the Eastern Bank deplored the fact that 'the decreased export of commercial commodities' made 'money redundant in India'.[7] Although these remarks referred mainly to India, the position was identical in Ceylon. The decline of trade reduced the main outlets for the banks' funds—bills of exchange and credits for foreign trade. This was accompanied by a reduction in other domestic assets 'owing to the desire to safeguard capital pending the improvement in general world conditions.'[8] When the decline in the volume of foreign trade during the depression curtailed their main avenues of investment, the banks reacted by contracting their other domestic assets as well. In the final analysis, therefore, it was the specialization of the banks in the finance of foreign trade which was responsible for the contraction of credit during the great depression.

The Evolution of an Exchange Standard

Although, as in earlier years, the currency supply during the inter-war period was governed by conditions in the export industries, the mechanism of currency issue differed in an important respect from that which had prevailed up to 1914. The Currency Commissioners began increasingly to resort to the issue of notes against the tender of sterling or Indian exchange. Similarly, when currency notes were returned to them by the banking system they redeemed these notes in Indian or sterling exchange instead of in rupee coin.

[4] Chairman's speech at annual general meeting, April 1930.
[5] May 1932. [6] April 1933. [7] March 1933.
[8] Chairman's speech at annual general meeting of National Bank of India, April 1933.

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Until December 1916, the Currency Commissioners had dealt only in rupee coin or sovereigns. The amendment to the Currency Ordinance in 1917 permitted credits at the Bank of England to be reckoned as equivalent to gold coin. But the actual system of issue developed in a manner never contemplated either by the original Paper Currency Ordinance or by its several amendments.

The immediate cause of this new development was the abnormal monetary conditions in India soon after the first world war. The rise in the price of silver, together with large surpluses in Indian trade, led, as was seen in the last chapter, to an appreciation of the Indian exchanges. The rupee sterling rate rose by stages from 1s. $5\frac{31}{32}$d. in January 1919 to 2s. $10\frac{13}{16}$d. in February 1920. The banks were reluctant to invest their funds in sterling bills as the rising exchange rate would have involved them in heavy losses. In India, therefore, there was acute scarcity of money. From the banks' point of view their branches in Ceylon were on a par with their Indian branches, and the same considerations of a rising exchange and a shortage of cover were responsible for their unwillingness to discount sterling bills freely. The position was complicated by the ban on the export of rupee coin imposed by the government of India. In the circumstances, the power of the Currency Commissioners to issue notes against credits at the Bank of England was of little use. The problem of the exchange banks was not that of securing funds for the purchase of sterling bills but that of bringing back these funds to India and Ceylon without loss once they had been transferred abroad through the purchase of bills.

During the post-war boom there was an increasing demand for currency which the banks would normally have met by importing rupee coin from India. But between May 1918 and May 1919, when the post-war boom was at its height, the currency circulation remained roughly stable between Rs. 37·3 million and Rs. 37·5 million. The mechanism of currency issue had once again stalled.

In August 1919, the Currency Commissioners relieved the stringency by issuing Rs. 3 million in notes to the Bank of Madras in Colombo against Indian currency tendered in Madras. At the same time the government of India was per-

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suaded to permit the export to Ceylon of Rs. 3 million in silver rupees. In January 1920, the Bank of Madras obtained a further Rs. 3 millionsworth of notes by depositing its sterling equivalent in London.[9]

When the post-war boom petered out and export markets once again became stagnant the Currency Commissioners were faced with the opposite problem of redeeming the notes which were returned to them by the banks. The Currency Ordinance required that these notes should be redeemed in rupee coin or in sovereigns. But since the beginning of 1917 additions to the coin portion of the currency reserve had been negligible, while the bulk of the currency expansion had taken place against sterling or rupee credits. As a result the reserve of coin had fallen below the statutory level of 50 per cent. of the notes in circulation. For example, on 31 January 1920 the coin in the Currency Commissioner's vaults amounted to only Rs. 13·48 million, against a note circulation of Rs. 49·64 million—a ratio of just over 27 per cent. In addition, Rs. 7·85 million was held at call at L.C.W. and Parrs Bank in London. If this were regarded as equivalent to coin, the coin reserve would have amounted to about 43 per cent. In July and August 1920 the Commissioners redeemed a total of Rs. 2·71 millionsworth of currency notes in rupee coin. By July 1920 the coin reserve had fallen to Rs. 11·86 million and the Commissioners, for the first time since the introduction of the Paper Currency Ordinance in 1884, imported rupee coin on their own account. In that month half a million rupeesworth of Treasury bills held by the Currency Commissioners in London were discounted and the proceeds, together with the sum of Rs. 7·85 million which had been at call with L.C.W. and Parrs Bank since 1917, were remitted to Madras to be used for shipping rupees to Ceylon. As a result, in August 1920 the coin reserve stood at Rs. 16·33 million against a note circulation of Rs. 47·2 million—a ratio slightly above the minimum of one-third.

When, therefore, in April 1921, Rs. 2·46 million in notes were returned to the Currency Commissioners, they preferred to redeem these notes in Indian exchange, rather than reduce their stocks of coin any further. They realized Rs. 2·5

[9] B. W. Fernando: *Ceylon Currency, British Period*, 1939, pp. 41–42; and Monthly Statements of the Commissioners of Currency for 1919 and 1920.

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millionsworth of Indian six-months' Treasury bills in order to obtain the exchange. Notes were again redeemed in exchange in April of the following year and in the currency contraction in the years of the great depression. In September 1938, in the midst of the trade recession of that year, the notes were redeemed in sterling drafts. Table 36 below sets out the major instances of currency contraction during the inter-war years and the manner in which the currency was redeemed.

TABLE 36

REDEMPTION OF CURRENCY, 1920–1938

Month in Year	*Contraction in Circulation*	*How Redeemed* Rupee Coin	Indian Exchange	Sterling Exchange
		Rs. million		
July 1920	1·808	1·808		
April 1921	2·460		2·460	
April 1922	6·460			3·698
Feb. 1928	2·512	2·512		
March 1928	2·522	0·022	2·5	
Feb. 1931	5·30	1·5	3·8	
March 1931	5·7	3·7	2·0	
June 1931	1·897	0·897	1·0	
Sept. 1931	1·4	1·4		
Oct. 1931	0·606	0·606		
Sept. 1938	3·5		3·5	

Source: Monthly Statements of the Commissioners of Currency.

Issue of Notes against Exchange

In the early post-war years the Currency Commissioners had been compelled to issue notes against exchange because rupee coin was not available. Later, however, they preferred to accept exchange rather than coin from the banks, even though coin could be imported freely from India. Table 37 sets out the major increases in the note circulation during the period 1924 to 1926. Table 38 relates to the next period of currency expansion during the economic recovery of the thirties and the early years of the second world war.[10] In both tables the last column shows the percentage of the coin reserve.

After 1924 the issue of notes against exchange became the

[10] The figures relating to the two periods are set out separately for convenience of presentation. During the thirties small quantities of coin trickled in to the Board nearly every month. To have listed the increases in circulation so caused would have made the table unnecessarily cumbersome.

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normal method of currency expansion. Between 1924 and 1926 Rs. 12 million was issued against Indian or sterling exchange, while only about Rs. 3·5 million was issued against rupee coin. Similarly, in the period to which Table 37 relates, Rs. 26 million was issued against exchange, while the increment of coin was only Rs. 1·28 million.

TABLE 37

CURRENCY EXPANSION, 1924–1926

Month in Year	*Increase*	*Rupee Coin*	*Issued Against Indian Exchange*	*Sterling Exchange*	*Coin Reserve per cent.*
			Rs. million		
Oct. 1924	1·0		1·0		48
Sept. 1925	5·0		1·0	4·0	42
Oct. 1925	3·0			3·0	42
Dec. 1925	2·0			2·0	42
Aug. 1926	2·0	2·0			39
Sept. 1926	2·0			2·0	39
Nov. 1926	1·58	1·58			39

Source: Monthly Statements of the Commissioners of Currency.

TABLE 38

EXPANSION OF CURRENCY, FINANCIAL YEARS 1932–33 to 1939–40

Financial Year	*Net Increase in Circulation Rs.*	*Coin Rs.*	*Sterling Exchange Rs.*	*Indian Exchange Rs.*	*Coin Reserve at End of Financial Year per cent.*
1932–33	62,000	62,000	—	—	32·90
1933–34	1,054,000	54,000	1,000,000	—	32·29
1934–35	1,064,000	64,000	1,000,000	—	31·64
1935–36	1,188,000	188,000	—	—	31·94
1936–37	4,054,000	54,000	4,000,000	—	29·37
1938–39	4,080,000	80,000	—	4,000,000	29·45
1939–40	16,114,000	114,000	—	16,000,000	26·02

Source: Annual Reports of the Auditor-General.

From the above account of the manner in which currency was issued and redeemed it is clear that the entire system of note issue had almost imperceptibly been transformed. Certainly the officials at the Colonial Office and the Treasury, who in 1884 had drafted Ceylon's Paper Currency Ordinance with such punctilious attention to detail, would hardly have recognized the system of the late thirties as their own brain-child: over the years, several changes had taken place. For instance, the Commissioners now exercised much more discretion in the

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distribution of their investments, whereas before 1914 the investment portion of the currency reserve was about equally distributed between Indian Government securities on the one hand, and British and Colonial stock on the other. In later years the Commissioners freely transferred their funds from rupee to sterling stock, according to market conditions and exchange fluctuations. In the late thirties nearly the whole of the invested portion of the reserve was held in sterling securities.[11]

Secondly, the original ordinance had regarded a coin reserve of 50 per cent. of the note circulation as the normal ratio. But after 1917 the proportion of coin had been invariably below that level. It remained around 40 per cent. until the heavy currency contraction of the thirties, when the reserve sank below the statutory minimum of one-third of the value of notes in circulation. Subsequent issues of currency against sterling and rupee credits reduced the 'proportion' from 33·60 per cent. on 30 September 1932, to 29·46 per cent. at the end of September 1939, and to 22·4 per cent. at the end of the next financial year. The Commissioners of Currency made no attempt to restore the reserve by selling securities and importing coin as they were clearly required to do by Section 5 of the Ordinance of 1884.

The most significant departure from the provisions of the original ordinance was, of course, the substitution of rupee or sterling credits for rupee coin as a means of issuing or redeeming currency notes. The Paper Currency Ordinance of 1884 did not envisage the issue of notes against exchange. On the contrary, the Commissioners were empowered to issue notes only against the tender of rupee coin. If the reserve of coin at any time amounted to over 50 per cent. of the value of the note circulation, the Currency Commissioners were permitted to invest the excess coin in certain specified types of securities. The Amendments to the Currency Ordinance in 1917 merely allowed credits at the Bank of England to be counted as part of the coin reserve. This was an emergency measure necessitated by the scarcity of rupee coin. The amendment, however, was never repealed. It remained on the Statute Book, and profoundly influenced the development of the currency system in the years that followed.

[11] Shenoy, B. R.: *Ceylon Currency and Banking*, 1941, pp. 163–68.

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The failure of the Currency Commissioners to maintain a coin reserve at least equal to one-third of the circulation as well as the purchase of securities when the coin reserve had fallen below one-half, were both officially condoned as being in accordance with the provisions of the amending ordinance of 1917. Thus, the Report of the Auditor General for 1933–34, referring to the issue of Rs. 1 million in notes against a sterling credit, states:

'The effect of the increase in the note circulation against an increase in investments has been the reduction in the proportion of the coin reserve. The Currency Ordinance No. 32 of 1884 requires that the coin reserve should not fall below one-third of the notes in circulation and that no further investment should be made until the coin reserve amounts to one-half at least of the notes in circulation. These requirements were suspended by Section 5 of the Ordinance No. 1 of 1917.'[12]

The above passage is clearly a misinterpretation of the Ordinance of 1917. Section 17 of the Ordinance No. 32 of 1884 ran as follows:

'If at any time the specie held by the Commissioners as mentioned in Section 12, should be reduced below one-half of the notes in circulation, it shall not be necessary for the Commissioners (except by special direction of the Governor) to sell and realize any of the said securities, unless and until the amount of specie in their hands shall be less than one-third of the notes in circulation. Provided that no further investment in the said securities shall be made until the reserve mentioned in Section 12 amount to one-half at least of the amount of currency notes in circulation.'

Section 5 of Ordinance 1 of 1917 merely adds two further *provisos* to the original section. It reads as follows:

'Provided further that the above *proviso* shall be deemed to have been suspended as from the thirtieth day of December 1916, until such date as shall be notified by the Governor in the Government Gazette. Provided further that during the said suspension, the

[12] Report of the Auditor General, 1933–34, para. 441. Cf. also para. 440: 'In August 1934 the circulation of currency notes in the island was increased by one million rupees with the sanction of H. E. the Governor, who decided that the coin reserve need not be increased by a similar amount. At the request of the bank which received the notes, it was allowed to place the sterling equivalent of the amount to the credit of the Commissioners of Currency in London, to be invested in sterling securities.'

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limit of the proportion of the value of the currency which may be invested in securities under Section 13 shall also be suspended and be deemed to have been suspended, as from the said date.'

As far as it concerned the currency reserve, the effect of this Ordinance, therefore, was to enable the Currency Commissioners to buy investments even though the proportion of coin had fallen below one-half. In other words, Section 5 of the Ordinance of 1917 suspended only the *proviso* which forbade the purchase of securities when the reserve was below one-half. Nothing in this Ordinance relieved the Currency Commissioners of the obligation imposed on them in Section 17 of the original Ordinance to maintain at all times a reserve equal to at least one-third of the notes issued. As can be seen from Table 38, the proportion of coin was invariably below one-third of the note circulation after the currency contraction in the great depression. When, after 1932, the Commissioners proceeded to issue notes against rupee and sterling credits which were later invested in securities, they were violating the provision of the currency law even though the Governor's sanction had previously been obtained.[13]

The developments reviewed above represent the gradual evolution of an exchange standard in Ceylon. What is remarkable is that this evolution took place in spite of the provisions of the law. Currency practice went ahead of currency legislation. The key to the understanding of this development is to be found in the almost total disappearance of rupee coin from the internal circulation after the introduction of one-rupee and two-rupee notes in 1917. These notes proved so popular that rupee coin became superfluous. Even as a method of remittance to India, bank drafts and Chetty drafts were rapidly superseding coin. In the late thirties the Indian silver rupee had, in fact, become something of a curiosity, only reluctantly accepted as a means of payment.

In the circumstances, the Currency Commissioners were themselves understandably reluctant to accumulate a barren reserve of coin when the investment of this reserve would have yielded an income. They had realized that the purpose of the currency reserve was to meet an external drain rather than an internal drain. Calls on the reserve were made only when the

[13] Report of the Auditor General, 1933–34, para. 441.

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banking system wished to transfer funds abroad, and for this purpose it was more convenient to keep a liquid reserve abroad rather than accumulate cash in the Treasury vaults.

From the banks' point of view, the new technique of issue and redemption of currency notes relieved them of the cumbrous and expensive business of moving rupee coin backwards and forwards between India and Ceylon. Thus it was more convenient for both parties to the transaction to deal in exchange; and it was a facility for which the banks were prepared to pay a small commission to the Board. The price at which the Commissioners bought and sold exchange depended on the cost of shipping rupees in either direction.

The Currency Ordinance of 1941

It was only in 1941, two years after the outbreak of the second world war, that the island's currency law was altered to take account of the new system that had evolved. The question of a revision of the currency laws had been engaging the attention of the authorities for some years previously. The problem had been discussed by the Financial Secretary with officials at the Colonial Office as early as 1935 and had been referred to an expert committee of the Colonial Office in 1937.[14] In May 1938 the Financial Secretary issued a communiqué indicating the lines on which new legislation was contemplated. It was felt that the time was ripe for the creation of a separate Ceylon rupee. In fact such a step was long overdue considering that much smaller units of the Colonial Empire had by now their own currency units. Basically the new proposals were an attempt to legalize existing practice. The Board of Commissioners of Currency was to issue Ceylon rupees, against the tender of Indian exchange, at the rate of one Ceylon rupee to one Indian rupee. Similarly, the Board was to redeem Ceylon rupees with Indian exchange. However, it was felt that 'an unqualified link with India would leave Ceylon in her present position in which she is bound by the currency policy of India'.[15] Provision was therefore made for an optional link of the Ceylon rupee with sterling which would come into

[14] Observations of the Financial Secretary in introducing Currency Ordinance in 1940; Ceylon Hansard, 1940, p. 415; *Ceylon Daily News*, 23 May 1938.
[15] *Ibid.*

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operation if the sterling value of the Indian rupee was altered. In such an event it was open for the Governor to suspend the obligation to issue or redeem Ceylon rupees with Indian exchange at the pre-existing rate of one Ceylon rupee to one Indian rupee, and to empower the Commissioners to deal only in sterling exchange at the existing parity of 1s. 6d. to the rupee. Such a precaution would 'provide for the possibility of the Ceylon government pursuing its own currency policy'. The Financial Secretary also emphasized that a great advantage of the new system was that the idle reserve of rupee coin amounting to over Rs. 14 million could be invested to yield an income of at least Rs. 400,000 a year.

The most significant aspect of the new proposals was the decision to establish a separate Ceylon rupee. As was seen in earlier chapters, in the years after the closure of the Indian mints in 1893, and once again in 1903, when there was a scarcity of rupee coin in Ceylon, there had been a widespread demand amongst the planting community of the island for a separate unit of currency. On both occasions such a step was considered impracticable owing to the intimate commercial relations between Ceylon and India and the difficulties of maintaining the international value of a separate currency unit. The intervening years, however, had seen the adoption of exchange standards in various parts of the Empire and it had been realized that the technique of management was relatively simple.

An Ordinance embodying the new arrangements was read for the first time in the State Council of Ceylon in February 1940. The Financial Secretary,[16] in introducing the Ordinance, commended it to the House for the two reasons we have already mentioned. In the first place it enabled the country to follow her 'own currency policy' independent of Indian policy. And secondly, there would be a gain to revenue in that the practice of holding a proportion of the currency reserve in coin was to be discontinued and the entire reserve could be held in securities.

It might be expected that the prospect of being able to follow 'an independent currency policy', whatever that phrase implied, would have had a wide appeal to the public, con-

[16] Ceylon Hansard, 1940, pp. 415–21.

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sidering that hitherto the country had had no voice in determining the exchange value of its currency, but had merely trailed behind the devious courses followed by the Indian rupee. The only coherent opposition to the draft Ordinance came from a group whose interests were likely to be affected by the adoption of a currency policy independent of India. The Ceylon Chamber of Commerce was opposed to the provision for an optional link of the Ceylon rupee with sterling which was to come into operation in the event of a revaluation of the Indian rupee. It was felt that if the sterling value of the Ceylon rupee was higher than that of the Indian rupee, export of Ceylon produce would be at a disadvantage in competition with that of the Indian output of the same commodities. The argument applied particularly to tea and coconut products. The exchange banks were even more alarmed at the prospect of an appreciation of the rate of exchange between the Ceylon rupee and the Indian rupee. Owing to the absence of suitable investment outlets, due especially to the narrowness of the money market in Ceylon, the banks invested a substantial proportion of their deposits in India. The liabilities of the banks in Ceylon were greater than their local assets—the difference consisting usually of investments in India. As long as the two countries had the same currency unit this was a perfectly safe arrangement for the banks, as there was no exchange risk involved. If, however, the Indian rupee was devalued while Ceylon decided to maintain her rate unchanged, the banks' Indian investments would have depreciated in terms of Ceylon currency. The banks therefore preferred that Ceylon should accept whatever rate India adopted.[17] To that end they sought the deletion of the clause in the draft Ordinance which provided for an optional link with sterling. On 4 April 1940, the Financial Secretary moved in the State Council that the bill be read a second time. But an amendment that the whole question be deferred for a year carried the day. In January 1941, the Financial Secretary reintroduced the bill, omitting the objectionable clause. It passed its third reading in the State Council on 27 May 1941.

There was hardly any informed discussion of the new

[17] Ceylon Hansard, 1940, pp. 415–21.

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Ordinance. Perhaps the most serious objection to the new system came from a member who said:

> 'He (the Financial Secretary) wants to transfer the 14 million rupees that are now in the Treasury as a guarantee against our note issue to Delhi. . . . I object to it because I would like to have my reserves in my own Treasury, in my own country. It does not matter if we lose our money that way.'[18]

The desire to have 'my reserves in my own country' was certainly a legitimate one. But in this instance the reserve of coin had already been allowed to fall to negligible proportions. In any case the rupee was merely a token coin, whose bullion value was only 30 cents. In fact, while the Currency bill was being discussed, the government of India had decided to discontinue the old silver rupee and introduce a new coin with a bullion value of only 15 cents.

Main Provisions of the Ordinance

Ordinance No. 21 of 1941 followed the lines which had by then become standard ones for currency systems in the British colonies; while most colonial currencies, however, were linked directly to sterling, the Ceylon rupee was connected to sterling only indirectly in so far as the Indian rupee was convertible into sterling at a fixed rate. Ceylon was therefore on a rupee exchange standard rather than a sterling exchange standard. The following were the main provisions of the new Ordinance:

(1) The composition of the Currency Board (now the Board of Commissioners of Currency) was widened to include two unofficial members. The Board was now to consist of 'not less than three and not more than five' persons. The Financial Secretary, the Deputy Financial Secretary, and the Deputy Chief Secretary were *ex officio* members of the Board. Two other members were to be nominated by the Governor after consultation with the Board of Ministers. The nominated commissioners were removable by the Governor and were entitled to resign by letter to the Governor (Section 2).

[18] Ceylon Hansard, 1941, p. 86.

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(2) The Ceylon rupee, divided into 100 cents, was established as the standard unit of value.

(3) The Board of Commissioners of Currency was empowered to issue currency notes and coins of such denomination and design 'as may from time to time be approved by the Secretary of State for the Colonies' (Section 12). The currency notes so issued were legal tender in Ceylon. The Board was obliged to issue Ceylon currency in Colombo 'to any person who shall pay or cause to be paid to the Reserve Bank of India at Bombay the equivalent value in Indian currency of the Ceylon currency required at the rate of one Indian rupee to one Ceylon rupee' (Section 14). Similarly, the Board was to pay Indian currency at Bombay to any person paying to the Board in Colombo the equivalent value in Ceylon currency (Section 15).

(4) A currency security fund was established to which was transferred all the moneys and assets which were held by the former Currency Board. Indian currency received against the issue of notes was to be credited to the Security Fund. In addition, each year a sum equal to 1 per cent. of the Security Fund was to be credited to the Fund out of the Board's income (Section 2). It was permissible for the Governor, with the approval of the Secretary of State, to direct that this annual payment be discontinued if at the end of the financial year the amount of the Security Fund exceeded 110 per cent. of the value of the notes and coin in circulation (Section 33). Similarly, Indian currency paid out in exchange for Ceylon rupees was to be a charge on the Security Fund.

(5) The Security Fund was to be held by the Crown Agents for the Colonies and by the Reserve Bank of India, who were to act as the Board's agents in the United Kingdom and India respectively (Section 23).

(6) Under the general direction of the Board, with the prior approval of the Governor, the Board's agents were empowered to invest the Security Fund (*a*) in securities of the government of any part of the British Dominions, other than that of Ceylon; (*b*) in securities guaranteed

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by the above governments; (*c*) in any other securities approved by the Secretary of State; or (*d*) in a security issued by the government of Ceylon by authority of the War Loan Ordinance No. 1 of 1941, provided the sum so invested did not exceed 10 per cent. of the Security Fund.

(7) The coin reserve of the old Ordinance was replaced by 'a liquid reserve'. The Board, with the prior approval of the Governor, was to determine what proportion of the Security Fund was to be ordinarily held in liquid form. Such a liquid portion could be held in London or in Bombay in cash or on deposit, lent in London or in Bombay at call or on short term, or invested in realizable securities at these two centres (Section 23).

(8) All income from investments held in the Security Fund together with all other receipts of the Board were to be paid into a separate Income Account (Section 26). All expenses of the Board in the discharge of its functions were chargeable to the Income Account as also the annual payment of one per cent. of the Security Fund referred to earlier. If in any year the liabilities of the Security Fund exceeded its assets the surplus (if any) in the Income Account, or such part of it as was equal to the excess, was to be transferred to the Security Fund (Section 29). Any surplus not required under this provision was to be credited to the general revenue of the island. Any deficiency in the Income Account was likewise to be paid out of general revenue (Section 30).

(9) The amount of the Security Fund was to be the aggregate of the following:

(*a*) The liquid reserve.

(*b*) The market value of the Board's investments, less any advance that might have been obtained by the Board, if the liquid portion of the Security Fund was insufficient to meet payments falling due.

(*c*) The realizable value of silver held by or on behalf of the Board.

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(*d*) The realizable value of the silver in the coin established by the Board to be in circulation or in the coin held by the Board.

(10) The Board was required to publish an annual statement in the Government Gazette, showing its assets and liabilities as at 30 September each year.

The new Ordinance came into operation on 1 September 1941. On that date the assets and liabilities of the former Currency Commissioners were transferred to the reconstituted 'Board of Commissioners of Currency'. The assets amounted to Rs. 85,382,000 and the liabilities to Rs. 82,278,895. The excess of assets over liabilities was credited to the general revenue.

Thus, when Ceylon was called upon to play a major part in the Allied war effort after the entry of Japan into the war, the currency expansion which this function necessitated was not handicapped by the scarcity of rupee coin as a reserve. The working of the Currency Board system during the war and post-war years is taken up in the next chapter.

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CHAPTER X

WARTIME INFLATION AND POST-WAR ADJUSTMENT, 1939–1950

The eleven years covered in the present chapter comprise the final phase of the Currency Board system in Ceylon. For most of the period the conditions in which the system functioned were altogether novel. Both in character and magnitude the monetary problems of war as well as those of post-war adjustment differed from anything hitherto experienced. For convenience of treatment the post-war adjustment-phase is taken to end with the establishment of the Central Bank of Ceylon in July 1950.

The War Period

The war period itself falls naturally into two parts, the point of division being the entry of Japan into the war in December 1941. Until then the pattern and the pace of the island's economic life remained relatively undisturbed. Export prices, which had been depressed since the last quarter of 1937, recovered soon after the outbreak of war in Europe. The most important development in the export sector was the suspension of the tea auctions both in Colombo and in London. By the end of 1939 all exports of tea into the United Kingdom had been brought under official control. The United Kingdom Ministry of Food became the sole importer of tea into that country. Payment was made according to a contract price for each estate based on the average prices realized during the previous three years, to which was added a uniform rate per pound for all estates to cover the increased cost of production. This allowance varied from year to year and was fixed by periodical negotiation between the two governments. Rubber, coconut products, and the minor exports continued to be traded in the open market until 1942.

The average price of tea rose from 77 cents in 1939 to 92 cents in 1941 and that of rubber from 47 cents to 56 cents. Of the various coconut products, only oil was markedly affected.

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The average price of a ton of coconut oil rose during the same period from Rs. 218 to Rs. 468. The index of export prices, which in 1939 was 114, rose in 1941 to 163. The rise in the index of import prices was slightly steeper, from 101 to 147.[1] Owing to the periodic interruption of supplies of imports, the government fixed maximum prices for a wide range of essential goods. On the whole, however, the effects of war were only remotely felt at this stage.

After Pearl Harbour, the scene was completely transformed. With the march of the Japanese across Burma and Malaya it was anticipated that the island would soon receive their attention. The economy was immediately placed on a war footing. In 1942 agreements for the purchase of Ceylon's output of rubber, of several coconut products, and of plumbago were concluded between the Ceylon and the United Kingdom governments.

The spread of the war to the East led to a large increase in the volume of expenditure both by the civil government and by the services. In addition to the expenditure on civil defence, there was the expenditure necessitated by the introduction of a whole array of controls ranging from the control of imports,

TABLE 39

MONEY SUPPLY, 1938–1945

Year	*Currency Circulation*	*Demand Deposits*
	Rs. million	
1938	45·1	94·3
1939	52·3	123·8
1940	63·3	162·4
1941	96·4	181·2
1942	184·0	298·4
1943	214·7	295·5
1944	308·8	392·2
1945	449·5	460·8

Source: Statistical Abstract of Ceylon, 1949.

exports and exchange to the control of firewood, fish and coconuts. Government expenditure rose from Rs. 127 million in 1938–39 to Rs. 320 million in 1945–46. At the same time the expenditure of the military authorities continued to increase. The volume of the Allied military expenditure in

[1] Base 1934–1938 = 100; Statistical Abstract of Ceylon, 1949.

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Ceylon is not known but it is estimated to have been about Rs. 400 million in the last year of the war.[2]

The counterpart of this increased expenditure was an unprecedented increase in the quantity of money in circulation, both of currency and of bank deposits. As can be seen from Table 39, the currency circulation in December 1945 was nearly ten times its 1938 level, while the volume of demand deposits increased five-fold in the same period.

The Currency Circulation

It was seen in an earlier chapter that under the Currency Board system the total volume of currency issued by the Board depended on two closely related factors—the balance of payments, and the policy of the banking system. To repeat our earlier analysis, the balance of payments consists of the following separate items:

A. The balance on current account.
B. The balance of independent capital movements.
C. Accommodating capital movements, i.e. changes in the foreign assets of the banking system.
D. Changes in the assets of the Currency Board, which cause equivalent changes in the currency circulation (ΔM).

Since the balance of payments must always balance, $A + B + C + D = 0$. An increase in the Currency Board's assets, as they are held abroad, is equivalent to an outward movement of capital and, therefore, is a negative item in the balance of payments. Similarly, a decline in the currency reserves is an inward movement of capital and a positive item in the balance of payments. D is equal to ΔM but opposite in sign. Substituting—ΔM for D, we have: $\Delta M = A + B + C$. In other words, the change in the currency circulation is equal to the algebraic sum of all the other items in the current and capital accounts.

This statement is, of course, a truism. It is as much a truism as the proposition from which it is derived. It is a useful *ex post* identity. But like all *ex post* equations it does not tell us anything about the causal processes involved. For these are

[2] B. B. Das Gupta: *A Short Economic Survey of Ceylon*, 1948, p. 65.

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interwoven with the factors which determine A, B and C. A and B are influenced by such factors as the prices of exports and imports, the volume and the terms of trade, and the complex of psychological and economic motives which give rise to international capital movements. As we have seen, C (accommodating capital movements) depends on the policy of the banking system as regards the distribution of their assets between the foreign and the domestic money markets. Table 40 shows the available data relating to changes in each of the four items listed above during the years 1939 to 1944. The figures are very rough estimates, and our analysis is necessarily imprecise.

TABLE 40

CURRENCY FLUCTUATIONS AND THE BALANCE OF PAYMENTS, 1939–1944

(1) *Year*	(2) ΔM	(3) *A*	(4) *B*	(5) *A + B*	(6) *C*	(7) *Errors and Omissions*
			Rs. million			
1939	+17	− 17	+ 13	− 4	−23	+ 44
1940	+11	− 23	+ 3	− 20	−30	+ 61
1941	+33	+ 47	− 77	− 30	+16	+ 57
1942	+88	+117	− 4	+113	−80	+ 53
1943	+31	+ 33	− 78	− 45	−30	+115
1944	+94	+ 49	−147	− 98	−13	+205

Source: Government of Ceylon: Post-war Development Proposals.

Owing to the large 'Errors and Omissions' in the available figures the equality between changes in the quantity of currency and the sum of the other three items does not hold. The table, however, shows the role of the accommodating capital movements of the banks. It seems a reasonable guess that in these years, except perhaps in 1941, the banks' overseas assets behaved in a compensatory manner offsetting the expansionary effect of the other items in the balance of payments. Such compensatory movements clearly took place from 1942 to 1944 when there were large increases in Allied war expenditure in the island. Over the entire period the banks' overseas assets increased by Rs. 110 million which, if transferred to Ceylon, would have increased the currency circulation by an equal amount. A striking feature of the above table is the increase of 'errors and omissions', especially in the last three years of the war. As will be noticed, these figures are all positive in sign.

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The bulk of these undoubtedly represent the influx of United Kingdom funds for war expenditure in Ceylon which assumed considerable proportions from 1942. Although the precise volume of this expenditure is not known the figures in column 7 provide some indication of its probable magnitude.

In fact, after 1941 Allied war expenditure became the largest single factor responsible for the increase in the currency circulation. In this respect the war-time inflation differs both from the expansion of currency which generally accompanied rising export prices and from the experience during the first world war when there was no occasion for substantial military outlays in the island. In the immediate pre-war years, and until 1942, the currency circulation seldom exceeded 12 per cent. of the value of exports. In 1945 the proportion was as high as 55 per cent.

Hitherto our discussion of monetary fluctuations has been confined almost wholly to changes in the volume of notes issued by the Currency Board—a limitation imposed on us by the absence of adequate statistics. The greater availability of statistics, particularly after 1943, makes it possible to undertake a somewhat more detailed analysis. For this purpose it is necessary to define briefly certain concepts which are commonly used in monetary analysis. The amount of currency issued by the Currency Board or other monetary authority is termed the 'gross currency circulation'. For most purposes it is necessary to know the volume of currency actually in the hands of the public—that is, the circulation exclusive of the cash holdings of the banks and of the government. The cash reserves of the banks do not constitute an effective part of the money supply. They are important only in so far as they affect the liquidity of the banking system. Similarly, the cash holdings of the government, though undoubtedly important in influencing both government policy and the liquidity of the entire financial system, is excluded on the grounds that more often than not monetary analysis is concerned with the influence of the currency supply on the private sector of the economy. Thus, while government balances are excluded, the changes in such balances lead to an equivalent increase or diminution of currency in the hands of the public, or the 'active currency circulation'. The total of demand deposits is similarly adjusted by excluding inter-bank deposits and governmental

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deposits. The sum of these two quantities of currency and of bank deposits constitutes the money supply in the hands of the public, the 'active money supply' or the 'active monetary circulation'. It is with changes in this total that the analysis which follows is primarily concerned.

The Money Supply

Clearly, a change in the active monetary circulation can be caused only by a change in the assets of the two sources of the supply of money—the Currency Board and the banking system. While the entire assets of the former are held overseas[3] those of the banking system consist both of local assets and of overseas assets. The overseas assets of both the Currency Board and of the banking system can change only as a result of a surplus or a deficit in the balance of payments (A + B). If the purchases of foreign exchange of the banks are greater than their sales the addition to their holdings of foreign exchange is matched by an increase in the volume of bank deposits locally. If the banks transfer exchange to the Board and obtain notes, the gross circulation increases. There is, however, no change in the active monetary circulation but merely a change in the ownership of overseas funds. A 'repatriation' of the overseas assets of the banks cannot of itself influence the quantity of money in active circulation. Such transfers, however, affect the cash reserves of the banks, and hence their ability to acquire domestic assets. The same reasoning applies to the effect of a balance-of-payments deficit on the money supply. The active circulation declines by the amount of the deficit.

A change in the active monetary circulation, then, will be equal to the sum of changes in the following:

1. The external assets of the Currency Board.
2. The external assets of the banking system.
3. The domestic assets of the banking system excluding cash.
4. The government's holdings of currency and bank deposits.
5. The quantity of non-monetary deposits of the banking system (i.e. fixed and savings deposits).

[3] The Currency Ordinance of 1941 empowered the Board to hold Rs. 20 million in Ceylon Government War Loan, guaranteed by the United Kingdom. The War Loan, however, was re-lent to the United Kingdom and was therefore in effect a foreign asset. Cf. Chap. IX.

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If we ignore the influence of the last two items a change in the active circulation (ΔM_1) is equal to the sum of the surplus or deficit in the balance of payments and the change in the non-cash domestic assets of the banks (N). That is, $\Delta M_1 = A + B + \Delta N$. In other words, the active monetary circulation is determined by the balance of payments and by banking policy. We saw in a previous chapter that the chief influence on Ceylon's balance of payments was the price level of her exports and imports. It was also seen that the main outlet for bank credit in Ceylon lay in the foreign trade sector of the economy. When export values rose the demand for credit increased. The increase in the national income due to the rise in export values as well as the rise in import prices which generally accompanied an export boom led to an increase in the volume and value of imports. This led to a further increase in the demand for bank credit. At the same time the surplus in the balance of payments enhanced the liquidity of the banks and enabled them to meet the increased demand. Similarly, a decline in export incomes led to a fall in the demand for credit and a decline in the liquid assets of the banking system. In other words, the amount of the banks' domestic assets and the balance of payments itself are functions primarily of the level of export prices. Left to the free play of market forces, the two influences are likely to work in the same direction.

The distinguishing feature of the war-time increase of the money supply was the fact that the amount of war expenditure rather than the level of export prices became the main factor influencing the money supply. The value of exports in 1945 was roughly double that in 1939, whereas the gross monetary circulation rose by nearly 900 per cent.

Table 41 analyses the sources of the war-time increase in the active monetary circulation in terms of four of the five causal factors mentioned earlier. Figures of changes in the government's cash balances are not available.

The total increase in the active money supply was Rs. 727 million. Of this increase, Rs. 551·7 million or over 75 per cent. was due to an increase in external assets of which by far the greater share was in the assets of the Currency Board. The increase in the banks' external assets amounting to Rs. 152

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million was only 28 per cent. of the total and was, in fact, less than the increase in their domestic assets.

The United Kingdom government's expenditure in the island, which was largely responsible for the increase in the money supply, consisted both of the disbursements on account of the bulk purchase of tea, rubber, copra, coconut oil, and

TABLE 41

SOURCES OF INCREASE IN MONEY SUPPLY, 1940–1945

Year	*Changes in External Assets of*		*Change in Domestic Assets of Banks*	*Change in Fixed and Savings Deposits of Banks.**	*Total*
	Currency Board	*Banks*			
		Rs. million			
1940	19·4	63·2	5·1	– 1·8	89·5
1941	25·7	– 14·4	33·2	– 10·8	55·3
1942	86·1	78·1	– 12·3	4·1	147·8
1943	37·7	13·2	71·5	– 22·6	145·0
1944	84·2	58·0	58·0	– 24·6	224·8
1945	146·6	– 46·1	19·8	– 33·8	154·1
Total	399·7	152·0	175·3	– 89·5	727·0

Sources: Statistical Abstract of Ceylon; Ceylon Year Book.

* An increase in fixed or savings deposits causes a fall in the money supply.

plumbago and of purely military expenditure. The method by which the rupee finance necessary for this expenditure was raised has often been described in connexion with the problem of the 'sterling balances'. The Currency Board, under the Ordinance of 1941, was required to issue Ceylon rupees against the credit of Indian rupees to its account with the Reserve Bank of India in Bombay. The United Kingdom government was able to obtain Indian funds by a similar provision in the Reserve Bank of India Act which required the Bank to purchase sterling at a fixed rate. Inflation of currency and credit in Britain, therefore, automatically provided the means of acquiring Indian or Ceylon currency.

Sterling Balances

A direct result of the methods of finance and economic control adopted during the war was the accumulation of foreign balances, mainly in sterling. By far the largest portion of these balances represented the sterling assets of the Currency Board and of the commercial banks. The rest consisted of the sterling investments of the government and certain

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governmental agencies and institutions. The ownership of the sterling assets at the end of December 1945 was as follows:

TABLE 42

DISTRIBUTION OF STERLING BALANCES, 31 DECEMBER 1945

	Rs. million
Government Surplus Funds	297·5
Currency Board	372·3
Commercial Banks	156·2
Post Office Savings Bank and Ceylon Savings Bank	74·3
Other Government Funds	60·1
Loan to United Kingdom Government	102·1
Total	1062·5

Source: Statistical Abstract of Ceylon, 1949.

Sterling balances are, of course, nothing new in Colonial finance. Just as it has been the practice of Colonial governments to invest surplus funds in sterling assets and for Colonial currency reserves to be invested wholly or partly in sterling, the branches of the British banks in the Colonies held a considerable proportion of their assets in London. It is, however, the phenomenal increase in these balances and the manner in which they occurred which are of special significance. The increase in the sterling balances held by the Currency Board and by the commercial banks was the counterpart of the increased money supply of external origin. In addition to the increase in the money supply due to a surplus in the balance of payments on current account there was an abnormal 'influx of capital' for war expenditure.

The abnormal character of the war-time accumulation of sterling balances might be illustrated by considering the probable consequences of a similar influx of funds during peace time. It is a familiar proposition in the theory of capital movements that a movement of capital must sooner or later be followed by a transfer of goods and services to the receiving country. A normal influx of capital would have led to an increase in real investment and a rise not only of money incomes, but also of real incomes in the receiving country. The accompanying increase in imports would have extinguished, at least partly, the increase in overseas assets. It is precisely this transfer of goods and services which did not take place

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during war time. Although the export industries were strained to their utmost capacity, imports were at a bare minimum owing both to losses of the sources of supply and to diversion of productive resources to war purposes in the supplying countries. The expenditure of surplus purchasing power on domestic goods was thus a contributory factor to the fall in the purchasing power of the rupee. The sterling balances represented the foregone consumption or the 'forced savings' of the community. They were the counterpart of the labour and resources utilized by the Allied governments for which no equivalent was received.

The Banking System

In comparison with the expansion of the currency issue the rate of increase of bank deposits was moderate. On the average the gross currency circulation increased twice as fast as the total of bank deposits. As a result of the unequal rate of increase of the two components of the money supply, demand deposits, which comprised over two-thirds of the gross money supply in 1938, was only just over half the money supply at the end of 1945. The reason for the lag in the expansion of bank deposits is revealed by an examination of the assets structure of the banking system set out in Table 43.

TABLE 43

STRUCTURE OF BANK ASSETS, 1939–1945

Amounts in Rs. million

	Cash and Balances with Local Banks		*External Assets*		*Loans and Advances*		*Bills Discounted*		*Ceylon Govt. Securities and Treasury Bills*		*Total Deposits*
	Amount	*per cent.*	*Amount*	*per cent.*	*Amount*	*per cent.*	*Amount*	*per cent.*	*Amount*	*per cent.*	*Amount*
1939	15	9·0	85	52·1	29	17·8	2	1·2	12	7·4	163
1940	20	9·3	148	68·5	28	13·0	3	1·3	17	7·8	216
1941	27	11·2	133	55·1	36	14·9	1	0·4	44	18·3	241
1942	59	17·4	211	62·2	15	4·4	1	0·3	53	15·6	339
1943	53	13·6	224	57·4	17	4·4	8	2·1	80	20·5	390
1944	64	12·8	282	56·5	18	3·6	4	0·8	123	24·6	499
1945	188	30·7	236	38·6	21	3·4	6	1·0	153	25·0	612

Sources: Ceylon Year Book; Statistical Abstract of Ceylon.

During the war, especially after the end of 1941, the bulk of the export trade as well as a considerable portion of the import trade was handled by the government. The finance necessary for this trade was usually provided by the Ceylon government acting on its own account or on behalf of the United Kingdom

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government. The development of state trading narrowed what had hitherto been the main outlet for bank credit. As the table shows, bank advances rose from Rs. 29 million in 1939 to Rs. 36 million in 1941. They declined to Rs. 15 million in the following year but had recovered to Rs. 21 million in 1945. Throughout the war years, however, the ratio of advances to total deposits steadily declined, falling from 17·8 per cent. in 1939 to 3·4 per cent. in 1945. Similarly, although the volume of bills discounted rose from Rs. 2 million to Rs. 6 million during these years, it formed a smaller proportion of total deposits in 1945 than it did in 1939. The bulk of the war-time increase of bank deposits was due either to an increase in external assets or to investment in Ceylon government securities by the banks.

Inflation

Inflation and deflation in an export economy are usually attributable to external causes. This is especially true of the British Colonies, where government expenditure is, for the most part, limited by the size of the government's revenue and the availability of sterling loans. The 'general price level' in an export economy is to a large extent determined by the prices of exports and imports, a heavy dependence on imported goods being a necessary corollary of specialization on export production. For our present purposes, commodities entering into an index of the general price level may be divided into three categories:

A. Export goods which are also sold at home.
B. Import goods.
C. Domestic goods.

During a period of rising export prices the national income rises *pari passu*. And since the cause of the rise in export prices is the increase in the level of activity abroad, import prices rise as well. Prices of domestic goods and services rise owing to the increase in monetary expenditure induced by the increased export incomes and owing to the increase in price of imported substitutes or of the import component of domestic goods. The extent of the rise in the prices of domestic goods depends both on their supply elasticities and on the marginal increment of income expended on them. The supply elasticities are usually

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low owing to the numerous bottlenecks in the supply of capital, entrepreneurship and technical skills. Thus the domestic price level tends to rise as a result of the rise in prices of all three groups of commodities of which import goods are the most important from the point of view of the cost of living.

In this period, although the main inflationary factor was war expenditure and not the level of export prices, the analysis can be made on much the same lines. The phenomenal increase of money incomes during the war was accompanied by a considerable fall in the supply of imports. For example, imports of rice fell from about 10·5 million cwt in 1938 to 3·5 million cwt in 1945. Estimated domestic production increased by about 2 million cwt. The index of the volume of imports fell from 104 to 75 during the same period, touching a low of 60 in 1942. As in the case of rice production, there was some increase in the production of foodstuffs and other domestic goods. But by and large the scarcity of imported materials precluded any appreciable increase in the production of domestic goods although the scarcity of imports increased the pressure of demand for such goods.

The diminution of supply on the one hand, and the increase of aggregate demand on the other led to what has come to be called an 'inflationary gap', which was partly closed by an inflationary rise in prices. The fall in the volume of imports of the order of 25 per cent. together with the increase in the gross money supply by over 600 per cent. provides some idea of the probable magnitude of the 'inflationary gap'.

The market's method of bridging an 'inflationary gap' is a rise in the price level until aggregate supply and aggregate demand are equalized. Such a process, however, would have been disastrous to the community and the war effort alike. Like most countries, Ceylon sought to curb inflation and to achieve an equitable distribution of the restricted supply of goods by an extensive system of price control, rationing and 'permits'. Technically, therefore, part of the community's money income became unspendable and the inflation was 'suppressed'. The cost-of-living index for Colombo town, calculated on the basis of controlled prices, rose from an average of 104 in 1939 to 221 in 1945.[4] Employees in government and

[4] Statistical Abstract of Ceylon: Base: November 1938–April 1939 = 100.

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mercantile services and some non-estate wage-earners were paid war allowances on the basis of this index. Wages on estates were adjusted to a separate estate cost-of-living index number.

It is usual to measure the degree of suppressed inflation by comparing the ratios of the money supply to the index of retail prices. Table 44 sets out figures for Ceylon based on the cost-of-living index number.

It is seen that the ratio of the money supply to prices had more than doubled at the end of 1945, a result that at first sight might seem attributable to the sterilization of purchasing power through the use of the various controls referred to earlier. If the 1939 ratio were considered normal it might be deduced that about Rs. 366 million in notes and deposits would have been sufficient to support the 1945 level of prices and that roughly half the active money supply represented 'surplus purchasing power'. Such a conclusion, however, is unjustified. The changes in the cost-of-living index number do not reflect adequately the changes in the purchasing power of the rupee. Not only were commodities unobtainable in the same quantities as in the pre-war years, but also they were seldom obtainable at controlled prices.[5] This was true especially of

TABLE 44

SUPPRESSED INFLATION, 1939–1945

End of Year	(1) *Active Money Supply*	(2) *Average Index Number*	(3) *Ratio of* (1) *to* (2)
	Rs. million		
1939	165·3	104	1·6
1940	212·8	112	1·9
1941	263·4	122	2·2
1942	430·7	164	2·6
1943	438·3	196	2·2
1944	616·1	200	3·1
1945	729·4	221	3·3

Source: Statistical Abstract of Ceylon, 1949.

commodities whose prices were controlled without the introduction of a system of rationing. Considerable quantities of such goods found their way to a scarcely concealed black

[5] Cf. Speech of the Finance Minister at second reading of the Appropriation Bill 1947–48: 'The index of the cost of living has been calculated on the basis of controlled prices whenever they apply. It is common knowledge, however, that the actual prices at which business was done was in most cases above the controlled prices.' Ceylon Hansard, 1947, p. 414.

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market which was freely patronized by large sections of the population. The actual degree of price inflation and hence the community's cash requirements were much greater than the above table suggests.

Apart from price controls and rationing of varying degrees of effectiveness, the major anti-inflationary measure available to the authorities was that of siphoning off surplus purchasing power through the savings movement. The quantity of savings in the form of savings certificates, deposits of the Post Office Savings Bank, of the Ceylon Savings Bank and of savings deposits of the commercial banks is shown in Table 45.

TABLE 45

GROSS SAVINGS, 1939–1945

	Rs. million		*Rs. million*
1939	43·2	1943	66·9
1940	44·0	1944	102·2
1941	44·5	1945	162·7
1942	40·4		

Source: Statistical Abstract of Ceylon, 1949.

The total increase in savings between 1942 and the end of the war was about Rs. 122 million. Against this must be set the increase in the government's rupee debt by nearly Rs. 200 million over the same period. To the extent that savings out of the public's current income were invested in government stock the effect was anti-inflationary. However, over 40 per cent. of the debt was purchased by the commercial banks, who thus increased the supply of money by an equal amount.

Terms of Trade

An important aspect of the war-time inflation was the unusual behaviour of the terms of trade. The expansion of the money supply during an export boom was usually accompanied by an improvement in the terms of trade with export prices rising faster than import prices. During the war, however, the position was reversed. While it was no problem to place a ceiling on the prices of the country's exports, Ceylon had to obtain a considerable portion of her imports from countries whose price levels were not rigidly controlled. As a result her terms of trade deteriorated from 137 in 1939 to 61 in 1945. A unit of imports in 1945 cost more than twice as much

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as it did before the war, a circumstance which was primarily responsible for the diminution of the national real income during the war years.

The Post-war Period

The transition to a peace-time economy was a slow process. The world-wide scarcity of consumption goods required the maintenance of varying degrees of control over the import and distribution of consumption goods. By the end of 1946, however, much of the war-time control machinery had been dismantled although it was found necessary to continue the issue of a basic ration of rice at a subsidized rate. The arrangements for the bulk sales of tea, rubber, and plumbago were terminated at the end of 1946. In January of the same year the Ceylon government signed a contract with the United Kingdom agreeing to sell her, for a period of five years, the country's entire exportable surplus of coconut oil and copra.

The increase of monetary expenditure in war time had led to a large increase in the volume of employment. There had been a flow of labour from the underemployed rural sector of the economy into the new war-time occupations and the services. The cessation of war expenditure meant that hundreds of skilled and unskilled workers were thrown out of work. Servicemen were being demobilized while the demand for manpower on the part of the civil defence services suddenly ceased. The relaxation of the apparatus of controls reduced employment in government service. A serious unemployment problem emerged. The total number registered at the Unemployment Exchanges rose from 1053 in 1944 to 36,544 in December 1946.[6] Some attempt was made to meet this problem by the introduction of a number of relief schemes.

The central feature of the economic readjustment in the post-war years was the decline in aggregate money demand due to the cessation of war-time expenditure both at home and overseas. Although there were moderate increases in the prices of tea and of coconut products, the period as a whole was one of income deflation, heightened by the almost continuous depression in the rubber industry. The average price of high-grown tea in Colombo rose from Rs. 1·20 in 1945 to Rs. 1·28 in

[6] Statistical Abstract of Ceylon, 1949.

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1946 and Rs. 1·75 in the following year. There was some improvement in the prices of coconut products which were not subject to bulk sale agreements. The rubber industry, however, was less fortunate. In October 1946, soon after the termination of the war-time arrangements, world prices began to fall. The government introduced a subsidy scheme in order to prevent a total collapse of the industry: it stood ready to buy all first grade rubber sheet offered for sale at a 'floor price' of 65 cents per pound with appropriate differentials for other grades. Owing to the continued downward trend of prices the 'floor price' was lowered to 55 cents in December 1947.

Owing to the favourable prices ruling for tea and coconut products the total value of exports continued to rise. But the relaxation of controls and post-war scarcities abroad led to large rises in import prices. At the same time, the pent-up demand of war time led to a considerable increase in the demand for imports. The net result was a worsening of the balance of payments and a drain on the country's foreign reserves. A surplus on current account of Rs. 84 million in 1946 turned into a deficit of Rs. 180 million in 1947. External assets declined by Rs. 263 million during this year. There was a slight improvement in the trade position in the following year which produced a balance-of-payments surplus of Rs. 13 million. In that year the average price of tea was nearly Rs. 2·00 per pound while the rubber market rose until July when the price averaged 71 cents per pound. There was a fluctuating decline during the rest of the year with the price falling to 53 cents per pound in December. The decline continued well into the following year with the average price falling to 48 cents per pound in July. This price, which was below the cost of production of all but the best estates, led to a shrinkage of the area under tapping and unemployment amongst estate workers. The prospects for the industry were dismal until the devaluation of September 1949 ushered in a recovery of prices.

The deficits in the balance of payments in the early post-war years were met out of the sterling balances. In May 1948, through the Sterling Assets Agreement, the use of these balances was regulated. Ceylon agreed to a limit of £3·5 million being set for the remainder of 1948. This sum was credited to a No. 1 Account in which all current earnings of sterling were also to be

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deposited. The rest of the sterling assets were blocked in a No. 2 Account. Hitherto the movement of funds from Ceylon to the sterling area countries had not been restricted. The Sterling Assets Agreement necessitated the extension of exchange control to include sterling area countries. During the first six months of 1949 an additional £1¾ million was released from the No. 2 Account and £7 million in the following year. The control, besides keeping the demand for foreign exchange within the limits set by the Agreement, had as its objective the conservation of the foreign exchange resources in the interests of national economic development.

Devaluation

The devaluation of sterling followed by that of several other currencies produced an almost immediate effect on export prices. The London price of rubber which was 10·3d. at the end of August 1949 rose to 13·19d. at the end of September 1949. The price of tea at the Colombo auctions also began to climb steadily upwards. The improvement in prices continued until it soon merged with the boom in raw-material prices after the outbreak of the war in Korea. The balance of payments became favourable. Not only was the drain on external reserves stopped, but the movement of reserves in the opposite direction was soon to become embarrassingly large. The balance of trade, which had shown a deficit of Rs. 35·8 million during the first eight months of the year, turned into a surplus of Rs. 9·1 million at the end of October. The year ended with a trade surplus of Rs. 35·3 million, which was nearly double that of the previous year. External assets which had fallen to Rs. 860 million in August stood at Rs. 933 million at the end of December.[7]

During 1949 Ceylon, like the United Kingdom and many other sterling area countries, had been faced with the twin problems of a decline in export incomes and a balance-of-payments deficit. A continued decline of rubber prices would have required some form of governmental intervention. The policy of a 'floor price', abandoned in 1947, while it stabilized producers' incomes could only aggravate the drain on the external assets. Devaluation, which seemed imminent by the

[7] Ceylon Trade Journal, February 1950.

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beginning of September 1949, was eagerly awaited by those interested in the future of the rubber industry.

According to the provisions of the Currency Ordinance, the international value of the Ceylon rupee was tied to that of the Indian rupee. When India reduced the gold value of her currency by maintaining an 18d. rupee there should have been an automatic devaluation of the Ceylon rupee. But the government of Ceylon, although it decided to maintain the traditional exchange rate with sterling and the Indian rupee, took the opportunity of defining the value of the Ceylon rupee in terms of gold. Ordinance No. 40 of 1949 amended the Ordinance of 1941 and fixed the par value of the Ceylon rupee at 2·88 grains of fine gold. Since this was the same as the par value of the Indian rupee, the new arrangements preserved the pre-devaluation exchange rate between the Ceylon currency and the currencies of the sterling area countries (except Pakistan) which were Ceylon's principal trading partners. The dollar value of the rupee was reduced in the same proportion as the dollar value of sterling, that is by 30·52 per cent.

Apart from its temporary effect on the speculative demand for foreign exchange, the principal effect of currency devaluation is on the balance of trade. Through its effect on the quantities and prices of exports and imports it affects also the level of domestic prices, the cost of living and the level of incomes. Much of current economic analysis has been concerned with the price effects of devaluation, the precise result depending on four elasticities—the elasticity of foreign demand for exports, the home elasticity of supply of exports, the foreign elasticity of supply of imports and the home elasticity of demand for imports. It has been shown that the balance of trade will improve in response to devaluation as long as the sum of the two demand elasticities is greater than unity.[8]

Analysis along these lines is of limited usefulness in considering the effects in Ceylon of the devaluations of September 1949. In the first place, the theory is concerned with the effects of a unilateral devaluation, whereas the major aspect of the devaluation in September 1949 was the fact that Ceylon's

[8] Cf. e.g. Joan Robinson: "The Foreign Exchanges", pp. 183–209, in *Essays in the Theory of Employment*; A. J. Brown: "Trade Balances and Exchange Stability": *Oxford Economic Papers*, April 1942, pp. 57–75.

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exchange rate with her main trading partners, India and the United Kingdom, remained unchanged.

Secondly, since Ceylon is a small supplier of her main exports (except perhaps of tea) it is unlikely that rupee devaluation affected their prices significantly whether in terms of sterling or of dollars. The same is true to a much greater degree of the prices of imports into Ceylon. The causes of the improvement in Ceylon's balance of trade, therefore, must be sought in the effect of sterling devaluation itself on world prices and incomes. The effect of the devaluation of the Ceylon rupee was to raise the rupee prices of exports and imports in the same proportion as the degree of devaluation. In other words, if Ceylon had not devalued, her export and import prices would both have been 30 per cent. lower than they were.

The improvement in the balance of trade after devaluation must be attributable to one or more of the following factors:

1. An improvement in the terms of trade—that is, a greater rise in export prices than in import prices.
2. Changes in the quantities traded due to price changes, the precise effect depending on the four elasticities.
3. Changes in quantities traded due to income changes at home and overseas.

Table 46 shows the monthly indexes of the value and volume of exports from July to December 1949. Table 47 shows the same data on a quarterly basis as well as the terms of trade and the balance of trade.

The tables reveal that by far the most important influence on the balance of trade after devaluation was the improvement in the terms of trade, which rose from 75 in the second and third quarters to 85 in the last quarter of the year. The index of export prices rose from 317 in August to 380 in December. There was some increase in the quantities of rubber and coconut products exported, but tea exports declined. The increased foreign demand for rubber and coconut products is attributable to the revival in economic activity in Europe and America soon after devaluation. Both 'commodities' have high income-elasticities of demand. The index of the volume of imports had declined by about 30 per cent. at the end of the third quarter of the year but had recovered to 111 at the end of the

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last quarter. The influence of devaluation on the volume of imports is not likely to have been significant both because the level of the national income was rising after devaluation and

TABLE 46

INDEX NUMBERS OF EXPORTS: PRICE AND VOLUME
JULY–DECEMBER 1949
(1934–38 = 100)

Month	Prices				Volume			
	All Exports	Tea	Rubber	Coconut Products	All Exports	Tea	Rubber	Coconut Products
July	307	292	146	601	139	166	97	99
August	317	304	149	613	141	159	125	90
September	323	310	141	643	110	109	151	61
October	339	326	174	631	127	144	140	46
November	357	338	192	672	130	117	158	143
December	380	356	205	733	135	133	167	107

Sources: Quarterly Bulletin of Statistics; Ceylon Trade Journal.

TABLE 47

TERMS OF TRADE AND TRADE BALANCE
SECOND–FOURTH QUARTER 1949
(1934–38 = 100)

1949	Volume of Imports	Price of Imports	Price of Exports	Terms of Trade	Balance of Trade Rs. million
Second quarter	138	412	309	75	−72·5
Third quarter	98	416	314	75	−27·3
Fourth quarter	111	419	356	85	+35·3

Sources: As in Table 46.

because the price-elasticity of demand for imports is, in any case, low.

The Balance of Payments and the Money Supply

During the immediate post-war years the policy of the banking system was as important a factor as the balance of payments in influencing the gross currency circulation. Table 48 shows the balance-of-payments surplus or deficit on current account and the gross and active circulation of currency and of bank deposits for the period 1945 to 1949. The figures for June 1950, shortly before the establishment of the Central Bank of Ceylon, are also included. The table reveals that movements in the gross currency circulation bore little correspondence with fluctuations in the balance of payments. Thus in 1947,

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although there was a deficit of Rs. 180 million on current account, the gross circulation increased from Rs. 392·5 million to Rs. 411·8 million. In 1948 the increase in the gross circulation was about equal to the surplus on current account, but in the following year the gross circulation increased by nearly Rs. 50 million although there was a deficit on current account of Rs. 30 million. Again, during the first half of 1950 the gross circulation declined by nearly Rs. 100 million although the balance of payments was almost even. On the whole, the most important influence on the gross circulation was the change in the banks' holdings of cash.[9]

TABLE 48

BALANCE OF PAYMENTS AND MONEY SUPPLY 1945–JUNE 1950

End of Year	*Surplus or Deficit on Current Account*	*Gross Currency Circulation*	*Govt. Cash Holdings*	*Banks' Cash Holdings*	*Active Currency Circulation*	*Total Demand Deposits*	*Govt. Deposits*	*Deposits with Public*	*Total Active Money Supply*
				Rs. million					
1945	+308	449·5	5·6	113·5	330·4	460·8	61·8	399·0	729·4
1946	+ 84	392·9	5·3	112·9	274·7	480·4	88·3	392·1	666·8
1947	−180	411·8	4·2	169·5	238·1	468·0	143·6	324·4	562·5
1948	+ 13	426·4	4·2	181·1	241·1	528·9	163·2	365·7	606·8
1949	− 30	476·1	4·2	228·0	243·9	558·7	153·2	405·5	649·4
June 1950	+0·1	378·0	3·1	117·8	256·8	551·3	108·4	442·9	699·7

Sources: Statistical Abstract of Ceylon; Annual Report of Central Bank of Ceylon, 1950.

On the other hand, the active currency circulation shows a greater degree of correlation with balance-of-payments fluctuations. In 1947, the active circulation declined although the gross circulation had increased. Both in 1948 and 1949 the active circulation remained almost unchanged in spite of changes in the gross circulation and a net deficit in the balance of payments. Similarly, during the first half of 1950 the active circulation increased slightly although the gross circulation fell by Rs. 100 million. The correlation between the active currency circulation and the balance of payments is only to be expected. For the public's transactions demand for currency is a function of the level of economic activity which, in Ceylon,

[9] The balance-of-payments figures for 1946 must be treated with caution. The recorded items show a surplus of Rs. 84 million, but 'errors and omissions' amounted to Rs. 139 million. The gross circulation declined by Rs. 56·6 million during the year. It is likely that the currency contraction was due to an unidentified movement of capital.

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is heavily dependent on the export industries. In other words, the balance of payments determines not so much the supply of currency but the demand for it on the part of the public through its influence on the level of incomes. Rising export prices lead to a surplus in the balance of payments and an increased demand for currency, while falling export prices produce an opposite sequence of events.

Banking Policy

Since government cash holdings were negligibly small during this period the active currency circulation was approximately equal to the gross circulation less the cash holdings of the banks. In so far as a change in the gross circulation represented merely a change in bank cash it had no special economic significance other than its effect on the liquidity of the banks. As mentioned earlier, the banks were in the habit of holding a large proportion of their assets abroad. Such assets were always convertible into cash through the Currency Board.

Broadly speaking, the proportion of their assets which the banks choose to hold abroad will usually be governed by the following considerations:

1. The availability of domestic investment opportunities.
2. Possible fluctuations in the balance of payments.
3. The risks of exchange fluctuations.

Clearly, since domestic lending is the most profitable side of their business, the banks will attempt to meet the domestic demand for credit as long as the available investment outlets satisfy their canons of security and liquidity. In other words, the banks will transfer their assets to and fro between foreign and domestic money markets according to the availability of their conventional investment outlets. The only limits to this policy will be those imposed by the necessity of meeting an excess demand for foreign exchange during periods of bad trade and the need to avoid an overbought position either in Ceylon rupees or in foreign currencies. This latter consideration was unimportant so long as the Ceylon currency was linked statutorily to the Indian rupee, for the banks could then invest a proportion of their assets in India without risk of exchange loss.

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Table 49 sets out the assets distribution of the banking system during the period 1945 to 1950, and the percentage of each type of asset to the total deposit liabilities. The figures do not add up exactly to 100 owing to minor omissions in the available statistics.

TABLE 49

ASSETS OF THE BANKS, 1945–1949

	1945		1946		1947		1948		1949	
	Rs. million	*per cent. of 6*	*Rs. million*	*per cent. of 6*	*Rs. million*	*per cent. of 6*	*Rs. million*	*per cent. of 6*	*Rs. million*	*per cent of 6*
1. Cash and Balances with other Ceylon Banks	188·0	30·4	175·6	27·6	264·9	38·4	307·3	40·4	407·2	47·9
2. External Assets	236·5	38·2	217·2	34·1	121·0	17·5	149·4	19·7	114·6	13·4
3. Advances	21·4	3·5	48·7	7·7	89·8	13·0	82·1	10·8	101·1	11·9
4. Bills Discounted	5·7	0·9	18·6	2·9	40·9	5·9	46·6	6·1	53·2	6·3
5. Ceylon Government Securities and Treasury Bills	153·1	24·6	176·7	27·7	176·0	25·4	184·3	23·2	204·1	24·4
6. Total Deposit Liabilities	621·9	...	637·2	...	693·3	...	761·9	...	852·6	...

Source: Statistical Abstract of Ceylon.

It is seen that the percentage of external assets varied between 38·2 per cent. in 1945 and 13·4 per cent. in 1949. During the same years the banks' cash balances rose from 30·4 per cent. to 47·9 per cent. of total deposits. The return of free trading in the commodity markets led to an increase in the demand for bank advances and a larger volume of bills of exchange were being offered for discount. The proportion of advances increased from 3·5 per cent. to 11·9 per cent. between 1945 and 1949 while 'bills discounted' rose from 0·9 per cent. to 6·3 per cent. Increased demand for credit was only one of the factors which induced the banks to convert some of their external assets into cash. The other was the fear of a devaluation of the Indian rupee and a threatened embargo on the movement of funds out of India.

The significance of the flexibility of the banks' holdings of external assets is that it can act as a buffer between the domestic money supply and a gain or loss of foreign exchange through fluctuations in the balance of payments. It imparts a distinct element of flexibility to the credit policies of the banking system, which need not be governed exclusively by variations in the stock of bank cash. It is not possible to estimate how

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important this flexibility was before 1939. It was of some importance in the abnormal conditions of war time in that investment abroad helped in a large measure to absorb the surplus liquidity of the banks. Table 50 analyses the causes of changes in the active monetary circulation during the four post-war years and the first half of 1950.

TABLE 50

CAUSES OF CHANGES IN MONEY SUPPLY, 1946–JUNE 1950

	1946	1947	1948 *Rs. million*	1949	June 1950
1. External Assets of Currency Board	−56·6	+18·9	+14·6	+49·7	−98·1
2. External Assets of Banks	−19·3	−96·2	+28·4	−53·2	+59·3
3. Non-cash Domestic Assets of Banks	+63·8	+62·7	+ 6·3	+22·0	+30·3
4. Fixed and Savings Deposits of Banks	+ 2·6	− 2·6	− 3·9	+ 0·8	+ 0·5
5. Government's Cash Holdings	−25·6	−54·8	−19·6	+10·0	+45·9

Sources: Statistical Abstract of Ceylon; Annual Report, Central Bank of Ceylon, 1950.

It can be seen that the banks were consistently increasing their holdings of non-cash domestic assets (bills, advances, and government securities) even though the influence of the balance of payments was contractionary. Advances increased from Rs. 21·4 million in 1945 to Rs. 101·1 million in 1949, and the banks' holdings of Ceylon government securities and Treasury bills rose by over Rs. 50 million in the same period. In 1948, when there was a surplus in the balance of payments, the banks preferred to increase their overseas assets and accumulate cash balances rather than increase their holdings of domestic earning assets. Over the period as a whole, the increase in the banks' domestic assets was due to the increase in the value of exports. Clearly, the banks were able to finance a rising volume of exports in spite of a loss of reserves through balance of payments deficits.

The importance of banking policy as a determinant of the total money supply depends on the relative proportions of foreign and domestic assets which 'backs' the money supply. Under the Currency Board system the entire note circulation is

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issued against foreign assets. A considerable proportion of the total of bank deposits represents merely a monetization of balance-of-payments surpluses. The banks are largely passive agents with regard to this process. A balance-of-payments surplus leads automatically to an equivalent increase in bank deposits, and similarly a deficit leads to a decline in the quantity of deposits. Such changes in the total of bank deposits are matched by equivalent changes in the banks' foreign assets.

A balance-of-payments surplus therefore increases the liquidity of the banks and a deficit reduces it. In addition to the 'primary change' in deposits the banks may cause a 'secondary change' by increasing or reducing their holdings of domestic assets.

Balance-of-payments surpluses usually arise in periods of high export prices, that is, during export booms. At such times, the demand for bank advances for financing exports automatically increases. At the same time the increased level of incomes and economic activity generates an additional demand for credit from the import and domestic sectors of the economy. A secondary expansion of credit, therefore, is most likely to occur. It is extremely improbable that banking policy will counteract the primary increase in deposits. The most the banks are likely to do is to moderate the secondary expansion of credit by increasing their ratios of external assets. From Table 50 it is clear that the banks acted in this way in 1948 when the secondary increase in deposits was only Rs. 6·3 million as against an increase of foreign assets by Rs. 28·4 million. As a result the ratio of external assets rose from 17·5 per cent. to 19·7 per cent. (Table 49). Similarly, in the first half of 1950, domestic assets increased by Rs. 30·3 million while external assets rose by Rs. 59·3 million, leading again to a rise in the proportion of external assets (Table 50). The tendency for the ratio of external assets to increase during a period of rising export prices does not necessarily imply that the banks played a deliberately regulatory role. For it is a reasonable assumption that owing to the higher rates of return obtainable from domestic assets the banks will expand their holdings of such assets to the maximum consistent with their notions of liquidity. Two facts serve to explain the banks'

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behaviour. In the first place, the banks are aware that a substantial proportion of their external assets are as ephemeral as the boom itself and will be slowly drained away in the inevitable downturn of prices. Secondly, the underdeveloped nature of the economy and the conservatism of banking policy narrowly limits the domestic assets which the banks can acquire.

The same line of reasoning applies to a decline in bank deposits caused by a deficit in the balance of payments. There will be a primary contraction of deposits equal to the deficit in the balance of payments. At the same time there will be a decline in the demand for bank accommodation owing to the fall in the level of incomes. The fall in bank liquidity will usually be an inducement to the banks to contract credit. Whether in such a situation the banks will actually increase their domestic assets depends both on the availability of sound investment outlets and on the existence of excess cash in the banking system. Thus both in 1947 and 1949 the banks acquired domestic assets in spite of a primary fall in deposits. They were able to do so because they held a very high proportion of cash in both years—38·4 per cent. in 1947 and 47·9 per cent. in 1949. There is no reason to assume that the banks will play a similar compensatory role when their reserves of cash are low.

The Bank of Ceylon

Before concluding our review of the war and post-war monetary developments, reference must be made to the remarkable rise of the Bank of Ceylon. At the outbreak of the war the bank had barely been established. Its total deposits at the end of September 1940 were Rs. 18·2 million. The figure had risen to Rs. 114 million at the end of the war and stood at Rs. 273·1 million in September 1952, which was roughly a third of the total volume of deposits of all commercial banks operating in the island. At the same time the 'loans and advances' of the Bank of Ceylon were over a third of the total loans and advances of the entire banking system. The doubts which were expressed at the time of its establishment have been completely belied. The bank has made banking facilities freely available to Ceylonese businessmen and

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entrepreneurs.[10] But in all essential respects it remains an institution in the British tradition making short-term loans for the finance of trade. No attempt has so far been made to enter the fields envisaged by the Banking Commission in 1934.[11]

[10] Cf. Statement of the Chairman, Bank of Ceylon, at Annual General Meeting, 1953. 'We shall continue to have always in view the part your bank was intended to play in placing the Ceylonese entrepreneur in a position in which he can compete on equal terms with his non-Ceylonese counterpart.'

[11] By the Finance Act, No. 65 of 1961 the Bank of Ceylon was nationalised 'in keeping with the government's policy of socialism'. (Budget Speech, 1961–62.)

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CHAPTER XI

THE BEGINNINGS OF CENTRAL BANKING

The Monetary Law Act No. 58 of 1949 establishing a central bank in Ceylon was passed by Parliament in March 1949. It altered the entire system of issuing money in Ceylon. The Bank commenced business on 28 August 1950.

Central banks set up in many countries during the inter-war years had usually been established after much public discussion. In contrast, there was remarkably little public interest in creating a central bank for Ceylon. The question was first broached by the government itself shortly after the country obtained independence in 1948.[1] The only book on Ceylon banking, written in 1939, had attempted to make a strong case against a central bank.[2]

The reasons for the public's indifference seem fairly clear from our earlier discussion of monetary and banking developments in the island. For nearly a hundred years the only articulate group within the economy had been a small number of British plantation owners who, in the early decades of the present century, had been joined by a group of indigenous landowners and businessmen. As regards the country's monetary standard, for years it had been the doctrine of the Colonial Office and of the Treasury that the island's intimate commercial relations with India justified, if it did not demand, the use of the Indian rupee in Ceylon. The rupee standard relieved Ceylon of the burden of managing the exchange value of her currency unit. The arrangement met the needs of the British planting interests, since both their supply of labour, as well as the rice which they issued in part payment of wages, were obtained from India. In addition, India was Ceylon's biggest competitor in the market for tea. A monetary policy which suited the tea planters in India, therefore, was

[1] Cf. Ceylon Hansard, 1947, p. 411: Speech from the Throne: 'In regard to finance, my government intends to seek expert advice with regard to changes in our financial structure which may be necessitated by the transition from a colonial to a free national economy.'

[2] B. R. Shenoy: *Ceylon Currency and Banking*, 1941, pp. 230–8.

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automatically acceptable to the planters of Ceylon. Only on one occasion did the Ceylon planters violently object to the use of the Indian currency; and that was between 1893 and 1897 when the export industries of both India and Ceylon were equally affected by the appreciation of the Indian rupee. From the point of view of the 'producing interests' of the island, the Currency Board system at most times worked satisfactorily. The convenience of the currency link with India and the ready availability of credit facilities to the British-owned export and commercial sectors of the economy implied that the politically most influential element in the island did not desire a change. In the early decades of the present century the class of indigenous capitalists and landowners were dissatisfied with existing banking arrangements. But then the problem was not that of controlling banking and credit but the more elementary one of ensuring them adequate banking and credit facilities. It was not realized at that stage that the two problems were even remotely connected. In 1934 the Ceylon Banking Commission had concluded that the rupee link served the interests of the island well and that its financial structure was not developed enough to justify the establishment of a central bank. By and large, the authorities as well as that section of the public most closely interested in monetary and banking affairs seem to have been satisfied with the existing arrangements.

The government's proposals for the establishment of a central bank which were made soon after the war stemmed essentially from the vague notion that reliance on an exchange standard was inconsistent with Ceylon's newly-won political independence.[3] The manner in which the currency was expanded during the war gave additional weight to this attitude.[4]

Early in 1949 the government obtained the services of Mr. John Exter, an economist attached to the Board of Governors of the Federal Reserve System of the United States, to make

[3] Cf. Ceylon Hansard, 1949, col. 708: speech of the Finance Minister at second reading of the Monetary Law Bill: 'Now with the advent of freedom and the consequential changes in the economic structure which the Government has undertaken and with the changes which are taking place around us, it is quite clear that the whole outworn and outmoded system must give way to something more modern.'

[4] Cf. *loc. cit.*, col. 414, speech of the Finance Minister: 'Britain required funds in Ceylon for her purchases and for military expenditure incurred in the country. She was able to secure the necessary funds by making use of Ceylon's dependent monetary status.'

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recommendations for the establishment of a central bank. The Finance Minister preferred to find someone from outside the United Kingdom 'because of the supervisory influence which the British people had over us for about 150 years'.[5]

In contrast with the proceedings of the Ceylon Banking Commission, which was remarkable for the public interest it aroused, there was little public participation in the deliberations of the Commission on central banking. This indifference was due perhaps to the technical nature of the problems involved. But it was due no less to the fact that it was not clear to the public how the creation of a central bank at the apex of the existing monetary structure could benefit them.

Mr. John Exter's 'Report on the Establishment of a Central Bank for Ceylon'[6] was issued in November 1949. It was, in fact, not a report at all but a draft Monetary Law bill interspersed with short comments on certain provisions of the bill. Again, in contrast with the Banking Commission's Report, the document did not examine the basic problems of money and credit which confronted the island's underdeveloped export economy. The Report was content to superimpose a central bank on the existing banking and credit structure. One of the fundamental deficiencies of the structure of credit in Ceylon is the lack of adequate channels for the diffusion of bank credit throughout the various sectors of the economy. The Report did not examine this problem at all, nor consider to what extent the position had altered since the Banking Commission issued its Report. Then again, it did scant justice to the widely held view that a central bank in an underdeveloped economy can be most effective if it engages in commercial banking operations as well.[7] And, most important perhaps, it ignored the vital relationship between central banking policy and policies of long-term economic development.

The Constitution of the Central Bank

The structure, powers, and duties of the Central Bank of Ceylon are, in all essential respects, similar to those that have

[5] Ceylon Hansard, 1949, col. 701: speech of the Finance Minister at second reading of the Monetary Law Bill.
[6] S.P. 14 of 1949.
[7] Cf. R. S. Sayers, *Central Banking after Bagehot*, 1957, pp. 118–19.

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come to be associated with 'traditional central banking'.[8] The bank's capital of Rs. 15 million was appropriated from the surplus assets of the Currency Board. The Monetary Law Act created a Monetary Board of three members, consisting of the governor, the Deputy Secretary of the Treasury, and one other appointed by the Prime Minister. The assets and liabilities of the Board of Commissioners of Currency were transferred to the Monetary Board, which was entrusted with the task of controlling 'the cost, availability and supply of money' in accordance with the national monetary policy.[9]

The central bank was given the power of note issue and wide powers for controlling the volume of credit created by the commercial banks. It was essentially a bankers' bank.[10] Besides the government, its only other customers were to be the two government-sponsored long-term credit institutions—the State Mortgage Bank and the Agricultural and Industrial Credit Corporation.

As regards the issue of currency, the Central Bank differed fundamentally from the Currency Board in that it was empowered to hold domestic securities as part of the assets 'backing' the note issue. The Monetary Law Act does not require the maintenance of any specific proportion of gold or foreign currencies against the note issue. It merely requires the Monetary Board to keep an international reserve 'adequate to meet any foreseeable deficit in the balance of payments'.[11]

In the sphere of credit control, the Bank is equipped with practically all the weapons of modern central banking. It does not have a single published 'bank rate' but is empowered to fix its rates 'in accordance with the character and term of

[8] Owing to its origins, the detailed structure of the bank with its formidable array of credit controls is more in keeping with recent American than with the British tradition. The constitution of the Central Bank of Ceylon bears a family likeness to that of the Phillipines. Mr. Exter was joint-author of the Phillipines central banking legislation. Cf. D. L. Grove and J. Exter: "The Phillipine Central Bank Act", *Federal Reserve Bulletin*, August 1948, pp. 938–49.

[9] Monetary Law Act, para. 2.

[10] The Monetary Board prescribes the reserve ratios to be maintained with the central bank. 'The ratios so prescribed shall not be less than five per cent. or more than twenty per cent. in cases of time and savings deposits and shall not be less than ten per cent. or more than forty per cent. in cases of demand deposits'. Within these limits the ratios may be varied from time to time but 'shall not exceed four percentage points in any one period of thirty days'. At least fourteen days' notice of the date on which any increase is to become effective is required, except in extraordinary circumstances (*ibid.*, para. 93).

[11] *Ibid.*, para. 65 (i).

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each such operation'.[12] It is empowered to rediscount for the commercial banks 'commercial credits' with not more than 180 days to run from the date of their acquisition by the Central Bank, and 'production credits' with not more than 270 days to run, and also to make advances against similar assets or against government or other specified securities.[13]

It has been recognized that the traditional instruments of control such as discount-rate policy and open-market operations are likely to be particularly ineffective in a backward economic and financial structure. The Bank has therefore been given wide powers to control directly both the volume and the use of bank credit. It also has powers to control the nature of commercial bank portfolios. For instance, the Central Bank may fix the maximum permissible maturities for loans and investments, and the nature and amount of the security required for various types of credit operations. It may prohibit commercial banks from increasing the amount of their loans and investments or fix limits to their rate of increase. It may prescribe the maximum ratios which various classes of assets may bear to the capital of a bank. In times of inflation, the Bank may prescribe reserve ratios not exceeding 100 per cent. on any increase of deposits after a certain date. It has powers to prescribe the minimum cash margins against which letters of credit may be opened and the power to fix different margins for different classes of transactions.[14] Yet, as is the case with most central banks, the Bank's powers to check an expansion of credit are far more formidable than those designed to stimulate an increase of borrowing. For the latter purpose, the Bank must rely on the indirect effects of the traditional methods of increasing the liquidity of the commercial banks—low discount rates, open market purchase of securities, and a lowering of reserve requirements.

Perhaps the most significant departure from tradition is the attempt made in the Monetary Law Act to lay down a code of rules to guide the conduct of central banking operations. For instance, in determining its domestic monetary policies the bank is enjoined to

> 'consider their effects on Ceylon's international financial position as evidenced by the relation of domestic to world prices and costs,

[12] Monetary Law Act, para. 86. [13] *Ibid.*, para. 82. [14] *Ibid.*, paras. 99–104.

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by the level and composition of exports and imports, by the international balance of payments, and ultimately by the stability of the Ceylon rupee and its free convertibility for current international transactions.'[15]

Then again, the Bank is required to take remedial action whenever it anticipates a threat to domestic monetary stability and also to submit a report to the Minister of Finance analysing the causes of the actual or threatened monetary disturbances. In any case, the Monetary Board is required to submit such a report in the event of a change in the money supply by more than 15 per cent., or a change in the cost of living exceeding 10 per cent. of its level in the corresponding month of the previous year.[16]

Presumably this attempt, not merely to create a central bank but also to write a manual for central bankers, was occasioned by the fear that a new central bank has neither the traditions nor the experience required for making *ad hoc* decisions. However, as the author of the Report himself admits, 'central banking is less good law than good practice', and the dangers of this attempt seem obvious. Granted that it is impossible to anticipate the innumerable monetary problems and the conjuncture of economic forces that might arise in a changing environment, it is futile to draw attention only to the most obvious of them. The technique of central banking is necessarily the product of a continuous process of evolution, of adaptation to changing situations. Flexibility is the hall-mark of good central banking policy. Anything which hinders that flexibility or encourages a 'rule-of-thumb' attitude to essentially dynamic problems is for that reason undesirable. By way of illustration, the paragraph quoted above which requires remedial action in the event of a threat to monetary stability is, to say the least, superfluous. For, the very purpose of central banking is to ensure that such a threat does not develop or to take remedial action if it does.

A further danger of this procedure is that it enshrines in a legislative enactment the monetary and economic doctrines of a particular period, and of a particular phase of economic development. Fashions in economic thinking are no less volatile than fashions in many other departments of human

[15] Monetary Law Act, para. 62(2). [16] *Ibid.*, para. 63(1).

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behaviour. The heresies of one period may become the orthodoxies of the next. The objectives of social and economic policy and the community's scale of values are continually changing. The rules laid down to guide the Central Bank's domestic monetary policies in the paragraph quoted above are clearly based on certain preconceptions regarding the structure of the economy and the limits of governmental action. Clearly, the international stability of the rupee and its 'free convertibility' would not be of such primary importance, for instance, in a regime of planned international trade as it would be under conditions of private trading.

A glaring example of theoretical analysis of limited validity written into the Monetary Law Act is paragraph 68, which enumerates the circumstances in which the Monetary Board may recommend a change in the par value of the Ceylon rupee. In effect, it attempts to provide a definition of 'fundamental disequilibrium', a concept which has so far eluded attempts at precise definition. It is no doubt true that the law can always be changed. But the process of law-making is necessarily slow, and in any case the embodiment of certain dogmas and practices in a legal enactment tends to give them an unwarranted degree of sanctity which can be an obstacle to change. It is desirable that legislation should confine itself to as broad a definition of the powers and role of a central bank as possible, while leaving the criteria of policy to the central bankers themselves.

The objectives of central bank policy are set out in the Monetary Law Act as follows:[17]

1. The stabilization of domestic monetary values.
2. The preservation of the par value of the Ceylon rupee and the free use of the rupee for current international transactions.
3. The promotion and maintenance of a high level of production, employment and real income in Ceylon.
4. The encouragement and promotion of the full development of productive resources of Ceylon.

In other words, the Central Bank is charged with the task of securing (in so far as it is possible by action authorized by the Monetary Law Act) stability of prices, of exchanges and of a high level of employment, and of encouraging at the same time

[17] Monetary Law Act, para. 5.

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the full development of the productive resources of Ceylon. For convenience, these may be called the 'stability' and 'development' objectives. As the author of the central banking legislation has pointed out, stability and development are seldom mutually consistent. In fact it is the task of economic policy to reconcile these two objectives—that of short-period stability of prices and incomes with a consistently rising trend of economic activity.

In earlier chapters we have examined the behaviour of prices, the foreign exchanges, and incomes under the operation of the Currency Board system, and have also surveyed the development of the economic system over a hundred years. In this entire period neither prices nor incomes were stable. The prices of coffee, tea, rubber, and other export products were determined in world markets. Import prices were determined abroad, and the prices of domestic goods generally followed the same trend though the response was often lagged and 'sticky'. Similarly, both money incomes and real incomes were governed by the level of export prices and by the terms of trade. On the other hand, the mechanism of the Currency Board system ensured stability of the rate of exchange with India, while the exchange rate with sterling was determined by the fluctuations of the rupee–sterling rate in India, which was by no means stable. The investment of foreign capital which has been responsible for the economic development of the country was unrelated to the currency system itself, except in so far as the guarantee of convertibility of the rupee encouraged foreign investment. At the same time there is no evidence that the considerable fluctuations in the rupee–sterling rate which occurred in the nineteenth and early decades of the present century were a substantial hindrance to capital investment.

The remainder of this chapter is devoted to an analysis of the extent to which central banking policy achieved its several objectives during the first seven years of the Bank's existence. Although too much importance should not be attached to its successes and failures in the early years of its life, such an analysis ought to provide guides to future policy and indicate possible shortcomings in its attitudes, techniques and objectives.

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Economic Background

The period of rather over seven years, from August 1950 to the end of 1957, which it is our task to review, may be conveniently divided into four phases:

(i) A period of rising export prices and monetary expansion, which in fact commenced about the end of 1949 and ended about March 1951.
(ii) A period of falling export prices from March 1951 until about the end of 1953.
(iii) A period of relatively high export prices from the beginning of 1954 to the end of the following year.
(iv) A period of low export prices continuing throughout 1956 and 1957.

Before going on to discuss the influence of central banking policies during each of these periods it is necessary to survey briefly the salient changes in the economic background on the basis of which the above division has been made.

The improvement in export prices which followed the devaluation of September 1949 continued into the following year when the outbreak of war in Korea gave rise to a boom in the export industries. The most spectacular price increases were enjoyed by the rubber and coconut industries. The average price of rubber sheet, which was 73 cents per pound in December 1949, stood at Rs. 3·19 per pound in February 1951. The index of the prices of coconut products rose from 138 in January 1950 to 193 in May 1951. On the other hand, the tea market was only mildly affected; the price in March 1951, Rs. 2·47 per pound, was lower than the post-devaluation price of Rs. 2·78 in November 1949. But the market remained firm throughout the period and the quantity of tea exports increased. The balance of payments on current account showed a surplus of Rs. 146·7 million in 1950. Although there was a surplus of Rs. 116·2 million in 1951, the Korean boom had virtually collapsed at the end of the first quarter of the year.

From March rubber prices began to fall and the decline continued throughout the following year. In December 1952 the price stood at Rs. 1·31 per pound, which was less than half its level at the peak of the boom. From the beginning of 1953,

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under a trade agreement with the People's Republic of China, Ceylon agreed to supply China with 50,000 metric tons of rubber annually for five years. In return, China was to supply Ceylon with 270,000 metric tons of rice annually. The prices were to be negotiated each year by the two governments and to be revised in the event of a substantial change in the world prices of either of the two commodities. The agreement stabilized the rubber market and obtained for Ceylon prices which were much higher than those ruling elsewhere. The negotiated prices were 32d. per pound in 1953 and 28d. per pound in 1954.

Although the value of exports, at Rs. 1676 million, was nearly Rs. 200 million higher than in the previous year, the balance of payments on current account in 1953 showed a record deficit of Rs. 445·6 million due both to a deterioration in the terms of trade and an increase in the volume of imports. Export markets remained stagnant throughout 1953, although an improvement in the prices of tea and coconut products reduced the balance-of-payments deficit to Rs. 158·3 million.

In the following year there was a dramatic change in the trade position. While the value of exports rose to Rs. 1794·3 million, imports declined to Rs. 1341 million and the current account yielded a surplus of Rs. 368·4 million. The increase in the export earnings was due almost wholly to a boom in the tea industry. The average price of tea, which was Rs. 2·01 per pound in December 1953, rose to Rs. 3·33 in December 1954. In contrast, rubber in the open market fell to Rs. 1·11 per pound while the index of the prices of coconut products declined from 118 to 97 during the same period. The terms of trade improved from 110 to 170.

The rise in tea prices continued throughout the first quarter of 1955, after which they fell drastically until the third quarter of the year—the f.o.b. price per pound falling from Rs. 4·27 in the first quarter to Rs. 2·85 in the third quarter. The effects of the decline in the tea prices as also of a decline of nearly 20 per cent. in the prices of the three major coconut products was off-set to some extent by the rise in rubber prices, which were on an average about 15 per cent. above their 1954 level. With a rise in the value of exports to Rs. 1962·6 million the current account showed a surplus of Rs. 322·8 million.

The 'near-boom' conditions which had been characteristic

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of the two preceding years gave way to a mild depression continuing throughout 1956 and 1957. Both tea and rubber prices fell. The average price of tea (all qualities) fell to Rs. 2·78 in 1957 while the prices of the major coconut products reached the lowest levels recorded since 1949.

While the value of exports continued to decline the value of imports rose from Rs. 1447 million in 1955 to Rs. 1530 million in 1956 and to Rs. 1962 million in 1957, primarily as a result of a deterioration in the terms of trade. The surplus on current account was only Rs. 81·7 million in 1956, while 1957 showed a debit balance of nearly Rs. 200 million.

National Income and Prices

Fluctuations in the export sector implied corresponding changes in income. The national income of a country is equal to its aggregate expenditure on goods and services. The Keynesian identity for a closed economy may be expanded as follows to cover the case of an open economy: $Y = C + I_p + I_g + G + E - M$, where

Y = Gross national product (income).
C = Private consumption expenditure on goods and services.
I_p = Private investment.
G = Government expenditure on current goods and services.
I_g = Government investment.
E = Exports.
M = Imports.

The estimated gross national expenditure of Ceylon for the year ending 30 June 1951 is shown in Table 51 below.

TABLE 51

GROSS NATIONAL EXPENDITURE AT MARKET PRICES
YEAR ENDING 30 JUNE 1951

	Rs. million
Private Expenditure on Goods and Services	3147
Government Expenditure on Current Goods and Services	514
Private Investment	441
Government Investment	233
Exports	2014
Imports	1642
Gross National Expenditure (Income)	4670

Source: Annual Report, Central Bank of Ceylon, 1951.

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Of the above determinants of national income, investment (both private and government), government expenditure on current goods and services and exports may be regarded as independent variables, whereas both private consumption and imports are dependent on the level of national income.

The distinguishing characteristic of an underdeveloped export economy is the overwhelming influence of the foreign demand for exports on the size of the national income. In the above estimates the value of exports constitutes over 43 per cent., while gross investment forms only 14 per cent., of the national income.[18] Thus variations in export prices rather than variations in value of investment are the most important short-period determinant of changes in the national income of Ceylon, a change in the value of exports leading to a multiple change in the level of the national income according to the familiar 'multiplier' principle.[19] In a developed economy where the ratio of investment to national income is high, a central bank can attempt to influence the level of the national income by influencing investment activity. In an underdeveloped economy, however, such action is likely to be swamped by fluctuations in export prices. The central bank is thus often compelled to take income fluctuations as part of the environment in which it has to function unless such fluctuations are minimized by 'non-monetary' methods such as stabilization schemes or by exchange-rate variations.

The Stabilization of Domestic Monetary Values

According to the Monetary Law Act the first duty of the Central Bank is 'to stabilize domestic monetary values'. The very structure of the economy, however, makes this task almost impossible to achieve. A corollary of her concentration on export production is that the country spends a high proportion of her national income on imports—on articles of mass consumption. Thus the domestic price level (as measured by a

[18] The ratio of export proceeds to national income in Ceylon is one of the highest in the world; cf. United Nations Year Book of National Accounts Statistics (New York).

[19] $\Delta Y = K\Delta E$; $K = \frac{1}{s + m}$, where s and m are the marginal propensities to save and to import respectively.

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cost-of-living index number) is extremely sensitive to price fluctuations originating abroad.

As we have seen, the general level of prices within a country is in fact composed of three separate price levels:

(*a*) The price level of goods and services produced at home.
(*b*) The price level of imported consumption goods.
(*c*) The price level of those export goods which are also consumed at home.

The cost-of-living index number is an average of these price levels appropriately weighted. Since Ceylon supplies only a small proportion of the total world supply of her exports, the price level of export commodities cannot be influenced by central bank action. Similarly, Ceylon cannot influence the price level of her imports because she purchases only an infinitesimal fraction of the world output of these commodities.

Thus, it is only the price level of the 'domestic group' of commodities which come within the range of central bank

TABLE 52

NATIONAL INCOME AND PRICES, 1949–1957

Year	*Gross National Income Rs. million*	*Index of Export Prices* (1948 = 100)	*Index of Import Prices* (1948 = 100)	*Index of Prices of Domestic Goods* (1952 = 100)	*Cost of Living Index* (*Nov.* 1938–*April* 1939 = 100)*
1949	2967	106	96	85·8	258
1950	3501	144	99	89·8	272
1951	4619	175	119	96·6	283
1952	4476	136	128	100·0	281
1953	4491	139	118	101·6	285
1954	4772	155	108	101·1	284
1955	5234	162	102	100·5	281
1956	5096	152	106	100·0	281
1957	5200	145	112	104·9	288

Sources: Statistical Abstract of Ceylon; Annual Reports of the Central Bank of Ceylon.

* In 1953 the base year was changed to 1952. The indices here have been recalculated with base year 1938/39. The figures for 1952–57 are therefore approximate.

action. The prices of these goods depend on the aggregate monetary demand for them. Theoretically, the Central Bank could stabilize the price level of domestic goods by stabilizing aggregate monetary demand. To do this, however, it is necessary to stabilize national income which, as we have seen,

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cannot be achieved by a central bank in an underdeveloped export economy.[20] As Table 52 shows, gross national income during this period moved in step with export prices, while the cost-of-living index number reflected the movements of its three component price levels.

Central Banking and the Money Supply

Although central bank policy cannot by itself stabilize prices and incomes, it may moderate the amplitude of fluctuations and promote economic stability by influencing the supply of money. This aspect of the Central Bank's functions has been emphasized in the Report on the Establishment of a Central Bank for Ceylon. Its main criticism of the Currency Board system was that the currency supply was determined entirely by fluctuations in the balance of payments. 'The greatest significance of the introduction of a Central Bank', says the Report, 'lies in the power of the Bank consciously to influence the supply, availability and cost of money in Ceylon'. It is able to do so by engaging in 'domestic credit operations to augment or offset the effects on the economy of its foreign exchange operations'.[21] The emphasis here is not on the stabilization of prices and incomes but on the much narrower one of stabilizing the supply of money. While under the Currency Board system the total money supply was determined by the balance of payments and by banking policy, under a central bank system there is a third factor in the form of the domestic credit operations of the Central Bank.

Clearly, mere stability in the money supply is only a partial, and sometimes misleading, criterion of the success of central bank policy. On the other hand, the money supply must be responsive to the changing needs of the economy. In the short period it should promote economic stability, while in the long period it should foster economic growth. If, however, we assume that the amount of money in circulation is a function of the level of economic activity, a fall in the monetary circulation would be symptomatic of income deflation, while a rise in the circulation would indicate a rise in the national income,

[20] Cf. Annual Report of the Central Bank of Ceylon, 1957, para. 18: 'Movements of prices in Ceylon do not necessarily reflect changes in the internal money and credit situation.'

[21] Report on the Establishment of a Central Bank for Ceylon, 1949, pp. 5–6.

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an inflationary rise in prices, or both. In the following paragraphs an attempt is made to evaluate the operations of the Central Bank of Ceylon, bearing in mind the above considerations.

Table 53 sets out an analysis of the causes of changes in the money supply during the period under review. The total

TABLE 53

CAUSES OF CHANGES IN THE MONEY SUPPLY SEPTEMBER 1950 TO DECEMBER 1957

Rs. million

	30.9.50 *to* 31.3.51	31.3.51 *to* 31.12.51	1952	1953	1954	1955	1956	1957
(i) *External Assets of Central Bank and Commercial Banks*	+283·4	−81·7	−375·1	−132·6	+341·0	+218·9	+20·4	−209·2
(ii) *Domestic Assets of Central Bank*	+ 6·1	+ 1·0	+142·4	+ 58·3	−221·0	− 26·0	−30·2	+ 64·5
(iii) *Commercial Banks' Credit to Government*	+ 25·8	−46·7	+ 67·3	− 18·8	− 26·2	− 26·2	+62·7	− 7·4
(iv) *Commercial Banks' Credit to Private Sector*	− 3·1	+73·5	− 32·2	+ 18·0	+ 37·5	+ 12·9	+ 93·0	+55·3
(v) *Fixed and Savings Deposits of Commercial Banks*	− 17·7	−11·2	− 12·1	− 5·5	− 36·2	− 15·9	−31·2	−38·4
(vi) *Government's Cash Holdings*	− 62·0	+37·7	+ 92·5	+ 7·1	− 16·8	− 46·5	−61·0	+49·2
Total Changes	+232·5	−27·4	−117·2	− 72·5	+130·3	+115·8	+ 53·9	−86·8

Source: Annual Reports of the Central Bank of Ceylon.

change in the money supply is the algebraic sum of changes due to the six causes shown in the above table. As a first approximation these causes may be classified under two heads: (*a*) externally induced changes and (*b*) internally induced changes. All influences due to the external transactions of the economy would be reflected in item (i)—the foreign assets of the banking system. Changes due to internal factors may be further subdivided into those originating in the private sector and those due to the government's financial operations. Thus item (iv) originates in the private sector, while items (ii), (iii), and (vi) originate in the government sector. Item (v)—changes in the quantity of fixed and savings deposits—could, of course, originate in both sectors.

The efficacy of central banking must be judged by the impact of the Bank's policies on the private sector—since its transactions

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with the government sector are intertwined with the government's overall economic policy. Similarly, the expansionary or contractionary effects of changes in the volume of fixed deposits or in the volume of the government's cash holdings are not directly attributable to central banking policy.

In each of the four periods under consideration changes in the total of external assets of the banking system[22] was the most important cause of changes in the money supply. In order to offset such externally induced fluctuations, the Central Bank can take several types of action to influence the domestic component of the money supply. The Bank can itself buy or sell domestic assets and also attempt to influence in various ways the ability and willingness of the commercial banks to hold such assets.

In the inflationary period of the Korean boom the monetization of external assets added Rs. 283·4 million to the total money supply. At the same time the domestic assets of the banking system, far from offsetting this increase, themselves increased by Rs. 29·8 million. The rise was due entirely to an extension of credit to the government. The commercial banks' credit to the private sector declined by Rs. 3·1 million. The main factors making for a decline in the circulation were a rise in fixed and savings deposits by Rs. 17·7 million and an increase in the government's cash holdings by Rs. 62 million. The net result was an increase of Rs. 232·5 million in the money supply.

The attitude of the Central Bank towards the increase in the money supply was that it was necessary in order to finance the larger value and volume of trade and the rising level of economic activity. The Bank's Annual Report for 1950, referring to the expansion of bank credit in that year,[23] states that 'its (the Bank's) investigations have disclosed that the bulk of this credit has been essential to finance the growing volume of Ceylon's trade in recent months'. It adds:

> 'as the value of exports rises, due to a rise in their prices and an increase in their volume, it is to be expected that there will be an extension of credit to finance them. This type of credit expansion is the least harmful to an economy, because it is short-term credit

[22] I.e. the commercial banks and the central bank.

[23] Over the year as a whole, bank credit to the private sector increased by Rs. 60·5 million.

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to enable the commercial movement of goods. If the value of exports contracts, credit will also contract. Thus, the new money will disappear if and when the time comes, just as naturally as it first appeared.'

The statement above recognizes an important fact about an export economy, that is that the bulk of the credit extended by the banks is to the export sector and as such its volume fluctuates with changes in the quantity and price of exports. The same argument applies to an extension of credit to finance an increase in the value of imports.

One could go further and state that during a boom a larger monetary circulation is necessary not only to finance the growing value and volume of foreign trade but also to finance the increased turnover of domestic goods and services.[24] It is clear that during a boom the money supply must of necessity increase. The problem which confronts the Central Bank is how far it ought to take offsetting action and how far it is justified in tightening credit by raising interest rates and engaging in open-market operations. If it is granted that an increase in the quantity of money is necessary in order to support the higher price and income structure during a boom, it will be realized that offsetting action will be confined within very narrow limits.

The second problem is much less easy to resolve. A balance-of-payments surplus leads to a rise in the liquidity of the banking system through an increase in cash and external assets. Thus there is considerable scope for a secondary expansion of credit. In discussing the necessity for restrictive central bank action one has to bear in mind the almost exclusive connexion of the banking system with the foreign trade sector of the economy. Banks in Ceylon were first established to meet the requirements of a 'plantation' economy exporting raw materials and importing manufactured goods, and they still, by and large, confine themselves to their original functions. Whatever credit outlets exist in the domestic sector of the economy tend to be affected by the prosperity of the export

[24] An increase in income will be divided between savings, and expenditure on imports and on domestic goods and services. Only the last will influence employment and prices at home. To the extent that domestic production is inelastic, there will be a rise in the 'domestic' price-level. This too requires an increased monetary circulation.

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industries owing to the dependence of the entire national income on the size of the export income. All except one of the major banks in Ceylon are 'exchange banks', interested in loans to the domestic sector only if they are likely to lead to a sale or purchase of foreign exchange at some later date. Following the traditions of British banking, they insist on a type of security against loans that is difficult to come by. Only a small fringe of business is developed at all along the lines of Western capitalist enterprise. The bulk of whatever production there is outside the export sector is still organized along primitive lines. There is only a very small 'private enterprise' sector catering for a purely domestic market. As a result, banks during a boom find that they have few reliable credit outlets to absorb their surplus liquidity.

This view is supported by a passage in the Central Bank's Annual Report for 1951[25] which, referring to the entire inflationary period, says:

> 'At no time during the year did the banks hold less than Rs. 53 million in excess reserves and at one time they held Rs. 92·8 million. Moreover, the figures understate the total liquid reserves of the commercial banks, since some of them, as just indicated, held large balances overseas that could be brought to Ceylon in case of need. In most other countries central banks have had to restrain credit expansion to the private sector in order to check inflation. In Ceylon the Central Bank did not need to.
>
> In one way the reluctance of the banking system to lend has been an advantage: it has made central bank policy easier during a period when inflationary pressures were strong. But from a long-run point of view it is a discouraging commentary on Ceylon banking as well as on Ceylon enterprise, that in a year when the country was unusually prosperous, when bank resources were large and when the Central Bank was imposing no really important curb on the creation of private credit, the increase in such credit was so small. From December 1950 to December 1951, bank extension of private credit in one form or another increased by only Rs. 76 million. Much of this increase can be accounted for by the necessity for financing imports and exports at higher prices. A major task of the Central Bank in the years to come will be to stimulate the commercial banks to extend a larger volume of credit to the private sector of the Ceylon economy.'

[25] Paras. 38 and 39.

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It is not often that one finds a central bank complaining that banks have not extended enough credit during a boom. This seeming paradox can only be explained by the underdeveloped nature of the Ceylon economy and its reliance on a banking system which is totally unsuited to the structural environment. From a short-term point of view, the Central Bank's objective would be to tighten credit during a boom in order to check, as far as possible, the upsurge of the price-level. But from a long-run point of view, an underdeveloped economy, if it is at all capable of unaided development, should find a boom period particularly favourable to economic expansion. And such an expansion should undoubtedly receive the blessing of the Central Bank. This is a dilemma of credit policy in a backward export economy which seems incapable of solution along traditional lines.

In a backward economy such as that of Ceylon, where there is a hard core of underemployment and unemployment in the rural sector, a mechanical anti-inflationary policy during a boom is definitely ill advised. It is only during a boom that this sector experiences even a slight increase in employment, and of activity in the form of increased production and trade. There appears a tendency for the pressure of the population on the land to be eased, and for a drift towards other occupations, primarily in the urban areas. At the same time the increased profitability of production attracts those who are kept away at normal times owing to the high risks of business inherent in an underdeveloped country. In the circumstances, making credit prohibitively expensive may not amount to killing the boom, but it does prevent the domestic sector of the economy from sharing, however indirectly, in the fruits of the export boom. Faced with this dilemma, the Central Bank is liable to find the scope and efficacy of quantitative control extremely limited. On the other hand, it must lean heavily on qualitative or direct controls of which there are several in its armoury. Not all of them are likely to be equally effective.

The major restrictive action taken by the Central Bank during the Korean inflation was to raise the minimum reserve requirements of the commercial banks' demand deposits from 10 to 14 per cent. from January 1951. At the end of the previous year the banks held Rs. 85·9 million in excess reserves.

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In January the excess reserves fell to Rs. 57·9 million. At the same time the Bank 'informed the commercial banks that it did not wish to encourage them at this time to bring their balances to Ceylon from overseas'. It was felt that 'the repatriation of such balances would increase the banks' excess reserves and thus tempt them to engage in non-essential domestic lending'. This was followed by a request to the banks not to extend 'any non-essential, and particularly speculative, credit in the future'.[26]

It is, of course, impossible to estimate the effect of these measures on the volume of credit. On *a priori* grounds, it seems unlikely that the effect was significant. In spite of the rise in the reserve requirements the banking system as a whole had excess reserves of Rs. 57·9 million. Although the uneven distribution of these reserves could have hampered some banks, their high degree of liquidity would have enabled them to borrow from one another or draw on their external assets if suitable investment outlets were available. The request not to extend credit may possibly have acted as a damper on the banks' activities; but considering that bank lending was closely geared to the export and import trades, the significance of such 'moral suasion' remains doubtful. In any case, it left the decision as to what types of credit were 'non-essential' to the judgment of the banks themselves. Similarly, the indication to the banks that the Central Bank did not wish to encourage the repatriation of foreign balances could only have mildly restrained them. As long as the banks had excess reserves, foreign balances were a secondary reserve against which they could have created a substantial volume of credit. Nevertheless, the Bank's reliance on qualitative controls is significant, for measures to control the direction of credit are likely to be much more effective in Ceylon's economic environment than the traditional methods of quantitative control. The power to fix 'ceilings' on particular types of loans was not used in this period although it is undoubtedly one of the most powerful weapons at the Bank's disposal.

However, between September 1950 and the end of the year there was no secondary expansion of credit to the private sector. The banks' holdings of loans, overdrafts and bills of exchange

[26] Annual Report of the Central Bank of Ceylon, 1950: paras. 18 and 36.

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declined by Rs. 3·1 million. The explanation probably is not that the private sector was starved of credit, but that it was satiated. For during the monetary expansion of the preceding twelve months, credit to the private sector had increased by Rs. 63·5 million. This credit, together with the funds made available by the rise in export incomes, enabled the private sector to finance itself without assistance from the banks.

In contrast to the apparent moderation of the private sector, the government made large demands on both the Central Bank and the commercial banks, whose total holdings of government debt increased by Rs. 31·9 million, which added an equivalent amount to the money supply. This, however, was counteracted by an increase in the government's cash balances, so that the net effect of government operations was deflationary.

Although the Korean boom had ended in the first quarter of 1951, the year as a whole yielded a balance-of-payments surplus —the large surplus in the first quarter of the year and the very much smaller one in the last quarter offsetting the deficits of the second and third quarters.[27] Between March 1951 and December 1951 the total money supply declined by Rs. 27·4 million, while external assets fell by Rs. 81·7 million. An expansion of bank credit to the private sector of Rs. 73·5 million and a decline in the government's cash balances of Rs. 37·7 million partially offset the effect of the balance of payments. The domestic assets of the Central Bank rose by a mere Rs. 1 million. The banks' credit to the government sector declined by Rs. 46·7 million. The most noteworthy feature of the behaviour of the banking system during this period was its ability to meet the domestic demand for credit in spite of a fall in liquidity. Over the year as a whole the proportion of the banks' loans and advances to total deposits rose from 22·6 per cent. to 31·5 per cent., while the proportion of investments declined from 33·6 to 28·9 per cent.[28]

By the end of the year deflation was well under way. The Central Bank reacted by lifting its 'moral embargo' on the repatriation of the banks' overseas assets and, in fact, took steps to encourage such repatriation. To this end, the Bank fixed maximum working balances in sterling for each bank and

[27] Annual Report of the Central Bank of Ceylon, 1951.
[28] *Ibid.*, 1954, para. 67.

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announced that it might refuse to purchase forward sterling from any bank whose actual balances exceeded the working balance limit. The change of policy was implemented in January 1952.

Throughout the next two years a decline in the foreign assets of the banking system was consistently tending to reduce the money supply. During 1952 the deflationary effect of the adverse balance of payments was offset by domestic credit creation for the government. The Central Bank's holdings of government securities and its temporary advances to the government increased by Rs. 142·4 million and the commercial banks added Rs. 67·3 million in government securities and Treasury bills to their portfolios. Commercial bank credit to the private sector, on the other hand, fell by Rs. 32·2 million, in sympathy with the decline in the value of exports.

In 1953 external assets fell by Rs. 132·6 million and the total money supply by Rs. 67·4 million. Again the main factor counteracting the influence of the balance of payments was an increase of government borrowing. The Central Bank's holdings of the government debt, consisting largely of short-term advances to the Treasury, showed an increase of Rs. 58·3 million. The banks increased their credit to the private sector by Rs. 18·0 million, which was offset by an almost equivalent decline in their holdings of government securities. The fall in the money supply was, therefore, roughly equal to the fall in the external assets less the domestic credit creation of the Central Bank. To counteract the fall in the banks' liquidity, caused by the decline in their foreign assets, the Central Bank lowered the reserve requirements on demand deposits to 10 per cent. While this step does not appear to have influenced the banks' lending policies appreciably, it relieved their uncomfortably tight liquidity position.[29]

The revival in export prices in the early months of 1954 led to an expansion in the money supply by Rs. 130·3 million. The external assets of the Central Bank and of the commercial banks rose by Rs. 341 million. Once again the government's financial operations were the main counteracting factor. The

[29] Cf. Annual Report 1953, para. 49: 'The contraction in the money supply involved a reduction in the resources of the commercial banks. By July 1953, it had become clear that the banks were reaching a point where they might be obliged to restrict their lending to the private sector.'

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government reduced its floating debt by Rs. 214·1 million. Treasury bills were reduced by Rs. 85 million, outstanding Central Bank advances of Rs. 72·1 million were repaid. There was a total decline of Rs. 247·2 million in the amount of government debt held by the Central Bank and the commercial banks. Bank credit to the private sector expanded by Rs. 37·5 million. It was the view of the Central Bank that 'since higher internal liquidity and lower costs of borrowing did not give rise to inflationary pressures within the economy, it was not necessary for the Bank to engage in open market operations for purely disinflationary purposes'.[30]

During the following year external assets increased by Rs. 218·9 million. Mainly owing to the contractionary influence of a reduction in the government debt held by the banking system and an increase in government's cash balances, the money supply increased by only Rs. 115·8 million.[31] Bank credit to the private sector increased by Rs. 17·8 million, the increase being shared about equally between export bills and loans.

In spite of the rise in the money supply and the rise in the liquidity of the banking system (the ratio of liquid assets to total deposits rose from 38·7 to 49·8 per cent. during the year) there was no evidence of 'inflationary tendencies'. The banks' holdings of domestic assets (loans and investments) actually declined by Rs. 10 million. Bank rate remained unchanged at 2½ per cent. Once again it was demonstrated that restrictive central bank action was superfluous in the context of the Ceylon economy.[32]

However, the rise in the liquidity of the private sector as well as of the banks induced the Central Bank to advise the government to float new issues totalling Rs. 197 million. In addition, the Central Bank decided to issue its own securities to the value of Rs. 10 million.[33] This issue was of a purely experimental nature and was promptly over-subscribed. Commenting on this experience the Bank's Annual Report for the year states:

> 'the facts relating to 1955 reflect a situation that is normal in Ceylon as regards bank credit to the private sector. Although the loanable resources of the bank may fluctuate considerably, the

[30] Cf. Annual Report, 1954, para. 41.
[31] Cf. Table 53, p. 273.
[32] Cf. Annual Report, 1955, paras. 19 and 45.
[33] Cf. *ibid.*, para. 20.

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> level of bank credit tends to be relatively stable, any moderate changes in credit extension being normally accounted for by changes in the need for finance of the export trade. Such conservative lending policies are for Ceylon, partly an advantage, partly a weakness. They are an advantage to the economy in that bank credit expansion does not accentuate the swings of the economy caused by fluctuations in export prices. They are a weakness in that if conservatism becomes too rigid a creed, they would be utterly inappropriate in an economy requiring rapid development.'

There was a net addition of Rs. 20·4 million to the country's external banking assets during 1956. This was achieved despite the fall in export prices and a deterioration in the terms of trade. However, unlike in previous years when the foreign balance was the dominant influence on the supply of money, in 1956 domestic credit creation was far in excess of the balance-of-payments surplus and the money supply rose by Rs. 54 million. Bank credit extended to the private sector increased by Rs. 92·4 million, offsetting the contraction due to an increase in fixed and savings deposits and in the government's cash holdings which totalled Rs. 92 million. The increased credit requirements of the private sector were due mainly to delays in the shipping and clearing of cargoes caused by the Suez crisis and by congestion in the Port of Colombo. It is significant that the banking system was able to meet this increased demand at a time when the effect of central bank action was deflationary. During the year the Central Bank's holdings of government securities declined by Rs. 30·2 million. In addition the Bank issued Rs. 10 million worth of its own securities. Once again there was no occasion for active central bank intervention. Open market operations were not undertaken to any significant extent, and bank rate remained unchanged. In spite of the increase in the money supply 'there was no evidence that this rise was associated with inflationary tendencies in the economy'.[34]

In 1957 external assets declined by Rs. 209·2 million while the money supply fell by only Rs. 86·7 million. The deflationary effect of the balance of payments was counteracted by a transfer of government rupee cash to the public (Rs. 49·2

[34] Annual Report, 1956, para. 14.

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million). Commercial bank credit to the private sector increased by Rs. 55·3 million, an increase necessitated by the rise in the value of imports and by the congestion in the Port.[35]

Although as a result of the adverse balance of payments the banks lost nearly Rs. 60 million of their external assets, the ratio of bank cash to total deposits was as high as 12·9 per cent. while the ratio of liquid assets to total deposits was 33 per cent. The banks were able to meet the increased demand for credit owing to their large reserves of liquid assets. Apart from two issues of its own securities at the beginning of the year, 'to reduce excess liquidity', the Central Bank did not engage in open market operations. The reduced liquidity of the banking system induced a hardening of interest rates, but bank rate again remained unchanged at 2½ per cent. Active central bank action during the year was confined to a broad directive to the commercial banks not to extend credit for the import of non-essential goods.[36]

Instruments of Central Bank Action

In an assessment of the influence of central bank policy in these years, two facts deserve special emphasis. First, in spite of the existence of the Central Bank, changes in external assets continued to be the most important determinant of the money supply. There are no grounds for believing that central bank action significantly affected the rate of domestic credit creation by the commercial banks, except when the latter extended credit to the government by buying long- and medium-term bonds and Treasury bills. At the same time, bank credit to the private sector of the economy was governed primarily by the value of exports and imports. As Table 53 indicates, there is no connexion between changes in the amount of bank credit extended to the private sector and the acquisition of domestic assets by the Central Bank. Thus between March and December 1951, bank credit to the private sector increased by Rs. 73·5 million, but the Central Bank's domestic assets increased by only Rs. 1 million. Similarly, in 1954 bank credit to the private sector increased by Rs. 37·5 million although there was a decline of Rs. 221 million in the Central Bank's domestic assets. Similarly, in 1956, bank credit to the

[35] Annual Report, 1957, para. 80. [36] *Ibid.*, 1957, para. 30.

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private sector increased by Rs. 93 million in spite of a fall in central bank assets by Rs. 30·2 million.

Secondly, the behaviour of bank advances and the fact that bank lending in Ceylon is geared to foreign trade suggest that the volume of bank credit to the private sector is largely demand-determined. During a boom a rise in export incomes and the increase in the value of imports leads to an increase in the demand for credit. At the same time, the boom adds to the liquid reserves of the banking system through a surplus in the balance of payments. Thus the banks are able not only to meet the increased demand for bank advances but also to increase their holdings of government securities if such assets are available. Similarly, during a period of falling export prices there is a fall in the banks' liquidity through a deficit in the balance of payments, while there is also a decline in the demand for bank credit owing to the contraction in the volume of foreign trade. The reduced liquidity of the banks is accompanied by a decline in the demand for bank credit. Their excess reserves enable the banks, at most times, to get by without a secondary contraction of credit. The extent of the relationship between the credit creation of the banks and the volume of foreign trade is brought out in Chart VII where the two series, 'Bank Credit to Private Sector' and 'Volume of Foreign Trade',[37] show a close correlation. The chart shows also that variations in the Central Bank's holdings of government securities (open market operations) scarcely affected the commercial banks' creation of credit for the private sector. In fact, the two series are negatively correlated. On the other hand, the Central Bank's holdings of government securities shows a slight positive correlation with the amount of commercial bank credit extended to the government.[38]

The negligible impact of central bank operations on the rate

[37] The main determinant of the demand for credit is the value of exports, which in turn influences the demand for bank credit to finance imports through its effect on national income. A survey of bank advances conducted by the Central Bank showed that on 30 September 1957 66·6 per cent. of advances of the commercial banks were for 'commercial' purposes. 21 per cent. of the total of bank advances were made against documentary bills, and 30·4 per cent. against 'stock in trade'. (Annual Report, 1957, paras. 110–11.)

[38] The correlation coefficients are as follows: bank credit to private sector/volume of foreign trade: +0·44; bank credit to private sector/Central Bank holdings of government securities: −0·02; commercial bank credit to government/Central Bank holdings of government securities: 0·15.

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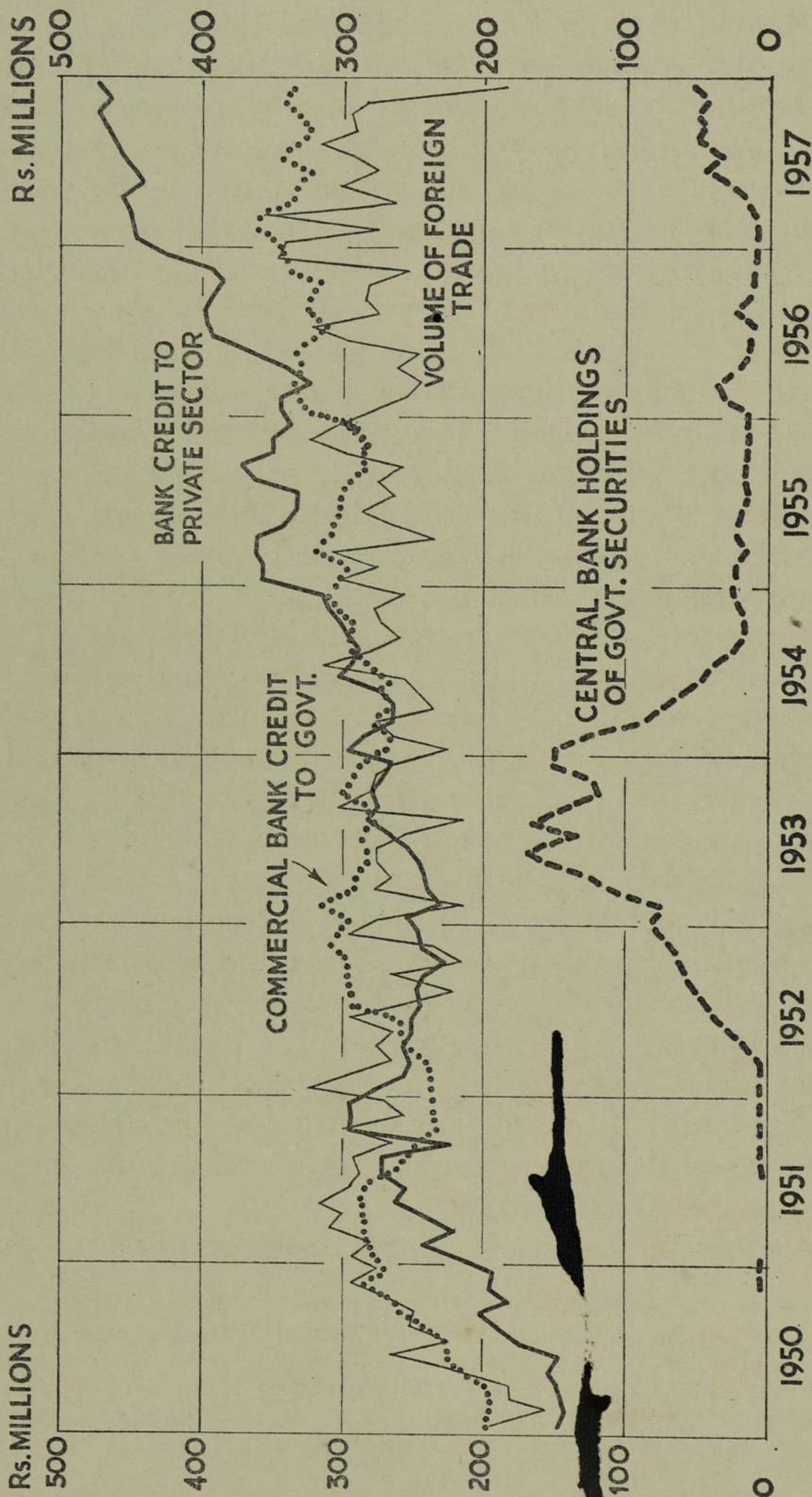
CHART VII. BEHAVIOUR OF BANK CREDIT, 1950–1957



Source: Annual Reports of The Central Bank of Ceylon

of domestic credit creation of the commercial banks is due to two reasons. While the demand for credit from the private sector is determined by the fortunes of foreign trade, the supply of credit tends to be independent of central bank action owing to the fact that the banks hold excess reserves of cash. Thus, as is seen from Table 54, there is no definite relationship between changes in the monetary liabilities of the Central Bank and changes in the volume of credit extended by the commercial banks.

TABLE 54

DOMESTIC CREDIT CREATION OF COMMERCIAL BANKS 1950–1957

	30.9.50 *to* 31.3.51	31.3.51 *to* 31.12.51	1952	1953	1954	1955	1956	1957
				Rs. million				
Changes in Reserves of Commercial Banks	+47·3	+10·6	−60·9	−67·0	+42·0	+36·7	+15·0	−63·7
Changes in Commercial Banks' Domestic Assets	+22·7	+26·8	+35·1	− 0·8	−11·3	−13·3	+155·7	+47·9

Source: Annual Reports of the Central Bank of Ceylon.

The primary role of the Central Bank has been that of helping the government to run budget deficits. The influence of government finance on the money supply was second only to that of the balance of payments. During the two financial years 1951–53 the government's budget deficit amounted to Rs. 483·5 million. Towards this amount the Central Bank contributed over one half—Rs. 255·5 million, by increasing its domestic assets (provisional advances to government, and government securities). The rest was subscribed by the commercial banks and by non-bank investors, mainly institutions. It is significant that during these two years the Central Bank's holdings of the government debt increased more than the non-cash domestic assets of the entire commercial banking system.[39] Table 55 shows how the deficit was financed.

Clearly, deficit expenditure on this scale would not have been possible but for the co-operation of the Central Bank.[40] If government expenditure tended to mitigate income deflation during this period, it also quickened the drain on the country's

[39] The figures are: Central Bank's holdings of government securities: + Rs. 142·5 million; Commercial banks' non-cash domestic assets: + Rs. 58·8 million.

[40] Again, in the financial year 1956–57 the government ran a deficit of Rs. 196·4 million. Towards this the Central Bank contributed Rs. 130·1 million.

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foreign assets, which fell from Rs. 1184·7 million in September 1951 to Rs. 607·2 million in September 1953—a decline of nearly fifty per cent.

TABLE 55
DEFICIT FINANCE, 1951–1953

	Rs. million
Central Bank	255·2
Commercial Banks	34·6
Non-bank Investors	93·8
Drawing down of Cash Balance	99·9
Total	483·5

Source: Annual Reports of the Central Bank of Ceylon.

Although the Central Bank was an accessory of the government's financial policy, it remarks in its Report for 1952 that the uninterrupted and heavy drain on the foreign assets was due to this very policy. Government policy, it argues, helped maintain consumption and imports during a slump and thus prevented the automatic corrective of income deflation from operating.[41] Now, this automatic corrective was part of the mechanism of the Currency Board system. What the Bank is complaining of is that monetary events did not conform to the pattern which would have obtained had there been no central bank. This almost contradictory attitude of the Central Bank, as well as the experience of these years, raises in an acute form the question of the role of deficit spending in an underdeveloped export economy and the position of the central bank in relation to it.

The classical weapons of central banking played hardly any part in the events of this period. The Central Bank did not attempt to control the volume of credit by effecting a change in interest rates. On the other hand, it would appear that it was unable to pursue an independent 'interest-rate policy'. The Central Bank discounts Treasury bills for the banks at one-eighth of one per cent. above the last average tender rate and also grants advances against specified securities. This 'advances rate' remained at 2½ per cent. from the commencement of business by the Bank until July 1953, when it was raised to 3 per cent. The occasion for this change was that market rates had already risen and 'it represented an adjustment to the

[41] Annual Report, 1952, para. 12.

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basic change that occurred'.[42] The Treasury bill rate had risen from 0·92 per cent. in February to an average of 2·47 per cent. in July, which had led to a rise in the bank's 'discount rate' for Treasury bills. But in June 1954, owing to increased liquidity of the banks, the Treasury bill rate had fallen to 1·65 per cent. and the Central Bank was rediscounting Treasury bills at 1·775 per cent. The Central Bank's advances rate was then reduced to 2½ per cent. again, in step with the market rates.[43] The most important influence on the structure of money rates was the Treasury bill rate, changes in which led to changes not only in the rates of the Central Bank but also in long-term interest rates. Owing to the dominance of the Treasury bill rate, the Central Bank's rates are likely to fall during an export boom when the liquidity of the banks is high, and rise during a slump owing to the decline in the bank's liquid assets. The scope for a 'contra-cyclical' monetary policy is thus extremely limited.

Open-market operations were not used significantly as a method of influencing the cash reserves of the banks. Apart from the technical difficulties involved in large purchases and sales in a narrow market, the Central Bank was hampered by the need to provide funds for the government, which meant that at most times the Bank was a buyer of securities, irrespective of the policies followed by the commercial banks. In 1954, when the government's demands for Central Bank funds had been reduced, the Bank undertook open-market operations to a limited extent. In spite of the increase in bank liquidity during the year, the Central Bank did not find any evidence of 'inflationary pressures' originating from the extension of bank credit to the private sector. The sale of securities was designed purely to provide an investment outlet for the increased quantity of loanable funds in the market. In periods of boom, when the liquidity of the banks is extremely high while the scope for the employment of funds is restricted, open-market operations can, in fact, have no other function. Whether their use in this manner is justifiable is probably a matter of judgment. The primary task of reducing bank liquidity is more directly achieved by the raising of reserve requirements.

Just as its traditional instruments of control were little used,

[42] Annual Report, 1953, para. 44. [43] *Ibid.*, 1954, paras. 40–42.

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the Central Bank's less conventional powers of influencing the money supply were not used at all. The explanation is that during this entire period a formidable problem of curbing bank credit creation did not arise. The narrow field to which the banking system catered offered little scope for the expansion of bank credit. In fact, the failure of bank credit to expand in spite of a rise in the banks' capacity to lend was a problem which engaged the attention of the Central Bank.

The record of central banking during this period is far from impressive. No doubt the Central Bank can within limits prevent an excessive expansion or contraction of credit and the financing of mushroom ventures. If ever the banks abandon their usually conservative lending practices, the Central Bank can prevent a 'non-essential or speculative' expansion of credit. It can contribute towards healthy banking practices through bank supervision. It can advise the government on financial matters. It can stabilize or nurse the government security market. In all these fields it can achieve a lot. Yet its influence on the economic system has been superficial. The Bank, in fact, was no more than a spectator watching the economy tossed backwards and forwards by the fluctuation of world prices. The root cause of this situation is the structure of the economy itself—the abject dependence of its national income on export production. As a result, the supply of money and the level of prices and incomes are all dominated by forces beyond the control of the Central Bank.

The main factors responsible for the limited efficacy of central banking in the context of Ceylon's underdeveloped export economy may be briefly summarized as follows:

1. The dependence of the national income and the level of prices upon the value of exports limits the scope for price, and income, stabilization.
2. The concentration of bank lending in the foreign trade sector of the economy and the reluctance of the banks to venture into other sectors of the economy minimizes the need for central bank intervention.
3. The high liquidity of the banking system makes it difficult for the Central Bank to influence the volume of bank credit by varying its own domestic assets.

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4. The government's fiscal operations often conflict with the requirements of central bank policy. In the event of such a conflict the needs of the government have priority.

In a broad sense, these remain the problems of central banking in Ceylon.

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CHAPTER XII

CONCLUSION: MONETARY PROBLEMS IN AN UNDERDEVELOPED EXPORT ECONOMY

The foregoing pages reviewed the evolution and the functioning of the island's monetary and banking institutions for a period of well over a century. The changes in the methods of currency issue and the influences which shaped them were examined. The important role of the banks in the business of supplying credit and of indirectly regulating the monetary circulation was repeatedly emphasized.

Looking back, one is struck less by the changes that occurred than by the fundamental similarity in the behaviour of the money supply throughout our entire period. Just as in the pre-bank era, apart from the import of currency by the government for its own requirements, the country's money supply was imported by the Chettiar traders on behalf of the Colombo Merchant Houses, the banks imported currency in 'the era of the exchange banks'. In both periods funds were required for the production and export of coffee. The coming of the banks introduced greater certainty and elasticity to the arrangements. The growth of the coffee plantations made such a specialist function necessary. The banks provided an elastic supply of paper currency for which a great demand had arisen from the planters and European businessmen, a convenience of which they had hitherto been deprived by the steadfast objections of the British Treasury and the Colonial Office to the issue of paper currency by governments. Both in its seasonal as well as in its cyclical changes, the amount of currency in circulation was governed by the demands and the fortunes of the country's staple export industry. At the same time, there was a secular increase in the circulation in step with the increasing value of coffee exports.

When, after 1884, the banks' issues were replaced by those of the government, still it was the demand of the export sector which was the determinant of the currency supply. While earlier the banks had imported specie and issued notes against

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it, they now imported specie and obtained notes from the Currency Board. In the one case, changes in the currency circulation were accompanied by a rise or fall of the banks' reserve of coin, in the other they were matched by changes in the reserves of the Currency Board. In both cases the banks were responsible for the import of coin while it was being exported by them and by traders and also taken away by the Indian estate-workers returning home. The Currency Ordinance of 1941, whereby notes were issued and redeemed against foreign exchange, was a logical and natural evolution from the earlier system. True enough, the arrangements differed in detail. Experience showed that the banks were able to regulate their note issues according to the 'needs of trade'. But it also showed that, contrary to the ideas of those who advocated note issuing banks in the Colonies, neither the enlightened self-interest of the banks themselves nor the meticulous care of the framers of the Colonial Banking Regulations could ensure a system that was proof against the vicissitudes of trade or the failings of bank directors. It was safer to separate the business of note issue from that of commercial banking.

The Currency Board system was the very embodiment of soundness and safety. The specie reserve of one-third of the note circulation that the banks maintained was their cash reserve against their entire liabilities—both currency notes and deposits. Thus two-thirds of the circulation was backed by their other banking assets of varying degrees of liquidity. A 'locking up' of such assets was a threat to the note issue and hence to the entire economy. On the other hand, the Currency Board was required to keep a minimum reserve of one-third in coin and the remainder in specified sterling securities. The whole of the note issue was backed either by coin or by sound foreign assets. It has been called a 100 per cent. reserve system. Basically, however, the change was one of form rather than of substance. As in earlier days, the country was importing its supply of currency and the circulation exhibited the same trends, whether seasonal, cyclical or secular.

Into the pattern of currency fluctuations woven by the varying fortunes of trade there occasionally entered the disturbing influence of Indian currency policy. Often the tightness or extreme ease in Indian monetary conditions were transmitted

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to Ceylon, and major currency changes in India, such as the closure of the mints in 1893 or the appreciation of the rupee during and after the first world war, affected Ceylon's supply of money.

While the technique of currency issue underwent several changes, the operations of the banking system hardly changed at all. The banks were at all times suppliers of cash to the community. The import and export of coin by them were governed by the demand for currency and credit from the foreign trade sector of the economy. Until after the first world war their annual imports of coin tended to be concentrated in the busy season of the export trade. Over a period of years, imports of coin rose and fell with the phases of the trade cycle. The banks' business has been always primarily with the export and import trades. And their main earning assets were the traditional ones, bills of exchange and short-term advances for the finance of trade. But as recently as 1939, when the Bank of Ceylon was established under government auspices, the forces of banking tradition triumphed over the desire for change and experiment.

The major institutional change in the country's economic structure came with the establishment of the Central Bank of Ceylon in 1950. The supply of money could thereafter be influenced by official action. Currency could be issued not only against foreign assets but against domestic assets as well. Banking policy could be influenced directly and indirectly to conform to a 'national monetary policy'. But our study has suggested that such action was sometimes unnecessary and often innocuous. The main determinants of the money supply continued to be the balance of payments and banking policy, both being closely related to fluctuations in the value of exports. The major role of the Central Bank was that of financing the government's budget deficits which, in fact, were not noticeably influenced by any strict policy of long-term development or of 'compensatory spending'. By 1957 the experience of seven years of central banking showed that there were very strict limits to action designed to influence the lending policies of the banks. At best it can but moderate the secondary changes of bank credit during a boom or slump. On the other hand, experience demonstrated that a 100 per cent. reserve of foreign

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assets against the note circulation is not essential for monetary soundness even in an underdeveloped economy subject to wide fluctuations in its foreign exchange earnings.

The Currency Board System

The establishment of the Central Bank of Ceylon came at a time when there was a growing interest in the working of the Currency Board system which was the standard method of currency issue in the British colonies. In recent years the system has been criticized on several grounds. The main attack has been directed against the requirement of a 100 per cent. reserve, and against its automaticity which has been compared to that of the international gold standard. Both points were urged in the Exter Report on a Central Bank for Ceylon and, somewhat more vehemently, by Mr. J. Mars in his account of "The Monetary and Banking System of Nigeria".[1] It has been argued that a 100 per cent. reserve system increases unnecessarily the cost of the currency in that a foreign reserve has to be maintained even against that hard core of the circulation which will never be offered to the Currency Board for redemption.[2] Foreign reserves represent 'forgone imports'. Under the Currency Board system a country has to purchase its currency from abroad just as it purchases any other commodity, and in this respect the system differs from more advanced and enlightened systems of issue. Mr. Exter points out that a 100 per cent. reserve is 'a costly luxury' for an underdeveloped economy, while Mr. Mars has argued, with regard to Nigeria, that increments of the local circulation are 'virtually obtained at the expense of a commodity loan by Nigerian producers to London.'[3]

The criticism of the automaticity of the Currency Board system is closely related to the cost argument. It has been shown that the Currency Board is merely a glorified money-changer exchanging a 'superior' currency, usually sterling, for domestic currency, and vice-versa. It has no power to influence the supply of money. From the obvious fact that foreign

[1] Margery Perham (ed.): *Mining, Commerce and Finance in Nigeria*, 1948, Part II, Chap. IV.

[2] Report on the Establishment of a Central Bank for Ceylon (Exter Report), p. 4 (S.P. 14 of 1949).

[3] Perham (ed.): *Mining, Commerce and Finance in Nigeria*, 1948, p. 190.

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reserves can be acquired only through surpluses in the balance of payments, it was deduced that the colonial currency supply was *determined* by the balance of payments.

> 'Under the Ceylon system,' says the Exter Report, 'under which a 100 per cent. reserve is required against the note issue, and the use of cheques is not highly developed, the money supply tends to be automatically responsive to surpluses and deficits in the balance of payments. Whenever Ceylon is acquiring foreign exchange faster than she is utilising it (i.e. when there is a surplus in the balance of payments) the banks purchase Ceylon rupees from the Currency Board with their surplus exchange. The Currency Board pays the banks by drawing rupees from its unissued stocks and it holds the foreign exchange in Bombay or in London. . . . On the other hand, when the country is utilising foreign exchange faster than she is acquiring it, the banks meet the demand by purchasing it from the Currency Board with rupees. The Board retires the rupees from circulation and transfers the exchange to the bank by draft or T.T.'[4]

Similarly, Mr. Mars says,

> 'this automaticity in the issue and redemption of currency means, however, nothing more or less than that increments or decrements of the localised circulation are strictly determined by the balance of payments. In fact, increments or decrements of (West African) currency are the one item that brings about equality between the positive and negative items of the balance of payments.'[5]

More recently, however, Miss Ida Greaves, in a pamphlet on *Colonial Monetary Conditions*, published under the auspices of the Colonial Office, has made an uncompromising defence of the Colonial monetary arrangements.[6] She has rightly emphasized the role of the banks in regulating the amount of currency in circulation. She has pointed out that when there is a transfer of the banks' sterling or other foreign funds to the Currency Board in exchange for notes, or the sale of currency to the Board for sterling, there is no net change in the total amount of sterling belonging to the Colony's monetary system, but merely a change of ownership of these assets.[7] In a subsequent

[4] Exter Report, p. 4.
[5] Perham (ed.): *Mining, Commerce and Finance in Nigeria*, 1948, p. 186.
[6] Colonial Research Studies, No. 10, H.M.S.O., 1953. [7] *Ibid.*, pp. 66–67.

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article, referring to the burden of 'forgone imports', she says: 'I do not think there is such a burden.'[8] In reply to the alleged automaticity of the Currency Board, she argues that the banks' demand for currency from the Board is governed by the public's demand for it. The banks returned currency to the Board only when it was in excess of their requirements, just as they obtained notes only when they needed more cash in their tills. Our analysis of the working of the Currency Board system shows that both points of view are partly true and partly superficial.

In an earlier chapter, we developed an elementary equation for the gross currency supply: $\Delta M = A + B + C$. It is clear that increments or decrements of the circulation are determined not only by the balance of payments $(A + B)$, but also by the accommodating capital movements of the banks (C), which are largely a function of the level of economic activity within the country and the demand for bank credit which it generates. During periods of rising export incomes the banks find that the demand for credit does not increase at the same rate as the increase in their liquidity. Thus the proportion of their foreign assets to total local deposits rises and there is in effect an outward movement of capital distinct from autonomous capital movements (B). It is essential to distinguish between a capital movement as represented by a change in the foreign assets of the banks from an autonomous capital movement, because the former is influenced by considerations of a purely monetary character. On the other hand, during a period of falling export values, accommodating capital movements absorb the first shock of a deficit in the balance of payments. That is, when $(A + B)$ is negative, C is usually positive.

If the superficiality of the argument that the balance of payments determines the currency supply arises mainly out of its failure to distinguish between autonomous capital movements and the accommodating capital movements of the banks, it is at least partly due to the failure to appreciate the difference between the gross and the active circulation of currency. Clearly, a mere rise or fall of bank cash is of no monetary significance.

[8] "Sterling Balances and the Colonial Currency System: A Comment", *Economic Journal*, Dec. 1953, p. 921; also: Hazelwood: "Sterling Balances, etc.", *Economic Journal*, Dec. 1952, p. 942.

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It is immaterial from the point of view of the economy as a whole whether an accretion of foreign exchange as a result of a balance of payments surplus (i.e. $A + B > O$) is held abroad or held idle in the banks' vaults. What is important is the ability and willingness of the banks to meet an increased demand both for credit and for hand-to-hand currency when it arises. Given their lending policies, it is the sole function of the banks to do so. Similarly, a diminution in bank cash is important only in so far as the banks are compelled to restrict credit by a lack of reserves. When the banks return currency to the Board they usually do so, not because they are short of foreign currency to meet a balance-of-payments deficit, but because they cannot find profitable investment for their funds within the country. Except perhaps during a 'great depression' their foreign assets are more than adequate to meet payments deficits without recourse to the Currency Board. The element of truth in the Mars–Exter argument is that changes in the currency circulation and changes in the balance of payments occur at the same time. It is incorrect to argue that one strictly determines the other. They are both the result of changes in export prices and the national income.

Moreover, even if one assumed away the variability of the banks' external assets during the ups and downs of trade activity, it is still not possible to claim that the balance of payments determines the gross circulation in any meaningful sense. A balance-of-payments surplus arises usually because of a surplus in the balance of trade. Under any monetary system such a surplus must be invested abroad or held in the form of an idle reserve of the monetary metal. Our second equation ($\Delta M = A + B + \Delta N$) shows that the active money supply must necessarily change when there is a change in the country's foreign earnings unless offsetting action is taken by the banks by changing the volume of their domestic non-cash assets. The difference, then, between the Currency Board system and a more 'advanced' system is that under the former offsetting action cannot be undertaken by any official agency.

Although Miss Greaves is on strong ground when she rebuts the argument that the balance of payments strictly determines the money supply, she does not recognize the full implications of the Currency Board system when she argues that it does not

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involve the community in any cost in the form of forgone imports. If part of the currency reserve were invested in domestic securities, the foreign exchange which would otherwise be sterilized from the point of view of the national economy would be available to finance government expenditure on public utilities and economic development without recourse to foreign borrowing.[9] Earl Grey, when he advocated the establishment of government paper currencies in the Colonies, was impressed by the opportunity for 'economising capital' which it would provide. But the Currency Board system which was ultimately evolved, in fact gave the colonies the equivalent of a fully metallic circulation, except that the investment of the currency reserves yielded an income to the Board. The abandonment of Earl Grey's proposal for the investment of currency funds partly in the debentures of the Colony itself had an unfortunate effect on the evolution of the entire system of Colonial finance. Not only did it imply the investment of the entire currency reserves abroad, but it also sidetracked the question of the development of domestic security markets in the Colonies. Much has been written on the consequences of investing currency reserves abroad. Few, however, have commented on the equally obvious fact that the banks in the Colonies invested the bulk of their deposits overseas. It was seen that in Ceylon, as late as 1939, not more than 25 per cent. of banking assets were held within the country, and the proportion is likely to have been much lower before the government began issuing its own domestic securities. The readiness with which banks invested in government securities after 1937 and their practice of holding large quantities of Indian rupee securities, leave no grounds for believing that they would have been averse to taking up domestic securities in earlier years had they been available.

In spite of its limitations, the Currency Board system met the requirements of Ceylon's export economy exceedingly well. In fact, through the banking system it was closely geared to the island's foreign trade. A rising demand for currency and credit from the export sector was accompanied, through trade surpluses, by an accretion of foreign assets with which to meet it.

[9] Cf. E. A. Birnbaum: "The Cost of a Foreign Exchange Standard, etc.", I.M.F. *Staff Papers*, vol. V, No. 3, pp. 480–81.

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The best indication that the system worked satisfactorily is that there never was a word of complaint against the system itself from the planters and businessmen whose influence on the government of the time was considerable.

The question has been asked whether 'the monetary system has been an independent influence on the development of colonial territories as export economies.'[10] An adequate answer to it must take account of both the banking system and the Currency Board. For the latter was merely a passive agent in the business of currency issue. Even so, the question is a misleading one in that the entire monetary system of Ceylon was an adjunct to her export economy. Since banking policy was attuned to the needs of that economy, it follows that the monetary arrangements were conducive to its development on the same lines. The causes of the lopsided development of the Ceylon economy are more deep-rooted than can be explained purely or mainly by reference to its monetary system. At bottom, it was due to the fact that capital investment was largely confined to the export sector and to the commercial activity dependent upon it.

Owing to the narrow field to which the banks catered, the country's monetary structure was extremely sensitive to every impulse originating in the export sector and equally impervious to changes outside it. By and large, the familiar shortages of technical skills, long-term capital and entrepreneurial ability inhibited any appreciable rate of growth outside the export sector. The native capitalist class which was thrown up as a result of the growth of the plantation economy was incapable of making an independent contribution to the country's economic revolution. The Currency Board system and the export economy itself were the products of the same historical forces.

In the light of the above remarks, the assertion sometimes made that the Currency Board system imparts 'a deflationary bias' to a growing economy[11] is of doubtful validity. As regards the export sector it was not true at all. On the other hand, the deficiencies in the monetary and banking system were

[10] A. D. Hazelwood: "Economics of Colonial Monetary Arrangements", *Social and Economic Studies*, Vol. III (1954), p. 303.

[11] Report on the Establishment of a Central Bank for Ceylon, p. 5: S.P. 14 of 1949. Analyst: "Currency and Banking in Jamaica", *Social and Economic Studies*, Vol. I, No. 4 (August 1953), p. 47.

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not the most significant factors inhibiting economic growth outside the export sector. If at all, it was banking policy rather than the currency arrangements that were at fault. There was not a shortage of currency, but a shortage of capital and credit, and of the inducement to invest.

Problems of Central Banking

What role, then, can the central bank play in such an environment? Much has been written on the limitations of traditional central banking techniques in an underdeveloped money market. In Ceylon, as in most underdeveloped export economies, the use of interest rates as a method of influencing the money supply is restricted both by 'perverse' changes in bank liquidity that accompany rising or falling export prices, and by the small volume of domestic borrowing that is at all sensitive to interest rate changes. Open market operations are hampered as much by the absence of a broad and active security market as by the overriding requirements of government finance. Variable reserve ratios are of doubtful value during a boom as long as banks have excess reserves of cash and foreign assets. They are unlikely to be effective in a slump because the banks cannot be forced to lend. In the circumstances, it is reasonable to assume that direct control of the creation and the use of bank credit such as is possible through portfolio ceilings, high reserve ratios and a distinct prohibition of certain types of loans, should play an increasingly important part in anti-inflationary policies. Similarly, the problem of stimulating bank lending in a slump remains unsolved.

The experience of the Central Bank of Ceylon is significant for two reasons. In the first place, it confirms the current doctrine regarding the limited efficacy of the traditional instruments of central banking in an underdeveloped economy. More important, however, it suggests that in an underdeveloped export economy, a central bank conceived merely as a regulator of the banking system can at best play a superficial role.[12]

The instability of prices and incomes is the country's major short-term problem, a problem aggravated by periodic varia-

[12] The need for central bank action is minimized when the banking system, as in Ceylon, consists of a few large banks following conservative lending policies. In economies in which the banks adopt more aggressive lending policies the need for central bank regulation is greater.

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tions in the terms of trade. Owing to the overwhelming importance of export production in the economy, nearly every other determinant of national income is in one way or another functionally dependent on the value of exports. An underdeveloped export economy is more unstable than a 'closed' developed economy in that the value of exports rather than investment is the chief determinant of the national income. In any given period its export prices fluctuate much more violently than total investment normally does in a developed economy. This source of instability is somewhat counteracted by a high marginal propensity to import. At the same time the high degree of dependence on imports of consumption goods makes the general price level extremely sensitive to price changes originating abroad. A rise in export prices usually causes a rise in both money and national real income. But the prosperity has an unequal incidence. Export incomes and producer incomes rise, but the real value of fixed incomes declines owing to the rise in the cost of living. During a slump in export prices producer incomes fall while fixed income earners are hit by a decline in the volume of employment. A policy of economic stabilization, therefore, must aim not only at stabilizing money income but also at stabilizing real income and the volume of employment. It is clear that in such a context conventional central bank action must be combined with policies on a wider front.

Stability of export prices might be achieved by the creation of marketing boards which absorb price increases during a boom and subsidize export prices in a slump. This policy might be supplemented by the sale of the major articles of consumption at subsidized prices at a time when import prices are rising. Long-term trade agreements such as that with China can introduce a large element of stability both to export and import prices. At the same time greater use might be made of flexible exchanges. Exchange appreciation during a boom damps down both the rise in export prices and the rise in living costs. Exchange depreciation in a period of falling export prices can moderate the attendant fall in money incomes. It cannot however prevent the fall in real income caused by an adverse movement in the terms of trade. Our historical analysis gives us strong grounds for believing that

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controlled variations of exchange rates is unlikely to be as damaging to capital investment or international trade as is sometimes supposed. The whole question of economic stabilization in an underdeveloped export economy, however, requires a closer examination than is possible for us to undertake in this study.

Central Banking and Economic Development

We have referred to stability and development as the twofold objectives of central banking. In an underdeveloped economy the emphasis must necessarily be on development. Economic development necessarily engenders monetary instability which can, however, best be attacked by supplementing monetary policy with direct economic controls over prices, imports and the rate of consumption expenditure.

Granted our proposition that the Currency Board system met the needs of the export sector of the economy, the sole justification of central banking must lie in its ability to venture outside the narrow limits of that sector. Since the rest of the economy is 'underdeveloped' this implies that the Central Bank must directly or indirectly participate in the task of economic development. At the same time the Central Bank must take steps to mould the banking system according to the requirements of a developing economy. Left to themselves the banks are likely to confine themselves to their traditional fields of activity. They should be encouraged to enter sectors of the economy which they have so far sedulously avoided, such as the fields of domestic industry, trade and agriculture. Since it is presumably the greater element of risk inherent in these fields which makes the banks avoid them the Central Bank should take steps to insure their riskier types of loan operations.[13]

The Central Bank must fill the gaps in the country's credit structure, particularly in the long-term and medium-term markets. This it can do by itself providing such credit or by supplying funds to the specialist institutions that might be set up. The Monetary Law Act empowered the Bank to grant loans or advances to banking institutions which give advances upon mortgages whether of movable or immovable property. So

[13] This suggestion is contained in the Report on the Establishment of a Central Bank for Ceylon: S.P. 14 of 1949, p. 7.

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far neither the public institutions such as the State Mortgage Bank and the Agricultural and Industrial Credit Corporation nor private lending agencies have taken advantage of this provision.[14]

Central Banks in many other countries both developed and underdeveloped have made special efforts to ensure that bank credit was diffused throughout the economy. For example, the Commonwealth Bank of Australia had its Rural Credits Department and also made loans to primary producers through its General Banking Division. The Reserve Bank of India set up an Agricultural Credits Department to supervise and co-ordinate the activities of the Bank with regard to agricultural credit. It is regrettable that the Central Bank of Ceylon overlooked its obligations in these directions and contented itself with attempting merely to control the supply of money. The Exter Report states that

> 'by helping to direct the savings and credit resources of the nation as well as foreign capital into new agricultural development and new industries, it (the central bank) can stimulate a diversification of the economy which will make it more resilient to changing economic conditions abroad'.

However, the only specific suggestion as to how this might be achieved is that the Bank should make loans to mortgage institutions and the Co-operative Federal Bank. Unfortunately, there has been no development along these lines. As we have seen, this is at bottom due both to a deficiency in the inducement to invest and to a shortage in the supply of bankable assets. Both features are common to all underdeveloped economies. The land law of the country and the defective titles to land make borrowing on the mortgage of land extremely difficult. It is the duty of the Central Bank to investigate this whole question and to suggest remedies.

Since the country's banking and credit institutions, as at present organized, have proved so inadequate, the question arises whether there should not be a radical departure from tradition regarding the roles both of the Central Bank and of the banking system. The weight of tradition is against a central bank engaging in commercial banking actively. Yet there is a

[14] Monetary Law Act, para. 84.

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strong case in Ceylon for the Central Bank to act as a pioneer in carrying bank credit into areas hitherto untouched. After all, this has been a task which the normal incentive of private profit has proved powerless to achieve.[15]

Similarly, in order to remedy the deficiencies in the long- and medium-term markets the commercial banks should be encouraged to hold a minimum percentage of long- and medium-term loans. When such loans have the blessings of the Central Bank they should become a little more attractive. If in addition, the Central Bank can guarantee such loans, it should certainly overcome the commercial banks' ingrained reluctance to handle them. 'Mixed banking', though now out of fashion, has a fairly respectable history. It was not unknown when countries such as England, France, Germany, and the U.S.A. were themselves underdeveloped. The traditional canons of bank liquidity are wholly out of place in an underdeveloped economy. It is useful to remember that even the so-called liquid assets of the bankers are not really liquid unless the Central Bank is prepared to make them so. In the interests of rapid economic development it is urgently necessary that a part of the country's savings should be channelled into productive investment through the banking system.

A national plan for development is now a recognized part of economic policies in underdeveloped economies. Clearly it is the duty of the Central Bank not only to help government finance its plan within the limits set by the availability of international reserves, but also to formulate monetary and economic policies conducive to the success of a programme of planned development. In this respect the Central Bank's objective of short-period stability must be co-ordinated with the objective of long-term development. Perhaps the greatest deficiency of the early years of central banking in Ceylon was its failure to effect this co-ordination. It is mainly by advising and participating in the government's plans for economic development that the Central Bank can make any contribution to the country's welfare. Such action necessarily requires a greater degree of control over trade, prices, consumption and spending than has hitherto been attempted in Ceylon. The delicately flexible

[15] The case is cogently stated by Professor R. S. Sayers in his *Central Banking after Bagehot*, 1957, pp. 108 *et seq.*

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monetary policies of advanced countries are of limited usefulness in an underdeveloped economy. The narrow task of controlling the supply of money, the task of controlling a few banking institutions, cannot in the context of the Ceylon economy be enough justification for the existence of a central bank, for the simple reason that the supply of money is determined in a fundamental sense by the nature of the country's economic activity. The balance of payments dominates not the supply of money in the country but its national income. The impressive armoury of monetary controls with which the Central Bank has been endowed requires a broad-based economic structure if they are ever to be purposively used. Economic development is a prior condition of effective central banking. Against the background of planned economic development to which Ceylon is committed neither the traditional form of commercial banking nor the traditional form of central banking can play a positive role.

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FROM DEPENDENT CURRENCY TO CENTRAL BANKING IN CEYLON

This book is at once a contribution to the economic history of Ceylon, a contribution to monetary [illegible], and—most importantly—a work illuminating the [illegible] problems of transition from colonial dependence to the central banking system of an independent state.

It begins with the formulation in 1825 of the "currency policy" for Ceylon, a policy followed in all the British colonies. By analysing the subsequent monetary and banking development of Ceylon the author has made a broad sketch of the country's economic development, and analysed the functioning of monetary and banking institutions in a backward export economy. The adequacy and relevance of current theory to the country's problems, especially those arising from trade fluctuations, are thoroughly reviewed. The examination—in the light of this analysis of the economic problems—of the transition from the Currency Board system of a British Colony to the Central Bank of an independent state, and of the early experience of this Central Bank, should be of wide interest to all who are concerned with the problems of economic development.

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