



India's 1966 Rupee Devaluation and Reserve Currency Status: A Critical Analysis

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Abstract – The transformation of the Indian Rupee into a multi-continental reserve currency is changed into a domestic instrument, is one of the most important but least studied monetary disasters in the history of monetary post-colonial economics. The Rupee was the legal tender in the period of the time between 1947 and 1966 within the Persian Gulf and East Africa hence settlements of trade, oil within as well as remunerations of millions of people. The special position of the Rupee which was brought about by remnants of British imperial currency systems produced acute economic benefits, such as seigniorage accrual, lower transaction cost, and greater diplomatic bargaining power. With the encouragement of the International Monetary Fund and the World Bank, Prime Minister Indira on 6 June 1966 promulgated the devaluation of the currency which with a contraction of the parity of the Rupee of 36.5 per cent, undermined international confidence in the currency. All Gulf states abandoned the Rupee and shifted to monetary systems pegged to the Dollar within a seven-year period, and East African jurisdictions at the same time shifted to de-legalized, sovereign currencies. This enquiry examines the policies that caused the Rupee system to go wrong globally, challenges the politics of the political economy of the decision of 1966, evaluates the prescient nature of the warnings delivered by the domestic economists, and assesses the strategic consequences of this policy failure that have long-run reconstructions, which is proving crucial in the deliberation of the present regarding monetary sovereignty and a reserve currency group.

Keywords: Indian Rupee Devaluation 1966, Gulf Rupee History, Reserve Currency India, Indira Gandhi Economic Policy, IMF India 1960s, Rupee International Status.

1. INTRODUCTION

1.1 The Forgotten Empire of the Indian Rupee

Take the following case the buyer comes to a market in Kuwait City in the year 1960, and the prices are in Indian Rupees then the buyer goes to Bahrain to sign an oil deal, and the deal is settled in Rupees issued by the Reserve Bank of India, and finally, the buyer in Muscat gets a government salary, and the bank notes are stamped by the Indian monetary authority. This was not hypothetical but a fact, which existed throughout the Persian Gulf and East Africa almost twenty years after the independence of India.

The Indian Rupee at some point in global finance used to hold an eminent status which is hardly imaginable in the present day times. Although the discussion on reserve currencies now only focuses on the Dollar, Euro, Yuan, and historically on the British Pound, the role of Rupee as a multi-continental medium of exchange, store of value and a unit of account has been forgotten by most people in economics. However, this forgotten part of monetary history is more significant to historical knowledge than it is often perceived by all historians who place such emphasis on financial power building and destruction, the nature of policy decisions as a path dependency, and the fact that economic credibility once lost is famous hard to regain.

The history of the architecture of the global rupee and its eventual collapse sheds light on the key realities behind monetary sovereignty that go beyond the particularities of Indian life in the middle of the twentieth century. Primarily, this story shows that one policy choice that was taken under the international pressure and directly against the domestic professional advice can alter the strategic stance of a country within the global economy permanently. Not just a technical change of an exchange rate, the devaluation that looked on 6 June 1966 is a strategic error that ripped away decades of developed financial plumbing, and predetermined development pathways that would have added value over the decades that followed.

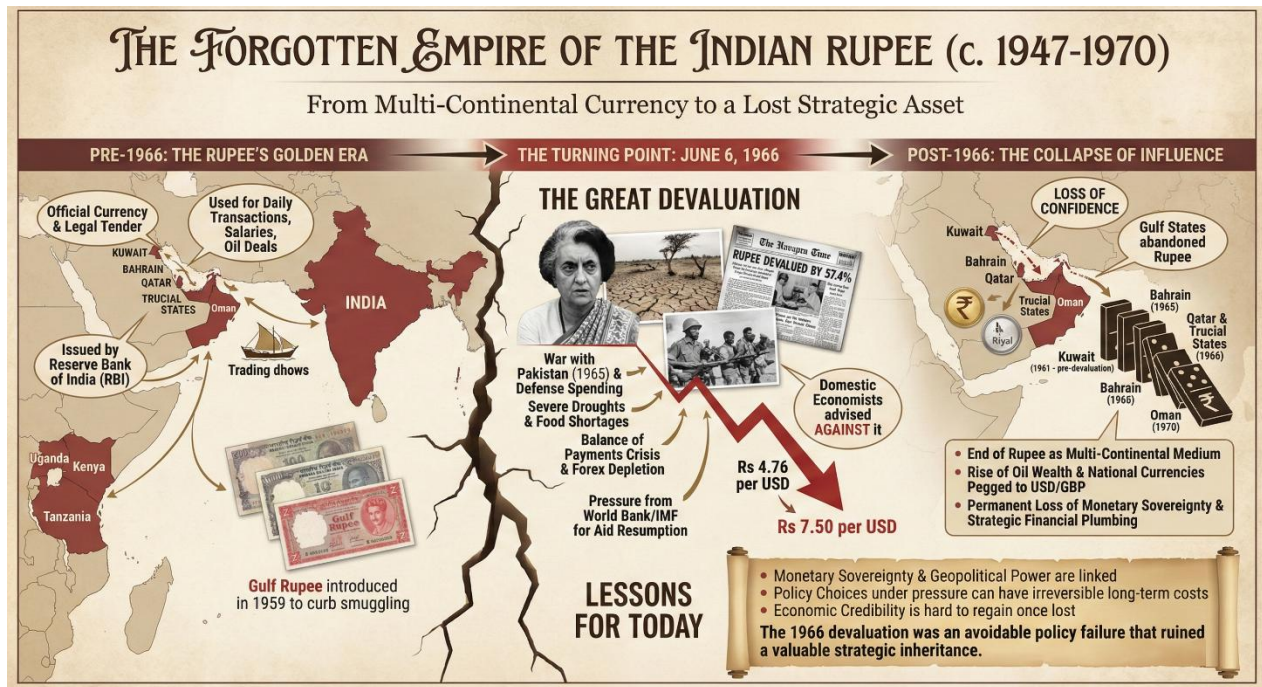


Fig -1: Forgotten Empire of the Indian Rupee

This paper looks at the entire trajectory of this change. It shows that the global Rupee system has been operationalized and thus gave India a series of economic benefits that went way beyond mere facilitation of trade. The paper breaks down the exact political and economic forces that triggered the ruling in 1966, such as the reason why Prime Minister Indira Gandhi decided to ignore the direct warnings of leading Indian economists. It shows how the devaluation caused a domino effect of loss of confidence that saw each of the Gulf states abandon the Rupee in seven years though an oil boom started to make untold wealth in the area. Lastly, it gives an account of what this history can teach us about the current discussions on currency internationalization, the independence of monetary policy, and the connection between the sovereignty of the economy and geopolitical power.

The thesis itself was simple but, as a consequence, the 1966 devaluation was not a misfortune but an essential economic decision. It was a policy failure that was avoidable and thus ruined a strategic valuable inherited and the cost is increasing with every decade. The reasons behind this, and why the antagonistic economists were right, are crucial knowledge to any human who has to negotiate the obscurantists of economics, politics and national strategy nowadays.



2. OBJECTIVES

The research has a number of interrelated goals that combine to provide an entire picture of the rise and fall of the Rupee as a reserve currency.

To begin with, the original working of the global system of the Rupee between 1947 and 1966 as documented by the research explains how the Gulf Rupee and East African Rupee worked, the economic gains that India gained out of this system, and how the hegemony of currency would be translated into actual advantages to Indian trade and diplomacy. All too frequently, the concept of reserve currency status has been theorized this analysis puts the concept on concrete illustrations, flow of transactions, and institutional designations that made the system operational.

Secondly, the paper recreates the decision-making process leading to the 6 June 1966 devaluation including the economic situation of the mid-1960s India, the exact pressures that the international financial institutions exerted on the situation, and the domestic political factors that influenced the decision of Prime Minister Gandhi. The motivations behind the decision and the people who opposed it shed some light on bigger problems of how governments can overcome financial crises and international conditionalities.

Third, the study measures the real implications of the devaluation, short-term and long-term. This is to monitor the reaction of the Gulf countries, gauge the economic costs that accrue to India and to examine whether the promised benefits of devaluation are realised. This analysis shows why the domestic economists who had sounded an alarm against devaluation were right in their forecasts.

Fourthly, the paper draws modern lessons out of this historical event. It discusses the lessons of the fall of the Rupee about what it takes to be a reserve currency, how the central banks of emerging-market economies could deal with externalities without losing monetary sovereignty, and what the role of democratic deliberation is in the key principal economic decisions. These questions are still very acute to the policymakers today.

Last but not least, the study examines the counterfactual. It speculates on what path the development path in India would have taken had the Rupee not fallen in the 1970s oil boom, measures how much wealth flowed through the Gulf financial channels that would have flowed through the Indian institutions, and explains the real extent of the opportunity cost incurred in 1966.

3. THE ARCHITECTURE OF THE GLOBAL RUPEE SYSTEM (1947–1966)

3.1 The Gulf Rupee Mechanics and Motivation

The Gulf Rupee was not a mere geographical addition to the Indian Rupee but a monetary tool that was carefully designed by the Reserve Bank of India in 1959 with a particular economic problem to solve but maintain the Indian monetary influence in the Persian Gulf region.

The technical description of how this worked was as follows The RBI issued unique banknotes which, though the same nominal value as a standard Indian Rupee, was printed in red ink instead of the normal multicolor scheme. These notes were limited to circulating in the Gulf states Bahrain, Qatar, the Trucial States (today the United Arab Emirates) and Oman. When Kuwait became an independent state on 1 April 1961, it ended up converting the Gulf Rupee into the Kuwaiti Dinar, thus ending its circulation in the principality. The red ink was used as a visual warning against a repatriation of these notes to India in the absence of express permission, a relatively minor design choice that solved a major financial impediment that had faced India during the late 1950s.

Smuggling of gold was the problem of interest. At the same time that India was maintaining strict capital controls and currency restrictions, it saw that its diaspora in the Gulf, as also other commercial networks, were buying gold in the international market and trying to bring it back to India. The process was simple Indian workers in the Gulf could buy their earnings in gold, which was easily got in Dubai and other markets in the Gulf at global prices and later resell to India, where gold fetched a very high premium because of domestic policies and cultural supply. The margin in the profit made smuggling a viable economic activity though characterized by a legal risk.

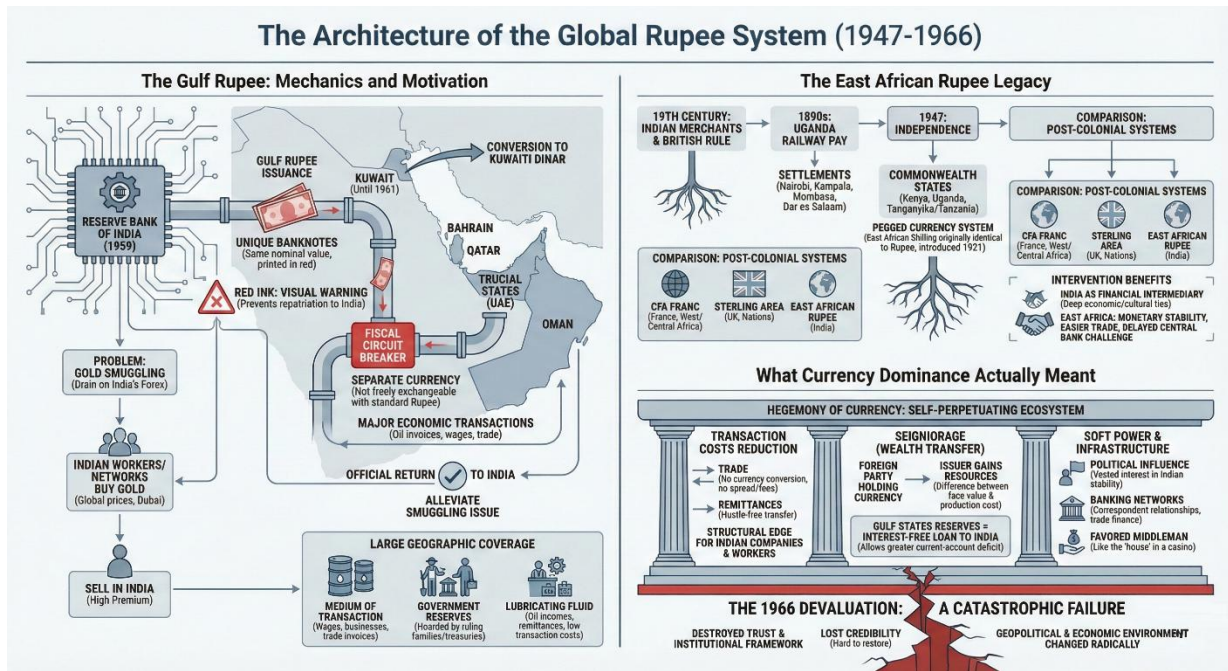


Fig -2: Architecture of the Global Rupee System

This illegal fund flow castrated India foreign-exchange reserves since, despite the fact the transactions were created in Rupees, final settlement was made in terms of converting it to the dollar. The RBI had created a fiscal circuit breaker by establishing a separate Gulf Rupee that could not be freely exchanged with the normal Indian Rupees. In this way, the Gulf Rupees might be used in the major economical transactions of the Gulf but had to be officially returned in India and thus alleviate the issue of gold-smuggling without necessarily involving removing the Indian presence in the monetary market of the Gulf.

The gulf rupee had a large geographic coverage. In Kuwait, where oil revenues were making huge fortunes, the Rupee was the major form of medium of transaction in daily lives. The Kuwaiti infrastructure laborers were compensated using the Gulf Rupee, the merchants calculated their businesses using the same currency, and the trade invoices were also set in the same currency. The same trend was used in Qatar, Bahrain, and what was to be the UAE. Governing families and treasuries also hoarded large reserves of Rupee.

Therefore, the oil incomes, the backbone of the Gulf prosperity, were channeled via the Rupee-denominated channels. The local government or contractors were normally paid in Rupees by the oil companies in the region and the Indian exporters did not have to convert their money to Gulf markets. The remittances that Indian workers sent back to the country faced low transaction costs since both sending



and receiving terminals worked under the framework of one currency. Therefore, the business affair between India and the Gulf operated with the Rupee as the lubricating fluid. The economic justification was very attractive to the Gulf states in those days. The Rupee was supported by the reserve bank of India which was an institution that credibility was partly attributed to its relationship with the British Pound Sterling platform. The elevated position of India as a major trading partner, one of the key sources of labor migration to the Gulf, and one of the key providers of goods and services made the transactions easier, removed the exchange-rate risk in one of its most important bilateral relationships and removed the administrative cost of creating new monetary authorities.

In the case of India, the benefits were high. Every Gulf Rupee that was in stock or in circulation in the region represented actual goods and services that India did not have to offer instant delivery. Seigniorage is this the gain that a currency issuer makes out of the difference between the face value of money and the cost of producing it. By holding Rupees in reserve, the states of the Gulf were lending money at interest-free rates to India and, consequently, accordingly, were letting India spend more than it saved, as long as foreign entities are willing to hold Indian paper. In addition to seigniorage, the system minimized the transaction costs over a large trading system. The Indian business was also spared of hedging currency risk or conversion fees in dealing with the Gulf markets, and this was a competitive advantage to Indian exporters against those of countries whose currency was not accepted in the region. This financial integration successfully established a larger economy zone with India in the financial centre.

A diplomatic aspect also came to the fore. Dependence of finance generates political power those Gulf states that have large Rupee reserves were given a vested interest in the political stability of India and the monetary policy choices that had an impact on the value of the Rupee. This correlation gave India a kind of sway in the regional affairs that was beyond the capabilities of its military or diplomatic strength. This financial tie in the intricate geopolitics of Middle East life after a colonial era was consequential.

3.2 The East African Rupee Legacy

The history of the East African Rupee began earlier on and had a lineage development that has followed a different course but it demonstrates the same: inherited monetary infrastructure can provide lasting gains when properly upheld.

The circulation of the Indian Rupee in East Africa had been going on since the nineteenth century when it was introduced by the Indian merchants and later consolidated during the British colonial rule. In the 1890s, when Indian indentured labourers were hired to work on the Uganda Railway, the pay was in Rupees. However, once the Indian mercantile communities settled in Nairobi, Kampala, Mombasa and Dar es Salaam, Rupee came to be the currency of trade as a matter of fact. In understanding this fact, the British colonial rulers officially endorsed the arrangement. By 1947, when the Indians gained their independence, every State in the Commonwealth (Kenya, Uganda and Tanganyika, now Tanzania) had used a currency system pegged to the Indian Rupee. The East African shilling was originally established as identical to Indian Rupee and the East African Currency Board kept stores in part in Rupees. By the 1947, East Africa was already using the East African shilling which had been introduced in 1921 and it had taken the place of the Indian Rupee more than fifty years ago. Therefore, the interaction between the Indian and East African system of currency was historical and not current as compared to the circulation of real Indian note of currency in the Gulf Rupee. The local currency was directly pegged and supported by the Indian Rupee to establish a monetary union that was based in India.



This kind of set up is worth comparing with other post-colonial currency systems. France continued to issue the CFA franc in West and Central Africa, a currency issued by the French Treasury and pegged against both the French franc (and subsequently the Euro) at an affordable cost to France to give it a strong influence on the economic policies of fourteen African countries and to keep the trade flows oriented towards France. The United Kingdom maintained the Sterling Area which was a system of nations that based their currencies on the Pound sterling and kept reserves in London. The structures survived long after the official decolonization process was instituted as they benefited both sides the metropolitan authority guaranteed the monetary influence and the seigniorage benefits, whereas the former colonies gained currency stability and easier access to the key markets.

The intervention by India in East Africa would have provided similar benefits. This is because Indian merchants dominated the retail trade in the area; Indian professionals occupied key positions in the colonial government, education, and health care. The economic and cultural relations were deep and complex. These ties were strengthened by an anchored monetary relationship and made India the regional financial intermediary. This arrangement benefited East Africa territories. The Rupee peg allowed monetary stability in the difficult transition to independence, made trade operations with India, the main partner, easier, and delayed the daunting challenge of creating new central banks and monetary authorities, letting new governments focus on other urgent needs. In the case of India, the advantages had been similar to the Gulf Rupee regime, but on another geography and economic relations. The structure not only lowered the transaction costs of Indian businesses with operations in East Africa, produced seigniorage in the reserve holdings, and also provided financial leverage in a region where India already had an extensive commercial presence.

3.3 What Currency Dominance Actually Meant

The actual consequences of the reserve-currency status of the Rupee went beyond such intangible ideas as prestige or power. The hegemony of currency offers a self-perpetuating ecosystem of economic benefit that increases with time.

The first dimension is transaction costs. Whenever an Indian exporter sold textiles to a Kenya or Bahrain buyer, the whole process might be completed in Rupees without currency conversing. Aggregating the savings through thousands of such transactions entails significant fiscal advantages though it seems that this is a minor thing. Exchanging the currency presents bid/ask spreads, bank charges, and time loss which may destroy profitability among small and medium size businesses. The Rupee system removed such expenses, which gave the Indian companies a structural edge over the other countries that need to convert their currencies on a per deal basis. The same logic can be used in the case of remittances. To India, hundreds of thousands of Indian workers sent money back home in the Gulf and East Africa. When the sending and the receiving parties were in Rupees, transference was almost hustle free. Conversely, a Filipino employee sending the money back to the Gulf would have to translate the income of the money into dollar or the domestic currency and every transaction would attract charges and subject the transaction to unfavorable exchange rates. This disparity also promoted the hiring of Indian labour by the Gulf employers.

Seigniorage should be more thoroughly discussed, as it is a type of wealth transfer that cannot be seen on the traditional trade statistics. In case a foreign party possesses a currency, it grants the issuer physical resources in place of paper (or, more often, electronic entries). As an example, issuing 100 Rupee note which cost 2 Rupees to issue gives the issuer, in return, the benefit of 100 Rupees of goods and services the difference (98 Rupee), is pure profit to the issuer of the note. This effect is exacerbated by the fact that Gulf states accumulated a lot of Rupee reserves as a block and used the accumulated amounts to conduct



trade and cement their own currencies. All the reserves held by the Rupee in fact represented a loan to India with no interest. The fact that foreign entities were willing to hold assets in the form of Rupee allowed India to have a greater current-account deficit than would otherwise be sustainable.

Similar dynamics occurs in the United States with the Dollar in an even greater scale. The Americans have the freedom to import more than what the United States is exporting due to the fact that the foreign central banks, corporations, and individuals are ready to hold on to the reserves of Dollar. This costlier privilege allows the U.S. to live above its means of production and fund government deficit at interest rates that are calculated below the level it would reflect considering fundamentals. A smaller-scale analogue was enjoyed in India in the Gulf and East African Rupee systems. The soft-power dimensions appeared as well and it affected the relationships and diplomacy in the region. As the UAE had large stocks of the Rupee, it developed an interest in the Indian economic policy, and the stability of the Rupee. This established natural consultation and mutual interest channels which went beyond certain trade negotiation. Financial interdependence may also be leverage, in which a given country can affect the behaviour of a fellow country without necessarily being coerced.

The infrastructure aspect was also crucial. To operate the Rupee system, there was need to establish correspondent banking relationship, clearing systems, and credit arrangements between the Indian banks and Gulf and East African financial institutions. These long term relationships led to the formation of sticky networks which enabled not only currency dealings but also, trade finance, letters of credit and commercial lending in the region. The Indian banks succeeded in becoming the favored middlemen in any kind of financial exchange. This situation, economically, is similar to the condition of a house in a casino, it is not only a participant in the transactions but also an intermediary and receives a small portion of all exchanges and determines the conditions of the game. India was in that situation in the territories where the Rupee was used as a reserve currency. The economic benefits were institutionalized and self-enhancing. The impact of the 1966 devaluation was therefore disastrous. It did not simply change an exchange rate it destroyed the trust and institutional framework that the whole structure was based on. After such a failure of credibility, it took decades to restore, and by the time it was restored, the geopolitical and economic environment had changed so radically that there was no chance of it being reconstructed.

4. CURRENT TRENDS THE ROAD TO JUNE 6, 1966

4.1 The Economic Context

In order to understand the logic behind the devaluation of 1966, it is necessary to examine harsh economic pressures that India faced in the middle of 1960s. This episode could not be described as a normal cyclical contraction instead, India was also struggling with several crises, which jeopardized the stability of its economy and political framework. The crisis in balance-of-payments was the most imminent threat. By 1965, the foreign-exchange reserves of India had reduced to amounts that could only allow about two months of import cover, as compared to the three months that economists agree is the lowest level of cover. Any drop and reaching under this standard puts a country at risk of abrupt cutoffs of capital flows and the derailment of trade, which may trigger a domino collapse of the economy.

The fact that reserves have fallen precipitously can be credited to a combination of factors. The Second and Third Five-Year Plans saw India adopt an intensive approach to industrialization which had to large-scale imports of machinery, equipment, and technology the amount of imports in the prices of machinery and equipment increased at an alarming rate, but export earnings did not. This meant that India had to

fund a structural trade deficit either by foreign aid, loans or reserve withdrawals in either case, which were strained by 1965.

Current Trends: The Road to June 6, 1966 & The Economic Context

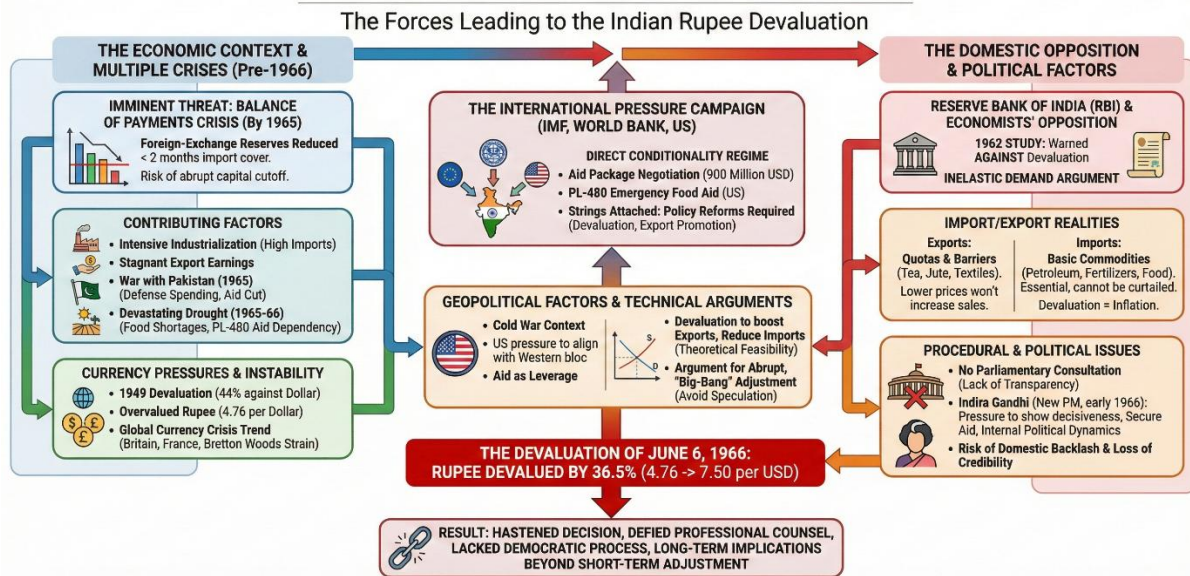


Fig-3: The Road to June 6, 1966 & The Economic Context

These hardships were compounded by the war against Pakistan in the year 1965. Even small-scale military actions cause devastating economic impacts on developing nations; they destroy trade, cause emergency defense spending, and scare away the possible foreign investors, who are afraid of the continuing instability in the region. In addition, the United States and other Western powers cut off aid to both India and Pakistan in the war hence cutting off a vital source of foreign financing at a time when India was most in need. The war could not have come at a worse time at a time when India was also experiencing a devastating drought. There was a failure of the 1965–66 monsoon season in vast regions resulting in severe food shortages. Agricultural production which was already not enough to feed a growing population, just collapsed further forcing India to import foods on an emergency basis, although foreign exchange was not available. This way, the government was petitioning to the United States to provide emergency food aid under the program of PL-480 program making India very dependent and in need.

There were also other antecedent pressures of exchange rates. Britain revalued the Pound Sterling against the US dollar in 1949, and India, whose currency was pegged to the Pound under the Sterling Area agreements, had to face a decision, whether to keep the current Rupee Dollar rate, which would mean revaluing against the Pound, or to devalue at the same time as Britain. India decided to devalue making its exchange rate 4.76 Rupees per Dollar, 44 per cent and a big depreciation but was carried out in an environment where devaluations of currencies were becoming widespread and less outrageous. India was at a crossroad as of 1966. Rupee was generally considered to be overvalued at 4.76 per Dollar and the Indian goods were costly in the global market and imports seemed artificially low. Traditional economics has argued that a strong exchange rate will cripple the competitiveness of exports and increase the propensity to import, which, in turn, aggravates the trade deficit. The World Bank and the International Monetary Fund (IMF) thus came up with the argument that India needed to devalue the Rupee in order to fix this underlying maladjustment.



The currency crisis in India was a part of a bigger trend of currency instability of the 1960s. The sterling pound of Britain was devalued by 14 per cent in 1967, the Franc of France was devalued in 1969 and the Bretton Woods system of pegged exchange rates was becoming strained. The currency crisis, a manifestation of structural tension, eventually initiated a system collapse in the years 1971–73. The devaluation of India in 1966, dramatic in scale as it was, was part of more general pattern of currency realignments as post war economic structure became unsustainable.

4.2 The International Pressure Campaign

The motivation behind India to devalue was largely that of the IMF and the World Bank that was backed by the government of the United States. This was not a polite diplomacy game but a direct conditionality regime whereby financial aid directly corresponded with certain policy choices.

The chronology of events shows how the pressure campaign worked. India had a large aid package that was negotiated in late 1965 and early 1966. The country was in urgent need of developmental aid that would help in maintaining the intended industrialization and emergency food aid to contain the drought crisis. The World Bank showed readiness to form a group of donors to offer them some money, about 900 million dollars' worth, which was a staggering amount in 1966 money. Through the PL-480, the United States provided India with emergency food aid whereby India could use local currency, instead of precious foreign exchange reserves, to buy American grain. But these offers came with strings attached to them. The IMF and World Bank officials argued that the issues that India faced in its economy were caused by policy distortions such as overvalued exchange rate, too much influence of the state, and lack of concentration on export promotion. The institutions required India to pursue a structural adjustment program in order to receive assistance with a high place in a massive depreciation of the Rupee.

The pressure was increased by geopolitical factors. At the peak of the Cold war, the non-alignment policy of India aggravated the American policymakers who wanted the South Asia region to join the Western bloc. Johnson administration considered Indian economic vulnerability as a chance to impact policy reforms to bring India nearer to western economic designs and this could shift India political position in the cold war environment. The 1965 war when aid was suspended on the basis of treating India and Pakistan equally also highlighted the dependency on aid as leverage by the United States. The technical arguments put forward by the IMF and the World Bank are theoretically feasible. A strong currency will affect the competitiveness of exports, by reducing the price of the Dollar of Indian exports, by lowering the value of the Rupee, this would stimulate exportation. At the same time, devaluation will make importations costlier in terms of Rupee, which may help prevent the import demand, reducing the trade deficit. All these effects are expected to enhance the balance of payments and restore the foreign-exchange reserves.

Besides, the institutions argued that devaluation had to be trenchant and abrupt, other than gradual. Gradual changes would tend to create a feeling of additional devaluations, which would trigger speculative attacks and capital flight. An intense, non-recurrent adjustment would create a new equilibrium and remove uncertainty. The 36.5 per cent devaluation which came to pass was this big-bang method. This was normal technical advice in the eyes of the Western economists employed in the IMF and the World Bank based on mainstream economic theory. Many nations effectively used exchange-rate adjustment as one of the stabilization mechanisms hence there was no strong argument to consider India as an exception.

4.3 The Domestic Opposition



Not everybody among the stakeholders agreed that the best solution was through devaluation. Among Indian economists and policymakers, there were strong protests and their conclusions should be considered as they were justified later in the course of events.

The devaluation issue had been researched by the Reserve Bank of India (RBI) in 1962 and strongly warned against it. The RBI analysis was done based on the elasticity of exports and imports. To achieve a devaluation that enhances the balance of trade, exports should be more and imports less when they are cheaper and more expensive respectively. This involves the price adjustment in response to changes in prices by foreign purchasers, and the readiness of domestic consumers to make substitutions off imports. RBI came to the conclusion that the Indian exports were experiencing inelastic demand. This meant that lowering their price would not significantly pick up their sales since the major exports of India at that time, which included tea, jute, cotton textiles and spices were limited by quota system and barriers to market entry in the key importing nations. An example would be Britain which placed strict quotas on the imported Indian textiles in order to protect its local industry. The lowering of the cost of Indian textiles would not increase sales as it was regulated and the quantity was limited rather than the price.

Similarly, the Indian imports were much concentrated on basic commodities petroleum, machinery, fertilizers, and food grains in drought years. These were not luxury goods that were easily curtailed. The inputs needed in industries were petroleum and imported machinery should have been needed in the industrialization program. Farmers needed to use fertilizers in order to maintain yields. In the 1965–66 drought, food imported was a survival and not a choice issue. Thus, an increase in the cost of imports through devaluation would not significantly decrease the imports; it would only increase the price of the Rupee of the basic commodities which would increase inflation. This argument of inelastic demand was publicly expressed by a number of economists. C.N. Vakil, a renowned Bombay University economist informed him that devaluation would do no good to boost exports but create severe inflation by increasing cost of importations. The policy was a source of suspicion even to I.G. Patel who later became a Governor of the RBI, despite serving in the government. In the Planning Commission, calls emerged in support of structural adjustment, specifically the enhancement of infrastructure, reduction of regulations, investment in quality improvements, to just make its exports competitive, as opposed to currency adjustment.

Other issues also expressed by the opposition were procedural legitimacy and democratic legitimacy. Most significant decisions on economic policies must be argued out and passed in parliament. The devaluation of 1966 was declared without any prior consultation in Parliament because there was no public opinion. The decision was enacted by Prime Minister Indira Gandhi, who was only in office since January 1966 after the unexpected death of Lal Bahadur Shastri, and not through consultations.

The lack of transparency was strategic in nature. Government initiatives taken without an explanation or discussion cannot foster popular support of temporary suffering to reach a long-term benefit. The government had lost credibility when the anticipated outcomes of devaluation did not take place and the inflation exploded. The devaluation was used by the opposition parties as a sign of governmental incompetence and bowing down to foreign influence, which caused permanent damage to the image of the government. The personal political stand of Indira Gandhi in early 1966 too had a hand in the decision making. She was still in office just a few months after her assuming office and she had inherited a dire economic crisis with no strong popular mandate. The powerful regional wing of the Congress Party, the so-called Syndicate, had backed her choice as opposed to more experienced candidates, which put her in an awkward power equilibrium with the party leadership. She had to deal with the common predicament in any new leader entering a crisis situation; she had to show decisiveness and assert a presence in the face



of the strong internal pressures, which she had to do in an extremely tight time frame. She might have felt that in order to gain the much-needed help, she needed to comply with the pressure of devaluation by IMF and World Bank officials as the precondition, as failure to do so would subject her to criticism at both the international and domestic levels, where her opponents can label her as indecisive or incompetent. The result was a hastened decision that defied professional counsel, lacked a democratic process, and had implications that stretched way beyond the short-term exchange-rate adjustment.

5. THE DEVALUATION DECISION WHAT ACTUALLY HAPPENED

5.1 Technical Mechanics

June, 6, 1966, an announcement of the Indian government on the devaluation of rupee officially changed the exchange rate of 4.76 to 7.50 rupees per dollar. This adaptation had been a 57.6 per cent rise in rupees to buy one dollar, or the other way, a 36.5 per cent fall in the of the dollar in rupees. The repricing of the Indian currency against the global reserve currency that occurred overnight of 4.76 to 7.50 rupees to the dollar was a strong indication of how the Indian currency was repriced against the world reserve currency. To present the practical consequences of this event, it is possible to refer to the following situations. A German machinery order taken by an Indian importer who was spending on a shipment worth 100,000 dollars was shocked to find a rise in the cost of rupee to 750,000 rupees. The fact that such a situation was an unexpected financial loss was not hedged against by any means and got adopted by everyone. The consequences were that many companies that could not cover the increased price of the rupee had to cancel the orders, thus disrupting the industrial activities and the pattern of investment.

In the case of an Indian exporter, the financial computations were different but the disturbance was contingent. A cost base of 47,600 rupees was previously a threshold that incurred by a textile producer to export at minimum cost of 10,000 dollars in order to make a breakeven point. After devaluation, output was recuperated at a cost of just a mere 6,347 when converted into rupee. Despite the fact that such a nominal adjustment was to make Indian exports more competitive, empirical evidence showed a dampened increase in export volumes. There were still quota restrictions and long term market access barriers so that the lower prices could not be translated into real export benefits. The most apparent collateral effect was the inflationary consequences. The imports of petroleum, fertilizers as well as the industrial raw materials were high in India. The 36.5 per cent rise in the cost of their rupee overnight spread across the economy increasing the prices of fertilizers and hence increasing the costs of agricultural inputs. The surges of prices in the petroleum spilled over into the transportation cost and increased the cost of any product to be shipped. High costs of industrial inputs reduced the margin and forced the manufactures to increase the price of their sales.

The inflationary effect was enhanced by the time of devaluation. At the same time, India was undergoing a devastating drought in the years 1965–1966, thus raising the food prices already due to the shortage. The escalation in the additional importation added a demand-pull inflationary strain over the supply side shock in the food industry. This also led to the fact that wholesale price index, which was already rising at around 7 percent per year before devaluation, grew into double-digit inflation in the following years. Economists also see a second effect, so-called real exchange rate adjustment. Although the nominal devaluation was 36.5 percent, the real exchange rate which includes both the domestic and foreign prices, does not change as much when the inflation in domestic market is higher than foreign one. The visible benefits of increased competitiveness were partially washed away in the case of India where post-devaluation inflation happened swiftly. By 1968–1969, analysts had estimated that the depreciation of the real effective exchange

rate had been in the range of 20–25 percent, much less than the actual 36.5 percent devaluation. India, in this way, had a drag of inflation without enjoying the estimated increase in export competitiveness.

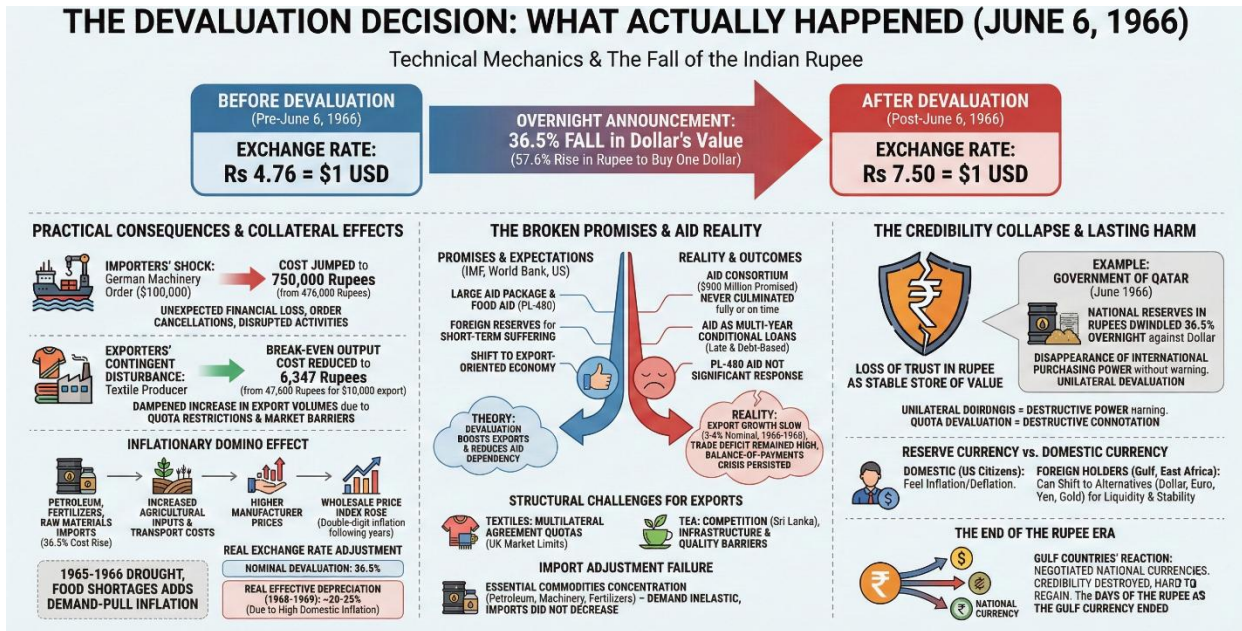


Fig -4: Devaluation Decision

The very first objective of creating a new stable equilibrium at 7.50 rupees per dollar was compromised by the processes of inflation, inability of export development to fit the forecasts and the continued pressure of balance-of-payments. The rupee was therefore in distress. In the following years, more modifications were made. By the early 1970s, real terms (with inflation being factored in) the rupee had been dominant by 57 per cent, compared with its position in 1965. This adjustment was a one-time adjustment, thus, the initial stage of a long-term depreciation path.

5.2 The Broken Promises

The devaluation drive was majorly based on promises in terms of benefits in the future. Both IMF and the World Bank noted that a large aid package would be available in case India showed interest in economic reforms with devaluation being the main pillar of this interest. The United States proposed that food aid in the form of PL-480 would go up to a country which would demonstrate its willingness to liberalize its economy. The devaluation advocates of Indian thought that these foreign reserves would help absorb short term suffering and fund the shift to an export-oriented economy. As a matter of fact, the assistance that was promised was much less compared to what was expected. The entire aid consortium of \$900 mechanically million that the world bank had talked about never culminated in the expected size or within the expected time. The assistance was organized as a multi-year consortium commitment, not immediate payment and a lot of it was not grants but loans. Although certain relief was given, this was late and conditional upon continued circumstances and often in the form of debt, thus increasing the fiscal load of India. United States PL-480 food aid still flowed but even before devaluation it was already flowing and was not a significant response to the policy change.



More essentially, the promises were based on the economic logic which did not become reality. The dominant theory was that devaluating would help to strengthen the export performance, and subsequently, the foreign exchange earnings would be boosted which would subsequently facilitate the reduction of aid dependency in the long term by India. But Indian exports did not increase after devaluation. Export growth was very slow between 1966 and 1968 averaging 3 –4 percent (nominal) a year. The performance of Indian exports when corrected to global trade growth rates actually declined and the percentage of Indian exports in the world export still moved downwards in the long run which had started to decline in the 1950s. What happens to non-response to exports This was what critics had expected. The primary export goods of India were structurally challenged such that they could not be overcome by price adjustments. The textile industry, which is a major part of the exports, faced limits in the form of quota concerning the Multilateral Agreement that limited the amount of imports by Britain, which was one of the largest markets in India. Production of Indian textile 36.5 percent cheaper failed to boost sales to Britain since the quantity of imports was controlled by regulation; the low price only served as the price cut of the same amount sold.

The same was the case with tea exports. The main rivals of India were Sri Lanka (then Ceylon), and the major importers countries had specific relations with certain suppliers and grade of quality. Price was a determinant although not binding constraint of volumes to be exported more important determinants were infrastructure bottlenecks, quality standards and barriers to market access. At the importation side, the expected adjustment was not realised. According to Economic theory, the increased costs of imports, in rupee, would discourage demand. However, as critics had predicted, the imports of India were very concentrated in the essential commodities. With the essentiality of fuel to the running of the industries, petroleum imports did not increase and machinery imports did not decrease as the industrialisation programme needed equipment that was not available locally, fertilizer imports sustained agricultural production.

The trade deficit was therefore not reduced in accordance to the outcomes of devaluation. India was still operating huge external deficits funded by aid, loans and reserve withdrawals. The balance-of-payments crisis which had originally inspired devaluation lasted until the end of the 1960s and into the 1970s. In the meantime, the aftermath inflation following devaluation came with a physical price to the common Indians. The wholesale price index increased by 134 (1961 as 100) to 155 in 1967– a close to 16 percent growth in a period of one year. The prices of food increased even faster. In the case of a poor country where families used most of their incomes on food, this was a major decline in the standard of living. The political reaction was also significant: the Congress Party lost the elections of the year 1967 with a significant loss, having lost its first significant electoral defeat after independence. Not the only cause, but with a wide perception of being symbolic of government incompetence and cynicism to foreign pressure, devaluation was common law.

5.3 The Credibility Collapse

The lasting harm caused by the devaluation of 1966 did not arise directly by the economic consequences of the devaluation but by the loss of trust in the rupee as a stable store of value. This psychological effect especially on those holding the currency internationally portrayed an irreversible nature.

Take the case in the perspective of the Government of Qatar in June, 1966. There were national reserves, which, in turn, were in Indian rupees, which provided the basis of the own currency of the country and represented its savings. The value of these reserves as compared to the dollar dwindled 36.5 percent overnight. The disappearance of the greater part of the international purchasing power, more than a third,



did not happen due to the domestic policy move or prior notice. The short-term economic cost was felt but the bigger picture was the future. The question would be how could India implement a 36.5 percent overnight devaluation without any advance warning and consultations and yet how could they not implement a second or third devaluation. How can it be ascertained that the rupees one has to-day would be of any value to-morrow. The trust that the issuer will keep the value stable on which currency was established was torn apart.

The case is fundamentally different in the case of a reserve currency than in the case of a domestic currency. When the monetary policy of the United States changes and the dollar value changes, the American citizens will feel the implication of the changes in monetary policy through inflation or deflation within the country. They, however, still use the dollar due to the fact that it is their local currency. Dollar holders who are foreigners, however, have alternatives. They carry dollars since the U.S. currency provides heavy liquidity markets, moderate stability, and universal versatility. In case trust in the stability of the dollar is seriously undermined, then foreign central banks and companies may shift to euros, yen, or even gold.

Similar reasoning was used in Gulf and East African countries that used the rupee. The rupee in these jurisdictions was not definitely needed but convenient and seemed to be stable. This assumption of stability was destroyed by the devaluation of 1966. When such assumption no longer existed, convenience could not support the arrangement any longer. Where one reserve currency is unstable in nature, it makes sense to move to a currency which at least offers the access to the deepest capital markets in the world, in this case, the dollar, which is controlled by the most influential economy. The connotation of unilateral devaluation was particularly destructive. The economic policy is a statement of priorities, ability and dependability of the government. Devaluing without prior consultation or even warning to the nations that rely on the rupee was an indication by India of prioritization of domestic issues over the interests of the international currency holders. This might have been economically sound according to the narrow view of India, but it made the holdings of rupee highly risky to foreign governments and companies.

A more generalized lesson comes out with regard to credibility in the economic policy. Reputation is a capital asset which is built up by the continuing behaviour through time. It may however be destroyed suddenly by a single act which is contrary to expectation. Before 1966, the Indian rupee had the advantage of credibility, as a result of its linkage to pound sterling system, and the prudent management of the Reserve Bank of India. This credibility died after 1966. Not even a thousand proclamations and promises could soon bring it back. Rhetoric is not enough to recover trust, but rather, it takes a show of commitment over long durations. The Gulf countries got a bitter lesson on the dangers of depending on the currency of another nation. Their reaction was a quick and strong one. In several months, it started to negotiate the formation of individual national currencies. The institutional and technical work was taking time but the course was clear cut. The days of the rupee as the gulf currency ended.

6. THE GREAT RUPEE EXODUS (1966–1973)

6.1 The Gulf's Response

The collapse of the Gulf Rupee system was a seven-year affair with all the participating states showing near the same trajectory an initial shock on the devaluation, a deliberative review of other arrangements, and finally, the establishment of an independent national currency pegged on the United States Dollar instead of the Rupee. The first country to do so was Gulf Country A (e.g., Kuwait) but its direction was different in more detail as the country had already introduced its own Dinar in 1961 after gaining independence with Britain. That Dinar had however retained a connection with the Rupee under the wider



Sterling Area arrangements. The Gulf Rupee was completely removed, and the Kuwaiti Dinar made the official currency of Kuwait on 1 April 1961. This move was a statement of clear-cut that Kuwait had too much oil wealth to have in a currency that could be easily devalued at the will of an external government.

In September 1966 Gulf Country B (e.g., Qatar) and Gulf Country C (e.g., Dubai) followed with the introduction of the corresponding Riyals three months after the Indian devaluation. This swift reaction highlights how fast the trust on the Rupee had fallen. The already Pound–Sterling–pegged currency soon changed in the expectation of additional depreciation. In 1973 when the United Arab Emirates formally was established through the consolidation of seven emirates, the newly established UAE Dirham was explicitly pegged at a fixed value of 3.67 Dirhams per Dollar. The UAE foreign–exchange reserves also became largely Dollar–denominated, unlike the former Rupee.

The Bahraini Dinar, which came into use on 16 October 1965 already predates the Indian devaluation of 1966. It was not just the Indian policy that influenced the transition in Bahrain but the desire of the state to have an independent government. However, in 1966 Bahrain officially disconnected itself to the Rupee system. The Dinar initially pegged on the pound before eventually pegging on a Dollar. Saudi Arabia that had been using its own Riyal since 1952 further increased its building of Riyadh as a financial hub in the region, making it consciously an alternative to a possible Rupee–based system. The circulation of the Indian Rupee in some cantons of the sultanate was abandoned and the Omani Rial was introduced in 1970 by Oman. The Rial was originally pegged against the Pound and then against the Dollar. By 1973, a survey examination of the Gulf region indicated that no individual nation continued using the Indian Rupee and also no currency peg to the Rupee.

The economics of oil can be used as a major explanation of why Dollar pegs are favored over a Rupee–based system. By the late 1960s and early 1970s, oil had risen to become one of the leading economic motifs that take place in the world. The oil prices were expressed in Dollars, the international oil companies used to pay out the concessions in Dollars, and the revenues of the Gulf oil flowed back to the Gulf treasuries in Dollar–denominated accounts. The infrastructure of the oil market world had thus become Dollar transactions. The natural logic model of Gulf states within this setting was pegging their local currencies on the Dollar. When the revenues flowed in Dollars and imports were valued in Dollars, a Dollar peg would have eliminated any exchange –rate risk on the largest transactions. It also shunned the volatility and uncertainty of having a currency which varied relative to the main trading one.

Credibility and stability were also vital factors. The United States was the hegemony both economically and militarily despite its domestic issues. The Dollar was supported by the complete sovereignty of the US government, the biggest economy, and the richest capital markets. The holding of Dollar reserves guaranteed easily convertible liquidity and acceptance in the international markets. Contrastingly, the India of the post–1966 development was a developing nation plagued by repeated balance–of–payments crisis, with its policy–making processes being conditional to the IMF and the World Bank. The Indian devaluation had proven that it was ready to devalue without consulting the international currency holders. This would mean that rational finance ministers would have little reason to keep national reserves in Rupees when Dollars were far superior in terms of stability and liquidity.

India suffered some losses in more than just the circulation of currency notes in the Gulf. It gave up its position of a financial intermediary of a reserve currency. Before 1966, the Indian banks were natural intermediaries to the Gulf trade finance. In the region, following 1973, Western banks especially the American and British banks dominated over Indian financial services. The recycling of petrodollar flows was done in New York and London, which deprived India of capitalization of the Gulf revenues.

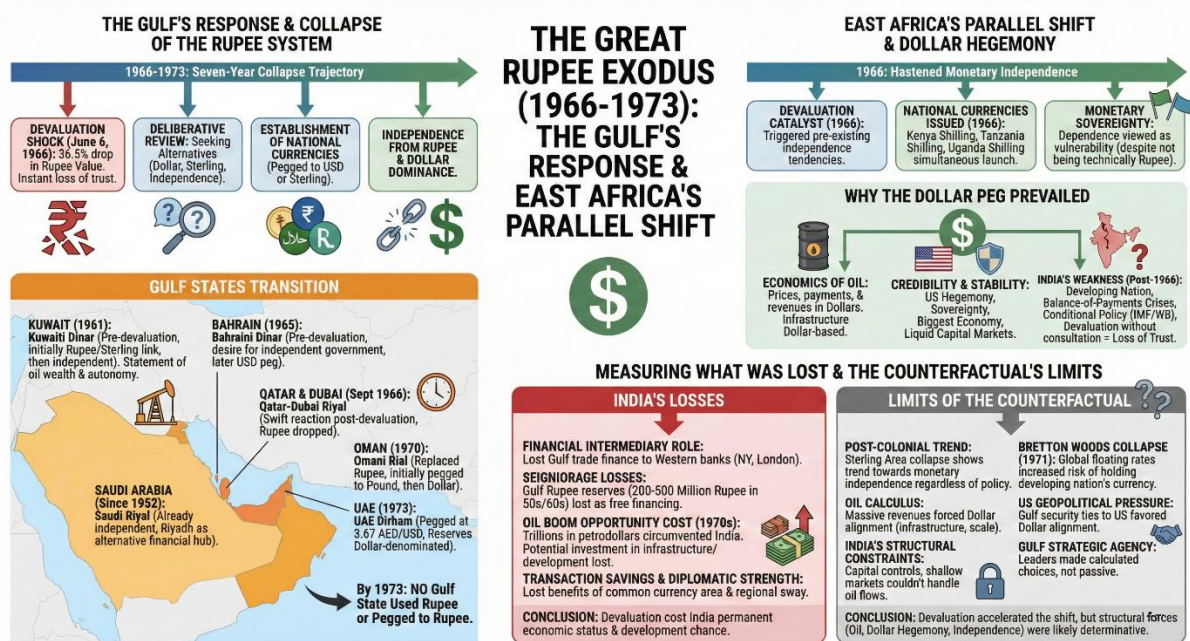


Fig –5: The Great Rupee Exodus

This shift was very costly to India especially in terms of time. The 1970s was the period of unprecedented rise in oil prices, and the crisis of 1973 increased the oil prices by nearly 4 times in a single night. Gulf countries had just piled wealth in a level that could not have been imagined ten years ago. The oil revenues would have been in Rupee channels and the oil surpluses could be invested in the Indian financial institutions had the Rupee remained the reserve currency of the region. India might have also used the position of banker to the Gulf to gain capital that would have benefited itself in terms of developmental purposes.

Rather, all the money flow circumvented India. The Gulf oil wealth was then channeled into Dollar-denominated assets which were mainly the US Treasury securities. Western banks made their profits by handling Gulf investments. The emergence of financial centres in Bahrain and Dubai attracted expertise and investment in infrastructure that would have instead been channeled to urban centres in India. India was therefore left out of what would be the biggest capital flows in the world economy in decades.

6.2 East Africa's Parallel Shift

A similar trend was observed in the territories of East Africa, but the motivators were slightly different. The devaluation in 1966 hastened already established monetary independence tendencies towards the still larger post-colonial nation-building process. After gaining independence Kenya, Uganda, and Tanzania (a union of Tanganyika and Zanzibar in 1964) still issued the East African shilling. The connection between this shilling and Indian Rupee was weakening. The final impetus was received in the devaluation of 1966. Both countries came to a conclusion that monetary sovereignty justified the necessity to issue a national currency, kept only by its central bank.

In the year 1966, Kenya came up with shilling. Similarly, Tanzania and Uganda followed suit in their respective shilling the same year. The fact that these actions were taking place simultaneously was not by chance. The Indian devaluation was an evidence that dependence on the currency of another country



created unacceptable vulnerability. Even though the East African shilling was not technically equivalent to the Indian Rupee, the sense of inferiority was enough to trigger a total monetary autonomy.

The East African transition was not similar to the Gulf in a number of dimensions. These were relatively poorer states that were not given the oil riches that gave the Gulf states a high bargaining power in global finance. The East African countries were forced to sustain aid relations with the past colonial states and international organizations that limited viable monetary policy alternatives, even though nominal independence was present. A larger issue was that of post-colonial currency agreements. France retained fourteen African states tied to the CFA Franc on a fixed exchange rate basis. The countries of British Commonwealth, in turn, had links to the Sterling Area. These agreements lasted decades, demonstrating that the connections between the former colonies and the metropolitan powers in the form of currency was not necessarily volatile.

The structural factor that differentiated the position of India was different. The devaluation of 1966 proved that India would not give much value to the interests of the international holders of Rupee. France and Britain, on the contrary, though losing positions in the world, were still the developed countries, rich in financial markets with stable currencies. India is a developing nation that had its fair share of economic struggles and policy unpredictability thus a credibility gap that influenced its financial strength in East Africa. The monetary loss of influence in East Africa had less immediate economic impact than the Gulf rupture due to the fact that the former implied little trade box and economic significance. However, there were significant strategic implications. India had already established itself as the leader of non-aligned movement and champion of South-South cooperation. Having economic connections with East Africa would have offered a platform to other financial structures which would not be dependent on the past colonial powers. When these connections were cut off, it was too late.

6.3 Measuring What Was Lost

It is hard to quantify the costs of failing to be a reserve-currency, since it requires quantification of the benefits that India would have gained under a counter-factual scenario which did not come to pass. However, these figures can be bounded with estimates.

The most direct cost is the seigniorage losses. It has been estimated that the Gulf states as a bloc had between 200 million and 500 million of the Rupee reserves in the 1950s and 1960s. These reserves were physical resources which India could tap into without goods or services being delivered on the spot. This source of practically free financing was finished by the collapse of the Rupee system. More to the point, India had forfeited the accrued oil resources of the following decades. Gulf oil revenues were more than \$1 trillion on a cumulative basis between 1970 and 1980. Provided 510 percent of that wealth had been invested through the Indian financial system, the fees, interest payments and economic spillovers would have generated tens of billions of dollars to India, which could then be used to finance infrastructure, education and industrial development in a vital economic transformation phase.

The transaction-cost savings in the case of Indian businesses are more difficult to measure but had economic significance. Currency union studies have indicated that bilateral trade may rise by 30–90 percent through a common currency by removing conversion costs and exchange rate risk. Whereas the Rupee system was not a formal currency union, it provided the same benefits to Indo-Gulf trade. These losses eliminated benefits, which made Indian exporters face the challenge of increased costs and risks of joining the Gulf markets. The loss also had strategic costs that can hardly be found in normal economic data. With the break in financial connectivity, India lost the diplomatic strength in the Gulf. In matters that



involved policy choices that involved the interest of the Indians, the Gulf nations no longer had to think of how it would affect the Rupee or even the financial relationships with India. This meant that India had more trouble realizing its foreign-policy goals in the area.

The argument of counter-factual is particularly acute in the case of oil boom of 1970s. Consider what would have happened had India retained the Rupee as a reserve-currency. In 1973, as the price of oil rose four times, the Gulf countries would have accumulated huge reserves of Rupee which would have needed deep capital markets to be invested productively a market that was not yet present in the Gulf. Such funds would have best been used in Indian markets to fund infrastructural and industrial development. In its place, New York and London seized the flows of petrodollars. Western banks re-injected these dollars back into the loans to developing countries, which precipitated the debt crisis of the 1980s. Gulf countries created Dollar-based sovereign-wealth funds that are currently worth trillions of dollars. This activity did not have any serious benefit to India as it was not part of the system.

Even some of the economists can estimate that even a small proportion of petrodollar disbursements into India in the 1970s might have caused compound growth effects, and several percentage points to GDP over the next decades. These figures are speculative but they illustrate the level of the opportunity cost. The verdict is definite the devaluation in 1966 had much more costs than short-term economic shock. It preempted a move towards development that might have turned out to be revolutionary. The benefits of retaining the reserve-currency status would have increased over time, more with every decade. India made that status crumble on one day and thus made India permanently poorer than it would have been.

6.4 The Counterfactual's Limits Why the Gulf Rupee May Have Been Doomed Regardless

The main idea underpinning the article is a counter-factual that not undergoing the 1966 devaluation would have allowed the Rupee to remain the reserve-currency and India to enjoy the oil boom of 1970s. Such a situation deserves serious questioning as it could exaggerate the possibility of holding the Rupee over structural influences that are transforming the world monetary system and the politics of the Gulf region. Take into account the course of the other post-colonial currency regimes. Even without any dramatic devaluations, the Sterling Area, a precursor to the Gulf Rupee system was breaking down during the 1960s. Britain had rather good monetary policy compared to that of India, but former colonies unsystematically shed the reliance on Sterling. This was fueled by the fact that new states that gained independence needed financial autonomy to solidify the political independence. The symbolism of issuing national bank notes with national iconography, controlling one's currency and domestic monetary policy was too good to resist throughout Africa, Asia, or the Caribbean.

Same logic was represented by Gulf states. The decision of Kuwait to introduce the Dinar in 1961, five years ahead of India to do so, was an indicator of a sovereign coinage program after gaining independence towards Britain. The Dinar of Bahrain, which came into force in 1965 was the product of nationalistic desires and not the deficiency of Indian finances. The trend shows that the perfect management of the Indian monetary may have only delayed, but not stopped the shift of the Gulf to independent currencies. Calculus was altered essentially by oil. A rupee-based set up was convenient until the early 1960s when oil revenues were modest. Nevertheless, in the 1970s, oil revenues shot up forcing Gulf states to match Dollar-denominated systems. The oil sales were based on Dollars and the infrastructure of the global oil market which included the oil companies, oil financing institutions and shipping arrangements was centered on Dollars and Pounds and not on Rupees.



In theory, Gulf states would have demanded oil sales that were denominated in Rupees. This would have been practically a source of great complications. Purchasers of oil would have required reserves of Rupee, and India would have been required to leave the Rupee fully convertible so as to enable such transactions. However, capital controls existed in India because it did not even have reserves possible to fully convert itself. Therefore, maintaining the Gulf Rupee system on such a large scale would have needed financial muscle which India clearly showed was lacking in its balance-of-payments issues. Scuttling of the Bretton Woods system in 1971 also made things more complex. This fixed-exchange-rate system which supported the Gulf Rupee system collapsed when President Nixon terminated Dollar-gold convertibility. The world became floating rate and more volatile in terms of currency. The position of reserves in the currency of a developing state, a target of endemic balance-of-payments stress, was more than ever risky in this novel setting, despite the devaluation of the year 1966.

The economic performance of India during 1970s and 1980s also supports the counter-factual. Financial markets did not develop freely because of modest growth rates, ongoing balance-of-payments crises, and broad economic controls. Where would they invest the Rupee reserves even when the Gulf states wanted them? Fundamentally, India had shallow financial markets, capital controls on free movement of capital and limited returns. The reserve management of Dollar-denominated assets in comparison, was much more appealing due to their depth and liquidity. The increased strategic significance of the Gulf to the United States increased politically. The Gulf stability was based on American security assurances, military alliances and diplomatic assistance. There is no indication that the United States would have accepted the wholesome Middle Eastern financial system, which would have been pegged on the currency of a non-aligned country with close Soviet relations. Pressure to conform to the Dollar system geopolitically was great and probably unavoidable.

Take a certain case. Consider, though, that India had not devalued in the year 1966, and held perfect monetary policy up to the 1970s. Saudi Arabia had overnight billions of Dollars in the bank when the oil prices quadrupled in 1973. Would Saudi Arabia take these Dollars back in Rupees and have them as reserves? This would involve India selling Dollars in its reserves to buy Rupees which cannot be done on the scale that is needed. Would Saudi invest in the Indian assets. There would be limited financial depth and capital controls. Therefore, it follows logically that oil revenues were kept in Dollars since it was the only system available, which could absorb the oil revenues. Another assumption of the counter-factual is that it is the Indian policy that limited the Gulf decision-makers to passive roles. In actual sense, the leaders in the Gulf were doing some strategic calculations on their interests. Even with the ideal belief that the Rupee was stable, Gulf states could still have wanted to be affiliated to the strongest military and economic power in the world. Oil wealth gave them a strategic logic which would automatically lead towards Dollar alignment, regardless of whether they pursued Rupee policy.

Although the 1966 devaluation was certainly a very expensive affair and possibly it spurred the process of 235 the monetary segmentation of the Gulf, the extent of the cost later on might have been exaggerated. The forces of structural independence of this Gulf monetary and alignment to the Dollar were strong and probably determinative. The moral of the story is that counter-factual arguments in economic history need to take into consideration systemic tendencies, which can dominate an individual policy choice. The devaluation of 1966 was not a good move that cost India a lot in terms of economic gains. Nevertheless, the argument that it deprived India of the chance to be the financial go-between to the entire oil boom exaggerates the causal role of one policy incident and underestimates the overall forces restructuring the global monetary system, which would have marginalized the Rupee in any case.



7. CONCLUSION

The history of the Indian Rupee as a reserve currency teaches us valuable lessons in the contemporary economic policy. Firstly, it demonstrates that credibility that had been diligently nurtured over years may be destroyed in a short period of time. British colonial financial relations gave the Rupee the role of the Gulf and East Africa. It took approximately two decades before it failed when it was debasement on June 6, 1966.

Credibility, stability, and size of economy are prerequisites to a country to be a reserve currency. All three were due to its association with the sterling system, prudent policies of the reserve bank of India, the stability of the Bretton woods and the fact that the Indians were very much tied to the gulf and East Africa by trade. Credibility and stability was ruined in 1966 by devaluation. Meanwhile the economic issues of India diminished its size hence the Rupee was no longer able to be used as a reserve currency.

The existing processes of internationalizing a currency should be able to satisfy these three needs. An example where this is lacking is the Chinese Yuan, though the economy is huge, there is no credibility due to the capital controls and vague policies. The Euro is credible and big but it is undermined by the political divisions. US dollar is still superior due to its credibility, stability and big economy.

The second one concerns the political aspect of economic policy. The devaluation of 1966 was not democratically elected or rather it was forced by the international pressure and hence it lacked the support of the people. Prime minister Gandhi did not go through Parliament which deprived him of the political capital that could hold the policies together. The moral is that drastic economic reforms which entail short term sacrifices must be democratically legitimized in order to outlive. External structural adjustments are typically unsuccessful without domestic support.

The third point is that the policies that are supposed to be effective may be constrained by structural restrictions. Opponents described Indian trade by having restrictions like textile quota, the quality of agriculture and inelastic demand of imports. These problems could not be solved by changes in exchange rates. That lesson is still true. In the case of a prevailing structural factors, varying exchange rate makes insignificant impact and may increase inflation. Repair of infrastructure, regulation, quality, and access to the market is even more effective than the price corrections.

The fourth one is that timing and sequence of reforms are of essence. India was depreciating as an economy was already suffering because of a drought and post-war stress, which further aggravated the outcomes and agitation. Bringing in the capital account or trade liberalization may be very disastrous before the economy is competitive.

The fifth moral is that quick solutions are usually long term in expenses. India relinquished its reserve-currency status in the narcissistic hope of absent assistance. This can be rightly termed as short sightedness where the immediate demands take pre-eminence over the long term objectives.

Out of these lessons we can extract some rules to follow to be credible we must act in a certain way and in a transparent manner, major reforms should be democratically justified and have a strategic core instead of price adjustments, reforms must be implemented in the proper sequence, and long-term needs must not be sacrificed to short-term demands. To have a reserve currency once again, India needs to realize long-term macroeconomic stability, well-developed financial markets, full convertibility of the capital-account, well-developed legal systems, and sustained growth. Gains have been achieved and even total convertibility is politically sensitive. Trying to regain credibility will require decades of consistent policy, not mere rhetoric. The 1966 case demonstrates the way that decisions in a crisis can establish irreversible



courses. It makes us remember that the reputation, strived to be created and easily ruined, is applicable to currencies, institutions, and nations.

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