# WHITHER CENTRAL BANKING?

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FORUM OF FREE ENTERPRISE
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"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

1899-1965

Founder-President

Forum of Free Enterprise

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In the ten and odd years since I relinquished charge as Governor of the Reserve Bank of India, the Indian banking system has undergone far-reaching changes, reflecting both the needs of the Indian economy and the changes in the government's economic philosophy. The injection of politics into banking is not an unmixed blessing. In particular, it has tended to give a tinted image of the effect of the nationalisation of the major commercial banks in July 1969. There is a tendency to suppose that the only major developments in banking have taken place since then and that nationalisation has become one of the major tools of the *Garibi Hatao* programme through an expansion of banking activities by leaps and bounds both functionally and in terms of geographical coverage. Far be it for me to deny that nationalisation has given a concerted push in certain directions, a push which, in many cases, was badly required. But historical objectivity compels one to reiterate that Indian banking had made substantial progress even in the pre-nationalisation days, a progress whose pace and direction were determined by the historical forces operating at the time. Even in a period of revolution, there are certain matters which cannot be subjected to too rapid a change without danger and one of these matters is the financial mechanism of a country.

By the mid-sixties the Reserve Bank of India had more or less completed the process of elimination of the weak units which had proliferated during World War II, and consolidated the banking system. Functionally too, some orientation had been given to expansion of credit for small-

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* The author is a former Governor of the Reserve Bank of India. This text, reproduced with his kind permission, is based on inaugural remarks at a seminar on the Banking system held in Madras on December 1, 1972.

scale industries and participation to some extent in medium-term financing. To stimulate the participation of commercial banks in the provision of medium-term finance, refinance facilities were offered through a special institution called the Refinance Corporation for Industry. For assisting the development of banking habit, deposit insurance had been instituted. Another area in which, by the mid-sixties, the banks had made substantial progress was in the field of expansion of branches particularly outside the city areas, and the training of staff to equip them for a much faster expansion of branches and diversification of their activities. There was little attempt to give credit to the farmer because at the time the deliberate policy of the government was that rural credit should be the prerogative of co-operative institutions.

In other words, in the ordinary course, important changes in the functioning and management of banks, including a great deal of professional element in the top management had taken place. What has happened is a further push and orientation through conscious state policy; this would not have been possible without a great deal of confusion before the earlier steps that had been taken. In a planned economy like ours, governmental direction and initiative are not only inevitable but desirable to a large extent. The last three years have witnessed a vigorous expansion of branches of commercial banks and a serious effort at credit planning. But it must not be forgotten that deposit mobilisation has been facilitated to a large extent by the substantial deficit financing of government; and this mobilisation would have happened whether banks had been nationalised or not. To what extent the expansion of branches has been done at the cost of quality, it is not easy to say. There are certainly complaints that quality has suffered and indiscipline has increased. Also, one suspects that there has been over-emphasis on the flow of credit to the so-called weak and priority sectors, without considerations of ultimate viability. There are complaints too that so far as the top management of the commercial banks goes, by and large, there has been no radical departure from conventional attitudes and methods of working.

It would also seem that for the tasks that have been set for the banking system the banks in general have not built up adequate staff - not so far as numbers go; if anything, perhaps there are too many employees — but in regard to specialisation. Banks are now called upon to function as developmental agencies, not only providing credit but, to an extent, helping the establishment of business units, particularly by the small entrepreneurs. To meet the challenges of their functioning as development agencies, banks have to engage in the recruitment of hundreds and thousands of specialists and also provide massive training facilities for the staff at all levels. I would consider this as one of the important points of the Commission's recommendations — in particular, what they say about infusing into the minds of the staff a sense of their *involvement* as essential elements in the totality of the country's economic programme. It is worth recalling, in this context, that initially after nationalisation there was a sense of euophoria about this amongst bank employees but this has tended rapidly to disappear.

I consider that possibly the most important of the recommendations made by the Banking Commission relates to the organisation of agricultural credit, particularly to the farmers who may be regarded as below the poverty line. In regard to farmers generally the policy of government ever since the turn of the century has been to depend on co-operative organisations. Following the experience of what happened in Germany, Denmark, Holland and other places and also in Japan, it was believed that if only farmers got together and constituted themselves into co-operatives, such a structure would enable them to organise effectively the provision of the credit required for their agricultural operations and getting out of the grip of money-lenders. There was a basic fallacy underlying this concept because in the countries referred to, farming was a successful form of business in the sense that farming generally provided a surplus. In India that was never the case except in regard to the few who happened to belong to the category of large-scale farmers. Nevertheless, government swore by the co-operative movement and for a period of over 70 years we have tried to build the whole structure of rural credit on the basis of co-operative organisations.

The political independence in the country made no change in this basic concept, but it has led to two changes one of which really goes to the root of the whole problem. I refer to the proposed legislation on the ceilings on agricultural holdings. I know the government has been faced here with a cruel choice. With the tremendous growth of population, the pressure on land has been increasing relentlessly and from this point of view there are possibly good grounds for the proposed legislation. But I would point out that from the point of view of creating a viable rural economy the effect of ceilings on agricultural holdings may well be to eliminate or perhaps to reduce the surplus in agriculture.

The second change that has taken place is that since Independence there has been a more systematic analysis of the problems involved. This, for the first time, was undertaken by the All-India Rural Credit Survey carried out by the Reserve Bank of India under a Committee of Direction. Unfortunately, the report added more philosophical arguments in support of previously accepted dogma. In their general report, the committee pointed out certain basic factors which, they said, led to the comparative failure of the co-operative movement. The fundamental factor to which they drew attention was that the majority of villages were poverty stricken and, consequently, had no surplus, and that at the bottom the movement consisted of a combination of the weak. They might well have said that this was so not merely at the bottom but at various levels except at the top. In an extremely well-written but, in retrospect controversial, socio-economic analysis, they pointed out that apart from functional, structural and administrative defects, the main cause for the failure of the co-operative movement was that during the colonial regime to which this country had been subjected, the rural structure which previously had been based on caste and had been economically self-sufficient has had, superimposed on it, a powerful urban, highly monetised economy supported by colonial rule and administration and by big financial institutions.

While the colonial rule itself underwent transformation and gradually gave rise to an independent democracy the nature of the association between the rural community and the big financial institutions centred in urban areas continued without change and this made it impossible for the co-operative movement to succeed. The committee accordingly recommended that the only manner by which the movement could succeed was by making the poor sections of the community, which meant the overwhelming majority of the rural population, have the support of a countervailing force which could be expected to be more powerful than the urban financial institutions. In their judgement, such a countervailing force could only be the state and in the main their recommendation was that the cooperative movement should, as its principle prop and support, be partnered at various levels by the state. This was the basis of the consequential recommendation that the governments should participate in the share capital and consequently in the management of the co-operative institutions of various types.

Although this recommendation was accepted by government the problem was complicated by an excessively rigid adherence to certain ideological concepts. The main ideological concept was that the members of a cooperative society should know each other and consequently no co-operative society should be large in geographical coverage than a single village. From time to time, recommendations were made that it was essential for the success of co-operative institutions that they should be well managed and viable and, for, this purpose, the geographical coverage should be much larger than a single village, but government, for quite some time, obstinately refused to accept the proposal that there should be large sized societies.

Whether one accepts the fundamental socio-economic diagnosis made by the Committee of Direction set up by the Reserve Bank of India or not, it is manifest that they failed to notice that the state could, in a democratic set up, mean not an all-pervading benevolent diety but only the government of the day manned by human beings. In other words, the state would mean only the political party in power for the time being. I scarcely have to elaborate what this has meant. The co-operative movement, by and large, has continued to be a failure in the real sense of the term whatever claims may be made about the increase in the number of societies, increase in membership and increase in the sums lent to farmers.

Apart from the fact that there are considerable areas in the country where, on any reasonable standard, the movement has totally failed, even in those areas where it has been regarded as being reasonably successful unauthorised overdues have increased alarmingly. More important, there are legitimate complaints that in their operations the societies have failed signally to give the legitimate share of credit to the weaker sections of the community. In other words, the complaint, for which there has been great deal of justification, is that the more substantial farmers have benefited from the resources available to the co-operative institutions because they have political pull. It cannot be gainsaid that there has been too much of politicalisation in the functioning of co-operative societies and this has cut right across the principles and concepts on which the movement was originally based.

It is against this background, that the Commission has recommended a system of rural banks. The commission has not gone to the extent of saying that the co-operative societies should be scrapped. I imagine one could scarcely expect that from a Commission headed by Mr. R. G. Saraiya. What they have suggested instead is that where they are efficiently being run they should be operated as rural banks. In other places, which means over the major part of the country, the system of rural banks should be set up backed by commercial banks. In other words, a significant change in concept has been introduced, namely that instead of state participation there should be participation by commercial banks. The basic idea of the co-operative movement, that it should be a union of people who intimately know each other, has been abandoned.

The question at issue now is whether commercial banks which, by and large, have been nationalised and come under the influence of governments can be trusted to be less political than government themselves. This is a question on which everyone is entitled to have his opinion but taking a long view of possible political developments for the future, one is entitled to have doubts as to whether the change, although structurally important, is in fact going to be decisive in character.

Now I turn to a subject which, unfortunately, has not been referred to at all in the report of the Banking Commission because it was outside its terms of reference and yet this subject, namely, the role of the central bank in the country's economy, is crucial to the whole issue of how the banking mechanism operates. It is crucial from two points of view — firstly from the point of view of the overall control of credit and, secondly, from the point of view of organising the mechanism for channelling savings into the organised financial sector subject to rigorous central discipline.

These were to objectives with which the Reserve Bank of India was set up in 1935; its primary purpose was stated to be preservation of the stability of the currency but to this was added the rider that the bank should so operate as to subserve the wider national interest. There is a possible conflict of objectives here. In the context of developments that have taken place since Independence, the latter expression should obviously be interpreted to mean the furtherance of economic development in accordance with successive plans.

The conflict lies in the fact that the furtherance of planned economic objectives in the case of a developing country such as India could only mean a continuous inflation of prices, which means a continuous erosion of the stability of the currency; this is inevitable in any development process for by no conceivable stretch of imagination could a country such as ours possibly raise resources, by non-inflationary means, enough to meet both current needs of administration as well as the needs of a massive developmental effort. The question has never been as to whether we could do without inflation; the question has always been what is the degree of inflation which the country can tolerate.

This is not a point on which any dogmatic views can be expressed because the problem is not one of mere economics; it is intermixed with problems of political psychology, for the degree to which people are prepared to sacrifice current consumption for future development involves questions of political compulsions and political freedom. There was a time when it was thought that 2 to 3 per cent rise per year in prices should be regarded as not unreasonable for a developing economy during the process of development. This was the view propounded by the well-known economist Prof. Arthur Lewis and, in the first 10 years of planned progress, India was able to stick to this level. Over the period from 1952 when we began the era of planned development till 1962, the total increase in prices was 25 per cent — approximately a little over two per cent per year. There are others who say that 5 to 6 per cent increase in price should not be regarded as unreasonable. But, however that be, it is clear that the increase in prices that we have recently witnessed in our country is of an order which, on any view, is wholly intolerable.

In this context, the argument has been made in high quarters that inflation is a universal phenomenon and that what has been happening in our country is not an original sin but just part and parcel of world-wide economic process. But this argument overlooks the fact that in affluent societies, the effect of inflation is qualitatively wholly different from the effects of inflation in a poverty stricken country such as ours. In the United States, for instance, or in western Europe or even in Japan, inflation would conceivably mean postponement of shifts in the matter of durable goods; instead of changing automobiles or television sets over two or three years, people would probably have to postpone doing so for an extra year or two. That would not seem to me a real hardship although the people of these affluent countries might think differently. In our country inflation, particularly of the magnitude which we have been witnessing recently, hits millions of people at the most vital spot, namely in their consumption of essential goods like foodstuffs and clothing. I consider that any comparison with what is happening with affluent societies is nothing less than an affront to the intelligence and the sentiments of our people, and I hope that we will not hear this again.

Where does the Reserve Bank of India come into this matter? The answer is that the Reserve Bank is the primary creator of currency and bank credit and technically has the major responsibility for creating the monetary conditions which create and sustain inflation. But unfortunately for the bank and the people of this country the Reserve Bank is not the sole deciding authority as to the degree to which currency and credit can be expanded at any particular point of time. The real deciding authority is government and government is subjected to several pressures, some perfectly legitimate and others quite illegitimate and, in a democracy, government generally prefers to take the easy way, which is always open to the sovereign authority, of expanding credit. I am not saying for a moment that government should not exercise this right. Obviously there can be only one sovereign authority in a country and that should be the government elected by the people and responsible to the people.

The Reserve Bank is in no position to assess the options open to a government and to assess the extent to which it is politically possible or expedient to resist pressures. But while conceding this, it is necessary to point out that the whole object of setting up a Reserve Bank in a country would be frustrated if the process of expansion of credit is virtually automatic as it is at present. When I was Governor of the bank, the procedure was that if the central government deposits fell in any week below Rs. 50 crores, *ad hoc* treasury bills were automatically issued to make up the deficit and this was done way down in the bank hierarchy with the consequence that no one higher up, for example the Governor, even knew about it till the weekly statement was issued. And no one knew about it in the Finance Ministry either. I believe it is correct to say that even today the process by which *ad hoc* treasury bills are issued to the central government is virtually automatic. There is no debate between the Reserve Bank and government on the question of the expediency of creating additional money. My point is that the object with which the central bank is set up in a country would be frustrated unless the expansion of credit beyond a certain limit is exposed to a debate between the bank and government and, if there was difference of opinion between the two, to a public debate in Parliament.

In Australia, for instance, the statutory provision was and perhaps still is that where there is a difference of opinion between the Reserve Bank of Australia and the Commonwealth Treasury which could not be settled by discussion, the Governor has the right to set out his views in writing and the Commonwealth Treasurer formally exercised his undoubted prerogative of over-ruling the Governor, but the papers were all submitted to Parliament for debate. The virtues of some such procedure are twofold. First, it puts government to the necessity of exercising a conscious choice in a sensitive matter which could have serious political consequences. Secondly, it has the advantage that the country is aware of the options before government and the particular reasons which have motivated government in exercising any particular option. Where for instance the issue is one of increasing dearness allowance or defence expenditure, it is a matter of utmost importance that the country should be aware of the economic consequences of the financing of the additional funds required by recourse to deficit financing.

There are other issues involved which are also of some public importance. There are debates in our country as to what exactly is connoted by the expression "deficit financing." We had the curious spectacle the other day of some confusion of thinking in the treasury benches as to what would be the consequences, so far as its inflationary impact is considered, on an investment by commercial banks in government securities. It is of some importance that concepts should be clearly defined. This is not an esoteric subject. There is no reason why the issues involved cannot be explained in simple terms capable of being understood by the common man. I have come to the conclusion that these and other connected issues revolving round the question of how the Reserve Bank is actually functioning, in particular to what extent it is offering advice to government and to what extent government is accepting or modifying its advice, ought to be the subject of a new commission of inquiry.

There is too great a tendency in India to treat the operations of the Reserve Bank as a mystique to be discussed in public only at peril. But other countries have had commissions of enquiry, and nothing but good has come of the exposure of the mystique to the sunlight of such public discussion. Any such commission could go not only into the question of what constitutes money supply and deficit financing and the connected problems of the role played by the Reserve Bank and commercial banks in the floatation of government loans but also into another equally important subject, namely whether the Reserve Bank is inhibited in carrying out its primary role by the multiplicity of development tasks which have been loaded on its back, such as industrial finance, agricultural finance, inspection of commercial banks and the rest.

There is undoubtedly a case for saying that in a developing country it is not enough for the central bank to devote itself exclusively to the primary function of regulating currency and credit and that it should take a live interest in developmental activities but *prima facie,* there is reason to think that we have gone too far in this direction by overloading the Governor of the bank with a multiplicity of functions and that better results could be achieved if at least some of these functions were taken away from him.

*The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise*

## APPENDIX I

### Reserve Bank of India

### Profit and Loss Account for the Year ended June 30, 1972

**INCOME**

| | Rs. P. |
|---|---|
| Interest, Discount, Exchange, Commission, etc. ... ... ... | 157,16,50,995.40 |

**EXPENDITURE**

| | |
|---|---|
| Establishment ... .. ... | 20,93,25,621.86 |
| Directors' and Local Board Members' Fees and Expenses ... ... | 65,527.68 |
| Auditors' Fees .. .. .. | 90,000.00 |
| Rent, Taxes, Insurance, Lighting, etc. .. | 1,02,10,648.99 |
| Law Charges ... ... .. | 2,16,523.57 |
| Postage and Telegraph Charges .. | 11,87,907.87 |
| Remittance of Treasury .. .. | 67,29,577.01 |
| Stationery, etc. ... ... ... | 27,98,163.31 |

| | |
|---|---|
| Security Printing (Cheque, Note Forms, etc.) ... ... .. | 4,80,22,762.31 |
| Depreciation and Repairs to Bank Property | 1,06,19,459.89 |
| Agency Charges ... ... .. | 7,28,37,842.14 |
| Contributions to Staff and Superannuation Funds ... .. | ................ |
| Miscellaneous Expenses ... ... | 95,46,783.63 |
| Net available balance ... .. | 120,00,00,177.14 |
| TOTAL .. | 157,16,50,995.40 |

## RESERVE FUND ACCOUNT

| | |
|---|---|
| By Balance on 30th June 1972 ... | 150,00,00,000.00 |
| By transfer from Profit and Loss Account | Nil |
| TOTAL .. | 150,00,00,000.00 |

## APPENDIX II

### MONEY SUPPLY WITH THE PUBLIC

| | | Rs. crores |
|---|---|---|
| 1960-61 | .. | 2,869 |
| 1965-66 | ... | 4,529 |
| 1971-72 | .. | 8,111 |
| February 1973 | over ... | 8,900 |

## APPENDIX III

### Scheduled Commercial Banks in India

Rs. crores (rounded)

| Year (last Friday) | No. of reporting banks | Deposits | Advances |
|---|---|---|---|
| 1960-61 | 89 | 1,747 | 1,320 |
| 1965-66 | 76 | 2,950 | 2,288 |
| 1968-69 | 73 | 4,338 | 3,396 |
| 1969-70 | 72 | 5,028 | 3,971 |
| 1970-71 | 73 | 5,906 | 4,684 |
| 1971-72 | 74 | 7,098 | 5,258 |
| Feb. 1973 | | 8,356 | 5,698 |

## APPENDIX IV

### CHEQUE CLEARANCES (ALL CENTRES)

| Year (last Friday) | No. (in thousand) | Amount in crores of rupees (rounded) |
|---|---|---|
| 1960-61 | 54,809 | 12,551 |
| 1965-66 | 75,922 | 20,957 |
| 1968-69 | 92,710 | 28,253 |
| 1969-70 | 1,03,871 | 33,067 |
| 1970-71 | 1,12,093 | 36,958 |
| 1971-72 | 1,16,439 | 43,105 |

APPENDIX V

## COOPERATIVE CREDIT

Amounts in crores of Rupees

| Category of Institution | | Year 1960-61 | 1965-66 | 1970-71 |
|---|---|---|---|---|
| State Cooperative Banks | Number | 21 | 22 | 25 |
| | Deposits | 72 | 147 | 279 |
| | Other borrowings | 25 | 199 | 294 |
| | Loans & advances outstanding | 167 | 307 | 534 |
| | Overdues | 7 | 9 | 35 |
| Central Co-operative Banks | Number | 390 | 346 | 341 |
| | Deposits | 112 | 237 | 439 |
| | Other borrowings | 141 | 244 | 393 |
| | Advances (outstanding) | 220 | 438 | 813 |
| | Overdues | 27 | 87 | 274 |
| | ,, % of outstanding | 12.5 | 19.9 | 33.7 |
| Primary Agricultural Credit Societies | | | | |
| | Number | 212,129 | 191,904 | 160,780 |
| | Active | 171,124 | 168,224 | 140,546 |
| | Dormant | 41,005 | 23,680 | 20,234 |
| | Deposits | 15 | 34 | 69 |
| | Working Capital | 300 | 617 | 1,153 |
| | Loans outstanding | 218 | 427 | 784 |
| | Loans overdue | 44 | 125 | 322 |
| | % | 20.3 | 29.4 | 41.1 |

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—Eugene Black

311

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