

CONTENTS

- Introduction
- Monetary and Credit Policy
- Financing Governments
- Rural Credit
- Towards a State Banking Sector
- Banking Developments
- Financing Industry
- The External Sector
- The Bank and Governments
- Appendixes
- Selected Documents
- Index

This is the second volume of the history of the Reserve Bank of India, the first (covering the period 1935–1951) having been published in 1970. The book covers the larger part of the first two decades after independence, when pioneering steps were taken to strengthen, develop, and diversify the country's economic and financial structure. The Reserve Bank of India played a notable role in bringing about these changes. As it met with the challenges and demands of a developing economy, the Reserve Bank was itself transformed in a considerable measure. This volume narrates not only the history of an important public financial institution in India in the process of change, but also sheds light on the country's economic development during these crucial years.

— C. Rangarajan
Governor, 1992–97
Reserve Bank of India

BALACHANDRAN

THE
RESERVE
BANK
OF INDIA

1951–1967

THE RESERVE BANK OF INDIA 1951–1967

Jacket illustration: 'Prosperity through Development', mural by K.S. Salve on the ground floor of the Reserve Bank of India's Central Office building in Mumbai; ceramic tiles on a wooden base.

Rs 1195

ISBN 019564468-9



9 780195 644685



OXFORD

G. BALACHANDRAN

This is a comprehensive history of the Reserve Bank of India, the country's central bank and its most important financial institution. It is based on unrestricted access to the Bank's records. The volume spans the 1950s, when India embarked on planned economic development, and brings its account of the central bank's activities in the sphere of public policy up to the crisis years of the mid-1960s. Not only was the Reserve Bank an active agent and participant in the process of planned development, the institution was also greatly transformed by its demands and challenges.

Therefore, while surveying the Bank's discharge of its role as the monetary policy authority, *The Reserve Bank of India 1951–1967* details its role in mobilizing resources for central and state governments, regulating the banking system, and establishing an institutional infrastructure for agricultural and long-term industrial credit in India. It also covers developments in India's external sector, including the country's efforts to raise long-term foreign assistance for development and the rupee devaluation of 1966. The book concludes with an elaborate survey of evolving relations between the central bank and central and state governments in India during these two decades.

The depth and detail of this study, which is the first account from the inside, as it were, of the functioning of a major public institution in post-1947 India, makes it a pathbreaking book. It is essential reading for students, researchers, and teachers of economics and modern Indian history and bankers. The book, which revisits some new and old debates and controversies, will also appeal to a wider general readership.

G. Balachandran teaches at the Department of Economics, Delhi School of Economics. His other publications include *John Bullion's Empire: Britain's Gold Problem and India between the Wars* (London, 1996).

THE RESERVE BANK OF INDIA
1951-1967

Committee of Direction

CHAIRMAN

Dr C. Rangarajan

Shri R.N. Malhotra
(June–December 1990)

Shri S. Venkitaramanan
(1990–92)

MEMBERS

Shri M. Narasimham

Shri S. Venkitaramanan

Shri P.L. Tandon

Shri S.S. Tarapore

Dr Y.V. Reddy

CONSULTANTS

Dr G. Balachandran

Dr C.J. Batliwalla

MEMBER-SECRETARY

Shri U.K. Sarma
(1990–1994)

Shri S.N. Dalal
(1994–1996)

History Cell

A.L. Verma
(Adviser-in-Charge)

N. Gopalaswamy M.Y. Khan P.M. Bhatia

M. Joseph A.A. Chougale C.N. Vazirani

M.I. Koshy K. Balasubramanian Amena Lakkadghat S.A. Joseph

Lobha Haldankar R.K. More H.R. Amberkar

Nirmala Joshi Sandhya Gajare

A.T. Bhawe D.A. Rane

THE RESERVE BANK OF INDIA

1951–1967

G. Balachandran
Delhi School of Economics



RESERVE BANK OF INDIA

DELHI
OXFORD UNIVERSITY PRESS
CALCUTTA CHENNAI MUMBAI
1998

Oxford University Press, Great Clarendon Street, Oxford OX2 6DP

*Oxford New York
Athens Auckland Bangkok Calcutta
Cape Town Chennai Dar es Salaam Delhi
Florence Hong Kong Istanbul Karachi
Kuala Lumpur Madrid Melbourne Mexico City
Mumbai Nairobi Paris Singapore
Taipei Tokyo Toronto
and associates in
Berlin Ibadan*

© *The Reserve Bank of India 1998*

*Reserve Bank of India
Central Office
Mumbai 400 001
India*

ISBN 0 19 564468 9

*Library of Congress Catalog Card Number
98-900105*

*Typeset and printed in India at Tata Donnelley Limited,
and published for the Reserve Bank of India
by Manzar Khan, Oxford University Press
YMCA Library Building, Jai Singh Road, New Delhi 110 001*

FOREWORD

It gives me great pleasure to present *The Reserve Bank of India, 1951–1967* in the fiftieth year of our independence. This is the second volume of the history of the Reserve Bank of India, the first (covering the period 1935–1951) having been published in 1970. The book covers the larger part of the first two decades after independence, when pioneering steps were taken to strengthen, develop, and diversify the country's economic and financial structure. The Reserve Bank of India played a notable role in bringing about these changes. As it met with the challenges and demands of a developing economy, the Reserve Bank was itself transformed in a considerable measure. This volume narrates not only the history of an important public institution in the process of change, but also sheds light on the country's economic development during these crucial years. I hope it will be read as an important contribution to the history of central banking in general, and in the developing countries in particular.

The history of a public institution serves one important function which is not always apparent. A history based on official documents and making the latter available to the interested public, together constitute an important exercise in public accountability. Despite its retrospective aspect, this form of accountability is not without its contemporaneous impact upon the institution's 'present'.

The focus of this book is on the Reserve Bank and public policy. In addition, as an institution, the Bank grew in size and complexity, and the changes in its organization and management are important subjects deserving to be analysed in their own right. It is therefore proposed to cover the Bank's organizational history over a longer-term perspective, in the next volume of the Reserve Bank's history.

In writing this book, Dr Balachandran has been guided by the Committee of Direction which was set up as soon as the decision to write the present volume was taken. The membership of the Committee has remained more or less unchanged since its beginning, except that Shri R.N. Malhotra ceased to be part of the Committee after he relinquished office as Governor.

Shri U.K. Sarma served for over four years as Officer on Special Duty, and undertook the patient job of unearthing the basic information and putting it together to provide the base for further construction. Dr Balachandran was entrusted with the writing of the history in 1995. The present volume is essentially his work. The Committee of Direction discussed from time to time the chapters written by him and offered advice on the details as well as the approach to various issues. I gratefully acknowledge the time and effort put in by the members of the Committee of Direction. It needs, however, to be pointed out that Dr Balachandran had full freedom to express his views in the book, even when members were not in agreement with them. The Committee of Direction was always of the view that a historical narrative cannot simply be a catalogue of events, and that since interpretation is the essence of any history, this book would necessarily have to bear the stamp of its author. In placing on record our deep appreciation of the work done by Dr Balachandran, the Committee wishes to make it very clear that the interpretation and selection of events and issues are entirely his responsibility.

I am sure this book will be read with profit by all those interested in the economic development of modern India.

C. RANGARAJAN

Chairman

Committee of Direction

October 1997

PREFACE

This is a history of the Reserve Bank of India covering the years 1951–67. It is based on the records of the Reserve Bank, and where necessary and available, some other public records. The focus of the book is on the Bank's engagement with public policy. It steers clear of issues of organization and management. While a short chapter on these subjects would have done insufficient justice to their importance, a longer and more detailed study would have made for an unmanageably large volume.

It is useful at the outset to say what this book is not. It is not an economic or financial history of India. Nor does it provide a comprehensive account of Indian economic or financial policies and their formulation. The Reserve Bank of India was, and remains, India's pre-eminent public financial institution entrusted with responsibility for monetary policy. It also discharged a wider range of public responsibilities than almost any other central bank. This history of the Reserve Bank may therefore yield insights into many more issues of public policy than the history of other central banks. But the Reserve Bank did not have a monopoly of policy-making. As such, while this book is an important input into a comprehensive account, so far unwritten, of Indian economic policies during the 1950s and 1960s, it is not such an account.

Yet *The Reserve Bank of India, 1951–1967* is in many ways a pioneering book, and it is a privilege to be associated with it. It is the first account from the inside, as it were, of the functioning of a major public institution in post-independent India. Debates over India's post-1947 economic and social policies have not receded with time. Unfortunately, neither have they benefited from a hindsight enhanced by access to official documents such as other democratic countries normally place in the public domain after a suitable interval. The present work will not fill this void in our knowledge of our own recent past, but I will be satisfied if it helps to highlight and lessen it.

A notable feature of this volume is the publication, for the first time, of a selection of the Bank's documents. These have not been abridged in any way, even though doing so would have enabled some more documents to be reproduced. The documents are arranged largely in the same order as the

chapters themselves, and most of them are referred to, quoted, or discussed at length in the narrative. Consequently, they are not annotated.

It is possible to approach the history of a central bank's public policies from several directions. Historians of economic thought, for example, would be most interested in the evolving intellectual and theoretical basis of the institution's monetary practice. Those wishing to marry the Muse of history to the metrics of quantitative analysis might like to focus on assessing, as precisely as their models allow, the impact of the central bank's policies on the latter's target (and non-target) variables. The political basis of policy would probably most engage the attention of students of politics and political economy. In addition, one may adopt a parachutist's perspective by placing the Bank against the widest possible background, while the truffle-hunters amongst us may like to do the opposite. Merely to catalogue these possibilities, which are not exhausted by this list, is to highlight the many stools amidst which this book must inevitably fall. I should hope, however, that readers will find worthwhile, the sacrifice of the elevation offered by these stools for the relative solidity of terra firma.

I am often asked whether a history of a public institution which is based on privileged access to its documents can be 'objective'. This question admits of two interpretations. To address its more commonplace meaning first, I can unhesitatingly state that I had unrestricted access to the Bank's documents and complete freedom to read and interpret them, and write this history. This will be obvious to anyone reading the book.

In a broader and more academic sense, this history is as 'objective' as any history can be, in that every statement and view expressed in it is supported by the documentation. But equally, it is important to beware of the illusion that a history is something that exists outside of us and merely awaiting capture between cloth covers. Histories are constructs—patterns we draw to make sense of our own past. This past is merely latent in the historical materials, and emerges through our engagement with them. The historian unavoidably brings a variety of intellectual and other dispositions and preoccupations to this engagement, including some which are unambiguously of the present. Sometimes, a history may be as much a chronicle of the times in which it is written as of the times of which it writes. Such histories are no less 'legitimate' or 'objective'. However, where this history of the Reserve Bank is concerned, I am confident that while not shying away from stances in the present, it carefully documents and assesses policies (including some which were merely debated and not adopted), their rationale, and their

successes and failures against the background of the concerns, preoccupations, and motivations and attitudes of the period with which it deals. Yet it remains true that no two histories by different historians of a public institution based even on its own documents will be similar, and that another historian might have written a different account of the Reserve Bank.

The periodization adopted here needs little explanation. The starting point was given by the terminal date of the last volume. The year 1967 marked an important watershed in India's economic development due to the crises of the mid-1960s and the policy responses to them. However, readers should note that one consequence of drawing a line at 1967 is that many policy and other initiatives the Bank undertook earlier did not mature until the 1970s, so that a detailed account or assessment of them would have to await the publication of the next volume of the Bank's history.

This project got under way about eight years ago, while in its present form, this book has been three years in the making. During these three years, I have accumulated an enormous burden of debt to many individuals within the Reserve Bank and outside. Foremost among them is the then Governor, Dr C. Rangarajan, who invited me to write this book and who thereafter supported this project in every possible way. But for his keen interest, initiative, and counsel, this project would not have come to fruition in the present form. Few individuals could have devoted so much time and attention to a history of the past in the midst of making it in the present. Mr M. Narasimham, Mr S. Venkitaramanan, Mr P.L. Tandon, Mr S.S. Tarapore, and Dr Y.V. Reddy were members of the Committee of Direction which was set up by the Reserve Bank in 1990 when the project was initiated. I would like to thank them for their courtesy in reacting promptly to the typescript, for readily sharing with me their knowledge of the period and its events, and despite disagreements, for not seeking to interfere with my judgement or evaluation of them in any way. I also had the good fortune in other ways as well, of being able to rely upon the counsel and experience of successive Deputy Governors, and the Executive Director, Dr A. Vasudevan. Dr I.G. Patel, Mr Manu Shroff, Dr V.V. Bhatt, and Mr S.S. Thakur discussed developments in the external sector with Dr C.J. Batliwalla, while I am indebted to Mr V.G. Pendharkar for discussing with me and Dr Batliwalla over several meetings, a wide range of issues bearing on the history of the Reserve Bank.

Material at the Bank of England, the Federal Reserve Bank of New York, and the World Bank and the International Monetary Fund have been used in writing this book. On Dr Batliwalla's behalf and my own, I should thank

Mr Henry Gillet and his staff in London, Ms Rosemary Lazenby in New York, and the Indian Executive Directors and their staff at the World Bank and the International Monetary Fund in Washington. The photographs used here are published with the permission of the *Times of India* and the Press Information Bureau, while the cartoons are from the *Times of India* and *Shankar's Weekly*.

This book would not have been possible without the unstinting efforts and cooperation of the History Cell of the Reserve Bank of India, whose dedicated staff, both past and present, had already located the bulk of the documentation when I arrived on the scene. Some of them had departed the History Cell earlier, but my appreciation of the efforts of Mr U.K. Sarma, who did the initial spadework for the project, and Dr N.A. Mujumdar, who researched the material on monetary policy, is no less sincere for that reason. So too my appreciation of the efforts put in by Mr A.G. Athavale (government finances), Mr P.G. Krishnamoorthy (banking), and Mr P.T. Kurien (deposit insurance).

Once the chapters were written, the staff of the History Cell undertook the elaborate and painstaking exercise of verifying the details and the data, made important suggestions for revisions, and checked the proofs. As officers in charge of the Cell, Mr S.N. Dalal and later Mr A.L. Verma provided excellent support and cooperation, and helped overcome the many obstacles to which a project such as this is prone. I thank them warmly. Apart from assisting with the research and writing of the introduction, the chapters on monetary policy, government finances, and Bank-government relations, and some appendixes, Dr N. Gopalaswamy played an invaluable role in coordinating the efforts of the other staff of the History Cell and in seeing the typescript through press. His commitment to the project was unflagging, while his cheerful willingness to undertake a variety of responsibilities was complemented by his efficiency in discharging them. There is not a single page of this book to which Dr Gopalaswamy has not contributed in some way, and he fully deserves to share in the credit for the final product.

Dr C.J. Batliwalla is justly the co-author of the chapters and the appendixes on the external sector. The parts of the book with which she has been directly associated bear the imprint of her painstaking research and study, while all who know her will vouch for her commitment, hard work, and unfailing good humour. She was ably assisted in her task, first by Mr G.J. Jog and then by Mr M. Joseph, from whose eye for detail and sense of writing style, many other parts of this volume have also benefited.

Mr M. Devarajan initially collated the basic material, and later checked the chapters on rural credit, and Mr T.J. D'Mello those on industrial finance. Mr E.T. Rajendran's ready and cheerful assistance was as valuable as his

extensive knowledge was a source of great comfort and assurance in the four chapters on banking and some other related parts of the book. Besides taking over responsibility for the industrial finance chapters, Mr P.M. Bhatia helped develop the index for this volume. To him also should go a share of the credit for the jacket of the book.

Mr S.A. Joseph was instrumental in painstakingly putting together the selection of documents at the end of the book. This task was greatly complicated by a variety of factors, and he deserves to be complimented for fulfilling it with great tenacity. Dr M.Y. Khan made useful suggestions. Mr A.A. Chougale, Mr C.N. Vazirani, Mr K. Balasubramanian, and Mrs A.S. Lakkadghat helped in ways too numerous to mention. Mr M.I. Koshy was always reliable, and his initiative and positive and cheerful approach often helped overcome difficult problems. Mr H.R. Amberkar, Mrs N.V. Joshi, and Mrs S.H. Gajare shouldered typing duties willingly, and a special word of appreciation is due to Mrs Joshi for putting aside many personal problems to word-process the documents and other material with her customary care and accuracy. Mrs L.S. Haldankar not only discharged her own administrative duties with great efficiency and warmth, but also the additional responsibilities she willingly undertook. I am indebted to Mr R.K. More for his hard work and sincerity. It is a pleasure to appreciate the services of Mr A.T. Bhawe who discharged all his responsibilities promptly and with dedication, and of Mr D.A. Rane who always offered cheerful help and cooperation.

I should also take this opportunity to thank the Library of the Bank's Department of Economic Analysis and Policy, and the Central Records and Documentation Centre, Pune for their excellent support and cooperation. And a special word of thanks to Mr S.K. Venkitachalam at the Central Office.

It is a privilege to have been associated with the staff of the History Cell in this collective endeavour and a pleasure to acknowledge the kindness, consideration, and support which I have received from everyone at the Reserve Bank.

There are many whom I have to thank outside the Reserve Bank. First and foremost, Mr Samuel Israel for copy-editing, designing the page layouts, other editorial consultancy, proof-reading, and finalizing the index. Mrs Sarah Israel and Ms Rivka Israel transformed the production of this book into a friendly and collaborative family effort as they brought to it a care and diligence which were matched only by their warmth and unfussy generosity. I owe a special word of thanks to Ms Soniya Khare. At the Oxford University Press, Ms Nitasha Devasar offered helpful advice and opened doors, behind which Mr Thomas Abraham, Mr Subhasis Ganguli, and Mr S.A.A. Zaidi helped in various ways. Ms Sumita Arora designed the jacket. It is a pleasure to thank the friendly staff at Tata Donnelley, notably Mr Joe Rego who brought, besides vast expertise, a rare

sense of enjoyment of his work to bear on the production of this book, for their splendid support.

My grateful thanks to Dharma for initiating me into this history. The Delhi end of the project was based at the Centre for Development Economics, Delhi School of Economics. Without the enabling environment created by the CDE, this book would have taken much longer to write. I thank the office-bearers of the CDE, especially my colleagues T.C.A. Anant and V.N. Pandit, for all their help, and the staff, notably Jai and Narender, for their cheerful support. I am also grateful to Anant and Aditya Bhattacharjea for reading and commenting on parts of this book, and to Ashwini Deshpande for sharing my teaching during the final stages of the writing.

Researching and writing this book has involved prolonged periods of absence from home. I can never adequately express my gratitude or appreciation to Molly for having made this book, and other things, possible. Nor to my parents and Molly's for all their help. Piroune is too young for any of this to mean much to him, but it is a consolation that he will read this book, if at all, only after he has long forgotten my frequent absences from home.

The courteous staff at the Reserve Bank's Visiting Officers' Flats at Nepean Sea Road provided me a home during my visits to Mumbai, and I thank them, in particular the caretaker Mr M.H.K. Jugari, for their extraordinary warmth and hospitality. And last but not least, Umesh Chavan for his reassuring presence and cheerful assistance at all times.

I made and renewed several friendships in the course of this project. These friendships kept me company during the many months of toil, when deadlines were missed, changed, and missed again, and the end of the tunnel appeared only dimly in sight. These friendships and their warmth and generosity will abide long after the memories of the labours through which they endured and grew have abated.

G. BALACHANDRAN

December 1997
Delhi

CONTENTS

List of Tables	xvii
List of Illustrations	xviii
1. <i>Introduction</i>	1
MONETARY AND CREDIT POLICY	9
2. <i>Deficit Financing and the Environment for Monetary Policy</i>	12
Deficit Financing and the Bank	13
Deficit Financing and Monetary Control	27
3. <i>Monetary Policy, 1951–61</i>	50
The First Plan, 1951–56	51
The Second Plan, 1956–61	64
4. <i>The Difficult Years, 1961–67</i>	87
Credit Policy, 1961–64	89
The New Credit Policy	94
Monetary Policy, 1965–67	102
Preferred Sectors and Moral Suasion	112
Towards Regulating Interest Rates	114
Conclusion	125
FINANCING GOVERNMENTS	133
5. <i>Managing the Centre's Finances</i>	135
Preparing a Loan Issue	136
Central Government Loan Operations	139
Treasury Bill Operations	167
Ad hoc Treasury Bills	173
Public Borrowing: An Overview	178

6. <i>Banking for State Governments</i>	184
The Bank and Federal Financial Integration	185
Ways and Means Advances and State Governments' Overdrafts	192
Market Borrowings by State Governments	205
RURAL CREDIT	229
7. <i>Charting New Vistas</i>	231
The All-India Rural Credit Survey	233
Medium-term Lending for Agriculture	251
Reorganizing Land Mortgage Banking	254
8. <i>The Bank and Cooperative Credit</i>	264
Reorganizing the Cooperative Financing Structure	264
Primary Societies	272
The Bank and the Green Revolution	302
Rethinking Cooperation	306
Conclusion	310
TOWARDS A STATE BANKING SECTOR	317
9. <i>From Imperial Bank to State Bank</i>	318
The Imperial Bank after Independence	319
Creating the State Bank of India	334
State Bank of India: The Early Years	347
10. <i>Subsidiaries of the State Bank</i>	355
Regulating the State Banks	356
Realigning Major State-associated Banks	359
Rural Credit Survey and its Aftermath	364
State-associated Banks in Reorganized States	372
The Ad hoc Committee's Proposals	381
Voluntary Takeover of State-associated Banks	387
Some Subsidiary Issues	392
Epilogue	395
BANKING DEVELOPMENTS	397
11. <i>Regulating Banks and Deposit Institutions</i>	400
Inspecting Banks	401

Evolving Capital Adequacy Norms	405	
Improving Banks' Liquidity	416	
Management and Control of Commercial Banks		423
Regulating Cooperative Banks	433	
Regulating Non-bank Deposit Institutions	441	
12. <i>Crisis, Consolidation, and Growth, 1951–67</i>		453
Controversies over the Banking Situation		
in West Bengal	455	
Licensing Banking Companies in the 1950s	466	
The Banking Crisis in Kerala and Aftermath	470	
Banking Consolidation in the 1960s	483	
Branch Licensing Dilemmas	486	
Introduction of Deposit Insurance	490	
Trends in Indian Banking, 1951–67: An Overview	505	
FINANCING INDUSTRY		513
13. <i>Building an Institutional Infrastructure</i>		515
The Committee on Finance for the Private Sector	515	
The Refinance Corporation for Industry	523	
The Industrial Development Bank of India	531	
The Unit Trust of India	540	
14. <i>Financing Small Industries and Exports</i>		553
The Bank and State Financial Corporations	553	
The Bank and Small Industries	565	
Financing Exports	579	
THE EXTERNAL SECTOR		591
15. <i>The Problems of Plenty, 1947–56</i>		593
Sterling Balances: Framing the Issues	595	
The Six-year Agreement	605	
Washington Balances and Reserve Diversification	608	
The Rupee in a Convertible World	613	
Sterling Convertibility and After	621	
The Bank's Role	623	
16. <i>Dealing with Scarcity, 1957–63</i>		625
The Crisis of 1956–58	626	

The Search for Funds	629	
Foreign Aid for the Third Plan	644	
17. <i>Crisis and Devaluation, 1963–67</i>		657
Reappraising Assistance to India	658	
Scraping the Bottom of the Barrel, 1965–66	666	
Devaluation	672	
Conclusion	692	
18. THE BANK AND GOVERNMENTS		695
APPENDIXES		745
A. Currency: Changes and Challenges		746
B. P.L.480 Arrangements		760
C. The Palai Central Bank		767
D. The Bank and the Mundhra Affair		794
E. Administering Exchange Controls		808
F. Quota Increases at the Fund		836
G. Bilateral Rupee Payment Agreements		845
SELECTED DOCUMENTS		857
Index		1176

TABLES

1. Changes in Money Supply, Wholesale Prices, and National Income, 1951–67	128
2. Components of Money Supply, 1951–67	129
3. Reserve Bank's Advances to Banks against Government and Other Trustee Securities	130
4. Seasonal Variations in Bank Credit, 1951–67	131
5. Absorption of Government Securities	180
6. Ownership of Central and State Government Securities	181
7. Open-market Operations	181
8. Maturity Distribution of Central and State Loans	182
9. Growth of Ad hoc Treasury Bills	182
10. Treasury Bills Outstanding	183
11. Progress of Cooperative Banks	312
12. Progress of Cooperative Land Mortgage Banks	314
13. Progress of Banking	510
14. Foreign Exchange Reserves	693

ILLUSTRATIONS

1. Benegal Rama Rau, Governor, 1949–57	52
2. H.V.R. Iengar, Governor, 1957–62	68
3. P.C. Bhattacharyya, Governor, 1962–67	95
4. Meeting on credit policy, 1967	112
5. N. Sundaresan, Deputy Governor, 1950–54	139
6. Inauguration of National Plan Loan, 1964	145
7. K.G. Ambegaokar, Deputy Governor, 1955–60	149
8. Inauguration of Premium Prize Bonds, 1963	161
9. Inaugural meeting of first Finance Commission, 1951	195
10. T.T. Krishnamachari with state finance ministers, 1957	220
11. Dharwar farmers cashing loan cheques at the central cooperative bank	270
12. B. Venkatappiah, Deputy Governor, 1955–62	291
13. B.K. Madan, Deputy Governor, 1964–67	415
14. Morarji Desai meeting bankers, 1961	420
15. Inauguration of Bankers Training College	424
16. Bhattacharyya talking to bankers, 1966	432
17. Sixth annual conference of SFCs, 1959	563
18. Five-rupee note issued in 1950	748
19. Ten-rupee note issued in 1950	749
20. Failure of Palai Central Bank, 1960	788
21. Interviewing applicants for foreign exchange, 1958	820
22. Iengar with Per Jacobsson, Delhi, 1958	838

Other illustrations on pages 15, 23, 53, 92, 144, 218, 222, 471, 472, 548, 610, 634, 640, 643, 648, 686, 687, 716, 762, 817, 819, 853.

Introduction

Under its Act, the Reserve Bank of India is entrusted with the responsibility for 'securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'. The wide range of responsibilities it felt moved to discharge during the 1950s and 1960s might appear at first glance to confound the laconic prose of the Bank's founding legislation, if not dilute its principal mandate. Monetary policy was the Reserve Bank's most important function, but it was one which it had to perform in a setting radically different from that found in traditional textbooks on the subject.

This difference was constituted principally by the insufficient depth and the underdeveloped nature of the Indian financial system. Central bank practices and conventions were widely premised in the 1950s upon the existence of a well organized financial sector characterized by articulate markets and institutions. Not to speak of institutions of the money market, even the country's commercial banking system was poorly evolved and thinly spread at the start of our period. There were 566 commercial banks in India in 1951 with 4,151 branches, the overwhelming majority of which were confined to the larger towns and cities. Each office of a scheduled commercial bank served, on an average, a population of 1,36,000.¹ Savings accounted for nearly a tenth of the national income. But if one may make a stock-flow comparison in passing, savings held in the form of bank deposits amounted to a little under 9 per cent

¹ Scheduled banks are banks listed in the second schedule of the Reserve Bank of India Act.

of the national income. They also made up only 12 per cent of the estimated gross savings of the household sector. Two-fifths of bank credit were accounted for by trade, and only about a third by industry. Agriculture received a minuscule proportion of the credit disbursed by banks.

The poor development of the banking system reflected and reinforced the more general lack of depth in the country's financial system. Assets of financial institutions amounted only to about a third of India's national income in 1950. Nearly half these assets were owned by the Reserve Bank. Organized credit institutions were, besides, a negligible presence in rural India. According to the Report of the All-India Rural Credit Survey commissioned by the Reserve Bank in 1951 and carried out over the next two years, only about 3 per cent each of the total amount borrowed by cultivators in 1951–52 came from the government and cooperatives, and less than one per cent from commercial banks. Moneylenders accounted for 70 per cent of the total, and traders for about 6 per cent. The Committee on Finance for the Private Sector (which too was appointed by the Bank in 1953 and was known popularly as the Shroff Committee) mentioned in its Report that indigenous bankers were estimated to finance 75 to 90 per cent of the total internal trade of the country. Based on such estimates, it has been calculated that indigenous bankers and rural moneylenders perhaps accounted for nearly a third of the assets of financial institutions in 1951.² If the estimate is right, the former's assets exceeded those of the commercial banking system in 1950–51.

The Bank's ability to regulate even commercial bank credit or the wider aspects of these institutions' activities was limited in the early 1950s. The Bank's lending rate was lowered from 3.5 to 3 per cent in November 1935, and unmoved by the cataclysmic changes taking place meanwhile, there it remained for the next sixteen years. This rate, besides, was largely inoperative. The Imperial Bank of India had functioned as a quasi-central bank until the Reserve Bank was founded. Even afterwards, it continued to make large advances to commercial banks, and its call rate for advances of Rs 5 lakhs or more against government securities remained below the Reserve Bank's lending rate until 1950.

India being largely an agrarian economy, the demand for bank credit was subject to strong seasonal influences. These influences weakened, but did not entirely disappear by 1967. The busy season, which ran from about October to April each year, was usually characterized by a surge in the demand for credit. An important justification for establishing central banks in many

² R.W. Goldsmith, *The Financial Development of India, 1860–1977* (Delhi, 1983), p. 190.

developing countries including India was that they could help finance seasonal trade and relieve credit stringency during the busy season. But with commercial banks facing an abundance of liquid resources, the Reserve Bank's role in making seasonal advances to them remained limited until 1946. Until November 1951, the Bank helped reinforce commercial banks' liquid resources principally by taking over their holdings of government paper.

Nor did the Reserve Bank have much power, until the promulgation of two ordinances in the late 1940s and the passage of the Banking Companies Act in 1949, to regulate the functioning of the banking system. It was powerless to check the post-war banking crisis which saw such well-known names as the Nath Bank and the Exchange Bank of India and Africa bite the dust. Inevitably, the Bank could not immediately begin to exercise the powers entrusted to it by the 1949 legislation so that, where the banking sector is also concerned, the beginning of the period covered by this volume represents a significant turning point in its history.

In other formal and substantive respects, however, the Reserve Bank of India had grown by 1950 into a recognizable central bank. It held the monopoly of the note issue and the reserves of scheduled banks, acted as the banker to the central government and to the governments of Part A states, managed their public debt, and held and managed the country's external reserves. Thus, to paraphrase the concluding lines of the earlier volume of the Bank's history, the first decade and a half of the Reserve Bank's existence saw the foundations being laid of central banking in India. 'Perhaps a few floors [were] also built.' But it was not until the 1950s and 1960s that the edifice of central banking in India began to assume formidable proportions.

II

Four pillars of this edifice may be distinguished throughout the 1950s and 1960s. Monetary policy was the first. It was unveiled in November 1951 when the Reserve Bank abandoned its historic 3 per cent lending rate and along with it, the earlier policy of cheap money. Thereafter, particularly from the mid-fifties, the Bank followed an active monetary policy which, while anticipating or reacting to short-term pressures, had also to be sensitive to the needs of the planning process. Regulating commercial banks and promoting their orderly development was the second pillar. The timing and context of its erection were determined by the banking crisis, which was still abating slowly in 1951, and the powers newly entrusted to the Reserve Bank to oversee and strengthen India's weak and unwieldy banking system.

The Reserve Bank's vigorous involvement in promoting the

institutionalization of credit to agriculture and industry provided the other two pillars of the central banking edifice which came up during the next two decades. The foundation for the third pillar, which was laid even in 1934 when the Bank Act was passed, was greatly strengthened nearly two decades later when the Reserve Bank set up the All-India Rural Credit Survey as part of its determined initiative to come to grips with the challenge of promoting agricultural credit institutions. The survey was a follow-up to the Rural Banking Enquiry Committee, and its recommendations were intended to serve as the blueprint for expanding institutional lending agencies into rural India.

In course of time, the Report of the Rural Credit Survey became the Bank's gospel in the sphere of rural credit. The Reserve Bank was required by its statute to promote agricultural credit, but its discharge of these responsibilities was marked by a certain diffidence until the late 1940s. Thereafter, especially with the expansion of the State Bank of India formed in 1955 by taking over the Imperial Bank, and the growth and spread of the cooperative movement, the Bank became steadily more involved in developing the cooperative credit system and meeting its financial requirements.

Despite its impressive expansion in quantitative terms, the cooperative credit system did not, in the end, live up to the expectations of its principal promoter and all-India financier. The Bank's approach towards cooperative credit aroused intense controversies lasting several years, while their resolution did little to overcome the setbacks caused to the overall health of the movement by a prolonged period of indecision and uncertainty.

In 1954, the Shroff Committee recommended a more active role for the central bank in promoting the availability of finance for industry. Officials at Mint Road were not entirely free from doubt about the course on which they were embarked. Still, for the most part, the Bank stuck with impressive resolve to its developmental responsibilities, which it adapted and expanded in the 1960s to set up institutions capable of mobilizing and channelizing longer-term funds into industry. The Bank's promotional activities also deepened, and its efforts to institutionalize credit were soon complemented by those to institutionalize savings in the economy. So much so, by the mid-sixties, its wider initiatives came to be regarded as representing the 'institutional dimension' of monetary policy in India. Nearly everywhere, the edifice of central banking rested on the first two pillars. The third and fourth pillars, which might appear as mere scaffolds in retrospect, were at first unique to the Reserve Bank, and marked a novel departure for a central banking institution. Therefore, it is instructive to preface the history of the Reserve Bank during our years with a brief survey of the architecture of which these pillars formed a part.

The first five-year plan document underlined the importance of a 'network of credit institutions' to encourage and mobilize 'larger savings from current income' which were otherwise merely hoarded, particularly in the rural areas, and deploy them to meet the 'large credit needs of agriculture and industry, especially ... cottage and small-scale' The central bank, which the plan document emphasized, commanded a high 'moral prestige',

would have to take on a direct and active role ... in creating ... the machinery needed for financing developmental activities all over the country and ... in ensuring that ... finance ... flows in the directions intended.

Almost at the same time as these lines were written, the Reserve Bank of India set up the Rural Credit Survey. The recommendations of the Rural Credit Survey are summarized in chapter 7. We may merely note here that as well as urging the flow of institutional credit for agriculture, the Rural Credit Survey's General Report recognized the 'need to make rural savings *possible*', rather than merely making them '*available*' (p. 487; emphases in the original). The former depended not only on the growth of incomes and promoting the habit of thrift—the latter in any case the Indian people had in abundance—but on the existence of agencies, whether 'cooperative or other', '[inspiring] confidence and [evoking] local interest'. The Report's recommendations relating to the nationalization of the Imperial Bank of India and the banks associated with the former princely states, and the development of cooperative credit institutions, were motivated, therefore, not merely by the need to make credit available for agriculture, but to encourage and mobilize savings in the country's rural areas. The takeover of these banks would, moreover, assist the integration of India's financial system.

Apart from helping to channelize credit to such hitherto neglected sectors as agriculture and small industry, the Bank's object of promoting and mobilizing savings by 'institutionalizing' it, held direct implications for the second pillar of the Bank's edifice. Financial deepening and widening connoted and depended upon the availability of a range of assets combining 'safety, liquidity, and yield'. The banking system was potentially the most popular repository of the savings of the household sector, and it was therefore vital to reinforce its foundations. The Shroff Committee underlined the objective of channelizing household savings directly into the assets and intermediaries of the capital market, and the Bank recognized this objective in the 1960s by promoting institutions such as the Unit Trust of India.

Thus from the early 1950s, the Reserve Bank began moving towards the vision outlined in the first plan document. But it did not itself

articulate such a vision until the middle of the next decade. In 1966, the Governor, P.C. Bhattacharyya, argued that a 'fundamental task of monetary policy' was to create an appropriate 'institutional framework'. By this he meant the

conditions for the effective mobilization of the supply of actual and potential savings through the promotion of financial intermediaries and the creation of a spectrum of financial assets on the one hand and on the other the effective investment of these resources through the adaptation of the credit structure to subserve the needs of development.

Despite the difference in phraseology, it is easy to discern this statement's evocation of the first plan document's views on the necessity for a developmentalist framework for monetary policy.

Pillar or scaffolding, the latter features of the central banking edifice in India were also intimately connected with the first. The 'institutionalization of savings' complemented the 'institutionalization of credit', and was judged to be inseparable from monetary policy for at least three reasons. First, by providing effective channels for transmitting their impulses, a well developed financial system would greatly assist the Bank in implementing its general and selective credit policies. Second, to the extent the growth of savings and the ability of banks to mobilize them increased, the latter's dependence upon the Reserve Bank for accommodation would be reduced. Although rights of access to its accommodation became the principal instrument of the Bank's monetary policy in the 1960s, this was more an admission of weakness than of strength. Once the banking system was better able to meet the expanding demand for credit from its own resources, other more traditional instruments of monetary policy could be expected to come fully into play. Finally, the mobilization of savings by institutional agencies would lead to a better match between the demand for investible funds in the economy and their supply. The government's demand for resources was generally greater after the mid-1950s than the ability of financial institutions other than the Reserve Bank to meet. Larger savings and their mobilization by the government, either directly or through the banking system, would contribute to moderating deficit financing, and enhance the effectiveness of the Bank's monetary policies.³ Besides, they would better help reconcile or meet competing demands for credit.

³ In this book, deficit financing is defined narrowly as the change in the government's indebtedness to the Reserve Bank of India.

III

To further extend the metaphor used earlier, *The Reserve Bank of India, 1951–67* offers readers a detailed account of the edifice of central banking in India as it came up during these years. It is based, with some important exceptions, on the documents and papers of the Reserve Bank of India. The attitudes, policies, and events narrated here were set within a wider social, political, intellectual, and economic context which is no doubt important to their understanding. However, the book is *not* an economic history of the India of its time. Nor, is it about social, political, or intellectual history, though some of their echoes may be faintly distinguished, and the last chapter attempts explicitly to draw together the political, ideological, intellectual, and institutional influences on the Reserve Bank's perspectives, attitudes, and development. For the most part, therefore, *Reserve Bank of India* assumes the reader's familiarity with the major features of the history of the 1950s and 1960s, and does not generally dwell upon them except where it might be necessary to do so to make more intelligible the institutional history of the central bank which is told in its pages. To attempt anything else would have made the book even longer than it is now. Besides, to be meaningful, such an effort would have required access to complementary material in government departments and elsewhere. However, wherever available and judged necessary, material from other archives has been used to fill gaps in our story. This is particularly true of the chapters on the external sector (chapters 15–17), where it is necessary in the interests of coherence, to place the Bank's rather limited and indirect involvement in the actual policy-making process against the background of India's financial diplomacy during these years and the formulation of its external economic policies, in particular the rupee's controversial devaluation in 1966. Given that so little has been published about India's economic and political development in the last fifty years which is based on official documents, it is hoped that even as an institutional history, *Reserve Bank of India* will shed important light on the wider contexts and circumstances in which the events and policies it describes are set.

The first part of the volume opens with a discussion of the environment for the Bank's monetary policies during the 1950s and 1960s, and its efforts to come to terms with the challenges posed by deficit financing and the need to promote the plan effort. The Bank deployed some instruments from its existing armoury of monetary policies and acquired a few new ones, and chapters 3 and 4 provide a largely chronological account of the Bank's monetary policies during the first three plan periods, and its use of these instruments to resolve the conflicting objectives and influences to which its policies were subject.

The next part has two chapters devoted to a discussion of the Reserve Bank's role in helping to meet the financial needs of the central and state governments. Beginning with constitutional provisions and historical precedents, it surveys, once again largely in a chronological manner, the Bank's management of their public borrowing and debt. The Reserve Bank advanced substantial amounts to the central government against ad hoc treasury bills and to state governments as ways and means advances and overdrafts. The latter, in particular, became a serious problem in the mid-sixties, and the Bank's efforts to moderate deficit financing by the centre and the expenditures of state governments are also discussed in these chapters.

Then follow four chapters in two parts, dealing essentially with the follow-up to the Report of the All-India Rural Credit Survey. Opening with a summary of the principal conclusions of the Rural Credit Survey, these chapters go on to examine the Bank's efforts to implement its proposals for developing cooperative credit institutions, and for taking over and transforming the Imperial Bank of India and the banks associated with the former princely states to serve as instruments of national policy. A few major recommendations of the Rural Credit Survey soon became controversial, and these chapters also outline the Reserve Bank's response to these controversies.

Chapters 11 and 12 deal with banking developments. The former presents an account principally of the regulation of banks, while the latter chapter deals with efforts to strengthen and consolidate the banking system which was in a state of crisis in some regions of the country for several years after the war, and which was again buffeted by crisis in 1960. The 1960 crisis was caused by the collapse of the Palai Central Bank, the story of whose handling by the Reserve Bank is narrated in an appendix to this volume. The next part, comprising chapters 13 and 14, discusses the Bank's efforts to promote and diversify the sources of credit for industry. These two chapters are followed by three chapters (15–17) on developments in the external sector of the Indian economy and the Reserve Bank's role therein.

In recent years, relations between central banks and governments have become a topic of intense debate the world over. The concluding chapter of the book surveys the evolution of these relations in the Indian context, which in important political and constitutional respects too, is unique for any central bank, in the background of the wide diversity of its responsibilities and the intellectual and institutional influences to which it was subject. This chapter discusses the effects which these features of the Reserve Bank's context and functioning may have had on the freedom and effectiveness of its monetary policies, and closes with a brief assessment of its successes and failures during our period.

MONETARY AND CREDIT POLICY

Monetary policy is, by common agreement, the defining function of a central bank. Uniquely for a central bank, the Reserve Bank of India undertook a variety of developmental initiatives in independent India, though monetary policy remained its central preoccupation. The principal structural features of the Bank's economic and financial environment and the resulting diversity in the nature of its responsibilities as a central bank have already been discussed in the introductory chapter. Monetary policy, which is usually understood to represent policies, objectives, and instruments directed towards regulating money supply and the cost and availability of credit in the economy, could not remain unaffected by this inherited context. Therefore the Reserve Bank of India was prone to take a rather wider view of its monetary policy than more traditional central banks, including within its ambit the institutional responsibility for deepening the financial sector of the economy. Thanks to the Bank's own initiatives and the stimulus of the ongoing process of planned development, the institutional context of monetary policy underwent substantial change during our period. At the same time, tensions between the Bank's concern to regulate credit and its wider responsibility to spread and deepen the domestic financial system were often not far in the background. Some of these tensions might be regarded in the light of experience as transient or short-term while others persist to this day, but their impact on the Bank's decision-making at the time can hardly be overlooked.

As important, the financing of planned development in a poor economy was a source both of challenge and of constraints for the Bank in its role as the monetary policy authority. While the short-term management of seasonal,

inflationary, and balance of payments pressures remained an important focus of monetary policy, the overall investment targets proposed in the five-year plans provided the backdrop against which this responsibility had to be discharged. The interactive nature of the relationship between inflationary pressures in the economy and the mobilization of real resources to finance the plan effort gave monetary management a particular salience during these years. In practice, this relationship too translated into a conflict for whose resolution the Bank had much responsibility but little power. On the one hand, inflation had to be controlled in order to promote savings and investment and the plan effort. But on the other, having to step in frequently to cover the budgetary gaps of the central and state governments weakened the Bank's ability to conduct an independent monetary policy. For the Reserve Bank of India therefore, short-term monetary policy meant not merely managing clearly identified variables such as the price level or the exchange rate, but doing so consistent with supporting a given plan effort. Unfortunately but perhaps unavoidably in the circumstances, this reconciliation was generally effected at the cost of the private sector's credit requirements.

Given the formidable constraints they had to negotiate, the Bank's persistent efforts to balance its diverse responsibilities represent, on closer inspection, an important source of insight for historians as well as for others interested in the broader issues of economic development. Faced with the growing gulf between everyday practice and the canons of orthodox central banking, few contemporary officials recognized they were blazing a trail (whatever may have lain at the end of it), nor were they conscious of the ingenuity they brought to addressing the challenges facing them. In tackling these largely short-term challenges, they did not entirely lose sight of the larger picture. But the practical necessities of decision-making under multiple constraints often led to the adoption, sometimes against the better judgement of its officers if not always of the Bank, of measures which created bigger problems in the longer term than the more immediate ones they helped to resolve. As the logic of decision-making became endogenized in the form of precedents and institutional evolution, the course was set for departures which however small or partial in the beginning, exercised over a period of time a tangible influence on the overall effectiveness of the Bank's monetary policy.

This part of the volume is organized in three separate but related chapters. The first begins with a broad overview of fiscal developments during the three five-year plan periods covered by this volume and of the Bank's evolving attitude towards deficit financing and its impact upon monetary variables in the economy. From being initially passive about the resource assumptions of five-year plans, the Bank learnt from experience to be more proactive and to

urge upon planners the importance of realistic estimates of growth and resource mobilization targets. Concerns such as this led to efforts to formulate a monetary budget for the third five-year plan. Apart from defining the context for monetary policy, deficit financing also raised new questions about currency management and the effectiveness of the Bank's existing tool-kit of monetary policy. In addressing these questions, the Bank endeavoured to augment its powers, as well as adapt the Indian currency and monetary apparatus for the changes and challenges lying ahead. Its efforts in this direction are also discussed in this chapter.

The second and third chapters of this section present a largely chronological account of the Bank's monetary and credit policies during the years covered by this volume.

Deficit Financing and the Environment for Monetary Policy

Deficit financing, defined narrowly as the change in the government's indebtedness to the Reserve Bank of India, has been an important part of plan financing in India, and a key element in determining the environment for monetary policy. This generalization is also largely true for the three five-year plans spanning the years covered by this volume. Of the total public sector outlay (actual) of Rs 1,960 crores in the first plan (1951–56), Rs 260 crores (or 13.26 per cent) were accounted for by the Bank's lending to the government. Lulled by low rates of inflation during the first plan and the availability of large sterling balances, the planning authorities took recourse to deficit financing for a quarter of the investment effort in the second plan (1956–61). Thus Rs 1,170 crores of the actual public sector outlay of Rs 4,672 crores represented the change in the government's indebtedness to the Bank. The lessons of the second plan were not entirely lost on the country's planners. But neither were they fully learnt, and the corresponding figures for the third plan (1961–66) were Rs 1,133 crores and Rs 8,577 crores respectively, the former representing a more modest 13.2 per cent of the latter. Borrowings from the Bank accounted for Rs 676 crores (or 10.2 per cent) of the actual public sector outlay of Rs 6,628 crores during the three annual plans (1966–69) which preceded the resumption of quinquennial planning in 1969.

The impact of these levels of deficit financing on the key monetary policy variables of a closed economy, viz. money supply and the rate of inflation, was quite pronounced. During the first plan, money supply rose by only about 10 per cent or a compound rate of growth of under 2 per cent per annum, while wholesale prices (1952–53=100), largely reflecting external developments in the aftermath of the Korean boom and a succession of good harvests at home, actually fell by over 17 per cent in this period. Inflationary pressures were however unrelenting during the next two plans, wholesale prices rising nearly 35 per cent alongside a rise in money supply of about 32 per cent

during the second plan. Wholesale prices rose some 37 per cent during the third plan, while money supply, aided by rapid expansion of commercial bank credit, increased by over half.¹

DEFICIT FINANCING AND THE BANK

In the early years of planning, there was consensus among India's policy-makers about the need for deficit financing as a means of plugging the gap between ambitious investment plans and the low levels of savings in an underdeveloped economy. Indian planners were not unaware of the dangers of the inflation which might result. But with large foreign exchange reserves, they were confident of the government's ability to manage the supply-side of the economy. This consensus was also largely echoed by the International Monetary Fund mission headed by Edward Bernstein which came to India in 1953 at the invitation of the government.

For much of the 1950s, the Bank was part of this consensus. Although the impact of deficit financing on prices had aroused concern already in 1951-52, price stability did not return as a major cause of worry at the Bank until the mid-fifties. Besides, the Bank recognized the need for any plan to go beyond what available resources dictated, even if some part of the additional investment had to be financed through additions to money supply. Ironically despite the first plan document highlighting the important role of the central bank, the Reserve Bank also took a rather modest and self-effacing view about its own part in the planning process during these years, insisting that while it was entitled to be consulted by the government regarding the dimensions of the plan effort, the final decisions rested with the latter. The monetary policy authorities were, consequently, content to 'function within the limitations created by the effort to carry out the plans'.

The Reserve Bank of India was not given sufficient time to consider the first five-year plan, the plan document arriving in Bombay only towards the close of October 1952. Any contribution the Bank made to the first plan document appears to have been cosmetic, rather than substantial, with the Governor, B. Rama Rau, for instance, choosing merely to object to the plan document's suggestion that 'real democracy' implied the 'equality of incomes'. While the intervening years may have revealed the Bank's earlier fears about

¹ In keeping with the definition in vogue at the time, 'money supply' in this volume refers to 'narrow money' (M1), comprising currency in circulation and demand deposits.

inflation to be exaggerated, concern about prices resurfaced towards the end of 1955, though more in the context of the second plan's priorities than its financing proposals. Commenting on the former, Rama Rau cautioned the Finance Ministry that the public investment envisaged in the plan would lead to excess demand for consumer goods, and to 'serious inflationary pressures'. Though not seemingly within the Bank's remit, Rama Rau added, it was his duty to bring these dangers to the government's attention since the Bank was 'partly, if not mainly, responsible for applying appropriate remedies to curb inflation'.

The Bank's Central Board of Directors was given an opportunity to reflect on the draft documents of the second plan in January 1956. Several members of the Board were apprehensive that the financing requirements of so large an investment programme with a planned public sector outlay of Rs 4,800 crores would involve substantial recourse to the Bank and generate inflationary pressures. Similar views had been voiced earlier during the Economists' Panel's rather cursory discussions of the second plan, among others by D.R. Gadgil, a Director of the Central Board and B.K. Madan, Economic Adviser at the Bank. The Bank's *Annual Report* for 1955-56 emphasized the need for financial stability promoted by a 'judicious mix' of monetary and fiscal policies and warned against taking too sanguine a view based on recent experience, of the pressure that the stepped up plan effort and the manner of financing it was likely to exert on prices. This already marked a departure from the more hopeful view the publication had taken a year earlier. But the Bank also persisted in its belief that no government sensitive to the welfare of the people and, one may add, having at regular intervals to renew its popular mandate, would go very far down the path of inflation. Hence the view prevailed that 'calculated risks' in regard to inflation were justified and that development plans should not be sacrificed to allay fears on the price front unless stabilization were to prove impossible.

There were several reasons why the Bank's overall attitude towards deficit financing during this period was nuanced and pragmatic, rather than doctrinaire. Some of these emerged clearly in the course of the visit to Bombay in February 1958 of Per Jacobsson, the Managing Director of the IMF. The latter's discussions at the Bank revealed that while not altogether unsympathetic towards India's development problems and efforts, he was sceptical about the policy of deficit financing and doubtful that it would give the government any substantial command over additional real resources for investment. Coming at the end of nearly two stressful years of the second plan, Per Jacobsson's plea for monetary stability would

THE BRIDGE THAT T.T. BUILT



— Tol. 5 Dec. 1956

not have failed to strike a responsive chord in Bombay. But placed as it so often was in the position of a credible protagonist of the government's views to the Fund and an interpreter of those of its interlocutors to the authorities in New Delhi, the Bank used three arguments to explain to the visitor why the level of deficit financing envisaged in the second plan was unlikely to affect prices as severely as feared, or unduly expand money supply.

The second plan provided for net reserve losses of Rs 200 crores over five years to finance part of a payments deficit 'planned' with the object of transferring real resources to India from the rest of the world. (The remainder was expected to be covered by capital inflows and external assistance.)² Hence, the Bank's credit to the government sector would not translate directly into an increase in money supply but would be moderated by changes in the country's foreign exchange reserves. Secondly, the process of monetization which was

² Reserve losses during the first year of the second plan were larger than plan estimates for the entire five-year period. But the Bank and the government continued at this time to maintain, in public, the validity of the second plan's assumptions.

continuously under way in the economy could be expected to accelerate as a result of the development effort and lead to changes in the income velocity of money.³ Finally, there was the prospect of rising incomes and standards of living. Both these factors were likely, in the first instance, to increase the public's demand for cash balances. Declining reserves and rising cash balances with the public could, the Bank argued, be expected greatly to moderate the inflationary potential of the government's budgetary outlays during the second plan.

In judging the effects of deficit financing on the economy, the Bank was also disposed to consider a number of other factors some of which in turn, helped determine the range of monetary policy instruments deployed to stabilize prices. For example it regarded the availability of wage goods, chiefly foodgrains, as a major influence upon the extent to which any given level of deficit financing or public investment affected domestic prices. Generally speaking, the Bank also expected the relatively small role played by bank money in overall money supply and the substantial leakages of currency from the banking system to mitigate the inflationary impact of the expansion of its credit to the government. Briefly in the mid-fifties, the Bank apprehended rapid deposit growth weakening its control over the commercial banks' credit mechanism, and armed itself with powers to regulate it. These powers were even used twice in 1960. But throughout these years, currency formed about two-thirds or more of money supply and the Bank's judgement was, on the whole, that the potential for multiple credit creation was realistically still quite limited for any given level of base money.

The Bank's efforts to persuade Per Jacobsson that deficit financing in India was not beyond the limits of prudence were not entirely unavailing. Though his 'basic ideas' did not change very much, Per Jacobsson appears to have recognized that his early reactions were based on 'first hurried impressions' and that the issue showed itself, on closer examination, to be 'not quite so simple'. But within the Bank itself, a sense of unease had long been palpable. As the volume of deficit financing grew during 1956-58 and the price and external payments environments deteriorated, the Bank grew progressively more vocal in expressing its views that deficit financing should be kept within manageable limits, and that plan exercises should bear a closer

³ Readers may note that as used in these chapters, the term 'monetization' lends itself to two meanings. Firstly, it refers, as in this instance, to the process by which the so-called non-monetized sector is brought into the 'monetized' sector of the economy. Elsewhere in these pages, the term is also used in the more contemporary sense, to represent the monetary effects of deficit financing.

relation to the availability of real investible resources in the economy and to the ability of the government to mobilize them.

TOWARDS A MORE CAUTIOUS APPROACH

The turning point, to the extent that it is possible to identify one, probably came as early as August 1956. Although the external payments position had turned markedly adverse in recent months, there was no sense yet of a crisis. Indeed the bill to amend the currency cover which was then at an advanced stage assumed that the country's foreign exchange reserves would normally not fall below Rs 500 crores. This assumption would soon be belied, but few contemplated the possibility in July 1956. As discussed at somewhat greater length below, the Deputy Governor, K.G. Ambegaokar, spent several days in August arguing the case for *increasing* the government's issue of ad hoc treasury bills (or ad hocs), his object being to tide the Issue Department over its problem of finding eligible assets to back the additions to currency necessitated by the growth of commercial bank credit. Towards the end of August, a letter from Rama Rau to the Prime Minister, Jawaharlal Nehru, mentioned the possibility of the second plan outlay having to be reduced in the event of the price and foreign exchange positions getting out of hand, and monetary policy instruments being found wanting. But such scenarios were still regarded as hypothetical.

Accompanied as it was by considerable debate within the organization, the change which came over the Bank's outlook after August 1956 was not as sudden as it might seem. Some of the arguments in this debate percolated to the outside world in the form of hypothetical formulations about alternative resource scenarios, about the monetary impact of the deficit financing exercise, and so on. But from autumn 1956, the Bank began raising the tone of its cautionary remarks about inflation. Senior Bank officials even began to voice their concern about the price situation in public, and to think aloud about the distortions in the flow of resources which inflation might cause. This concern deepened as the real dimensions of the exchange problem dawned on the Bank's officials and it became clear that apart from domestic savings, the availability of foreign aid was critical to achieving the second plan's investment targets. A detailed discussion of the Bank's monetary and credit policies is reserved for the chapters which follow. We may merely note here that although the Bank was committed to a policy of 'controlled expansion' which satisfied the demand for productive credit without the resulting monetary growth outpacing the community's capacity to mobilize real resources, its stance during the 1956-57 busy season tended against its own better judgement to emphasize expansion at the cost of control. With monetary policy following

the expansionary course set by fiscal policy, prices—particularly of food articles and agricultural raw materials—continued to rise, leaving the Bank with little choice but to impose selective controls. Although it was sensitive to the limitations of general instruments of credit control and alive to the advantages of selective controls, overall policy during the 1956–57 peak season (discussed in chapter 3) was too liberal for the Bank's liking.

The developments during the 1956–57 busy season, including differences with the Finance Minister over the thrust of policy, held several lessons for the Reserve Bank. Even generally inflation-averse governments, officials at Mint Road now realized, might easily overestimate the limits of prudent deficit financing and that, once under way, the latter triggered an inflationary dynamic which was not easy to check or reverse by means of monetary policy alone. Hence in the long run, there was no serious alternative to financing investment except through increasing savings or otherwise mobilizing real resources. Since the real resource effort appeared to have reached a plateau and there were limits to the extent to which it could be stepped up in the near future, by the summer of 1957 the Bank began more openly to consider the option of reducing the size of the second plan. The meetings which the new Governor, H.V.R. Iengar, held with state finance ministers during these weeks brought home to him the difficulties they faced in getting resources for the plan. While 'afraid to speak ... their minds' in public, he informed the Union Finance Minister, T.T. Krishnamachari, in July 1957, they were willing in private conversations to talk frankly about the need to 'cut the Plan down to available resources'. Many ministers thought such a step unavoidable, and felt it was a 'serious mistake' for the central government to maintain that the plan would not be scaled down on any account since doing so merely raised the political and other costs of the eventual climb-down. Iengar was quite outspoken to Krishnamachari about his own preference:

I realize ... the Government of India are in an exceedingly difficult position; for any Government to have to say ... that they are defeated is politically and otherwise a difficult ... thing to do; but the question seems one of emphasis and mode of presentation.

Although there was little it could do other than warn, the Bank had grown by now to be watchful for signs of fiscal laxity. The Bank's net credit to the government peaked in 1957–58 at Rs 421 crores, dropping the following year to Rs 156 crores. But the 1959–60 budget proposed a deficit financing component of Rs 245 crores, provoking Iengar to protest to the Finance Minister, Morarji Desai, that apart from being in excess of anything 'conceived to be probable' earlier, the planned deficit made the price level hostage to the

prospects of a 'really first class' monsoon. In the event, the actual deficit at the end of 1959-60 was lower by about Rs 100 crores than planned. The 1960-61 budget in turn allowed for a deficit of Rs 250 crores. Alerting the Finance Minister that the resulting inflation would 'seriously embarrass' the government and set the third plan off to a rocky start, the Governor declared that monetary policy being limited in scope, its effectiveness would be 'immeasurably enhanced if fiscal policy worked in the same direction rather than against the current of monetary measures instituted by the Bank'. Moreover, severe restrictions on bank credit while 'deficit financing continued apace' were likely to distort 'the price and cost structure' and 'dampen ... productive enterprise'. The Governor also urged the minister to undertake an immediate review of the 'internal resources and expenditure position' in the concluding year of the second plan so that the actual extent of deficit financing during the plan did not exceed the original estimate of Rs 1,200 crores. Unless this were done, he insisted, the third plan's resource exercises 'will not inspire the least confidence', and the 'foundation of resources' for the plan would be viewed by 'objective observers to be extremely shaky'. The realized deficit during 1960-61 (Rs 137 crores) was much smaller than planned. The actual second plan investment too, fell short of estimates by nearly Rs 130 crores.

The inflationary and balance of payments pressures encountered during the latter half of the 1950s and the associated shortfall in meeting the second plan's investment targets exerted a sobering influence on the country's planners. The third plan was conceived along altogether more modest lines. The Bank too was more closely involved with its resource exercises. The latter were intended partly to determine some 'safe level of deficit financing' at which additional investment resources were usefully mobilized without unleashing inflationary pressures. But there were two imponderables to reckon with. The first of these was the supply of wage goods—principally foodgrains—in the economy which in turn depended largely on factors beyond the control of the government and the Bank. The second imponderable, of relatively recent vintage in the reckoning of officials at the Bank, was the monetary expansion likely to result from any given increase in the latter's credit to the government.

The Bank preferred a realistic third plan financed through realizable revenue and public borrowings targets so that neither the original resource exercises nor the actual financing of the plan would involve recourse to high levels of deficit financing. It was also conscious of the risks of large publicly-funded investment projects, particularly in the infrastructure sector, facing major time and cost over-runs. Once begun, such projects could not easily be given up or suspended in the interests of short-term monetary stability. Hence the

Bank advised the government to 'err on the safer side' in determining the size of the plan and the volume of deficit financing required to finance it. The scope for deficit financing was also now more limited in the Bank's view, since the background rate of inflation was already quite high and the external reserves position, unlike at the outset of the second plan, was far from comfortable. The third plan provided for a growth in national income of 30 per cent during the five-year period. The Bank's technical staff studied the resources position for the plan both independently and as part of an inter-departmental working group, and undertook an exercise to formulate a monetary budget for the third plan. This exercise built on the Bank's own recent work on money supply in India by a working group of its economists which marked an important turning point in its understanding of the monetary impact of deficit financing.⁴ However, this understanding did not begin to exert a consistent influence on its own monetary practice until the 1980s.

On the basis of the growth rates projected in the plan document and the extension of the monetized sector it judged likely to take place during the next five years, the Bank estimated that a monetary expansion of Rs 1,000 crores would be consistent with the requirements of price stability. With an estimated money multiplier of 1.36, this called for additions to reserve money of no more than Rs 750 crores. Of this Rs 200 crores were expected to be added against the eligible assets of the private sector, leaving Rs 550 crores to be added through increased Bank lending to the government. The latter amount represented, in the Bank's view, the 'maximum level of non-inflationary deficit financing'.

The Bank had relatively little difficulty in persuading the government to accept this figure. But there was the more insidious risk that the planners' determination to 'bump up the size of the Plan' on the basis of 'assumed resources discovered by some people' would lead in the end to a much larger volume of deficit financing than the plan estimates assumed. Of direct concern to the Bank in this connection were the public borrowing estimates for the third plan. The Perspective Planning Division of the Planning Commission appears to have suggested a net market borrowing target of about Rs 1,300 crores for the plan. Since maturities during these years were expected to amount to Rs 940 crores, this translated into gross borrowings of Rs 2,240 crores (or Rs 450 crores per year). This was nearly twice the government's gross market borrowings of about Rs 1,200 crores during the second plan

⁴ See 'Analysis of Money Supply in India', *Reserve Bank of India Bulletin*, Part I (July 1961), and Part II (August 1961). The Bank's working group comprised S.L.N. Simha, V.V. Bhatt, A.G. Chandavarkar, and D.R. Khatkhate.

when maturities aggregated to Rs 385 crores and net market borrowing to Rs 816 crores. The second plan had set a net borrowings target of only Rs 700 crores and the higher amounts it managed to collect might suggest, on the face of it, that the government had been very successful in marketing its loans and that the demand for them exceeded earlier expectations. But according to a note by the Division of Monetary Research prepared on the basis of the data available to it until November 1960, the absorption of government securities *by the public* during the second plan was only about Rs 310 crores. This was adrift of the plan target by nearly Rs 400 crores and moreover, was not much higher than the corresponding first plan figure of Rs 290 crores. Of greater relevance here, the shortfall was made up by the Bank's subscriptions and by the 'adventitious aid' that became available thanks to the P.L.480 rupee resources deposited with the State Bank of India.

The Bank was convinced even in August 1957 that the second plan borrowing targets were 'quite unrealistic'. The results of the 1956 and the 1957 loan flotations were disappointing, and raised disturbing questions about the financing of the remainder of the plan. The Governor lost no time in conveying his misgivings to the Finance Minister, T.T. Krishnamachari, and at his instance, to an informal meeting of the Union Cabinet in September 1957. Despite Iengar's fears, however, the Bank managed largely to offload in the market its acquisitions of the loans the government floated or issued between 1956 and 1959. But, for a variety of reasons that need not detain us here, such sales became increasingly difficult to effect in the concluding year of the second plan. On the other hand, until the late fifties many within the Bank believed that since the government used a part of its loan proceeds to cancel ad hoc treasury bills held in the Issue Department, the Reserve Bank's subscription to central loans could justifiably be regarded as a funding operation. But this complacency did not endure the second plan years when the net creation of ad hoc treasury bills amounted to Rs 945 crores and no easy solution appeared to the problem of deficit financing. In 1961, for example, the government's borrowing during the year fell short of the budgeted figure. With prospects of borrowing in the market receding, thoughts in the government turned towards creating a new tranche of loans for issue to the Reserve Bank. The Bank was not keen to take up another special issue. It still held nearly two-thirds of the loans it had bought in 1960 and did not feel confident of being able to dispose of any further acquisitions. The volume of deficit financing, as Iengar informed the government, increased by the extent to which the Bank was unable to sell its initial subscription to a government loan:

This is a contingency to which we have more than once drawn [the] government's attention in our discussions of the loan programme, and I fear this year's operations confirm my view that the plan target is unlikely to be realized.

The Bank's views had no impact, however, on the borrowing plans of a government determined to achieve the second plan investment target. Thus apart from cash contributions (and conversions), loans to the extent of Rs 105 crores were 'specially created' for issue to the Bank so that the government might succeed in raising the budgeted amounts from the market during the last two years of the second plan.

Its experience during the second plan convinced the Bank of the need to frame the third plan's borrowing estimates too along conservative lines. Besides, with P.L.480 funds no longer likely to be available to support the central government's public borrowing programme, the Bank had good reason to apprehend that it would in the end be required once again to make good the shortfall in meeting the government's ambitious public borrowing targets through further recourse to inflationary financing. Hence it urged the adoption in the first place of a more modest public borrowing programme than the one suggested by the Perspective Planning Division. On the other hand, the resources of the banking system having grown impressively since the beginning of the second plan, banks could now afford larger contributions to government loans. Sensitive too, to the dictates of politics, the Bank recognized that 'it would not do' to reduce the third plan's net borrowing target below the original second plan estimate of Rs 700 crores. This in the event was the Bank's proposal. But the Finance Ministry increased this figure to Rs 750 crores, and later to Rs 850 crores by including in it the Rs 100 crores expected to be raised through prize bonds. This translated into a gross public borrowing target of about Rs 1,700 crores during the third plan. According to a note by M.V. Rangachari, Deputy Governor, the third plan Resources Committee 'had its work cut out in seeing that this figure was not further raised by the perspective planners'. Though 'optimistic', the final figure accepted by the Resources Committee was, in the Bank's view, not 'completely unrealistic'.

While these estimates formed the basis of the original third plan deficit financing and public borrowing projections, thanks largely to factors beyond the control of the country's economic decision-makers, the government's finances during this period went awry. Nor were the planned growth targets achieved. But the Bank's efforts to persuade the government to minimize recourse to deficit financing did not cease throughout these years. Even at the

You Said It

By LAXMAN



**When I said, "Think of a quick-
yielding project to generate
resources for our Fourth Plan,"
I did not mean this!**

—Tol, 21 Jan. 1965

height of the political emergency triggered by the border conflict of 1962, the Bank thought it necessary to caution the government that the effectiveness of monetary policy depended 'to a considerable extent on the direction in which fiscal policy tends'. By 1965, its views had hardened further: it was 'essential' now, the Bank declared in a note the Governor sent to Prime Minister Shastri in June,

that deficit financing be *eliminated* for the time being, or at least, reduced considerably even if it means the slowing down of certain activities or ... projects which are not of a basic character. The alternative would be a real deflation later—a course which would have very bad repercussions.

In fact, as the actual deficit in 1964–65 exceeded revised estimates presented in the 1965–66 budget, earlier hopes of ‘avoiding’ deficit financing in 1965–66 began to fade. Therefore at the instance of the Governor, P.C. Bhattacharyya, the Prime Minister, Lal Bahadur Shastri, addressed a letter to his own Finance Minister, T.T. Krishnamachari, in June 1965 asking him to take advance measures to ‘revise the outlay’ on some ‘major heads of expenditure’ so that any ‘possible shortfall in [budgetary] receipts’ for 1965–66 ‘would be counterbalanced’.

As both the food and external security environments deteriorated in the mid-sixties, the Bank’s efforts to rein in the government’s finances were far from successful, particularly as the third plan years drew to a close. Yet as noted earlier, not only did deficit financing account for a smaller proportion of the total third plan outlay than in the two preceding plans, the absolute magnitude of Bank credit to the government was also lower during the third plan than during the second. Learning further from the third plan experience, the Bank decided to examine the fourth plan arithmetic more closely than had been its wont. Internal studies convinced the Bank that the plan depended on a number of doubtful assumptions including a growth rate of over 8 per cent and an average savings rate of about 11.5 per cent. The latter implied a marginal savings rate of 18 per cent, as against about 14 per cent in the third plan. Some investment requirements, particularly for power and inventories, were also found to have been severely underestimated. The Bank was critical too of the plan’s foreign exchange budget. Let alone providing for some increase in reserves from the bare minimum levels they had reached, it left little room for error or for additional demands which might arise. Therefore the Bank proposed to the government that the plan should be ‘based on more realistic estimates of both domestic and foreign resources’ and that a ‘smaller plan’ was needed ‘if we are really serious about [avoiding] deficit financing’. ‘Material balances tables’, Bhattacharyya also pointed out to Morarji Desai, Deputy Prime Minister and Finance Minister, in April 1967, could not remain unchanged if the financial resources actually available for the central government’s plan expenditures fell short of earlier estimates. The plan should therefore be

reworked in the light of the new situation and after making realistic estimates of the possibilities in regard to overall income growth, scope for modifying the existing savings–income ratios, trends in foreign trade and payments, etc.

The Bank’s ‘recalculations’, according to Bhattacharyya, suggested a plan size of Rs 19,000 crores rather than the Rs 23,750 crores proposed in the

fourth plan's draft outline. In the event, circumstances conspired against the original fourth plan which in the end had to be abandoned.

By the mid-sixties the Bank was beginning to raise its sights. As mentioned above, it was now inclined to consider ways of 'eliminating', rather than as earlier merely restricting, deficit financing. This was of course easier said than done, and though the Bank's net credit to the government represented a smaller proportion of the annual plans' outlay than of the three completed five-year plans, the journey was not uneventful or without setbacks. The budget for 1966-67, for example, assumed market borrowings of Rs 280 crores. But the Bank, which continued to subject the government's borrowing operations to close scrutiny, was of the view that Rs 225 crores represented the more realistic figure and that the budgeted amount would not be realized unless the Bank made a cash subscription of Rs 65 crores. This, the Deputy Governor, B.N. Adarkar, remarked, would be 'inconsistent with the general tenor' of the Bank's credit policy. The Governor also pointed out that he could not 'justify the R[eserve] B[ank] putting another 65 crores this year when we have not been able to unload any securities subscribed last year'. The Bank managed, in the event, to convince the government to reduce the size of the 1966 flotations to Rs 260 crores; and thanks to the success of Bhattacharyya's personal efforts to persuade the Life Insurance Corporation and some quasi-public bodies such as the Bombay Port Trust to increase or maintain their contributions, it managed to hold its own cash subscription down to Rs 37 crores. But the Bank's success in these respects was more than undone, however, by the unprecedentedly large volume of ad hocs created during the year, their net issue of Rs 260 crores in 1966-67 representing until then the largest addition to the Bank's holdings of these bills in any single year.

DEFICIT FINANCING AND INFLATION: THE BANK'S VIEW

The Reserve Bank of India's understanding of inflation during much of our period was more structuralist than monetarist in the narrow sense of the term. Officials at the Bank were sensitive to a number of structural factors which, in the short and medium term, mediated the relationship between explanatory variables such as public expenditure, change in the government's indebtedness to the Reserve Bank, and changes in money supply on the one hand, and the rate of inflation on the other. The arguments the Bank brought up in its discussions with Per Jacobsson, though intended merely to highlight some characteristics of the Indian monetary system, already had a structuralist ring to them. Other considerations which the Bank understood to influence

the price outcome of any given policy included changing income distribution and the availability of foreign exchange, the latter not being viewed as solely a monetary variable. But by far the most important of such factors were bottlenecks in the wage goods, intermediate goods, and infrastructure sectors, an influential Bank study citing discontinuities in the 'aggregate supply function ... [due to] structural rigidities' as a feature affecting the impact of monetary policy in a developing economy such as India's.⁵ In keeping with this line of 'structuralist thinking', the Bank believed that while monetary policy worked to 'dampen the pressures originating on the side of demand' to the extent the latter exceeded supply, it could not

by itself ... be expected to restore balance in prices when the underlying trends make for increase either due to forces on the supply side or due to the impact of other factors such as fiscal deficits operating on demand.

The above diagnosis yielded a prescription which underlined the complementarity between fiscal and monetary measures even to curb inflationary tendencies. But the Bank was also usually at pains to emphasize longer-term measures which would give the country's economic managers greater physical control over the functioning of key markets such as those for foodgrains. Thus, despite harbouring some reservations about the inflationary impact of buffer-stock financing, the Reserve Bank was generally supportive, particularly as some of the wider structural constraints began discernibly to affect the economic environment, of policies to guarantee minimum prices to cultivators and maintain buffer stocks of the most important wage good—foodgrains.

Inevitably, the Bank's structuralist, rather than narrowly monetarist, perspective influenced the formulation and execution of its monetary policies. It might also be said to have had important longer-run consequences for the structure of the Indian financial system. On the one hand, policy could never be indifferent to what might be regarded as the genuine needs of the productive sectors of the economy. Thus while credit which might fuel speculation in essential commodities might have to be squeezed, the needs of the infrastructure sectors or the demand for credit to build a buffer stock of foodgrains could not for instance be overlooked even in an environment otherwise characterized by monetary tightness. This meant in turn considerable flexibility in the deployment of the traditional instruments of monetary policy, and some innovation in the development of new ones. Instruments which worked in a

⁵ V.G. Pendharkar and M. Narasimham, 'Recent Evolution of Monetary Policy in India', *Reserve Bank of India Bulletin*, April 1966, pp. 340–61.

generalized way, such as the Bank rate, were sometimes viewed with reservation because they were feared to 'discourage developmental activity in the private sector, ... lower the prices of Government securities and therefore raise the cost of future Government borrowings'. Far better in the circumstances to deploy selective instruments which favoured borrowing for essential purposes and penalized borrowing for non-essential or speculative ones.

Views such as these were already present both within the Bank and outside from the early 1950s. For example, as pointed out earlier, even the otherwise modest first plan document had ambitious expectations from the central bank of a planned economy. The central bank, the plan document affirmed, could not confine itself merely to a 'negative regulation' of the 'overall supply of credit', but should instead direct it into the desired channels. Despite high rates of inflation in the intervening years, this view of the role of central banking was reinforced as the country came face to face with a daunting set of simultaneous economic and military challenges during the 1960s. The underlying logic and the actions flowing from it culminated in the policy of directed credit and interest rate regulation which, for better or for worse, became important features of the Indian financial system for over three decades thereafter.

DEFICIT FINANCING AND MONETARY CONTROL

The public investments initiated during the second plan and sustained during the third imposed a number of responsibilities on the Bank. These included helping the central and state governments to raise resources in the market and keeping them in funds. The Bank's roles as banker to governments and manager of their loans (discussed in greater detail elsewhere) had several important implications for the conduct of its monetary policies. In the beginning the Bank had maintained a reserved and watchful stance, more especially in relation to the debts of state governments. Although caution was not entirely forsaken, from the mid-fifties the Bank grew noticeably more indulgent towards the financial needs of the public sector. Partly, of course, the new approach reflected the intellectual attractions which the government's plans for economic development held even for officials within the Bank. But there were also limits to how far the Bank could resist the winds blowing from Delhi, especially if by doing so it ran the risk of losing all influence over the government's economic policies.

Hence, whatever its reservations—and these were not inconsiderable nor were they always smothered in silence—the Bank remained willing, on the whole, to meet the public sector's demand for resources, even if that meant

rationing credit to the private sector. Their acquiescence in the proposals the central government made in January 1955 for the financing of its ways and means aptly illustrates how Bank officials viewed monetary policy priorities during these years. Not long afterwards Parliament passed legislation to abandon the fractional reserve system in favour of a more elastic system of note issue. Necessary as this change was to meet the currency requirements of an expanding economy, the Bank was largely unmindful even at this time of the quality of the Issue Department's assets portfolio and of the nature of the domestic assets which replaced foreign assets in it. Finally, even while giving up fractional reserves, the Bank acquired the power to vary reserve requirements so that it could regulate the impact of large public expenditures on the ability of the banking system to expand credit to trade and industry. Although, as noted above, the Bank grew more vocal subsequently in giving expression to its reservations about the direction of the government's financial policies and its advice did not always go unheeded, its complaisance in the matter of ad hoc treasury bills—as well as more generally—blunted the edge of its criticism. The former also opened the floodgates to 'automatic monetization' and in the longer run to the inflationary financing of budgetary deficits by the Reserve Bank.

DEFICIT FINANCING AND ASSETS OF THE ISSUE DEPARTMENT

The Bank extended credit to the central government either against dated securities or against ad hoc treasury bills. The Bank might pick up the securities at the time of their issue or subsequently, to hold as part of its own portfolio or in order to unload them later on a more receptive market. The dangers of inflationary financing were not altogether absent in the case of dated securities: although the Bank and the government did much to assist the growth of a secondary market for the latter's loans—one which in later years became increasingly captive—there was, as we saw above, always some risk that these assets might not command a ready market outside the Bank. But the principal risk of inflationary financing of the government's expenditures arose from the latter's practice of issuing ad hoc treasury bills to the Bank in order to keep itself in funds.

Creating Ad hoc Treasury Bills: The Arrangement of January 1955

Under its Act, the Bank is authorized to make advances repayable within three months to the central and state governments. The Bank's advances to the central government during our period were made against the issue of ad hoc treasury bills. The latter made their first appearance in 1920 when the Government of India issued them to the Currency Department (the precursor

of the Bank's Issue Department) to minimize the domestic deflationary impact of reserve losses sustained to finance a prolonged flight of capital that year. They were created for the first time after the founding of the Bank during the second world war. Ad hoc treasury bills for about Rs 293 crores were also created in 1948–49 to replace sterling securities in the Issue Department transferred to the British government in the wake of the 1948 sterling balances agreement. While ad hocs created during the war were soon retired with the proceeds of dated loans, those created in 1948–49 were largely renewed on maturity, and remained outstanding to the tune of Rs 253 crores at the end of March 1954.

To the extent ad hoc treasury bills were funded or retired by issues of dated debt to the public, monetary expansion against them was not intrinsically a more inflationary form of financing than that against dated securities held in the Bank's Issue Department. Indeed, from July 1958 ad hoc treasury bills were funded in a limited way every year, the total volume of funding between then and March 1967 amounting to Rs 825 crores. But apart from the conditions in the market for the government's long-term debt, the prospect of funding ad hoc treasury bills into traded gilts, and consequently their potential for inflation, turned crucially on the volumes in which these assets were issued.

The Reserve Bank of India Act merely enabled the Bank to make short-term advances to the central government. It did not *require* the Bank to make such advances. But in January 1955, the Bank agreed, rather somnolently and without much serious thought, to a suggestion of the Finance Ministry to create ad hoc treasury bills in such a manner as to ensure that the central government's cash balances did not fall below Rs 50 crores at the end of each week. The availability of soft credit in unlimited quantities from the central bank through the creation of ad hocs helped undermine financial discipline at the centre. It also seems to have encouraged state governments to draw unauthorized overdrafts from the Bank. In due course the latter were 'regularized' by the centre making grants to overdrawn state governments, these grants themselves often being financed through the creation of fresh ad hoc treasury bills. In this way, the Bank became a source of cheap credit not only for the central government, but also indirectly for state governments.

The initiative to create ad hoc treasury bills to ensure that its cash balances did not fall below some minimum at the end of each week came from the Government of India. Writing to G. Balasubramanian, the Secretary of the Bank, on 8 January 1955, H.S. Negi, a Deputy Secretary at the Finance Ministry, pointed out that the government assumed a

minimum working balance of Rs 50 crores in its ways and means estimates, and that since the balance had fallen to Rs 40 crores, the Bank should 'arrange to have ad hocs issued to the extent of Rs 10 crores'. Two days later, Negi wrote another letter to Balasubramanian in which he enclosed the 'usual ways and means forecast' of the government for January and February 1955, and pointed out that in order to maintain the central government's cash balances with the Reserve Bank 'in the neighbourhood of Rs 50 crores at the end of every month', it was necessary to create 'new special ad hocs' of about Rs 30 crores in January 1955 and Rs 20 crores in February 1955. Then followed a telephone conversation between the two officials, the upshot of which was that the Bank agreed 'in future' to 'create ad hoc treasury bills in suitable blocks to the extent necessary in order to maintain [the] Central Government's cash balance roundabout [sic!] Rs 50 crores on Fridays'. This was reiterated by the two sides in May 1955 following a pointed query from the Bank about the government's ways and means forecast for the month which assumed a closing balance of less than Rs 50 crores. With the Deputy Governor, Ram Nath, and Rama Rau himself endorsing the 'standing instructions' in January 1955, the matter of extending credit to the central government was thereafter handled at the operational level, with the decision to create ad hoc treasury bills whenever necessary before books were closed on Fridays resting, for all practical purposes, with the Reserve Bank's Manager in Calcutta and its Secretary in Bombay.

Abandoning the Proportional Reserve System

Section 33 of the Reserve Bank of India Act, as adopted in 1934, provided for an inflexible domestic currency system based on a proportional reserve under which two-fifths of the assets of the Bank's Issue Department were required to be held in the form of gold coin, gold bullion, or foreign securities. Of these assets, at least Rs 40 crores were to be in the form of gold coin and bullion. Currency was the predominant component of money supply in India, and the proportional reserve system afforded little scope for expanding it except by running a payments surplus. With the accelerated development effort expected to increase the demand for currency and the second plan projecting a sharp decline in the country's foreign exchange reserves, the current provisions of the Reserve Bank Act looked likely to hamper the authorities' ability to meet this demand. On the other hand, while it was possible to achieve an elastic currency system by allowing domestic assets to be substituted for foreign assets in the Issue Department, the substitution might have some implications for monetary stability. In addition, as existing

currency cover provisions were being relaxed through a legislative amendment, the Bank was confronted with the problem of finding eligible *domestic* assets against which the note issue could be expanded.

The proportional reserve system was largely a relic of pre-war currency arrangements. By the early 1950s, the view had gained ground that the principle of tying note issue to the size of a country's exchange reserves represented an unnecessary complication in monetary arrangements. Moreover, while yielding a return, idle exchange reserves represented a cost to the economy in the form of investment and growth foregone. Since the main function of exchange reserves was to finance a temporary balance of payments deficit, the former's size ought to be related, in this view, to the likely extent of instability on the external account rather than to the size of the note issue. On the other hand, countries which adopted a proportional reserve system either tied up their foreign exchange reserves unnecessarily or were obliged to change their legal provisions frequently. Following this line of reasoning, several countries did not prescribe any minimum holdings of gold or foreign exchange against the note issue. Far from encouraging fiscal profligacy as many contemporaries feared, the new system only increased the responsibility of the authorities to maintain domestic and external stability through an appropriate mix of policies.

The initiative to reconsider India's currency cover provisions in the light of more modern requirements came from the government. In a letter he wrote to Governor Rama Rau in the summer of 1955, B.K. Nehru, Joint Secretary in the Finance Ministry, reflected that unless changed, the existing provisions would impose a 'very sharp limit' to deficit financing and the country's ability to run a payments deficit. Outlining three alternatives—lowering the proportional cover, moving towards a fiduciary system, or doing away altogether with the statutory requirement of a currency reserve—Nehru indicated the government's preference, subject to the Bank's views, for a simple fiduciary system. The Finance Ministry was also eager that whatever the change proposed, it should be made 'long before the need for it begins to be felt so that no question of a crisis of confidence may arise when the law is amended'.

Besides envisaging deficit financing of the order of about Rs 1,200 crores, the second plan as already pointed out anticipated that the country's foreign exchange reserves would be drawn down by about Rs 40 crores each year. An imbalance of this magnitude would, under the existing provisions, reduce the Bank's power to issue notes by Rs 100 crores annually; so that, according to a memorandum to the Bank's Central Board, at the current rate of expansion of note issue, 'the available foreign reserves in the Issue Department would fall below the legal requirement in a little over a year'. If gold held in the

Issue Department and valued in its books at 8.47512 grains of fine gold per rupee was revalued on the basis of the current rupee parity of 2.88 grains per rupee, an additional cover of about Rs 80 crores would become available, but even this would soon be inadequate. Hence the Bank needed little persuading that a change in the statutory provisions on currency cover was necessary.

In reviewing various alternatives, the Bank concluded that rather than adopt a fiduciary system as the Ministry proposed, it would be best to entirely dispense with the statutory requirement for currency cover. The Bank's argument, as set out in a note by its Economic Adviser, B.K. Madan, was that no statutory provisions concerning note issue could safeguard against the possibility of a 'substantial inflationary movement', more so as commercial banks' deposit liabilities, which were potentially the most dynamic component of money supply, were unaffected by them. While a proportional system where currency expansion was hostage to the economy's ability to generate a current account surplus could no longer be justified, there was in Madan's view, no advantage in replacing it with a fiduciary system. In the first place, even with the present proportional system, the note issue could rise to Rs 2,075 crores after the gold held in the Issue Department was revalued. Hence a fiduciary system would not make the note issue more elastic unless the limit was set at Rs 2,100 crores or more. But setting a limit so much higher than the present note circulation of about Rs 1,350 crores would 'confound public opinion, and give a greater shock to confidence than the removal of the cover provision'. In general, he pointed out, it was more consistent with the logic of the fiduciary principle to relax the limit as the need arose rather than in advance of it. In the longer run, a fiduciary system would require regular and repeated relaxations of the limit whether through parliamentary approval or executive action, with the accompanying risk of damage to the public's confidence in their currency system. Deleting the statutory provision would, on the contrary,

cut the Gordian knot once and for all, and subsequent assessment of the economic and monetary situation would be facilitated in terms of the total picture rather than of a figure ... [whose] significance ... might be magnified out of proportion to its relevance.

Madan also rejected the argument that note issue restrictions were an 'effective safeguard against the misuse of political power'. Not only was it a mistake to suppose currency to be the sole, or even principal arena of mischief, a 'formal restraint of limited efficacy' on currency expansion would be of little use

where the government was 'unmindful of its responsibilities to the country'. Far from the proposed move being a 'derogation' of Parliament's authority, it would enable the latter to be better 'exercised in ... enforcing the general responsibility of Government rather than only in formal fulfilment of a Section, ... [whose] essential rationale ... has been greatly modified'

However, in conveying its recommendations to the government the Bank preferred to make a less radical departure than the one Madan had argued for. In doing away with the present legal provisions, the Bank proposed that the government prescribe a 'minimum currency reserve, say Rs 300 or Rs 400 crores', which did not vary with the note issue. There was no 'theoretical basis' for such a practice, only the practical consideration of maintaining public confidence in the currency 'especially when we are resorting to deficit financing on an appreciable scale'. A minimum level of Rs 400 crores (£300 million) besides being practically the same as the amount earmarked as a currency reserve in the sterling balances agreement concluded between the Indian and British governments in February 1952, was also thought to give the authorities a reasonable cushion to finance the second plan (foreign exchange reserves aggregated about Rs 875 crores at this time) without arousing fears of a drain of these reserves such as might arise were the cover provisions to be entirely removed. The Bank added that the opportunity should also be used to revalue the gold in the Issue Department. The timing of these changes needed careful consideration, however, keeping in mind their possible repercussions on public confidence.

The government accepted the Bank's recommendations, with the proviso that the fixed currency reserve should consist of Rs 100 crores in gold, which was simultaneously to be revalued, and Rs 300 crores in foreign securities. The Bank was to keep, in addition, a foreign currency reserve of Rs 100 crores. If at any time the gold and foreign balances of the Issue Department fell below Rs 500 crores, the Bank would 'enter into immediate discussion with the Government of India as to what should be done about the situation'.

While in general agreement with the government's revised proposals, the Bank reflected that any reduction in the minimum gold reserve from the current (revalued) level of about Rs 118 crores to the suggested level of Rs 100 crores was liable to provoke misrepresentation and controversy. It saw no reason besides, to split the foreign exchange holdings of the Issue Department into a minimum reserve of Rs 300 crores and an additional reserve of Rs 100 crores, preferring a single consolidated reserve of Rs 400 crores. The Bank also suggested a simultaneous amendment to section 37 of the Reserve Bank of India Act, to enable these asset requirements to be suspended with the prior consent of the government for a period of six months in the first instance, and

subsequently for three-month periods, on the condition that the maximum reserve deficiency would not exceed Rs 100 crores and that the minimum gold reserve was at all times maintained. Alongside these changes, the Bank proposed repealing an archaic provision in the same section of the Act requiring it to pay a tax to the government in the event of the Issue Department's gold and foreign exchange reserves falling below the prescribed minimum. With the Bank having passed into public ownership and its surplus profits now payable to the government, this provision had lost all significance. Except for suggesting the minor modification of fixing the minimum gold reserve held in the Issue Department at Rs 115 crores, the Bank's final proposals were accepted by the government.

The amendment bill sparked off a lively debate in Parliament. Although the bill proposed a number of other important amendments including that to enable the introduction of variable reserve ratios (discussed below), the measure to relax the proportional reserve requirement aroused wide interest and comment. Criticism of the proposed cover provisions was along predictable lines. M.S. Gurupadaswamy thought it was a prelude to 'currency chaos' since it removed all safeguards on currency expansion. G.D. Somani also expressed a similar fear, while V.B. Gandhi deplored the fact that the Reserve Bank was going 'too far too fast.' It had put itself in a position where it could no longer say 'No' to the government and force the Finance Minister to come to the Parliament which in 'certain circumstances', he averred, 'should retain some control over the actions of Government in these monetary fields' Similar views were expressed in the Rajya Sabha where, however, the debate was much wider-ranging. Ironically, and as if to allay the apprehensions Ambegaokar had voiced in an internal note about 'revolutionary' parties abusing the new provisions should they come to power, Bhupesh Gupta of the Communist Party of India anticipated the Bank's evolving approach towards deficit financing and pointed out that the second plan's price assumptions were already being belied, giving rise to doubts about the ability of public investment to create durable income-generating assets in the community. Other members feared that the new provisions might enable a weak government to take recourse to inflationary financing and evade parliamentary control over its spending.

The Reserve Bank of India (Amendment) Act, 1956 became law on 6 October 1956. Within months of its passing, however, the new currency cover requirements proved less flexible than authorities had hoped. The balance of payments situation worsened with unexpected rapidity, the country's foreign exchange reserves having to be drawn down by Rs 262 crores in 1956-57 alone (as against Rs 96 crores for the entire first plan period). In the

circumstances, Iengar judged it necessary to inform the Central Board in April 1957 that in the absence of any drawings from the IMF, India's foreign exchange reserves could be expected to fall to Rs 445 crores by the end of June. The following weeks revealed the Governor's projections to have been optimistic and by July despite drawings from the Fund, reserves appeared in danger of piercing the new floor within weeks. By the end of July it became clear that 'there was no prospect' of any escape from suspending even the new section 33 requirement, and the Bank sought and obtained the government's approval on 30 July 1957 to relax its application for six months. This was a well-judged precaution, as gold and foreign securities held in the Issue Department dropped below Rs 400 crores on 2 August 1957 following a transfer of Rs 25 crores to the Banking Department. But reserves continued to decline at the rate of about Rs 9 crores each week and, as Iengar pointed out to the Central Board, not only was there no realistic hope of reserves being restored soon to the statutory minimum level, at the present rate of withdrawal even the additional Rs 100 crores that had become available would not last more than three months.

A further modification of the section 33 requirement was the obvious next step. The idea of doing away with the minimum (foreign exchange) balance provision was abandoned no sooner was it considered, for fear of its likely effect on public confidence in the changed situation. Such a step might equally create an impression abroad that the Indian authorities had given up all hope of controlling the drain. Besides, a minimum reserve provision might have some 'braking effect' on the government's ability to spend beyond visible means. However, Iengar also insisted that the new provision should be realistic and enable the Bank to carry on for a reasonable length of time without approaching the government repeatedly for its relaxation.

Though various other figures were talked about, the government decided in the end to prescribe a minimum reserve of gold and foreign securities of Rs 200 crores, of which an irreducible minimum of Rs 100 crores (on second thoughts raised to Rs 115 crores to preserve the status quo in this respect) was at all times to be held in the form of gold. Further, no lower limit of foreign securities was to be laid down in the event of an emergency covered by section 37 of the Act. Following the Committee of the Central Board approving these amendments, they were issued as the Reserve Bank of India (Amendment) Ordinance, 1957 on 31 October 1957, barely a year after the 1956 amendment bill passed into law. The Reserve Bank of India (Second Amendment) Act, 1957 passed to replace this ordinance further empowered the Bank to reduce its holdings of foreign securities in the Issue Department to any lesser amounts with the prior sanction of the government. Although debated and passed in

rather more controversial circumstances than its predecessor amendment Act, the bill aroused comparatively little opposition. The Finance Minister, T.T. Krishnamachari, sought to make a virtue of necessity by declaring in his speech introducing the bill that the country's foreign exchange reserves were useful only if they were freely available to be drawn in times of emergency and difficulty. In immobilizing so large a part of the reserve the country was foregoing its freedom for no obvious benefit. Allaying fears that the latest changes were a recipe for inflation which the Bank now lacked the power to check, he stressed that between the Parliament and the Reserve Bank, the system provided 'adequate machinery for exercising such vigilance as may become necessary from time to time in regard to the overall supply of monetary media in the economy'.

More Ad-hocism: The Search for Domestic Assets to Back Note Issue

Shortly after its decision to change the existing provisions for currency cover, the Bank was confronted with the problem of an imminent shortage of *domestic* assets for the Issue Department. Thanks to growing public and private investment expenditure, the demand for currency, which represented the liabilities of the Bank's Issue Department, rose steadily and the Bank apprehended that its ability to meet this demand would soon be constrained by the shortage of matching assets. The government's deficit financing operations and a payments surplus could both lead to increased demand for currency, but they also made matching assets (ad hoc treasury bills and foreign securities respectively) available to the Issue Department. From early in the second quarter of 1956, sterling securities were being depleted rapidly while bank credit to the private sector, financed largely by borrowings from the Reserve Bank of India, expanded. In the first instance these borrowings went to swell the assets of the Banking Department, but as they were withdrawn from the banking system in the form of currency, pressure was placed on the liabilities of the Issue Department. The Bank expected this pressure to increase, since in the wake of surging inflationary expectations during the past busy season, over three-quarters of the rapidly increasing money supply had taken the form of currency.

As noted above, the assets of the Issue Department were governed by section 33 of the Reserve Bank of India Act. Under subsection (3) of this Act, apart from gold coin, gold bullion, foreign securities, rupee coin, and rupee securities, assets of the Issue Department were to be held in the form of 'bills of exchange and promissory notes payable in India' which were eligible for purchase by the Bank under sections 17(2)(a), (b), and (bb), and 18(1) of the Act. While the last was an exceptional clause to be invoked only on 'a special occasion' or in an

emergency, such as for example a run on one or more banks, the other two sections allowed the Bank to purchase and rediscount bills of exchange and promissory notes arising out of legitimate commercial, trade, or seasonal agricultural operations. In practice however, the bulk of the Bank's lending to commercial banks was carried out against assets under sections 17(4)(a) (typically promissory notes issued by scheduled banks discounting government securities) and 17(4)(c) (documents pledged to the Bank under the bill market scheme) which were not eligible to be held in the Issue Department.

In May 1956, the Bank's officers began considering several means of tackling this problem. It seemed the longer-term solution lay either in assets created under sections 17(4)(a) and (4)(c) being made eligible as cover in the Issue Department or, carrying the measure one further step, doing away with the distinction between the Issue and Banking Departments. There were arguments in favour of both courses of action, but B.K. Madan objected to admitting in the Issue Department, assets 'which are known to assume large dimensions during a part of the year' since it would be 'definitely interpreted as throwing the floodgates of inflation wide open'. In contrast, although the abolition of the 'historic' distinction between the two departments was seemingly the more radical response, in the event of its adoption attention would be directed to 'general organizational aspects' and the 'public eye' might miss the 'particular part of the reform which helps the problem now under consideration'. Legislation in either event would be a long-drawn-out process. But a possible source of immediate relief lay in writing up the gold held in the Issue Department from its present book value of Rs 21-3-10 per *tola* to the official value (equivalent to \$35 per ounce) of Rs 62-8 per *tola* and retransferring the assets retired with these profits to the Issue Department pending the latter's final disposal.⁶

Views were also canvassed regarding a quick-fix solution—that of having the government issue ad hoc treasury bills in excess of its requirements. To some Bank officials in 1956 this solution appeared to offer more lasting relief than the transfer of revaluation profits. Besides it was easier to implement since, unlike changes in asset eligibility criteria or doing away with the distinction between the Banking and Issue Departments, no protracted legislative procedures were involved. There was, as we saw above, already an arrangement between the Bank and the government to create ad hoc treasury bills whenever the latter's balances with the Bank dropped below Rs 50

⁶ As the Bank's officers understood the legislation at the time, they were obliged to transfer the revaluation profits to the government, at the end of the month of June following the revaluation. For various reasons which need not be gone into here, the Bank preferred the profits to be deposited with it in a Special Reserve Account.

crores. A mere extension of this understanding, some officials at the Bank felt, would suffice for the purpose in view. On the other hand this would require suspending the practice the Bank followed of cancelling ad hoc treasury bills whenever the government's cash balances with it exceeded Rs 60 crores. Besides, other officials at the Bank, especially in the Research Department which was not consulted about the arrangement of January 1955, had grown wary of the consequences of expanding Bank credit to the government against ad hoc bills in an unregulated manner. Madan was unequivocally disapproving of a 'highly unsound' scheme which if carried into effect would oblige the government to increase its indebtedness to the Bank even when it had no need for the additional resources, indeed on the understanding that the government would not use its balances with the Bank for its own purposes.

Largely for reasons of public psychology and the distrust that might be evoked, opinion at the higher levels of the Bank was averse to doing away with the distinction between the Issue and Banking Departments. Expanding the class of assets which could be held in the Issue Department was regarded the more acceptable solution and it was decided to combine the legislative amendment required for the purpose with that enabling the Bank to retain the profits of gold revaluation in a separate reserve. But on further reflection it transpired that the Bank had earlier been wrongly advised and that it could retain the revaluation profits without the necessity of any amendment to its Act.

Even before this was known however, the Chief Accountant's Department had begun to dictate the course of events. Since April 1956 when this department first raised the 'purely hypothetical' prospect of a shortage of assets in the Issue Department, its officials favoured creating ad hoc treasury bills to overcome the problem, if necessary refunding to the government the discount charged on ad hocs to avoid straining its revenues and to weaken any resistance it might offer to the novel proposal. A note by V.G. Wagle in August 1956 carried this argument further, observing that, contrary to official claims and the Bank's fears of deficit financing on a large scale, 'the net amount of ad hocs actually created' during the first plan and the first four months of the second plan was 'only Rs 250 crores'. The note added that the large blocks of ad hocs the government created especially in March and September to pay states their shares of its revenues were mostly cancelled after state governments, which often had no immediate use for these receipts, invested them in central government treasury bills. 'The effect of the initial creation is, therefore, nullified by the subsequent cancellation and from our point of view these transactions have no particular significance.' Ambegaokar seems to have been persuaded by Wagle's argument, for he took up the

matter with the Finance Ministry on his next visit to New Delhi in August 1956. As Ambegaokar wrote, it was agreed at the meeting he held with officials at the ministry that, depending upon the Bank's needs, the government 'would be prepared to allow ad hocs to be created for our purpose or to maintain a larger cash balance for the time being'.

The Bank's Department of Research and Statistics, whose views had once again been ignored, fought a rearguard battle against this move. A detailed note by S.L.N. Simha in September 1956 pooh-poohed fears of a shortage of eligible domestic assets in the Issue Department and argued that no problems were likely to arise on this account for more than a year. He also drew attention to the 'persistent tendency' for rupee securities, 'representing mainly the creation of ad hocs' to increase in the Issue Department, and insisted that nothing should be done to encourage this trend. These views, as we have seen, already had Madan's support. But the die was cast. Ambegaokar appears to have felt confirmed in his earlier judgement by the new legal view, which now placed the Bank in the delicate position of having to seek another legislative amendment, this time for the sole purpose of modifying once more its rules of note issue. Not wishing to provoke further controversy the Bank shied away from such a step. In the Deputy Governor's view, the amendment would be unnecessary if the Bank could, as earlier agreed, 'rely on the Government coming to our assistance by allowing currency to be created against ad hocs in an emergency arising for a short while in the busy season'.

Rethinking on Ad hocs

Inexplicable as the Bank's eagerness to hold these assets might appear, it is sobering in retrospect to reflect that ad hoc treasury bills were seen at the time as a convenient means of keeping the government in funds, and later as a solution to what appeared to some officials at the Bank as a mere accounting problem in the Issue Department. The Bank's Research Department was not consulted in January 1955 and it was opposed to the course of action which the Bank proposed in August 1956. But its intervention failed to have any effect. Early in July 1957, Iengar was concerned enough to draw the Finance Minister's attention to a state of affairs where the creation of ad hoc treasury bills to maintain the government's closing balance each week had become a 'merely ... mechanical process', and no checks existed on the government's ability to spend without regard to the available resources. This was a recipe for disaster should a 'weak or careless Finance Minister' take office in Delhi. 'As matters now stand', the Governor declared, 'with an automatic expansion of currency at the will of Government, the Bank ... is not really in a position to discharge ... [the] responsibility' vested in it by statute of regulating 'the issue of bank

notes ... with a view to securing monetary stability in India'. Krishnamachari responded by rejecting the French practice to which the Governor had alluded in his letter, of subjecting the financing of the central government's ways and means to any 'rigid procedure'. The creation of ad hoc treasury bills was limited by the extent of the government's deficit financing proposals which were discussed with the Bank and had Parliament's approval. Declaring that the Reserve Bank would thus have 'every opportunity of discharging its responsibility of regulating the issue of Bank Notes ... with a view to securing monetary stability', the Finance Minister hoped that the Governor would be 'satisfied' so long as discussions about the government's borrowing programme and ways and means requirements 'took place in good time to enable the Reserve Bank to tender its advice ... [to] the Government'. Although consultations such as those suggested in Krishnamachari's letter did take place from time to time, the absence of any formal checks on the issue of ad hoc treasury bills greatly weakened the Bank's ability to influence their outcome.

Iengar's fears about the 1955 arrangement were not realized until after the end of the years covered by this volume. But despite Krishnamachari's assurances to the Bank, there were already signs during the second plan years that this facility was helping to loosen the purse-strings of the government. The net issue of ad hocs (i.e. those created less those cancelled) during the first plan years amounted, as noted earlier, only to Rs 250 crores. This figure shot up to Rs 945 crores during the second plan. Though it dropped to Rs 800 crores (or an average of Rs 160 crores per year) during the third plan, it rose once more to Rs 260 crores in 1966-67.

As pointed out above, the government agreed, largely at the Bank's insistence, to begin funding ad hoc treasury bills to a limited extent from July 1958 when the latter made up over 99 per cent of all securities held in the Issue Department. Ad hocs to the extent of Rs 300 crores were funded in July 1958 and Rs 150 crores in December 1959. Thereafter ad hocs of Rs 50 crores were funded each year (with the exception of 1963-64 when funding operations mopped up Rs 75 crores), the stated object being to continue operations at this level until the total volume of ad hocs outstanding was reduced to Rs 500 crores. But thanks to the rapid growth in the issue of ad hocs witnessed during these years, funding of this magnitude proved insufficient to make any impact on the Bank's holdings of these bills which rose steadily through the period covered by this volume to amount to about Rs 1,600 crores at the end of March 1967. Besides, the depressed conditions that overcame the gilt-edged market not long after funding began also helped attenuate the impact of the Bank's funding operations on the size of its net credit to the central government.

VARIABLE RESERVE REQUIREMENTS

Its founding Act gave the Bank few powers of direct control over the credit mechanism of commercial banks. But with increased public expenditure, rise in bank deposits, and the spread of the banking system, the Bank judged such control vital to effective monetary management. The power to vary commercial banks' reserve requirements was the additional instrument the Bank sought for the purpose. Taking this power required an amendment to the Reserve Bank of India Act, and the Bank took the opportunity yielded by the amendment on currency cover provisions to effect the necessary change in the Act.

Already since the war, officials at the Bank were in the practice of monitoring trends in the growth of banks' deposit liabilities and in the ratio of deposits to the total money supply. In India as in other countries with an underdeveloped banking system, currency was the predominant component of money supply. But the ratio of currency to money supply showed considerable short-term fluctuations. Experience indicated that the long-run trend in this ratio would be downward, but also that factors such as the rate of inflation could induce contrary trends in the shorter term. More than many other countries, India had been in the grip of price instability since the late 1920s and the ratio of currency to money supply mirrored this instability. After dropping sharply in the depressed 1930s the ratio rose through the inflationary war years, falling after the war ended before rising slightly in a rather belated reaction to the Korean boom. Thereafter the ratio remained mainly stable at around two-thirds until the late 1950s, rising from 1958–59 to peak in 1960–61 at about 70 per cent before falling off gradually thereafter.

To the Bank's officials, however, the latter developments were still in the future. In the mid-fifties they were faced with the expectation, or knowledge, of large deficit-financed investment outlays. The resulting increase in the demand for monetary media could be expected, in the first instance since the Indian economy comprised a large non-monetized sector and 'banking contact' did not coincide with 'trading contact', to take the form of a rising demand for currency. The expansion of the banking system would not immediately affect this 'cash drain' since in the initial stages banks too were likely to be merely another 'distributing agency for the note issue'. The preference for currency would be reinforced if the large plan outlays led to higher rates of inflation. Hence the reading within the Bank was that the ratio of currency to money supply would 'rise somewhat' at least for the foreseeable future. In the event, as the figures cited above show, the Bank's prediction of the likely future trend of the ratio was largely confirmed by later developments.

Though the impact of deficit financing was likely to be felt largely on currency, the Bank could not be indifferent to the rapid growth in the volume of bank deposits since the early 1950s. Deposit growth accelerated particularly from about the end of 1953, rising by a third within the next three years. Although there were some signs thereafter of a possible slow-down in deposit growth, there was little certainty about future trends. The banks' reliance upon Reserve Bank accommodation, markedly up since the inception of the 'new monetary policy' in November 1951, continued to grow. While this was propitious from the point of view of control over commercial bank credit, the Bank however apprehended that the government's deficit financing operations might undermine this prospect by placing 'independent resources' in the hands of commercial banks. Thus freed from having to depend on the central bank for accommodation, banks might prove less amenable to its control. By about the middle of 1955, therefore, desultory consultations were already under way within the Bank concerning the efficacy of varying reserve requirements in checking the expansion of commercial banks' credit.

Commercial banks operating in India have traditionally been subject to two types of reserve requirements. Under section 24 of the Banking Companies Act, all banking companies were required to hold at least a fifth of their time and demand liabilities in India in the form of cash, gold, or approved unencumbered securities. Although this stipulation did have implications for the banks' ability to expand credit, its object however was to preserve banking stability by ensuring that banks had enough liquid reserves to meet a drain, should one arise, on their resources. Besides, scheduled commercial banks were required, under section 42 of the Reserve Bank of India Act, to maintain with the Bank comparatively low minimum balances of five per cent of their demand liabilities and two per cent of their time liabilities, the latter reserve being counted as part of the banks' liquid reserves for the purposes of section 24 of the Banking Companies Act.

The Banking Companies Act did empower the Reserve Bank of India to regulate banks' advances and investments. Although seemingly giving the Bank powers only to regulate specific types of advances or transactions which it might determine in its discretion, the Bank could, in terms of section 21(1) of the Act, also impose a ceiling on the overall ratio of banks' advances to deposits. The Bank's power in the latter regard was never tested in practice but officials felt its use was beset with difficulties, in particular that a ceiling on advances would offend the freedom of banks to deploy their assets between advances and investments. Besides, a lowering of the ceiling might create a scramble for government securities and offset to some extent the contractionary effect of the lower ceiling unless the Bank itself began selling securities to

interested commercial banks. A raising of the ratio, on the other hand, would work only when a ready market was available for the securities which banks wished to offload, and might perhaps oblige the Bank to undertake open-market operations once again. In practical terms, therefore, the Bank's untested power to regulate the advances-to-deposit ratio of banks under section 21(1) of the Banking Companies Act might merely duplicate its existing powers to conduct open-market operations and give the Bank little *additional* power to control credit. In contrast, control over required *cash* reserves would affect the banks' *'total power'* to extend credit without interfering with their freedom of portfolio choice.

Hence, from the Bank's point of view, section 42 of the Reserve Bank Act offered the more promising possibility of acquiring an additional instrument, which was both handy and flexible, to control the expansion of bank credit. Before this possibility could be realized however, the Reserve Bank of India Act itself had to be amended since in its present form the Act gave the Bank no power to vary commercial banks' reserve requirements.

In the past too, the Bank had made attempts to acquire similar powers, but these had come to nought. In 1948 its efforts were overtaken by events. The Bank's Department of Research and Statistics revived the proposal the following year when, in the course of a general review of the Reserve Bank of India Act, it proposed an amendment empowering the Bank to vary minimum reserve requirements between five and twenty per cent in the case of demand liabilities and two and eight per cent in the case of time liabilities. During consultations, the government, while not being averse to the amendment in principle, advised the Bank against pressing for it so soon after the Select Committee on the Banking Companies Bill had rejected a similar proposal. In the event the question of pressing the amendment did not arise as the Bank's Central Board, for reasons which were not recorded for posterity, overturned its own Committee's recommendation and threw out the proposal. Against this background the Finance Ministry's proposal to change the basis of note issue, requiring as it did legislative approval to come into effect, lent a new sense of focus and urgency to the Bank's ongoing review of its powers to regulate credit expansion by commercial banks. But taking the power to vary reserve requirements while changes were being made to rules governing the note issue was not merely a practical convenience nor a happy coincidence. On the contrary, officials within the Bank recognized that a simultaneous move on the two fronts would accurately reflect the changing nature of monetary control in a growing economy characterized by large debt or deficit-financed public expenditures, with the quantum of bank credit especially to the private sector likely in due course to become relative to currency, an

increasingly important target of monetary policy. Therefore, in the Bank's view, a pair of amendments which had together the effect of exchanging the less relevant tool of monetary control, which in any case was no longer practical, for a more realistic and contemporary one would underline this shift to the advantage of the Bank and the government.

The tone of the Bank's arguments for a more flexible system of reserve requirements was set in a lengthy note by S.L.N. Simha and a shorter one by B.K. Madan. Part of the argument rested on the limitations of the other general instruments of credit control, viz. the Bank rate and open-market operations, especially in underdeveloped money markets. Where their deposits were rising rapidly under the impact of deficit financing and commercial banks did not need to approach the central bank for accommodation, the Bank rate would only be an indirect deterrent whose effect depended on how sharply it was hiked. Besides, the Bank rate had repercussions beyond the sphere of bank credit, for example on government borrowing, which the monetary authorities might independently like to avoid. In the absence of an articulate and broad-based market for government securities, the scope for open-market operations as a tool of monetary policy was also relatively limited. Given the narrowness of the market, even limited Bank intervention carried the risk of triggering disruptive price changes which might militate against maintaining orderly conditions in the market and increasing the appeal of government securities. Little would be gained, for instance, should the resources soaked up through open-market operations be reinjected into the economy through additional Bank lending to the government to meet its resources gap. In addition, no means were yet available to compel banks to buy government securities in the desired quantities. The most effective step open to the Bank, in such circumstances, was the defensive one, which it had been adopting since 1951, of refraining from making net *purchases* of securities. On the other hand, by a mere 'stroke of [the] pen', a variation in reserve requirements would produce 'instantaneous effects' upon the banks' ability to create credit. This instrument would be particularly effective in India since a majority of the banks operating here preferred not to hold reserves much in excess of the statutory requirements.

A system with variable reserve requirements did present some disadvantages. For one, it might create some uncertainty for the banks, especially if reserves were frequently varied. Besides, it would affect all banks without regard to the quality of their loan portfolios from the point of view of the needs of the community. While this drawback was common to all general instruments of credit control, it was however possible to implement a system of flexible

reserves, as several countries were already doing, with an eye to features such as the size of banks and their location, Simha argued.

These general arguments in favour of the Bank acquiring the power to regulate commercial banks' reserve requirements were reinforced in the particular context of the Indian economy at the time. Bank credit to the private sector was beginning to boom, the increase in 1955–56 alone being larger than the total bank credit extended to this segment during the preceding four years. Although the second five-year plan had yet to be adopted, enough was known about it to suggest that the planned public sector deficit would be of the order of Rs 1,200 crores. Simha, as others within the Bank at the time, did not believe a change in the ratio of currency to money supply very likely in the near future and expected the increase in the Bank's credit to the government taking the form very largely of currency. Demand deposits, he felt, were unlikely to register an increase of more than Rs 400 crores or a third of the anticipated public sector deficit during the plan; and since little scope existed for multiple credit expansion, the total expansion of bank credit during the second plan period was also likely to be of a similar magnitude. While there would be no fear of runaway inflation if only this scenario was realized, the actual extent of deficit financing might be much larger than planned. Nor could the likelihood of 'unhealthy credit inflation' be accurately visualized at every stage. Should such inflation materialize, Simha argued, the success of the development programme itself could be at stake. Therefore, it was 'prudent to have as many reserve powers at our disposal as possible' so that if necessary, action might be taken 'on a variety of fronts simultaneously'.

The Bank's internal notes also emphasized that while monetary policy was generally more effective as a deterrent, the ability of the central bank to stimulate the economy through appropriate forms of intervention should not entirely be overlooked. Recent events following the end of the Korean boom showed that a flexible monetary policy could yield 'surprisingly good results ... in ... toning up' a sluggish economy. Here too, the power to alter banks' reserve requirements, in this case the power to release banks' reserves, would prove useful to the Bank. 'Fixed reserves may be alright in a static economy, but a dynamic economy requires a variable system.' Broadly endorsing Simha's arguments, B.K. Madan remarked on the advantages of deploying general credit control instruments in an integrated way:

a combination of a small increase in the ratio of required reserves with a small rise in the Bank Rate and a small decline in security values might yield more effective results than a larger increase in the Bank Rate with no increase in required reserves.

At Governor Rama Rau's instance, the Bank's Department of Banking Operations examined the proposed move and came to the opposite conclusion. It reasoned that reserve requirements in India were already quite high and that should it wish to, the Bank could use its powers under the Banking Companies Act to curtail advances. The department also drew attention to the danger of banks implementing enhanced reserve requirements by reducing their holdings of government securities.

Internal differences notwithstanding, the Bank resolved to acquire powers to regulate banks' reserve requirements as necessary. In its final form the Bank's proposal envisaged varying these requirements between 5 per cent and 20 per cent of banks' demand liabilities and 2 and 8 per cent of their time liabilities. In order to make the instrument more elastic and flexible in application, the Bank also sought the power to impose reserve requirements of up to 100 per cent in respect of banks' additional deposits, subject only to the overall reserve limitation for the two deposit categories. Since banks incurred a cost, in the shape of interest charges, on their deposits, the Bank favoured paying commercial banks 'moderate compensation' at a rate it would be free to determine on the additional reserves impounded in excess of the statutory minimum.

The Bank's proposals aroused some opposition from the business and the banking communities. The Federation of Indian Chambers of Commerce and Industry (FICCI) argued they were unnecessary, since the government had repeatedly voiced its intentions to keep deficit financing within manageable limits. The new measures would also discriminate against the more enterprising banks which succeeded in mobilizing larger deposits. Questions were also raised about the interest rate which the Bank would pay on the additional reserves, and fears expressed that higher reserve requirements would immobilize banks' working capital and affect their earnings adversely. The FICCI demanded that if the measure was judged to be absolutely essential, the Bank's powers to vary reserves should be limited to twice the minimum requirement. The Indian Banks' Association (IBA) also took exception to the new proposals. It protested against vesting in the Bank additional powers whose need was not dictated by past experience. Indian banks had amicable relations with the central monetary authorities and had cooperated fully with the latter's recent directive (May 1956) to reduce advances on paddy and rice. So far there had been no occasion when past conventions and practices had failed to yield the intended results. The new powers proposed to be given to the Bank, the association argued, could have serious repercussions on the monetary and credit structure of the economy. Banks' profitability would suffer and they would be obliged to transfer some of the additional costs to

their customers in the form of higher charges. If enhanced reserve requirements were thought to be unavoidable, it suggested, they should be imposed only in respect of additional deposits, and the Bank should be required to pay interest at the Bank rate on such reserves.

Both when the bill was in draft and in the course of its public airing, the government was generally supportive of the Bank's efforts to arm itself with additional authority to restrict commercial banks' capacity to expand credit. However, it sought for its own clarification more details on how the proposed measure differed from or reinforced the existing powers of the Bank to regulate commercial banks' advances under the Banking Companies Act. The government also had reservations about the overall limit which at 20 per cent was felt to be too high, and proposed for the Bank's consideration a lower ceiling of 15 per cent. In response the Bank argued that any figure for the ceiling would be arbitrary and that there was a strong case, from the point of view of perfect flexibility, for not prescribing a ceiling and leaving the ratio to be fixed entirely at the Bank's discretion. However, the range had been prescribed to disarm possible criticism and a further reduction in the ceiling would diminish the Bank's power to control credit. Following the Bank's reply the government took public criticism in its stride and the Bank's proposals to amend section 42 of the Reserve Bank of India Act were incorporated in the bill without much change. For all the controversy it had generated earlier, this amendment too evoked relatively little debate in Parliament. Passed into law in October 1956, the new powers were deployed briefly, and unsuccessfully as we will have occasion to observe in the next chapter, in 1960, any systematic recourse to them having to await the inflationary developments of the early 1970s. In the meantime, in 1962, the practice of setting different reserve ratios for demand and time liabilities was done away with and the Bank given the power to vary the unified ratio between 3 per cent and 15 per cent of scheduled banks' demand and time liabilities. At the same time the liquidity provisions of the Banking Companies Act were amended and rechristened with unconscious irony as the Statutory Liquidity Ratio (SLR). As part of this reform the cash reserve requirements under the Reserve Bank of India Act were separated from the liquidity provisions of the Banking Companies Act, so that banks could no longer count their minimum cash reserves towards their liquidity reserves. As discussed in chapter 11, these changes were intended principally to bolster banks' liquid resources which had been declining as a proportion of their deposits since the mid-fifties. But once in place the ratio was varied by executive order to restrict banks' ability to lend to the private sector and siphon their resources into lending to the government sector. As discussed in chapter 4, soon after the new statutory liquidity requirements

came into effect in September 1964, the Bank also introduced the concept of a net liquidity ratio to regulate commercial banks' borrowings from it. This new concept and the accommodation regime based upon it compounded the effect of the new statutory liquidity ratio on banks' portfolio decisions inasmuch as they were now forced in effect to choose between increasing their investments in government securities (despite the increasingly unattractive returns these offered) or paying more on their borrowings from the Bank.

Meanwhile, as elaborated in the next chapter, the Bank took increasing recourse during these years to selective credit control measures. A beginning was also made from the early sixties to direct the flow of bank credit to certain preferred sectors of the economy such as defence industries, exports, small industries, collieries, and agriculture. Together with the succession of seemingly unconnected and minor changes in rules and practices governing central government cash balances, state governments' working balances and overdrafts, and the reserve and liquidity requirements of the banking system, these developments had the cumulative effect of gearing the country's monetary and credit system first towards accommodating and then towards meeting the financial needs of a resource-hungry public sector, and dealing residually with the credit needs of those segments of trade and industry that lay outside the preferred sectors. Innovative as the Bank was in its efforts to implement these evolving priorities, they had some altogether unintended consequences for government finances, the health of the banking system, and for private trade and industry. The Bank saw these dangers clearly enough at various times. But they were by no means judged to be inevitable, more so since many of the policies adopted in the 1950s and 1960s were regarded, even as late as the mid-sixties, as temporary and reversible expedients. Besides, the incremental nature of the changes that overcame the monetary and credit system during these years perhaps blurred, to some extent, the Bank's vision of the larger emerging picture: that even by the mid-sixties its credit policies were threatening to become on the one hand exercises in the 'physical' allocation of bank funds between the government and the private sector, and on the other exercises in the rationing of these resources across competing claimants, some of whom were preferred and others were not, from within the private sector.

Once the picture cleared however, it became apparent that it blended quite well with the emerging intellectual environment which now generally favoured discretionary methods of intervention in several spheres of the economy. Though some officials within the institution voiced their doubts and Bhattacharyya himself remained sceptical, the Bank too, was not altogether immune to the influences of this environment. Indeed, far from being defensive

about their subordination of general instruments of regulation to sectoral or selective ones, by the end of our period or shortly afterwards, senior officials at the Bank began actively to champion departures from inherited doctrines of monetary policy to better meet the development needs of a planned economy. Ineluctably, perhaps, this advocacy soon extended beyond the comparatively narrow confines of monetary policy or sectoral credit flows, to focus on the ownership and organization of the banking system. The latter issues, however, lie beyond the scope of these chapters and the present volume of the Bank's history.

Monetary Policy, 1951–61

The 1950s were years of substantial price fluctuations in India. The outbreak of the Korean war in June 1950 sparked off inflation worldwide, and India was no exception. The general index of Indian wholesale prices (base 1939=100) rose from the pre-Korean war level in June 1950 of 397.1 to 449.6 by the end of March 1951. Although a sharp break in commodity prices followed thereafter, particularly from June onwards, traders continued to take a bullish view of the future. This was reflected in the credit situation. Scheduled banks expanded credit by Rs 182 crores during the 1950–51 busy season, but the ensuing slack season witnessed a return of funds to the tune of only about Rs 86 crores. As a result, the seasonal low in the level of outstanding advances at the end of the slack season was about Rs 95 crores higher than the corresponding figure at the end of the preceding slack season. This, to the Bank, represented a clear sign that bank credit was being used to finance speculative stockholding. The first five-year plan which was then getting under way heightened the Bank's concern about latent inflation and the resulting distortion in the allocation of resources it might cause. The balance of payments deficit, widening since the second quarter of 1951, was another worrying factor. Further, with the arrival of the busy season, the demand for credit remained strong and banks sought to augment resources by reducing their holdings of gilt-edged securities. The policy of supporting the latter's prices through appropriate intervention was an essential ingredient of the cheap money policy adopted for many years. But thanks to the rising demand for bank credit, the Bank's open-market purchases which had averaged about Rs 86 crores annually in the preceding quinquennium, rose steeply to Rs 155 crores in 1950–51.

THE FIRST PLAN, 1951-56

The Bank believed, on the whole, that its support to the gilt-edged market had been 'discriminating and qualified'. But it led, in the words of P.S. Narayan Prasad who was the Bank's Economic Adviser at the time, to an 'exchange' of 'liquid money for securities', 'provided a basis for the expansion of credit by commercial banks', and caused the monetization of the public debt. Inflation could not be tackled, Narayan Prasad argued in October 1951, unless the 'net additions to money supply arising from the Reserve Bank's support of the securities market and ... the structure of yield rates which calls for such support' were eliminated. But a rise in the yields on government securities unaccompanied by a rise in the Bank rate might lead to banks expanding credit by borrowing from the Reserve Bank. Therefore it was necessary to 'apply restraint at both points', and raise the Bank rate too by half a percentage point from the prevailing 3 per cent.

THE NEW MONETARY POLICY

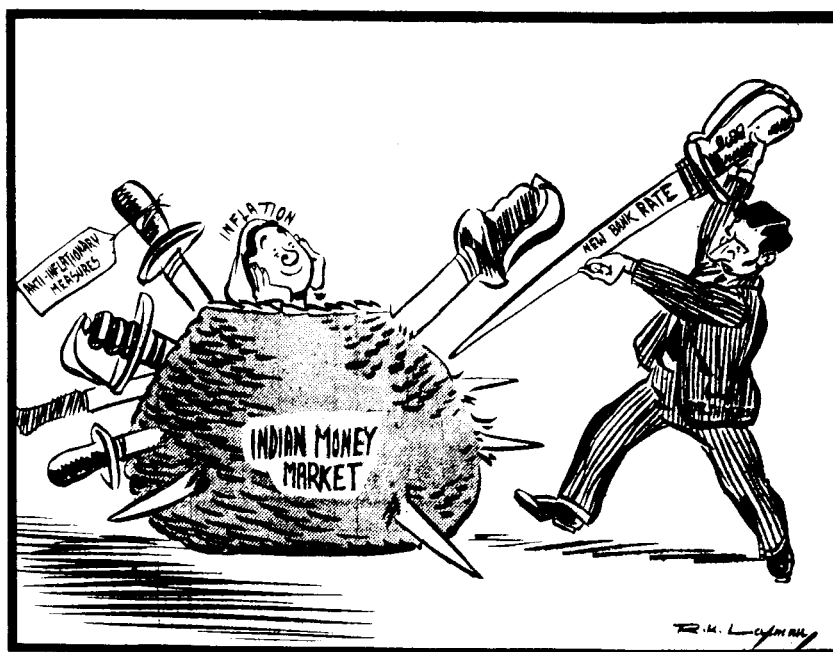
Prasad's 46-page memorandum came at a fairly advanced stage in the Bank's deliberations on an appropriate monetary response to the situation prevailing in the autumn of 1951. The Bank had been considering a move at least since August 1951 when the Governor, B. Rama Rau, resolved in consultation with the Finance Minister, C.D. Deshmukh, that an increase in the Bank rate, possibly by half a percentage point, had become unavoidable. The formal decision was however postponed until the middle of October. But with the busy season getting off to a sluggish start the decision was further put off to the middle of November. Finally on 15 November 1951 the Bank put up its lending rate to 3.5 per cent. At the same time it also decided, 'save in exceptional cases', to discontinue purchases of government securities from scheduled banks during the rest of the busy season.

These decisions marked an important departure from the Bank's earlier stance. Since November 1935, when the Reserve Bank of India itself had only been in existence for a few months, the Bank rate had stayed, seemingly unshakeably at 3 per cent which soon became a symbol of 'cheap money'. This rate, if not the underlying policy, had endured many political and economic vicissitudes, and more than one Finance Minister who wished for one reason or the other to see it changed. In the absence of an active bill market the Bank rate was the interest rate the Reserve Bank charged on its advances to scheduled banks. Until the early 1950s the Imperial Bank of India too, was a major source of accommodation for scheduled banks, and the Reserve Bank's rate was of relatively little practical use as an instrument of monetary policy so



Benegal Rama Rau, Governor, 1949–57

long as the former's call rate on advances was the lower of the two. The last few busy seasons had witnessed a gradual hardening of credit. The Imperial Bank's *hundi* (indigenous bill) rate, stationary at 3 per cent since November 1935, was raised to 3.5 per cent in January 1949 and to 4 per cent in January 1951. During the 1950–51 busy season the Imperial Bank also raised its call rate for advances of Rs 5 lakhs or more to scheduled banks against government securities from 2.75 per cent to 3 per cent, and that on loans below Rs 5 lakhs from 3 to 3.25 per cent. The major bazaar bill rates and the rates charged by exchange banks on overdrafts too, had been nudging upwards since the last two busy seasons. The general hardening of the Imperial Bank of India's lending rates encouraged banks to approach the Reserve Bank for accommodation and helped revive the Bank rate from its earlier dormant state. But as we saw above, the Bank apprehended excessive credit expansion should its rate became operative at 3 per cent, and felt justified in putting it up by half a point. Although inevitably in this instance, the Reserve Bank of India followed the market rather than led it and the hike in the Bank rate was intended to bring the latter in line with the changes that had already taken place in the interest rate structure, the Imperial Bank responded by raising its discount rate for *hundis* from 4 to 4.5 per cent and its general rate on advances

INVULNERABLE

— *Tol*, 18 Nov. 1951

to 4 per cent. Other scheduled banks also raised their deposit and lending rates by up to half a percentage point. The November 1951 decision thus marked the end of a lengthy period during which the Bank followed a passive interest rate policy, if not yet the inauguration of a more active one. The Bank rate stayed at 3.5 per cent until 1957 and was put up successively until 1965 when it reached 6 per cent, before being lowered to 5 per cent in March 1968.

The decision to 'refrain' from buying government securities was also a major departure from past practice, not to mention a significant aberration in the light of later developments, since for the moment at least, Bank policy was not dominated by the need to protect the market for government borrowing to the exclusion or neglect of other objectives. This move, which was signalled somewhat unusually through a press communique whose draft Rama Rau wrote in his own hand, was made in consultation with the government. Besides being essential for the success of the policy of dearer money, it was also justified on its own merits. The persistence of inflationary expectations in India and the lifting of some wartime import controls boosted the demand for

credit to finance stockholding and imports. Although the option of borrowing against government paper was always open to them, increasingly commercial banks preferred to augment their liquid resources by selling government securities. The Bank viewed this trend with growing disapproval since it led to monetizing the public debt and involuntary additions to base money in the midst of inflationary pressures.

The Bank's new open-market policy undoubtedly gave teeth to the Bank rate. With the closing of the repurchase window, the Bank's advances to commercial banks against government securities spurted from Rs 20 crores in 1949–50 and Rs 48 crores in 1950–51, to Rs 167 crores in 1951–52. But the Bank was not inclined to worry. The increase was only to be expected. Besides, the Bank judged that this mechanism was more likely than the one it had displaced to promote a reverse flow of funds during the slack season. In the event, seasonal advances to scheduled banks outstanding at the end of June 1952 amounted to only about Rs 1.68 crores. Greater elasticity in the seasonal expansion and contraction of credit was also an objective of the bill market scheme which, as discussed below, was instituted within weeks of the new monetary policy. Finally, the greater reliance banks placed on advances from it, the Bank hoped, would promote more frequent contacts with them and conduce to 'better mutual understanding ... in the context of the responsibilities placed on the banking system in the Five Year Plan'.

More immediately, however, the new policy on open-market operations depressed prices in the gilt-edged market. The trend in the latter market had been downward for almost a year, with the Bank supporting 3 per cent long-dated paper since December 1950. The Bank, according to the Deputy Governor, N. Sundaresan's weekly letter to the Finance Ministry written a couple of days after the new monetary policy was announced, remained in the market till as late as two-thirty in the afternoon of 14 November 'in order not to give any indication of an impending change' of policy. With the result, the market 'felt completely stunned' when the new policy was announced. Although trading was nominal when markets opened the following day, prices fell quite sharply. The decline was most pronounced in the case of long-dated and non-terminable securities, the pivotal 3 per cent 1986 Conversion Loan, quoted since 17 September at the support price of Rs 92-11, dropping to Rs 87-8 on 15 November. Yields on gilt-edged paper of various maturities tended to get dispersed as trading remained nervous and speculative for a few days; while the spread between these yields and those on other securities such as company debentures narrowed. In an effort to calm a skittish market the Bank issued another press communique on 20 November carrying a summary of the Governor's interview that day with bankers in Calcutta during which he was

reported to have declared that the Bank was 'responsible for the maintenance of the financial credit' of the government and that 'if the circumstances justified such a course' it would 'take appropriate measures to maintain government credit'. This statement managed to offend the Finance Minister who took a dim view of the Bank's perception of its own role in safeguarding the government's credit, but did little to reassure the markets. Although sentiments remained unshakeably bearish especially in Calcutta, the Bank appears to have felt in the absence of 'transactions of any magnitude' that the market quotations were largely nominal. According to Rama Rau, 'whenever there was an enquiry for the investment of a fairly large sum ... the prices quoted are much higher than the nominal market value'. 'Speculative activity', he argued, had brought about the fall in market quotations and 'no two brokers agreed on all the quotations'.

This brave front soon began to give way, however. Towards the end of November 1951 some 'peevisish' traders in Calcutta sold small quantities of the 1986 loan at Rs 80-14 when the Bombay quotation was Rs 82-8. Subsequently the market appeared to be steadying at Rs 80-12, with the Bank still preferring to wait upon events. But on 3 December a Calcutta broker, 'whether out of mischief or ignorance', sold the paper at Rs 79-6. Fearing any further fall to have 'very serious repercussions', the Bank decided in consultation with the government to resume support to the 1986 loan at Rs 80.

The new measures were not free from public controversy either. The announcement of Mint Road's decision to stand aside from the market raised many eyebrows, some commentators observing that it marked a departure from the central bank's tradition of secrecy with respect to the affairs of its most important customer, and that a less publicized (and 'amateurish') withdrawal may have cushioned the fall in gilt-edged prices. The latter's steep decline also provoked criticism. Accusing the Bank of being 'nobly absorbed' in pursuing 'orthodox principles of finance', a financial paper charged it with indifference to securities shedding 'a few hundred millions or a few hundred crores' and inflicting capital losses on commercial banks and insurance companies holding large volumes of these assets. In the event, responding to representations from bankers who apprehended the impact on public opinion of lower dividends and the publication of balance sheets showing losses on their investments, the Bank advised the government to exempt banks from the legal requirement of having to show in their balance sheets and accounts the market value of their investments on the last day of 1951, and to waive the application of sections 15 and 17 of the Banking Companies Act. The section 15 waiver enabled banks to pay dividends without writing off the depreciation

in the value of their investments in approved securities so long as they did not capitalize the depreciation or account for it as a loss. The original section 17 of the Banking Companies Act was thought to prevent banks from making appropriations from reserves to write off losses on their investments until the former equalled or exceeded their paid-up capital. This provision too was relaxed through an executive order to enable banks to write off the depreciation if they chose to do so.

The revival of the Bank rate as an effective tool of monetary policy, after a long interval during which it had had little bearing on the level and structure of interest rates in the market, was generally welcomed. But some critics saw the decision, which came a week after the Bank of England put up its discount rate, as a sign of the latter's tutelage over the younger central bank.

Anticipating the criticism that it was following blindly in the footsteps of the Bank of England, the press communique announcing the change in its lending rate (which too was drafted by the Governor) disclosed that the Bank and the government had arrived at this decision as early as August. This statement too failed in its intended purpose, and merely led to suggestions in some sections of the press that members of the Committee of the Central Board were aware of the impending change even in August. The actions of a Bombay trader who sold large stocks of gilt-edged paper for an eventual profit of about Rs 5 lakhs also fuelled rumours of a leak.

For its part, the Bank issued a statement asserting that no advance notice of its rate increase was given even to its Directors. This statement too, failed to please, one paper deriding it as an 'unwarranted "apologia"' because the 'very fact that the market was shocked by the suddenness of the Bank's decision' offered abundant proof that 'there was no leakage of information'.

THE BILL MARKET SCHEME

Although instituted as an afterthought in January 1952, the bill market scheme has since come to be regarded as an ingredient of the new monetary policy inaugurated in November 1951. The scheme aimed to provide eligible banks a mechanism they could use to obtain advances from the Bank against specially created bills of a self-liquidating character. Advances under the scheme were granted under section 17(4)(c) of the Bank Act against bills satisfying section 17(2)(a) of the same Act, i.e. those arising out of bona fide commercial or trade transactions, having a maturity not exceeding ninety days, and bearing two or more good signatures including one of a scheduled bank. To avail of advances under the scheme, eligible scheduled banks were required to convert their borrowers' demand promissory notes into usance promissory notes

maturing within ninety days and lodge them with the Bank as collateral. They were also free, generally, to withdraw any of these bills or to replace them with other eligible bills. The scheme, according to its promoters, thus combined 'the advantages of the cash credit system with those of the bill of exchange'. Advances under it were originally made at one half of one per cent below the Bank rate, with the Bank also agreeing to meet half the stamp duty charges on eligible usance bills. As introduced in January 1952, the scheme was confined to scheduled banks having deposits of Rs 10 crores or more. The minimum amount a bank could borrow at a time and the minimum value of each individual bill lodged as security were fixed at Rs 25 lakhs and Rs one lakh respectively. The first advance under the scheme was made in February 1952, yet by the middle of April that year limits aggregating to over Rs 44 crores had been sanctioned to eight eligible banks, six of whom availed of advances to the tune of over Rs 29 crores. Over the next few years the scheme was expanded to cover a larger number of banks, the minimum amount banks could borrow and the minimum value of each individual bill were both lowered, the usance period was increased to 180 days, and export bills were also brought under its purview. The Bank devoted serious thought at various times to bringing *hundis* under the scheme but refrained from doing so since not all *hundis* arose in the course of trade. Besides, it was difficult to ascertain reliably, the creditworthiness of borrowers issuing *hundis*.

As its name suggests, the new scheme was represented as a step towards creating a market for bills in India. But it also signalled the coming together of certain other objectives and considerations. The scheme was modelled principally on a practice prevalent in the 1920s and the early thirties to relieve seasonal stringency in the money market whereby the Currency Department of the Government of India (corresponding to the Issue Department of the Bank) made advances to the Imperial Bank against internal bills of exchange, *hundis*, and against bills the bank created out of advances it had made for the 'furtherance of trade'. At least twice earlier, during the 1947-48 busy season and again in July 1948, the then Governor, C.D. Deshmukh, considered reviving this practice which had fallen into disuse more than a decade earlier. However banks responded coldly to the idea, maintaining that the existing provisions of the Bank Act were 'sufficient to meet the normal or seasonal requirements of banks' for funds, and that the real need was to give the Bank more powers to make advances to scheduled and non-scheduled banks in an emergency. The Bank then concluded that no special measures were needed to relieve the market during the peak season.

In 1951-52 however, the decision to institute the bill market scheme by adapting the earlier precedent was taken and implemented in record time.

The initiative for the scheme came from the very top, Rama Rau appearing to have decided to seize the opportunity presented by the new monetary regime to put in place a supplementary system of advances that would enable the Bank to 'follow the utilization of the funds' it advanced to commercial banks. Hence a little more than a week after the new monetary policy was unveiled, the Governor held discussions with Roderick Chisholm, the Managing Director of the Imperial Bank of India, about 'the development of a bill market in India or, in the alternative, expansion of currency for seasonal requirements' against bills of exchange 'manufactured' by converting demand promissory notes of borrowers into usance bills. Rama Rau's earliest discussions with Chisholm on this subject took place on 23 November. Three days later Chisholm sent the Bank some papers dealing with interwar arrangements to relieve monetary stringency in the peak season. The same day officials at the Bank went to work, examining the possibility of adapting the historical practice to current requirements. The Department of Banking Operations' sceptical note on the subject was finalized on 29 November. Disregarding departmental reservations, the Governor passed his orders the following day asking for a draft scheme to be prepared for circulation and discussion. This was done within the next four days. There was some delay at this stage, bankers consulted about the proposals taking nearly a month to react. But by 12 January 1952 the Committee of the Central Board had approved the scheme and the circular announcing it was issued four days later.

The speed with which the bill market scheme was prepared and adopted should not be allowed to obscure the mixed feelings officials within the Bank entertained about it. The idea of reviving the interwar procedure to relieve peak season stringency did not fill the Department of Banking Operations with enthusiasm. A note by T.V. Datar, its Chief Officer, recalled the many difficulties the Bank had earlier apprehended would arise in working a scheme that depended largely on converting demand notes into time notes. Constituents might resist such conversions not least because of the stamp duty liability involved and were likely, in any case, to be unfamiliar with the requirements they would have to satisfy before their banks could take advantage of the facility. Ascertaining the financial standing of borrowers did not present major problems in the earlier arrangement which was confined to the Imperial Bank. Any similar scheme implemented now would have to include other banks. But an expanded scheme, Datar warned, would mean delaying approvals of individual limits for banks' constituents until the Bank had had an opportunity to satisfy itself about their standing. The alternative of accepting banks' certificates regarding the creditworthiness of their borrowers was full of risk. Datar also wondered whether as a 'measure of long-term policy', the Bank

should not seriously reconsider its support to 'banks even for seasonal requirements'. Deposits of banks

are fairly stable, while ... advances are rising year after year If the liquidity of the banking system is to be maintained, it would perhaps be worthwhile urging the banks to make a concerted drive to reduce their normal commitments so that their recourse to the Reserve Bank during the busy season would not strain their liquidity to ... breaking point.

If legal and practical difficulties were overcome and it was decided to institute the new system of advances, Datar cautioned, it would be necessary

to confine it to a few large and sound banks which may be relied upon to hold ... bills in their custody on behalf of the Reserve Bank, to hand over to us a certificate of the bills held along with their promissory notes, and to pass on the proceeds to us when the bills are realized.

In drawing attention to the liquidity aspect of banks' seasonal operations Datar anticipated an important consideration underlying the adoption more than a decade later of an accommodation regime based on banks' net liquidity ratios (or NLRs). But neither his reservations nor those of the Legal Department, which raised a number of largely procedural objections, cut much ice with Rama Rau whose response to Datar's note was to direct his department 'urgently' to draw up 'details of a practical scheme' for discussion at the next meeting of the Central Board (emphasis in the original). The rest is history.

The bill market scheme was accorded a favourable, even rapturous welcome by a market that had grown distinctly nervous about the impact of the Bank's new monetary policy. According to *Indian Finance*, Rama Rau had shown the 'correct insight into the needs of monetary institutions' affected by the new monetary policy. Six weeks later when the Bank announced having made advances totalling Rs 11 crores to banks against usance bills, *Indian Finance* was ecstatic. The scheme represented the 'first planned steps for a bill market' and from this point of view, the journal remarked with not a little exaggeration, its commencement would remain a 'memorable' event 'in the annals of the Indian money market'.

It is clear however in retrospect that much of the enthusiasm for the bill market scheme was misplaced. Though the scheme purported to pave the way for a bill market in a system dominated by loans, cash credits, and overdrafts,

it became merely a supplementary means of replenishing banks' resources. There were a number of reasons for this outcome, but chiefly the scheme itself was a flawed one in significant respects. Even if it was realistic to expect banks and their constituents to graduate over time from bills 'manufactured' by converting cash credit to genuine trade bills, the 1952 scheme created little incentive for them to do so. Consider here the provision for lodging bills as collateral, or the practice of sanctioning credit limits to banks' constituents qualifying for advances under the scheme and allowing the former to replace maturing bills with new ones. Clearly, neither feature was calculated to enhance the prospects of a bill market coming into existence in India. On the demand side too, many constituents of banks were nervous about the scrutiny their borrowing under the scheme attracted from the Bank. In the beginning, particularly, scrutiny sat lightly upon borrowers. Rejection rates were low, and early in the life of the scheme the Bank decided banks should not force their clients to submit balance sheets since doing so would 'add to the difficulties experienced ... in persuading [them] ... to convert advances into bills ... and hamper the working of the scheme'. Scrutinies became somewhat less cursory in subsequent years, but even as late as July 1955 a decision by the Bank's officers to reject an application from the Punjab National Bank for a 'bill market' credit limit to be made available to a Kanpur trader evoked fierce debate within the Bank; with Rama Rau, who took a great personal interest in the working of the scheme and who asked to be consulted about all decisions to reduce or reject limits, expressing astonishment that the Bank should turn down the proposal 'merely because ... he [i.e. the client of the bank] is interested in purchasing silver bars on behalf of speculators'. In the end Rama Rau yielded to the judgement of his subordinates, but in general too, from the second half of the 1950s, the Bank became more sensitive to the 'quality' of the credit supported by usance bills presented by banks. As a consequence, banks and their constituents grew more wary of approaching the Bank for accommodation under the scheme.

To some extent the bill market scheme was undermined during Rama Rau's own tenure as Governor by the government's decision to increase the stamp duty on bills. The details of this particular controversy and its fallout, in the form of Rama Rau's resignation as the Governor of the Bank in January 1957, are related in a later chapter. Suffice it for the present to point out that at the end of November 1956 the government mooted proposals to raise the stamp duty on usance bills forty-fold from two annas per Rs 1,000 to Rs five (or 80 annas). Early in 1956 the Bank had felt emboldened enough by the success of the bill market scheme to reduce or withdraw the concessions

extended to advances under the scheme. From November 1956 advances under the bill market scheme too, were charged interest at the Bank rate of 3.5 per cent. But the cost of borrowing under the scheme exceeded the Bank rate by the extent of the stamp duty on the usance bills created by the borrowing bank, with the State Bank of India, for example, calculating in December 1956 that the effective cost to it of funds under the bill market scheme exceeded the Bank rate by 0.39 per cent even at the lower stamp duty rates then prevailing. The steep increase in the stamp duty the government now proposed threatened to extinguish the bill market scheme altogether since the effective cost of borrowing under it was expected to exceed 4 per cent per annum, while banks could avail of loans against government securities at the Bank rate of 3.5 per cent.¹ However, more than the government decision which led to it, Rama Rau's exit represented the more permanent setback for the bill market scheme. Advances under the scheme peaked at Rs 560.6 crores during the 1956–57 busy season. But thanks both to demand-side factors and to the Bank beginning to view accommodation under the scheme with a certain amount of disfavour, advances slumped sharply in each of the next three years to bottom out at Rs 85.4 crores in 1959–60. The bill market scheme however continued for several years more during which it was also expanded to include export bills with maturities of up to six months. Advances under it also rose in the mid-sixties from the low levels they had touched at the turn of the decade. But the scheme never quite recovered to the position of importance it had occupied in the Bank's priorities during the Rama Rau years.

Neither the government nor the change in the stewardship of the Bank can however be blamed for the scheme's lack of success. Even within the Bank there was a certain lack of clarity about the objects of the bill market scheme. As we saw earlier, Rama Rau's note of his discussions with Roderick Chisholm mentioned easing seasonal stringency in the same breath as creating a bill market. The early notes prepared by the Department of Banking Operations did not regard the scheme as a precursor to the creation of a genuine bill market but as an alternative to it. The scheme, according to the department, was thus a second-best solution which would enable the Bank to follow the utilization of the funds it advanced to banks and ensure their repayment at the end of ninety days. But in the event, as pointed out above, allowing banks to replace maturing bills with new ones meant there was no

¹ The effective cost of borrowing under the bill market scheme typically exceeded the Reserve Bank's lending rate plus the stamp duty, since banks did not always utilize their bill market limits in full.

automatic tendency for advances to be called in at the end of three months. Six months after the scheme was instituted, the Department of Banking Operations persisted in viewing it as a supplementary replenishment arrangement and proposed discontinuing accommodation under it for the duration of the slack season since banks' liquid resources had increased and interest rates in the money market were coming down. But Rama Rau rejected the suggestion. Arguing that 'the office' had not 'understood the objects of the scheme' which was 'designed to create a bill market in India as a permanent measure', he insisted that it must 'of course continue even during the slack season'.

As later events showed, the Department of Banking Operations' view of the arrangement was the more realistic one. Commercial banks, as a study group appointed by the Bank in 1970 on enlarging the use of the bill of exchange and creating a bill market remarked, used the scheme merely as a source of supplementary accommodation in the peak season on the basis 'of improvised bills'. Officials within the Bank had been aware of this for some time, but it was not until H.V.R. Iengar (who did not entirely share Rama Rau's enthusiasm for the bill market scheme) became Governor that the Bank began considering ways of encouraging commercial banks to use its facilities 'sparingly and exceptionally'. Borrowers too grew notably less enthusiastic about the scheme except during periods when their banks faced an acute shortage of liquid resources, more so after the Bank put up the cost of its accommodation and began paying greater attention to the quality of the credit extended under it. So even the severely curtailed credit limits made available to banks under the scheme often remained underutilized in later years.

The bill market scheme revived in popularity in the early sixties as commercial banks sought to use Reserve Bank finance to sustain high credit-deposit ratios without unduly impairing their liquidity position by borrowing against created bills rather than against government securities. So much so, that officials at the Bank began seeing the scheme as a symbol of the growing dependence of commercial banks on credit from the Reserve Bank which they now sought to reduce; and in August 1964 they briefly turned their thoughts, ironically enough, towards charging a higher rate of interest on the Bank's advances under the bill market scheme than that proposed to be charged on its advances against government securities, export bills, and 'genuine internal bills of exchange'. More generally, the change that overcame the Bank's attitude towards the scheme in the 1960s also mirrored its new concerns and priorities: it was now more closely involved than in the fifties in financing the government sector and preferred to see commercial banks expanding lending

to the private sector by augmenting their deposit resources rather than on the strength of loans from the Bank.

THE QUIET YEARS, 1953-56

A combination of domestic policy factors, an improved supply position thanks to higher production and imports, and favourable external developments together helped spike the Korean boom in India. Bank credit fell some 12 per cent in 1952 and the downward trend was sustained the following year as well, so that the credit-deposit ratio of banks fell from a high of nearly 65 per cent in 1951 to less than 57 per cent two years later. Over 1952-53 wholesale prices too, dropped by over 15 per cent in contrast to a rise of 5 per cent the previous year. The Bank had reason therefore to feel satisfied that its new monetary policy had helped create conditions conducive to the 'expansion of credit for bona fide transactions' while discouraging speculation financed by bank credit. Although it was only later that the concept was explicitly elaborated, the new monetary policy represented the first instance of the application of a policy which later came to be known as one of 'controlled expansion'.

In contrast to an eventful first half, the latter half of the first plan period was relatively uneventful and was on the whole marked by stability. Worries about inflation revived in the concluding year of the plan, but otherwise the Bank could afford to lower the profile of monetary policy during these years whilst ensuring that the productive needs of the economy were met without fuelling speculation. After declining from Rs 462 crores the previous year to Rs 443 crores in 1953-54, outstanding advances rose to Rs 468 crores in 1954-55 and further to Rs 514 crores in 1955-56. Accommodation under the bill market scheme was made easier too, by progressively extending its coverage to all licensed scheduled banks, reducing the minimum limit for advances and for individual bills, and the grant of stamp duty concessions. The underlying economic trends were largely favourable, with wholesale prices actually recording a net decline during these years. Open-market operations represented the only active component of monetary policy in this period, with the Bank effecting net sales of securities (of about Rs one crore) in 1952-53 for the first time since World War II. The next three years were also marked by net sales of government securities, of about Rs 22 crores in 1953-54, Rs 28 crores in 1954-55, and Rs 16 crores in 1955-56.

Money supply trends too varied considerably between the first two years of the first five-year plan, and the last three. During 1951-52 and 1952-53, money supply declined by nearly Rs 220 crores, the bulk of the fall taking

place in the first of these two years. The unusual phenomenon of an actual decline in money supply in an economy where substantial investments were taking place provoked discussion within the Bank and with the government. The principal reasons for this were the fall in the country's foreign exchange reserves to the tune of Rs 160 crores during these two years to support domestic consumption and investment, a sizeable surplus in government revenues, and the accrual to the latter of the domestic proceeds of the US wheat loan.

Both industrial and foodgrains output rose steadily through the early fifties. These, together with favourable developments on the fiscal, prices, and money supply fronts, encouraged the government to step up its development outlays halfway through the first plan. The plan's projected public sector outlay was increased by Rs 175 crores to Rs 2,244 crores in October 1953. Budgetary deficits expanded to finance this enhanced outlay. With bank credit to the private sector booming and exchange reserves showing some rise, money supply increased substantially by over Rs 421 crores in the last three years of the plan. The growth of money supply in the last year (1955-56) alone was of the order of over Rs 264 crores. This increase of about 14 per cent over the money supply figures of the previous year was both a worrying sign at the Bank and an early indication of the shape of things to come in the second plan. Prices were another ominous portent. The existing series (1939=100) showed that wholesale prices declined some 12 per cent in 1954-55, but rose the following year by nearly as much. These increases spilled over into the inaugural year of the second plan when prices rose by about 8 per cent.²

THE SECOND PLAN, 1956-61

The latter half of the fifties presented a vastly more complicated environment for monetary policy than the first. These years coincided with the second plan, which was much more ambitious than its predecessor, involving a planned public sector investment outlay of Rs 4,800 crores of which a quarter was to be met through deficit financing. Commercial bank credit, the private sector's

² Until the late 1950s, the Bank relied on the wholesale prices (end of August) series cited here. This index was revised sometime towards the end of the decade. According to the new index (1952-53=100), average weekly prices fell by about seven per cent in 1954-55, dropped further by 5 per cent the following year, and rose by nearly 14 per cent in 1956-57. Needless to add, the revised index was not available to the Bank authorities until later in the decade.

demand for which increased as public sector investment translated into growth in aggregate demand, also showed a tendency to expand much faster during this period than in the earlier one. On the other hand, these years were marked by harvest shortfalls, a sharp fall in foreign exchange reserves due to large imports particularly of capital goods, and consequently by the imposition of controls on imports of many consumer and intermediate goods. The economy grew at a healthy rate of about 7 per cent per annum during two of the five years of the second plan period. But the overall picture was less impressive, real rates of growth aggregating to about 22 per cent during the entire period for a compound annual growth rate during the plan of just over 4 per cent. Thanks to high levels of deficit financing and despite the steep fall in foreign exchange reserves, money supply and wholesale prices rose by nearly a third. The large size of the second plan, the manner of financing it, the rapid expansion of bank credit to the private sector, and the multiple constraints which impinged on the plan and on the economy at large during these years called for a more activist monetary policy than at any time in the past history of the Bank. Hence the somewhat involved story of monetary policy during these years is also a story of the conflicting objectives which monetary policy had to reckon with if not always pursue, and the new instruments which the Bank began to deploy in an attempt to reconcile the objective of price stability within the broad context of deficit-financed growth envisaged by the country's planners.

The very first year of the second plan (1956-57) posed the kind of challenge to the Bank which it was to face at regular intervals during the next few years. Wholesale prices rose by 8 per cent (according to the old index which was all officials had to go by) over the previous year, even while markets showed signs of acute financial stringency. This stringency reflected the accelerated tempo of investment activity in the economy. But the resulting upward trend in money rates, call money rates, and the deposit and lending rates of commercial banks also threatened to put a brake on industrial expansion, with firms finding it increasingly difficult to raise resources. The Bank was inclined to regard this as characteristic of a phase in a boom during which the demand for investment outran the supply of savings in the economy, but was however loath to regard it as entirely a temporary phenomenon in a developing economy with a low underlying savings rate.

The situation eased in the next two years as there was a marked slow-down in industrial activity and in the rates of growth of bank credit and money supply. In 1959-60 however, both money supply and bank credit rose sharply, while commodity prices too appeared to be following in the wake of the quickened pace set towards the end of the previous financial year; moreover,

unlike in earlier years, the rise was largely in groups other than food articles. Money supply with the public increased by nearly 8 per cent during the year on top of a smaller increase of about 5 per cent in 1958–59. There was evidence too of unhealthy speculative activity in the share and commodity markets. Although the government's recourse to Bank credit declined in 1959–60 for the second successive year, the steep drop in foreign exchange reserves meant that these no longer provided a comfortable cushion against inflation. In brief, the dilemma facing the Bank for much of the second plan period was that though developmental expenditures were adding to inflationary pressures and boosting the demand for credit, it could not adopt a stringent credit policy without appearing to dampen productive investment. At the same time, the worsening external account prevented recourse to imports to curb inflation and created an environment in which speculative stockholding became an attractive bet. But as noted in the previous chapter, this dilemma was not one which, in the opinion of the Bank, monetary policy by itself could resolve.

CONTROVERSIES OVER CREDIT POLICY, 1956–57

As the first five-year plan drew to an end and the second got under way, the Bank was faced with the problem of acute financial stringency in the markets coexisting with considerable inflationary potential in the economy. The Bank was aware that easier credit would ease the stringency in the short term, but was also conscious of the risk of a liberal monetary policy fuelling speculation. During discussions with the government over policy during the 1956–57 busy season, the Bank's own preference was for maintaining a complementary restrictive policy stance in both the fiscal and monetary spheres alongside making special efforts to meet clearly identified credit needs which could be justified in the larger interest of the community. Not only was government policy more liberal than the Bank liked, the new Finance Minister, T.T. Krishnamachari, made little secret in public of his views on the policy stance the Bank preferred to adopt at the outset of the 1956–57 busy season, even making use of his meetings with bankers to signal a credit policy which was at variance with that of the Bank. Relations between the Bank and the government reached their nadir some weeks into this busy season. Although Rama Rau regarded Krishnamachari's decision to raise the stamp duty on bills as the major provocation, simmering differences over policy contributed greatly to the prickly relationship he shared with the Finance Minister during what turned out to be his final months in office.

A memorandum to the Central Board prepared in April 1957 describes with admirable clarity the approach which was advocated during the

past busy season and which H.V.R. Iengar, Rama Rau's successor as Governor, resumed canvassing with the government. According to this memorandum, while the Bank was aware of the need for expanding 'credit and money supply commensurate with the rapid development ... of the economy', relief

of financial stringency through *general* measures will assist inflation and may therefore prove self-defeating. In the present situation relief of financial stringency should rather be directed to the provision of credit for specific essential purposes while at the same time restraining excessive diversion of the limited supplies of credit for less essential, though more profitable and, therefore more attractive uses.

In common with other central banks, the Bank too was generally loath to rule out recourse to general instruments to manage demand in the economy. Besides, the Bank reasoned that 'the basic solution to the problem of stringency' lay in promoting savings, and higher interest rates had an important role to play in encouraging a larger volume of savings to flow into the banking system. Neither were officials unmindful of the advantages of selective credit controls. But not content merely to play a fire-fighting role, the Bank appears to have been quite keen during these months to keep the embers of inflation from breaking into flame.

The policy which the Bank adopted at the time was described as one of 'controlled expansion'. This, in the Bank's mind, signified a two-track policy of generally restraining demand in the economy while selectively easing credit. As a memorandum to the Committee of the Central Board put it, an appropriate monetary and credit policy had to use 'some combination of the two methods, and not either method to the exclusion of the other. It is this proper combination which we have continually to attempt to evolve.' But expansion preceded control by several months as a series of meetings Krishnamachari held with bankers and changes at the helm of the Reserve Bank culminated in credit policy being eased to meet busy season requirements. As part of this policy and in order to '[increase] the resources of the banking system and incidentally to lend support to the gilt-edged market', the Bank carried out open-market operations both in short-dated government securities and in long-dated and non-terminable paper. Commercial banks were also allowed to exceed their normal credit–deposit ratios, which in some cases touched nearly 85 per cent. As a result of the liberal policy, commercial banks' credit to the private sector rose by Rs 165 crores during 1956–57, a quantum of increase which was not exceeded until 1960–61.



H.V.R. Iengar, Governor, 1957-62

In the event, this policy could not be sustained. As we note in greater detail below, the Bank had begun selectively raising the cost of credit in some segments of the market even from November 1956. As wholesale prices rose nearly 14 per cent through 1956-57, the Bank reverted in July 1957 to the open-market stance it had adopted since November 1951 and up to October 1956. This reversal followed on the heels of an increase in the Bank rate from 3.5 per cent to 4 per cent on 16 May 1957. Alongside putting up the rate, the Bank also recommended a reduction in the stamp duty on usance bills from half a per cent to one-fifth of one per cent.

The long overdue increase in the Bank rate had been under contemplation for several weeks, and its precise timing was an outcome of discussions with the government which was understandably concerned about its impact on the market for its securities. The Bank's own preference was to raise the rate before the government entered the market with its loans rather than afterwards. The timing of the new monetary policy of 1951, which was announced after the central and state governments withdrew from the market upon completing their loan programmes for the year, was criticized by some who believed the Bank had broken faith with investors who bought these loans. The Bank did not wish to give room for similar criticism now and so preferred to have the

rate increase behind it when the government came into the market to gather its loans for the year. The government too, for its part, was convinced that a Bank rate increase was inevitable and that only its timing remained to be determined. But even here there were few options available. There was widespread agreement that the Bank rate increase could not be put off until the end of the slack season or even until July. Nor could the government hope to advance its loan programme and carry it out successfully in an atmosphere rife with expectations of a Bank rate increase. On the other hand, if a change in the Bank rate had to precede the government's loan programme it was necessary to allow a sufficient interval to elapse for the dust raised by the move to settle down. These considerations therefore pointed, in the Bank's view which Lengua persuaded the government to accept, to the necessity of putting up the Bank rate sooner rather than later.

The May 1957 increase in the Bank rate, according to the Governor's memorandum to the Committee of the Central Board, merely meant according 'formal recognition to a situation that has existed de facto for several weeks'. Earlier in March 1956, the Bank had put up the interest rate on lending under the bill market scheme from 3 per cent to 3.25 per cent. At the same time, the stamp duty concession previously allowed to 'bills' under this scheme was withdrawn. The lending rate was raised further to 3.5 per cent, which was the prevailing Bank rate, in November 1956. The latter translated into an effective lending rate under the scheme of more than 4 per cent when the government raised the stamp duty on usance bills shortly thereafter. The rate on advances against government and other approved securities was also raised from 3.5 to 4 per cent in February 1957 in order not to discourage the use of bills. Therefore, the decision of May 1957 was intended really to put a stamp on the interest rate changes already carried out by the Bank in some segments of the market for its credit, 'rationalize the lending rate structure of the Bank', and make the structure of its interest rates 'internally more coherent'. Raising the Bank rate had other advantages as well. For one, banks appear to have been reluctant to increase their lending rates without a formal increase in the Bank rate. Secondly, the Bank's loans to state governments and the Industrial Finance Corporation were made at the Bank rate. A low Bank rate which did not reflect the conditions of the market, officials at the Bank feared, would discourage these borrowers from approaching the market and offering 'appropriate rates for raising funds' and instead encourage them to 'lean more heavily on the Reserve Bank' for their financial requirements. Finally, the electricity industry was allowed a rate of return which was 2 per cent above the Bank rate, and keeping the latter at 3.5 per cent when the general pattern of lending rates and yields had

risen amounted to artificially depressing the rate of return allowed to firms in the industry.

Selective credit controls represented the second pillar of the Bank's policy in 1956–57. These controls expanded and intensified over the next few years. Besides, as these restraints were directed chiefly against foodgrains and other agricultural produce, their deployment threw up a conflict between the government's (and the Bank's) schemes to expand rural credit, and the shorter-term objective of price stability in a climate of inflationary expectations stimulated by high levels of public spending. That the government preferred, on the whole, to sacrifice rural credit to restricting inflation through more general methods reflected priorities which have been commented upon in other contexts as well. That the Bank, while cautioning the government about the inflationary effects of its deficits and about the problems associated with selective restraints, had eventually to take extensive recourse to them also reflects accurately its wider dilemmas in the context of India's development policies during these years.

SELECTIVE CREDIT CONTROLS

Although selective credit controls were introduced for the first time in May 1956, the Bank had been in the habit since World War II of advising or exhorting commercial banks to observe restraint in lending against shares and bullion, or against commodities like foodgrains. The Banking Companies (Control) Ordinance, 1948 gave the Bank power to regulate the direction of bank advances, but exhortations and advice remained the preferred methods. In the next few years the Bank began to develop a system to monitor and report on banks' advances against specific commodities. The latter included country piece-goods and yarn, cotton, kapas, jute and hessian, paddy and rice, gur and sugar, pulses, oilseeds, copra and gold. This system was backed up by occasional inspections so that by the middle of the fifties, a reasonably effective mechanism to monitor and enforce selective controls, if not always to accurately establish their necessity, was in place.

The immediate provocation for imposing selective controls in May 1956 was the doubling of banks' advances, as revealed by their monthly statements, against paddy and rice from Rs 11.6 crores at the end of March 1955 to Rs 24.6 crores at the end of March the following year. The increase in rice prices even in the midst of higher production also seemed to suggest the existence of some speculative fever in the market for the crop. Hence the Bank initiated consultations with the State Bank of India and the Central Bank, which between them accounted for the bulk of the advances against these commodities, and on 17 May 1956 issued its first selective credit control

directive under section 21(2) of the Banking Companies Act. This directive asked banks not to increase existing credit limits for advances against paddy and rice, not to sanction any fresh credit limits exceeding Rs 50,000 against these commodities to individuals, to raise existing margins in respect of loans against paddy and rice by not less than 10 per cent of their value, and to attempt to achieve a reduction in aggregate advances against them from current levels to 125 per cent or less of that in the corresponding period in the previous year. Broadly similar measures were promulgated in respect of 'wheat and other foodgrains' in September 1956.

Partly as a result of the directive but also under the influence of seasonal factors, advances against paddy and rice dropped from Rs 22.4 crores at the end of May 1956 to Rs 4.3 crores at the end of October. Following the decline in advances against rice and paddy during the 1956 slack season and in order to facilitate the transport and marketing of the new rice crop, the Bank withdrew its directive in November that year. Higher margin requirements on paddy and rice were reintroduced in February 1957, partly with an eye to the situation in Andhra Pradesh which accounted for a third of the total advances against the crop throughout India, and expanded to cover other foodgrains in June that year.

The Bank judged the 1956 selective credit control directive to have been 'reasonably successful' in its impact. But trade reactions to the policy were less positive. In a complaint to Finance Minister C.D. Deshmukh, some traders contended that there was little hoarding of paddy and rice and that banks' advances against the two commodities overwhelmingly financed legitimate trade in them. Besides they argued that the measure militated against trade in all primary commodities as banks might now hesitate to lend on their security. On a reference from the Finance Minister, the Bank stressed that trade fears of a fall in banks' credit against primary commodities were unfounded. Also, contrary to speculation, the May directive did not directly cause any capital loss to the banks but only affected those traders using bank funds to carry stocks in the hope of a rise in prices. Nor was the directive aimed at legitimate trading activity. It prohibited fresh advances and raising of credit limits but did not affect existing arrangements beyond prescribing an increase in the margin by 10 per cent. Finally, the Bank argued, the step was by no means permanent and would be eased or discontinued as conditions permitted.

From the latter half of 1957 the Indian economy showed signs of stagnation. The world economy too, was beginning to slow down following the onset of recessionary conditions in the United States. But inflationary pressures in the economy did not appear to be easing appreciably. A further constraining factor was foodgrains output which was over 10 per cent lower in 1957-58

than in the preceding year. The response of monetary policy to these events took the form of a progressive extension of selective credit controls. In June 1957 selective controls were applied to 'all foodgrains' and to sugar, and renewed, tightened, or modified regularly thereafter. Groundnuts were brought under selective controls in February 1959 and 'other oilseeds' in December the same year.

The proliferation of selective controls was largely, however, the result of the government's preferences rather than the Bank's. On the other hand while the Bank wanted the government to restrain public expenditure, it could not remain indifferent to the latter's concern about movements in the prices of key commodities like foodgrains and sugar, and of important agricultural raw materials or intermediate goods used by industry. The reintroduction of lending controls against sugar and foodgrains including paddy and rice in June 1957 was at the government's initiative, as were those on lending against sugar later the same month. In fact, governmental interest in selective controls extended to its highest levels, with Jawaharlal Nehru complaining to Iengar about banks allegedly flouting instructions to make large advances to millers and encouraging the hoarding of rice. The Prime Minister was also concerned that the Bank's lending to cooperative institutions contributed to rising food prices. As we discuss elsewhere in this volume, Nehru's misgivings perhaps related more to the Bank's approach to the overall organization of cooperative credit institutions than to the manner in which it administered its selective credit control policy. But the Finance Minister too favoured bringing cooperative credit institutions under the ambit of selective restrictions. Dissuading Krishnamachari from pressing his suggestion, Iengar pointed out that loans to cooperative societies against foodgrains were not very large and that their impact on grain availability and prices was mainly local in scope. Besides, the authorities were aware of the size of the stocks held by these agencies and would have little difficulty in requisitioning them should the need arise. Iengar also cautioned Krishnamachari against the dangers of reversing, at the first signs of difficulty, the government's strategy of increasing food output partly by financing farmers and their cooperative organizations to hold out for higher prices. While it was 'unfortunate' that this policy 'should have coincided with a period of rising food prices', the latter was not a 'sustainable argument' for changing it.

With the situation on the agricultural front threatening to cast a major shadow over the second plan, the air was thick during these months with suggestions to enforce State trading in foodgrains, if necessary on the basis of stocks procured compulsorily from farmers. These and similar ideas, which were sometimes aired at meetings of the National Development Council and

were believed even to have Nehru's backing, did not in the event translate into government policy. But it is worth pausing here to reflect on the irony of the Bank and the government debating, in the narrow, short-term, and somewhat unlikely context of monetary policy, some aspects of the role of the peasantry in the industrialization process, and of the Bank playing Nikolai Bukharin to the government's Preobrezhensky. With the second plan envisaging an accumulation process which the government had few levers of policy to effect, especially in agriculture, the impact of monetary policy instruments on the terms of trade between industry and agriculture acquired a salience few would normally attribute to them. Happily however, no lives were at stake in this re-enactment. Besides, Iengar not only kept his job, he also managed to bring Krishnamachari and the government round to the Bank's point of view on this subject.

In the early months of selective credit controls, the Bank had reasons to be worried about their enforceability. Inquiries revealed that commercial banks were not adhering faithfully to selective control instructions, while it transpired, in the course of the Governor's discussions with bankers, that the latter's head offices communicated Bank directives to the branches but thereafter did little to monitor their execution. The problem, according to Iengar, was the apathy, rather than defiance, of a 'mediocre crowd' of bankers who, while being 'pretty good at routine banking operations' were a 'poor lot' when it came to 'questions ... of general policy or ... new administrative techniques'. But the Bank's hand in dealing with the more recalcitrant banks was weakened because the State Bank of India happened to be one of the principal offenders. The former Imperial Bank which was taken into public ownership and rechristened in 1955 in order to serve as the government's instrument for expanding rural credit, had embarked on a programme of rapid expansion of its branch network. Many of these new branches were, as envisaged, in the rural areas, and advances against foodgrains represented the major part of their business and of their earning assets. Besides, as Iengar had correctly anticipated, it was not altogether easy for these branches to recall at short notice advances they had made to a large number of individual farmers. Finally, millers in the newly-created southern food zone had been forced by railway wagon shortages and newly imposed restrictions on food movement to build larger stocks than they wished to hold, and these could not be disposed of in a hurry except at a considerable loss. The State Bank therefore stressed the need for the Bank to coordinate its policy with the central and state governments, particularly in regard to zoning policy, food procurement, and the movement of foodgrains. In the event, regulation of credit against foodgrains became progressively wider and tighter during the remainder of

the year and the Bank also stepped up its monitoring of banks' implementation of these controls.

The Bank commissioned an internal study of the working of selective controls in July 1957. Although a number of officials at the Bank, including the Governor, were not happy with many aspects of the instrument, the study was provoked chiefly by the insistence of D.R. Gadgil, a member of the Bank's Central Board, that these controls were neither 'effective nor sound'. Iengar was also impressed by Australian studies which revealed that qualitative controls were not a happy experience for any of those involved in or affected by them. After surveying the working of qualitative controls in a few countries, the Bank's study came to the rather obvious conclusion that their effectiveness turned on a number of factors including the objective in pursuit of which they were deployed, the general financial and economic climate, notably the presence of inflation or inflationary expectations, and the institutional framework. Besides, it noted, qualitative controls could not substitute for quantitative instruments, and in fact the former depended on the latter for their efficacy, particularly where inflationary pressures were pronounced.

The study's findings about the Indian experience with selective controls were more interesting. Few major foodgrain traders, according to the study, possessed alternative assets such as government securities or shares. Therefore, restricting credit against foodgrains would directly affect their inventory behaviour. Although the volume of clean advances had gone up since selective controls were imposed and this merited investigation, foodgrain traders were unlikely to have been significant beneficiaries. The study also found that bank credit played an important part in financing trade in cotton textiles and sugar. The market for paddy and rice was, however, more differentiated in its dependence upon bank credit. Small traders specializing mainly in local and intra-state trade did not usually finance their stocks by borrowing from banks. On the other hand, though only a small proportion of the marketed surplus in rice found its way to markets outside the state producing it, bank credit financed an important share of this trade. This tendency was particularly pronounced in the major rice-surplus states of Andhra Pradesh, Madhya Pradesh, and Orissa, so that controls on lending against the grain could play a 'strategic role' in these three states. Interestingly, the measure did not really cause much hardship to genuine traders because they tended progressively to reduce their commitments in the slack season. Besides, trade being now psychologically more alert than earlier, the uncertainty of bank credit might dissuade operators from overextending their commitments. Selective controls had done little to move credit away from trade and towards industry; but while operating negatively, there was no evidence that banks' funds rendered

surplus by the measure were being diverted into other undesirable—but unregulated—uses.

The study also found that Bank directives to commercial banks to raise margins by a specified percentage affected different borrowers differently, since the initial condition, i.e. the margins originally charged by the banks on the same securities, varied. This problem could be avoided if the Bank imposed minimum rather than incremental or additional margin requirements. Finally, it stressed the importance of the Bank developing more knowledge about the functioning of markets, patterns of financing commodities and of arrivals and despatches, and estimates of stocks with trade, in order to better assess the reasonable requirements of trade for credit and intervene to curb speculation in a more timely fashion. But this was easier said than done. Besides, with selective credit controls often becoming a substitute for action along a wider front, the Bank came to feel that they always tended to 'come late' and were 'largely circumvented'. It was therefore necessary, the Bank believed, to 'act in advance and ... as much as possible through restriction of credit generally, than through a maze of separate, specific directives, which are got around'.

VARIABLE RESERVE RATIOS

Despite all the reservations, monetary policy during the next two years mainly revolved around selective credit controls. In addition, the Bank initiated closer consultations with bankers over credit policy, routinely exhorting them to follow the guidelines it issued at the beginning of each season. During the 1959-60 busy season, however, the price situation became a source of heightened concern, with Iengar urging the Finance Minister in January 1960 that it 'must be tackled energetically if we are not to find ourselves in deeper waters'. Besides, it emerged that after two years of relative moderation, the growth of bank credit to the private sector had begun once again to acquire sizeable dimensions. Although the upswing in industrial activity continued, industry was clearly yielding to trade in the allocation of bank credit. Clean advances were also 'showing an unusual rise'. The Bank attributed the higher trade demand for credit to 'large inventory profits in one line [sugar and cloth]' feeding 'hoarding propensity in other lines', and creating an 'artificial glow of prosperity'. The Bank was also nervous that credit-aided speculation might push up the raw material costs of industry. The bourse, assisted to some extent by a sharp increase in banks' advances against shares and direct financing of *badla* (or carry forward) transactions, came under the grip of boom conditions and the Bank interpreted the rising index of variable dividend industrial securities as a further sign of the 'abundance of money and liquidity in the economy'.

Alongside booming credit, bank deposits too increased rapidly. Thanks to rising deficit-financed public expenditures, bank deposits increased some 17 per cent in 1959 on top of a similar rate of increase in 1958 and 23 per cent growth in 1957. The substantial part of this increase was in the form of demand deposits. Besides, it was believed that the term structure of deposit rates which came to prevail in October 1958 as a result of an inter-bank agreement (on which more below) had led to the bulk of the expansion in time deposits taking place in the shorter categories. Another notable trend in recent years had been the rise in the velocity of bank money from 45.7 in 1956 to 48.6 in 1957 and 55.5 in 1958. The Bank expected this velocity to show a further rise when figures for 1959 were assembled. These trends indicated, in the Bank's opinion which was recorded in a detailed note sent to the Finance Minister in February 1960,

some decisive action ... to curb the creeping ascent of prices, to promote saving and to divert investment from avenues that seek quick riches and facile gains to channels that lead to sustained growth of the economy.

Although production was still 'well sustained', there was also the danger that the 'inflationary atmosphere' might distort the pattern of incentives against 'higher production, greater efficiency, and increased savings'.

In such a situation, action to restrict credit in respect of individual commodities, e.g. cotton textiles or sugar or jute, will not be adequate, for excessive liquidity ... has a way of breaking through any complicated network of selective controls The action required, therefore, is some measure of general restraint of monetary expansion, lest the objective of growth with stability should be jeopardized and, in the process, growth itself be retarded.

The Bank's recommendation evoked little immediate response from the government. The decision to tighten monetary policy was finally taken a month later in March 1960, but the new policy was different in its emphasis from what the Bank had envisaged in February. In keeping with the trend of the past two years selective controls were extended further, now to cover ordinary shares and clean advances. There was in addition a substantive policy change—a new *general* instrument—in the form of higher marginal reserve requirements.

The decision to impose higher marginal reserve requirements came into effect on 11 March. Scheduled banks were henceforth to maintain with the Reserve Bank additional reserves equivalent to 25 per cent of the increase in

their deposit liabilities from that date. In order to compensate for the interest cost banks bore on these additional reserves, they were allowed interest on the latter at the average rate they paid on deposits during the corresponding quarter, with the Bank rate as the ceiling. Before long this rate was felt to act as a disincentive for deposit mobilization, and in June the Bank raised the interest rate on additional reserves to half a percentage point above the average deposit rate during the half-year, subject to a ceiling of 4.5 per cent, or half a per cent above the Bank rate.

The March measures were not entirely without effect. The increased margin on shares and the ban on *badla* financing by banks and clean lending helped give teeth to the existing regime of selective controls. Taken towards the end of the busy season, the enhanced reserve requirements were probably designed more to ensure slack season reduction in credit than to check the expansion of busy season advances. Nevertheless, the immediate impact of the measure on bank credit was not negligible. Busy season advances between the beginning of November 1959 and 18 March 1960 stood at Rs 173 crores, as against about Rs 158 crores for the same part of the preceding peak season. But during the remainder of the busy season, when the increased reserve requirement began to affect banks' resources and up to the end of April 1960, bank advances were lower at Rs 16 crores as against about Rs 23 crores for the corresponding period of the preceding year. As a result, although peak season advances during 1959-60 exceeded the preceding year's record figure of Rs 182 crores, the increase over the previous year was held down to about Rs eight crores.

However, after declining from 119.4 on 27 February to 118.6 on 26 March, wholesale prices rose to 121.7 by 23 April. By the end of April the index of variable dividend securities too, recovered from a brief fall to breach the pre-March 11 level. Besides, the pace of credit contraction was too slow for the Bank's liking. These factors persuaded the Bank to increase the marginal reserve ratio once again, and on 6 May 1960 banks were directed to maintain additional reserves equivalent to 50 per cent of the increase in their deposit liabilities from that date. Immediately thereafter, Iengar wrote to scheduled banks urging them to contract bank credit during the slack season by Rs 110 crores, particularly against seasonal commodities, while major banks were individually advised of the order of contraction they should effect.

REGULATING ACCESS TO THE RESERVE BANK

The two-step increase in reserve requirements did help squeeze the liquidity of the banks. Excluding the State Bank of India, whose deposits declined under the impact of the new arrangements instituted for P.L.480 funds, free

reserves of banks (defined as cash *plus* excess reserves) declined from Rs 64 crores on 18 March to Rs 39.5 crores on 16 September 1960, the ratio of these to their deposit liabilities falling from 4.9 per cent to 2.9 per cent. But on balance, higher reserve requirements failed to achieve their intended purpose of moderating the expansion of bank credit and bringing about its effective contraction in the slack season. Rather, with demand for credit against non-seasonal commodities remaining high, bank credit confounded expectation and the seasonal pattern, to *expand* by Rs 4.6 crores during the 1960 slack season.

There are, even from the perspective of the Bank's own history, some unexplained aspects to its recourse to marginal reserve ratios in March 1960. Apart from the Bank note which made the case for a tighter monetary policy in February 1960 placing its emphasis somewhat differently from the policy which was subsequently adopted, it is useful to recall that so recently as 1958–59 the Bank had tended to play down the role of variable reserves in its 'comprehensive armoury of weapons of credit control'. According to the Bank's replies to the questionnaire circulated by the Radcliffe Committee, varying reserves was unlikely to have the 'same efficacy' in India as in other countries where there was

scope for large scale multiple expansion of credit. The calling of fresh reserves would certainly help to curtail credit ... but in the Indian banking context it would need a much greater variation in the level of reserves to induce the same effect on bank credit than would be necessary in countries with a fractional reserve system.

One explanation for the mystery behind the deployment of this instrument in March 1960 may lie in the fact that the government was perhaps not as keen as the Bank to see a rise in the Bank rate at the time and that variable reserves may have been seen as a promising compromise between the two positions. In the untested weapon's favour was the expectation, as the Bank told visiting IMF officials in December 1961, that 'it could take effect very quickly'. The Governor, on the other hand, appears to have considered raising the Bank rate, if not in March, certainly in April and May 1960 and again in June. On the last occasion he sought expert opinion on the likely impact of a higher Bank rate on the gilt-edged market and received in return a note which suggested that it would be quite significant. Recounting the year's credit policy developments in December 1960, a memorandum by the Executive Director, B.K. Madan, informed the Bank's Central Board that a higher Bank rate was not resorted to in March because the level of borrowing from the central bank was not 'unusually large'; so that for it to be effective, the Bank

rate hike would have had to be 'rather sharp' and this would have 'caused disturbance to the government securities market with the borrowing season ahead'. There is some evidence that the Bank and the government did not see eye to eye on the merits of a generalized 'dear money' policy later in the year when a new accommodation regime (discussed below) was decided upon by the Bank. Again in December 1960, there was widespread speculation in the press and elsewhere that the central government stood in the way of the Reserve Bank raising its rate. One may read this difference back to the beginning of the year, citing in support for so doing, simmering Bank-government differences over monetary policy since virtually the beginning of the second plan. But the most that can be said at this stage with any degree of confidence is that for so major a step, the decision to vary marginal reserve ratios appears to have been taken rather suddenly, almost peremptorily, with the Bank's confidential agenda-setting monetary policy note sent to the Finance Minister a month or so earlier making no mention of it. All else must remain conjecture in the present state of our knowledge.

Variable reserves failed for a number of reasons, but largely because of conditions prevailing in the credit market. Faced with a high and rising demand for credit and a rather unexpected fall in deposit resources after three years of rapid growth, banks found a number of quite legitimate ways to offset their impounded reserves. Apart from reducing their cash in hand and excess balances with the Reserve Bank—which together increased by Rs 1.4 crores in the 1959 slack season but fell by nearly Rs 25 crores through the 1960 slack season—banks also sold government securities to augment their resources. Banks' holdings of these securities tended usually to fall in the peak season and rise in the slack. During the 1958-59 peak season for example, banks reduced their holdings of government securities by Rs 3 crores and in the following slack season invested Rs 52.2 crores in them. In 1959-60 however, banks' peak season disinvestment amounted to Rs 53 crores. They followed this up in the ensuing slack season with further sales of government paper to the tune of Rs 4.7 crores, the latter figure almost exactly equalling the contra-seasonal increase in bank credit during these months. As a result, the aggregate ratio of investments to deposits of banks dropped from 32.3 to 27.8 per cent during the year ending September 1960. The third course banks adopted to augment their resources exposed a major chink in the Bank's credit policy armoury. This was to maintain large outstandings on the accommodation they drew from the Reserve Bank. Being another—relatively cheap—source of banks' funds, such borrowing too usually increased during the busy season, but shrank as demand for credit eased in the summer. During the 1960 slack season however, despite accommodation under the bill market scheme being

made more stringent, scheduled banks effected a smaller reduction than in the past of their debit balances with the Reserve Bank which totalled Rs 33 crores at the end of the slack season in September 1960, as against a mere Rs 3 crores a year earlier. This increase was reflected in the aggregate ratio of unencumbered securities to deposits of banks, which fell sharply from over 31 per cent in September 1959, to 23 per cent a year later. The fall in these proportions, particularly those for free reserves and investments, was more pronounced for banks other than the State Bank of India.

Clearly therefore, the unrestricted accommodation it offered banks and the latter's freedom to liquidate government paper undid whatever the Bank hoped to achieve through higher marginal reserve requirements. The banks' response could have been foreseen, and indeed was in 1956 when power was acquired to vary scheduled banks' reserve ratios. The Bank was already alive to the declining trend in the level of banks' slack season excess balances. But decisions on the level of excess reserves or cash balances to be carried were entirely for the banks to take, the central bank having no role to play so long as the legal requirements under the Reserve Bank of India Act and the Banking Companies Act were satisfied. In 1955, officials also contemplated the possibility of banks selling government securities to side-step the impact of higher reserve requirements. But opinion at that time was formed by the expectation that the latter would be imposed in a climate of rapidly rising deposits, and secondly that the demand for credit would not be inordinately high. In these circumstances, there was no particular reason to expect (a) that banks would experience a *fall* in their level of free reserves, and (b) that they would attempt to restore it by liquidating investments rather than reducing advances. But in 1960, both situations materialized.

The third possibility, of banks increasing their recourse to the Reserve Bank for accommodation, was not considered seriously by the Bank's Department of Research and Statistics in 1955. Simha's note, to which attention was drawn in the previous chapter, took cognizance of this possibility only to the extent it highlighted the tight reserve position banks were likely to face. The latter, in turn, was seen to be propitious for the success of variable reserves in India. Madan's note on variable reserve requirements too, completely ignored the possibility of banks taking recourse to loans from the Reserve Bank to circumvent higher marginal reserve requirements. On the other hand the Department of Banking Operations' office note opposing the proposed amendment had argued that commercial banks in India, unlike those elsewhere, did not 'disfavour borrowings from the Reserve Bank even during the slack season' because they had a high advances-to-deposits ratio by international standards and little excess liquidity. So that while higher

reserves were not indicated in these conditions, their imposition could be defeated by banks increasing their borrowing from the central bank. An implication of this argument was that restricting Bank lending to commercial banks would be more effective in checking their ability to expand credit than impounding additional reserves.

In the event, experience taught the Bank the same lesson within months of its decision to impose higher reserve requirements in March 1960. The ease with which banks decided to shed their investments in government securities came as something of a revelation, and the Bank was soon to initiate steps to limit their freedom in that respect. But the more immediate impact of recent developments upon the Bank's thinking was reflected in its resolution, reached by September 1960, that it had become necessary to 'curtail the present unlimited access of banks to the Reserve Bank and to prevent the monetization of Government debt'. The Bank also thought it 'inadvisable' to lend large amounts to the banks when the government was adopting inflationary methods of financing its investment projects. More widely, after the bill market scheme was instituted, banks had grown used to

dependence on borrowing from the Reserve Bank, so that their cash ratio [has] become progressively smaller. Such a situation was far from healthy. Besides, recourse to the central bank should normally be ... temporary ... [and confined to] financing the heavy busy season demand. For the rest, the banks should rely on the growth of their own resources to meet the expanding demands of trade and industry.

One of the reasons for the high level of banks' borrowing from the Reserve Bank was the low rate of interest of 4 per cent the Bank charged on its loans. Besides, the effective cost to the banks of their borrowing from the Reserve Bank of India to offset the impounded reserves was the difference between the Bank rate and the rate which the Bank paid on the additional reserves. By September 1960, arguments for a general policy of credit restraint had been strengthened by external developments, notably the continued loss of reserves despite tighter import controls. 'To a not insignificant extent,' therefore, in the Bank's opinion, 'external stability and internal stability [were] interlinked'. An increase in the Bank rate from the prevailing 4 per cent might restrain demand for credit as well as that for Bank accommodation. But the problems which the free use of this instrument posed for the government loan market could not be ignored any more in the autumn than it could be in the spring. On the other hand, physical credit rationing through a system of quotas for individual banks in the system was too inflexible a method to be of much real

value. Hence, the Bank decided to attempt rationing its credit to the banks through a price instrument which would at the same time not directly increase the cost of government borrowing or affect the gilt-edged market.

Thus was born the 'quota-slab' system instituted from 1 October 1960. Adapted from the contemporary French system of *enfer* and *super-enfer* and a similar Japanese practice, the proposed system of 'graded lending rates' or 'penal rates' originally assigned to each scheduled bank a quarterly quota equal to half the average volume of reserves required to be maintained by it under section 42(1) of the Reserve Bank of India Act during each week of the preceding quarter. Loans from the Bank within the quota were charged interest at the Bank rate. Borrowings above this limit and up to 200 per cent of the quota attracted a penal rate of one per cent above the Bank rate, while loans in excess of even this quota were granted only at the Bank's discretion in the form of 'special accommodation' which attracted a penal rate of 2 per cent above the Bank rate. These rates also now applied to advances under subsections 4(a) and 4(c) of section 17 of the Bank Act, so that it thereafter became unnecessary to fix separate ceilings for individual banks for borrowing under the bill market scheme. As penal rates helped restrain their borrowing from the central bank, banks' aggregate lending could also be expected to fall. But since the direct impact of the new measure was expected to vary with the extent of a commercial bank's reliance on the central bank for accommodation, the Bank sought to reinforce its restrictive impact by instructing commercial banks to adhere to a minimum lending rate of 5 per cent and to raise their average lending rates by at least half a per cent over the rate prevailing on 30 June 1960. The latter initiative, incidentally, marked the Bank's first entry into the area of lending rate regulation. To plug another possible loophole, some restriction was also introduced on the scope of the Bank's open-market operations, outright purchases now being confined to loans maturing in 1961.

Although the new accommodation regime made them superfluous, additional reserve requirements were persisted with in the existing form for some more weeks despite growing pressure from business, and to some extent from the government, to relax them. Finally on 11 November 1960, eight months after they were first introduced, the Bank began scaling down these requirements partly to guard against any undue stringency in the credit market during the peak season then getting under way. In the first instance the Bank waived the marginal reserve requirement on future additions to banks' deposits. In addition, the higher reserve requirement placed on deposits made between 11 March and 11 November was reduced to 25 per cent, thereby enabling the Bank to release Rs 14 crores, or about half the reserves impounded until then. Additional reserve requirements were finally revoked in their entirety on 13 January

1961 and an amount of Rs 13 crores released to the banks in consequence. In the Bank's evaluation, its experience with the instrument was not 'satisfactory', and officials of the Bank confessed to IMF officials their doubts that 'they would resort again to incremental requirements in the near future'. The use of the instrument, which was now potentially more effective following changes made meanwhile to the accommodation regime and to cash and statutory liquidity requirements, was considered briefly in 1965 and again in 1966, but it was not redeployed again during the years covered by this volume.

The new quota-slab system and the Bank's directive on lending rates led to a down the line increase in lending rates. The State Bank too, took steps to reduce its accessibility for other banks by raising its lending rates to 6 per cent from 4.25 per cent at places where the Reserve Bank had offices. At other places it charged 5 per cent but imposed some restrictions on the amount of lending it undertook. The State Bank's rate on loans to cooperative banks was also raised to 4.5 per cent from the earlier 4 per cent. In the wake of these measures, scheduled bank credit declined by Rs 29 crores between 30 September and 25 November 1960 against a rise of Rs 3 crores during the same period in 1959. Money rates also firmed up, the inter-bank call money market rate rising to over 4.6 per cent by the end of the year and to 5.25 per cent in January 1961. Unavoidably, rising interest rates elsewhere in the system could not but affect the market for government securities. Although the immediate effect on central government loans was small, loans of state governments came under greater pressure. The impact of the new regime was also felt in the unorganized sector. In Bombay, Multani *shroffs* raised their lending rates from the 9-11.25 per cent which prevailed on 7 October 1960, to 12 per cent a week later. In upcountry centres too, stated rates were reported to have touched the legal maximum of 12 per cent.

The system of graded lending rates which lasted for four years till September 1964 had some undoubted advantages, combining as it did elements of quantity and price rationing. It did not directly affect the yield on long-term securities and sought to achieve credit restraint with a gradual adjustment of the prices of government securities. Besides, under this system, the marginal lending rate could be raised to much higher levels than would be possible if action were contemplated directly on the Bank rate. The system was also not inflexible, in that both penal rates and quotas could be varied as circumstances dictated. In contrast, Bank rate decisions would be attended by too many considerations for quick or frequent changes to be possible, or even desirable.

However, this method could never produce on the market quite the same psychological impact as a rise in the Bank rate. The rise in lending rates

which followed the introduction of the quota-slab system was neither uniform nor orderly. Some lending rates, for example, were linked to the Bank rate and could not be increased without raising the latter. An effective interest cost higher than the Bank rate also created difficulties for electricity undertakings and others whose returns were linked to the latter.

In practice too, the quota-slab system was not as effective a quantitative check as hoped. Firstly, the quotas were fixed on a uniform basis so that both banks with high credit ratios and those with low credit ratios were treated on the same basis. This arrangement also encouraged banks with high liquidity ratios to increase their holdings of treasury bills rather than invest in dated securities. By allowing the former to run off during the busy season, such banks were able to obtain funds outside quota arrangements. Further, the freedom commercial banks had to pass on (or not pass on) the higher cost of borrowing from the Bank to their customers also mitigated the restrictive impact of penal interest rates.

Despite these problems, the quota-slab system remained in place as an important component of the Bank's credit policy apparatus during the next four years. The regime was further tightened in July 1962 preparatory to approaching the IMF for a standby arrangement, by reducing the basic quota and adjusting the Bank's lending rates on the other slabs. The latter were now four in number, and the interest rate on the highest slab was fixed at 2.5 per cent above the Bank rate. The net effect of this tightening was to raise the Bank's average effective lending rate by half a per cent or more. This increase was also reflected in the higher yields offered by the central government on the loans it issued later the same month. Thereafter the quota-slab system was liberalized or tightened as necessary on a few occasions before being replaced on the eve of the 1964–65 busy season by a scheme of accommodation based on banks' net liquidity ratios (or NLRs).

COMMERCIAL BANKS AND CREDIT POLICY

The reliance placed upon selective credit control instruments and the nature of the general control instruments it deployed obliged the Bank to develop close contact with commercial banks. Against this background, the bank used 'moral suasion' both to alert bankers to emerging trends which if not checked in time would invite Bank intervention, and to buttress its monetary and credit policy measures. The Bank sometimes chose to signal its approach to issues concerning monetary policy and the banking system through the speeches the Governor and his deputies made to important bodies such as the Indian Institute of Bankers. There were, besides, two channels of moral suasion which the Bank adopted on a more routine basis. Regular meetings between

the Governor and bankers were one. Apart from giving bankers an opportunity to ventilate their problems, the Governor used these meetings to elucidate the Bank's thinking on monetary policy and other issues and to exhort bankers to more closely observe the Bank's credit policy advice and directives. Meetings of this nature proved particularly useful in assessing the pulse of the market for credit, in removing (or reinforcing) bankers' misgivings about the extent to which they could rely on the Bank for accommodation, especially under the bill market scheme, and for understanding the difficulties banks faced in giving effect to policies of the Bank such as those on selective credit control. As these meetings became more frequent bankers also ceased presenting a monolithic front to the Bank, and although not all bankers were equally forthcoming, some issues were discussed on their merits rather than in a partisan spirit. The seeds of the Bank's policy to regulate its accommodation to commercial banks, for example, may well have been sown at one such meeting.

Regular letters from the Governor to heads of scheduled banks formed the other major channel of direct communication between the Reserve Bank and the commercial banking system. Both channels were used, particularly starting from the 1956-57 busy season. To some extent the general credit policy during that season bore the impress of the many meetings the Finance Minister and the Governor held with bankers. But despite these efforts and the restraining impact of the monetary policy measures of May 1957, credit continued to expand, the level of outstanding credit touching Rs 938 crores on 7 June 1957. Viewed in the light of rising prices and the volume of deficit financing projected for 1957-58, this was a worrying trend for the Bank. Therefore Iengar wrote to the banks towards the end of June 1957 exhorting them to reduce outstanding bank credit during the slack season and to bring down the credit-deposit ratio without reducing assistance to essential sectors, particularly industry. The Governor urged the banks also to reduce advances against agricultural commodities in short supply, and to reduce their recourse to Bank accommodation. This letter was partly an attempt to translate systemic objectives and targets to the level of individual banks within it. It was followed up by a wider appeal to bankers, whom Iengar addressed in Bombay and Calcutta in July and August 1957 respectively, to bring down the level of advances to about Rs 800 crores by the middle of October, since this represented in the Bank's judgement, a manageable base for credit expansion during the next busy season. This counsel was not entirely lost on the bankers. Aggregate credit declined from its June peak to Rs 847 crores by the end of September. But for certain fortuitous events the fall might have been even larger.

In the months which followed, the Governor continued to exhort bankers to refrain from making advances for speculative purposes, to closely scrutinize clean advances and discourage the practice of rediscounting clean *hundis*, and to reduce recourse to the Bank for accommodation. In the communications he issued at the beginning of the slack season, the Governor was also inclined to lay down suggestive figures for the extent of the off-season contraction of credit to be effected by the banks, Rs 100 crores in 1959 and Rs 110 crores in 1960. The latter suggestion, which in the event was not heeded, followed close on the heels of the increase in variable reserve requirements to 50 per cent in May 1960, while the original decision to impose additional reserve requirements in March 1960 had been preceded by more than one appeal from the Governor to bankers to restrain credit expansion during the 1959–60 peak season.

The Difficult Years, 1961–67

With two wars, a series of poor harvests including two droughts, and an unstable external environment, the 1960s were years of severe strain for the Indian economy. The demands on the exchequer rose as the needs of defence had to be met alongside those of development and the increased public expenditure financed against a background of stagnating agricultural production, unimpressive industrial growth, and a largely stagnant savings rate. Agricultural production barely rose above the 1960–61 level until 1964–65, dropping nearly 10 per cent in 1965–66, which was the first of two successive drought years. Food production too followed the same trend, stagnating until 1964–65 around or below the 72 million tonnes per year mark reached in 1960–61. Output rose to 78 million tonnes in 1964–65, but dropped nearly a fifth to a mere 63 million tonnes in 1965–66. It rose slightly to 65 million tonnes the following year before recovering to 80 million tonnes in 1967–68.

Consequently, these were also years of considerable price instability, the rate of inflation rising sharply from an underlying rate of below 3 per cent per annum during the first three years of the third plan to about 13 per cent in 1964–65, 8 per cent in 1965–66, and to a postwar high of nearly 16 per cent in 1966–67. The effect of price instability on the country's food economy was particularly pronounced, the wholesale index of foodgrain prices rising by over 26 per cent in 1964–65, 6 per cent in 1965–66, about 18 per cent in 1966–67, and again by a quarter the following year. For the years 1961–69 as a whole, the annual average increase in wholesale foodgrain prices was of the order of about 10 per cent.

The balance of payments remained under considerable pressure during the third plan. But assisted partly by import compression, the current account deficit fell steadily in absolute terms and as a percentage both of exports and of the national income during the first three years of the plan. Although the deficit rose sharply in 1964–65, it was still only about 1.7 per cent of the

gross domestic product. But from about \$0.9 billion in 1964–65, the current account deficit ballooned to about \$1.2 billion and \$1.57 billion in the next two drought-affected years, or to 2.2 per cent and 3.7 per cent respectively of the gross domestic product. This coincided with a worsening of the external aid environment, particularly in relation to the United States. Following the rupee's devaluation in June 1966 and sustained efforts at fiscal and monetary stabilization the current account deficit dropped steadily in the next three years, bottoming out at \$0.43 billion in 1969–70 when it represented under one per cent of the gross domestic product.

Despite a stagnant agriculture, the manufacturing sector witnessed impressive rates of growth in all but the concluding year of the third plan. Thereafter, however, the declining availability of food and agricultural raw materials and stringent import controls, which affected supplies of intermediate goods, triggered an industrial recession. This was reinforced on the demand side by the decline, both in real terms and as a share of national income, of gross fixed capital formation in the public sector which followed the end of the third plan. The prolonged period of stagnation in Indian industry since the mid-1960s has been the subject of wide comment. It is sufficient to note for our purposes, however, that real manufacturing GDP grew by less than one per cent per annum in the three years starting 1965–66; and although manufacturing growth was a more respectable 5.5 per cent in 1968–69, this was considerably below the rates witnessed since the mid-1950s.

Not surprisingly, the overall growth performance of the economy was lacklustre during the third plan period. Poor growth rates in the first two years of the plan and a negative growth rate in the drought-affected terminal year meant that real national income grew by less than 14 per cent during these five years, as against nearly 22 per cent during the preceding plan period, and the plan target of 30 per cent. This represented, in annual terms, a growth rate of incomes which barely outpaced the rate of population growth. Although the economy grew at over 8 per cent during 1967–68, growth remained poor (one per cent and 2.6 per cent respectively) during the other two annual plan years.

At one level, the task facing the monetary policy authorities during the 1960s was little different from that in the preceding years: the Bank had once more to ensure that the resources of the banking system did not go into speculative or socially unproductive channels, and that the legitimate needs of industry and trade (including during much of this period the needs of those sections of it geared towards meeting the needs of the country's defence) were met as far as possible. In practice, however, higher rates of inflation and the build up of inflationary expectations in a climate of severe shortfalls in the availability of food and other agricultural products and imported

intermediate goods rendered this task more difficult than before. Neither could the Bank adopt a rigid attitude towards the growth in public expenditure. Although the finances of the state governments deteriorated faster than those of the central government in the mid-sixties, the Bank could hardly afford to ignore the need for additional public spending in the wake of threats to the country's security and the drought situation. Finally, by the middle of the decade, the balance of payments position took a turn for the worse and the Bank had to contend not only with the need to stabilize the external sector but also to minimize the domestic inflationary fallout of the rupee's devaluation in June 1966; and for much of the closing years of the 1960s, monetary policy, while keeping inflation at bay, had also to attempt to mitigate the impact of the severe industrial recession brought on by import compression, the decline in public investment since 1965-66, and the foodgrains bottleneck.

The first half of the sixties were fairly active years from the point of view of the Bank's monetary policy. Unlike during the second plan, the easy option of putting off interest rate changes to protect the government's borrowing programme was no longer available. The Bank rate was put up thrice during the third plan, on the last occasion by a full percentage point to 6 per cent. This greater freedom of interest rate policy was partly secured by modifying banks' liquidity requirements and the Bank's accommodation regime to promote the market for government securities. Arguably therefore, rather than squeezing government spending, monetary policy was forced during these years to accommodate it. The longer-term effects of this measure on the allocation of credit between the government and the private sectors fall beyond the scope of this volume. It can however safely be said that these effects were not immediately apparent since stabilization became the dominant objective of the fiscal regime within months of the rupee's devaluation in June 1966. Selective credit controls were also in full play during these years but the Bank attempted to use them also as a positive instrument to encourage credit to flow into critical export and defence-related sectors. This the Bank was able to do because regulating commercial banks' access to central bank credit, first attempted towards the end of the second plan, became by far the most important weapon of monetary policy during the third. Mainly a general weapon of control, the Bank selectively relaxed it to refinance bank lending to certain preferred sectors.

CREDIT POLICY, 1961-64

The quota-slab system instituted in October 1960 remained the dominant feature of the accommodation regime for the greater part of the third plan

period. Rapid deposit growth, poor slack season contraction, and concern over rising prices forced a further tightening of access to Bank accommodation and, as pointed out in chapter 3, a four-tier system of lending rates was introduced in July 1962 which raised the Bank's average lending rate by half a per cent or more. The basic quota, which could be replenished at the Bank rate, was lowered to 25 per cent of the average statutory reserves of the bank for the preceding quarter. Borrowings in excess of this quota were charged at rising rates of one, 2, and 2.5 per cent above the Bank rate. The yields of the new central government loans announced at the same time were also fixed above those prevailing on securities of comparable maturity, the Bank viewing these measures as being necessary to adjust the pattern of rates in the money and capital markets to reflect the savings-investment gap in the economy. These adjustments also helped ease the disquiet at the International Monetary Fund and elsewhere, especially in the run up to discussions about the July 1962 standby arrangement, over the rigidity of India's interest rate policies.

The 1962-63 busy season was overshadowed by the border conflict with China. There were other complications as well. The expected seasonal fall in prices did not materialize, while industrial growth remained sluggish and foreign exchange reserves declined rapidly. Credit contraction had remained tardy during the preceding slack season despite the revised accommodation formula. During the last peak season scheduled bank credit of Rs 200 crores had been financed to the extent of nearly two-thirds from banks' own resources and the Reserve Bank expected this to be repeated, especially as the rise in defence expenditure could be expected to lead to a rise in banks' deposits. Hence the Bank felt justified in further tightening the accommodation regime, and from the end of October 1962 it introduced a three-tier system with the peak rate of 2.5 per cent above the Bank rate coming into operation for accommodation in excess of the level of a bank's statutory reserves. Such accommodation was moreover expected to be temporary, lasting no more than a week or so, with the Bank resolving to charge 'really penal rates' should it appear to be becoming a permanent feature. Borrowings between a quarter and a half of the statutory reserves were to be charged at one per cent, and those between 50 per cent and 100 per cent at 2 per cent above the Bank rate.

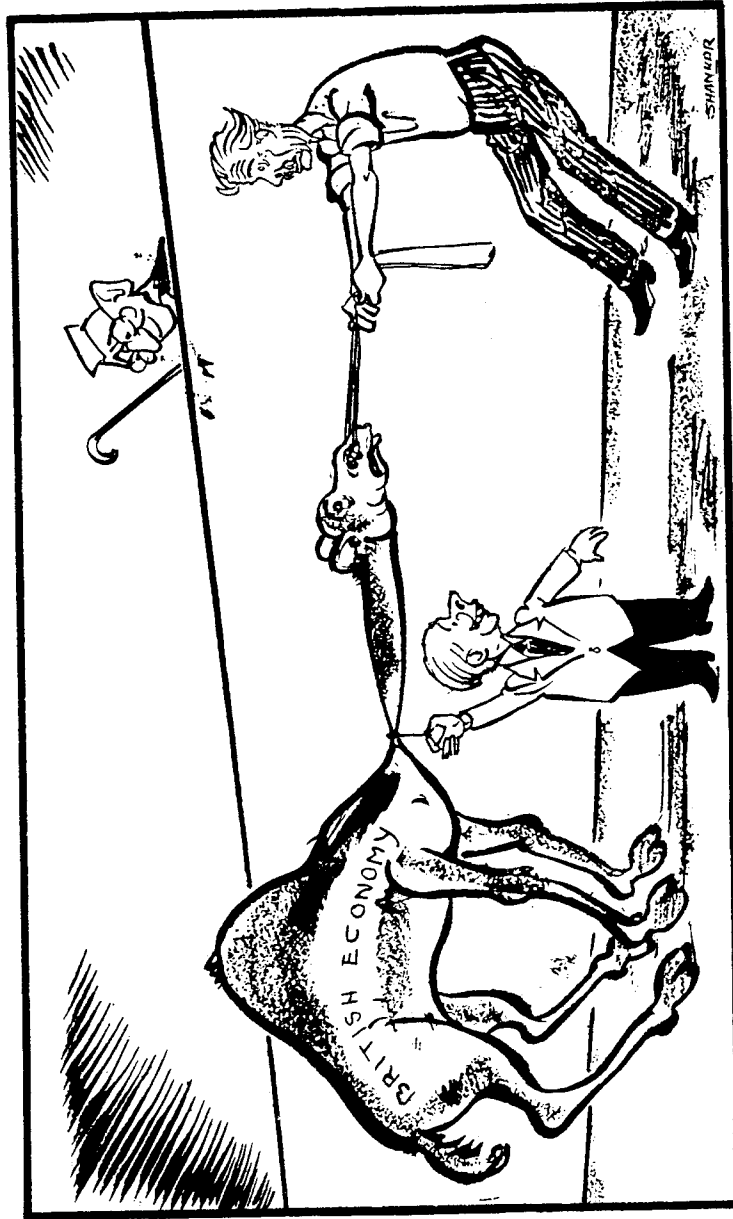
The new accommodation regime, as mentioned earlier, led to the firming up of lending rates in the market. Although the Bank rate remained formally at 4 per cent until January 1963, the average cost of borrowings from the Bank worked out to 5.46 per cent at the end of March 1961. The tightening of the terms of access to Bank credit in July 1962 added another half a percentage point to the Bank's average lending rate. Rates on the government's market

loans and on small savings also went up by half to one per cent, the lending rates of the banks moved up by half to two percentage points, and those of term-lending institutions, such as the Industrial Finance Corporation, state financial corporations, and the Industrial Credit and Investment Corporation, by half a per cent. The anachronism of a 4 per cent Bank rate which was out of line with market rates figured prominently during Art. XIV discussions with the Fund at the end of December 1962. The Bank itself was inclined to formalize the rate changes it had inaugurated several months previously, and decided on 2 January 1963 to raise the Bank rate by half a per cent to 4.5 per cent.

The Bank rate increase of January 1963 brought the curtain down on nearly three years of disagreement on this measure between the Reserve Bank and the Government of India. In the meantime, however, the Bank had raised its effective lending rates through the quota-slab system, and the new measure was intended mainly to bring the Bank rate once again in alignment with other interest rates in the market. Mint Road did not wish the hike to be read as a signal for dearer money, and the Governor advised commercial banks against passing the increase on to their borrowers since the average rate at which they borrowed from the Reserve Bank during the second half of 1962 was considerably higher than even the new Bank rate. Also in the Bank's view, it was important to avoid the 'impression among the borrowing public that the banks were forcing ... higher rates by ... entering into a sort of "cartel agreement" ' amongst themselves. Nor could they afford to ignore the effect of higher lending rates on the government's borrowing operations. The Bank however failed to have its way, as the banks insisted that although very little lending took place at 6 per cent, a 2 per cent margin over the Bank rate was the minimum required to maintain their earnings. The minimum lending rate was consequently raised to 6.5 per cent and before long, the State Bank of India and the term-lending agencies too raised their rate on loans by half a per cent.

Alongside the increase in the Bank rate, the quota-slab system was simplified, borrowings up to 50 per cent of the statutory reserves being permitted at the Bank rate, and the balance at 6 per cent. Borrowings in excess of the statutory reserves were permitted at 6.5 per cent. Since October 1962 the quota-slab scheme was operated more flexibly to take into account the needs of defence production, essential industries, and the export sector. Banks were also asked to reassess their advances portfolio, refuse advances where there was reason to suspect that they might be used for hoarding or speculation, and to consider recalling unsecured advances and those secured by gold and shares. The policy of granting preferential treatment to special

The Needle's Eye



By raising the bank rate, Britain hopes to ensure consumer austerity and step up exports.

— *Shankar's Weekly*, 30 July 1961

sectors (such as small-scale industries and cooperatives) was also extended; and in March 1963 an Export Bills Credit Scheme was instituted for making advances at a slightly lower cost, the stamp duty being exempted, against demand promissory notes backed by a declaration by the borrowing bank that it held eligible export usance bills in its custody.

Credit contraction during the 1963 slack season was unusually large, indicating a slow-down of investment activity. Besides, anticipating larger requirements for crop finance the Bank liberalized its system of lending rates and borrowing quotas in October 1963. The permissible quota for borrowings by scheduled banks, both against bills and government securities, was raised from 100 to 150 per cent of their average statutory reserves, with banks being allowed to borrow half this quota at the Bank rate (of 4.5 per cent) and the other half at 6 per cent. As the 1963–64 busy season progressed, however, it became apparent that the output of agricultural commodities was lower than earlier anticipated, and commodity prices came under renewed pressure. Credit, mainly assisted by increased recourse to the Reserve Bank, rose rapidly and the Bank felt obliged in March 1964 to formally revert to the accommodation regime prevailing prior to October 1963. However the Bank appears to have failed to sustain this restrictive stance over the next few weeks: for in nearly every case the cut in banks' borrowing quotas was restored subsequently in the form of 'special accommodation', with the result there was hardly any decline in the effective borrowing quotas of banks after March.

The year 1964 was a testing one for the Indian economic policy apparatus, not least for the Bank. The imbalance between aggregate demand and overall supplies led to prices rising sharply. Foodgrain prices, in particular, went up by more than a quarter. Given the nature of the underlying problem, policy came to focus largely on supply management through intensified procurement, larger imports, and better distribution. But during the twelve months ending 11 September 1964, money supply expanded by Rs 387 crores or some 11 per cent. While the government's rising indebtedness to the banking system was an important factor, bank credit to the private sector was also a major source of expansion, rising during the 1963–64 peak season by an unprecedented 26 per cent or about Rs 380 crores. Credit contraction in the following slack season was also only about a third of the earlier expansion. In the Bank's view this pointed to the importance of managing demand, particularly for inventories. On the fiscal front demand management called for holding down the level of deficit financing, while the task facing monetary policy was to deploy general and selective measures to restrain credit expansion to levels warranted by the productive requirements of the economy.

THE NEW CREDIT POLICY

Against this setting, the Bank effected a major revision of credit policy and its apparatus of control on the eve of the 1964–65 busy season comparable in scope and significance to the inauguration of the new monetary policy in 1951. As part of the new policy the Bank rate was put up from the existing 4.5 per cent to 5 per cent on 25 September 1964. The Bank also imposed restrictions on the inflow of banking capital from abroad which it felt might otherwise open the 'sluice-gates of expansion'. By far the more important change, however, was effected in the accommodation regime. The quota-slab system, where availability of credit was the key control variable, was discontinued and in its place was introduced a regime based on a new concept, the net liquidity ratio (NLR).

The new accommodation regime was the result of the Bank's search for a simpler and less discretionary form of central bank control over the expansion of commercial bank credit than the existing quota-slab system. Although other weapons of control too had much to commend them, the Bank's officials quickly rejected them as impractical. Higher reserve requirements were considered, only to be ruled out as being too blunt an instrument to meet the needs of a busy season credit policy particularly when banks' resources were already being strained to meet the enhanced statutory liquidity requirements which came into force from 16 September. A 'stiff increase in the Bank rate' of 1.5 per cent to 2 per cent, the Governor, P.C. Bhattacharyya, in particular felt, would have a 'salutary effect by enforcing the discipline of higher rates on the entire market structure'. But this was not possible because of 'budgetary interest cost considerations'. The Bank rate had also ceased to be a flexible instrument, its link with the 'operating rates' of the public sector and of local bodies having imparted to it a 'certain rigidity ... as an instrument of monetary policy'. The only practical course lay therefore in 'effectively raising the rate structure (in effect for the private sector)' with no more than a 'slight upward adjustment in bond yields'. Credit control, the Bank also concluded, should hence 'operate as it has done in the last two or three years on the access rights of banks to the Reserve Bank'. However it was not sufficient to restrict banks' access to central bank accommodation in order merely to make credit tighter, as this drove borrowers to seek non-bank sources of finance and helped restrict the 'area of effective central banking control'. It was also necessary to make credit dearer to ensure that there was an across the board increase in the interest rates facing the private sector.

Three formulas for regulating banks' access rights and the cost of central bank accommodation were aired in a note by M. Narasimham which formed



P. C. Bhattacharyya, Governor, 1962-67

the basis for discussions within the Bank about the 1964-65 busy season credit policy. The first was to adopt a system of differential lending rates under which the Bank would lend at the Bank rate against export bills, 'genuine internal bills of exchange', and government securities, and at half to one percentage point above this rate against bills under the bill market scheme. This idea did not make any headway: while the difficulty of distinguishing between genuine bills and 'created' bills might open the door to discretionary lending policies, officials at the Bank were also reluctant to be seen treating government securities with such 'undue preference'.

The second proposal involved fixing a credit-deposit ratio norm for banks and relating the Reserve Bank's lending rate to the margin by which the borrowing bank's credit-deposit ratio exceeded this norm. Deposits comprised nearly 90 per cent of aggregate demand and time liabilities of banks, and the credit-deposit ratio was 'effectively, though not exactly, the obverse of the liquidity ratio'. Besides encouraging them to mobilize deposits, the credit-deposit norm would also be more effective than a credit-*liabilities* norm in

discouraging banks from 'obtaining funds through inter-bank borrowings' to expand credit.

Therefore, according to Narasimham, this norm offered 'as rational a basis' as the liquidity ratio (which was the third formula and is described below) for regulating Reserve Bank lending, and had the 'further advantage of simplicity'. But with Bhattacharyya himself appearing to have preferred the third formula, the Bank adopted the concept of a 'net liquidity ratio' (NLR) as the basis of its accommodation policy.

Almost as 'cumbersome' to implement as the quota-slab scheme, this formula envisaged using a variant of the statutory liquidity ratio (SLR) to regulate the cost of the Bank's loans to scheduled commercial banks. Under the new method of accommodation which came into effect from 25 September 1964, the rate at which the Reserve Bank lent to a commercial bank depended on its net liquidity ratio. 'Net liquidity' represented the proportion of a bank's cash, balances with the Reserve Bank, current account deposits in other notified banks, and investments in Government and other approved securities, *less* its *total* borrowings from the Reserve Bank of India, the State Bank of India, and the Industrial Development Bank of India, to its aggregate demand and time liabilities.¹ In the scheme as it was originally introduced, a bank could obtain advances at the Bank rate so long as its net liquidity was at or above 28 per cent of its total demand and time liabilities.

At 28 per cent, the NLR nominally equalled the prevailing overall liquidity ratio (i.e. SLR plus the cash reserve ratio). But it represented a more stringent liquidity norm and a better index of a bank's liquidity position than the latter. While the cash reserve ratio remained unchanged at 3 per cent during the remaining years of our period, the SLR netted out only encumbered government and other approved securities. Thus, in principle, a bank could continue to borrow from the Reserve Bank against other assets and under the bill market scheme to replenish its resources, without breaching this statutory norm. In fact, a commercial bank might even finance its SLR obligations with funds it thus obtained from the Reserve Bank, by using them to buy government and other approved securities!

The net liquidity ratio, on the other hand, netted out *all* borrowings of a bank from the designated institutions. Under the proposed accommodation regime, the rate on a bank's *entire* borrowings would be stepped up by half a percentage point for every impairment of one per cent in its net liquidity

¹ This was the definition that came into force in December 1964. The original definition of net liquid assets adopted in September excluded 'other approved securities' on the assets side and borrowings from the Industrial Development Bank of India on the liabilities side.

ratio. Thus the scope for price rationing credit was now much wider, and by progressively increasing the cost of its credit, the Bank hoped to induce economy in the use of its facilities. The Bank also decided to cap the rates which foreign banks and the larger Indian banks (with demand and time liabilities of Rs 50 crores or more) could charge their borrowers at 9 per cent, so that they could not afford to borrow from the Reserve Bank at rates of more than about 8 per cent. This corresponded at that time to a lower bound for the net liquidity ratio of 22 per cent.

In a complementary move which reflected, perhaps for the first time, the integrated operation of credit and exchange control policies, the Reserve Bank also decided to place restrictions on the volume of funds foreign banks were allowed to bring in from their head offices, other branches, and correspondents, without its prior approval. This measure became effective from December 1964. Exchange banks preferred importing funds from their head offices to borrowing from the Reserve Bank to finance their credit expansion during the busy season, and the object of this move was to fortify the new accommodation regime besides ensuring that the latter did not unfairly discriminate against Indian banks.

Explaining the credit control initiative of September 1964 to heads of scheduled banks, the Governor drew their attention to the steady build-up of inflation in the economy and the large expansion of credit, not only to the government, but also to the private sector.

As we approach another busy season which will add further pressures on the system, there is imperative need for continuing a policy of monetary restraint. At the same time, the Reserve Bank is aware that with ... credit levels being as high as they are now and with the enhanced liquidity requirements now in force, banks might find it difficult to finance seasonal needs out of their own resources and that the reliance ... on the Reserve Bank would consequently increase. If genuine seasonal requirements are to be met within the framework of a policy of credit restraint, a modification of the existing system of control is indicated which would place primary emphasis on increasing the cost rather than directly restricting the availability of accommodation from the Reserve Bank.

As noted above, the announcement of the new accommodation regime coincided with the imposition of higher statutory liquidity requirements. The former also helped reinforce the impact of the statutory liquidity requirement on the market for government securities, since it would tend to favour banks

which held a larger proportion of their assets in the form of investments in these assets. But not, in the Bank's judgement, indefensibly so, since the lower rate charged on its loans to a bank with the higher liquidity ratio could be justified as a form of compensation to this 'comparatively underlent' institution for having 'sacrifice[d] ... [its] earning power'.

An accommodation regime based on net liquidity ratios also held a number of other advantages over the quota-slab system. While access to accommodation was not restricted, the new regime placed greater emphasis, as noted above, on the cost of credit. It also made credit dearer rather than merely tighter. Secondly, unlike the quota-slab system which did not differentiate between banks with high credit ratios and those with low, banks with overextended portfolios would find it difficult to expand credit except at an exorbitant cost to themselves. In this sense, the system brought interest rates more into play; or, as Bhattacharyya pointed out, it was a form of 'credit rationing by the purse'. Under this regime banks would be paying different rates of interest on their borrowings from the Bank and those with overextended loan portfolios would find that the only low-cost option open to them lay in expanding their deposit base. This could also be expected to have positive implications for the development of the banking system. Thanks to the inhibiting cost factor, moreover, recourse to central bank accommodation could also be expected to be temporary and of a revolving character. Finally, by providing refinance outside it for specific uses of credit, the Bank could also use the new regime to develop a positive instrument of selective credit control. Thus from its inception, export bills were rediscounted at the Bank rate while from November 1965 onwards, similar favourable treatment was extended to credit to finance food procurement and defence supplies.

Though the new accommodation regime was not as effective as hoped in its first busy season, there was a deceptive sense of success until the early days of 1965. Total scheduled bank credit during the busy season up to 8 January 1965 was, at Rs 155 crores, lower by Rs 21 crores than the corresponding figure for the previous year. This was, at any rate for the Bank, a redeeming feature in a situation where the price level was substantially higher than that prevailing a year earlier. But disaggregated data showed that while the exchange banks and the other major Indian banks increased their advances by less than they had done in the last season, the State Bank of India and its subsidiaries expanded credit faster than before; with the result, the latter institutions now came to account for over half the total increase in credit during this part of the 1964-65 busy season as against merely a third in the preceding one. These credit trends were reflected in the distribution of banks' demand for accommodation from the Reserve Bank. Busy season

Bank accommodation up to the first week of January 1965 totalled about Rs 88 crores. This was lower than the aggregate accommodation banks could draw on at the Bank rate but considerably in excess of what they had obtained during the corresponding period of the last busy season (Rs 31 crores). But nearly three-quarters of the higher amount were made up of borrowings by the State Bank of India which had barely sought any accommodation from the Bank at the same stage of the 1963–64 busy season. As for the other scheduled banks, their borrowings from the Reserve Bank were down to Rs 20 crores, from Rs 30 crores during the previous season.

Though more dramatic perhaps than the Bank anticipated, the differential growth of bank credit and of recourse to Bank accommodation owed directly to the new credit policy whose object it was to make it difficult for overextended banks to extend credit except at penal rates of interest. Banks with a tight net liquidity position (the Bank of Baroda, the Bank of India, and the Canara Bank for example) experienced low growth while the overextended exchange banks saw an actual decline in their outstanding credit. In contrast, the Central Bank of India, the Punjab National Bank, the Union Bank, and the State Bank of India increased their borrowings from the Reserve Bank in the new regime. Of the four, the increases in the case of the three private banks were quite small and they soon entered the penal zone. The State Bank of India posed the more formidable challenge to the restrictive character of the new policy. Despite a fall in its deposits, the State Bank had a favourable net liquidity position. Besides, this bank had comparatively large holdings of government securities which it could afford to run down without seriously endangering its liquidity position. Thus the bank shed gilt-edged stock to the tune of Rs 74 crores by 8 January 1965, as against about half that amount at the corresponding stage of the previous season.

There were a number of factors operating on the demand side as well. The State Bank faced demands from borrowers who were denied credit by their customary bankers many of whom did not have additional resources to lend. Credit limits already sanctioned by the State Bank too were being more fully utilized than in the past, while the depression in the capital market led to greater demand for credit from the banking system. But it also transpired that the subsidiary banks, if not always the State Bank of India, were in the habit of placing their money for a month or more in the inter-bank call money market, thereby contributing to easing its condition and enabling liquidity-starved banks to borrow in that market. Officials at the Bank believed it was in the 'nature of things for an economic mechanism to resist controls' and that some follow-up action was needed to make the new regime more effective.

The follow-up action was twofold. In the first place the Bank began leaning on the State Bank of India to reduce its borrowings from it. This effort met with mixed success. While the bank reduced its outstanding borrowings on at least two occasions in response to the Reserve Bank's advice, they began rising again soon afterwards, peaking at Rs 91 crores during March 1965. Officials at the Bank were even willing to swallow their own earlier argument that the new regime was intended to make credit dearer rather than tighter, and consider laying down an absolute limit for the State Bank's borrowings from the Reserve Bank so that it would be forced to 'discipline itself to the requirements of [a] stricter monetary policy'. But such a step was not eventually taken since the bank's net liquidity ratio soon approached the penal zone and it began winding down its borrowings. But with the Bank setting itself a stiff contraction target for the ensuing slack season, the State Bank was once again asked towards the middle of April to reduce its outstandings from the prevailing level of Rs 77 crores to Rs 50 crores by the end of the month, and to Rs 25 crores by the middle of May. The State Bank heeded the Bank's advice, but only after it was backed by a letter from the Finance Ministry conveying the same message.

The more general follow-up action was taken in February 1965, but it is useful first to set it against the background of the Bank's thinking at the time. The monetary and credit situation generated a number of mixed signals to the Bank. On the one hand monetary expansion during the fiscal year up to the end of January was lower (at Rs 188 crores) than during the preceding year (Rs 322 crores). Net credit to the government too was lower than in the preceding fiscal year, as was the expansion of bank credit to the private sector during what had elapsed of the busy season. But prices began rising even in the peak season, the index rising from 155.6 at the end of November 1964 to 161 on 9 January 1965, slipping back to 160.2 a week later. Even at these lower levels prices were higher by some 17 per cent compared to the previous year. There were other reasons too for the Bank to incline towards a gloomy view of the situation. Moderate as it had been so far, monetary and credit expansion during the current season came on top of steep increases in money supply in the two preceding years and the lower credit contraction that took place during the 1964 slack season. Commodity arrivals in the terminal markets were also lower than anticipated. The onset of the current busy season, besides, was delayed until December and market reports suggested that the bulk of the financing of goods such as cotton and oilseeds was yet to take place. Hence despite the favourable initial situation, there was reason to expect credit expansion during the current season to approach the previous year's record of Rs 377 crores or fall short of it, at best, by about Rs 25 crores. If the projected trends were allowed to be realized, the Bank apprehended, money

supply in April 1965 would exceed the peak level of the previous year (reached in April) by nearly 10 per cent. Against this background the Bank wished to 'restrict ... net bank credit to both government and the private sector [and] ... minimize the rate of expansion of money supply in the rest of the busy season'. Keeping the rise in bank credit down to Rs 300 crores was regarded as a realistic target below which 'production at important points' would be hampered. Bank lending to government during the rest of the busy season was also proposed to be restricted to Rs 25 crores. These targets, according to an internal Bank note, were consistent with a rise of about 7.2 per cent in money supply over the previous April peak.

To achieve this target however, the existing restrictive policy had to be reinforced. The major policy change was an increase in the Bank rate from 5 per cent to 6 per cent on 17 February 1965. This increase was indicated by other factors as well, including the foreign exchange position, the rise in the Bank of England rediscount rate to 7 per cent in November 1964, and approaching negotiations with the Fund for another standby arrangement. Although thanks to controls, the London Bank rate did not affect the Indian capital account directly, particularly after restrictions were imposed on the flows of banking funds, the wider spread between interest rates in India and London was believed to be delaying the remittance home of export receipts. In fact, Bhattacharyya who had for some months past been favouring a policy of dearer money, would have liked to put the rate up to the 7 per cent prevailing in London, but in the end the Bank balked at a jump of two points. A rise in the rate of even a full percentage point was unprecedented, earlier changes in the Bank's three decade long history until then having been of the order of half a per cent.

Other restrictive measures were adopted at the same time as the Bank rate was put up. The minimum net liquidity requirement for borrowing at the Bank rate was raised to 30 per cent and the cap on the advances rate of the larger banks (and foreign banks) was raised to 10 per cent from the prevailing 9 per cent. The Bank also decided to abstain from open-market operations until the pattern of yields had adjusted to the current structure of interest rates in the market. These measures were however largely ineffective for their intended purpose. After a delayed start the peak season picked up momentum rapidly and despite the more stringent accommodation regime, scheduled bank credit expanded by Rs 407 crores during the season. This represented the highest absolute increase in bank credit during a single season, but even the relative increase was at 24 per cent only slightly lower than the increase of 26 per cent recorded during the previous busy season.

MONETARY POLICY, 1965-67

Expansion of such magnitude in the busy season lent urgency to securing the orderly retrenchment of credit during the slack season. In addition, discussions within the Bank over slack season policy took place against the background of the standby agreement between the Government of India and the International Monetary Fund. Although the agreement itself was not finalized until March 1965, its intimations and those of the weak foreign exchange position it was intended to address were already discernible in the monetary policy announcements of February 1965. The standby agreement set a ceiling of Rs 3,044 crores for the Reserve Bank's net domestic assets in July 1965, and thereafter Rs 2,988 crores up to February 1966. (Holdings of these assets stood at Rs 2,819 crores in February 1965.)² The Bank had also indicated to the Fund its plans to reduce bank credit during the 1965 slack season by about Rs 200 crores.

There were, needless to stress, two aspects to not breaching the Fund ceiling. Net Bank credit to the government would depend largely on the 'behaviour of ad hoc treasury bills'. But the Bank itself could so conduct open-market operations as to reduce or postpone additions to its net domestic assets. Bank credit to the private sector was the second element in the situation. Thanks to faster than expected growth in bank credit and large issues of ad hoc treasury bills, the Fund ceiling was in danger of being breached even before the current busy season drew to a close. At the same time, foreign exchange reserves were declining rapidly and it seemed only a matter of time before they dropped below the legal minimum. Hence the government decided towards the third week of April to draw a portion of the standby credit. By going in for an early drawing the government also hoped to avoid having to engage the Fund in protracted consultations after the domestic assets ceiling was breached. This move was preceded by the letter from the Finance Ministry to the State Bank of India referred to above, to reduce its outstanding borrowings with the Bank by at least Rs 30 crores.

Given the large expansion of credit during the 1964-65 busy season, the Bank initially set its sights on securing as high a contraction of credit during

² According to the standby agreement, net domestic assets of the Reserve Bank included the domestic assets of the Issue Department, assets held in the Banking Department such as internal trade and government treasury bills purchased and discounted, investments, loans and advances to governments and banks, investments, loans, and advances made from the Bank's Long-term Operations Funds and Stabilization Fund, less liabilities (of the Banking Department) such as governments' deposits.

the 1965 slack season as possible. Apart from being desirable in itself, any realistic prospect of the Bank adhering to the Fund ceiling in the next busy season also depended on reducing bank credit substantially during the slack season: once the level of credit outstanding at the end of the slack season (or the outset of the next peak season) was sufficiently low, more realistic credit expansion targets could be set for the busy season up to February 1966. This was partly the reasoning behind the Bank's advice to the State Bank to reduce its borrowings from it by the middle of May. Credit contraction during the slack season was usually about half to 60 per cent of the expansion in the preceding busy one. In some years, as in 1964, the proportion fell away to 34 per cent, while in 1963 it was as high as 64 per cent. Against this background, the Bank believed a contraction of Rs 175 crores realistically possible in the 1965 slack season. The large size of Bank accommodation during the busy season, sizeable bank advances against seasonal commodities (62 per cent as opposed to 49 per cent in the previous busy season), and improved supply outlook for the latter were seen as propitious omens. On the other hand, the desire of traders and others to restore stocks they had run down during the previous summer threatened to increase the slack season demand for credit, while a major imponderable on the supply side was the rise in the deposits of the banking system which typically took place during this season as a result largely of the government's deficit financing operations and delayed export receipts. If bank deposits grew at a healthy rate, banks would be enabled to pay off their debts to the Bank and even raise their investments in government paper should they be disposed to do so, without contracting advances to any appreciable extent.

The thinking within the Bank in May 1965 was that deposits could be expected to rise by about Rs 200 crores during the slack season. Officials believed it would be possible to reduce outstanding bank credit by Rs 120 crores without any significant tightening of policy, and that contraction beyond this depended on the measures taken. But there was little sign, as the slack season progressed, of any substantial reduction in bank credit: during the six weeks ending June 11, for example, bank credit fell by only about Rs 25 crores in contrast to a decline of over Rs 35 crores during the corresponding part of the previous year. Apart from the persistent demand for credit from those who wished to restore their stocks, it also appeared that banks with tight liquidity positions had phased their non-seasonal advances to the slack season. To officials at the Bank, this indicated the need for a further tightening of policy.

Three policy measures were aired in internal discussions. The first was to raise the cash reserve ratio from the existing 3 per cent to 4 or 5 per cent.

On a deposit base of Rs 2,600 crores this was expected to lead to reserves of Rs 26 crores or Rs 52 crores being impounded. The advantage with variable reserves was that of the three instruments considered, this alone possessed an automatic sanction against non-compliance. There were however two problems here. First, for a moderately higher reserve ratio to exert an additional contractionary influence on bank credit, its imposition would have to be deferred until the normal slack season contraction had taken place since otherwise the latter could be set off against the higher reserve requirement. This meant waiting until August at least. Another argument against higher reserve requirements was that they might actually worsen the net domestic assets position should banks, for example, feel encouraged by their improved liquidity position to step up their borrowings from the Reserve Bank. In contrast two other instruments were together thought to offer greater promise of contracting credit in the slack season and preventing an increase in the Bank's net domestic assets.

The first of these was for the government to issue treasury bills or treasury deposit receipts, with the Bank offering them on tap to scheduled banks. This proposal emerged partly out of the Bank's concern that the market for treasury bills was often inactive even in the slack season, with banks preferring to park their surplus balances in the inter-bank call money market although it might sometimes offer a lower yield than treasury bills. The Governor raised this concern in May 1965 at a meeting with bankers called to underline the importance of adequate credit contraction in the slack season. Apart from expectations, bankers believed the tender system of offering treasury bills made for low yields during the slack season, while another disincentive was the non-availability of treasury bills throughout the week. There were also doubts in the market over whether the Bank itself favoured frequent investments and disinvestments in treasury bills.

The Bank therefore began examining ways of making the treasury bill a more attractive instrument of short-term investment to banks. Although there was some scepticism as to how much of the funds invested in the call money market could be diverted towards treasury bills, there was general agreement that this proportion should be increased to the maximum extent possible. One method considered was to offer the asset on tap through the week with yields ranging between 2.5 and 4.5 per cent depending on conditions in the call money market. But the latter might vary beyond this range of yields so that an alternative method of allowing the market to freely determine the yields, was also considered. In the end the former method was preferred as representing the less radical departure, and it was decided to fix the week's treasury bill rates each Monday on the basis of call money conditions during the preceding week.

The formal decision to inaugurate the supply of treasury bills on tap was taken early in June and the yield during the first week fixed, at the Governor's initiative, at a generous 3.5 per cent. The immediate response of banks to this new investment opportunity was none too enthusiastic, so that initially the Bank considered adding 'an element of compulsion' by directing commercial banks to invest a specified percentage of their deposits in treasury deposit receipts. Modelled on British wartime assets of the same name, officials expected this move to curb private sector credit in a way which was meaningful from the point of view of the standby agreement if some other means could also be deployed simultaneously to prevent banks from translating their improved liquidity positions into higher borrowings from the Bank. Hence the second suggestion which was for the Bank to prescribe a minimum reduction in banks' peak season credit so that they restored a given credit-deposit ratio or reduced their outstanding credit to some proportion of the seasonal peak.

Despite these detailed exercises the Bank 'refrained from adopting any quantitative measures designed to bring about a credit reduction' during the 1965 slack season. The only credit control measures taken during the season were of a selective nature. Banks were directed on 29 June to keep their unsecured advances at or below the level prevailing on 25 June 1965. The Bank also required importers to maintain advance deposits with banks of a quarter of the value of goods shipped, and banks to invest such deposits in treasury bills. Besides, commodity-specific controls were imposed on lending against paddy and rice, wheat, other foodgrains, groundnuts and other oilseeds, vegetable oils, and cotton and kapas.

The Bank also advised scheduled banks to increase investments in treasury bills. When this evoked no response—fewer treasury bills were sold in June 1965 than in the same month of the previous year—the Governor called another meeting of their chief executives on 21 June where the same point was made more forcefully and with rather greater success. As the peak season drew to a belated close and banks also grew used to their availability on tap, sales of treasury bills went up sharply from Rs 26.5 crores in June 1965 to Rs 142.8 crores in July. (The corresponding figures for the previous year had been Rs 32.4 crores and Rs 47 crores respectively.) With sales of treasury bills remaining high in the subsequent months as well, scheduled banks' outstanding investments in these instruments rose from Rs 5.31 crores at the end of March 1965 to Rs 20.1 crores at the end of March 1966. Thanks to the success of the new system of tap sales of 91-day treasury bills, the Bank also began to consider offering six month treasury bills on tap 'as a convenient instrument for banks to hold during the slack season....'

Tap sales helped expand the market for treasury bills, but did little immediately to help contract credit in the slack season. The total contraction effected up to August 1965 was a mere Rs 87 crores, against Rs 111 crores on a lower credit base in the last slack season. By now, of course, a contraction of Rs 125 crores seemed optimistic, let alone the Rs 175 crores the Bank had originally trained its sights on. Even the directive of 29 June against clean advances had to be modified as it led to an 'uproar', particularly 'from a number of small borrowers'. The Finance Minister, T.T. Krishnamachari, too opposed the directive, insisting that it would hurt industry most. Rejecting the Bank's argument that banks in any case did not lend substantial amounts to industry because they preferred to keep their resources free for the busy season and refusing to concede that any other course would make it impossible for the government to fulfil its commitment to the Fund, he directed the Bank, somewhat peremptorily from Washington, to modify its directive on clean advances.

By August 1965, however, the Bank's assessment of the credit expansion experienced during the previous busy season too had become rather more positive. Though higher than ever before at Rs 407 crores, credit expansion during the past busy season, officials at the Bank now felt, was not excessive in relation to the 'real level of transactions financed by the banking system'. Nor had the credit expansion proved inflationary. In October 1964 prices were nearly 15 per cent higher than those prevailing a year earlier. In April 1965, however, prices were only about 10 per cent higher. Despite the rapid increase in bank credit and in lending by the Bank, the market had remained tight. Inter-bank rates touched 10 per cent both in Calcutta and in Bombay which was unprecedented, while the unorganized market reported rates of 18 to 20 per cent. The weighted average rate on borrowings from the Reserve Bank reached 8.44 per cent on May 14, compared to the previous season's peak of 5.62 per cent on 27 March 1964. Thus, 'the absolute figures of credit expansion' did not, in the Bank's present view, 'reveal sufficiently the tightness of the rein on credit'. It would also be 'facile' besides, officials now argued, to 'interpret the large absolute level of expansion as signifying the ineffectiveness of the squeeze'.

This re-evaluation of credit developments in the previous busy season also put the current slack season in a somewhat different light. According to the new view, it was no longer possible to ignore the special factors which made the return flow of funds less smooth than normally. Despite large exports, the record production of sugar during the year left stocks to be carried until the beginning of the new sugar year. The government's buffer-stocking operations in foodgrains could also be expected to come in the way of a full return flow

of funds. Besides, textile stocks had accumulated with mills, while soyabean oil imports had been deferred to the summer because of difficulties in obtaining credit during the busy season. Although direct action on the reserve base through calling up additional reserves or issuing treasury deposit receipts was still mooted, there was not the same urgency about such measures as previously. Moreover, the imminence of state government loans meant that recourse could not be had immediately to these instruments. In the event, credit contraction in the 1965 slack season was only Rs 93 crores. This was less than a quarter of the credit expansion witnessed during the preceding busy season and less than half the contraction the Bank had hoped to see.

Discussions over the busy season policy for 1965–66 commenced against this background. The initial anticipation was that the expansion of scheduled bank credit during the season would be about Rs 425 crores, financed by fresh deposits (Rs 110 crores), disinvestment in government securities (Rs 170 crores), and central bank accommodation (Rs 145 crores). With credit expansion of this magnitude, the Fund's ceiling on the Bank's net domestic assets would come under pressure from December. Hence while permitting credit to 'expand up to the requirements of the economy', measures to check excessive expansion by tightening some existing instruments of control were also mooted. Bafflingly in the circumstances, some officials also proposed persisting with controls over the inflow of banking capital, advancing in their defence the same reasoning offered a year ago, namely that it might otherwise become 'the sluice-gates for credit expansion'.

Although counselling a general policy of restriction, economists at the Bank were overcome by a discernible 'tightness fatigue', with a note by M. Narasimham, which otherwise advocated a tight rein on credit, insisting that if the

level of transactions were even slightly above that of the last busy season, it would seem necessary to provide for this expansion ... even if it should mean piercing the net domestic assets ceiling, as the alternative to this would mean a squeeze so severe as to hamper economic activity.

This fatigue was more marked in V.G. Pendharkar's somewhat despairing note which questioned whether any link existed between credit policy and prices in the peak season. The latter, Pendharkar argued, were largely influenced by seasonal factors outside the control of the banking system. To suggest that an effective credit policy prevented matters from getting worse amounted to conceding that general credit policy instruments had no role other than supporting selective control measures. With the effects of monetary policy

being so indistinct in the peak season, Pendharkar wondered whether a 'tighter policy' was worth the price of lower investment and a further depression in the capital market:

A time when industrial production is likely to be decelerating and the capital market is in a depressed state is certainly not the time for tightening monetary policy. The capital market ... needs to be lifted out of the morass it has got bogged in. This argues for a reflationary policy.

Suggesting a monetary policy which besides exerting a 'favourable balance of payments impact' would not 'adversely affect the internal price situation', Pendharkar recommended relaxing controls over the inflow of foreign banking funds into India. He also wanted selective controls used more freely, some check on the rise in clean advances, and monetary policy concessions to boost industry and the capital market. Finally, Pendharkar counselled against raising the existing net liquidity ratio norm and any sharp escalation in the Bank's accommodation rates.

Independently, Krishnamachari echoed Pendharkar's scepticism about the impact of monetary policy on prices. Remarking in a letter to Bhattacharyya written in September 1965 that the 'beneficiary effect of monetary policies on prices was very very faint', the minister suggested that policies framed with an eye to the Fund undertaking had resulted in acute stringency in the market, 'stifled business ... and dampened an already slack share market'.

As it happened, credit policy in the early part of the 1965-66 busy season came to be dominated by the hostilities which broke out with Pakistan in September 1965. Considerations such as the size of the Bank's domestic assets consequently took a backseat. Monetary policy, it was now felt, should aim to preserve a 'reasonable balance between aggregate monetary flows and the availability of real goods and services', besides 'helping to bring about ... a diversion of resources' to defence-related sectors. While increasing the cost of accommodation for banks breaching the net liquidity ratio norm and relaxing (largely for balance of payments reasons) controls on inflows of banking capital imposed less than a year earlier, the Bank advanced schemes to refinance credit extended to the defence and exports sectors and make pre-production finance available to defence-related industries. Foodgrains procurement was the other area of preferential refinancing. While refinancing banks' advances to these preferred sectors liberally at the Bank rate, the Reserve Bank also decided to set such refinance off against banks' net liquidity ratios so that their other advances might be squeezed. In addition, selective controls were tightened for advances against foodgrains, oilseeds, and vegetable oils.

By the time the Governor joined issue with the Finance Minister in December 1965 over his views on the effectiveness of monetary policy, the emergency had passed. Bhattacharyya agreed with Krishnamachari that demands on bank credit had multiplied following the growth of the economy, the increase in sugar, foodgrains, and textile stocks, the depression in the capital market, and the virtual collapse of the unorganized credit market, in particular the operations of Multani *shroffs*. On the other hand, there was justified anxiety that bank credit which found its way into some of these sectors might not return to the banking system and that the latter would be able to expand credit only by being 'fed continually throughout the year by the Reserve Bank'. While the Bank had a responsibility to provide seasonal finance, non-seasonal finance Bhattacharyya underlined, should be met by the banks themselves out of their own resources:

If the banking system were to be fed by [the] ... Bank ... throughout the year, it would only add to the monetary pressure on the economy which is already suffering from the ... heavy deficits incurred by the Government

Explaining the current policy of checking banks' borrowing to meet non-seasonal needs, reducing the volume and duration of those to meet seasonal needs, and capping the interest rate on bank lending, Bhattacharyya argued that the 'very faint' impact of credit policy on prices was no reason to cheapen credit or increase banks' access to central bank accommodation. Nor was it possible to administer selective controls within an overall credit policy that was too liberal.

I fully share your view that conventional methods of monetary policy do not apply with the same force in our economy as in the western ones and that some measure of improvisation is needed all the time in order to achieve the ends we have in view But I would strongly urge on you that this is not the time when credit should either be cheapened or made more freely available generally. We have to wait to see that the economy is geared to a condition where increased production possibilities are apparent before we make any change in the monetary policy.

The 1965–66 peak season also saw the introduction of the Credit Authorization Scheme in November 1965. It was born of a suggestion TTK and Asoka Mehta (Deputy Chairman, Planning Commission) made to Bhattacharyya, to formulate ways in which to align credit policies more closely with the five-year plan. The French success in integrating credit allocation

with their system of indicative planning appeared to offer some promise in this regard, and this scheme was one of the several suggestions considered following its author Narasimham's study of the French experience. Under this scheme, scheduled commercial banks were required to obtain the Bank's authorization before sanctioning any fresh credit of Rs one crore or more to any one borrower, or any fresh limit which would take the total limits enjoyed by the borrower from the entire banking system to Rs one crore. Existing limits were however not affected. During the first two years of its operations, the Bank authorized additional limits totalling Rs 1,000 crores. The total authorized limit amounted to about Rs 3,080 crores at the end of December 1967. Rejections were few, with 2,255 approvals out of 2,330 applications. While 80 per cent of the authorized credit limits were for working capital purposes, purchase and discount of bills accounted for 8 per cent and term loans for 6 per cent. Limits for financing exports and sale of machinery increased in the first two years of the scheme from 3 per cent to 6 per cent.

The objective of the scheme was to bring credit operations into line with established national priorities. The main criteria used for examining applications for enhanced limits were the purpose of the advance in relation to the plan, the productive nature of the activity expected to be financed, and the optimum level of inventories. The scheme also helped prevent a few large borrowers from pre-empting scarce bank resources and in enforcing a measure of financial discipline upon them. The former consideration began to grow in importance as the authorities in Bombay and Delhi became sensitive to the impact of credit rationing on smaller borrowers: the protests that greeted the restriction of clean advances in June 1965 appears to have emanated largely from this segment, and meeting its credit requirements would become, increasingly in the future, an important object of credit policy.

Despite additional defence expenditures, the 1965–66 busy season did not witness a boom in bank credit, the latter expanding by only Rs 310 crores during these months. However, money supply rose by Rs 486 crores (or nearly Rs 100 crores more than the increase registered in the preceding peak season) principally because of the Bank's large net credit to government which amounted to Rs 387 crores during the 1965–66 busy season (as against Rs 160 crores in the 1964–65 busy season). Occurring at a time of a severe shortfall in the availability both of domestic goods and imports, the Bank apprehended that the government's large expenditures would inject considerable excess liquidity into the banking system. The normal contraction of credit during the 1966 slack season was expected to add Rs 75–100 crores, and deposits Rs 200 crores to banks' resources during these months.

As against this, banks owed some Rs 30 crores to the Reserve Bank, while existing reserve and liquidity requirements would immobilize another Rs 60 crores.

Nervous about the effects of the liquidity overhang of Rs 200 crores on credit and prices during the slack season, the Reserve Bank proposed immobilizing banks' additional deposits by calling up, in the first instance, the full increment of deposits in May 1966, and also impounding June deposits, if necessary, once more was known about the government's borrowing programme. However for reasons that are not recorded and which may well have something to do with the chorus of protests with which business and industry greeted the rupee's devaluation less than three weeks after Bhattacharyya's letter to the Finance Minister communicating this proposal, no such action was taken in the end, the Bank merely advising commercial banks to ensure adequate contraction of credit during the slack season and invest additions to their resources in treasury bills. The latter, the Bank may have rationalized, virtually amounted to voluntary impounding of deposits.

Credit contraction during the 1966 slack season amounted to Rs 86 crores, or about 28 per cent of the increase in credit during the preceding busy season. Banks' deposits however rose more than the Bank anticipated, by Rs 265 crores. But equally, their investments in government securities increased by Rs 298 crores as against less than half this amount the previous year. Consequently, the aggregate investment ratio of banks moved up smartly from 27.4 per cent to 34.3 per cent.

Credit policy during the 1966-67 busy season was framed initially in the expectation of a substantial recovery in agricultural production. Therefore the Bank allowed commercial banks to secure an additional refinance tranche at the Bank rate of 10 per cent of their net liquidity ratio at the end of the slack season. But once it became clear that there would be no recovery in foodgrains output, the Bank instructed the larger Indian banks and all foreign banks to ensure that 80 per cent of their seasonal expansion of credit was directed towards financing industry and foreign trade. Despite repeated warnings, credit expansion (about Rs 411 crores till 17 March 1967) remained, in the Bank's judgement, larger than that 'warranted by the availability of real goods' in the economy. Equally worrying was the increase in clean advances in the early part of the busy season. Therefore, at the end of March 1967 the Bank decided to implement the threat it had held out in October the previous year of charging 'really penal rates' of a minimum of 11 per cent on excess borrowing by banks whose net liquidity ratios dropped below 30 per cent. This had the intended effect, and the seasonal expansion of bank credit during

1966-67 was held down to about Rs 425 crores. After registering a sharp increase till January 1967, clean advances too dropped by April 1967 to levels below those prevailing at the onset of the busy season.

PREFERRED SECTORS AND MORAL SUASION

The concept of 'preferred' or 'priority' sector credit, which was beginning to make its appearance at this time, was intended to give a positive thrust to the Bank's credit control policies during these years. In July 1961 the Bank conducted a survey of loans granted to cooperative institutions and small-scale industries mainly in order to see how credit flows to these segments might be increased. The results of the survey showed that advances to small-scale industries at the end of June 1961 amounted to Rs 27 crores or only about 2.5 per cent of total scheduled bank credit. Advances to cooperative institutions amounted to Rs 9 crores, i.e. less than one per cent of total scheduled bank credit. With a view to giving banks an incentive to increase their lending to these two sectors, they were allowed in addition to the existing arrangements, to borrow at the Bank rate the amounts they advanced to these sectors. This arrangement which initially remained in force during the first half of 1962 was continued thereafter with some



Bhattacharyya (third from right) discussing credit policy with bankers, June 1967. Governor-designate Jha and Adarkar are to his right; Anjaria is to his left.

modifications. Besides, while access to Bank accommodation became progressively more restricted during these years, banks' lending to preferred sectors often qualified for refinance at the Bank rate. Preferred sectors varied over time, but included cooperative institutions, small-scale industries, food procurement credit, credit for financing defence production, industries producing essential goods, and exports. The availability of refinance credit for these sectors was further liberalized in January and March 1963.

The importance of agricultural credit in the Bank's priorities grew with the adoption of the new agricultural strategy. It came to the Bank's notice in May 1965 that its exhortations to banks to effect a sizeable contraction of credit during the 1965 slack season had the effect of reducing lending for agricultural development schemes under the refinancing programme of the Agricultural Refinance Corporation. The Bank had therefore to clarify that while restraint remained the guiding principle, a 'modest and desirable increase' in the provision of credit facilities for agriculture 'would not ... be inconsistent with the requirements of short-term credit policy'.

Export finance was another preferred sector, with the Bank lending against banks' promissory notes backed by export bills at lower rates of interest than under the bill market scheme. In June 1966 manufacturing industry was also classified as a priority sector. During the following busy season, the Governor directed large Indian banks and foreign banks to extend 80 per cent of their credit between the end of October 1966 and April 1967 to industry or against export and import bills. For this purpose the term 'industry' was defined broadly to include plantations, mining, transport, and power. The need to provide adequate credit to small-scale industries was also emphasized. However when credit trends during the 1966-67 busy season showed a pronounced rise in clean advances, the Bank suspected that banks were lax in reallocating credit between preferred sectors and the others. The Governor therefore took it upon himself to caution banks that Reserve Bank directives regarding the composition of their credit portfolios had the 'same binding force as any other obligation imposed by the Banking Regulation Act', and that penal action could follow if these were ignored. Allocative disputes once again came to the Bank's notice following complaints that many banks had responded to its exhortation by freezing all unutilized credit limits to the non-priority sectors. This affected trade, in particular those traders who had left some portion of their credit limits unutilized, while others who had used up their limits held on to their advantage. Demanding a change in policy, the Bank instructed banks to reduce limits pro rata, even if it meant recalling some advances, rather than freeze unutilized limits.

TOWARDS REGULATING INTEREST RATES

The greater frequency of Bank rate changes during the 1960s should not be allowed to obscure the segmentation that was taking place in the credit market during these years. In practice the Bank's credit policy aimed to increase this segmentation along several axes, notably through creating a captive market for government loans. Besides being substitutes for raising the Bank rate, both the quota-slab system and the accommodation regime based on net liquidity ratios involved differential rates of lending by the central bank and had the effect of keeping down the increase in the Bank rate needed for any given increase in the lending rate of commercial banks. But since the extent of commercial banks' dependence on its accommodation facilities (and therefore the costs to them of changes in the conditions of access to these facilities) varied, the Bank was forced to complement its access policy by regulating the interest rates banks charged on their loans. Although the issue had been discussed for several years previously, the Bank was also drawn in 1964 into regulating the deposit rates of commercial banks. While the increase in lending rates was intended to give greater teeth to its generally restrictive credit policy, the Bank regarded its efforts to rationalize the deposit rate structure as part of the wider institutional dimension of monetary policy which was beginning to find a more explicit place in its priorities at this time. As contemporary officials saw it, deposit rate regulation would encourage banks to offer more realistic and 'competitive rates of interest on deposits', boost longer-term savings, attract a larger proportion of these to the organized banking system thereby helping to 'institutionalize ... the financial and credit structure of the economy', and finally reduce banks' dependence upon the Reserve Bank for accommodation.

LENDING RATES

As we noted above, a consequence of the quota-slab system of accommodation introduced at the beginning of the 1960 peak season was the Bank's move asking commercial banks to increase their average lending rate by at least half a percentage point and maintain a minimum lending rate of one per cent above the Bank rate. This measure was necessitated by the fear that the rise in the Bank's lending rate might not affect banks that did not borrow from it, and by the need to ensure that the higher cost of borrowing was passed on to their ultimate borrowers.

Although this was the first step the Bank took towards regulating banks' lending rates directly, it had no reason to follow it up for some more time. In the meantime in January 1963, scheduled banks adopted an inter-bank

agreement on lending rates under which the minimum rate on all advances other than some specified exempt categories was fixed at 6 per cent. This yielded banks a margin of 2 per cent above the Bank rate. As it happened, the latter was put up to 4.5 per cent from 3 January, i.e. within two days of the inter-bank agreement coming into force; following which the participating banks increased their minimum lending rate to 6.5 per cent. In April 1963, the State Bank of India, which did not subscribe formally to the inter-bank agreement and which had not previously increased its lending rates, raised its general advances rate by one per cent. The long-term lending agencies also raised their lending rates by half a per cent in line with the Bank rate. Following the increase in the Bank rate to 5 per cent in September 1964, the minimum advances rate under the agreement went up to 7 per cent.

The Bank justified the increases of September 1964 (and February 1965) on the ground that the rate of interest was both an instrument for 'regulating the volume of investment and of augmenting the supply of savings'. Even though the responsiveness of investment to interest rate changes and the interest elasticity of savings were matters of dispute in India, it was generally conceded that interest rates were capable of affecting inventory investment. At least to that extent, the Bank concluded, they had a role to play in credit management especially in an inflationary environment. In the longer term the Bank envisaged the structure of interest rates also to help bring the public sector under some kind of financial discipline: the cost of capital, in its view, should be central to the evaluation of any project and the illusory cheapness of capital should not be allowed to dictate the inefficient use of scarce resources. This was however merely a shot across the government's bows which the Bank did not follow up in any sustained manner.

With the introduction of the accommodation regime based on net liquidity ratios, the Bank grew sensitive to the possibility of borrowers, whose demand for credit might remain unabated in a speculative environment, being able to absorb the higher interest charges their banks passed on to them. Hence in September 1964 it decided to impose a ceiling of 9 per cent on the rate that Indian banks with aggregate demand and time liabilities of Rs 50 crores or more and all foreign banks could charge on their advances. The immediate object of this directive was to make the Bank's tight money policy work without too great a rise in the Bank rate by squeezing the margins of commercial banks and reducing their recourse to the Bank for accommodation. The minimum advances rate under the inter-bank agreement was raised to 8 per cent following the increase in the Bank rate to 6 per cent in February 1965. Simultaneously the Bank raised the ceiling rate

on advances, overdrafts, and discounts of the larger Indian and foreign banks to 10 per cent.

DEPOSIT RATES

While the regulation of lending rates began essentially as an ad hoc expedient, the Bank had been disposed to consider regulating the deposit rates of commercial banks for about a decade prior to its first steps in this direction in 1964. At the beginning of the period covered by this volume, the interest rate structure of commercial banks was the outcome largely of uncoordinated decisions by the major commercial banks. The Imperial Bank of India set the trend both for deposit rates and lending rates. It offered the lowest deposit rates and could afford relatively low interest rates since it dealt mainly with 'prime' borrowers. Other commercial banks fixed their interest rates in relation to those of India's premier commercial bank. From October 1958 however, deposit rates offered by commercial banks were covered by a voluntary inter-bank agreement. This lasted until the mid-1960s when the Bank began to put in place a mechanism for regulating interest rates offered and charged by commercial banks.

The genesis of the inter-bank agreement on deposit rates can be traced to the competition for deposits and the adverse effect this was feared to have on the cost of banks' funds and the quality of their loan portfolios. Already in the early 1950s, many bankers were in favour of regulating competition for deposits by means of a voluntary agreement on deposit rates. The Bank Award Commission (1955), whose report had the effect of increasing the operating expenses of banks, also favoured such an agreement with its Chairman, P.B. Gajendragadkar, expressing surprise as to 'why in their own self-interest banks belonging to particular competing groups cannot agree among themselves on the ceilings for these rates'. If such an agreement did not come about voluntarily, Gajendragadkar declared, 'it may become necessary for Government to consider whether they can regulate the deposit rates for banks'.

In 1954 the Bank had responded with notable lack of enthusiasm to a suggestion by the Indian Banks' Association to prescribe ceilings on deposit rates. The case for controlling the latter rested mainly on the unhealthy effects of escalating deposit rates on banks' operating costs. It was also apprehended that rising deposit costs gave exchange banks a competitive edge over Indian banks: not only had the latter to invest a greater proportion of their resources in low-yielding government securities during the slack season when exchange banks moved their resources overseas, they were also less able than exchange banks (which dominated the financing of India's external trade) to pass on

higher interest charges to their borrowers. However, while being of the view that 'some sort of agreement to avoid a rate war among banks' was 'desirable', the Bank remained sceptical about competing banks arriving at an agreement amongst themselves. Little consideration was given at this time to regulating interest rates through executive or legislative action since such a course 'bristled with difficulties'.

The Bank's views on regulating deposit rates hardened somewhat after the Bank Award Commission's report. There was, according to its officials, 'hardly any case for a general regulation of deposit rates'. Regulation was not necessary to ensure the 'safety of funds held by banks' since the Bank enjoyed adequate powers under existing laws to 'scrutinize' the use banks made of their funds and take action if they were found to follow 'unhealthy practices'. Rising deposit rates were also not an 'unmixed evil'. At a time when advances were rising steadily and 'some check to the process' was 'desirable', higher deposit rates 'performed the salutary function of restraining the demand for credit' through higher rates on advances. The Bank also felt there was little it could do to force banks to arrive at a voluntary agreement if they did not want one.

Members of the Indian Banks' Association too responded coldly to Gajendragadkar's suggestion for a voluntary agreement on interest rates. Competition for deposits actually intensified in the months following the report, forcing the Chairman of the State Bank of India to devote a part of his speech to the Annual General Meeting of the shareholders of his institution to calling for a halt to the tendency. Demanding steps to discourage 'unhealthy competition', he suggested that if a voluntary agreement among banks was not 'possible because of the diversity of their size and standing', the government should 'consider suitable action for regulating deposit rates'. But whatever the State Bank's intentions in airing its views on the subject so openly, neither the Bank nor the government were at this time in favour of regulating deposit rates, Finance Minister T.T. Krishnamachari telling bankers in October 1956 that they were free to raise interest rates to attract more resources and the Governor, B. Rama Rau, also affirming the Bank's disinclination to prescribe interest norms and its preference for a voluntary agreement amongst banks.

When the issue revived in April 1958 the Bank held to its earlier view that voluntary agreement offered the only basis for regulating deposit rates of banks. Later the same year 36 banks, which accounted between them for 90 per cent of the deposits of all scheduled banks with the exception of the State Bank of India, arrived at an understanding among themselves which was formalized as the All-India Inter-Bank Agreement. This agreement which came into effect from October 1958 applied to Indian banks (other than the

State Bank of India whose interest rates were in any case the lowest in the industry) with deposits of Rs 5 crores or more. Under this agreement the maximum interest rate allowed on current accounts was a quarter of one per cent. A bank could pay up to $3\frac{7}{8}$ per cent (all per annum) on 'notice money' so long as the notice period for withdrawal was seven days or more, and up to 2.5 per cent on savings deposits. Cash certificates of three to five years' maturity were allowed 4 per cent while those of longer maturities were allowed a quarter of a percentage point more. The maximum interest on term deposits for less than three months was fixed at $3\frac{7}{8}$ per cent while that on term deposits of longer duration was set at 4 per cent. Indian banks having deposits between Rs 5 crores and Rs 25 crores were allowed to offer a quarter of a per cent more than these rates on term deposits. The agreed rates on 'notice money' and term deposits were lowered in September 1959 and again in August 1960, so that the maximum rate of interest offered on long-term deposits was now fixed at 3.5 per cent.

The Bank's disposition to see commercial banks arriving at voluntary agreements to regulate interest rates gave way gradually to a more interventionist policy from the 1960s. Partly, of course, this change accorded with the intellectual predilections of a new generation of middle and senior-level officers of the Bank. More importantly, the Bank had earlier been diffident about regulating deposit rates in a competitive environment marked by rising deposit rates, which it felt, reflected the shortage of banking funds in relation to the demand for them. But the inter-bank agreement threatened, at least in 1960, to betray the characteristics of a cartel, more so as banks' efforts to depress deposit rates coincided with a steep decline in the rates of deposit growth. This would not become fully apparent until later, but already by August 1960 the slow-down in the growth of bank deposits had begun to give rise to some anxiety within the Bank and in the government.

Even as internal notes pondered the role of higher interest rates in restoring deposit growth, the changes made to the inter-bank agreement in August 1960 appear to have spurred the Bank into action. There were, in the Bank's view, two things wrong with the existing structure of commercial banks' deposit rates. First, commercial banks still offered relatively high rates on short-term deposits, in particular on 'notice money' which was a form of deposit that only privileged clients were allowed to own and operate. Secondly, the rate offered on longer-term deposits was too low in comparison, with the result the spread between short-term deposit rates and longer-term rates was too narrow. This, the Bank believed, could adversely affect the ability of the banking system to mobilize the savings of the community. There was a slight widening of the spread in August 1960 when the rate on shorter-term deposits was lowered

slightly (by one-eighth of one per cent). But this did not go far enough in the Bank's view. In particular, the modifications did not affect the existing long-term rate structure which provided little incentive for deposits of one year or over. Despite its dissatisfaction with the inter-bank agreement, however, the Bank refrained from proposing major changes to the prevailing deposit rate structure, preferring instead in September 1960 to direct banks to ensure that the rate they offered on deposits for periods up to three weeks was at least 2 per cent below the Bank rate. This directive, which was evidently more demonstrative than substantive, represented the Bank's earliest initiative in the sphere of deposit rates. Its direct impact was limited, banks attempting naturally enough to get round the directive by offering 3 per cent on twenty-two days' deposits. The directive was nevertheless quite successful in its demonstrative role, the agreement banks appearing to have been persuaded by the threat of an imminent Bank intervention to review the interest structure on longer-term deposits and to offer higher rates on deposits of one year and over. Thus from November 1960 the rate offered on deposits of 12-24 months was raised to 3.75 per cent, with the rate rising in stages to 4.5 per cent for deposits of five years or more. The Bank withdrew its directive on rates on 'notice money' in February 1961. Following this, banks raised the rate on notice money to 3 per cent. But the rate on savings accounts also went up to 3 per cent. Deposit rates for maturities of three months or longer too increased, the maximum rate being now set at 5 per cent on deposits of five years or more.

By now, however, the inter-bank agreement had begun to come under strain from within. Early in February 1961, C.H. Bhabha, the Chairman of the Indian Banks' Association, informed the Governor, H.V.R. Iengar, that some medium-sized banks whose deposits had grown poorly in recent months wanted to increase their deposit rates by a quarter of a per cent. The exchange banks, on the other hand, were opposed to this suggestion. Warning the Governor of a possible collapse of the voluntary agreement, Bhabha proposed that the Bank should use its statutory powers to enforce a new integrated interest rate structure. Iengar himself was not averse to the suggestion. But other opinion within the Bank was still far from reconciled to this type of intervention which, in the event, did not prove necessary as banks agreed to a rise in interest rates on savings and term deposits in March 1961.

These rate increases could not paper over the cracks in the agreement for long. Towards the end of December 1961, Tulsidas Kilachand, who had meanwhile taken over from C.H. Bhabha as the Chairman of the Indian Banks' Association, met the Governor to discuss the situation arising out of the notice six banks had given him of their intention to terminate the agreement. These banks, which were all 'medium-sized' and which had deposits of between

Rs 25 crores and Rs 50 crores each, wanted to be allowed to offer a quarter of a per cent more on deposits than 'large' banks having deposits of Rs 50 crores or more. If these six banks did not resile from their position, Iengar and Kilachand agreed, there 'may well be a rate war' that would mark a return to the 'difficult position that was sought to be met by the inter-bank agreement' The Governor felt 'if the situation warranted it', the Bank should 'intervene with an appropriate directive to banks on deposit rates'. Asking the Bank's officers to formulate 'concrete proposals', he noted that the urgency of the issue stemmed 'not merely from the impending collapse of the inter-bank agreement but also the coming into force of the deposit insurance scheme'.

As described in another part of this volume, the Deposit Insurance Corporation, and along with it the scheme to insure bank deposits, came into existence at the beginning of 1962. In the months preceding its introduction, officials within the Bank and elsewhere apprehended that depositors of the bigger banks would be encouraged by the insurance scheme to shift their deposits to smaller banks (many of which were not covered by the inter-bank agreement) offering higher interest rates, and secondly that depositors might spread their deposits across several banks to maximize the insurance cover available to them. The Deposit Insurance Corporation was one of many initiatives the Bank took during these years to strengthen India's commercial banking structure. It was also engaged at this time in reducing the number of small, relatively unsound or unviable banks through voluntary or compulsory mergers, and consolidating the banking system. Apart from increasing banking risk, the diversion of deposits from the larger to the smaller banks, the Department of Banking Operations argued, would also retard the Bank's efforts to strengthen the banking system. The department therefore proposed that the Bank should issue a directive regulating banks' deposit rates, and it even circulated a draft directive which specified interest rates for four categories of banks and seven categories of deposits. But the Economic Department vetoed the idea, arguing that the Bank did not have sufficient information about the deposit rates of non-agreement and non-scheduled banks. Until this information was collected, the Bank's economists argued, it was wiser to 'resort to moral suasion ... than to direction'.

A directive would have to take account of the problems of all parts of the banking system while the information that we have relates to the interest rate structure of members to the Agreement and six non-member banks,

the Economic Adviser, V.G. Pendharkar, noted. Though keener than the Economic Department to take some form of action, Iengar deferred to its

advice which was also echoed by the Deputy Governor, M.V. Rangachari. Although it 'would be a pity if the agreement lapsed', the Bank, the Governor agreed, could not issue a directive to freeze the agreement without knowing why the six banks considered it 'unfair'.

At Iengar's instance, the Executive Director, D.R. Joshi, met representatives of the dissenting banks in January 1962 to seek their views. These bankers argued that the inter-bank agreement weakened their ability to withstand competition from the bigger banks which had abandoned the earlier practice of offering lower rates on deposits as a 'matter of prestige'. The continued refusal of the bigger banks to revise the agreement had left the dissenting banks with little choice but to seek its termination. N.M. Chokshi, the General Manager of the Bank of Baroda, who met Joshi separately on behalf of the bigger banks confirmed that the agreement would be terminated if the dissenting banks opted out of it, after which each bank would be free to quote its own rates for deposits. A fortnight later in February 1962, Kilachand and Chokshi met the Governor to complain about the 'adamant' attitude of the dissenting banks and about the 'scramble for funds and ... chaos in the money market' that would arise if the agreement broke down. The two bankers proposed to Iengar that the Bank should use its statutory powers to 'freeze the existing position'. According to Iengar, who had by now grown more wary of bankers' perceptions of the public interest, he

declined categorically to do anything of the sort. It would be a misuse of the statutory powers given to the Reserve Bank to use them merely for the purpose of enabling the Indian Banks' Association to deal with a domestic difficulty.

However, the Governor felt that the Bank should not hesitate to 'use its powers' if the situation apprehended by the Association, which at present was 'merely an assumption', developed as the two bankers anticipated. In any case, he pointed out, the Bank may have to intervene to regulate deposit rates 'in the context of the situation that might develop as a result of the setting up of the Deposit Insurance Corporation'.

Eventually, such an initiative did not prove necessary. The introduction of deposit insurance did not unsettle the deposits of the larger banks; while the threat posed to the inter-bank agreement by the dissenting banks was defused following its modification in June 1962 to provide for four categories of banks. The dissenting banks were placed in a newly-created 'medium-sized' category comprising institutions whose aggregate deposits ranged between Rs 25 crores to Rs 50 crores and were allowed to offer depositors one-eighth of a per cent more than the interest rate offered by banks in the largest category.

This formula incidentally, had originally been devised by the Department of Banking Operations and had formed the basis of its abortive proposal for a directive on banks' deposit rates.

It was at the initiative of the Bank that the question of regulating deposit rates returned to the fore in 1964. In March that year, Bhattacharyya wrote to scheduled banks suggesting that they examine afresh the interest rates they offered on deposits. Explaining the background to his suggestion in a meeting with bankers later the same month, the Governor underlined that the higher statutory liquidity requirements that would come into force in September 1964 and the growing demand for non-seasonal bank credit, especially from industry, necessitated a greater effort at deposit mobilization by the banking sector. Cautioning banks that loans from the Reserve Bank were available only to 'tide over temporary difficulties', he advised them against regarding the Bank as a 'source of finance all through the year'. Higher rates, the Governor told the bankers, would also enable them to compete with non-banking companies for deposits. Following Bhattacharyya's initiative, the Indian Banks' Association set up a committee towards the end of April 1964 with C.H. Bhabha as its Chairman, which favoured retaining the prevailing rates on deposits of up to six months and granting a small increase of a quarter of one per cent in the rates offered on deposits of longer duration. However, even this modest suggestion did not find favour with the members of the Association.

Consequently, opinion began crystallizing within the Bank in favour of regulating the term structure of deposit rates. Bhattacharyya himself appears to have favoured some such initiative, but the strongest advocacy of it came from M. Narasimham who was at this time the Director of Banking Research in the Economic Department. In the course of three notes written in July and August 1964, Narasimham built upon Bhattacharyya's observation to bankers in March that the time had come to 'give fuller play' to the rate of interest 'as a device to attract more funds into the system'. The term structure of deposit rates, he argued, should be such as to induce a larger flow of genuine savings or idle balances into banks in the form of time deposits. But the prevailing rate structure was characterized by a very narrow spread in the rates offered by banks on deposits of various maturities. Three-day deposits earned 3 per cent per annum while two-month, three-month, and one-year deposits earned a quarter, a half, and three-quarters of a percentage point more, respectively. 'The narrow ... spread', he argued, tended to 'discourage the genuine saver' and helped encourage the growth in deposits of non-bank financial intermediaries and other companies which were not easily amenable to monetary control. Advocating a 'rationalization' of the rate pattern,

Narasimham pointed out that left to themselves banks had proved unwilling even to reduce the absurdly high rate of 3 per cent they offered on call deposits, let alone raise rates on deposits of longer maturities. The Bank, he pointed out, had an interest in 'ensuring that the rate structure for short-term money is in alignment with the other market rates, including in particular, the discount rate on treasury bills'. Counselling direct intervention by the Bank, Narasimham proposed that banks should be disallowed from paying interest on deposits of up to a fortnight and should not offer more than one per cent on deposits of 15–30 days. He also proposed rates of 2 per cent on 31–60 day deposits and 3 per cent on 61–90 day deposits. Apart from encouraging longer-term deposits, the proposed rationalization would also help build a market for treasury bills which the Bank, as we saw above, was interested at this time in developing, and make them an attractive outlet for 'house-money' (i.e. the balances of quasi-public authorities such as the Life Insurance Corporation, municipalities, port trusts, and corporate entities) which was currently held in the form of three-day or seven-day deposits at 3 per cent.

Narasimham was not averse to the rationalization being brought about through suitable changes in the inter-bank agreement. But banks, he felt, had become complacent about the 'role of other incentives to deposit mobilization' following the 'faster rate of monetary expansion' in recent years. Recent developments, including the outcome of the Bhabha committee, did not 'give ground for hoping ... banks would be amenable to suggestions' for more realistic rates. The Reserve Bank, he felt, should either make a 'further attempt at moral suasion' backed by the threat of intervention if a voluntary agreement was not forthcoming, or go ahead and issue a directive prescribing ceiling interest rates. Since detailed regulation would be 'cumbersome' and 'difficult to supervise', he proposed confining the directive to deposits of up to three months' maturity while leaving the other rates 'uncontrolled'. As for the rate pattern on longer deposits, Narasimham supported the Governor's preference for letting the State Bank of India, which abided by the agreement without being a signatory to it, act as a 'pace-setter'.

Other opinion in the Bank about these proposals remained mixed. The Deputy Economic Adviser, P.J.J. Pinto, did not share Narasimham's views either on the necessity for regulation or its extent. In a lengthy note, Pendharkar too acknowledged that the structure of deposit rates was in need of reform, but he put forward some alternative considerations. Three-day deposits, he suggested, were not worth worrying about since they only amounted to a little over 2 per cent of total deposits. Arguing that 'action if any' in the sphere of interest rate regulation should be 'guided by considerations

of monetary control', Pendharkar pointed out that ceiling rates on three-month deposits might induce institutional investors to switch their funds to non-banking channels. If the objective of the ceiling is to induce these funds to move into treasury bills, he suggested, 'the yield and tender conditions' of the latter should also be so altered that 'funds are in fact ... diverted' towards them.

In the event, the Bank decided in September 1964 to prescribe maximum interest rates on shorter-term and indicate minimum interest rates on longer-term deposits. Apart from rationalizing the deposit rate structure to enable the banking system to mobilize savings better and thereby help fulfil one of the objectives of the Bank's credit policy, the object of the exercise was also to encourage banks to reduce their dependence upon the Bank for accommodation. According to the Bank's directive, deposits of up to fourteen days were to be offered the same rate as current accounts. Deposits of 15-45 days could be offered interest up to 1.25 per cent and those of 46-90 days up to 2.5 per cent. The latter restriction, some officials within the Bank hoped, would also help make the treasury bill 'an attractive outlet for ... "house-money"'. The *minimum* rates for savings deposits, and time deposits of 91 days, six months, and one year were recommended to be fixed at 3.5, 4, 4.5, and 5 per cent respectively. Banks were also advised to maintain an adequate spread on deposits of longer than a year's duration.

From February 1965 the Bank began *prescribing*, rather than as before merely indicating, minimum rates on longer-term deposits. Following the increase in the Bank rate to 6 per cent that month, the Bank raised the minimum rates payable on 91-day, six-month, and one-year deposits by a percentage point each. The inter-bank agreement, which continued to regulate interest rates on deposits of longer than one year, was also revised to take account of the new reality. In October 1966 however, the Bank simplified the regulatory regime by revoking the minimum rates on deposits of 91 days and six months while continuing to stipulate the maximum rate on savings deposits (4 per cent) and the minimum rate on one-year time deposits (6 per cent). A few months later in April 1967 the Bank also advised commercial banks to standardize rules for savings accounts and distinguish them from those applicable to current accounts. Savings accounts, the Bank reminded commercial banks, should be subject to some 'limitation on the number of withdrawals in a year as well as the maximum amount withdrawable on any one occasion without notice'

The impact of the September 1964 rate increases on banks' deposits became the subject of a 'lively controversy' which pitted the larger banks against the smaller- and medium-sized ones. Representatives of the latter emphasized

that the new regulations had helped banks mobilize larger deposits and enabled them to compete with non-banking institutions for longer-term deposits. The Chairman of the State Bank of India claimed, on the other hand, that higher interest rates had 'merely increased the cost of funds to the banks' without greatly increasing their deposit resources beyond what they would have gathered in the ordinary course with the earlier rate structure. Some bankers also argued that the increase in banks' deposit rates had contributed to depressing the capital market since investors' expectations about returns on equities and other stocks were now out of line with what industrial and business enterprises found themselves able to offer.

The Bank however remained positive about the working of the new regime of regulated deposit rates. A review carried out two years after the Bank's first directive to banks on deposit rates concluded that the revision of rates had 'materially lengthened the maturity pattern of bank deposits', the proportion to the total of deposits for one to three years going up from about 6 per cent to nearly 23 per cent after the new regulations were introduced, and those for three years and more rising from 6.4 per cent to 11.6 per cent. The rate increases may also have helped arrest the diversion of bank deposits towards non-banking companies, while the decline in the velocity of deposit money as a result of longer maturities was 'itself welcome in an inflationary situation'. Although the average rate of interest banks paid out on their deposits increased from 2.4 per cent in 1963 to 2.6 per cent in 1964 and 2.9 per cent in 1965, the Bank felt they could compensate themselves by running up higher credit-deposit ratios and making a greater proportion of their advances in the form of longer-term loans which yielded more and cost less to extend and monitor.

CONCLUSION

Writing to the Finance Minister, Sachindra Chaudhuri, about a fortnight before the rupee was devalued in June 1966, Bhattacharyya drew his attention, not for the first time, to the expansionary impact of fiscal operations on monetary aggregates which became more pronounced by the mid-sixties. The background to this warning was provided by the large growth in money supply during the preceding peak season despite a relatively modest increase in bank lending to trade and industry. The Reserve Bank, the Governor underlined, could not view this situation with 'equanimity', because the government's deficits would, together with the normal slack season contraction in bank credit, place large additional resources in the hands of the banking system when there was a 'squeeze on supplies'.

There was no alternative to taking some 'restrictive action on the monetary side' during the slack season. This, Bhattacharyya noted, 'will ... however affect only the private sector'. The Bank had been criticized in the past

on the ground that its monetary action seeks to control expenditures in the private sector at a time when fiscal operations which are the main element in the monetary imbalance remain uncontrolled. It is also stated that such a situation leads to excessive restrictions inhibiting production in the private sector.

Although the Bank had answered such criticism by pointing to the role of 'private expenditures as a positive element in monetary expansion', there was 'nevertheless ... considerable force in the argument' of the Bank's critics. It was also undeniable, he said, that

if [the] Government (and here I include the State Governments) were in a position to so order their affairs that recourse to deficit financing had been substantially smaller, the severity of action on the monetary side could, to that extent, be moderated.

The Bank could, of course, desist from intervention. But it would then have failed in its 'primary duty as the central banking authority'. If the Reserve Bank wished to be 'true to ... [its] charter', it would

necessarily [have] to take an overall view of credit operations and if Governmental operations continue to add liquidity in the economy, we have to try to counteract the effect of this by restricting expansion to the private sector to the maximum extent possible

Besides outlining the Bank's proposals, the Governor also communicated his hopes of meeting the 'essential needs of additional credit' during the lean season by continuing refinance facilities for food procurement, exports and defence supply bills, and credit extended to tea gardens, the latter at levels reached at the end of June 1966. Bhattacharyya also proposed lowering the cap on shorter-term deposit rates, among other reasons to reduce the 'administered Treasury Bill rates' to 3 per cent and 'rescind our minimum rates directive insofar as it applies to three months' and six months' deposits and savings bank deposits'.

As already mentioned, the most important part of the Bank's slack season credit policy proposals involved immobilizing the additions to banks' deposits in May 1966. These reserves, Bhattacharyya told Chaudhuri, could be released

when the busy season began or 'as and when ... banks desire to subscribe to government loan issues'. This method of credit control was not, in the end, adopted. Nevertheless the Governor's letter aptly underscores the constraints within which monetary policies came increasingly to be framed by the end of our period, and the trade-offs which the Bank had to make in order to accommodate the central government's 'fiscal operations' while 'limiting the secondary impact of the primary expansion' of money supply arising therefrom. With budgetary deficits regarded, despite the efforts made in the meanwhile to prune them, as an 'autonomous variable' over which it had no control, yet having to discharge its statutory mandate for 'securing monetary stability', by the mid-sixties the Reserve Bank of India's credit policies were on the verge of becoming exercises to find the means of pre-empting funds for a resource-hungry public sector and virtually in the 'physical' rationing of bank funds between competing claimants within the private sector. With the Bank also having to ensure that 'productive efforts in the private sector' were not hurt by its policies, general credit control instruments yielded place to selective instruments deployed both to restrict the flow of credit into some sectors judged by the authorities to be 'inessential', and to encourage lending to 'essential' or 'preferred' sectors.

By the time Bhattacharyya left office and was succeeded by L.K. Jha, the government initiated some measures aimed at fiscal consolidation. But the departures of the recent past had left their indelible mark on the Bank. Nor was there any going back in the emerging intellectual and ideological environment. 'Overall credit controls', according to Jha whose views were apparently shared by his new colleagues at the Bank, 'made no sense ... in a planned economy', and credit policy could subserve the goals of 'development and stability' only by establishing and adhering to 'sectoral priorities'. Jha's views were not new, evoking as they did the first plan document's vision of monetary policy in a planned economy. But for precisely this reason they illustrate, in a way that Bhattacharyya's more equivocal letter to Chaudhuri summarized above does not, the enormous distance the Reserve Bank of India's perspective on monetary policy had travelled between 1951 and 1967. What was in the beginning a heterodox view on monetary policy issuing from Yojana Bhavan had, by the end of these years, become a ruling orthodoxy within the portals of the Reserve Bank of India.

Table 1: Changes in Money Supply, Wholesale Prices, and National Income, 1951–67

Year	Money supply with the public (M1)	% change over previous year	Wholesale price index (1952–53 =100)	% change over previous year	National income (1948–49 prices)	% change over previous year
1950–51	2,018		111.8		8,850	
1951–52	1,804	–10.6	117.9	5.6	9,100	2.8
1952–53	1,765	–2.2	100.0	–15.2	9,460	3.9
1953–54	1,793	1.6	101.2	1.2	10,030	6.0
1954–55	1,921	7.1	89.6	–11.5	10,280	2.5
1955–56	2,220	15.6	92.5	3.2	10,480	1.9
1956–57	2,346	5.7	105.3	13.8	11,000	5.0
1957–58	2,417	3.0	108.4	2.9	10,980	–0.2
1958–59	2,530	4.7	112.9	4.2	11,650	6.1
1959–60	2,725	7.7	117.1	3.7	11,860	1.8
1960–61	2,869	5.3	124.9	6.7	12,740	7.3
1961–62	3,046	6.2	125.1	0.1	13,060	2.6
1962–63	3,310	8.7	127.9	2.2	13,310	1.9
1963–64	3,752	13.4	135.3	5.8	13,970	5.0
1964–65	4,080	8.7	152.7	12.9	15,000	7.4
1965–66	4,529	11.0	165.1	8.1	14,660	–2.3
1966–67	4,950	9.3	191.2	15.9	14,950	2.0

NOTE: All amounts in Rs crores.

SOURCE: *Report on Currency and Finance*, various years.

Table 2: Components of Money Supply, 1951-67

Last Friday of March	Money supply with the public (M1)	% change over previous year	Currency with the public		Demand liabilities		% share in incremental money supply	
			Amount	% of money supply	Amount	% of money supply	Currency	Demand liabilities
1950-51	2,018		1,407	69.7	611	30.3		
1951-52	1,804	-10.6	1,217	67.5	587	32.5	88.8	11.2
1952-53	1,765	-2.2	1,199	67.9	566	32.1	46.1	53.9
1953-54	1,793	1.6	1,229	68.5	564	31.5	107.1	-7.1
1954-55	1,921	7.1	1,312	68.3	609	31.7	64.8	35.2
1955-56	2,220	15.6	1,571	70.8	649	29.2	86.6	13.4
1956-57	2,346	5.7	1,623	69.2	723	30.8	41.3	58.7
1957-58	2,417	3.0	1,674	69.3	743	30.7	71.8	28.2
1958-59	2,530	4.7	1,792	70.8	738	29.2	104.4	-4.4
1959-60	2,725	7.7	1,931	70.9	794	29.1	71.3	28.7
1960-61	2,869	5.3	2,098	73.1	771	26.9	116.0	-16.0
1961-62	3,046	6.2	2,201	72.3	845	27.7	58.2	41.8
1962-63	3,310	8.7	2,379	71.9	931	28.1	67.4	32.6
1963-64	3,752	13.4	2,606	69.5	1,146	30.5	51.4	48.6
1964-65	4,080	8.7	2,769	67.9	1,311	32.1	49.7	50.3
1965-66	4,529	11.0	3,034	67.0	1,495	33.0	59.0	41.0
1966-67	4,950	9.3	3,197	64.6	1,753	35.4	38.7	61.3

NOTES: (1) All amounts in Rs crores.

(2) Demand liabilities include 'other deposits' with the Reserve Bank.

SOURCE: *Report on Currency and Finance*, various years.

Table 3: Reserve Bank's Advances to Banks against Government and Other Trustee Securities

Year	Scheduled Banks		State Coop. Banks		All Banks	
	A	O	A	O	A	O
1951-52	171.0	24.8	4.9	2.3	175.9	27.1
1952-53	96.4	15.7	3.9	1.9	100.3	17.6
1953-54	136.7	12.8	7.0	3.0	143.7	15.8
1954-55	198.8	10.6	9.8	3.8	208.6	14.4
1955-56	268.6	33.6	10.4	2.1	279.0	35.7
1956-57	456.5	31.6	8.9	3.8	465.4	35.4
1957-58	317.0	15.3	12.7	2.5	329.7	17.8
1958-59	399.8	50.0	15.9	3.5	415.7	53.5
1959-60	502.1	52.1	16.4	4.0	518.5	56.1
1960-61	817.1	49.2	27.0	3.9	844.1	53.1
1961-62	358.4	12.6	32.3	4.9	390.7	17.5
1962-63	337.9	19.1	50.4	6.7	388.3	25.8
1963-64	469.2	47.6	39.3	7.9	508.5	55.5
1964-65	752.8	99.5	45.3	9.9	798.1	109.4
1965-66	880.1	17.7	76.8	8.8	956.9	26.5
1966-67	641.1	59.4	71.7	7.8	712.8	67.2

NOTES: (1) All amounts in Rs crores.

(2) A=Advances; O=Outstanding at the end of March.

SOURCE: *Reserve Bank of India Bulletin*, various years.

Table 4: Seasonal Variations in Bank Credit, 1951-67

Year 1	Busy season expansion 2	(2) as a proportion of bank credit outstanding 3	Slack season contraction 4	(4) as percentage of (2) 5
1950-51 1951	182	20.1	85	46.7
1951-52 1952	62	6.3	110	177.4
1952-53 1953	50	4.3	66	132.0
1953-54 1954	53	4.7	39	73.6
1954-55 1955	63	5.5	32	50.8
1955-56 1956	164	13.9	4	2.4
1956-57 1957	148	10.7	42	28.4
1957-58 1958	89	6.0	118	132.6
1958-59 1959	182	12.4	79	43.4
1959-60 1960	189	12.0	20	10.6
1960-61 1961	199	11.4	77	38.7
1961-62 1962	204	11.0	42	20.6
1962-63 1963	203	10.0	121	59.6
1963-64 1964	376	17.9	139	37.0
1964-65 1965	407	17.3	93	22.8
1965-66 1966	310	11.7	86	27.7
1966-67 1967	426	11.8	101	23.7

NOTES: (1) All amounts in Rs crores.

(2) Col. 3 is with reference to bank credit outstanding on the last Friday of the September preceding the busy season.

SOURCE: *Trend and Progress of Banking in India and Report on Currency and Finance*, various years.

Unpublished Sources

- G.8 Governor's Correspondence with Government of India,
Ministry of Finance
- HC/MCP/1 Bank Rate, 1951–67
- G.60 Amendments to the Reserve Bank of India Act of Sections
33(2), 37, and 42
- C.366 Variable Cash Reserves—Correspondence
- A/c 57(2)57 Finding Eligible Assets for the Issue Department
- EDBD.2.
- 15A/B1.1005 Notes on Credit Policy
- BFF 14 Report of the IMF Mission to India (Bernstein Report)
- PF 22 Bill Market Scheme
- C.297 Advances to Scheduled Banks under Section 17(4)(c) of
the RBI Act
- C.96 Creation of a Bill Market in India
- B.1.1410 Regulation of Interest Rates on Deposits and Advances
- B.2.0062 Savings Bank Rules of Banks in India
- MS.47/1949-66 Money Supply

*Memorandum of Evidence submitted by the Governor of the Reserve Bank of
India to the Radcliffe Committee*

Memoranda to the Central Board and Committee of Central Board

FINANCING GOVERNMENTS

The next two chapters of this volume deal with the evolution and discharge by the Reserve Bank of its responsibilities for the management of the public debt of the central and state governments and its role as their banker. The Bank's responsibilities in these spheres expanded greatly from the 1950s as the state carved out a growing entrepreneurial and developmental role for itself, and spanned a variety of functions. It managed the issue of dated securities by the central government and state governments. As part of this, the Bank determined, often in consultation with governments, the size, timing, and the coupon rate of their loans, coordinated institutional support for them and subscribed to the issue on its own account. The Bank also undertook open-market operations and other initiatives principally to steady the market for central government paper, and occasionally intervened on behalf of state governments in the market for their loans. It managed, besides, the issue and cancellation of treasury bills on behalf of the central government. In addition to conducting their borrowing operations the Bank acted as a banker to the central and state governments, carrying out exchange, remittance, and banking transactions on their behalf, and providing resources to the former against ad hoc treasury bills, and ways and means advances and overdrafts to the latter.

This part is presented in the form of two chapters. Chapter 5 is concerned largely with the Bank's role in managing the public debt of the central government and its conduct of the latter's market loans and treasury bill programmes. It also contains a brief account of the Bank's financing of the ways and means requirements of the central government against the creation of ad hoc treasury bills. The discharge by the Bank of its functions in relation

to state governments forms the subject of chapter 6. However, for reasons of expository convenience, the preparatory aspects of loan issues by both central and state governments are discussed in the earlier chapter. In 1954 and 1963, the central government floated combined loans to raise its own requirements as well as those of state governments. These loans are also discussed in chapter 5.

Managing the Centre's Finances

The Reserve Bank's role in relation to the finances of the Union derives from the statutory provisions of the Reserve Bank of India Act, 1934. Section 20 of the Act requires the Bank to accept and pay out monies on behalf of the central government 'up to the amount standing to the credit of its account and to carry out its exchange, remittance, and other banking operations, including the management of the public debt of the Union'. For its part, the central government is required under section 21 to entrust to the Bank 'on such conditions as may be agreed upon, ... all its money, remittance, exchange and banking transactions in India, and, in particular ... deposit free of interest all its cash balances with the Bank' The Bank is also entrusted, again 'on such conditions as may be agreed upon', with the 'management of the public debt [of the Union] and with the issue of any new loans' by the central government. In the event of a failure to 'reach agreement on the conditions' with the Bank, the central government is empowered to 'decide what the conditions shall be'. But it cannot conduct these transactions otherwise than through the Bank except at places where the latter has 'no branches or agencies'. At such centres, the central government is allowed to 'hold ... such balances as it ... require[s]'. But the government is expected in practice to operate at these centres too through the Bank, with the latter appointing an agency bank (the Imperial Bank of India, later the State Bank of India and its subsidiary banks) to carry out some governmental functions on its behalf while itself retaining responsibility for the safety of government funds. In addition to the provisions of the Bank Act, the powers of the Bank to manage the public debt of the Union were reinforced by the Public Debt (Central Government) Act, 1944 which came into force from May 1946.

The statutory provisions of the Reserve Bank of India Act were underlined by the agreement the Bank and the Government of India reached in April 1935 concerning the operational details of their banking relationship. This agreement (which remains valid to this day) was supplemented from time to

time in specific aspects, such as for example the size of the central government's minimum balances and arrangements for extending temporary financial accommodation, through letters exchanged between the Bank and the government. (The Bank's agreements with provincial or state governments are discussed in the next chapter.) The Imperial Bank of India functioned as the Bank's agent for the first two decades of the latter's existence at centres where it was not directly represented. The agency role passed to the State Bank of India when it came into existence in July 1955. From the early 1950s, the Bank also engaged state-associated banks such as the Hyderabad State Bank and the Bank of Mysore to act as its agent in regions where these institutions had a strong presence. It should be added, for the sake of completeness, that the Bank remunerates these banks on the basis of agreed formulas which are revised from time to time. But it is not itself entitled to any remuneration for performing ordinary banking functions for the central and state governments other than the benefit it derives from holding their interest-free minimum balances. As a result, its governmental banking responsibilities might leave the Bank out of pocket. However, the Bank is compensated at agreed rates for managing the debt of the central and state governments, and for issuing their loans.

PREPARING A LOAN ISSUE

Issues of government loans required careful preparation: not only did the Bank wish to obtain funds on the best possible terms and conditions for its most important clients, it had also to ensure that the adverse effects of public borrowings on trade and industry were minimized to the extent possible. To some extent, of course, these objectives could be met through careful timing of government issues. The prevailing practice was to float government loans during the slack season. This arrangement suited everybody: the borrowing governments and trade and industry since they no longer competed simultaneously with each other for funds, and the banks and institutions which principally subscribed to gilt-edged stock since it helped ease the seasonality of their lending operations. As the Committee on Finance for the Private Sector (or the Shroff Committee) pointed out approvingly in 1954,

loan issues should normally be so arranged that the money markets are not subjected to an additional strain when banks are expected to meet the requirements of trade and industry during the busy season.

Although the peak season generally ended in April, it was not until May or June each year that the return flow of credit to the banking system acquired

significant proportions and banks began to feel awash with funds. Though exceptions were made during some years, it became something of a custom during the 1950s and 1960s to issue government loans between the months of June and September every year.

A major consequence of the extension to state governments of its role as their banker (discussed in the next chapter) was the centralized flotation by the Bank of loans of state governments. The general practice was for the central government to come to the market first. The financial requirements of the Government of India were given precedence because, besides being the single largest borrower, the loans it raised were 'intended for the benefit of the country as a whole in contrast to ... state government loans which are for the benefit of the people of the state concerned'. The terms on which the central government's loans were issued and its success in raising them also helped set a benchmark for state government loans. On the credit of the central government rested 'a good deal of public finance'. Twice during the 1950s and 1960s, loans of the central and state governments were floated together. But for reasons discussed below, this experiment did not succeed and was abandoned.

Although loans were not usually floated until June the following year, preparatory work at the Bank got under way from early December. The principal object of the preliminary exercises was to arrive at a reasonably accurate estimate of the size of the loans the central government (and those in the states) could raise from the market before their respective budgets were finalized. Informal consultations between the Bank and officials of the Finance Ministry culminated usually in the Bank preparing a note outlining its assessment of the conditions in the market, the likely trend in interest rates, and a suitable maturity pattern for the central government's new offerings. But the critical decision was without doubt the amount of money each of the borrowers could raise in the market during the year. Plan estimates provided a target for net public borrowing which governments sought to meet. The former were sometimes 'bumped up', often for non-economic reasons, and without much thought being given to the ability of the market to meet the resulting demand for funds. But the Bank, which had its ear closer to the ground, often judged the market incapable of absorbing the loans hopeful governments wanted to unload upon it and would advise them to lower their sights. This led, naturally enough, to a certain amount of bargaining—particularly, though not solely, with state governments.

The major details of the central government's loans were usually left to be settled, especially in the early years, during discussions between the Governor and the Finance Minister. The practice which finally evolved with respect to state loans was that state governments communicated to the Bank their loan requirements some time during the course of January each year. After these

communications were received, the Bank prepared a note containing its assessment of the amounts individual state governments would be able to obtain from the market. This assessment generally formed the basis of the central government's own views on this subject; and once the latter were made known, the Bank wrote to each state government intending to raise funds about the conditions prevailing in the capital market, the amount which it would be able to raise, the rate of interest it should offer, and the currency of its loan. As we will observe at some length in the next chapter, before this arrangement could be regarded as settled, however, doubts had to be resolved over the relative roles of the Bank and the central government in vetting state governments' loan proposals and the degree of autonomy the Bank exercised whilst judging their feasibility. In the early years particularly, officials of the Bank also held meetings with ministers and officials of state governments to finalize details of their loans but equally to help equip them to manage and promote their issues at the local level. State governments quickly became adept at promoting their loans, sometimes in rather unorthodox ways. Although meetings between the Bank and officials of state governments did not altogether cease and differences between them might persist over a number of issues, the preparatory stages of the loan issue were soon largely executed in the manner of a well-rehearsed drill. So much so, the Bank's letters to state governments enclosed drafts of their respective loan notifications, leaving some details such as the issue price of the loan to be finalized later. Closer to the time of the actual flotation, the Bank conveyed to state governments its views on the rate of interest they should offer on their loans and the price at which the latter should be issued. Although state governments sometimes disputed the Bank's judgement in these matters, as indeed its views on the amounts they could safely hope to raise and on the timing of their loans, they grew by and large to come to terms with the Bank's advice about their loan operations.

State government loans were typically issued together. One problem which cropped up with disturbing regularity in arranging state loans was that of preserving the secrecy of the latter's terms until they were formally announced. Unavoidably over the years, the practice developed of each state floating a loan being apprised of the terms of the other states' loans 'in order to enable [it] ... to decide the various issues' connected with its loan. Once the terms were regarded as settled but well before they were published, state governments began canvassing subscriptions from banks and other institutions. As a result, the details of an impending flotation of state loans became widely known in advance. Preserving secrecy required the cooperation of the state governments, and this proved elusive in practice because no state wanted to be left behind in the race to raise subscriptions from commercial banks and

other institutions. As B.C. Roy, the chief minister of West Bengal, told the Deputy Governor, K.G. Ambegaokar, in 1959, some years earlier his officials had deferred approaching banks until the loan was announced, only to find that the latter had 'already made commitments to other state governments who had got at them earlier'. But the Bank, unlike the central government, was not on the whole disposed to worry about this lack of secrecy. There was so little speculation in state loans, Ambegaokar argued, that nobody could use the advance information, which was in any case available quite widely in the market, to 'make any big profits'.

Once loans were thrown open to public subscription, the Bank maintained a close and regular watch over their progress, keeping in frequent touch for this purpose with state governments and its own offices over trunk telephone (in the 1950s and 1960s this meant booking calls several days in advance of the actual event for a predetermined time of a particular day), or through telegrams transmitted in code.

CENTRAL GOVERNMENT LOAN OPERATIONS

The central government's loan operations in the late 1940s were, according to the Deputy Governor, N. Sundaresan, marked by 'continued barrenness'.



N. Sundaresan, Deputy Governor, 1950-54

Despite Sundaresan's reputation for bluntness, this was an understatement. Net borrowings had actually been negative for four consecutive years from 1947–48 to 1950–51. Although the reasons for this were varied, a major factor was the political and economic uncertainty which followed the partition of the subcontinent. Even as late as May 1950, the Finance Minister, John Matthai, felt uncertain political conditions ruled out a long-term loan and preferred to make a 'decent success' of a medium-term loan to courting infamy with a long-term one. The Bank and the government decided initially to follow Matthai's instincts and float a medium-dated loan before better counsel prevailed. Sundaresan in particular argued that, though more likely to succeed, a medium-term loan would alert the market to the government's lack of faith in its own credit. If state governments followed the centre to float medium-term loans, 'we would have converted the gilt-edged market to a new philosophy, namely that the governments themselves are not sanguine of [their] long-term credit'. Cautioning against sacrificing 'for a mess of pottage of an eight-year loan ... the prospect of successfully floating a long-term loan ... for quite a number of years', he recommended holding the medium-term loan in reserve while the government tried out a modest long-term loan mainly targeted at institutions having the 'stomach' for such investments, since it was easier in a 'jittery market' to move from a long-term loan to a medium-dated loan than vice versa. On the other hand, if the object of a medium-dated loan was to signal a break with the prevailing policy of 'simulated cheap money', it was better

to take the bull by the horns and float a straight 3 per cent loan at par and face any criticism that may be levelled against such a move. The plunge has in any case to be taken if we want a swim and the shiver will only last but a while.

In the event, the Bank and the government followed Sundaresan's own preference and floated a fourteen-year, 3 per cent loan issued at par for Rs 30 crores in June 1950. Despite being the first long-term loan to be offered for cash in nearly three years, this loan was fully subscribed.¹

¹ Subscriptions for new government loans were accepted either in cash or in the form of specified maturing government securities. 'Conversions' referred to the issue of new loans against the tender of maturing loans. Although it was not unknown for new loans to be available only against either cash or maturing loans, most loans invited subscriptions in both forms. The last long-term loan for which cash subscriptions were accepted prior to the fourteen-year 1964 loan offered in June 1950 was the fifteen-year loan offered in November 1947.

The inauguration of planning in 1951 coincided with a gradual abatement of political and economic uncertainty. But this did little immediately to lift the clouds hanging over the market for central government loans.

Market sentiments remained adverse towards government loans during the first two years of the first plan. Hence, while the 1951–52 budget took credit for public borrowings of Rs 100 crores, an issue for only half this amount was floated in August 1951 in the form of a seven-year loan at 3 per cent. Although the loan was fully subscribed, cash subscriptions amounted only to about Rs 12.8 crores. Cash repayments during 1951–52 of maturing loans amounted to over Rs 47 crores, so that the government's net borrowing during the year was once again negative. The issue of a seven-year loan at 3 per cent was widely perceived to signal the beginning of a policy of dearer money and indeed, the Bank rate was put up by half a percentage point in November 1951.

The central government did not float any loans in 1952–53. Partly for this reason and thanks to the paucity of floating stocks and rumours of a reduction in the Bank rate, the gilt-edged market remained firm during these months. In June 1953, the Government of India returned to the market to raise Rs 75 crores in the form of medium-term National Plan Bonds (First Issue). The issue was fully subscribed, but cash subscriptions amounted to only Rs 23 crores. With cash repayments during the year totalling over Rs 63 crores, there was once again a net outflow from the central government's loan account of about Rs 39 crores. But since the latter amount almost exactly equalled the government's own holdings in its cash balance investment account of the 3 per cent 1953–55 loan which fell due that year, the repayments did not involve an actual net outflow of funds from the exchequer during the year.

The National Plan Loan

In the absence of large investment outlays, the budgetary position of the central government had remained easy during the early 1950s. But with the first plan outlay having been stepped up from 1953–54, a major new experiment was attempted in 1954 to translate the perceived public enthusiasm for the government's new developmental initiative into support for its loan programme. This experiment had some distinct features. All central and state loans for the year were centralized into a single National Plan Loan which opened for public subscription in April 1954. Unlike other government loans which closed within a few days, this loan was kept on tap until the middle of September. In a further effort to motivate the individual investor, the opening of the loan was accompanied by sustained efforts at the political and governmental levels to whip up public enthusiasm for it.

Although a loan such as this one had been talked about for some time, the immediate inspiration for this experiment was provided by Jawaharlal Nehru's address to the annual session of the Indian National Congress at Kalyani in January 1954. In the course of his speech, Nehru deprecated the tendency to depend solely on institutions for subscriptions to government loans and called for a popular campaign to mobilize financial resources for development. Nehru's call was echoed in a resolution passed at the session to harness popular support for a development loan, particularly among small investors. Soon after the Kalyani session, the Finance Minister, C.D. Deshmukh, initiated consultations with the Bank about a loan which he proposed should be kept on tap for about six months and a portion of whose proceeds would be distributed among the states agreeing to stay out of the market during the year.

Officials at the Bank harboured some misgivings about the proposal. In particular they wanted to make sure that the additional resources raised on behalf of state governments were used to reduce the quantum of deficit financing rather than to increase the size of existing plans which already stretched available 'physical and human resources' to their limit. Officials were also nervous that the success of the loan among individual investors, particularly in the rural areas, would come at the expense of collections under the small savings scheme which were already showing a 'declining trend'. There was some apprehension besides that larger government loans would lead in the first instance to a reduction in the resources available for investment by the private sector. But the Bank's overall response was positive. Unlike his deputy, Sundaresan, who felt it would mean 'nursing ... state governments with varying market credit', the Governor, B. Rama Rau, was not unfavourably disposed towards the principle of a common centrally floated loan. In fact, earlier in 1952 Rama Rau and Deshmukh had discussed between themselves the possibility of a 'big Central Development Loan of at least Rs 100 crores in the flotation of which the Prime Minister ... would take an active interest'. Nothing came of this idea at that time, but Nehru's address and Deshmukh's response to it provided another opportunity to carry out a similar experiment in 1954.

Hence the essential principle of floating a central loan—which in due course was christened the National Plan Loan—was settled without any great delay. It was also clear from the beginning that the loan would be available on tap. The Bank preferred the loan to open early in May after the busy season ended and funds began returning to banks. A mid-April opening, as the government proposed, might be better from the point of view of attracting subscriptions from the public, particularly from rural households still in

possession of the proceeds of the recent harvest, but the Bank felt this consideration was outweighed by the 'great psychological effect and ... stimulus' that would be given to the loan by a 'substantial contribution from institutions in the early stages'. On the other hand, even if the loan was kept open for six months, it would be hard to overcome the 'depressing effect' of a poor start. The middle of April, moreover, was 'a really bad time of the year for any future Finance Minister to tackle [the] repayment', when it fell due, of the large amounts proposed to be borrowed through the National Plan Loan.

There was general agreement that while no size would be fixed for the issue nor any target figure disclosed in public, the government should aim to raise Rs 150 crores to Rs 200 crores through the loan. A ten-year maturity was decided upon, ironically enough for fear that anything longer could prove unpopular with banks and institutions. It was also decided that the loan would carry an interest rate of 3.5 per cent and be sold initially at Rs 98-8 so as to give a yield to redemption of 3.68 per cent, and that its price would rise by 9 pies per cent, which was the approximate net interest accruing each week. Apportioning the proceeds of the loan between the states threatened to be a rather more difficult matter, but this too was quickly resolved, largely thanks to the central government holding firmly to the view that the Bank's judgement of the amounts each state would have been able to raise in the market on its own strength should form the basis of the eventual allocation. If any state was not prepared to accept the allocation, it could, in Deshmukh's words, 'try its luck in the market afterwards although ... with the Central loan on tap, no state would take this risk'.

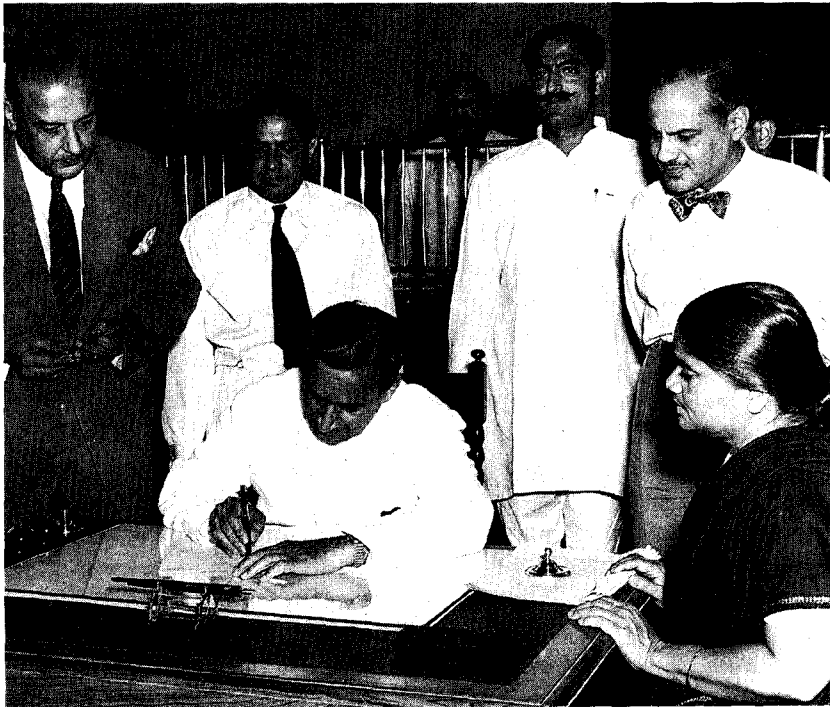
The National Plan Loan, 1964 was announced on 12 April 1954 and opened for public subscription a week later. The loan announcement was accompanied by an appeal from the Prime Minister to the nation and to chief ministers of states. The object of the loan, Nehru affirmed, was to involve everyone 'as partners' in the 'mighty adventure' of building a 'new India'. The success of the loan, he declared, would provide 'a measure of our self-reliance and of our determination to meet all contingencies'. The Governor too issued a special appeal to the Directors of the Bank's Central Board requesting them to persuade their friends and the institutions over which they had some influence to subscribe generously to the new loan.

The loan which was kept on tap for nearly five months was closed on 15 September 1954. The total subscriptions received for the National Plan Loan amounted to Rs 158 crores. This was far larger, on the face of it, than the amounts the central and state governments had been able to borrow in previous years. Nearly a quarter of the subscriptions came from areas outside the big

- *Shankar's Weekly*, 11 July 1954

centres of Bombay, Calcutta, and Madras, and were received at mofussil offices of the Imperial Bank, treasuries, or subtreasuries.

In truth, however, the success of the National Plan Loan was more apparent than real. Its principal object—of converting popular enthusiasm for planned development into resources for investment—was only partially realized, with relatively small subscriptions (defined rather generously as those up to Rs 5,000) contributing only Rs 6 crores, or less than 4 per cent of the total loan. On the other hand, the Bank's own contribution to the National Plan Loan amounted to Rs 58 crores or nearly 37 per cent of the total. Thanks to the political and other capital invested in this loan, the Bank felt itself under greater pressure than usual to make up for the shortfall in public subscriptions to it. Besides, while no target figure was publicly prescribed for the loan, the practice of publishing subscription figures at regular intervals largely in order to sustain the campaign's momentum obliged the Bank to make what was in effect an open-ended commitment towards ensuring the loan's apparent success.



Finance Minister C. D. Deshmukh inaugurating the National Plan Loan, 1964.
Durgabai Deshmukh is on his left.

In addition to the Bank, the central government subscribed Rs 10 crores to the loan, and the state governments Rs 7 crores. Thus collections from the public amounted only to about Rs 83 crores. This was not far in excess of the Rs 80 crores the central and state governments had managed to raise separately and rather more unobtrusively from the public the previous year. The biggest contributions to the loan came from states in which the traditional money market and commercial centres were located, viz. Bombay, Madras and Andhra, West Bengal, and Punjab. While a majority of the state governments staked little on the success of the loan and made no effort to motivate prospective subscribers in their areas, other states such as Punjab and Madras 'resorted to pressure of an undesirable sort'. By May 1954 reports were being received of industrial magnates and other affluent investors succumbing to pressure from some state governments and subscribing to the National Plan Loan by selling their existing holdings of government securities. So widespread was this practice that it led to a fall in the price of government securities all round. 'It looks as though the new loan has cast a depressing effect on the gilt-edged market', Sundaresan observed in May 1954.

Worse abuses were also reported. In Punjab, where districts were encouraged to compete with one another to raise subscriptions for the loan, *tehsildars* collected funds from contributors who received nothing in return except the goodwill of local government officials. These contributions were made over to the Punjab National Bank (with which the Punjab government entered into an informal arrangement) as its commission for subscribing to the loan in its own name. The commission (or the discount on the loan which was made good by public contributions) was calculated initially at the rate of 1.5 per cent of the loan taken up by the institution. Not satisfied with this, the bank attempted to raise the commission rate to 2 per cent, but its efforts were thwarted by state government officials' successfully persuading the Allahabad Bank to subscribe to the loan at a commission of one per cent.

In Madras and Andhra, several banks were persuaded to advance up to 95 per cent of the principal amount of the loan. Officials of the state government then got into the act, collecting Rs 5 each from members of the public who were made to apply for a bank loan at the same time as they applied to subscribe to the government loan. These involuntary buyers were also required to execute sale advices for their securities. Banks in the state then sold the scrip at a discount of 4 to 6 annas and the proceeds of such sales were adjusted against the advance and the accrued interest, with the balance being shared apparently between agents and officials. The 'rural' investor, the Bank ruefully noted, was 'content to make a small sacrifice in order to keep himself

in the good books of ... revenue officials to whom he has to look ... for various concessions and facilities'.

Similar practices were to become a common feature of state loans in later years, but in 1954 the Bank apprehended that the new loan would go to a discount because of the manner in which it had been raised. It did not take long for these fears to be realized. Selling pressure became evident in Punjab and Madras almost immediately after the loan closed, with the Punjab National Bank emerging as a persistent seller of the loan and two Madras brokers transacting sales of the loan to the tune of nearly Rs 3 crores. As a result, while earlier central and state government loans remained steady after the early flutter, or showed some improvement, the National Plan Loan proved decidedly weak, market quotations for it receding from Rs 98-5 immediately after the close of the loan to Rs 97-11 by November 1954 before rising to Rs 98-8 largely on the back of purchases by the Bank. Needless to add, thanks to the continued selling pressure the Bank was unable to make any sales out of its substantial holdings of the National Plan Loan.² Nor indeed, for that matter, could the Punjab National Bank which still held Rs 9.25 crores of the loan. The latter amounted to over 11 per cent of the money originally subscribed by the public to the loan and about 30 per cent of the total holdings of this loan in banks' portfolios in June 1955. The National Plan Loan remained a persistently weak performer down the years. The market was fully saturated with the loan and its price 'always tend[ed] to sag'. 'We must reconcile ourselves to the position that we may have to hold this baby indefinitely', Ambegaokar remarked some two years after the loan.

The fact of the matter is that this loan was unduly forced [upon unwilling investors] ... by state governments and is in fact a warning against any combined loan ... or any attempt to issue one loan of a very large size.

The Reserve Bank had come to the same conclusion much earlier. The combined loan, in its opinion, did not achieve any 'notable success' and separate loans were better from every point of view. While a majority of the state governments responded passively to the National Plan Loan campaign, the Bank felt they would be more willing to mobilize contributions for a loan whose proceeds they could retain in full without having to look to the centre for their assured share of the receipts of a combined loan. Besides, when

² Indeed, as table 5 (at the end of the chapter) shows, 1954-55 was the only year of the first plan during which the public's net absorption of government securities was lower than the net market borrowings of the central and state governments.

states came into the market on their own investors would be able to spread their purchases over a number of state loans rather than pour all their money into a single combined loan.

In 1955 the central government reverted to the practice of floating its loan separately, and it came to the market in July with a ten-year loan for Rs 100 crores. There were some differences within the Bank on the coupon rate on the loan, originating mainly from the decision to use these securities to pay compensation to shareholders of the Imperial Bank of India which passed into public ownership in July 1955. Ambegaokar favoured a 4 per cent rate on a longer-term (21-year) loan. Anything less, he argued, would be unfair to shareholders of the Imperial Bank since their shares returned a yield of 4.5 per cent. Besides, it was argued, since a large proportion of those who received these securities as compensation were likely to sell them, a long-term loan which offered a higher current yield without upsetting the overall pattern of gilt-edged rates would also enable the Bank to test the market's appetite for such assets. But another Deputy Governor, Ram Nath, felt a 4 per cent issue would have 'adverse psychological repercussions on the market' and advised a coupon rate of 3.5 per cent. There was also some fear that a 4 per cent coupon rate on a central government loan, no matter how long, might necessitate raising the rate on state loans. Rama Rau and Deshmukh sided with Ram Nath, and the government decided in the end to float the 3.5 per cent National Plan Bonds (second series) 1965 for Rs 100 crores on 1 July 1955 at an issue price of Rs 98.8 for a redemption yield of 3.68 per cent.

The loan was closed three days later. Total subscriptions amounted to Rs 104 crores, but of this only about Rs 30 crores came in the form of new cash. The Bank contributed Rs 15 crores additionally as cash and over Rs 36 crores in the form of conversions, so that it alone accounted for nearly half the sum raised by the loan. However with the 1955-56 budget having made a borrowing provision of Rs 125 crores, Delhi mooted the possibility later in the slack season of raising another loan of Rs 25 crores in the market. The government's proposal was partly inspired by the 'phenomenal success' of the two state loans floated in 1955 and by similar suggestions made in some financial journals. But the Bank was notably unenthusiastic about a second tranche of central government loans which it felt the market was in no position to absorb. The idea of issuing a central government loan fully to the Bank too was scotched, though not on grounds of monetary restraint. Rather the contrary, with Ambegaokar arguing that although such a course would mean more profits for the Reserve Bank, there was 'no special advantage' to the government 'in going in at present for a funded loan for a small amount ...'



K. G. Ambegaokar, Deputy Governor, 1955-60

when it could continue to make 'free and frequent' use of ad hocs to keep itself more cheaply in funds.

The Second Plan Years

Loans floated and retained by the central government amounted to about Rs 360 crores during the first plan. The second plan document envisaged doubling this figure to Rs 700 crores. The central government's large loan requirements naturally turned the attention of several officials in the central and state governments and at the Bank towards ways in which these could be met. The Bombay government, for example, proposed to the central government a scheme for a so-called 'compulsory savings loan' to help meet the public borrowing needs of the second plan. Some officials from Mysore also backed such a course while both the Madras and the Andhra governments had already made a fine art of wresting subscriptions to their loans from the public. The

Bank rejected the principle of what it called a 'forced loan', since it had the 'disadvantages of both taxation and borrowing and the advantages of neither'. Being involuntary like taxation, it would be equally unpopular. But unlike taxation, forcible loans would leave a 'large future liability' to be serviced, more so as periods and rates which could be regarded as reasonable for voluntary loans would be regarded as unduly long or low for compulsory loans. 'Compulsory borrowing', the Bank argued, would only hinder the scope 'both for taxation and voluntary borrowing' without helping to raise any additional resources for the government. The Reserve Bank also warned the government that any

significant restriction of the scope for taxation in the context of the objective of a socialistic pattern of society on the one hand and any substantial dislocation of the machinery of normal borrowing and lending on the other, through a comprehensive countrywide scheme of compulsory borrowing will be disruptive of the country's system of public finance, of fiscal equity, of the functioning of the capital markets, and seriously compromise the objectives alike of a satisfactory financing of the Plan and of lessening economic inequalities through taxation.

Though the Bombay government's proposal did not survive preliminary scrutiny, it helps illustrate an important aspect of public policy-making in India during these years. Although the second plan provided for a large public borrowing programme, few outside the Bank nor many within it had much idea of the challenges it involved or how these could be met within the existing system of governance.

The Bank too was more hopeful than knowing. For example, while the large, deficit-financed public expenditures likely to arise during the plan could be expected to add to banks' deposit resources, the extent to which these found an outlet in government securities was anybody's guess. The Bank nevertheless began taking steps to tailor the government's loans more closely to suit investor preferences. A major step it took in this direction was to offer in the market a menu of loans of different maturities rather than the single medium-dated loan the Bank had grown used to selling during the first plan.

The idea of a loan-mix originated with Ambegaokar who argued that under the prevailing practice, institutions did not invest in central government loans to the extent they might for fear of ending up with unbalanced portfolios. Some banks such as the State Bank of India and the Punjab National Bank already had large holdings of a single loan (the 1965 and 1964 loans, respectively). On the other hand, there were few short-dated loans (i.e. loans

maturing in 1961 and 1962) which were 'easily available' in the market. Besides, the Bank too had large holdings of the 1964 and 1965 loans, but its holdings of loans of other maturities were already so low that it could not afford to allow them to drop any further. If the government put several different loans on the market as part of a single issue, Ambegaokar maintained, it would 'in the aggregate give a much larger amount than one loan' whilst saving banks from the 'embarrassment [of] ... having an unbalanced investment portfolio' and enabling the Bank to

rectify the present deficiencies in its portfolio and make available to the market ... more of different kinds of maturities for which ... investors [may] have ... special predilections.

Ambegaokar's proposals met with general approval, and instead of a single medium-dated loan, the government decided in June 1956 to issue three loans of varying maturities. The three loans comprised a relatively short-dated 3.25 per cent loan maturing in six years, an eleven-year medium-dated loan at 3.5 per cent, and a long-dated eighteen-year loan at 3.75 per cent. No individual limits were prescribed, but a total amount of Rs 150 crores was fixed for all three loans. The Bank and the government also decided to adopt the existing practice in respect of state loans and retain excess subscriptions of up to 10 per cent (as against the prevailing 5 per cent) of the total issue. The loan, which opened on 16 July, closed two days later after aggregate subscriptions amounting to Rs 158 crores, including Rs 77 crores in cash, were received. The Bank was once again the major contributor, accounting for over half the total loan proceeds or about Rs 81 crores, of which just over half was in cash and the remainder in the form of conversions. The long-term loan, whose performance was watched with interest since it had the longest maturity of any loan issued since 1946, failed to live up to expectations, with subscriptions to it from lenders other than the Reserve Bank amounting only to about Rs 21 crores. The medium-dated loan did worse, the corresponding figure for it being about Rs 19 crores. The short-dated loan evoked the best response, with lenders other than the Bank contributing Rs 37 crores towards it. But even this scrip did poor cash business—cash subscriptions to it amounting only to Rs 10 crores. Commercial banks in particular, appear to have taken a guarded view of the future, using the opportunity offered by conversions to stretch their 1957 maturities merely as far as 1962. Thus nearly Rs 20 crores of the Rs 24 crores worth of securities they offered for conversion were invested in the short-dated loan. In contrast, the entire conversion offering of the Reserve Bank, of Rs 38.38 crores, was invested in the long-dated loan—strong evidence indeed that in the summer of 1956 there was a deep schism

separating the Bank's perception of the gilt-edged market from that of the commercial banks.

The Bank could not afford to be oblivious to these disquieting trends in investor perceptions. These trends were heightened, moreover, by the debacle of state loans floated in 1956. As we observe in greater detail below, a significant proportion of these were bought by investors under pressure from state governments and were financed by banks. Expectedly, strong selling pressure developed soon after these loans closed, and many state government loans went into discount. Central government securities too were caught in the melee. The volume of government securities in the market was clearly greater than it could absorb: not only was net absorption by the public of central and state government securities only half their net market borrowing, the Bank too turned a net buyer in the market during 1956–57 (tables 5 and 7 below). In addition to these factors, the monetary stringency which characterized the 1956–57 peak season and the rising demand for credit for investment also appeared to the Bank to rule out a large central loan.

There was thus, in the Bank's view as it formed in January 1957, 'very limited scope for fresh borrowing' during the year. Though the government might wish to put its borrowing figure at Rs 100 crores in order to 'make a good showing', Rs 50 crores represented the more realistic target. But even this amount could not be included in the budget estimates without disturbing the market. Hence Ambegaokar wondered whether the government should not 'camouflage the figure by giving a combined estimate for borrowings from the market ... [and] the small savings scheme' so that the market was kept guessing about its plans. In view of the 1956 experience, Ambegaokar also argued that it would be of 'tactical advantage to have a fallow year' for state loans to 'enable the market to get over the indigestion of the last issues'.

In the end the government decided to float a loan of Rs 100 crores in the form of a 3.75 per cent bond maturing in ten years and a 4 per cent loan maturing in 1972. These rates were pencilled in April 1957 and endured the increase in the Bank rate from 3.5 per cent to 4 per cent towards the middle of May. The loan was originally scheduled to be announced on 29 July, but the announcement was advanced by four days thanks to the misadventure of a junior official of the Government of India who managed on the morning of 25 July to lose the draft notification of the loan he was sent to fetch from the government press. The loan which opened on 5 August was closed within three days after subscriptions totalling about Rs 106 crores were received. Once again the apparent success of the issue concealed the fact that cash subscriptions by banks amounted only to about Rs 9 crores (as against Rs 13 crores to the central loan and Rs 20 crores to state loans in

1956), and that the State Bank had to be persuaded to put in a special subscription of Rs 10 crores over and above the Rs 11 crores it had contributed earlier. Results of the conversion too were poor, with only Rs 17 crores of the eligible securities outstanding with the public of Rs 57 crores being tendered for the new loans. Expressing his disappointment, the Governor, H.V.R. Iengar, told Finance Minister T.T. Krishnamachari that the poor response owed largely to the desire of banks to keep their resources liquid because of the monetary stringency and uncertainty about the extent to which they could rely upon the Reserve Bank for assistance in the peak season. The experience of public borrowing in the first two years of the plan also suggested, according to Iengar, that the second plan figures in this regard were likely to prove 'quite unrealistic'.

Despite this gloomy prognosis, the cloud hanging over the government securities market lifted gradually over the next few weeks. Thanks partly to the state governments (excepting Bombay and Mysore) staying out of the market, the large sales of securities banks made to the Reserve Bank, the small purchases they made of the loan floated in August 1957, the substantial increase in the deposit resources of the banking system, and the slower than expected onset of the peak season, the problem of 'indigestion' that Ambegaokar had spoken of was quickly overcome. Instead banks began to feel a pressing shortage of short-dated paper towards the end of the 1957-58 slack season. With the Bank unable to meet this demand because its own cupboard of short-dated securities was virtually bare, in November 1957 the government made a further issue—the first having been made the previous year—of the 3.25 per cent 1962 bonds. This issue of Rs 30 crores was entirely taken up by the Bank for sale on tap to banks and other institutional investors who took little time to absorb it. The market's appetite for gilt-edged stock was only whetted by the new issues. The public's net absorption of government paper in 1957-58 exceeded governments' net borrowing by over 60 per cent and after a gap of a year the Bank once again turned a net seller of central government securities.

Thanks to continued deposit growth and lower demand for bank credit in the peak season, the government's borrowing prospects brightened considerably in 1958. Though the Bank initially suggested a borrowing estimate to the government of Rs 125 crores, it was willing to contemplate a higher figure with equanimity and even adopt the government's suggestion to float the loan in May, rather than in June or July as normally. Thus in May 1958 the central government floated three loans for Rs 135 crores and collected subscriptions of Rs 142 crores including conversions of about Rs 9.5 crores. The short-dated loan, in particular, proved popular with banks who contributed Rs 22

crores to the issue. The Bank's subscription amounted to Rs 60 crores of which Rs 54 crores were in cash. Although this represented the largest cash contribution by the Bank to a central loan after the Rs 58 crores it subscribed to the National Plan Loan, officials at Mint Road were not disposed to complain in the background of the large net sales (of Rs 84 crores) by the Bank of government securities between July 1957 and April 1958. The more noteworthy feature of the year's loan operations from their point of view and from that of the development of the gilt-edged market was the cash contribution made by the other lenders which amounted to over Rs 78 crores.

Despite this issue and loans floated by state governments aggregating to Rs 50 crores, there was persistent excess demand in the market for gilt-edged stock in the autumn of 1958. Some brokers too represented to the Bank about the need to reissue medium-dated loans. Officials in the Bank who considered the suggestion early in August 1958 initially dismissed it. With large maturities falling due between 1963 and 1966, the Bank did not see much merit in making a further issue of any short-dated loans. Nor did there appear to be much demand from banks for medium-dated loans, of which the Bank still held a sizeable stock. But barely a fortnight later the situation had changed. Banks' demand for medium-dated loans led to a sustained rise in their prices, and the Reserve Bank apprehended that unless its stocks were replenished it would be unable to meet the market's demand for them. Therefore, at the Bank's instance towards the end of August 1958, the government issued two loans to the Bank for placing in the market, viz. a further issue aggregating to Rs 30 crores of the 3.5 per cent 1967 loan (whose price rose smartly even amidst speculation about a fresh issue of the stock to necessitate revisions in the loan notification almost up to the last minute) and an equal amount of the all new 3.5 per cent National Plan Bond, 1968. The issue of a new loan to the Bank was a departure from past practice, but officials felt it could be justified in the circumstances if the Bank was not seen to be profiting from its sales of the paper. With these two loans, the central government's borrowings during 1958-59 totalled Rs 202 crores as against Rs 136 crores the previous year. Despite the large size of the government's borrowings and thanks to the easy monetary conditions, the gilt-edged market remained firm throughout the year.

Encouraged by the 1958 experience and having to contend with large maturities totalling about Rs 120 crores, the government proposed raising Rs 225 crores in the form of loans and Rs 50 crores through treasury bills in 1959. The Bank felt the government's optimism to be unfounded. The investment-deposit ratios of banks were already close to 40 per cent and they were unlikely to contribute any large sums to government loans in 1959. The Bank first

pencilled in a figure of Rs 200 crores for central government loans, but decided in the end to issue a loan for Rs 175 crores in the first instance, leaving the remainder to be mopped up as in the previous year through a supplementary issue of loans of suitable maturity. Thanks to a bunching of maturities in the short-dated range, the Bank proposed to issue only two loans, a 3.5 per cent 1969 bond and a 4 per cent 1979 loan. The twenty-year loan was a major new feature of the year's loan programme. The longest loan to be issued since the second world war, it signified the desire of the Bank and the government to lengthen the maturity pattern of the latter's loan obligations and their willingness to suffer higher costs of borrowing for the purpose. The issue of these two loans, which was originally scheduled for the middle of June, was put off to early July because of the delayed end to the busy season.

The July flotation was a success. Total subscriptions amounted to about Rs 184 crores, of which Rs 89.38 crores represented conversions. The medium-dated loan proved the more popular of the two, attracting nearly Rs 103 crores, including the Bank's entire cash subscription totalling Rs 35 crores. The Bank did not judge the latter, and its contribution by way of conversion of about Rs 45 crores, to be excessive in relation to the volume of securities it had sold in the market during the previous twelve months, and was quite sanguine about the possibilities of offloading its new acquisitions during the course of the year.

The state loans floated in August 1959 turned out to be 'phenomenally oversubscribed', an aggregate issue of Rs 61.5 crores attracting subscriptions of over Rs 100 crores. As the Finance Minister, Morarji Desai, confessed to lengar, he would have liked to transfer the excess subscriptions to state loans 'if it had at all been possible to ... a corresponding central loan' to obviate the issue of a second tranche of the latter. Since that was not possible, the Bank and the government turned their thoughts towards floating a second loan, prospects for which were now suddenly brighter. The original intention, unlike in the past, was to make a public issue of the second loan, but when the time came to do so in October, the Bank decided it should take up the proposed issue aggregating to Rs 45 crores. Apart from the merits of approaching the markets again for a relatively modest amount, the Reserve Bank appears to have felt early in October 1959 that its stock of competitive short-dated paper could do with some replenishment. The Bank had lately been encouraging commercial banks to invest in short-dated stocks. But since the latter were in relative short supply, there was a perceptible hardening in their prices which, among other things, caused complications in the pattern of yields in the market. While its open-market operations would have benefited immediately from an additional issue of competitive 1964 paper, the Bank had to balance

against this the danger of loading the year too heavily. The year 1964 was already one of heavy maturities—the National Plan Loan, for example, falling due that April—and releasing more 1964 paper in the market might mean smaller conversion possibilities and larger loan repayments. Hence the Bank reverted to the advice it had favoured earlier of stretching out future maturities to the late sixties and beyond, particularly since the shortage of short-dated securities had also led to a ‘hunger [among] ... the banks’ for medium-dated stocks. However the idea of making the issue to the Bank rather than to the market endured the change in its composition. As later events were to show, the Bank’s judgement was probably mistaken in both respects, but the die had been cast and in October, the government issued two loans—a 3.5 per cent 1969 and a 3.75 per cent 1974 for Rs 25 crores and Rs 20 crores, respectively—to the Bank. Although, thanks to the second issue, the central government’s gross borrowings were higher in 1959 than in 1958, its net borrowings were substantially lower at Rs 107 crores as against Rs 181 crores the previous year. But this was to some extent offset by the sale of treasury bills.

Initial plans for the 1960 loan season were largely framed against the happy background of the government’s success in mobilizing funds in 1958 and 1959. Although the Bank felt even in January that the government’s estimate of Rs 225 crores for market loans was ‘somewhat on the high side’, it was not on the whole inclined to demur. The government, on the other hand, adopted Rs 250 crores as its market borrowing target in the budget. But monetary conditions turned stringent later in the year—while the demand for credit remained persistently strong, the Bank imposed stiff reserve requirements on banks’ additional deposits in March 1960—and the government followed the Bank’s advice to lower its initial borrowing target to Rs 175 crores. Two loans—including one for twenty years—were floated towards the middle of July 1960 to raise this amount. Total subscriptions to the loans amounted to about Rs 180 crores, of which Rs 106 crores were in the form of cash. The Bank put in Rs 50 crores in cash and effected conversions of nearly Rs 38 crores. As expected, the contribution of commercial banks other than the State Bank fell sharply from more than Rs 26 crores the previous year to about Rs 8.5 crores in 1960.

Though its cash subscription was considerably larger than in the previous year, the Bank looked upon the outcome of the loan, which had been floated in extremely adverse circumstances, with satisfaction. But it had no desire to plunge into the market again during the year despite the government being substantially adrift of its borrowing target of Rs 250 crores in the concluding year of the second plan. In October 1960, officials in Delhi began sounding

out the Bank about the prospects of a second loan for Rs 70 crores. The Bank was firm in ruling out a further public issue because of the 'prevailing monetary stringency and the depressed state of the gilt-edged market'. Nor was it in favour of 'creating special issues of the existing loans in the absence of genuine investment demand as this would amount to issue of ad hoc securities'. 'We are doubtful if it will be possible to achieve the [market borrowing] target ... before the end of the financial year', the Bank told the government. The gilt-edged market remained in the doldrums throughout 1960–61. The public made net sales of government paper to the tune of about Rs 63 crores, while the Bank's net purchase of central government securities during the year was, at Rs 112 crores, overwhelmingly the highest of any in the period covered by this volume.

Public Debt in the Third Plan

As already pointed out, the Bank had some say, along with the Finance Ministry, in determining the third plan public borrowing estimates. Although the latter was, at Rs 850 crores, rather higher than it would have liked, particularly given the performance of central loans in the market in 1956 and 1957 and after October 1959, the Bank could take some satisfaction from the fact that it was considerably lower than the figure initially proposed by the Planning Commission.

The 1961 borrowing programme was drawn up against the background of the third plan exercises. While the Bank proposed a gross borrowing figure of Rs 200 crores for the year, the government preferred to peg the amount at Rs 225 crores in its budget estimates on the ground that there were heavy maturities in 1961–62 aggregating to Rs 139 crores. Of the latter, Rs 75 crores fell due at the beginning of June 1961, while the remaining amount was payable two months later. With May now firmly belonging to the extended busy season, a cash loan that month was more or less out of the question. Hence the Bank advised the government to issue a pure conversion loan in May, and follow it up with a predominantly cash loan in July. Thus towards the middle of May 1961 the government issued a tranche of 3.5 per cent National Plan Bonds 1967, the latter's issue price being adjusted to allow a slightly higher yield on the new loan compared to the current market yield on a corresponding maturity. The loan opened on 29 May. The Bank and the government would no doubt have preferred a better investor response, but the conversion loan was, on the whole, quite successful. Subscriptions totalled Rs 93.5 crores (or 69 per cent of the maturing loans as against the preceding year's figure of 65 per cent). In addition, maturing loans amounting to Rs 4 crores were offered for conversion when the predominantly cash loans were

floated in July. Of the loans offered for conversion in May, no less than Rs 65 crores were held by the Bank and the State Bank of India both of whom put up their entire holdings of the maturing stocks for the swap. The government accepted the Bank's advice concerning the terms of the conversion issue, but lengar felt in hindsight that a slightly higher redemption yield achieved through a further reduction in the issue price would have led to better results.

This hypothesis was put to the test when the cash loans were floated. The latter were in the form of a 3.5 per cent 1969 bond and a 4 per cent 1981 loan aggregating to Rs 100 crores, with this loan being so priced as to give a slightly higher redemption yield than the 4 per cent 1980 loan available in the market. Morarji Desai preferred a larger issue to enable the government to meet its public borrowing target for the year, but the Bank felt the gap could be made up later in the season, should market conditions so warrant, by a second loan. Subscriptions totalled Rs 109 crores, of which Rs 50 crores were put in by the Bank. Public subscriptions amounted to Rs 59 crores, more than half (or Rs 33 crores) in the 1969 bond. Taken together, the government's gross borrowings in 1961 amounted to about Rs 203 crores. This was about 10 per cent below the budget estimate of Rs 225 crores, but as the conditions in the market evolved, there was little the Bank or the government could do to take the public borrowing amount up to the budgeted figure.

Nor did the pressure ease the following year when maturities totalled over Rs 183 crores. This meant the government would have to float loans for Rs 250 crores to add Rs 67 crores to its borrowed resources only a year after it had failed to raise the budgeted amount of Rs 225 crores from the market. Though ambitious, officials thought a borrowing target of Rs 250 crores not altogether unrealistic since the Bank, the State Bank, and the state governments held between them about Rs 135 crores of the maturing loans.³ With the busy season coming to a timely end, the Bank also decided in June that the entire amount should be raised in a single issue.

The large borrowing programme, however, necessitated a substantial increase in the structure of rates offered on central government loans, and this was the other major feature of the loans floated in 1962. When preliminary plans were made earlier in the year, the Bank proposed to issue a six-year loan maturing in 1968 at 3.5 per cent, a ten-year bond maturing in 1972 at 3.75 per cent, and a twenty-year 1982 loan at 4.25 per cent. By the time final proposals were prepared, the Bank came to the conclusion that some of these

³ The market borrowing estimate in the budget was Rs 260 crores. Of this, Rs 10 crores were expected to be realized through the sale of prize bonds. After the budget was passed, the government decided to follow the Bank's advice and discontinue the existing prize bond scheme from July 1962.

rates would have to be increased. The main problem lay with the 1972 maturity. A 3.75 per cent loan, officials felt, would be uncompetitive if issued at par, while a competitive discount was likely to sharply upset the market quotations of the 3.75 per cent 1974 loan. A 4 per cent 1972 loan, in contrast, would have a more benign impact on the market (though it could compete with small savings schemes) besides proving popular with banks and provident funds. If there were strong objections from the government to offering 4 per cent on the 1972 loan, officials at the Bank felt, it would be preferable to 'drop the ten-year loan completely rather than offer one that is not likely to prove popular and the bulk of which we may have to carry in our portfolio'. On further consideration, the Bank also came to the conclusion that a 3.5 per cent 1968 loan too could prove unpopular, particularly if the 1972 loan carried a 4 per cent rate, since there was already a 3.75 per cent 1968 scrip in the market. Officials in Bombay, Delhi, and Washington acknowledged that higher coupon rates would also smoothen the passage of India's application for a Fund standby, and the Bank advised the government that the most 'realistic approach under the conditions now prevailing' was to raise the interest rate offered on the six-year and the ten-year loan by a quarter of one percentage point, to 3.75 per cent and 4 per cent respectively. The 4.25 per cent rate on the 1982 loan, it felt, was adequate to attract the Life Insurance Corporation, the provident funds, and trusts who would, in fact, welcome the step-up in the yield on the long loan (the current yield on the 1981 loan being 4.11 per cent) more than complain about the inadequate spread between the medium-dated and the long-dated loans.

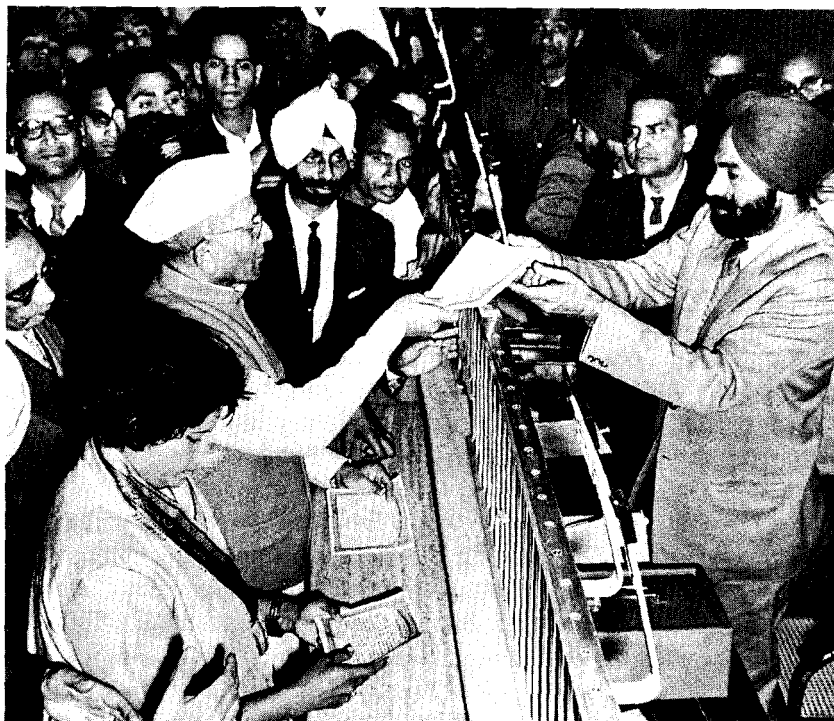
In the end the Bank and the government agreed on a slightly longer loan of 23 years rather than the 20 years proposed earlier, with the new 1985 loan offering 4.5 per cent. Both the Bank and the government had been concerned for some time past to stretch out the maturity pattern of the latter's obligations, and besides possessing the advantage of being more competitive, the 4.5 per cent rate enabled the government to offer in the market loans having the longest maturity of any issued since 1946. Thus, apart from featuring the largest single issue until then of Rs 250 crores (the previous highest being the Rs 175 crores floated in 1959–60 and 1960–61), the 1962 loan programme saw a fairly radical leveraging up of the interest rates offered on central government loans. These two features were not obviously unrelated, the Bank and the government recognizing that the ambitious loan programme would not succeed at lower rates. But as we will see below, even these new rates soon began to appear modest in the light of subsequent developments.

The 1962 loan, which was floated towards the middle of July, attracted total subscriptions of about Rs 257 crores. Of this Rs 154 crores, which was

Rs 6 crores more than the Bank's most hopeful estimate, was in the form of conversion, and the remainder in cash. The Bank's cash contribution amounted to Rs 30 crores which was substantially lower than the Rs 50 crores it had contributed to ensure the success of the much smaller loan programme undertaken the previous year. Of particular note, subscriptions to the new 23-year, long-term loan aggregated Rs 84 crores, which was more than those to the ten-year loan (Rs 81 crores) and not much short of the amount raised by the short-dated loan (Rs 92 crores). Taking 'all factors into account', the Bank informed the government in July 1962, 'the loan operations this year could be judged as satisfactory'. This, almost formulaic, sentence which figured with astonishing regularity in the letter the Bank wrote to the government at the conclusion of its loan operations each year was, given the challenge of the 1962 programme, something of an understatement.

The central government's loan programme for 1962, which was earlier thought to have been put to bed after July's successful issue, had to be unexpectedly revived in November in the wake of the border conflict with China, and a medium-term, ten-year loan was floated to help finance the additional expenditure on defence. Carrying a 4.25 per cent rate, offered at par, and kept on tap until 29 April 1963, the National Defence Bonds helped raise Rs 28 crores for the government. At the same time, the government also floated the 6.5 per cent Gold Bonds, 1977. Intended to translate the public outpouring of patriotic sentiment into financial resources to help fight threats to the country's security, subscriptions to these bonds were to be in the form of gold, gold coin or gold jewellery. Redeemable at par after fifteen years, the bonds carried an interest rate of 6.5 per cent. Gold tendered to the government under the scheme was in effect valued at the official (IMF) gold price of \$35 per standard ounce, and the higher interest rate offered under it was intended to take account of the premium on the metal in the domestic market. Total contributions to the loan, which too was kept on tap until the end of February 1963, amounted to about 16 million grams or about Rs 8.7 crores at the international price.

Shortly after the Chinese aggression, the National Development Council decided to combine the market borrowings of the central and state governments in 1963 in order to 'mobilize maximum resources for meeting the present emergency' Subsequently, the Finance Ministry decided in consultation with the Bank to raise Rs 400 crores (including Rs 100 crores for state governments) from the market during 1963-64. From its past experience, the Bank was not enthusiastic about the idea of a combined loan. The Deputy Governor, M.V. Rangachari, exploited an opening presented by an ambiguous reply the Deputy Finance Minister gave in response to a parliamentary question



Union Finance Minister Morarji Desai inaugurating Premium Prize Bonds in New Delhi, 1 January 1963

to impress upon the government even as late as March 1963, that there was a 'very strong case' from the 'practical point of view' and from that of 'mobilizing more resources' to preserve the existing arrangement whereby state governments came to the market separately for their requirements since it ensured that the latter took some interest in making their issues 'as much of a success as possible'. State governments did not 'take the same interest when only a Central loan is floated although part of the proceeds are handed over to them'. Besides, the higher rate offered on state loans acted as an inducement to commercial banks who supported state loans 'to a very much larger extent than ... the Central loan'. But the government decided to stick to the course determined by the National Development Council for 1963, especially since in the meantime state governments too had come generally to accept the proposed arrangements.

The Bank favoured a two-stage loan programme to raise the budgeted amount from the market. Since two Government of India loans aggregating

about Rs 176 crores were falling due at or before the beginning of June, it suggested a conversion issue in May of a short-dated six-year loan—one of the two maturing central loans (amounting to about Rs 58 crores) dated back to 1938 and its holders were thought likely to convert to short-dated stock or not at all—and a long 23-year loan. The conversion issue was a success. Subscriptions amounted to nearly Rs 139 crores, of which about Rs 86 crores were in the short loan and the remainder in the longer-dated stock. The response to the conversion offer was particularly good from holders of the stock floated in 1938, with conversions effected totalling over Rs 50 crores.

When the time came to finalize proposals for raising the cash tranche of the combined governments' borrowing for the year, the Bank took the view that the issue should be limited to Rs 225 crores, with a further tranche being issued later in the season should conditions in the market warrant it, to raise the aggregate of loans during the year to the budgeted amount of Rs 400 crores. The two cash-cum-conversion loans which were floated in the second half of July 1963 did not set the markets on fire. Unlike in 1954, the government decided against mobilizing the Prime Minister for the loan campaign, but Morarji Desai wrote personally to chief ministers of states requesting them to take 'suitable steps on the usual lines' to attract subscriptions and secure the support of major institutional investors in their areas. Despite Desai's efforts, total subscriptions amounted only to about Rs 146 crores, of which more than half was for the short-dated loan. The Reserve Bank therefore put in Rs 80 crores divided equally between the two loans in order to close the lists only a day before they were officially scheduled to close. As Rangachari confessed to L.K. Jha after the close of the loans, while the expectations the Bank and the government held from the public did not materialize, 'our fears that ... state governments would not take much interest as they do when state loans are floated separately appear to have been justified'.

Total subscriptions to the combined loans floated in 1963 aggregated to Rs 365 crores, comprising Rs 207 crores in cash and Rs 158 crores in conversion. To this may be added the Rs 6.13 crores collected by the government through the 4.25 per cent 1972 loan which was kept on tap. The centre allocated about Rs 100 crores out of the resources it raised to the states in the form of ten-year loans, the share of each state being determined generally on the basis of the gross amount borrowed by it from the market in the preceding year.

Although the net borrowings of the central government were considerably higher at Rs 143 crores in 1963 compared to the Rs 73 crores raised in 1962, it was still some Rs 35 crores short of its borrowing target. The government had initially accepted the Bank's advice on the size of the second issue on the

condition that 'every possible effort' would be made to float an additional tranche later 'so as to reach the budgeted target, if not actually to exceed it', but did little following the failure of the combined issue to follow up proposals for a third issue.

Despite the failure of the combined loan floated in 1963, the central government was not keen to revert to the earlier arrangement of floating separate central and state loans. A background note prepared by I.G. Patel, the Chief Economic Adviser to the Government of India, for a conference of finance ministers of states held in November 1963 argued for a permanent arrangement in which the centre undertook all general purpose market borrowings, while the states borrowed for specific purposes on behalf of institutions under their control. In return, the centre would share the loans it raised with the states and give them a higher share of collections of small savings. This arrangement, Patel argued, would make for better management of the public debt and monetary control, besides more clearly defining the responsibilities of institutional investors such as the Life Insurance Corporation in relation to the government's borrowing programme.

The Bank objected to these proposals on several grounds. Besides being inconsistent with the constitutional provisions governing the borrowing rights of states, Patel's plan overlooked differences in credit ratings between the central and state governments on the one hand and among state governments on the other, as well as the fact that many investors preferred state loans to those of the centre because of the higher coupon rates they carried. Nor would state governments as past experience showed, take much interest in the fate of a combined loan while straining every nerve to make a success of their individual loans. In addition, the Bank apprehended that Patel's proposal would require it to make larger contributions to ensure the success of loans issued in the future: while it followed the practice of making up the entire shortfall in public contributions to central loans, the Bank's contribution to state loans was limited at that time to 10 per cent of the issued amount.

The central government did not, in the event, press its point of view, and 1964 marked a return to separate loan flotations. With maturities during the year amounting to Rs 192 crores, the Bank proposed to the central government a borrowing target of Rs 275 crores in 1964-65. Although even this, as the government conceded, was 'somewhat optimistic', it felt compelled to increase the figure to Rs 295-300 crores 'purely for budgetary purposes'. On the other hand, the new statutory liquidity requirements slated to come into effect from September could be expected to create some additional demand from banks for government securities. With the bulk of the maturities falling due in April

and June, the Bank once again decided to float a conversion issue comprising a short-dated, six-year loan at 4 per cent and an issue price of Rs 99, and a 25-year loan at 4.75 per cent issued at par. There was, in the Bank's view, 'not ... much demand for a medium-dated loan', and nothing would be lost in 'leaving it out for the time being'. The issue floated in April proved quite successful, with maturing loans to the tune of nearly Rs 142 crores (out of a total of about Rs 192 crores) being offered for conversion. This was followed by a cash issue for Rs 150 crores of the same loans on identical terms in July, which netted nearly Rs 152 crores (of which Rs 67 crores were subscribed by the Bank) and took the central government's market borrowings for 1964-65 to Rs 294 crores.

The central budget assumed gross borrowings of Rs 270 crores for 1965-66 which was the terminal year of the third plan. This was subsequently slashed to Rs 250 crores, and an issue comprising two loans—a six-year 4.5 per cent 1971 loan issued at Rs 99.50 and a 25-year 5.5 per cent 1990 loan issued at par—was floated in June 1965. The issue netted Rs 251 crores, of which Rs 124 crores were in cash. Although the Finance Minister had declared in his budget speech the government's intention to reduce, if not eliminate, its dependence on Reserve Bank support to its loan programme, the latter's cash contribution to the 1965 loans amounted to Rs 66 crores. This was not by any means the largest contribution the Bank made in absolute terms to a central loan—that distinction belonged to the Rs 80 crores it put up for the combined 1963 loan and only the previous year the Bank had subscribed Rs 67 crores in a total cash loan of Rs 152 crores—but it represented the largest proportional contribution by the Bank to a publicly floated central loan in recent times. The Bank had also put up Rs 98 crores of the securities amounting to Rs 127 crores offered for conversion, so that over Rs 164 crores out of the government's total gross borrowings of Rs 251 crores in 1965 were contributed by the Bank. Further, unlike in 1964 when the Bank managed to sell loans issued to it during the year to the tune of Rs 106 crores, the corresponding figure for 1965 amounted only to about Rs 35 crores, while its net sales of all term loans during July 1965 to March 1966 did not exceed Rs one crore.

The central government was obliged to return to the market in October 1965 to mobilize resources for the defence effort. Two National Defence Loans, of three and seven years' duration, carrying interest rates respectively of 4.25 per cent and 4.75 per cent were issued on tap. Subscriptions in cash to these loans, which were promoted by Prime Minister Lal Bahadur Shastri in a radio address to the nation, and by a letter from the Governor, P.C. Bhattacharyya, to chief ministers of states, amounted to Rs 28 crores. In addition, the government floated a fifteen-year Gold Bond, subscriptions to

which were once again in the form of gold, gold coin, or gold jewellery, and attracted a nominal interest of Rs 2 per year for every ten grams of gold. Kept on tap for three months, Gold Bonds mobilized 13 million grams of the yellow metal.

Casting the 1966 borrowing proposals in the background of its inability to unload any significant proportion of its stocks of gilt-edged paper in the market during 1965-66, the Bank proposed to the government a gross borrowing target of Rs 225 crores for the year. But, as an office note remarked, the Bank and the government 'pull[ed] in different directions', with the latter proposing a gross borrowing target of Rs 300 crores. This was subsequently scaled down to Rs 280 crores, of which Rs 130 crores were expected to be in the form of cash. Officials at the Bank felt the government's borrowing target would not be met unless the Bank itself subscribed Rs 65 crores to the cash portion of the loan. This, as the Deputy Governor, B.N. Adarkar, remarked, violated the 'general tenor' of the Bank's credit policy. 'If deficit financing is to be restricted', he argued, the government would have to 'adjust ... [its] borrowing programme accordingly'. Suggesting a borrowing figure of Rs 250 crores, Bhattacharyya felt he could not 'justify the R[eserve] B[ank] putting another [Rs] 65 crores this year when we have not been able to unload any securities subscribed last year'.

In the end, the Bank and the government decided to float loans totalling Rs 260 crores. This issue, which was floated in July 1966, proved unexpectedly successful. Total subscriptions amounted to Rs 275 crores, of which nearly Rs 127 crores were in cash. Thanks to the larger than expected subscriptions of the State Bank, its subsidiary banks, other commercial banks, and state governments, the Bank's cash contribution could be held in check at Rs 37 crores.

Parliamentary Control over Government Borrowing

The role and the rights of Parliament in relation to the public borrowing programme of the central government came up repeatedly for discussion during these years. Apart from being raised in the form of questions or figuring prominently in Parliamentary debates, the Estimates Committee and the Public Accounts Committee also devoted some thought to giving effect to the provisions of Article 292 of the Constitution empowering Parliament to fix limits on the borrowing powers of the central government.⁴ The government

⁴ Article 292: 'The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees, within such limits, if any, as may be so fixed.'

generally took the view that while permitting the enactment of a law fixing borrowing limits, Article 292 did not mandate it. Parliamentary approval was sought and obtained for the five-year plan and the annual budgets, both of which gave details of the manner in which the government hoped to finance itself during these periods. Not only was further legislation therefore unnecessary, it was also unlikely to provide any 'real checks': while narrow limits would be 'impracticable', 'wide limits' would not 'offer any additional safeguards' against profligacy.

The Bank was generally content, whenever consulted, to go along with the government's view. The issue arose in 1958 of the rights of Parliament to be informed of the terms of central government loans and of the details of subscriptions to them. A report of the Estimates Committee of Parliament dealing with budgetary reform proposed that the government should submit to Parliament details of its borrowing programme both before and after it approached the market each year. The Finance Ministry was averse to the suggestion. Borrowing, it argued, was an 'executive function' and it was not 'practicable to go to Parliament every time a loan is ... raised'. Besides, the details and timings of loans were matters of 'high secrecy' which could not be divulged to Parliament in advance. However, the ministry had no serious objection to laying before the two houses, from time to time, a report on the results of government loans, and sought from the Bank its advice on the 'form and contents' of such a report.

The Bank agreed that there was no question of informing Parliament of the details of loans before they were floated. But it might often (though not always since Parliament was not in session continuously) be possible to table copies of loan notifications during the interval between their publication and the loans opening. The Bank also agreed with the Finance Ministry that it would not be 'desirable to disclose to Parliament any further details beyond what we now publish', i.e. total subscriptions in cash and conversion separately for each loan.

If we were to start giving particulars of subscriptions by certain categories such as banks and insurance companies ... it will not be possible to withhold effectively information regarding our own subscriptions.

The Bank subscribed large amounts to central loans and expected to continue doing so 'in the next few years because of the exigencies of planning'. But a large part of this was later sold in the market to banks and other investors. Publishing details of subscriptions to central loans, the Bank argued, would

only present a 'misleading picture' of the pattern of demand for government securities during the year and 'adversely affect the response from the market to new loans'

In 1964, the issue of statutory control over government borrowings came up more directly in a report of the Public Accounts Committee of Parliament. While the Finance Ministry was inclined to reiterate its previous views, there was a noticeable shift in the Bank's approach towards the subject. According to the Bank, it was not

realistic to assume that it will be possible to resist for all time the demand from Parliamentary Committees that a specific provision in the Constitution although ... not worded mandatorily should not be allowed to remain a dead letter.

Hence, while 'for the moment we may press for the maintenance of the status quo', the government should also give 'careful thought' to recognizing more explicitly the principle of Parliamentary sovereignty over government borrowing.

TREASURY BILL OPERATIONS

Treasury bills accounted for about a fifth of the rupee debt of the Government of India in March 1967. Bills with maturities of six months, nine months, and one year were first issued in India in October 1917, and 91-day bills were introduced at the beginning of the following year. Intermittently, bills with a currency of four months and eight months were also floated to spread maturities more evenly through the year. Soon after its inauguration in April 1935, the Bank took over the issue of treasury bills from the Government of India.

Except for a brief interval of three years between 1924 and 1927, treasury bills were sold in the market every year between 1917 and 1949. Following the inauguration of provincial autonomy, the Bank also began selling treasury bills on behalf of some provincial governments from April 1938. Sales of central government treasury bills were suspended after the auction of 20 December 1949 'as there were no tenders either from banks or the public'. The Imperial Bank of India, which was the main investor in these instruments, quoted 'extremely stringent money market conditions' as the reason for withdrawing its support. The practice of issuing treasury bills on behalf of state governments was discontinued from January 1950 and never resumed. The question of reviving central government treasury bill auctions was considered within the Bank and in consultation with the government at regular intervals thereafter, but a decision was put off for one reason or the other. The

idea was cautiously promoted in August 1951, only to be abandoned almost immediately.

The following April, however, the Bank began to examine the possibility of resuming treasury bill auctions more seriously. As a note by S.L.N. Simha argued, the open-market policy announced in November 1951 increased the necessity of making available to banks 'a short-term asset ... of a self-liquidating character ... on which they could readily obtain accommodation from the Reserve Bank'. Officials in the upper echelons of the Bank were also more favourably disposed to the suggestion now than before, Sundaresan for example, recording his view that treasury bills should now be 'one of the permanent features of ... [Indian] public finance', and it was tentatively agreed to revive treasury bills sometime during the slack season. The proposal was discussed between Rama Rau and Deshmukh in August 1952. The former cited the government's comfortable cash balance position to justify his own preference for six-month and nine-month bills. Three-month bills which banks were unlikely to renew, he felt, offered few 'compensatory advantages' for the government. Deshmukh however argued that three-month bills were essential for the success of the 'treasury bill system' even if it was introduced on an 'experimental scale', and he and the Governor agreed to the issue each week from early September, of treasury bills for Rs 3 crores split equally between bills of three-month, six-month, and nine-month maturities. The latter two categories of bills, they expected, would replace Government of India treasury deposit receipts of similar currency which were on offer to banks and their constituents.

The first auction of treasury bills since 1949 took place on 9 September 1952. In the event, the Bank decided to float only three-month bills at the outset for fear that their simultaneous issue may 'result in a somewhat anomalous alignment of discount rates between the various maturities'. It was also resolved to limit the issue to Rs 2 crores each week and not to issue intermediates 'till we [have] gain[ed the] experience'. As a further step to encourage the demand for them, the Bank decided to rediscount treasury bills at a concessional rate of half an anna above the average rate of the auction at which the bills under negotiation were issued. The earlier practice in this regard was to discount treasury bills at an anna above the average rate for them at the last weekly auction, subject to a minimum interest of half anna per cent.

After some discussion as to rates, the Bank decided to 'start with 2 per cent ... and build up ... gradually'. To begin the programme with a higher rate, Sundaresan felt, 'would lead to unnecessary speculation as regards money rates in the ensuing busy season'. The Bank was able to hold down the rate and yet raise short-term funds for the government thanks to an unusual

arrangement with the Imperial Bank which sent each week 'a blank signed tender for Rs 2 crores to be used at ... [the Bank's] discretion'. Thus at the first auction on 9 September, both the Imperial Bank and the Bank of India put in tenders for Rs 2 crores each and the Bank of Baroda for Rs 50 lakhs. The first-named bank quoted a floor price of Rs 99-8 (its tender at this auction left only the paise entry blank; this quote accorded with a maximum discount rate of Rs 2 per cent), while the price quoted by the latter two institutions varied between Rs 99-5 and Rs 99-6-6, corresponding respectively to discount rates of Rs 2-12 per cent and Rs 2-6 per cent. That the average rate of accepted tenders at this auction was held down to Rs 1-15-11 per cent reveals the extent to which the Bank's arrangement with the Imperial Bank allowed it to sway the market. Thanks too, to this arrangement, the rates at which other banks tendered for treasury bills firmed up and the difference between their rates and that offered by the Imperial Bank narrowed at subsequent auctions. But the average discount rate increased gradually to Rs 2-1 per cent by early October 1952 as the Bank itself priced the Imperial Bank tender at Rs 99-7-9 against the Rs 99-7-6 quoted by the Bank of India which was the only other major bank left at the auction.

When the treasury bill programme resumed, the Bank had hoped to issue six- and nine-month bills at fortnightly and monthly intervals, but plans for them were put on hold indefinitely. At least part of the reason for this was the tepid response the auction of three-month bills evoked in the market. After six weekly issues aggregating to Rs 12 crores, the Bank noted that treasury bills were 'still not popular with institutional investors'. There was little interest from banks other than the Imperial Bank of India which as we have already noted bid under a 'special arrangement', since they were 'able to lend money outside on better terms'. Even the Imperial Bank which accounted for the overwhelming bulk of the treasury bills issued (over Rs 19 crores of the Rs 28 crores issued until 9 December 1952), moved to limit and eventually end its support. With money getting tighter in the market, and the demand for treasury bills falling, the Bank suspended their sales for two weeks at the end of December 1952. There was little improvement in demand when auctions resumed early in January 1953, and the Bank considered holding auctions 'in abeyance for the next six weeks'.

That this decision was not finally taken owed to Rama Rau's success in persuading Roderick Chisholm, the Managing Director of the Imperial Bank, to continue tendering Rs one crore at each weekly auction of treasury bills. The Imperial Bank, Rama Rau and Chisholm agreed, 'will, if necessary, rediscount bills, but will not discontinue tenders'. Unless the treasury bill programme was continued in the busy season, Rama Rau argued, 'we would

be merely paying interest during the slack season on the surplus balances of the Imperial Bank and the other banks' The programme was thereafter limited to Rs one crore each week, but even at this reduced level of offerings the average rate climbed to Rs 2-7 per cent in the auction conducted on 21 January 1953. Seeing that the average rate had risen from Rs 2-3 within two months despite the reduction in the meantime in the size of the weekly programme, Deshmukh wondered whether it was 'worthwhile taking money' at the higher rate and whether 'Rs 2 ... was not a suitable maximum'. An official of the Finance Ministry remarked to Sundaresan:

We seem to be getting all the money only from the Imperial and I do not know if it is not merely transferring to Government the balance they otherwise keep with the Reserve Bank.

However, in the consultations which followed between the Governor and the Finance Minister, the latter agreed to the treasury bill rate being put up to about 2.5 per cent during the busy season.

Thereafter auctions of treasury bills continued practically without any interruption for over three years, though largely on the strength of the Imperial Bank and later the State Bank of India putting in a tender for the entire amount on offer at each weekly auction. But with conditions in the money markets becoming very stringent, 'banks ... not evincing interest in these bills', and even the State Bank immediately rediscounting the bills allotted to it in order to 'get a better return ... elsewhere', it was decided to discontinue the auction of treasury bills in April 1956. At this time the admittedly 'artificial' average rate of accepted tenders varied between Rs 2-8-1 and Rs 2-8-6.

Treasury bills were not issued for over two years until the end of July 1958. In November 1957, some bankers urged the Bank to resume treasury bill auctions on the plea that selective credit control measures and the general increase in their deposits had left banks in a 'comfortably easy cash position'. Although it harboured serious misgivings about allowing, as suggested, an average rate on accepted tenders of about 3.5 per cent, the Bank was attracted to the principle of resuming treasury bills auctions, partly no doubt because the 'creation of ad hocs [would] be reduced' thereby. The State Bank was consulted, and it too indicated that the government could 'safely count on [its] ... support' to the programme for six months to a year. But in the end the proximity of the approaching busy season and fear that the instrument would not appeal to investors unless it offered about 3.5 per cent discouraged the Bank from pursuing the bankers' suggestion. A 3.5 per cent rate would mean the Bank 'giving recognition to higher short-term interest rates. I do not think

that we should play such a role', Ambegaokar remarked. Instead, the short-term investment problem of the State Bank and some other banks was solved, as pointed out above, through the issue of a special tranche of the 3.25 per cent 1962 loan.

However, within a few months in June 1958, the Bank was persuaded by the early commencement of the slack season, rapid growth in the resources of the banking system, the steady demand for government securities, and the firm tone prevailing in the gilt-edged market to propose resuming weekly treasury bill auctions. Should these bills be issued now, Ambegaokar wrote to Rangachari, 'they [would] be keenly sought after ... during the busy season also'. The early offerings, he suggested, could be made at about 3.25 per cent with the rate being 'tapered down' in subsequent weeks to 3 per cent. The government accepted the Bank's suggestion and after July 1958 auctions of treasury bills were conducted more or less regularly until July 1965 when they were placed on tap, even though the State Bank of India was often the only bidder. A memorandum to the Committee of the Central Board prepared at the end of 1961 in response to queries about the programme from K.C. Mahindra and R.G. Saraiya justified the persistence on the ground that

auctions [of treasury bills] were held not for raising funds for the central government but to induce banks to hold these bills in their investment portfolio ... [and] creating a taste for them.

The Bank also maintained rather disingenuously that regular treasury bill auctions represented another step towards creating a bill market to supplement

the Bank's scheme of discounting trade bills for scheduled banks. It is for this reason that, unlike in the past, the weekly auctions have not been suspended even after the onset of the busy season.

Finally, though it was often the only bidder, the State Bank did not always rediscount these bills nor complain that the programme was in any way 'inconvenient' to it. 'In these circumstances and having regard to the object in view', the memorandum remarked, 'it does not appear necessary to discontinue the weekly auctions'.

Over two years later, in April 1964, the Government of India grew 'somewhat perturbed over the precipitate increase' in the rate of interest on treasury bills from 2.3 per cent before the auction held on 17 March to 3 per cent a fortnight later. Conveying the Finance Minister's disquiet, an official of the Finance Ministry wondered whether the time had not come to suspend treasury bill sales at least so long as the busy season lasted. The Bank pointed out in response that it was 'unrealistic to expect any one (except the State

Bank who do it to assist the bill market ...) to put their money in treasury bills' when the inter-bank rate ruled at over 6 per cent and banks paid out 3 per cent on call money. The Bank had allowed the rate to rise to 3 per cent after 'very careful thought' since it was convinced that it was 'in all the circumstances ... the proper rate'. 'We do not think that the auctions should be discontinued', Rangachari, who was now a Deputy Governor, also advised the government.

For about five years in the late 1930s and the early forties, the Bank had also sold 'intermediates' between weekly auctions of treasury bills. Made available from the day following one weekly auction until a day before the next, 'intermediates' were offered at a price which was usually three pias above that at which the bulk of the tenders were accepted at the preceding auction. The most important advantage of intermediate bills was that they provided an elastic means to relieve the market of surplus funds while allowing the central government to obtain, within limits, larger funds without forcing the discount rates upwards. In October 1958 the Bank took up the question of reviving 'intermediates' which were last suspended in July 1943, against the background of the 'large surplus funds' accruing to the State Bank of India in the form of P.L.480 deposits. While the State Bank, citing the impossibility of anticipating the demand for funds in the busy season and the uncertainty as to interest rates, wanted to invest the bulk of these resources in 91-day bills, there was little prospect of weekly auctions of treasury bills meeting its entire requirements. As it happened, the State Bank invested its balances not in intermediates, but in a special class of 'ad hoc' treasury bills created as necessary and sold at the same rate as 'intermediates'.⁵ But the Bank was persuaded by the excess demand which prevailed for treasury bills at this time—tenders received totalled Rs 8.75 crores against an issue amount of Rs 3 crores in the concluding October auction—to resume the sale of intermediate treasury bills in November 1958. The demand for these bills remained disappointingly small, however, total sales amounting only to about

⁵ These bills, which also had a currency of ninety-one days, were created in favour of the Bank and sold thereafter at a small commission to state governments and government departments having excess cash balances and to some foreign institutions such as the Central Bank of Ceylon and the State Bank of Pakistan. They were sometimes referred to as 'special ad hocs' to distinguish them from the ad hocs issued to the Bank by the central government to finance its ways and means. The underlying object of creating 'special ad hocs' was to eliminate sharp fluctuations in the demand for treasury bills at the weekly auctions. As discussed below, the distinction between special ad hoc treasury bills, intermediates, and treasury bills disappeared after the latter were placed on tap in 1965.

Rs 5 crores when they were put back on the shelf early the following month. Thereafter the Bank sold intermediates, sometimes in substantial quantities, at rather irregular intervals.

In July 1965, the Bank moved towards placing 91-day treasury bills on tap. The decision arose partly from the Bank's concern to promote the treasury bill market more actively in the slack season as a means of diverting banks' surplus balances from the inter-bank market. Bankers told the Governor, P.C. Bhattacharyya, when he raised this subject with them at a meeting in May 1965, that they found treasury bills unattractive because these were not available throughout the week. Besides, they argued, the tender system made for low slack season rates. There was also apparently some suspicion in the market that the Bank was itself ambivalent at best in its attitude towards rediscounting treasury bills. Overcoming considerable internal scepticism and in an effort to make treasury bills more attractive to banks, the Bank decided to offer the asset on tap throughout the week at rates determined each Monday on the basis of call money conditions during the preceding week. The formal decision to place treasury bills on tap was taken early in June and the yield during the first week fixed, at the Governor's initiative, at a generous 3.5 per cent. Bhattacharyya called another meeting of chief executives of banks in June 1965 to persuade them to put their funds in treasury bills.

Thanks to these efforts, sales of treasury bills went up sharply from Rs 26.5 crores in June 1965 to Rs 142.8 crores in July. (The corresponding figures for the previous year had been Rs 32.4 crores and Rs 47 crores respectively.) Scheduled banks' outstanding stock of these instruments also rose nearly fourfold from Rs 5.31 crores at the end of March 1965 to Rs 20.1 crores at the end of March 1966, or from one per cent to 2.4 per cent of their total investments in government securities. By 1966, banks themselves began pressing the Reserve Bank and the government to begin issuing 180-day treasury bills. The Bank too was disposed to believe the new system of tap sales of 91-day treasury bills was a success, and responding to bankers' suggestions, it drew up a scheme to offer six-month treasury bills on tap 'as a convenient instrument for banks to hold during the slack season'

AD HOC TREASURY BILLS

It was pointed out in an earlier chapter that following an exchange of letters with the Government of India in January 1955, the Bank agreed without much thought to top up the latter's balances whenever they fell short of Rs 50 crores at the end of any week. Thanks to this agreement, an enabling provision in the Bank Act—section 17(5) which authorized the Bank to make to the

'Central and State Governments ... advances repayable ... not later than three months'—became converted into a mandate.⁶ The advances so made were matched by the issue to the Bank of ad hoc treasury bills which were held in the Issue Department. While it was customary for a central bank to make temporary short-term advances to the government to cover mismatches between the flow profiles of the latter's receipts and expenditures, the practice which was made routine in 1955 gave the central government virtually unlimited right of borrowing from the Reserve Bank. We have also observed that soon after taking up office as Governor, Iengar alerted the Finance Minister, T.T. Krishnamachari, to the dangers of the prevailing practice. But the minister rejected subjecting the financing of government to any 'rigid procedure' and merely agreed to consult the Bank about the government's borrowing and ways and means requirements.

Consultations, if any, were desultory, with the Finance Ministry merely supplying to the Bank each month its ways and means forecasts and estimates of the volume of ad hoc treasury bills it expected to issue during the month. Even such 'consultations' soon ceased. But the Bank never stopped replenishing the balances of the government in the manner agreed in 1955. In what had become a well established routine even by 1957, the Bank itself created ad hoc bills to the extent indicated by its principal client's balances each week and merely informed the government of having done so. Apart from these routine credits, the Bank also created additional ad hoc treasury bills at the government's instance whenever the latter felt the need to hold larger cash balances. By March 1958, despite misgivings about this method of financing the central government's budgetary outlays, the Bank grew reconciled to the 'realities of the situation', viz. that ad hocs represented 'in fact a permanent debt of the Government which would not be repaid ordinarily'.

Not surprisingly in the circumstances, the average net volume of ad hoc bills issued by the government ballooned from Rs 50 crores per annum during the first plan to Rs 189 crores per annum in the second, before falling to Rs 160 crores per annum during the third plan years. However, in 1966–67 the net volume of ad hoc bills created rose sharply to Rs 260 crores (table 9).

⁶ The Hilton Young Commission (1926) which first officially recommended the establishment of the Reserve Bank had proposed allowing the new institution to make advances to the government repayable within three months of the end of the financial year in which they were made. The Select Committee on the Reserve Bank of India Bill felt besides being too liberal, the original provision would encourage the government to take 'undue latitude' with these advances, and limited their currency to three months.

Funding Ad hoc Treasury Bills

On the other hand, ad hoc bills to the tune of Rs 825 crores were 'funded' into dated securities between July 1958 and March 1967. The idea of funding ad hoc treasury bills first originated with the Bank early in 1958. The immediate practical object of the Bank's suggestion was to redress the imbalance in the domestic assets portfolio of its Issue Department which now overwhelmingly comprised ad hoc treasury bills. At regular intervals since April 1956, the Bank had faced the problem of finding eligible assets against which to expand currency. But the present embarrassment arose because the central government's balances during the preceding months were 'replenished on a much higher scale than the [public's] demand for additional currency', and dated securities transferred to the Banking Department to balance the assets and liabilities sides of the Issue Department's books. Transferring foreign assets from the latter department to the former was ruled out initially because the income on sterling assets (which made up the overwhelming part of India's foreign assets) held outside the Issue Department attracted UK income tax. After this hurdle was removed, the Bank began to feel uneasy about lowering the Issue Department's holdings of foreign assets to the statutory minimum and thereafter expanding currency solely against ad hocs whose availability was now the only certain factor of the situation.

The Bank also considered the possibility of holding ad hoc treasury bills in its Banking Department. But its auditors ruled that ad hocs would have to be held as 'bills purchased and rediscounted' rather than as 'investments'. In August 1956, as pointed out in chapter 2, Ambegaokar overruled the warnings of the economists to endorse the idea of persuading the central government to issue ad hocs in excess of its own cash requirements to enable the Bank to expand currency. But in 1958 V.G. Wagle, author of the idea Ambegaokar had carried to Delhi some eighteen months earlier and now the Bank's Deputy Chief Accountant, disapproved of extending loans to the government from the Banking Department against ad hocs which 'would not be repaid'. To the Bank's economists, however, the problem raised by Wagle was merely presentational, and there was no difference between ad hocs held as 'bills purchased and discounted' in the Banking Department and as 'Government of India rupee securities' in the Issue Department. If anything, the Economic Adviser, B.K. Madan, may have found the former course more attractive because of the transparency it might lend to the Bank's financing of the central government.

Nor did other solutions considered earlier when the Bank faced a shortage of eligible assets for the Issue Department appear to hold much promise in 1958. The plan to buy gilt-edged stock outright from the market, rather than

lending to banks against their security, evoked little support because it would have meant unwarrantedly altering monetary conditions to overcome an accounting problem. The latter drawback did not affect a scheme the Bank finalized in January 1957 to rediscount bills under the bill market scheme instead of making advances against them, so that such bills could be held as section 17(2) assets in the Issue Department, but little was heard of it in March 1958. There was some support in 1955–56 for abolishing the distinction between the Bank's Issue and Banking Departments. The Bank considered abolition again in March–April 1958 at the central government's instance. But officials at Mint Road now resisted the suggestion since it would be 'interpreted as a method of whittling down the provisions regarding the cover for the note issue'. In any case, neither the Bank nor the government particularly wished at this time to face Parliament with another bill—the third within three years—to amend currency cover provisions either directly or indirectly. Abolition, moreover, would not eliminate the need for funding ad hocs since it was 'not quite appropriate' for the Bank to hold three months' treasury bills which have to be 'perpetually renewed'.

On the other hand, with the Issue Department's cupboard of dated securities virtually bare, some action was urgently called for. Funding, as Madan and Simha proposed, was the most attractive option. The government was initially unenthusiastic, and differences developed, besides, over the details of funding operations. The Bank was in favour of creating a further tranche of an existing, quoted, non-terminable loan against about a third of its holdings of ad hoc treasury bills of Rs 875 crores. North Block opposed funding the government's ad hoc short-term liabilities into existing loans for fear of depressing gilt-edged prices, and preferred converting them into special non-terminable loans carrying low rates of interest. But the Bank argued against this course: such loans, it pointed out, would not be quoted in the market and could not be held in the Issue Department without an amendment to the Reserve Bank of India Act.

In the end North Block came round to the Bank's point of view, and Jawaharlal Nehru's speech presenting the 1958–59 budget affirmed the government's intention to begin funding its floating debt. Mint Road now proposed funding ad hoc bills of Rs 300 crores into a 3 per cent non-terminable loan then quoting at Rs 71 in the market. But Finance Ministry officials objected to issuing further quantities of a loan quoting at Rs 71 since it meant creating securities of the nominal value of about Rs 422 crores, treating the difference (of Rs 122 crores) as a discount in the books of accounts, and an addition of Rs 5.5 crores to the government's interest

liabilities. Officials in Delhi instead preferred funding the floating debt into a loan which was at or close to par, and after some discussion it was finally decided to issue to the Bank in July 1958 a fresh tranche of the 4 per cent long-term loan floated with moderate success some weeks earlier. One of the conditions of the operation was that the Bank would transfer to the government in the form of higher profits, the additional interest (amounting to Rs 4.5 crores) it earned on these assets. At the time that this operation was carried out, dated securities accounted for only one per cent of the assets of the Issue Department.

Attitudes within the Bank to funding operations remained somewhat mixed during the next few months. Ambegaokar argued for example that funding increased the cost of government borrowing without conferring any advantage on the Bank since in addition to making additional depreciation provisions in the wake of large-scale funding operations, the latter would have to carry in its books assets which were far from liquid. Funding, he suggested, was more suited to the object of contracting currency. What was wanted now was not funding, but

some kind of check over an unlimited recourse by Government [to Bank credit] for whatever period it may be. In the present circumstances, it can only be achieved through informal consultations and understanding and I do not think ... [the] mere conversion of ad hocs into dated securities will help in any way.

But the Bank wanted funding operations to proceed on a modest scale if only to prevent the precedent which had now been set from falling into disuse. Support from the government too proved less reluctant so long as it did not have to pay a discount, and after Finance Ministry officials were convinced that relatively small-scale funding operations would not greatly erode the Bank's current depreciation provision (which was in any case normally higher than that warranted by the 'approved scale') and that funding operations would mean little or no loss of revenue to the exchequer. Thus the Bank and the government decided to cancel ad hoc bills to the tune of Rs 150 crores in December 1959.

Thereafter the Bank resolved to fund Rs 50 crores of these bills annually until its holdings of them came down to Rs 500 crores. To its credit, the Bank managed in consultation with the government to achieve or exceed its annual funding target every year. But inevitably, thanks to the rate at which the government created these assets in the 1960s, the other goal of bringing the volume of ad hocs in the Bank's books down to Rs 500 crores proved

elusive. Larger and more meaningful funding operations were also moreover no longer within the realm of practical policy by the mid-sixties, the government for instance turning down the suggestion officials at Mint Road made in 1964–65 for a modest increase in the volume of ad hocs funded to Rs 75 crores. With the Bank's executives learning to live with this reality, the funding of ad hocs became another routine event in the institution's calendar. As an office note, written in November 1967 to prepare the ground for the next funding operation, remarked with an irony of which its author may not have been unaware,

in the past it was indicated that we should resort to cancellation of ad hocs for Rs 50 crores annually until the figure [for the total volume of ad hocs outstanding] was reduced to Rs 500 crores, the present balance of which is Rs 1,514 crores Having regard to the size of the present holdings of ad hocs it is suggested that we may go in for funding of a further Rs 50 crores as was done on the last occasion.

PUBLIC BORROWING: AN OVERVIEW

The public's net absorption of gilt-edged stock during the course of the year offers a good index of the government's success in marketing its loans. During the first plan years, the government's loan programme proved insufficient to satisfy the market's appetite for its securities, and the excess demand was met out of the Bank's holdings of them. In all but one of the remaining years of the period covered by this volume, however, there was an excess supply of gilt-edged securities in relation to demand, and overall during the second and third plan years, net purchases by the public amounted only to about 60 per cent of the increase in the loan liabilities of the central and state governments. (The corresponding proportion for the period as a whole was about 73.5 per cent.) The Bank, the central government, and the state governments accounted for the remainder (table 5). The pattern of ownership of government securities (table 6) as revealed by the surveys the Bank conducted at regular intervals after 1958 also reflects its rising share of the government's debt. Insurance companies' holdings remained largely unchanged in proportional terms, while the importance of commercial banks declined. On the other hand, there was a nearly threefold rise in the share of provident funds' holdings of central and state government loans.

The Bank's monetary policy stance during these years being generally one of restraint, we should expect to find its open-market operations characterized

by net sales of government paper. Besides, the large subscriptions the Bank made to central loans at the time of their issue would have meant, other things remaining the same, that it was more likely to enter the market as a seller than as a buyer. As table 7 shows, the Bank indeed made net sales of government securities during these years. But their extent (net sales represented only about 9 per cent of the Bank's aggregate open-market transactions in gilt-edged stock during these years) might seem unexpectedly small.

The Bank's open-market operations were at best a passive feature of its monetary policy. According to an authoritative note on the objectives of its open-market policy, the Bank's operations in this sphere were intended to promote 'orderly market conditions', effect sales 'on a net basis over the year' of the Bank's security holdings, and 'even out ... distortions in the yield pattern'. Of these, the first objective was by far the most important. In 1960, for example, credit policy was sought to be tightened by impounding a quarter and then half the additional deposits of banks. But the Reserve Bank persisted in feeding them funds through purchases of government securities to the tune of an unprecedented Rs 150 crores. More generally, thanks to the over-supply of government paper especially in the 1960s, the Bank's open-market operations threatened with increasing frequency to undermine its monetary policies rather than support them. Note from table 7, for example, that the Bank was a net buyer of securities to the sizeable tune of nearly Rs 52 crores during 1960-66 when its lending rate went up from 4 to 6 per cent and when it initiated a series of measures to regulate the accommodation extended to banks. However, the new statutory liquidity requirements and the institution of the net liquidity ratio-based lending regime in 1964 helped increase the demand for government paper, particularly among foreign and the larger Indian banks. They also lent a tone of stability (mainly seasonal but also generally) to the gilt-edged market and some teeth to the Bank's monetary policies.

Finally, it was pointed out above that the Bank wished simultaneously to stretch out maturities into the longer term and increase the issue of short-dated stock to attract larger support from banks. The resulting thinning in the middle of the maturity structure of government stock is reflected in table 8. Table 9 captures the growth of ad hoc treasury bills during our period while table 10 summarizes the volume of treasury bills outstanding every year.

Table 5: Absorption of Government Securities

Year	Net market borrowings by the centre and states	Net absorption by public	Col. 3 as percentage of Col. 2
1	2	3	4
1951-52	-24.9	-9.6	
1952-53	12.9	33.4	258.9
1953-54	-3.5	80.5	
1954-55	110.7	92.5	83.6
1955-56	82.0	93.1	113.5
Total I Plan	177.2	289.9	163.6
1956-57	140.7	70.6	50.2
1957-58	70.7	113.3	160.3
1958-59	226.8	194.6	85.8
1959-60	174.7	143.1	81.9
1960-61	134.0	-63.7	
Total II Plan	746.9	457.9	61.3
1961-62	136.8	35.6	26.0
1962-63	183.4	99.1	54.0
1963-64	150.0	100.7	67.1
1964-65	185.1	172.8	93.4
1965-66	234.3	137.5	58.6
Total III Plan	889.6	545.7	61.3
1966-67	176.7	169.1	95.7
Total	1,990.4	1,462.6	73.5

NOTES: (1) All amounts in Rs crores.

(2) These figures do not include transactions on state governments' cash balance investment account, the Bank's operations in state loans, and repayment of state loans held by state governments.

(3) The term 'public' includes all investors other than the Reserve Bank and the central and state governments. The total net absorption of government securities by the public equals subscriptions by the public, less cash repayments to the public in respect of maturing loans plus (or minus) net open market sales (or purchases) by the Bank and for the government's cash balance investment account.

(4) Figures from 1956-57 include investments of P.L.480 funds. These are excluded from 1960-61 because of the change in the arrangements for banking these funds. Hence the two sets of figures are not strictly comparable.

SOURCE: *Reserve Bank of India Bulletin*, March 1968.

Table 6: Ownership of Central and State Government Securities

	At the end of	
	December 1957	March 1967
1. Governments	10.9	8.1
2. Reserve Bank of India (a+b)	17.0	31.1
(a) own account	15.6	30.2
(b) on account of others	1.4	0.9
3. Banks	24.0	22.9
4. Insurance companies	13.5	13.8
5. Provident funds	5.5	15.0
6. Others	29.1	9.1
Total	100.0	100.0

NOTES: (1) Figures are percentages to total.

(2) Others include joint-stock companies, local authorities, trusts, individuals, state financial corporations, etc.

SOURCE: *Reserve Bank of India Bulletin*, February 1960 and March 1968.

Table 7: Open-market Operations

Year ended March	Purchases	Sales	Net sales or purchases (—)
1951	155.4	98.8	~56.6
1952	66.7	54.7	~12.0
1953	12.9	14.3	1.4
1954	17.8	40.0	22.2
1955	30.1	57.8	27.7
1956	22.1	38.0	15.9
1957	47.5	28.3	~19.2
1958	24.2	89.2	65.0
1959	65.2	154.3	89.1
1960	23.3	83.6	60.3
1961	138.4	26.0	~112.4
1962	66.6	33.0	~33.6
1963	72.3	49.5	~22.8
1964	30.0	74.7	44.7
1965	73.1	147.2	74.1
1966	95.8	93.6	~2.2
1967	65.1	128.0	62.9

NOTE: All amounts in Rs crores.

SOURCE: *Reserve Bank of India Bulletin*, various years.

Table 8: Maturity Distribution of Central and State Loans

Maturity period	December 1957	March 1967
0-5 years	31	44
5-10 years	37	22
10-15 years	12	11
Over 15 years	7	17
Non-terminables	13	6
Total	100	100

NOTES: Figures are percentages to total.

SOURCE: *Reserve Bank of India Bulletin*, February 1960 and March 1968.

Table 9: Growth of Ad hoc Treasury Bills

Period	Ad hocs created	Ad hocs cancelled	Net ad hocs created	Ad hocs funded	Net after funding
I Plan	350	100	250		250
II Plan	1,975	1,030	945	500	445
III Plan	2,430	1,630	800	275	525
1966-67	705	445	260	50	210
Total	5,460	3,205	2,255	825	1,430
Ad hocs created in connection with pensionary and other liabilities					164
Ad hocs outstanding at the end of March 1967					1,594

NOTES: All amounts in Rs crores.

SOURCE: *Reserve Bank of India Bulletin*, March 1968, and statement submitted to the Committee of the Central Board, 12 April 1967.

Table 10: Treasury Bills Outstanding

At the end of March	Total	of which ad hocs
1951	358	275
1952	314	268
1953	315	261
1954	335	253
1955	472	366
1956	595	488
1957	836	714
1958	1,295	1,190
1959	1,225	1,022
1960	1,298	1,020
1961	1,106	886
1962	1,175	912
1963	1,300	1,048
1964	1,382	1,099
1965	1,444	1,142
1966	1,612	1,388
1967	1,920	1,594

NOTES: (1) All amounts in Rs crores.

(2) Ad hocs outstanding during 1951–54 were created in 1948–49 to replace sterling securities in the Issue Department transferred to the British Government under the Sterling Balances Agreement of July 1948; ad hocs were created from 1954–55 almost wholly to replenish the centre's cash balances.

SOURCE: *Report on Currency and Finance*, various years.

Banking for State Governments

Constitutionally and historically, the Bank's relations with state governments evolved rather differently from those with the centre. Section 21 of the Bank Act which defines relations between the Bank and the central government is, as we saw in the last chapter, mandatory in character. But section 21A, which deals with relations between the Bank and state governments, is permissive.¹ In the constitutional set-up emerging out of the Government of India Act, 1919 (sections 45A and 80A), which was in force when the Reserve Bank of India Act was passed and the Bank came into existence, in 1934 and 1935 respectively, local legislatures were not competent to make any laws detracting from section 21 of the RBI Act. With the inauguration of provincial autonomy in 1937 under the Government of India Act, 1935, a province's public debt fell squarely within the competence of its legislature. But the Reserve Bank continued to discharge these responsibilities, since under section 292 of the Government of India Act, 1935, all the laws in force in British India when the former came into effect continued in force until a competent legislature decided otherwise. Although Madras objected to the Reserve Bank being entrusted with the management and issue of its public debt, no province passed laws, as it was competent to do, enabling its debt to be managed or issued differently. It was much less clear whether provincial legislatures had the power to pass laws under section 151 of the Government of India Act, 1935, differing in their provisions from those of section 21(1) of the Bank Act as it existed at

¹ Section 21A was introduced in 1951 by splitting section 21 as it existed prior to the amendment into two sections. The new section, which came into effect in November 1951, now reads as follows: 'The Bank may by agreement with the Government of any state undertake—(a) all its money, remittance, exchange and banking transactions in India, including in particular, the deposit, free of interest, of all its cash balances with the Bank; and (b) the management of the public debt of, and the issue of any new loans by, that State.'

the time, dealing with the custody of a provincial government's funds. In the event, no province contemplated such a legislation, so that the whole of section 21 of the Bank Act continued to remain in force up to the Republic's inauguration in 1950.

Under the *Constitution of India* (Art. 372), all laws applicable in the territory of India at the time of its commencement were to continue in force until they were repealed or altered by a competent legislature. Thus while section 21 of the Reserve Bank of India Act continued to apply to the so-called Part A states, neither this section nor the wider piece of legislation of which it formed a part applied to the so-called Part B states made up of territories belonging to the former princely states. The extension to the latter of the Reserve Bank's role as banker to government and the reforms attending this step therefore held both symbolic and substantive significance at the time, and were thought to represent an important landmark on the road to India's political-economic integration.

THE BANK AND FEDERAL FINANCIAL INTEGRATION

The problem of integrating in the financial sphere provinces which were coming together in the political acquired urgency soon after the accession of the former princely states. The Indian States Finances Enquiry Committee (V.T. Krishnamachari Committee, 1949) remarked on the unsatisfactory nature of currency and governmental banking facilities in the former Part B states. Recognizing the importance of treasury, currency chest, and remittance arrangements in promoting both the deepening of the financial sector of the economy and the integration of the Union, the committee underlined the need to study them more closely as a prelude to future reform.² A review of the treasury and allied arrangements prevailing in the former Part B states was therefore included among the terms of reference of the Rural Banking Enquiry Committee (Purshotamdas Thakurdas Committee, 1950).

The Rural Banking Enquiry Committee found that treasury, currency

² 'Treasury' arrangements refer to those made for the receipt and payment of monies on the government's account. 'Currency chests' comprise 'large stocks of notes and coin ... kept in separate receptacles at important treasuries in order to provide currency for the transactions of Central and State Governments'. Currency chests form part of the Issue Department of the Reserve Bank. Payments into the chest by the government constitute payments to the Reserve Bank, and withdrawals constitute receipts from the Bank. In principle, currency chests enable the government to deploy surpluses at one centre to meet deficits at another without physically moving funds from the former to the latter.

chest, and government banking functions in the Part B states were either performed departmentally or by the Imperial Bank of India, and one or more local banking institutions which were mostly ill-equipped to handle larger responsibilities in this sphere. Among the latter were the State Bank of Saurashtra in Saurashtra; the Bank of Mysore in Mysore State; the State Bank of Bikaner, the Bank of Jaipur, and the Bank of Rajasthan in Rajasthan; the Bank of Indore in Madhya Bharat; the Bank of Patiala in the PEPSU (Patiala and East Punjab States Union); and the Hyderabad State Bank in the former Nizam's dominions. The committee strongly advocated converting non-banking (or departmental) treasuries into banking treasuries. Doing so would enable banking facilities to spread to rural areas and bring the public into regular contact with banking institutions, and together with the spread of currency chests, help promote integration by making it easier to remit funds from one centre to another. It recommended bringing banking and treasury arrangements in these states in line with those prevailing in the provinces. In operational terms, this meant appointing the Reserve Bank of India as the sole banker to the governments of the Part B states. In the committee's view, this was fundamental to the whole scheme of federal financial integration and a necessary precondition for ensuring uniformity in banking, treasury, and currency chest arrangements across the length and breadth of the country. Other banks, including those currently performing governmental functions in these states, the committee recommended, could continue to do so as agents of the Bank provided the latter found them equipped for the role.

Alongside these investigations, the government also took steps to amend the Reserve Bank of India Act to enable it to become the banker to Part B states after executing agreements with them. The amendment was necessitated because legal opinion at the time held that Parliament was not competent to extend the scope of the existing section 21(1) and (2) of the Bank Act to Part B states since, as pointed out above, the custody of the consolidated and contingency funds of a state and its public debt were subjects solely within the competence of its legislature. The Bank's original (and, as we will observe below, enduring) inclination was to make the resulting amendment to section 21 mandatory, on the 'pith and substance' assumption that since the 'Reserve Bank of India' formed part of the Union list, the whole of an Act amending the Bank Act fell within the legislative competence of Parliament even though the amending Act might 'incidentally encroach' upon the 'custody of state monies' and the 'public debt of a state'. But with the Law Ministry opining that the pith and substance principle would not suffice to make the amendment *intra vires*, the Bank and the government were faced with the option of either

taking recourse to Art. 252 under which sections 20 and 21 of the Bank Act could be extended to Part B states after their legislatures passed resolutions to that effect, or making the amendments to section 21 in a permissive form. The Select Committee on the amendment bill preferred the latter course. Arguments in its favour were strengthened by the Bank too now adopting the temporizing view that it would not be possible for it immediately to 'undertake in any Part B state all the functions ... at the same time', and that it would be better to word the new legislative provision in a manner as to allow it some choice in the matter.

Even as this amendment bill inched its way through the legislative maze, the Bank began to canvass governments of the Part B states about the recommendations of the Rural Banking Enquiry Committee. These governments were generally not unreceptive to the recommendations and almost all of them were willing in principle to appoint the Bank as their bankers. But differences cropped up between the Bank and some state governments over the role that banks in which they held a considerable interest and which currently transacted treasury and banking functions on their behalf would have in the new dispensation. Understandably, some state governments were also not keen to lose the accommodation facilities they enjoyed from their current bankers and the interest they earned on the cash balances they maintained with these institutions. Although the Bank denied any intention to 'hustle ... States' into the new arrangements, it was nothing if not persistent. The Reserve Bank's eagerness to achieve the financial integration of the Part B states may partly be explained by the intrinsic merits of the scheme and the importance it attached to the role of banker to governments. As a confidential brochure on the integration proposals which the Bank prepared for use by state governments pointed out, central banks all over the world functioned as 'bankers to Government and [held] their accounts'. Apart from being 'economical and convenient', this arrangement was necessary because of the

intimate connection between public finance and monetary affairs and the opportunity it affords to the Central Bank of assessing the financial situation at any given time and of giving appropriate advice to Government and taking necessary remedial measures.

The Bank's seeming persistence also owed in some measure to the newly unleashed energies of the Department of Banking Development which had recently been created to give effect to the recommendations of the Rural Banking Enquiry Committee. Thus without waiting for the Reserve Bank of India (Amendment) Act, 1951 to be passed, N.D. Nangia, the acting head of

this department, began pressing the central government to take 'preliminary steps' to ensure that the agreements with the Part B states envisaged in the Act were signed without delay. He urged the central government in April 1951:

While there may be some room for difference of opinion as to whether or not the Imperial Bank should be appointed the Reserve Bank's agents in all the Part 'B' States, the Government of India will, no doubt, agree that the matter of the appointment of the Reserve Bank as bankers to all States is of such fundamental importance that, if necessary, they should not hesitate to exercise their powers under the Constitution to overcome any difficulties that may be raised by the States.

The Government of India followed the Bank's suggestion and at the end of June 1951, advised governments of the Part B states to take the steps needed to appoint the Bank as their bankers by April the following year. The target date was subsequently put off to July. But the government was also more sensitive than the Bank to the special situation prevailing in some of the Part B states and the susceptibilities of their governments. There was, according to a view that the Bank gathered both from the central government and through its direct contacts with officials of the Part B states, a general 'impression amongst the representatives of several governments' that an agreement with the Reserve Bank would lead to their 'autonomy in financial matters ... [being] seriously encroached upon' Two issues, in particular, seemed to call for attention. The first as noted above was the role in the new arrangements of the state-associated banks which carried out treasury and banking functions on behalf of some Part B states. The central government took the line that where a state had 'developed a Bank of its own and ... entrusted it with ... treasury functions' it was 'retrograde now to ask them to reverse the process and themselves assume treasury functions'. Much better to entrust treasury work to them as agents of the Reserve Bank under 'suitable safeguards'.

Following the central government's advice, the Bank began to take a more pragmatic and differentiated view of agency arrangements in the Part B states. Subject to certain conditions relating to its powers of inspection over them, the types of business they could undertake, the appointment of their chief executives, and the presence on their boards of a nominee each of the Bank and the central government, the Bank now grew ready to entrust agencies to some of the former state-associated banks. These included the State Bank of Saurashtra and the Hyderabad State Bank for Saurashtra and Hyderabad respectively, and after a 'suitable interval', the Bank of Mysore for the former

Mysore state. The Bank was also willing to offer agency in Rajasthan to a bank, if one could be formed expeditiously, that amalgamated the operations of the Banks of Rajasthan, Jaipur, and Bikaner. The Travancore and Patiala banks, however, were not to be entrusted agency arrangements for another three years, while the Bank of Indore was judged unlikely in the near future to qualify for agency responsibilities.

The second issue pertained to short-term accommodation to governments of the Part B states many of whom had arrangements with the Imperial Bank and other commercial banks to draw ways and means advances. 'Theoretically', such arrangements, the central government agreed, were 'inconsistent with the relationship envisaged for the future between the State and the Reserve Bank'. But

our experience with the smaller Part A states is that it is not always possible for them to meet the short fall in the ways and means by short-term borrowing in the market and the restriction of ways and means accommodation by the Bank to the amount of the minimum balance has operated too harshly on them.³

While states should be asked to terminate their arrangements with the Imperial and other banks, the government felt, the Bank 'ought to evolve a more flexible arrangement for the grant of accommodation by the Reserve Bank' Officials at the Finance Ministry and the States Ministry advised:

If the Reserve Bank's accommodation is to be strictly limited to three months loans not exceeding the minimum balance of the state, this is bound to raise a difficult situation for many states. Until they establish their credit some kind of transitional arrangement enabling them to continue their present borrowing facilities would seem inescapable.

The Bank's keenness to speed up the country's financial integration wavered briefly towards the end of 1951 and in the early months of 1952 when it began apprehending that rapidly expanding currency chest facilities would encourage state governments to draw upon them to finance their deficits. The circumstances in which the Bank came to harbour this apprehension and the manner in which it sought unsuccessfully to tackle this problem are discussed at greater length below. Suffice it to note here that at the same time as the Bank was momentarily balking at the prospect of having perhaps to forsake a certain degree of monetary control to secure better financial integration, the

³ Ways and means and minimum balance provisions for states are discussed below.

governments of some of the Part B states grew more attracted than before to the idea of coming under the 'scope of the Reserve Bank of India Act'.

The developments that made for this change of attitude included the revival of the market for state loans and the crucial role the Bank played in managing the loan issues of state governments, particularly after the practice of underwriting state loans was abandoned in 1951. States' requirements for loan finance went up sharply with the inception of planning and the proliferation thereafter of loan-financed development projects. Although nothing prevented a Part B state which had not appointed the Bank as its banker from floating loans in the market, it could not count on the Bank's assistance in managing the issue except in the event of the Public Debt Act, 1944 being extended to its future loans after its legislature passed resolutions to that effect under Art. 252(1) of the Constitution. Until then, it could expect to 'pay higher interest rates than would otherwise be necessary'. Though the Art. 252(1) procedure was being talked about, it appeared to several governments to be an elaborate and time-consuming process. At the same time, the attractions to the Part B state governments of their existing banking arrangements seemed to pale before the promising prospects of an agreement with the Reserve Bank, particularly if the latter would extend substantial accommodation to them, and the banks in which they held an interest could be appointed as agents of their new banker. Thus in very short order, the governments of Madhya Bharat, Travancore-Cochin, Mysore, and Hyderabad appointed the Bank as their banker during the course of 1952 and 1953.

Two states—PEPSU and Rajasthan—however held out. In both cases, the bone of contention related to the nomination of the agency bank. For reasons discussed elsewhere, the Bank was unwilling to contemplate the Bank of Patiala as an agency bank, while mutual rivalries and bickering kept the three Rajasthan banks from coming together to realize their combined potential to be the Bank's agents in the state.

Against the background of the failure to reach agreements with the governments of PEPSU and Rajasthan, the constitutional and statutory provisions governing relations between the Bank and state governments came once more into focus after the All-India Rural Credit Survey submitted its report. This report recommended amending the law and 'if necessary ... the Constitution' to

make it obligatory on all State Governments and not merely, as hitherto, the State Governments of Part A and Part C states, to appoint the Reserve Bank as their sole banker.

Legal opinion also held that Art. 283(2) of the Constitution would have to be

amended if the 'custody of moneys of *all Governments* should be compulsorily entrusted to the Reserve Bank' [emphasis in original]. As things stood, the Bank's Legal Adviser, B.N. Mehta, argued, even the legislature of a Part A state 'can now make a law taking the custody of the moneys of the State out of the hands of the Reserve Bank'. Following these ruminations, Rama Rau addressed the Finance Ministry in December 1954 asking it to take the opportunity presented by the recent introduction in Parliament of a bill to amend the Constitution to effect the necessary changes to the text of Art. 283(2). The Bank, the Governor informed the Finance Ministry, 'had arrangements with all the Part B States', but it was encountering 'difficulties in regard to PEPSU and Rajasthan'. Since it was 'difficult to amend the Constitution frequently', the present opportunity should be used, he argued, to pass an amendment which was 'not at all likely to be controversial, for it [only] places all Part B States in the same position as Part A and Part C States'.⁴

The Finance Ministry conceded the strength of the Bank's general point that it was 'desirable from a long-term point of view to ensure uniformity ... and to obviate the possibility of future retraction by any State' of its appointment of the Bank as its banker. But for procedural reasons, this amendment could not be joined to the existing bill and had therefore to be deferred. On the other hand, the Finance Ministry told the Bank in February 1955, 'with the State Bank of India in the offing', the chances of these two Part B states falling in line had 'greatly improved'. The public debt of Rajasthan and PEPSU too, would be entrusted to the Bank once their legislatures passed resolutions under Art. 252(1) submitting the state to the provisions of the Public Debt Act. As for the other aspects of its relations with these state governments, the central government advised the Bank, it was 'preferable ... for obvious reasons ... to reach ... agreement by voluntary negotiation'. In the event, the lack of uniformity in the application of the Bank Act to the different categories of states within the Union, which was a source of concern to the Bank, ceased to be of any consequence before long, since the reorganization of states in 1956 put all the states of the Union on the same footing. But the clause in the Bank Act defining its relations with state governments has continued to be permissive in character and different in wording from that defining its relations with the central government.

⁴ The Part C states were Ajmer, Bhopal, Bilaspur, Coorg, Delhi, Himachal Pradesh, Kutch, Manipur, Tripura, and Vindhya Pradesh.

WAYS AND MEANS ADVANCES AND STATE GOVERNMENTS' OVERDRAFTS

Under section 17(5) of the Reserve Bank of India Act, the Bank is allowed to make ways and means advances to the central and state governments repayable in three months. As we saw in the last chapter, the Bank's accommodation to the central government was extended against ad hoc treasury bills. In contrast, accommodation to state governments took the form of unsecured and secured ways and means advances. Although the legal view was that nothing in the law prevented the Bank from renewing the accommodation it extended to a state government, it preferred generally not to allow such renewals to take place. While this policy worked well until 1948, thereafter several instances arose of state governments being unable to repay their advances even after they were called upon to do so by the Bank.

Unlike in the case of the central government, ways and means advances to state governments were subject to certain limits set usually at a multiple of the minimum balances they were obliged to maintain with the Bank. Although initially ways and means advances to state governments were also referred to as overdrafts, in course of time the latter term was used to refer to drawals by state governments in excess of their ways and means limits.

In 1937, when the Bank first entered into agreements with provincial governments, minimum balances varied between Rs 5 lakhs for Orissa and the Northwest Frontier Provinces and Sind, to Rs 40 lakhs for Madras, and aggregated to Rs 1.90 crores. Provincial governments were also allowed to draw ways and means advances to the extent of their minimum balances. After the partition of the subcontinent, aggregate balances and limits declined to Rs 1.52 crores, but rose thereafter as the Part B states were brought within the ambit of these arrangements. Although borrowing from the Bank in excess of these limits was not unknown, the latter generally sufficed to meet the temporary financial needs of provincial governments until the early fifties. But they proved inadequate for the needs of governments disposed now to play a more active developmental role, and from October 1950 some states began running up large overdrafts on their accounts with the Bank. The most prominent among these was the Madras government, whose account was almost continually overdrawn from April 1951 to July 1953 and whose overdrafts on one occasion exceeded Rs 22 crores against the normal ways and means limit of Rs 40 lakhs.

The stock explanation the Madras government gave for its 'chronic indebtedness' to the Reserve Bank was that the overdrafts arose because of the 'large expenditure ... on development and irrigation projects ... approved

by the Planning Commission'. The state government also argued that these schemes had reached an 'advanced stage' at which they could not be slowed down or abandoned. In addition, officials from the state argued, the government had to meet large expenditures on famine relief and stocking up foodgrains. Bihar and Orissa were the other states which ran up overdrafts during 1950–53.

As the Bank was aware from the outset, it could do little under the existing arrangements to check overdrafts of governments since individual agents had no information about the current credit of the state government. The latter's net cash position was worked out each working day by the Bank's Central Accounts Section in Calcutta and these calculations were inevitably subject to different reporting lags. Even after it was established that a state government was in the red, the decision to dishonour its cheques had to come from the centre. As a Bank memorandum pointed out,

there is no provision in the Reserve Bank of India Act for allowing such overdrafts but we have no alternative than to acquiesce in them. Under the present procedure, state governments can draw upon us, the State Bank of India branches, treasuries, etc. *without any limit* and we or our agents cannot dishonour cheques drawn by the state governments [emphasis in original].

Disturbed by the prospect of state governments making unregulated drawings from currency chests and treasuries to finance their budget deficits, the implications of such drawings for monetary stability, and the helpless state to which it was reduced in dealing with the problem, the Bank even turned its thoughts in the latter part of 1951 and in the first few weeks of 1952 to devising 'drastic changes ... in the treasury and accounting set up of the country' The changes officials at the Bank turned over in their minds extended to 'curtailing' currency chest facilities—it was initially thought that overdrafts by state governments largely took the form of 'raiding currency chests', i.e. making drawals from them in excess of the payments made into them—or setting up an independent machinery to handle the central government's transactions with the public and leaving state governments to their own banking devices. Nothing much came of these ruminations. While the former course was not seriously pursued for fear that it would lead to 'considerable ... dislocation, the country having become used to the system over ... 70 years', force state governments to hold their balances outside the banking system, and reduce remittance facilities, the latter was thought to be both inexpedient and 'highly expensive'. Until 'some safeguards ... [were] devised ... to ensure that currency chests would not be operated upon to

support budgetary deficits', the Bank and the government agreed towards the end of 1951, 'it would be better to confine the chests to a few principal centres, and to see that the balances therein were kept as low as possible'. But this policy was never seriously followed because it was soon realized that the expression 'raiding currency chests' was merely a metaphor for state governments' overdrafts and not an accurate description of the banking and other arrangements which gave rise to them. Although 'raids on currency chests' were not altogether unknown and Madras was known to have been particularly successful at them in 1950-51, contrary to the earlier impression states' overdrafts resulted mainly from payments made at the offices of the Reserve Bank and its agent(s). Restricting the expansion of currency chest and treasury facilities, it was therefore felt, was no answer to the problem.

There cannot be much doubt that at least momentarily, until B. Venkatappiah (who came to Mint Road as Executive Director in October 1950) brought his steadying influence and his experience of financial administration in the Bombay state to bear on its thinking on this subject, the Bank's executives were shaken by their experience in dealing with state governments' overdrafts. Both Ram Nath and Sundaresan, the two Deputy Governors, were orthodox central bankers. Rama Rau was no less orthodox at this time for having been a civil servant, and it is not unlikely that their collective hopes for financial integration were gravely weakened by the conflict they saw between this imperative and the Bank's statutory mandate for preserving monetary stability. The Bank used a variety of means, ranging from formal approaches to informal links with officials of state governments, to urge the latter to 'keep a vigilant eye on their ways and means position'. The Bank also produced, in due course, a formidable body of work on the finances of state governments. Initiated partly as an outcome of B.K. Madan's membership of the first Finance Commission, this work continued as a result of the close interest the Bank took in the financial problems of state governments, and gave it unmatched expertise on this subject.

Useful as such knowledge was, the problem of states' overdrafts and the conflict between monetary stability and deeper financial integration had, in the ultimate analysis, both to be addressed in the political domain. Besides, with the Bank as well as the central government formally committed to integration, it became necessary to devise other solutions to overcome the problem.

The state governments sought more generous ways and means limits. In this they had the support of the central government. For its part, the Bank sought an increase in the minimum balances state governments were required to hold, on the ground that the 'cost of management and the turnover on government accounts' had risen substantially since these balances were fixed



The inaugural meeting of the first Finance Commission, New Delhi, December 1951. B.K. Madan is at the extreme right. At the other end is M.V. Rangachari, later Deputy Governor.

in 1937, the revenues and expenditures of the provincial and central governments, both taken together and separately, having for instance quadrupled between 1937–38 and 1950–51. On the other hand, interest rates had come down, and with them the compensation to the Bank for discharging its duties as banker to governments. As a result, the income the Bank earned annually from its investment of the minimum balances of the central and state governments amounted only to Rs 6.57 lakhs, but the agency commission it paid to the Imperial Bank alone amounted to more than four times that figure.

The Bank's solution, which it advanced during the course of 1952, was to quadruple the aggregate minimum balances of state governments. The central government preferred a doubling of these balances to avoid straining states' resources. The Bank's proposal to quadruple the existing limits for ways and means advances to state governments was, however, retained so that they were now set at twice the revised minimum balances. In addition to 'normal' ways and means advances, each state was now allowed to draw a special advance of up to Rs 2 crores against central government securities. The interest rate on the former remained at one per cent below the prevailing Bank rate, while that on the latter and overdrafts varied with the size of the drawings. Several states wanted more generous limits and lower rates of interest, but Madras—whose budget was said to have been in deficit for nine months of the year—demanded limits that were adequate to cover its budgetary gap. The real consideration shaping the Bank's policy, the Madras government argued, should be 'whether the needs of the state government are genuine and whether the Bank has the necessary funds'. In addition, Madras sought

additional advances to be made against the general security of state governments' revenues and assets.

There was little sympathy at Mint Road for the Madras proposals which, if accepted, would tempt even the most prudent state government down the path of fiscal profligacy. The Bank, Ram Nath told the central government, could not contemplate undertaking a financial liability of the kind proposed by the Madras government and if states wished to persist with deficits, some other machinery would have to be devised to finance them. States, he pointed out, wanted to be autonomous financially, but refused to pay their own way. As a result, the 'scheme for financial autonomy' had come to mean, for both the Bank and the government,

the worst of both the worlds, with the States pursuing their own courses under the guise of financial autonomy and at the same time requiring the Centre to put up the resources needed (directly or through Reserve Bank) for meeting the inevitable financial consequences of those policies.

The revised limits came into operation from April 1953 for all states except Madras which, along with the newly formed state of Andhra, exchanged the necessary letters in August 1954. These limits and minimum balance requirements were adjusted in 1956 at the time of the reorganization of states but no fundamental revisions were made to them until 1967.

The new limits failed in their intended object of averting overdrafts by state governments. Andhra, which was carved out of the former Madras state, followed in the latter's footsteps and soon ran up sizeable overdrafts, while Orissa and Bihar became persistent offenders. At the Bank's instance the Finance Minister, C.D. Deshmukh, apprised the Union Cabinet of the problem in January 1956. Overdrawing by states, a memorandum prepared for the cabinet pointed out, not only 'contravened' agreements between their governments and the Reserve Bank, they also forced the latter to

act against the provisions of the Reserve Bank Act which prohibits advances of more than three months' duration. They also contravene[d] Article 293(2) of the Constitution which requires prior sanction of the Central Government to State borrowings.

Besides being 'highly irregular', unlimited withdrawals from the currency chests were a potential source of 'extreme danger', for should this 'tendency ... become widespread', it would spell 'an end to financial planning and monetary control'. The Bank had so far chosen not to embarrass offending governments by refusing payments, but the time had now come to put the

matter on a 'proper footing'. State governments, the cabinet summary suggested, should 'devise measures' to clear overdrafts immediately after they were brought to their notice, if necessary by borrowing from the centre to cover seasonal shortfalls in revenue collections or delays in receiving plan funds. If however, a state

is not able to satisfy the Centre that the deficit is due to either of these causes, it must curtail its expenditure forthwith and square up its balance within a fortnight or so, failing which it must face the risk of the Reserve Bank stopping its payments.

Although this was 'an extreme step ... involv[ing] grave issues ... it was ... in the last resort, the only deterrent' which would 'instil a sense of financial restraint and responsibility on the part of the State Governments', the memorandum argued.

The cabinet approved these proposals in general but decided to allow erring states a month's time to bring their accounts back into credit. But the cabinet decision had little impact. Andhra Pradesh, Bihar, and Orissa continued to be in the red where they were soon joined by Kerala and Madhya Pradesh. In July 1957 Bank officials informally canvassed their counterparts in the Finance Ministry about the possibility of implementing the cabinet decision and stopping payments of state governments with persistently overdrawn accounts, but were told that while the centre 'accepted the principle that states should not take forced loans' from the Bank, 'political considerations' prevented it from taking the proposed step. Some weeks later in September 1957 the Governor, H.V.R. Iengar, raised the subject at an informal meeting of the members of the central cabinet and in November at a conference of states' finance ministers. Although the Prime Minister, the Home Minister, and the Finance Minister 'impressed on ... State Gov[ernmen]ts the imperative need' to avoid overdrafts and the state ministers 'nodded agreement', the situation showed no signs of improvement.

In the meantime, the Bank also grew concerned about the manner in which to show states' overdrafts in its books. Its auditors had served a warning in August 1957 that showing overdrafts as 'loans and advances to Governments' was merely a temporary expedient justified only by the Bank's assurance that these debits were 'temporary and would soon be adjusted'. With the latter denouement appearing to recede into the future, the Bank felt the time had come 'to take more drastic steps than hitherto', including the 'politically unpalatable' step of stopping payments from the accounts of overdrawn governments. But the immediate pressure for such measures eased with the Finance Ministry resolving to 'clear the matter up satisfactorily before the

end of the current financial year' by releasing to states the grants and loans due to them, and make 'reasonable arrangements for the future'.

The central government intervened as promised to ensure that no state was overdrawn at the end of March 1958. But overdrafts resumed almost immediately in the new financial year and these were once again brought down with help from the centre, so that no state was in the red to the Bank when it closed its books for the year at the end of June. This, in the event, set the pattern for the next few years. More than once, the Bank was disposed to consider measures such as charging states 'really penal rates' on their overdrafts, but was persuaded by the Finance Ministry to abandon them. Penal rates, the latter argued, would only add to the financial burden of states which already faced several demands on their resources but had few means to raise capital or finance deficits. The Bank revived the proposal for 'deterrent rates' in July 1959 when it felt overdrafts were to some extent caused by state governments managing their finances badly. But once again little came of its efforts.

The problem of states' overdrafts abated somewhat over the next two years. But it revived from 1961–62 and for the next few years overdrawn accounts were squared annually, usually with the centre's help, in time for the closing of the Bank's accounts. The centre debited the accommodation from its assistance to the states either the same year or over a longer period, and in some cases special loans were given to states to clear their overdrafts. States felt encouraged by this automatic procedure to increase their excess drawings and this, as we observe below, was soon to become a source of some concern. In the meantime, M.V. Rangachari's arrival at the Bank as Deputy Governor introduced briefly a new dimension to its consideration of the problem. Rangachari had earlier handled states' finances as Special Secretary in the Finance Ministry, and he took the view in a memorandum he presented to the Committee of the Central Board in June 1961, that it was neither

practicable nor necessary for the Reserve Bank to take action in regard to ... State overdrafts beyond bringing them to the notice of the Finance Ministry and urging them to take remedial action to ... improve the situation. ... the Reserve Bank is not in a position to prevent these overdrafts and it cannot stop payments without paralysing the administration.... There is no danger from the Reserve Bank's point of view, of any loss resulting from these overdrafts as it is inconceivable that the Central Government would remain unconcerned if a State finally defaults. In actual practice they have been clearing these overdrafts from time to time and there is no reason to suppose that they will not continue to do so.

Provoked by Rangachari's observations, Mehr Chand Mahajan, retired Chief Justice of the Supreme Court and a Director on the Central Board, remarked that they were 'in the nature of special pleading in defence of an unauthorized action'. The Deputy Governor, according to Mahajan, merely raised a 'bogie or a ghost' by suggesting that dishonouring a state government's cheques could lead to a political crisis. He questioned the constitutional and legal propriety of the Bank allowing state governments to overdraw their accounts with it, and declared that Rangachari's note would not 'stand scrutiny by the Court'.

The Legal Department of the Bank felt overdrafts were legally in order. Rangachari believed the problem was political and financial, and not one at which merely the law could be thrown. If the Centre was not willing to 'sort out the problem' and a state government defaulted on its obligations to the Reserve Bank, Article 360 of the Constitution (containing 'provisions as to financial emergency') would come into play and 'bring the Centre back into the picture'. Therefore, there was no alternative to the centre—whose financial position was only a little better and which took recourse automatically to ad hoc treasury bills whenever it needed funds—and the states coming to an agreement. The doubts raised by Mahajan were then referred to the Law Ministry. Though informal consultations suggested that the latter sided with Mahajan's view of the matter, the legal and constitutional doubts surrounding it were not conclusively resolved.

The central government's attitude towards states' overdrafts began to harden after the 1962 elections, with both the Finance Minister, Morarji Desai, and the new Governor, P.C. Bhattacharyya, taking a close interest in the problem. Apart from writing repeatedly to chief ministers on the subject, sometimes conveying threats of their payments being stopped, Desai informed Prime Minister Jawaharlal Nehru of the diversion of plan resources which resulted from states' overdrafts and the central government's manner of covering them. Though Desai informed chief ministers that he had authorized the Bank to stop payments where overdrafts were not cleared after the agreed notice period of one month, Bhattacharyya remained diffident at this time about taking so drastic a step. Writing to L.K. Jha, Secretary in the Finance Ministry, at the end of July 1962, he repeated Rangachari's argument that the centre could not wash its hands of the problem, since if a state's payments were stopped, Delhi might have to take over its financial administration. However, departing somewhat from Rangachari's earlier emphasis, Bhattacharyya wondered whether the centre should not invoke Article 360 *before* payments were 'actually stopped by the Bank and ... chaos ... [was] created' in the state. In any case since the issue was ultimately a political one, he sought to know whether the Finance Minister fully appreciated the implications of the Reserve

Bank carrying out his threat to the states. Desai, it appears, was not unmindful of the difficulties state governments would face, but he expected them to approach the centre in such a contingency. The Finance Minister, Jha informed the Governor, wanted to underline the importance of making state governments 'realize that overdrafts from the Reserve Bank are not to be used for meeting ... ways and means difficulties'.

Probably because he felt the Bank balked at taking any extreme measures, Desai took the initiative in January 1963 to draw Bhattacharyya's attention to Bihar's finances. The state's overdrafts continued to be large despite special assistance from the centre. Further assistance, he argued, would merely encourage the state to put off the needed reform of its finances, and the time had come for the Bank to notify Patna of its intention to stop payments of the Bihar government's cheques after a month. When this notice was issued, Bihar informed the Bank that the centre's project assistance was in arrears and that it required two months to set its finances in order. The latter was done with the help of an advance of Rs 7 crores from the centre made on the condition that Bihar would 'accept stoppage of payment by the Reserve Bank as a necessary and inevitable consequence' if it continued to overdraw its account with the Bank. A similar situation was reached with Kerala six months later. Both the centre and the Reserve Bank agreed on the need to dispel the impression states carried that the centre would always step in in June every year to clear their overdrafts. While there was no question of leaving them 'unadjusted' in the Bank's books, states had to be kept under 'continuous pressure' to pay off their excess dues to the central bank.

These resolutions notwithstanding, overdrafts grew considerably in magnitude in the mid-sixties, with the centre having to lend Rs 23 crores to four states in June 1964 and twice that amount to seven states the following year before the Bank's books were closed. As their revenue receipts suffered in the wake of droughts and relief expenditures went up, some governments even began using overdrafts 'in effect as Plan resources'. By October 1965 the problem had become 'chronic' in Andhra Pradesh, Assam, Kerala, and Rajasthan, while state governments in general attached 'little importance to the proper management of their financial affairs'. The central government too grew concerned now about the effect of states' deficits on its own fisk. However, despite Prime Minister Lal Bahadur Shastri and Finance Minister T.T. Krishnamachari repeatedly urging state governments to reform their finances, the situation continued to worsen. Thus by March 1966, ten states had overdrafts aggregating Rs 171 crores.

By 1965 states' overdrafts were complicating the centre's efforts to achieve a measure of fiscal stabilization, and in February that year Bhattacharyya

explicitly cited the 'absence of greater fiscal discipline' on the part of state governments as a factor which precluded the Indian government from approaching the International Monetary Fund for the medium-term balance of payments assistance it urgently required. During these months, at the Governor's instance, the Reserve Bank considered terminating banking agreements with states having persistently overdrawn accounts. But by the end of the year, it had veered round to Rangachari's view that this was not a 'desirable' course to adopt, since it would

throw the States in the hands of commercial banks and they might get into overdraft arrangements with such banks which might affect the security of the depositors. There is also the danger that periodically the State administrations might be brought to a standstill ... when funds from the commercial banks cease to be available.

The more 'practicable' solution, according to Rangachari, was to ensure that states did not have 'free or unlimited access' to currency chests located at non-bank treasuries and to the facilities available at banking treasuries. The principal proposal in the latter regard to emerge from discussions between officials of the Bank, the Finance Ministry, and the Comptroller & Auditor General's office was that of regulating expenditures from currency chests 'through a system of monthly or quarterly letters of credit or limits on drawings placed on all drawing and disbursing officers'. These limits were to be related to budget estimates of state governments determined in consultation with the Bank. Such a 'radical scheme', its sponsors felt, could be 'sold' to the states only as a measure to 'reform and modernize ... the existing archaic treasury system', and if the opportunity was taken to regulate the central government's ways and means as well.

After all, there is not much difference between the States running an overdraft with the Reserve Bank and the Centre financing its deficit by the automatic issue of ad hocs when the balance falls below a limit which is the present practice. This is well known to the States and some of them have in the past suggested that they should have the same facilities. It is therefore essential that the changes in the procedure which are proposed are put as common to both the States and the Centre.

Although Bhattacharyya himself was attracted to the idea of states being persuaded to consult the Bank about their budget estimates, officials at the Bank did not find much to commend in the new system of checks. Apart from

its feasibility being in doubt—there was no reason to expect state governments to abide by a system which gave the Bank's officers the power to question the provisions of their appropriation acts—some officials at the Bank feared it would result in 'continuous bickering between the States and the Reserve Bank' and perhaps culminate in the former having 'access to deficit financing from Reserve Bank ... in exactly the same way as the Centre'. 'In fact', according to the Bank's Secretary, S.D. Deshmukh, it was 'better to concede this [right at the beginning] than to accept the present proposal'. The system of regulating drawals by disbursing officers had had Rangachari's blessings, but B.N. Adarkar, who replaced him as Deputy Governor, proposed a simpler solution in April 1966, whereby the central government took over the overdrafts of states as and when they occurred instead of waiting until June each year, converting them into advances to their governments, and recovering the latter from the assistance due to them.

Adarkar's proposal attracted wide support within the Bank and a modified version of it was eventually put forward in August 1966 as part of a plan to increase states' ways and means limits. But the scheme the Bank finally chose to convey to the Government of India in May 1966 was a modified version of the one proposed by Rangachari who, despite having meanwhile joined the Mysore government, continued to assist the Reserve Bank in dealing with state governments' finances. Under this rather elaborate scheme, the Bank was not to be involved in formulating states' budgets or clearing their estimates. The focus, instead, was on controlling the 'flow of expenditure out of the Consolidated Fund so that this by itself does not lead to overdrafts'. Budgeted expenditures adjusted for any deficit in the estimates were to be distributed among the 'various drawing officers' who would make disbursements within their limits and according to budgetary provisions. The Bank had the responsibility for coordinating this system. The Central Accounts Office would convey to each state government daily by telegram, its cash balance position, while officers of the Bank at each state capital would work 'in close association' with the local Finance Department. Enclosing the details of Rangachari's scheme to the Finance Minister, Sachindra Chaudhuri, Bhattacharyya expressed the hope that state governments would

agree to submit themselves to the suggested small measure of discipline, as the alternative would be for the Reserve Bank of India to request the Central Government to be relieved of the responsibility of acting as the banker to the State Governments

The central government circulated the Bank's scheme, along with the sweetener of higher accommodation limits, to the states at the beginning of

June 1966 'in the hope that it could be worked ... [and] more drastic alternatives may not become necessary'. The scheme received a uniformly cold reception from state governments which thought it too cumbersome and impractical. Much to Bhattacharyya's disappointment, the Finance Ministry too, chose not to press the scheme on the states. It preferred, in his words, to 'proceed on the old lines and tell C[hief] M[inister]s that once the normal ways and means limits are refixed any overdraft in excess of such limits will automatically result in stoppage of payment'.

Bhattacharyya was sceptical about the success of this approach. A cabinet memorandum dating from the middle of July 1966 embodying the Finance Ministry's proposals to check overdrafts envisaged requiring state governments to balance budgets and undertake not to run further overdrafts, and subject to these, offering them an increase in ways and means limits. Should a state run into the red after these reforms, the cabinet memorandum proposed, the Bank should ask the overdraft to be cleared within two weeks failing which it could take steps to stop its payments. Bhattacharyya sought stiffer proposals involving more automatic stoppage of payments by states running overdrafts and a commitment from the central government that it would not ask the Bank to 'hold its hand' where states deviated from these terms. But he failed to have his way.

The Bank and the government next turned their attention towards revising the minimum balances and ways and means limits of state governments. There was some discussion about the criteria on which these should be based. The Economic Department proposed relating limits to some proportion (7 to 8 per cent) of the average revenue receipts or capital and revenue receipts of a state in the preceding quinquennium. The suggestion of fixing each state's limits on the basis of the ratio of its past average indebtedness to revenue and capital receipts was also briefly considered. While one Deputy Governor, D.G. Karve, favoured the 8 per cent formula, Adarkar thought the resulting thirteen-fold increase in ways and means limits (on the basis of revenue receipts alone) to Rs 122.75 crores was overgenerous. Besides, he argued, it was better on practical grounds to relate the new limits to old or existing ones rather than use altogether new criteria. His own suggestion was to scale up limits in the same proportion as the increase in the revenue and capital receipts of state governments since 1951, i.e. by a factor of 5.85.

The simplest proposal, and one which the Bank chose in the end to put forward, was to increase the aggregate of states' minimum balances from the level which prevailed in 1937 to the same extent as the central government's minimum balances with the Bank. The latter had increased from Rs 10 crores in 1937 to Rs 50 crores currently and the Bank proposed, after making adjustments for the reorganization of states, to increase their aggregate

minimum balances to Rs 12.70 crores. The revision was to be implemented in two stages, with only half the increase coming into effect from November 1966. The Bank also proposed fixing limits for normal ways and means advances at the same level as minimum balances and those for special ways and means advances at double that level. Interest on all ways and means advances was to be charged at Bank rate uniformly. The opportunity of this 'comprehensive review' of its arrangements with state governments, the Bank also argued, should be used to 'enforce the stricter and more logical view' that all ways and means advances to states should be cleared before three months and not allowed to be renewed. The central government, the Bank now proposed in an adaptation of a suggestion Adarkar had made a few months earlier, should take over states' overdrafts whenever the latter failed to clear them within the stipulated period of three months rather than waiting until the end of June to do so. Where a state failed to repay within three months an overdraft secured on the pledge of central government securities, the Bank proposed, the latter should have the power to take these assets over.

The central government responded to these proposals as it had done in the course of similar exercises in the past, by suggesting almost a halving of the revised minimum balances, fixing normal ways and means advances at thrice these balances, and special ways and means advances at twice the normal ways and means limit. The latter limit, the government desired, should not be enforced if the borrowing state government could offer central government securities as collateral. It also proposed lowering the interest charged on all advances to one per cent below the Bank rate. If an unauthorized overdraft persisted for more than a week, the central government proposed, the Bank should ask the concerned state government to clear it within three weeks or face a stoppage of its payments.

These revised proposals were brought into effect from March 1967. Close on their heels, the central government granted special ways and means advances of over Rs 59 crores to enable states to repay all their outstanding overdrafts. Thanks to the last, central assistance to enable states to clear their overdrafts came to nearly Rs 237 crores between June 1965 and March 1967.

The new limits and the clean slate initiative were followed by a conference of chief ministers and finance ministers convened in Delhi at the beginning of April 1967 at which Bhattacharyya underlined the need to avoid overdrafts and explained the steps the Bank proposed to take against states failing to restore order to their accounts. There were limits, he stressed, to how far the Bank could 'continue to carry in its books an operation which is illegal under the Statute'. However, despite the reforms and the threat of their payments being stopped, state governments continued to overdraw on the Bank, and by

November 1967 overdrafts had climbed steeply to Rs 65 crores. Earlier in October, the Deputy Prime Minister, Morarji Desai, had advised the Bank not to balk at stopping payments of states failing to get out of the red. Preliminary exercises the Bank carried out in March 1967 suggested that not all sources of leakage of funds could be plugged. Nor could state governments be allowed to default on their external liabilities. Ceasing payments would no doubt cause great inconvenience to the public and a certain amount of disaffection and unrest. Some transactions of the central government, such as the payment of pensions to its retired employees at treasuries and subtreasuries, would also be affected. But on the whole, it was possible to enforce an order to stop payments on a state government's account effectively.

However, when the decisive moment came in November 1967, the Bank drew away from any extreme measures. L.K. Jha, who had meanwhile become Governor, informed Morarji Desai that rising expenditures by state governments, particularly in the months preceding the general elections, and the market's lack of appetite for their loans had led to the financial position of some states deteriorating to an extent where 'even with the best efforts', most of them would not be able to 'muster enough resources within three weeks to clear their overdrafts'. Nor could states' payments be stopped lightly, as the move was bound to have 'serious repercussions ... of a political nature' and on the 'already dangerous law and order situation'. If 'policemen do not get their salaries', Jha pointed out, 'we cannot expect them to be on the side of law and order'. The Governor therefore suggested holding another conference of states at which their representatives could be urged to cut their plans, curtail expenditure, and mobilize additional resources.

If after such a review a State does prove to be recalcitrant and if there is no other remedy left, the stoppage of payments may have to be a last resort remedy. However, to take this extreme step at this juncture on three weeks' notice may not be the best method of dealing with the situation.

MARKET BORROWINGS BY STATE GOVERNMENTS

Provincial governments, as the governments of states of the Indian Union were referred to earlier, were not major borrowers in the capital market in the pre-plan period. The slump in the central government's borrowing operations was matched by that in the demand for the securities issued by these governments only four of whom entered the market during 1946-51

to raise Rs 24.5 crores through eight issues. To this may be compared the Rs 41 crores raised by seven governments through 21 issues during 1940–46. All but one of the loans floated during 1946–51 were underwritten, including two by the Bank, while four others for Rs 13 crores did not come to the market because no satisfactory underwriting arrangements could be made.

Conditions remained unfavourable for state governments' borrowing operations even after the launch of the first five-year plan. However, with the need to raise resources having become rather more pressing than in the past, governments (including those of some Part B states with whom the Reserve Bank was in the process of entering into banking arrangements) began more actively to consider the possibility of floating market loans. This section gives an overview of state governments' loan operations during the years covered by this volume and discusses the Bank's role in facilitating and regulating their issues.

It was only after some controversy, and penetrating scrutiny by governments of even the Part A states, that the Bank managed to define its role in relation to their loan issues in the constitutional and political dispensation that emerged from the upheavals of 1947–50. The Bank had long been criticized in some quarters for failing to ensure uniform terms for all gilt-edged flotations and for its refusal to support state government loans in the open market or to nurse the market prior to a new state loan. But a new row erupted in March 1951 when some state governments complained that the Bank's advice to them about the size and terms of their loans merely reflected the 'restrictive authority' the central government wished to exercise over their market operations. Denying the allegation the first time it was made openly at the conference of Governors and Rajpramukhs in March 1951, the Finance Minister, C.D. Deshmukh, argued that the Reserve Bank offered its counsel to state governments independently in its role as an 'expert adviser' and on the basis of its assessment of 'their credit and the conditions of the money market'. This however failed to reassure many state governments. 'What is worse', Deshmukh observed somewhat indignantly in August 1951 about the persistence of similar complaints, it was being suggested that the centre's 'motive ... [was] to raise money from the market at the cost of state governments'. Denying that the centre had 'any such motive', Deshmukh wanted it brought to the attention of state governments that on many occasions in the past the Bank had 'advised ... the Centre also to cut down its borrowing programme', and that in 1950 'on the advice of the Reserve Bank the Centre refrained from issuing any loan at all other than a conversion loan'. Besides, although it was

open to the Reserve Bank to refer any question for the guidance of the central government, ... it remains true to say that such guidance is not primarily influenced by the relative needs of the Centre and ... [of] the States.

The Bank agreed with Deshmukh. Yet, perhaps apprehending that it would otherwise have to shoulder the entire burden of resisting states' demands to be allowed to float large loans in an unreceptive market and unsure yet of the extent of its influence over their governments, the Bank told the central government that the latter could not afford to adopt an attitude of lofty indifference towards states' loans since these were bound to 'have repercussions on the centre's existing loans and ... borrowing programmes in the future'. A few months later, in December 1952, the Bank also pointed out to the central government, while explaining its objections to a proposal from West Bengal to raise a loan for a salt works, that the Planning Commission had been set up to 'decide upon the relative priorities' of investment proposals and oversee the 'allocation of resources'. Allowing state governments to come into the market in an uncoordinated manner to finance schemes not 'approved or formulated' by the Commission would, the Bank urged, 'necessarily entrench upon the resources available for the schemes approved under the Five Year Plan, as the total investible funds in the hands of institutions and others ... [was] limited'. A possible way out of this 'difficulty' might be to

lay down a requirement that if a State desires to embark upon a scheme it may do so with its own resources, but if it wishes to raise funds from the market ... by the issue of a public loan or by negotiation with private investors, it must obtain the approval of the Planning Commission for the project.

We may note here in passing that the Bank however grew increasingly sceptical in later years, among other things, of the Planning Commission's targets for market borrowing by state governments.

Despite a few dissenting notes, struck notably by Madras, the political climate in December 1952 was much more congenial than at any time in the recent past to suggestions for allowing the central government to play a bigger role in determining states' investment priorities and the means of financing them. But with this desirable denouement still in the future, the Bank resolved in 1951 to give the loan programmes of the central and state governments the same careful consideration, helping these bodies to raise funds in the market to the extent possible while ensuring at the same time that a stable pattern of interest rates was maintained. The Bank's credibility in these testing times

when precedents were still in the process of being established and a single wrong step might undo a great deal of effort, depended on its ability to stabilize the interest rates on government loans. While the central government was by far the biggest borrower and the Bank's relations with it were by now on a rather even keel, uncoordinated and competitive borrowing by state governments presented a possible source of danger to a gilt-edged market recovering slowly from the effects of the political tumult of 1947–50. Thus when Madras held out a threat in 1951 of raising its loan, whose size the Bank felt was too ambitious, on 'terms ... such as would attract investors adequately', the Bank responded with alacrity, enquiring of the state government whether this meant 'a rate of yield as might prejudice the pattern of other loans including [of] the Government of India' In the event, the Bank's responsibility for ensuring a stable and orderly pattern of gilt-edged rates came to be recognized more widely within a couple of years of this episode, with the central government letting it be known to state governments that they should either accept the 'considered advice of the Reserve Bank' as to their borrowing rates and the other terms of their loans 'or stay off the market'.

To some extent, of course, the anxiety state governments voiced in the early years about the roles of the Bank and the central government reflected the newness of the prevailing constitutional and political arrangements and the understandable desire of these institutions to test the limits of their powers and responsibilities within them. Differences of attitudes, perceptions, and expectations narrowed as these arrangements stabilized over time and as state government officials came into closer contact with those at Mint Road and became more familiar with the manner in which its market assessments were carried out. The Bank too, learned to take the compulsions of state governments in its stride and as well as assisting their issues, played an important role in promoting the popularity of this class of gilt-edged stock among commercial banks. In later years especially, the Bank made conscious efforts to create a level field for the loans of all states. This was judged necessary since the significant commercial or financial centres were all concentrated in a few regions and left to itself, the market tended to be biased in favour of some states' loans. It is also an apt illustration of the Bank's approach towards the borrowing plans of state governments as the former evolved in the 1950s and 1960s that, while never ceasing to exhort them to borrow wisely and spend carefully, the Bank rejected a proposal the central government made in 1964 to restrict state governments' access to the market. The Bank argued that besides violating an important constitutional principle, the proposal would, if implemented, limit the range of gilt-edged stock available in the market

and weaken the attraction of these instruments for institutional investors such as commercial banks.

On the other hand, differences between the Bank and states did not altogether cease during these years. The size and terms of state loans often proved contentious. In addition, differences cropped up over the size of the Bank's contribution to state loans, the manner in which states mobilized subscriptions, and the extent to which they could retain excess subscriptions to their loans. Difficulties of communicating between Delhi, Bombay, and the state capitals made it harder for the Bank to ensure complete coordination with state governments whose officials were not above exploiting these difficulties to try to have their own way vis-a-vis the Bank.

The Planning Commission's propensity during these years to persuade states to step up the size of their plans was another complicating factor. In 1956, when loans of several states went to substantial discounts soon after they closed and the Bank stepped in heavily to ensure the success of the West Bengal loan, B.C. Roy, the chief minister of West Bengal, insisted that the Planning Commission was responsible for this state of affairs since it had placed his government in the unenviable position of having to borrow Rs 7 crores every year during the second plan. Iengar averred that the Commission did not consult the Bank about the size of the loans state governments might raise. Indeed it was not

within their province to advise on the amount which can be raised by state governments in the market in any particular year. The competent authority in this matter is the Reserve Bank which is in close and intimate touch with the market.

But the Planning Commission too, washed its hands of the matter, pointing out to Roy that the actual size of a state's loan had to be determined by the Bank and the Finance Ministry and that its own role was limited to indicating the magnitude of resources each state had to find for its plan. The mode of financing the latter, the Commission maintained, was largely for the states to determine. Attention was drawn in an earlier chapter to the manner in which the Planning Commission was disposed to approach the problem of finding resources for the five-year plans. Thanks to this and the reluctance and limited ability of state governments to raise resources through taxes and small savings, the Bank was frequently in the position of having to advise them to limit their borrowings and therefore to curtail their plans to the extent of the resources they could mobilize. However, from the early 1960s in particular, the Bank was able to line up the Finance Ministry behind its efforts to limit state

governments' borrowing programmes to amounts which, in its judgement, the market could absorb. As well as sharing to some extent the Bank's concern for the state of the gilt-edged market, the Finance Ministry also had reasons to be worried about the consequences of over-borrowing by the states for its own loans and future borrowing prospects.

The Early Years

Since 1938, the practice had prevailed of underwriting loans issued by provincial governments. The system of underwriting proved useful in the initial stages, but a feeling began to develop by the late 1940s that it placed provincial governments at a disadvantage and prevented them from 'getting what little they would have got' through a 'straight public issue'. According to some officials at the Bank, the underwriting procedure made for excessive rigidity:

either the loan will have to be issued at the lowest rate quoted by the underwriters to secure the full amount ... even though a good portion of ... [it] might have been tendered at more favourable rates, or the loan issue ... abandoned altogether.

Besides, if states had to 'reach any stature at all, they should get educated' about the market's evaluation of their credit. It was only too easy otherwise, according to the Deputy Governor, N. Sundaresan, to persist with the 'sheer camouflage [of] paying terrible discounts [of 6 annas per cent which were often passed on to the subscribers] to borrow modest amounts'.

Proposals were mooted within the Bank to discontinue the practice of underwriting state government loans in 1950 but to little immediate effect. The following year, five state governments, Madhya Pradesh, West Bengal, Bombay, Madras, and Uttar Pradesh, proposed to come to the market with loans for Rs 15 crores. These proposals together presented a formidable challenge to the Bank. The advent of planning had clearly emboldened some states to propose a borrowing programme which was the most ambitious yet of any they had ventured since the end of the war. Few could question the urgency with which governments wished to promote the economic development of these large and very important states, especially after the inception of the planning process. But the Bank had also to be mindful of wider considerations to which individual state governments, even when they were led by men of acknowledged political and personal stature in the public life of the new republic, would not normally be sensitive, without appearing to be out of step with their developmental aspirations. On the other hand, since these were still early days for the new constitutional arrangements, the manner in which it handled the 1951 borrowing proposals was certain to affect the future of the

Bank's relations with the states of the Union and its own role in the emerging scheme of things.

Officials at the Bank were generally sceptical that the states would be able to borrow any money at all in the market, let alone the Rs 15 crores they sought. But the Bank was content to whittle down the size of the programme to Rs 10.75 crores. The prospects of raising even this amount appeared dim after an informal meeting Rama Rau convened of underwriters and brokers dispersed amidst 'general feeling that no combination ... [of them] would be able to conjure up more than a crore of rupees' Thus, while the state governments, four of whom wanted their loans underwritten, faced a choice between risking a 'straight' loan and not borrowing at all, the Bank could either discontinue existing underwriting arrangements and float the loans with its support, or abandon the programme itself and along with it, a good opportunity to promote its influence over the public borrowing decisions of state governments.

There were, in the view the Bank held at the time, major obstacles in the way of state governments raising loans in the market. Their securities appealed to a 'limited clientele' who preferred yield to liquidity, while small banks and insurance companies bought them only because the borrowing governments forced them to do so. Since those who bought states' loans unwillingly took the first opportunity thereafter to sell their holdings of them and the latter often represented a 'large proportion ... [of] the ... debt', the market quotations of these loans tended to sag immediately after they closed. The big banks did not hold state loans. Nor did the Reserve Bank hold or buy them save in rare circumstances such as which prevailed in the summer of 1947. Convinced that purchases by the Bank were inflationary and gave state governments a 'false impression' of the popularity of their loans, officials at Mint Road refused at first to entertain the possibility, Sundaresan for example, remarking that the Bank would 'become an asylum' for states' loans if it began extending buying support to them. Open-market operations would no doubt help improve the liquidity and strength of states' loans, but there was little immediate prospect of undertaking them unless state governments agreed to bear the resulting losses.

If the prospects for states' loans appeared difficult in 1951, floating 'straight' loans was nothing short of a gamble. But the Bank's was not the final word, and with state governments determined to come to the market, it was decided to 'abandon the idea of underwriting states' loans' that year and advise all state governments to float 'straight loans in the market' for realistic amounts and at reasonable rates. Feeling that the time had come to 'give a bold and honest indication of stepping up interest rates', the Bank also advised the

states to offer modest amounts—‘to aim too high and achieve too low may jeopardize ... credit [and] ... future borrowings’—in eleven-year loans at coupon rates of 3.5 per cent. Besides, braving further criticism, it asked the government of Madras to price its issue at 4 annas and the governments of Uttar Pradesh and Madhya Pradesh at 8 annas below par. The Bombay and Bengal issues were to go out at par. The loans were also scheduled now to open towards the middle of September, shortly after a central government loan (the 3 per cent 1951–54) was discharged, so that its proceeds might find their way into the new issues.

As the date for announcing the 1951 states loan programme drew near, there was a growing fear of failure within the Bank and some debate about its role in the event of public subscriptions falling short of the issued amounts. Sundaresan even put in place arrangements to enable the issue to be called off, if necessary even hours before its announcement on 10 September, for fear that ‘otherwise [state governments may] ... blame the Reserve Bank for having recommended the flotation of loans which proved to be complete flops’. There were also differences within the Bank about its responsibility for the success of these loans. Arguing that state governments faced difficulties in selling their holdings of central loans and that having recommended the present course, the Reserve Bank owed it to the states to ‘go to their succour’ if public subscriptions fell short of the recommended amounts, Rama Rau was in favour of the Bank putting about Rs 2 crores into the loans. His deputy took the more orthodox view. Bank financing of market loans amounted to ‘inflationary’ financing, and the amounts it recommended to state governments represented ‘targets ... not an assured minimum’. If the public response turned out to be poor, Sundaresan declared, ‘it should be treated as part of the day’s game’. Besides being unsound, the course proposed by Rama Rau was bound to strengthen the ‘fantastic notions’ states already harboured about their credit. The differences between Rama Rau and Sundaresan went up to the Finance Minister who, while generally assenting to the orthodox principle Sundaresan espoused, felt there could be no objection to the Bank distributing Rs 2 crores over the five loans ‘so long as no particular loan ... [was] over-supported in this way’. The Bank’s assistance, the central government pointed out, would help ‘maintain some strength in the market [and] ... a cordial relationship between the Reserve Bank of India and the State Governments’.

In the event, the announcement went off without a hitch on 10 September and the loans opened and closed on 17 September after total subscriptions of Rs 10.97 crores. Thanks to some favourable conditions, including the maturing of the central loan, large interest payments made on other loans around the time of the issue, and the absence of any internal or external political or

economic crisis, total *public* subscriptions exceeded the Bank's expectations. But despite 'even ... the greatest pressure ... exerted by the state authorities concerned' on investors within their states, these fell short of the target by over Rs 3 crores, the Bengal loan being the only one to be taken up in full by the public. The shortfall in the case of the other loans was made up by contributions from the Bank (Rs 1.52 crores) and from the state governments themselves. The Madras government, to which the Bank had recommended Rs 3 crores and which even days before the announcement wanted the loan amount raised to Rs 4 crores, citing among other factors the presumed willingness of a well-established local bank to underwrite the entire issue for sale at par, managed Rs 2 crores. Madhya Pradesh which indented for Rs one crore performed the worst, getting only about an eighth of that amount. The poor performance of the state loans, Sundaresan concluded somewhat rashly, meant 'it would be most inadvisable to launch ... large ... projects on the assumption that this country will be flowing with milk and honey' in the coming years.

Whatever the Bank's preferences, several large investment projects were on the anvil in the states, and their need consequently for resources and recourse to the market only increased in subsequent years. But as it happened, the practice of underwriting state loans was never revived. Although not so intended, the decision to abandon underwriting and the related move by the Bank to contribute substantially to making up the shortfall in public subscriptions to the four state loans in 1951 helped greatly to enhance its influence over the loan programmes of state governments in the next few years.

The following year the Bank felt state governments would stand a better chance if they were allowed to come to the market before the central government. The latter accepted the Bank's advice in the first instance, but did not in the event float any loans in the market during the year. The Bank also proved more willing on this occasion to let the states determine the size of their borrowing operations so long as they were confident of the strength of the local sentiments in their favour. The Bank's new stance was largely a response to the Madras chief minister, C. Rajagopalachari's suggestion that he should be allowed to take a gamble on a larger loan than the one the Bank was prepared to consider. Apart from the popular enthusiasm created by the development programmes his government had launched in the state and its success in mobilizing loans from farmers and other 'small men' for its irrigation schemes, Rajaji maintained that in 'sheer self-interest, if not on nobler impulses, ... the money-bags ... [would] hasten to strengthen ... [his] hands' by subscribing to the loans floated by the state. But while not standing in the way of state governments' loan proposals,

the Bank resolved to distribute its own subscriptions 'impartially' and not 'give any undue preference to any one state'.

In the event, four loans were issued initially in 1952 for a total of Rs 12.5 crores. The loans were generally a success, the Madras loan of Rs 5 crores, in particular, being oversubscribed to the extent of Rs one crore. The success of the Madras loan raised a fresh set of problems as the state government wished to retain the oversubscribed amount for its ways and means needs. Subscriptions to the loan, Madras officials argued, represented a 'moral asset' for the chief minister and his government which should not be 'frittered away'. Finding no reasonable means of implementing it, the Bank initially opposed the state government's proposal. The loan had been raised to finance electricity schemes and productive irrigation works and it would not be 'proper to use it for any other purpose' even if in practice there were 'no means of discovering how ... [a] loan ... [was] utilized', as doing so might 'provoke criticism and ... destroy public confidence'. However, because of the state government's precarious ways and means position, the central government too was keen to find some way of letting Madras keep the additional money, and Deshmukh felt the 'altered circumstances' necessitated 'readjust[ing] ... attitudes in a matter like this'. At Deshmukh's instance the Bank advised the Madras government to reissue its loan against the excess subscriptions, but this advice could not be carried out since it came after treasuries in the state had already returned a major portion of the oversubscription from the public.

There were, perhaps unavoidably, some inconsistencies during these early years in the Bank's approach towards state governments' loan flotations. To an extent, no doubt, this was because not all states were yet equal either constitutionally or in terms of the market ratings of their loans. But the inconsistencies extended beyond these factors and arose too from the relative novelty of the process the Bank was in the midst of learning to administer. It was pointed out above that officials at the Bank demurred when West Bengal wanted to place a loan for Rs 2 crores in December 1952 for a project which was not included in the five-year plan. But it allowed the 1952 loan programme of state governments to drag on till March 1953. First in December 1952 and again four months later, Uttar Pradesh applied to the Bank to be allowed to issue to the Punjab National Bank Rs 4 crores in all of its new 4 per cent 1964 loan. 'Piece-meal issues' such as these, the Bank felt, were 'contrary to the terms of the original notification' and not a 'healthy practice'. Besides, officials at the Bank noted in March that the Punjab National Bank had borrowed large amounts from the Reserve Bank at 3.5 per cent, so that to some extent it was using the latter's funds to earn half a per cent's interest for itself. Four per cent loans were also quoting at a premium while the UP loan was proposed to be

issued to the Punjab National Bank at par. But with the state government, which had not issued any loans for three years before 1951, needing the money and being 'very keen' to borrow from the Punjab National Bank 'in spite of these considerations', the Bank decided not to stand in its way. In this case, unlike in the case of the West Bengal proposal, the Bank did not consider the uses to which Uttar Pradesh intended to put the proceeds of its loans and whether these formed part of the state's plan. But it turned down a request from Mysore—a Part B state—in August 1952 to be allowed to raise Rs 3 crores to finance plan projects on the ground that there was no market for it.

In all eleven states, including for the first time five Part B states (Mysore, Saurashtra, Madhya Bharat, Travancore-Cochin, and Hyderabad), entered the market in 1953 with 4 per cent ten-year loans aggregating Rs 31 crores. Once again the terms of the Madras loan posed some dilemmas for the Bank and the central government. Since the state was soon to be bifurcated, it was decided after some debate to raise the Madras loan on behalf of both the successor states, with buyers being asked to indicate the state for which their subscription was intended. The Bank had originally proposed issuing the Bombay and West Bengal loans at par, the Madras loan at Rs 99-12, and the remaining loans at Rs 99-8. But the Bank's judgement was challenged once more by Rajagopalachari who insisted that the Madras loan should not be priced higher than the Mysore and Travancore-Cochin loans since the three states were 'linked together commercially'. The Bank opposed the idea. Travancore-Cochin, it felt, was financially 'in a bad way and up against communist propaganda' and, despite Rajagopalachari believing only he stood between 'Madras and anarchy', the credit of the two states could not be equated. The time had also come to be 'firm with States ... and ask them, if they are not agreeable to our advice, to go off the market'. But the central government had little stomach at this time for a confrontation, its officials fearing Rajaji would only 'create further trouble' if he was not allowed to have his way. Not only did Madras have large outstandings both to the centre and the Bank, it was also essential to keep the state's mercurial chief minister in good humour if the proposed bifurcation plans were to go forward smoothly. Hence while affirming the principle that the Bank's advice as to terms was generally binding on the borrowing states, Rama Rau acceded to Rajaji's request to knock 4 annas off the issue price of the Madras loan.

The 1953 programme was more ambitious than anything the Bank had attempted earlier on behalf of the states and there were naturally some apprehensions about the size and scope of the year's operations. But the loans were a handsome success, with total subscriptions amounting to Rs 40 crores. The Madras loan alone was subscribed more than twice over, gathering over

Rs 10.5 crores against an indent of Rs 5 crores. On the other hand, the Mysore and Travancore-Cochin loans fared quite poorly early on, the former for example attracting subscriptions of only Rs 62 lakhs in the first few days out of a loan issue of Rs 3 crores. But with the Madras loan attracting an overwhelming response, the state government decided in consultation with the Bank to close the loan in advance of the notified date, Rajaji thereafter appealing to the public to divert their funds to the Mysore and Travancore-Cochin loans.

The issue of allowing states to retain their excess subscriptions arose again in 1953. The practice until that year had been for states to retain subscriptions up to 5 per cent in excess of the notified amount. Prior to the year's loan flotations, this was raised to 10 per cent. But Madras made an effort once more to retain the entire subscription for its loan. 'It seems sad to give back money which subscribers definitely wanted to give us for our ways and means', Rajaji remarked in a letter to Rama Rau. The Bank independently came to the conclusion that there was 'considerable force' in Rajaji's argument. The issue document for the Madras loan had promised full allotment to all those who subscribed Rs one lakh or less. Since such subscriptions alone amounted to Rs 6.5 crores when the loan closed on 23 July, a 'peculiar position' had arisen wherein 'those who had put [in] applications for more than Rs one lakh were ... not entitled to any allotment whatever'. The Bank therefore felt the need to devise a procedure which did not entirely exclude the larger subscribers, and at its suggestion the central government acceded to Madras's request to enable those who had put in for more than Rs one lakh to be given full allotment unless they applied for a refund of their subscriptions within about a week of the closing of the loan. This unprecedented step sparked off protests in the press and from the stock exchanges, the Calcutta Stock Exchange Association for example pointing out that the terms of the issue were 'irrevocable' and that 'public morale and confidence' depended on their inviolability. Besides, as in the past, the Madras government had secured subscriptions

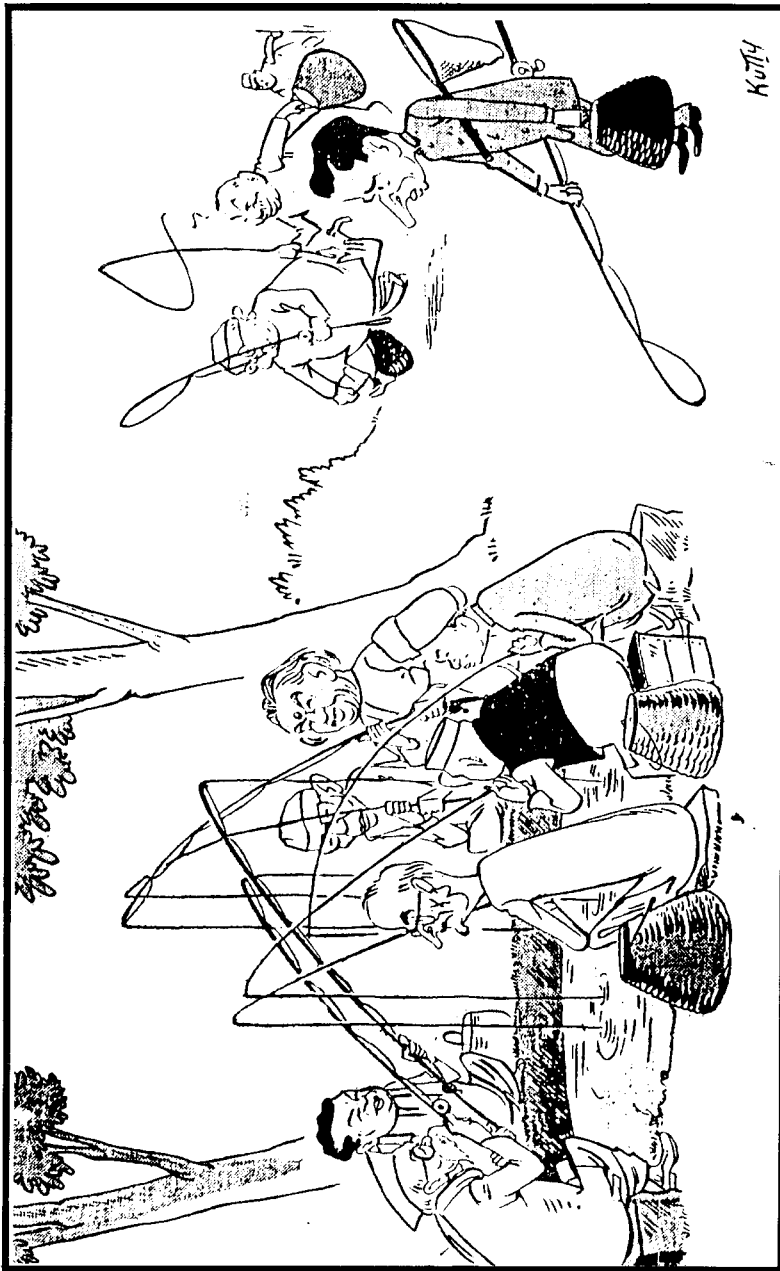
by holding before the Insurance companies and others the threat of nationalization and imposing on the District Officers and other big people compulsory quotas If indeed in the present condition of the capital market languishing under lack of investible funds, state governments be allowed to squeeze the limited resources of the capital market as the Madras Government are doing ... then it will certainly be difficult for the Union government as also the industrial enterprises in this country to borrow their requirements later on from the market which is already in a dried-up condition.

But the decision having been taken, the central government defended the Madras government's action as being 'correct taking all factors into account'. The Bank however had learnt its lesson. Officials reconsidered their earlier advice and came to the conclusion that allowing Madras to retain excess subscriptions was 'not only against the established convention but was also wrong in principle'. Consequently, they did not entertain requests from the state government to be allowed to repeat the 1953 precedent three years later. Madras was instead asked to float another loan after a few weeks, tailoring it if necessary to meet the needs of small investors whom, in this instance, the government purportedly did not wish to disappoint.

As it had done the preceding year, the Uttar Pradesh government approached the Bank once more in November 1953 to be allowed to make a special issue of Rs 2 crores to the Punjab National Bank of its 4 per cent 1963 loan, at a price of Rs 99-8, against a market price of Rs 99-12. The Bank objected to the proposal. The Punjab National Bank, it was now reported, invested in UP loans in return for securing the deposits of municipal local bodies and quasi-government organizations in the state. The bank already held over Rs 2.5 crores of the UP government's 1964 loan, and the latest proposal amounted to using 'one chosen bank ... to finance the whole reissue' and making 'a present' to it of the difference between the proposed issue price and the market price of the loan. Besides, in the Bank's view, 'the propriety of any single ... bank holding such a large parcel of securities which are not readily marketable' was 'seriously open to question'. Much to the surprise of officials who apprehended 'political considerations' would force Delhi to back the Uttar Pradesh proposal, the central government sided with the Bank and the state government was asked not to sell its stock to the Punjab National Bank except at the prevailing market price.

As pointed out above, the states (with the exception of Mysore and Saurashtra) and the central government floated a combined loan in 1954. The following year marked the return to the earlier practice of separate central and state loans and plans were made initially to float a ten-year loan carrying a 4 per cent coupon rate. However, by July 1955 some 4 per cent 1963 and 1964 loans were being quoted at premiums of up to one rupee or more, and a ten-year loan did not make sense unless it was issued at 3.75 per cent. Not willing to experiment with interest rates, however, the Bank decided to increase the maturity of the loan from ten years to twelve while keeping the coupon rate intact. The 4 per cent 1967 loan was floated in August 1955 for an aggregate amount of Rs 35.75 crores. The loan was to have been kept open for two weeks, but it was so heavily oversubscribed that it was closed within as many days. The Bank had intended 'as a concession' to contribute up to 15 per cent of the subscriptions in the hope of being able to sell its acquisitions over a

"Nothing Left for Me?"



Seven State Governments have announced a second issue of their Loans.

—Shankar's Weekly, 28 Aug. 1955

period of time, but such support did not prove necessary. The response to the August flotation encouraged seven states to float a second tranche for Rs 11.75 crores on the same terms. This loan too was oversubscribed. Total subscriptions to these two tranches amounted to Rs 67.8 crores, against the notified amount of Rs 47.5 crores. The amount retained by the borrowing governments aggregated about Rs 55 crores.

Emboldened by these results, fifteen states (of whom Punjab, Orissa, and Rajasthan were entering the market for the first time) proposed borrowing Rs 64 crores in September 1956 through 4 per cent twelve-year loans (Bombay alone floated a fourteen-year loan at this rate) issued at prices ranging from Rs 99.25 to par. Though there was some uncertainty in the air because of the impending reorganization of states, total subscriptions amounted to Rs 74 crores of which Rs 68.7 crores were allotted.

The success of the states' loan programme in 1956 was, however, more apparent than real. For one, the Bank had to intervene heavily in some cases, having for example to buy a fifth of the West Bengal loan before it could be declared a success. Certain other loans including those which were oversubscribed went to a discount even before the lists were closed, as those who bought them to oblige insistent local officials took the first opportunity to sell. Banks which had financed the purchase of some states' loans—scheduled banks' advances against state government and other trustee securities rose by Rs 22 crores during the course of September 1956—too began recalling their advances as the busy season got under way, forcing investors to unload their securities on an unwilling market. So much so, by November 1956 some state loans were quoting at a discount of Rs 1-14 on their issue price.

The fall in the prices of state government securities in September 1956 was not altogether unexpected. The Madras government, for example, had earlier warned the Bank to expect large sales until the loans bought in response to 'intensive canvassing' by its officials 'found their way to more permanent resting places'.

Whatever be the orthodox views on this form of salesmanship, we have to recognize the fact that the method has proved effective for hard-pressed states and will therefore be repeated. It is therefore prudent that we devise correctives to ensure that the bonds do not slump immediately after issue and thereby prevent avoidable loss to fugitive investors.

The 'corrective' Madras suggested was for the Bank to finance market intervention with the unutilized portion of the funds it had set aside for buying state government loans at the time of their issue.

State government loans going to a discount soon after they were sold was a common enough occurrence and one of long standing, but the extent of the fall in their prices in 1956 took the Bank by surprise. The fundamental problem, as officials at the Bank saw it, was that the market was in no position to meet the ambitious loan targets of state governments, while some of the latter, as we observed above, were inclined to blame the Planning Commission for this state of affairs.

The Bank was far from keen to intervene in the market to stabilize the prices of state government securities. The problem was not confined to Madras alone and there were floating stocks of Rs 15 crores or more of several states which were thought to be contributing to the depressed state of the market. The responsibility for managing the price of their stock, the Bank felt, lay principally with the state governments who did not lack the resources, whether in the form of Government of India securities in their cash balance accounts or balances in their sinking funds, to invest in their own loans. Buying intervention by the Reserve Bank on its own account was ruled out because there was no 'reasonable prospect' of its being able to 'dispose of the purchases to the market in the near future' and the Bank's intervention would therefore merely amount to 'financing ... state governments with created money'. Although repurchases by the issuing government amounted to recognizing its failure to raise the full amount of the loan, it was 'better to adopt this course than to ... risk ... depreciation [in the market price of the loan and] ... future borrowing'. In the event, the Bank intervened to steady the prices of a few

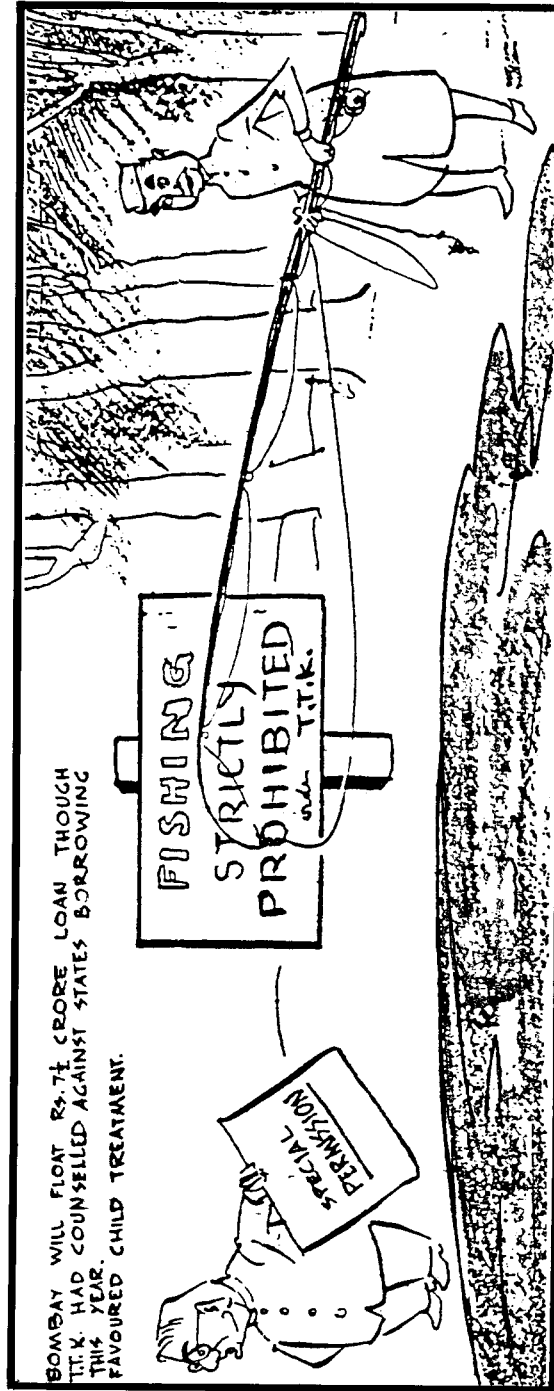


TTK addressing state finance ministers at the Bank, Bombay, 23 June 1957. Iengar is seated next to him; at the extreme left is D.R. Gadgil, a Director of the Central Board.

state loans during the course of the year after the concerned governments placed funds for the purpose at its disposal.

With the 1956 loans still weighing heavily on the market, the Bank counselled state governments against issuing fresh loans in 1957 and to concentrate their energies on collecting small savings. In the beginning, Krishnamachari felt it would be 'politically very difficult to take a strong line with state governments' and place an embargo on their loans, or even to 'fix an upper limit for each state'. While the central government pondered its next step, states made plans to come to the market with loans of nearly Rs 50 crores, Madras alone setting its sights on Rs 10 crores. Iengar discussed the issue with a few finance ministers but no state (with the possible exception of West Bengal) appeared willing to eschew market loans during the year. The central government on the other hand, was slow to appreciate the gravity of the situation or the latter's implications for its own loan programme. Many states such as Madras and Andhra, the Bank felt, would be unable to raise much money unless they offered at least 4.5 per cent and used other methods to persuade investors in the bargain. Once the markets learnt about the states coming in at 4.5 per cent, the central government loan 'would become a flop' at 4 per cent, while the use of pressure to raise subscriptions for state loans would only demoralize the market further. State governments maintained for their part that unless a loan could be managed, they would either have to slash their plan outlays—which was 'very difficult and contrary to the express intentions' of the central government—or take recourse to deficit financing. C. Subramaniam, the finance minister of Madras, admitted 'quite frankly' to the Governor that he preferred 'getting a state loan through the use of pressure' to 'facing ... general disruption of the economy by increased deficit financing' The former would 'at worst ... have the same effect as a tax' and make the state government unpopular. But higher rates of inflation spelt both disorder and unpopularity. Conveying the views he had gathered from his meetings with several chief ministers and finance ministers of state governments, Iengar told the centre that a situation had now been reached in which 'the states and the centre must take concerted action in the matter of raising loan resources', and advised Krishnamachari to convene a conference of some finance ministers and the Bank to discuss the issue.

This conference, whose chief claim to fame has hitherto rested on what transpired outside its formal sessions (Krishnamachari having purportedly given his consent to investing the funds of the Life Insurance Corporation in Haridas Mundhra's concerns during an adjournment in its proceedings), convened in Bombay in June 1957 to hear both Iengar and the Finance Minister advising states to keep off the market during the year. In return they



BOMBAY WILL FLOAT RS. 74 CRORE LOAN THOUGH
T.T.K. HAD COUNSELLED AGAINST STATES BORROWING
THIS YEAR. FAVOURED CHILD TREATMENT.

were promised a two-thirds share of the cash receipts under the small savings scheme. Krishnamachari, who was by now quite alarmed that large state loans would hamper his own borrowing programme, went further than the Bank wished to venture, and warned states proposing to issue loans that banks would be advised against buying them or financing others to buy them. These warnings had the desired effect and only two states—Bombay and Mysore—floated loans in 1957 for Rs 6 and 3 crores respectively. Subscriptions totalled Rs 12.7 crores, of which Rs 9.9 crores were retained by the two governments.

The Boom and Slump in State Loans

The dearth of state loans the preceding year and easy monetary conditions led to a strong and persistent demand for government securities in 1958. Ten states came to the market in July 1958 and one in October with loans amounting to Rs 50 crores. Some controversy erupted over reports from Andhra Pradesh of subscribers who had been pressurized into buying securities offering them to brokers at a discount of 75 paise even before the loan opened formally to public subscription. The Bank took a firm stand, asking the state government to put an end to this practice or risk forfeiting its support for the loan. The threat worked, with the state government instructing officials not to use 'undue pressure ... to secure subscriptions' to the loan. It also initiated arrangements to buy back the loan from those who wished to sell, in order to maintain the price. In the event, subscriptions to the two issues totalled Rs 65.8 crores, of which Rs 54.4 crores were retained. Easy conditions persisted the next year as well, with the twelve-year loans amounting to Rs 63.5 crores floated in August 1959 by thirteen states at a reduced coupon rate of 4 per cent evoking an 'astonishingly good' response in the market. Loans of eleven of these states (including Kerala which first decided to stay off the market after local bankers refused to support its loan in protest against the debt relief legislation passed by the state government, but which decided to approach the market after coming under President's rule) were closed on the very first day, while the other two were able to close their loans the following morning. Total subscription amounted to Rs 102.4 crores, but only Rs 69.5 crores could be retained. Although the central government disapproved of the suggestion because other states might react adversely to it and there were some differences within the Bank as well, the Madhya Pradesh government was allowed at the Deputy Governor, K.G. Ambegaokar's instance to take advantage of the 'favourable investment demand and make a lasting improvement' in its ways and means by floating a second tranche of its loan for Rs 2 crores.

The recent success of state loans led the Bank to consider lengthening the currency of this category of securities to fifteen years and narrowing the

spread between their coupon rates and those on central loans to a quarter of a percentage point from the prevailing half. But such ideas were soon thrust into the background as the gilt-edged market slid into a morass in 1960. A nine-year loan at 4 per cent was the best the Bank could recommend to the dozen states who entered the market for Rs 75 crores in August 1960. Collections aggregated Rs 85.5 crores, but satisfaction at this outcome was clouded by the realization that commercial banks financed their subscriptions out of borrowings from the State Bank and the Reserve Bank, and by reports from some states, particularly Andhra Pradesh, that the local authorities had once again used 'pressure tactics for enlisting public support' for their loans.

The inaugural year of the third five-year plan saw a slight leveraging up of the coupon rate to 4.25 per cent on the eleven-year state loans issued in 1961. Thirteen states floated loans totalling Rs 80 crores, and though some loans required support from the Bank, the Life Insurance Corporation, and the State Bank, actual subscriptions totalled Rs 92.2 crores of which Rs 87 crores were retained. The Andhra Pradesh government took the unusual step of asking its collectors and treasury officials to begin accepting deposits from intending subscribers without waiting for the state loan to open. It was common enough for state governments to informally canvass banks and other institutions for subscriptions before their loans opened or even before they were announced. But this was the first instance of a state government allowing its loans to open informally before the notified date. The Bank protested Andhra Pradesh's attempt to sidestep its own loan notification in this manner, and demanded the withdrawal of the offending instruction as a price for going ahead with the loan. But since advance subscriptions to the loan had already begun to flow in, the Bank could do little in the matter other than refuse to accept them at its own offices and warn the state government to desist from such practices in the future.

The following year, 1962, saw a further increase in the coupon rate on state loans, to 4.5 per cent. All the states with the exception of Jammu and Kashmir entered the market with twelve-year loans for a notified amount of Rs 93.5 crores at issue prices ranging between Rs 99.50 and Rs 100. Subscriptions totalled Rs 109 crores of which Rs 100.7 crores were accepted. After a year's flirtation with combined loans, a dozen states returned to the market in 1964 to raise Rs 100 crores in the form of twelve-year loans which now carried coupon rates of 4.75 per cent. The Bank had once more to come to the rescue of some states, on this occasion of Madras and Maharashtra, but the issue succeeded in mobilizing Rs 109.6 crores.

In 1965-66, which was the terminal year of the third plan, states planned to raise Rs 108 crores, but a major inhibiting factor was the Bank's decision

to discontinue subscribing to state loans as part of the government's 'rigorous and exacting disinflationary policy'. The Finance Ministry wanted states to exercise restraint in their borrowings while the Bank too thought it had become necessary to 'check ... the demands' of states which were 'expanding too rapidly'. This proved difficult in practice because a majority of the fourteen states intending to enter the market proposed borrowing relatively small amounts of Rs 4 crores to Rs 9 crores. However, the Bank decided that it could not, 'in keeping with its overall responsibility for sound monetary management', extend any support to state government loans that year. Despite this, all fourteen states entered the market in August 1965 with twelve-year 5.5 per cent loans amounting to Rs 101 crores. Public subscriptions fell well short of the targeted amount. The Finance Ministry stuck resolutely to the view that leaving their loans undersubscribed would send the right signal to state governments and force them to be more modest in their demands on the market in the future. The Bank too remained firm that its resources should no longer be used to support state loans. But at the same time, it wanted to avoid advertising the failure of the loans programme, and Bhattacharyya intervened to ensure that the states distributed the unsubscribed portions of their loans among themselves. Total subscriptions amounted in the end to Rs 107 crores. Of this nearly Rs 22 crores were contributed by the various state governments who proved no less eager than other involuntary investors in the past to sell their holdings at the first opportunity. Consequently, the state loans floated in 1965 went to sizeable discounts almost immediately.

With the market clearly losing whatever appetite it had had for their loans, the Bank now redoubled its efforts to persuade state governments to set modest targets and more attractive terms. One consequence of the steady increase in the size of the states' loan programme in recent years, as R.K. Seshadri (who had meanwhile moved from the Finance Ministry to become an Executive Director at the Bank) observed in 1966, was to make the 'terms of issue more and more unreal, at the cost of investors who are not in a position to resist ... local pressure'. Both the Finance Ministry and the Bank now maintained that the market borrowing figures which states settled in consultation with the Planning Commission should not be regarded as 'committing' them 'in any manner', and the Bank slashed the total size of state loans in 1966 from the Rs 118.5 crores proposed by their governments to Rs 93.5 crores. Secondly, while retaining the existing twelve-year coupon rate of 5.5 per cent, states were encouraged to issue their loans at prices ranging from Rs 98 to Rs 99—no loan being issued at par. But even the resulting redemption yields—which ranged from 5.62 per cent to 5.73 per cent—were not to the satisfaction of large institutional buyers such as the

Life Insurance Corporation of India whose Chairman urged the Bank to ensure that state loans offered terms which were 'in harmony with ... market conditions' at least at the time they were floated. But the Bank was understandably keen not to see a further rise in the coupon rates on gilt-edged stock, and preferred instead a reduction in the quantum of public sector borrowing. The real problem was 'not so much ... the rate of interest ... as that the size of the programme ... [was] much larger than it should have been'. The solution therefore lay in reducing 'the size of the total borrowing programme', the Bank concluded.

Attention was drawn above to the unorthodox methods state governments used to 'market' their loans. Initially confined to Madras and later to Andhra which soon outshone its mentor in this respect, these states' methods came to be adopted more widely from the late fifties. Where state governments were determined to squeeze the market to the last rupee, the Bank's disapproval was of generally little consequence. As the growth in their expenditures outpaced that in resources, state governments began exercising 'extraordinary pressure' on potential subscribers to their loans. By 1966 it had become common for state government officials to force businessmen, especially those 'dealing in licensed or controlled commodities', and contractors vying for public contracts to subscribe to loans or put up contributions that could be used to subsidize subscriptions by others. Despite such efforts, the year's loan programme failed to set the markets on fire. State governments once again entered as buyers in a major way, taking up Rs 24.35 crores (which amounted to a quarter of the total subscriptions) of their own or of one another's loans. Even so, the issue could be closed only after the Life Insurance Corporation and the State Bank of India agreed, at the Bank's urging, to make up the shortfall in public subscriptions.

Not surprisingly, prices of the loans floated in 1966 fell sharply within a few weeks. The Madras, Andhra Pradesh, and Uttar Pradesh loans were particularly badly hit by early sales and were soon being quoted at prices as low as Rs 91. Market reports remained gloomy and the Bank's prognosis based on them was that there was little chance of these loans rising above Rs 94 during the next few months. In fact, the Bank feared many of the loans issued in 1966 would still be quoting at sizeable discounts when state governments returned to the market the following year. The evidence was therefore unmistakable, in its view, that the 'borrowing programme in the last two years has been considerably in excess of the market's capacity to absorb these loans'. But few state governments or the Planning Commission appeared willing to draw these lessons, with the latter suggesting to the former a borrowing target for 1967-68, which at Rs 140 crores was nearly 50

per cent higher than the amount state governments managed with great difficulty to raise the previous year.

Unpublished Sources

- G.8 Governor's Correspondence with Government of India, Ministry of Finance
- C.76 Central Government Loans—Policy
- C.117 State Government Loans—Policy
- C.66 Open-market Operations
- RD.6 Rural Banking Enquiry Committee—Reserve Bank's Views
- PR(R)-36 Amendments to the RBI Act
- C.158 Extension of Banking Arrangements to Part B States
- SY.95A Central Government Treasury Bills—Policy
- C.169 Ways and Means Advances—Policy

Memoranda to the Central Board and Committee of Central Board

RURAL CREDIT

The Reserve Bank of India was a pioneer central bank in the sphere of rural credit. Its founding Act and subsequent amendments entrusted to the Bank responsibility for enlarging the availability of rural credit. Rather diffidently shouldered until the 1940s, this responsibility was reinforced after 1947 and more markedly from the 1950s. The years covered by this volume were thus marked by a number of initiatives culminating in the Bank and the government taking a more direct role in setting up and developing cooperative and other types of rural credit institutions. Equally, the Bank's own functioning was deeply affected by its growing exposure to the relatively new and unusual world of rural credit.

No other central bank faced quite the same set of challenges as the Reserve Bank of India, and there were few precedents in the beginning that it could draw lessons from. Not surprisingly, therefore, the Bank's early steps in this unfamiliar terrain were really in the nature of feeling its way. The Bank convened an informal conference on rural credit to assess its role in the light of the report of the Rural Banking Enquiry Committee. This was followed by the constitution of an expert Standing Advisory Committee on Agricultural Credit with the Governor himself as its chairman. The most important preliminary step from the point of view of its impact on the longer-term policy and institutional regime was, however, the commissioning and completion of the landmark All-India Rural Credit Survey. The Report of this Survey, which was submitted in 1954, underlay most of the rural credit initiatives of the Bank over the next several years.

This part of the volume is organized in two chapters. Chapter 7 begins

with a brief summary of the developments culminating in the setting up of the All-India Rural Credit Survey, outlines the principal features of its Report, and the official and non-official response to it. It then goes on to survey the Bank's role in reforming institutional arrangements for supplying medium- and long-term credit for agricultural development. Chapter 8 discusses the Bank's role in restructuring the short-term cooperative credit structure and reviews its growing differences with the government over some basic principles of cooperative organization. It concludes with an account of the Bank's efforts to gear rural credit institutions to meeting the financial requirements of the so-called green revolution.

The Report of the Rural Credit Survey also led to the formation of the State Bank of India and its subsidiary banks. These developments are covered in chapters 9 and 10, which together comprise the next part of the volume.

Charting New Vistas

The Reserve Bank of India Act, 1934 envisaged a special developmental role for the Bank in the sphere of agricultural credit with responsibility, in particular, for financing seasonal operations and the marketing of crops. Bank finance was normally made available through eligible banks and cooperative institutions, neither of which was a major presence in the rural sector. As such the Bank itself remained a negligible source of rural credit until after independence. The pace of progress in this sphere quickened from the later 1940s. The Bank had lent a paltry Rs one lakh in the form of short-term refinancing to state cooperative banks in 1945–46. This increased rapidly to Rs 5.37 crores in 1950–51, or to about a sixth of state cooperative banks' total short-term lending to central cooperative banks.¹ The increase was made possible largely by the Bank adopting simpler rules and procedures for lending to cooperative credit institutions and a lower lending rate pegged at 1.5 per cent below the Bank rate. But the scope for reform on the supply side was limited so long as factors on the demand side precluded any substantial increase in the volume of Bank credit. The principal factor on the demand side was the weakness or absence of cooperative credit institutions.

The Darling Report (1935) had proposed that the Bank 'should deal only with ... provincial or central banks that are thoroughly sound ...', and observed that only three provincial cooperative banks, viz. those of Bombay, Madras, and Punjab, satisfied this criterion. Neither the situation nor the prescription had changed fifteen years later. The Rural Banking Enquiry Committee (Thakurdas Committee, 1950) stressed the importance, for an efficient system of agricultural finance, of a sound cooperative credit structure capable of developing close relations with the Bank. The informal conference hosted by the Bank in February 1951 to follow up the proposals of the Thakurdas

¹ In the cooperative credit pyramid, central cooperative banks functioned principally at the district level and intermediated between state cooperative banks (or apex banks) and primary agricultural credit societies.

Committee underlined that effective Bank assistance would be possible only in states where a well-knit and properly integrated structure of rural financial institutions existed, with a well-established apex institution at the helm to maintain effective liaison with the Bank and other lending institutions.

The story of the Rural Banking Enquiry Committee was recounted in the earlier volume of the Bank's history. Briefly, this committee recommended expanding the Bank's presence in all the major states including the former princely states (called Part B states), and of a reconstituted Imperial Bank of India, other commercial and cooperative banks, and postal savings institutions in the smaller towns. It proposed special efforts to strengthen cooperative institutions and extending cheap remittance facilities to rural banks and indigenous bankers in order to encourage their expansion into the interior. The committee did not investigate in any detail the institutional organization of short-term credit for cultivators. Two alternative models of organization of rural credit were canvassed in the late 1940s. While the older model stressed the role of cooperative institutions in delivering rural credit, the idea of setting up State-owned agricultural corporations for the purpose also commanded a number of adherents, especially in the former Bombay Presidency. The committee came down on the side of the former and rejected a principal role for State-owned institutions at the local level.

The Bank's preference in this regard coincided with that of the Thakurdas Committee. At the same time the Bank could not be oblivious to the fact that in 1947-48, advances and deposits of cooperative institutions were meagre, amounting respectively to Rs 1,225 and Rs 357 per society and Rs 30 and Rs 9 per member. In the circumstances the Bank felt rather more strongly than the committee, the imperative need to reorganize the cooperative structure on solid foundations.

The Bank followed up the Rural Banking Enquiry Committee with the informal conference. The conclusions of the conference too, have been summarized in the earlier volume of the Bank's history. It is sufficient to note here that following the conference's recommendation the Bank decided to organize a Rural Credit Survey and constitute a Standing Advisory Committee on Agricultural Credit. Two amendments to the Reserve Bank of India Act intended to boost the Bank's role in financing agriculture were already on the anvil in the early part of 1951. These amendments made cooperative bank paper eligible for rediscount under Section 17(2)(a) of the Bank's founding Act and increased the period of accommodation for seasonal agricultural operations and marketing of crop from nine to fifteen months. In its original form the latter amendment proposed restricting the duration of the loan to one year. But despite the Bank's reservations, the Select Committee on the bill increased it to

fifteen months to cater to the needs of growers of crops such as sugarcane. The Select Committee also added a new section to the Act authorizing the Reserve Bank to act as the banker to Part B states and an amendment empowering the Bank to call for weekly returns from all state cooperative banks.

A second set of amendments arose directly from the recommendations of the informal conference and these were passed by the legislature towards the end of 1953. These amendments widened the meaning of the terms 'seasonal agricultural operations', 'crops', and 'marketing of crops' to cover 'mixed farming' and processing of crops by farmers and their organizations, allowed advances to cooperative banks to finance the production and marketing activities of cottage and small-scale industries, and enabled medium-term lending to cooperative banks. The Bank's Central Board had rejected the first two of these three amendments as recently as 1949 when it considered the suggestions made by the Cooperative Planning Subcommittee (R.G. Saraiya subcommittee, 1945). It was a sign of the Bank's developing appreciation of rural India's credit requirements in the intervening years that it backed these reforms in 1953.

THE ALL-INDIA RURAL CREDIT SURVEY

The first major initiative of the Bank based on the recommendations of the informal conference was to commission a comprehensive survey of rural credit in August 1951. On the face of it, this exercise might be mistaken for a statistical investigation. The terms of reference of the expert committee (or the Committee of Direction) set up to carry it out were to 'direct the planning, organization, and supervision of the Survey', 'interpret its results', and 'make recommendations'. But as the Governor, B. Rama Rau, informed the government, the issues of concern to the inquiry were 'economic and administrative and not just statistical', and had come to the fore

directly out of the recent efforts to reorient the policies and activities of the Reserve Bank in the sphere of rural credit in response to reiterated demands in Parliament and elsewhere that a more constructive role should be adopted by the Reserve Bank in this context.

The Bank had drawn up a threefold programme, whose first two aspects (concerning 'procedural reforms' for financing cooperatives and 'organizational development and reform' of the cooperative credit structure) could be pursued simultaneously with the Reserve Bank formulating its longer-term policies on rural credit. The main task before the Rural Credit Survey was to 'recommend

practicable policies for the future'. In reality, therefore, the terms of reference of the expert committee were 'much wider than would be appropriate in connection with a merely statistical investigation'.

In the event, the All-India Rural Credit Survey was notable not only for the policies its Report recommended, but also for the wealth of the data it collected and processed. The Survey covered seventy-five districts around the country. Eight villages in each were chosen for the Survey, which was based on a sample of fifteen households from each of the selected villages. The major part of the field investigations, conducted principally by staff drawn from the cooperative and agricultural departments of the states, was completed during November 1951–July 1952. Drawing on the results of these field studies, the Survey's Committee of Direction, headed by A.D. Gorwala and comprising D.R. Gadgil, B. Venkatappiah, P.S. Narayan Prasad (who replaced B.K. Madan on the committee in October 1951), and N.S.R. Sastry drew up its Report which was submitted in August 1954. The Report filled three volumes. Of these, a two-part Survey Report contained the survey data and findings, while the Technical Report dealt with survey methodology. The General Report contained the analysis of the data and the recommendations.

The Survey found that the mechanisms of trade and finance worked against the interests of the rural population and in particular the rural producer. 'Power' and 'finance' continued to be located in largely urban areas. Credit and financial institutions tended to be oriented towards urban rather than rural needs since their executives and directors were more responsive to the former. This bias was not confined to private institutions of finance but also extended to State institutions. Both sources of finance were loosely connected.

At the far end of the chain ... are the village leaders such as *panchayatdar* and *Patel* who occupy the local seats of power, and the village financiers such as [the] moneylender and trader who are the local sources of finance. In view of their being a part of the channel of power and finance they are also recipients of power and finance from sources and reservoirs higher up the channel. Sometimes two or more of these—the village leader, the village lender and the village trader—are one and the same person and a broad affinity governs their attitudes towards the rest even where there is more than one leader ... lender ... and trader. Leadership in particular is important. It may be based on the ownership of property, on the advantage of education, on the hereditary position held in the preponderant local caste, or a combination of all or some of these factors and finally ... on political influence.

Not surprisingly hence, the Survey found 'rural credit to be an extraordinary complex of needs, purposes, fulfilments and frustrations ... surrounded and interpenetrated by many forces ... economic, sociological, institutional' Families covered by the Survey had, on average, a debt of Rs 160. However in nearly a third of the survey villages, average borrowing per family exceeded Rs 400, while it was below Rs 100 in 35 villages. The credit supply picture emerging from the Survey confirmed earlier impressions about the negligible presence of cooperative and other organized credit institutions in rural India. Of the total amount borrowed by cultivators in 1951-52, about 3 per cent each came from the government and cooperatives and less than one per cent from commercial banks. Non-institutional credit agencies accounted for the bulk of the lending to cultivators, with professional moneylenders contributing nearly 45 per cent of the total, and agriculturist moneylenders another quarter. According to the Report,

today agricultural credit that is supplied falls short of the right quantity, is not of the right type, does not serve the right purpose and by the criterion of need (not overlooking the criterion of creditworthiness) often fails to go to the right people.

The Survey reviewed the record of the various institutions purveying agricultural credit. Banks did not, by and large, look upon agricultural finance as part of their general business, though they did finance agriculture indirectly by lending to merchants engaged in trade in agricultural commodities. Some banks lent directly to agriculturists on the pledge of produce and valuables and on mortgage, but little had changed in the two decades since the Indian Central Banking Enquiry Committee (1931) commented on the negligible role of commercial banks, including the Imperial Bank, in making credit directly available to agriculturists. The Imperial Bank's advances for 'agricultural production' constituted a minuscule proportion of its total advances. The Report also noted that production finance for agricultural activities accounted for less than 4 per cent of commercial bank advances and credit to cultivators for less than one per cent. Even this meagre proportion was concentrated in a few districts of the country. This pattern was also reflected more generally in the poor spread of banking facilities. Moreover, since commercial banks were mainly interested in marketing agricultural produce rather than in financing production directly, their presence was largely confined to major marketing centres or *mandis*. Nor did the commercial banking system play a significant role in augmenting the resources of the cooperative credit structure. The former accounted for a mere 7 per cent of the working capital of state cooperative banks, while district cooperative

banks received only a negligible proportion of their resources by way of credit from commercial banks.

The Report also criticized the government's agricultural loans as generally being unsuited to farmers' needs. The former took the form of *taccavi* which played a useful role in times of famine and distress or in backward areas and for poor borrowers.² But in a

setting more normal as to season, area, and class of borrower ...
Taccavi is apt to be little else than the ill-performed disbursement
 of inadequate money by an ill-suited agency.

The basis of security for *taccavi* loans was 'inappropriate', its timing was 'inconvenient', and its disbursement was subject to delays and 'impositions of various kinds on the borrower'.

Although earlier committees had reported on the small role played by cooperatives in providing rural credit, the Survey was struck by the 'utter insignificance' of these institutions. They did not cover large parts of the country and large segments of the agricultural population. A very small proportion of the credit provided by cooperatives reached medium or small cultivators who, even when they were members of cooperatives, met the bulk of their credit requirements from other sources. Socio-economic factors, principally the concentration of economic and political power in the village in the hands of a few individuals, were a formidable obstacle to cooperation. Besides the latter suffered from a dearth of suitable personnel, training, and infrastructure. Yet it was impossible to overstate the importance of rural credit cooperatives. It was almost 'axiomatic' that no form of credit organization was better suited than cooperative societies to rural requirements.

Where larger production is the aim, the moneylender's credit is ...
 unsuitable. The alternative is institutional credit, private or other,
 but this tends ... to confine itself to the bigger cultivators if it is
 not channelled through some form of cooperative association of
 the borrowers.

Consequently there was no alternative to cooperation at the rural base of the agricultural credit pyramid. Even at the higher levels 'there is eventually no alternative more suitable than a cooperative form of credit organization'. As the Report summed up the Survey's assessment and prescription, 'cooperation has failed, but cooperation must succeed'.

² *Taccavi* loans are advances to cultivators for productive purposes which are recovered along with the land revenue.

'Positive and deliberate' measures rather than 'small administrative, functional or other changes' were required to ensure the success of cooperative credit institutions and enable them to become self-supporting. The movement had to be strengthened against competition and opposition from private trade and other private interests. As importantly it had to be protected from their embrace:

... private banking and private trade, particularly at the village level, have a vested interest in the failure of cooperative credit. This is less ... strong and more implicit ... at the higher levels but stronger and more explicit at the lower stages. When a local cooperative gets into the charge of a village moneylender, and more especially the landlord-moneylender, he becomes the society, the depositor and the borrower, all of them together or each in turn

Besides it was also necessary to equip cooperatives with finance and modern business techniques.

Only the State, the Report argued, could provide the requisite initial help in each of these respects. Indeed, for many societies, State participation might make the difference between viability and collapse. Therefore, partnership with the State, which was also expected to participate in the share capital of cooperative credit societies, was a key element in the Rural Credit Survey's recommendations. Bringing in the State necessitated changes to the dominant pattern of organization of primary cooperative societies, which could not expect to attract government contributions to share capital if they continued to be registered as unlimited liability units or restricted their membership to a chosen few. The Report also envisaged that in order to be viable under Indian conditions, primary societies would have to be fairly large, and cover a number of villages.

The Rural Credit Survey pointed out that the State's role would become even more significant and wider-ranging if cooperative credit was viewed merely as one aspect of wider cooperative rural economic activity involving food processing, warehousing, and marketing. The State's tendency in the past had been to 'over-administer and under-finance' the cooperative movement, but this had now to yield to a 'total programme ... of rural orientation of the operative forces of the country's administrative and financial organization' motivated by a 'combination of rural conscience, rural will, and rural direction'. Moreover, since cooperative credit institutions depended on the banking system for a number of services, there was 'need for positive State association with a defined sector of commercial banking'. To this end,

the Report recommended the creation of the State Bank of India, through the statutory amalgamation of the Imperial Bank of India and the major state-associated banks, to undertake an expeditious programme of banking expansion particularly in the rural areas. The Reserve Bank was expected to manage the Imperial Bank's passage to State ownership, hold a portion of the equity of the new bank, and employ it in agency roles at centres where the Bank was not represented.

The Report devoted a separate chapter to the Bank's role in the proposed integrated system of cooperation and rural credit. This role was 'of crucial importance' and represented 'a natural and logical evolution' of the Bank's responsibilities such as would add to its 'strength, soundness and ability in the discharge of its wider functions as the Central Bank of the country'. The Report envisaged a key role for the Bank in coordinating the proposed network of cooperative institutions and for its Agricultural Credit Department in overseeing their functioning. The Bank would occupy a 'strategic position' in the cooperative credit sector, while in the other two sectors of the proposed integrated system of rural cooperation, viz. cooperative economic activity and the training of cooperative personnel, it would be 'among the principal participants'. The Report approvingly quoted the Bank's recognition that it could not turn to 'central banking practices evolved in the highly industrialized countries of Western Europe' for guidance to finance rural India's credit requirements. In enlarging its development functions as the Report recommended, the Bank would be

further departing from the orthodox pattern of central banking in other and differently situated countries, [but] it will at the same time be approaching nearer what the central bank of *this* country ought to be.

The Survey Report also made a number of recommendations concerning long-term finance for agricultural development. Finding the latter virtually non-existent in India outside the erstwhile Madras Presidency, the committee recommended the establishment of a central land mortgage bank in each state with branches in each district. Compact and cohesive yet viable, primary banks were to follow after the other two tiers of the structure had found their feet. The existing system of land mortgage banking, the committee felt,

raises inadequate funds in a manner ill-related to demand and usually lends them in a manner uncoordinated with development; acts as if prior debts, and not production, had prior claim on its attention; reaches mainly the large cultivator and reaches him late.

This, the Report stressed, had to be replaced with a motivated lending policy which emphasized loans for productive purposes such as land improvement and purchase of machinery. In keeping with the need for loans for varying periods, the Report recommended that central land mortgage banks should be encouraged to float debentures and that the Reserve Bank and the proposed State Bank of India should take positive steps to create an effective market for them. The Report also suggested the issue of special development debentures to finance specific programmes of land improvement, and of rural debentures to tap the savings of rural households. Finally, the committee recommended a number of measures which the state governments could take in the administrative, fiscal, and legislative spheres to facilitate the creation and functioning of long-term lending institutions in agriculture.

The Rural Credit Survey recommended the establishment of a National Agricultural Credit (Long-term Operations) Fund and a National Agricultural Credit (Stabilization) Fund from which to meet the liabilities arising from the Bank's new functions. Apart from an initial non-recurring contribution of Rs 5 crores, the Bank was to contribute at least Rs 5 crores to the former fund and Rs one crore to the latter fund annually from its profits. The Operations Fund was intended to finance long-term lending to state governments to enable them to subscribe, whether directly or indirectly, to the share capital of all types of cooperative credit institutions, and enable the Bank to assist land mortgage banks through direct loans and the purchase of their 'special development debentures'. The Stabilization Fund was intended mainly as a source of medium-term finance for cooperatives to help them convert short-term loans which had gone into default due to natural factors like drought. The Bank's expanded rural credit responsibilities were to be overseen by two committees. The smaller of these was to be confined to the Bank and entrusted with overseeing the implementation of its rural credit programmes. The larger committee was envisaged as an expert policy-review body that would bring together the Bank, the Government of India, and the proposed National Cooperative Development and Warehousing Board.

The Report also proposed the establishment of other dedicated funds such as the National Agricultural Credit (Relief and Guarantee) Fund under the Ministry of Food and Agriculture, a National Cooperative Development Fund and a National Warehousing Development Fund under the National Cooperative Development and Warehousing Board, an Integration and Development Fund under the State Bank of India, a State Agricultural Credit (Relief and Guarantee) Fund and a State Cooperative Development Fund under each state government, and finally Agricultural Credit Stabilization Funds corresponding to each level of the cooperative pyramid. Apart from the State Bank of India and the

National Cooperative Development and Warehousing Board, the Report also proposed an All-India Warehousing Corporation and similar organizations in the states.

The agenda for action and institution-building proposed by the All-India Rural Credit Survey was by almost any reckoning, impressive in scope and ambition. The widespread reaction it evoked in the press and elsewhere also attests to the considerable impact of the Survey Committee's Report. Equally noteworthy was the despatch with which the Bank and the government moved to implement its principal recommendations. The Report of the Rural Credit Survey was submitted in August 1954 and published in December the same year. By February 1955 the basic features of the new cooperative infrastructure had been agreed upon and action initiated to carry out the legislative and other changes needed to set it up. Intensive consultations followed at various levels to discuss and approve the main recommendations of the Rural Credit Survey Committee, while most of the proposed legislative changes went on the statute book by the end of April 1955. By May or June 1955 therefore, the decks were cleared for the inauguration of the programme of cooperative development envisaged by the Rural Credit Survey Committee.

To judge from the press coverage, the wider public reaction to the Report was largely positive, even in some cases eulogistic. *The Times of India* for example hailed the Report as a 'monumental effort' which filled a 'major void in the Indian economic picture'. The *Economic Weekly* remarked that the Report had dealt 'very commendably' with the 'rural problem as a problem not only of economic arrangements directed to several worthwhile ends, but also of social adjustments, leadership, and psychological orientation'. Malcolm Darling, who was probably the foremost authority on agricultural cooperation and credit in the colonial government and whose recommendations had provided a framework of organization and activity for the Bank's Agricultural Credit Department, welcomed the 'wide sweep' of the Survey, 'its wealth of illustration, the gradual building up of its proposals, and [their] firm cementing together' He commended the 'remarkable Report' to 'all countries wrestling with the problem of increasing production in order to satisfy a rapidly increasing population'.

Inevitably, there was some criticism focusing mainly on the role envisaged for the government in the cooperative sector and the committee's plans for the Imperial Bank. *Indian Finance* presented a positive appraisal of the Report but remarked on the committee's 'awkward brand of eclecticism'—'in the temple proposed to be erected for cooperatives, the deity to be installed is the Government'—and believed the committee was unrealistic in expecting the

State's 'dominance' to be temporary. *The Hindu's* disagreement with the Report was more fundamental. Observing that according to the Survey, nearly three-quarters of rural credit needs were met by private lenders, it said the committee should have formulated its policy to accord with this reality. Instead

it has plumped for a strengthening of the cooperative credit organization to be reinforced by a ... Reserve Bank-cum-State operated bank formed by the amalgamation of the Imperial Bank and ten State Banks. The Committee's unlimited faith in the virtues of State control is only equalled by its ill-conceived distrust of the individual—whether he is a moneylender, trader, or even an agriculturist

Although the cooperative movement had by the committee's own admission failed in spite of a half century of government support, its solution is 'more Government control and more State-sponsored Cooperation'.

Some cooperators too opposed the Report of the Rural Credit Survey, notably for proposing State partnership in primary societies. As we observe below, the principal orthodox arguments against its recommendations also cropped up in internal Bank discussions of the Report and at meetings of the Standing Advisory Committee on Agricultural Credit. But in attacking the Rural Credit Survey's findings, orthodox cooperators offered few positive suggestions or alternatives. Besides, many critics of the Rural Credit Survey opposed State *partnership*, but not State funding if it came without any supervision. Appeals to 'fundamental principles of cooperation' or to the necessity for 'democratic give-and-take' between the State and cooperative societies and for 'aid without strings' did little to mask the fact that few in the Indian cooperative movement were sufficiently alive to the hazards of freely entrusting large public funds to private bodies even if these be cooperatives. Nor were critics of the Bank's approach willing altogether, to abandon the principle of exclusivity (of membership) to qualify for public funds. For example, they generally regarded small farmers in need of rehabilitation as 'primarily the duty and responsibility of the State'. The cooperative movement could not, according to them, be expected to undertake 'a programme of rehabilitation' since the latter was not a 'foolproof banking proposition'.

The Bank's Reaction to the Report

In contrast to the energy and purpose which came later to mark its pursuit of the policies recommended by the Rural Credit Survey, the Bank's initial

response to the latter's Report was cautious and uncertain. The Agricultural Credit Department which was soon to expand into the nodal agency for rural credit, was initially quite sceptical about several of the Committee's recommendations. It is useful to summarize the department's reservations here, since it helps to illustrate the intellectual distance the Bank and its rural credit officers travelled to keep pace with society's changing expectations from the cooperative sector. Although some orthodox cooperators distrusted the Agricultural Credit Department and campaigned to transfer its functions to a variety of bodies outside the Bank, it is worth noting that within the Bank, this department echoed some of their criticisms of the Committee's proposals for cooperative reform. These and similar criticisms returned to haunt the Bank a few years later and led to growing differences with the government over the organizing principles of the cooperative credit movement.

The views of the Agricultural Credit Department were largely formed at this time by its Chief Officer, J.C. Ryan. He was brought into the Bank in 1954 on deputation from Madras state where he was the Registrar of Cooperative Societies, to strengthen and equip the Agricultural Credit Department for the formidable new responsibilities that lay ahead. Ryan retired from the Madras government in 1955 and remained the Chief Officer of the Agricultural Credit Department until 1960. He was, in many respects, a larger than life presence in the rapidly expanding department, whose stamp is clearly discernible at all levels of its functioning. But schooled in the orthodox tradition of cooperation practised not without some success in Madras, Ryan's initial response to the Report of the Rural Credit Survey was one of scepticism. He challenged the Report's emphasis on the State subscribing to the share capital of primary societies. State participation was not necessary to enhance the borrowing limits of most societies since they were constituted on the basis of unlimited liability, and their credit limits fixed in relation to members' net assets. It was of dubious benefit to societies founded on limited liability. More fundamentally, the Report's stress on the size of a society's owned capital, Ryan argued, risked introducing principles of joint-stock banking into the cooperative sector. The former represented a 'union of capitals'. It was an 'association of lenders' which lent chiefly to those outside itself. Primary societies were, in contrast, 'unions of individuals', or 'associations of borrowers who lent only to themselves'. Reiterating fundamental principles of cooperation which he felt had been ignored by the Rural Credit Survey's Report, Ryan's note remarked that cooperative credit societies 'capitalized honesty' and borrowed on the strength of the thrift of their members. Their activities were of an 'educative character' and were always informed by the principle of self-help.

If facilities for borrowing are provided by increasing the share capital of primary societies with State subscriptions this educative character will gradually disappear. There will be less desire to save and rely on oneself and an increasing tendency to depend on the State. While it is certainly necessary to extend rural credit, it is more important that the agricultural-borrower should be educated in self-help and thrift.

Ryan also feared that the proposed Stabilization Fund would weaken the cooperative movement by making the borrower 'less responsible than he should be'. Such a fund may make lenders too less responsible, and increase the risks of loans being given without adequate scrutiny, or of bad debts being written off without much effort to recover them. Thanks to such hazards, he pointed out, the Government of Madras had been forced to scrap the Revolving Fund which it had earlier set up to relieve distress caused to borrowers by famine. In any case, he contended, the Stabilization Fund should not be entrusted to cooperative central banks whose 'managements ... are in increasing measure in the hands of borrowers' representatives', but to an 'independent agency unconnected with the cooperative movement', such as the Judiciary or the Revenue Department, or a Credit Stabilization Board set up by the State under a special statute. The separation of roles would, in the officer's view, leave central cooperative banks 'intact as business institutions and avoid producing the impression that they are also agencies for relieving distress'.

The Report's plan for large primary credit societies covering many villages also came in for criticism. It went against the thrust of national development plans organized around the village as the unit. More importantly, large societies were unlikely to benefit small cultivators and tenants. The sustained expansion of rural credit depended not on lending against property, but lending against a borrower's character. The possibility of capitalizing such non-tangible assets constituted the essential advantage of a cooperative form of credit organization over one based on joint-stock banking principles. The Report also recognized the necessity for primary societies' lending operations being informed by criteria such as the borrower's character and honesty. But according to Ryan, its proposal for large societies undermined this emphasis, since it would be difficult to assess the character of intending borrowers if they were spread over a large area covering several villages. Once the principle of 'proximity' was violated, the small borrower would cease to get credit on reasonable terms, and societies would, in effect, confine themselves to lending on the pledge of movable and immovable properties, thereby defeating the very objects which the Report hoped to promote.

Ryan also objected to the structure of organization of rural credit institutions proposed by the Committee. The proposal for cooperative and land mortgage banks at the higher levels of the rural credit structure acquiring shares in institutions at the lower level was unsound, as it involved the 'creditor (becoming) a partner in the affairs of the borrower'. This model of ownership was particularly inappropriate in the centralized land mortgage banking structure where money raised by the centre was passed on to the units, who themselves had no responsibility for raising any funds.

The Report's recommendation that membership of primary credit societies should be open to all persons residing in the areas they covered, and that anyone refused admission should have a right of appeal to the Registrar of Cooperative Societies, also did not, according to Ryan, accord with the voluntary basis of cooperation. Though emanating in the desire to make credit available to every creditworthy borrower, this recommendation, Ryan felt, treated agricultural credit societies as public bodies and violated their autonomous powers, particularly in relation to how they constituted themselves.

An agricultural cooperative credit society is not a public institution like a village panchayat or a municipality, where residence for a prescribed period ... entitles one to vote. It is a private body like a Cricket Club or the Cosmopolitan Club ... brought into existence by a group of individuals getting together on a voluntary basis These individuals have a right to say which one of their fellow villagers can be permitted to associate with them and which should be kept out, in the same way as the Cosmopolitan Club can blackball any applicant for membership without assigning any reason.

The right to exclude persons judged to be unsuitable was particularly important in the case of unlimited liability societies where bad members might put at risk the 'worldly belongings' of other members of the society. It could not be denied even to limited liability societies, since defaults by a few borrowers could lead to the other members of a society losing their share capital contributions.

Ryan's views did not in the event, carry the day. As noted above, similar views had been aired on earlier occasions and considered by the Rural Credit Survey Committee, so that they did little to arrest the momentum generated by the Report. At other levels of the Bank too, some recommendations of the Rural Credit Survey did not command immediate acceptance. According to the Deputy Governor, N. Sundareshan, Governor Rama Rau held 'certain strong views' on the need for the funds proposed by the Committee. The Governor

himself confessed that while he had no 'strong objections' to the proposed funds, he was not convinced of their necessity and that he favoured suspending the Bank's internal exercises to determine how it could finance contributions to them.

While some aspects of detail in the Survey's proposals for the rural credit structure were no doubt debated, there was in general an impressive consensus on the broad thrust of the Report—that the asymmetry between the tasks facing the cooperative movement and its coverage and resources could not be redressed unless the State was drawn into partnership with it and that this partnership necessitated some departures, none altogether novel or untested, from certain orthodox conceptions of cooperation—and its principal recommendations. The Credit Survey's Report was still in draft form when a rough programme of action was devised first to consider the Report's recommendations, and then to pave the way for their implementation. The Finance Ministry, and in particular the Finance Minister, C.D. Deshmukh, too was anxious that decisions and legislative amendments necessitated by the main recommendations of the Report should be adopted with the least delay, so that action on the Credit Survey's Report was set in train almost immediately after it was submitted.

Towards the end of 1953, the Bank and the government jointly established the Central Committee for Cooperative Training to organize and direct the development of manpower for the cooperative sector. This Committee and the Bank's Standing Advisory Committee on Agricultural Credit met jointly in January 1955 to consider the Report of the All-India Rural Credit Survey. This meeting was also attended by senior officials of the Government of India from Finance, Food and Agriculture, and the Planning Commission. It is useful briefly to summarize the proceedings of this meeting, since some of the points raised there resonated in some form or other through the cooperative movement and official policy for much of the next decade.

There was some criticism at the meeting, for example by M.B. Nanavati, distinguished cooperator and former Deputy Governor of the Bank, of the Committee's Report focusing too closely on rural credit for productive needs, and not enough on the cultivator's need for consumption loans and other areas of activity where the cooperative presence would prove useful. Cooperation, Nanavati felt, should deal with the 'whole man', and he implied that this perspective was lacking in the Report. Tarlok Singh, Joint Secretary at the Planning Commission, also felt that the Report had treated areas of cooperation other than credit 'somewhat broadly'. At the Governor's invitation, J.C. Ryan criticized the Report from the standpoint of 'orthodox principles of cooperation', while D.G. Karve defended the departures the Report made

from them on the ground that cooperatives could no longer afford to be 'exclusive clubs', and that they should become 'all-embracing'. The idea of a cooperative as a 'closed shop' was also rejected by M.R. Bhide, Joint Secretary in the Ministry of Food and Agriculture.

It was however the principle of State partnership that evoked the most comment at this meeting. A number of cooperators welcomed State participation in the equity of cooperatives, though they wanted the principle to be applied flexibly. Some cooperatives, they emphasized, might opt not to invite the State while others might not be viable without it. There was near unanimity among those who welcomed State participation that the latter should not overwhelm a cooperative of which it was a member, either through its voting strength or through its bureaucracy. The principle of State participation was however contested both by Bhide and more indirectly by Tarlok Singh. Defending the Report, D.R. Gadgil pointed out that rural credit, and not cooperation, formed the substance of the Committee's brief. The Committee had dealt with cooperation only because it felt this to be the most suitable agency for supplying agricultural credit. But it had refrained from covering the subject in all its aspects for fear of straying too far from its brief. He pointed out that state financial corporations could be regarded as an alternative to cooperatives. When earlier committees proposed the former course, cooperators were forced to choose between 'acting as closed associations cherishing certain spiritual values or functioning as agencies of State policy embracing all creditworthy agriculturists'. Implying that the State could not be expected to leave the field open to 'closed shop' cooperatives, much less associate with them legitimately, he pointed out that if cooperators

could not accept the type of Cooperation envisaged, then, the State would have to think of alternative arrangements to implement its policies. The last word on this subject rested with the State and the people and not with cooperators alone.

Summing up the discussion, the Governor, who was also the Chairman of the two committees, noted that it would be inappropriate to expect the pattern of cooperation to be uniform across the length and breadth of the country. While there was general agreement on the principle of State partnership, the extent of this would depend, he stressed, on the 'requirements of each area'. The joint meeting then endorsed the broad thrust of the Report of the All-India Rural Credit Survey, and underscored the importance of coordinating the reorganization of rural credit with planned agricultural development, growth of marketing and processing facilities, and of cottage and other rural industries. The committees were both of the view that the object of credit reform in the

agricultural sector should not only be to increase the availability of institutional credit, particularly to small and medium cultivators, but also to link its use effectively to production.

These views set the tone of much of the rest of the deliberations on the Report at the other levels of decision-making in the Bank. Within a few days of the joint meeting, the Bank's Central Board also backed the Survey Committee's Report. Apart from the proposal to establish the State Bank of India, the Board too paid particularly close attention to the Committee's recommendation to reorganize cooperative credit and economic activity on the basis of State partnership. The Governor's report to the Board echoed the earlier discussions in the Standing Advisory Committee, but he also went beyond it to defend the principle of State partnership. The Report, the Governor affirmed, had ended the extended debate between proponents of State assistance to agriculture and those who took the orthodox line that cooperation should be independent of all State influence and assistance. Indeed, the kind of partnership between the State and the cooperative movement outlined by the Survey Committee was not novel, being already in vogue in several states. The total contribution of state governments to the share capital of various apex cooperative institutions exceeded half their paid-up capital, and all the Report recommended was to generalize the principle rather more widely. Finally, the Governor supported the Committee's expanded conception of the role of the Reserve Bank in an undeveloped country. The Bank had inevitably to take on a major developmental responsibility in the sphere of agricultural credit which, he stressed, could be more effectively discharged in partnership with the cooperative movement than through new corporations.

The Government of India was also engaged in considering the Report at almost the same time as the Bank. The most immediate decision confronting the government related to the future of the Imperial Bank of India. For reasons discussed elsewhere, the Bank and the Government thought it prudent to announce the decision to nationalize the Imperial Bank of India and reconstitute it as the State Bank of India at the same time as the Report was released. The government's response to the other recommendations of the Report was considered at the secretariat level by an inter-ministerial committee comprising representatives of the Planning Commission, the Food and Agriculture Ministry, and the Ministry of Finance. There was, inevitably, some difference of opinion within the government on some important aspects of the Report. For instance, both the Food and Agriculture Ministry and the Planning Commission were opposed to the State participating in the capital of primary societies as it 'may well injure the development of the National Extension and community development programme'. The Report's proposals for developing

warehousing and marketing in the cooperative sector were also not to the satisfaction of the Commission. But as the Cabinet memorandum on the Rural Credit Survey Report noted, there was general acceptance of its recommendations and of the 'responsibilities devolving in this behalf on the Central Government', particularly those for wider planning, coordination, and financing of cooperative activities. The Cabinet memorandum remarked that the problem of rural credit had been investigated by many committees and commissions, and several proposals aired in its connection. The Rural Credit Survey Committee had, however, made the most detailed and authoritative study of the problem. It had had

the benefit of a countrywide sample survey investigation and in their recommendations have laid under tribute along with the results of the survey all the extant material on the subject including reforms suggested from time to time. [The Committee have] propounded a fully worked out and comprehensive solution of the problem of rural credit. In this much-canvassed subject, it would seem best for early and effective action that the solution as evolved by the committee is taken as the basis of discussion.

Viewing the Report in the background of the country's development plans, the Cabinet memorandum noted that the ambitious scheme for cooperation proposed by the Survey would have to be phased in over several years. The problem of credit could not, moreover, be solved by a reform of the credit mechanism alone but only as part of a general programme of agricultural reorganization. Hence it would be necessary to ensure that cooperative schemes sponsored under the proposed programme were coordinated with other developmental activities in the Community Project and National Extension Services Block areas where they should first be implemented. Since responsibility for agriculture and rural credit rested with the states, the memorandum proposed convening a conference of ministers of state governments concerned with cooperation to discuss the Report's recommendations. While deferring the adoption of a detailed plan of action, the Cabinet memorandum generally endorsed the Report's proposals for the development of cooperative marketing and warehousing, and those for the establishment of funds under the Ministry of Food and Agriculture. However, the memorandum argued that the object of the Relief and Guarantee Fund might be better met through an undertaking on the part of the centre to support state governments whenever their own Credit Stabilization Funds were strained beyond capacity.

The liability which this fund is concerned with is a highly contingent liability, and it can therefore be argued that it may more appropriately be met out of the current resources of the Union Government.

It is worth noting, in passing, that the idea of a central relief fund was also put forward by the cooperative development subcommittee constituted in connection with the preparation of the second five-year plan, and although the Bank returned to the charge on the basis of this document, the Centre remained unshaken in its view that such a fund was superfluous.

The Indian Cooperative Congress met in Patna in March 1955 to discuss the recommendations of the Survey Committee. The Congress accepted the recommendations, including those pertaining to State partnership, in principle, but suggested that in order to preserve the autonomy of cooperative institutions, government nominees to the boards of State-supported institutions should not exceed three in number and that they should as far as possible be experts and persons of special cooperative experience rather than government officials.

The Ministry of Food and Agriculture also convened a special conference of state ministers of cooperation in New Delhi on 16 April 1955 to consider the Survey Committee's proposals. In his speech to the assembled ministers, the Union Food and Agriculture Minister, Ajit Prasad Jain, declared that the Rural Credit Survey Committee had produced a 'monumental document' which contained 'one of the most comprehensive' analyses of 'rural credit and connected problems', and 'a practical scheme for [the] development and reorientation' of the cooperative movement. He praised the Reserve Bank for playing an 'ever-increasing role in organizing rural credit'. Citing expert opinion, he said the Bank had given

a new life and potent leadership to the cooperative credit movement in recent years. Probably, no other central bank in the world is doing as much to help develop and finance cooperative rural credit institutions. This ... novel feature of the Reserve Bank ... has no parallel in the banking system of the highly industrialized countries of the West.

The conference also approved the principle of State partnership and the proposed integrated scheme of rural credit. It however cautioned that State participation should not become a pretext to dilute the popular character of cooperative institutions or undermine the initiative and responsibility of their members. The ministers also set targets for 1960–61 that envisaged the trebling of the membership of primary agricultural societies from the existing base of

five million members, a fivefold increase in short-term and medium-term loans which stood at Rs 30 crores and Rs 10 crores respectively, and an increase in long-term loans from Rs 3 crores currently to Rs 25 crores in 1960–61. However in order to avoid overextending financial and organizational resources, the conference decided to initiate the integrated scheme for rural cooperation on a pilot basis in two or three districts in each state during the next two years, using the resources available in the first plan.

The speed with which the Report's findings were endorsed and acted upon suggested, according to its critics, a 'measure of predisposition'. Even if the Bank was so predisposed, this explanation fails to account for the promptness with which the government and legislative bodies proceeded to clear the decks for implementation. Legislation to enable the Bank to carry out the responsibilities entrusted to it under the new arrangements was the next step, and this was carried out with the utmost despatch. The Bank prepared a draft bill which, among other things, authorized it to make long-term loans to state governments to subscribe to the share capital of cooperative institutions and to central land mortgage banks, and set up the proposed special funds. At the same time the existing statutory limit of Rs 5 crores on medium-term loans was removed. The bill also provided for a third Deputy Governor who, it was intended, would have exclusive responsibility for rural credit. The Bank's Central Board approved the bill towards the end of February 1955. The Bank was keen to have the necessary legislation passed in the budget session of Parliament, and progress thereafter was swift. The government accepted the bill within weeks. Introduced in the Lok Sabha on 26 April 1955, it was adopted by both houses on 29 April and passed into law on 8 May 1955.

Debate on the bill focused, expectedly, on the question of expanding rural credit. Introducing the bill, the Minister of Revenue and Defence Expenditure, A.C. Guha, affirmed that in spite of the weaknesses of the cooperative movement, neither the Bank nor the government had lost faith in it, and that both were committed to making cooperative organizations the principal channel for rural credit. Commenting on the growing role of the Bank in the sphere of rural credit, he stated that the binding constraint on the availability of resources was the capacity of the cooperative structure to utilize them effectively. The Bank's initial contribution to the Long-term Operations Fund had already been raised to Rs 10 crores from the Rs 5 crores proposed in the Survey Report, and more funds would be made available as necessary. Responding to the criticism of members that the amounts involved were inadequate, the minister argued that it was 'no use putting [in] a bigger sum unless we can set up the appropriate machinery to utilize' it. The minister also defended the Bank against criticism that its inspection procedures were intrusive, and

emphasized that even though cooperation was a state subject, cooperative organizations voluntarily subjected themselves to Bank inspection and offered its inspectors every assistance in discharging their duties.

Legislation to set up the National Cooperative Development and Warehousing Board and the Central Warehousing Corporation was passed in 1956, the former coming into existence in September 1956, and the latter in March 1957. The following years also saw the establishment of warehousing corporations in most states.

The newly created post of Deputy Governor was filled fittingly by the elevation of B. Venkatappiah who, along with Gorwala, played a key role in formulating the Rural Credit Survey's recommendations and then following them up both within the Bank and outside. Venkatappiah's assumption of the new position in July 1955 marked a new phase in the expansion and development of the Bank's Agricultural Credit Department, which soon established a presence in every state of the Union. Finally, while the Rural Credit Survey's suggestion to constitute an advisory council comprising representatives from the states, economists, cooperators, and other experts was not adopted because it would duplicate other existing expert bodies, the Bank felt the need to reconstitute its Standing Advisory Committee on Agricultural Credit so as to make it an expert, rather than merely a representative, body.

It is helpful to distinguish the three spheres in which the Bank initiated and coordinated action in direct consequence of the recommendations of the Rural Credit Survey Committee. These were (i) the nationalization of the Imperial Bank of India and the banks associated with the former princely states, (ii) restructuring the short-term cooperative credit structure, and (iii) reorganizing the institutions specializing in longer-term lending for agricultural development. The creation of the State Bank of India and the Bank's efforts to develop a viable short-term cooperative credit structure are discussed in the chapters which follow. The remainder of this chapter deals with the Bank's evolving policies towards medium-term lending to agriculture, and with its efforts which culminated in the creation of the Agricultural Refinancing Corporation of India, to support and finance an effective mechanism for purveying longer-term agricultural loans.

MEDIUM-TERM LENDING FOR AGRICULTURE

Until 1953, the Reserve Bank of India was not allowed to grant medium-term loans. An amendment to section 17 of its Act enabled the Bank to grant such loans for agricultural purposes, subject to an overall ceiling of Rs 5 crores.

The creation of the National Agricultural Credit (Long-term Operations) Fund in 1955 helped relax this ceiling. In 1956 the Bank was authorized to specify from time to time the purposes for which it would make medium-term loans. Over the years such loans were made to finance a wide range of investments, including land reclamation, bunding and other land improvements, preparation of land for orchards, purchases of livestock and agricultural machinery, construction of farmhouses, and acquisition of shares in cooperative sugar factories. In 1967, this list was expanded to include sinking of wells and installation of pump-sets. The Bank extended medium-term assistance to land mortgage banks on the guarantee of state governments. In the beginning, land mortgage banks made loans only on the mortgage of land, but this stipulation was eased in 1959–60. The period of a medium-term loan was also originally restricted to three years. The limit was raised to five years in 1956, but a state cooperative bank was allowed to use only a quarter of the funds it drew from the Bank to lend for the longer period. Until 1960 the Bank charged state cooperative banks the same concessional interest rate on medium-term loans as it did on short-term loans for seasonal agricultural operations, i.e. 2 per cent below the Bank rate. The ultimate borrower was charged 6.25 per cent per annum.

In 1959 the Bank conducted a rapid survey of medium-term agricultural lending throughout the country to ascertain the adequacy of loan supervision. Operational matters such as fixing credit limits, the rate of interest, and the nature of security were also to be reviewed in the light of this survey which revealed that utilization of loans was far from satisfactory. Nor was the monitoring of loan use effective: cooperative banks were concerned mainly to secure their loans, and did not pay much attention to the purposes for which the latter were taken. 'Chattel' was a complicated form of security in India since the term was not defined in Indian law. There were also problems in identifying chattels such as cattle and in providing for their insurance and maintenance. Partly to moderate the extent to which security dominated 'purpose' in the priorities of cooperative medium-term lending institutions, in September 1960 the Standing Advisory Committee recommended waiving the requirement for mortgage of land on small medium-term loans up to Rs 500. It also recommended fixing the rate of interest on the Bank's medium-term loans at half per cent above that on its short-term loans. This increase was partly intended to discourage cooperative banks from using the Bank's medium-term funds to extend short-term loans.

Earlier the Bank was of the view that it could only be a source of supplementary medium-term assistance to cooperative institutions. However after 1962, the Bank consented to refinance up to three-quarters of the medium-

term loans that apex and central cooperative institutions made over and above a 'basic level' of lending. This level was defined as the volume of medium-term loans made by these institutions out of their own resources at the end of June 1962. Experience showed that, either because they could not maintain their lending at or above the 'basic' level or the time-lag involved in drawing funds from the Bank was too long, central cooperative banks were reluctant to make medium-term loans and often did not utilize their limits in full. As discussed later, the time-lag problem also rose in a different form in the case of land mortgage banks making long-term loans to agriculture. The question of liberalizing the Bank's refinancing norms first arose in 1962 and then again in 1967. On the latter occasion, the Government of India wanted central cooperative banks to be set a maximum 'basic' level of Rs 10 lakhs. Besides, it suggested allowing banks with audit ratings 'A' and 'B' to draw advances of up to half their owned funds, subject to a ceiling of Rs 15 lakhs. These advances were proposed to be set off against limits sanctioned by the Bank. Faced with such requests, the Bank generally refused to yield on the principle that it would only reimburse loans already made by the disbursing agencies and that it would not advance interim or provisional medium-term (or for that matter long-term) credit. However, it agreed progressively to relax its refinancing norms. In 1963 the margin contribution of state and central cooperative banks to a medium-term loan had already been reduced to 10 per cent from the 25 per cent prevailing until then, while in 1967 the Bank agreed to lower as circumstances warranted, the threshold or 'basic' level of medium-term lending that qualified a cooperative financing agency for access to the Bank. Such adjustments, in the Reserve Bank's view, were superior to the alternative of forsaking its role as a *refinancing* agency and contributing to the working capital of cooperative financing institutions.

By the mid-1960s, the Bank was forced to rationalize its policy and procedure on medium-term lending. The object of the exercise was to optimize the utilization of available medium-term resources and to ensure that medium-term loans were clearly demarcated from short- and long-term loans. The new medium-term loan policy adopted in April 1965 counselled lenders to extend long-term loans whenever a borrower required more than five years to repay the loan. It sought to further mitigate the emphasis on security and the tendency to disregard the purpose for which a loan was sought, by relating loans to the project's outlay estimated on the basis of standard unit costs, and the borrower's capacity to repay. As another step towards reducing the importance of property as a qualification for credit to finance new investments, the income expected to be generated by the project financed by the loan was also to be taken into account wherever that could be reliably assessed.

REORGANIZING LAND MORTGAGE BANKING

Having come into existence in the depressed 1930s mainly in order to reduce the farmer's burden of debt, land mortgage banks made loans in their early years largely for the redemption of prior debts and mortgages on land. The challenge facing the Bank and the state governments in the 1950s was to transform the existing system of land mortgage banking into a more dynamic instrument of financing longer-term productive investment in agriculture.

Land mortgage banks were spread unevenly across the country. More than half the states of the Union did not have a single land mortgage bank in 1951, while only five states, viz. Madras, Bombay, Orissa, Mysore, and Travancore-Cochin, boasted central (i.e. in this case, state-level) land mortgage banks. In one state, Madhya Pradesh, land mortgage banking was carried on by a separate department of the state cooperative bank. Following the passage of the Saurashtra Land Reforms Act in 1951, a central land mortgage bank was set up in the state with the immediate objective of enabling tenants to acquire occupancy rights. During the next few years, a number of other central land mortgage banks were established, so that there were eighteen such banks by the middle of the second five-year plan.

There were 286 primary land development banks at the end of 1950–51. Sixteen primary land mortgage banks were organized during the first plan, and this number rose steadily to 161 and 210 in the next two plans, and by June 1967 a total of 707 primary land mortgage banks were in existence. Nearly 450 of these were, however, in the areas covered by the three southern states of Andhra Pradesh, Madras, and Mysore where land mortgage banking had begun making notable strides in the 1930s.

The structure of rural long-term lending institutions was not uniform across the country. In some states, it was federal in nature, with primary land mortgage banks affiliated to the central land mortgage bank. In other states, particularly where the system was still in its infancy, the structure was more unitary, with the central land mortgage bank also functioning at the local level through its branches. A number of expert committees recommended a federal structure for the land mortgage banking system. Primary land mortgage banks were thought to allow greater play than the branch of a central bank for local initiative, promote better monitoring and recovery of loans, and help popularize instruments for mobilizing agricultural savings such as rural debentures. But the land mortgage structure remained unitary and centralized in a number of states until the end of the period covered by this volume, and the All-India Rural Credit Review Committee (1969) had once again to underscore the advantages of a decentralized 'long-term cooperative credit structure'. The

reach of the land mortgage banking system also varied across states. As late as 1967–68, primary banks or branches of the central bank existed at the taluk or subdivisional level only in Andhra Pradesh, Gujarat, Maharashtra, Mysore, and Madras. In most other states, these institutions were confined to district or divisional centres.

In order to strengthen central land mortgage banks financially, state governments were encouraged to subscribe to their share capital. The Bank financed these subscriptions to a significant extent out of the National Agricultural Credit (Long-term Operations) Fund which was set up in 1955–56, and which had accumulated resources of Rs 20 crores at the end of the following year. By 1967–68, state governments had contributed Rs 6.67 crores to the share capital of central land mortgage banks, or about 27 per cent of their total paid-up capital. The Rural Credit Survey had recommended State participation in the share capital of primary land mortgage banks as well. It will be recalled that the Bank's Agricultural Credit Department had questioned the necessity for such contributions since primary land mortgage banks were not generally required to raise their own resources and depended entirely on central land mortgage banks to finance them. This view appears to have prevailed within the Bank which did not finance state governments to acquire stock in these institutions. Policy in this regard however underwent a change from 1969, when it became apparent to the Bank that the continued viability of the land mortgage banking structure as a whole depended on strengthening the capital base of primary land mortgage banks. A stronger capital base was expected to enable primary land mortgage banks to absorb at least some of the growing proportion of overdue loans instead of shifting them to the central land mortgage banks, and relieve the latter from having always to finance primary banks out of interim accommodation raised at relatively high rates of interest. The new policy, incidentally, eased some of the continuing pressure on the Bank to finance the working capital requirements of central land mortgage banks. Greater accountability, it was also hoped, would enable primary land mortgage banks to play a more effective role in assessing, monitoring, and recovering loans.

Contribution to Resource Mobilization

In its early years, the Bank harboured reservations about extending credit of a long-term nature, believing that a central bank should keep its resources liquid at all times. Land mortgage banks raised their resources through the issue of debentures. These were guaranteed by state governments, but the Bank initially remained averse to investing in them. The Bank's view in this regard underwent a change in 1948 when it agreed to buy up to 10 per cent of

the debentures of the Madras Provincial Land Mortgage Bank. The Bank later raised this ceiling to 20 per cent in 1950, though thanks to the public demand for them, it was not required to take up more than 5 per cent of the Madras debentures floated during 1948–50. In 1950 the Bank also supported debentures of the Bombay land mortgage bank to the tune of Rs 4 lakhs out of a total issue of Rs 30 lakhs. The informal conference on rural credit endorsed these initiatives. As central land mortgage banks experienced difficulties in finding buyers for their debentures, in December 1953 the Bank and the Government of India agreed to take up, in equal proportions, the unsubscribed portions of their issues up to a combined maximum of 40 per cent. Although the second plan envisaged a large increase in the target for long-term credit to agriculture, the Government of India discontinued its contributions to these debentures from 1956. The Bank's commitment to supporting these debentures did not waver, however, while institutions like the State Bank of India and the newly nationalized Life Insurance Corporation stepped into the breach caused by the government's withdrawal.

Both the Rural Credit Survey and the Government of India envisaged the Bank playing a bigger role in helping land mortgage banks mobilize resources. The Bank's role in this respect was twofold. It remained an important source of finance for central land mortgage banks, standing by at all times to buy up to a fifth of the debentures they floated. It also helped coordinate the investments of other public bodies such as the State Bank of India, the Life Insurance Corporation, the National Cooperative Development Corporation, and commercial banks. The Bank's role in forming what the All-India Rural Credit Review Committee later referred to as a 'consortium of ... investing agencies' proved particularly crucial during the credit squeeze of the mid-1960s. By 1967, this consortium acquired a quasi-formal character as the Bank began to convene annual meetings of the major institutional investors to work out in advance the distribution of land mortgage debentures between them. Following the Bank's intervention and the growth of 'social control' over banking, commercial banks too began assisting land mortgage banks' debenture issues in a significant way after the mid-sixties. Their acquisition of these assets increased from Rs 0.9 crore in 1965–66 to Rs 3.9 crores the next year, and to Rs 18.1 crores in 1967–68. The interest of the State Bank and the Life Insurance Corporation in these debentures waned in 1966–67 as they felt unable to reconcile the many competing demands on their resources. The Bank stepped in with larger support for these debentures, but this was clearly not enough to offset the recession in the demand for them. Fears that central land mortgage banks might fail to play their role in boosting productive investment in agriculture, especially in the green revolution districts, prompted

the Government of India to resume funding their debentures. The central government bought debentures to the tune of about Rs 8 crores in 1966–67, and Rs 15 crores in each of the next two years.

Ordinary debentures were designed largely to suit the requirements of institutional investors such as banks, insurance companies, and trusts. They were issued in August and September when demand for credit was usually slack and institutions were well endowed with liquid resources. The Rural Credit Survey was concerned to ensure that as well as channelizing resources into agriculture, the new rural credit structure should assist in promoting and mobilizing savings by rural households. The rural debentures scheme was mooted with the latter object in view. In order to prevent the diversion of institutional funds, rural debentures were to be available only to individuals and village panchayats. Unlike ordinary debentures, these were to be floated in the post-harvest season when rural households came into possession of new resources. The other details of the rural debentures scheme were worked out by the Bank in 1958. In its original form, the scheme envisaged central land mortgage banks granting loans to agriculturists for six or seven years against mortgage of land and, to use a latter-day expression, securitizing these mortgages in the form of one or more special series of rural debentures. Rural debentures were to offer a slightly higher rate of interest than ordinary debentures, and be of the same duration as the mortgages they securitized. In order to support and promote rural debentures the Bank agreed to underwrite up to two-thirds of their issue, the resources for meeting the shortfall in public subscription coming out of the Long-term Operations Fund. The Bank also recommended to the government to treat rural debentures on par with National Savings Certificates and exempt the interest on them from income tax.

The first series of debentures under this scheme was floated for Rs 75 lakhs by the central land mortgage banks of Saurashtra, Andhra, and Orissa in 1958. The debentures were for a period of seven years and carried an interest rate of 4.5 to 5 per cent. Public subscriptions amounted to Rs 34 lakhs, of which the bulk was for debentures of the Saurashtra bank. It would be harsh to judge this initial issue a total failure. However, the scheme had to be modified almost from the outset since central land mortgage banks experienced difficulty in bundling together an adequate number of seven-year mortgages, the demand for loans being mostly for durations of fifteen years or more. Following representations from central land mortgage banks and state governments, the Bank convened a meeting of concerned officials from these agencies in August 1958 to formulate a new scheme. Under this scheme, central land mortgage banks were allowed to grant loans for up to fifteen

years. The counterpart rural debentures were to be issued in two parts. The first part, for 7/15ths of the amount, was to be issued to the public for seven years and the balance for fifteen years to the Reserve Bank. The Bank also agreed to accept interest at a lower rate of four per cent on its holdings of rural debentures so that central land mortgage banks might afford a higher rate to the public and evoke a better response from them at the same time as holding down the cost of funds to the eventual borrower.

In spite of modifications to the scheme and the Bank's support, the success of rural debentures remained modest and uneven. Of rural debentures aggregating Rs 17.4 crores issued up to June 1967, public subscriptions amounted to only about Rs 7.4 crores. The bulk of the debentures was also issued by a few central land mortgage banks, the Bombay and Gujarat banks alone, for instance, accounting for Rs 5.5 crores of the rural debentures worth Rs 7.09 crores issued during 1964–67 by eight central land mortgage banks. As many as eight central land mortgage banks were unable to float any rural debentures in the first decade of the scheme. The All-India Rural Credit Review Committee noted that rural debentures were the only area of their activity where central land mortgage banks, who otherwise relied almost entirely on public institutions for their resources, were expected to show some drive and dynamism. Its assessment of the scheme forced the Review Committee to conclude that central land mortgage banks were largely lacking in both attributes.

Central land mortgage banks secured interim accommodation from state governments, the state cooperative bank, or the State Bank of India to finance their mortgage acquisitions which were subsequently securitized in the form of debentures. Many banks found this a cumbersome practice leading, among other things, to delays in the release of loans to primary land development banks and to the ultimate borrower. Efforts to cut delays by crediting funds to primary land development banks before they had sanctioned loans meant, inevitably, some inefficiency in their use and loss of income. Hence, the demand grew for interim accommodation, or short-term working capital, to be extended out of the Bank's Long-term Operations Fund. The Bank believed it would be 'fundamentally inappropriate' for it to provide short-term accommodation to central land mortgage banks since it might mean, in the event of land mortgage banks' debentures attracting poor public support, that it would have no other option than to convert the major part of its short-term loans into debentures and acquire, in the bargain, excessively large proportions of their issues. At the Governor's urging, the Bank's Standing Advisory Committee on Agricultural Credit reiterated at its meeting in February 1957 that state governments and state cooperative

banks would have to continue meeting the short-term requirements of central land mortgage banks.

It was pointed out above that in the early years of their functioning land mortgage banks mainly provided loans for repaying old debts. Although debt relief legislation and rising prices of agricultural produce since the war helped ease the problem of rural indebtedness, redemption of older debts remained the predominant purpose for which long-term loans were issued. The Rural Credit Survey found that in 1951–52, the Mysore land mortgage bank had made no loans at all for productive purposes, while only 14 per cent of the loans of the Madhya Pradesh and a fifth of the loans of the Maharashtra land mortgage banks were not for redemption of past debt. The Survey underlined the importance of reorienting the lending of land mortgage banks towards productive projects, and the Bank lost no opportunity thereafter to reiterate this goal. At the Bank's instance, land mortgage banks were also progressively renamed land development banks in the 1960s in order more accurately to convey the changed role of long-term lending institutions in agriculture.

The proportion to total lending by land mortgage banks of loans for productive purposes rose steadily from less than a fifth at the time of the All-India Rural Credit Survey to 55 per cent in 1957–58 and 70 per cent in 1961–62. The Bank did not believe it was advisable altogether to eliminate loans made to redeem past debts, but remained convinced that more could be done to promote productive lending. After repeated pleas failed to produce the desired effect, the Bank resolved to make its support for their debentures in 1967–68 conditional on central land mortgage banks advancing at least 80 per cent of their loans for productive purposes. The threat appears to have paid off. The classification of loans advanced by central land development banks in 1967–68 showed that over 80 per cent of them were given for 'easily identifiable productive purposes', while another 17 per cent financed 'other productive purposes' such as 'levelling and bunding, land reclamation, fencing, repairs to wells, other land improvements, etc.' Although these figures varied across states, only in Pondicherry did the proportion of loans for non-productive purposes exceed 20 per cent. The latter proportion was sought to be brought down to 10 per cent throughout the country in the course of the following year. Of the total, at least 70 per cent of the loans were to be for 'easily identifiable productive purposes' such as 'sinking of wells, purchase of pump-sets, tractors, and other farm machinery'

Formation of the Agricultural Refinance Corporation

It soon became apparent to the Bank and others following the working and progress of land mortgage banks that they might, unless supported in their

efforts by a larger agency, fail to satisfy the latent demand for productive investment in agriculture. In addition, land mortgage banks were not geared to financing certain types of agricultural investments, for example those in the command areas of irrigation projects and for the development of plantations and horticultural crops. The outlays involved were considerably larger than in other projects and necessitated special terms such as longer moratorium and repayment periods. Some central land mortgage banks were known to finance projects of this nature (notably land reclamations and rubber plantations) by floating special development debentures whose issues the Bank underwrote to the extent of 75 per cent. But special debentures were issued on a modest scale and a majority of central land mortgage banks remained reluctant to get involved in large-scale development projects. The latter required specially tailored loan packages which often necessitated detailed coordination with various development departments of the state government and with short-term lending institutions. Such coordination was often beyond the ability and resources of primary land mortgage banks. Even central land mortgage banks could not be expected to set aside their regular preoccupations and interest themselves in more than an occasional development project requiring large outlays and special terms.

In 1960, the Committee on Cooperative Credit (Vaikunth Lal Mehta Committee) advised examining the possibility of using P.L.480 funds to finance medium- and long-term productive investment in agriculture. Consequently the Bank and the government, which were both concerned to promote longer-term investment in major projects of agricultural development, began to think in terms of a specialized agency to finance such investments along the lines of institutions recently established for the purpose of financing industrial development.

The Governor, H.V.R. Iengar, from the outset was alive to the possibility that the demands of agricultural credit might require the establishment, at some stage, of specialized institutions for the purpose. As he told the Finance Minister, T.T. Krishnamachari, in 1957 during discussions about the relative roles of the Reserve Bank of India and the State Bank in rural credit, the Reserve Bank's current position in the latter sphere was largely the product of a 'historical accident' and an eventual resolution might lie in setting up a separate corporation affiliated to the Bank, to finance agricultural credit. When some in the Government of India wanted the Bank to suspend 'banking principles' and liberalize lending to the agricultural sector, the Governor had said, more in sorrow than in defiance, that it might be better from the country's point of view for a separate corporation to undertake such financing than for the Bank to show many bad debts in its books. However, window-dressing

concerns were not uppermost in the Governor's mind in January 1961, when he mooted to L.K. Jha, Secretary in the Finance Ministry, a proposal to set up a refinancing organization for land mortgage banks, modelled along the lines of the recently established Refinance Corporation for Industry, to fund agricultural development projects such as major land improvement and reclamation, and rubber and orchard plantation.

A major argument in favour of the new corporation was that it would draw financial assistance from sources other than the Bank, including special funds under the P.L.480 programme and public borrowing. Once set up, the refinancing agency could also diversify its operations beyond land mortgage banks, actively helping to finance other institutions like commercial banks as they interested themselves in agricultural development, horticulture, and other non-traditional areas of agricultural activity. Presenting the Bank's scheme to establish a public limited company to finance large but individually profitable schemes of agricultural development, Iengar told the Standing Advisory Committee on Agricultural Credit that the new thrust reflected in this proposal complemented the earlier emphasis which the Bank and the government had placed on promoting short-term agricultural lending through rural cooperatives. However, both he and the Deputy Governor, B. Venkatappiah, affirmed that the new corporation would, at least to begin with, channelize its resources principally through the cooperative credit structure, especially land mortgage banks, and that the Bank would make available to the former, resources additional to those it normally advanced out of its Long-term Operations Fund.

Following discussions with the government, it was decided to organize the new institution as a statutory corporation. Although largely a refinancing agency, the corporation was also enabled by its statute to entertain applications to directly finance projects for which cooperative or even commercial bank finance might not be easily forthcoming. The new institution was not expected normally to lend resources to meet working capital requirements. To match the enlarged scope of the new agency, its paid-up capital was doubled from Rs 2.5 crores to Rs 5 crores, and the membership of its Board raised from seven to nine members, including a full-time Managing Director. The corporation was allowed to hold the Bank's share of its dividend in a special interest-free fund. While central land mortgage banks were expected to be the principal channel for routing the resources of the corporation, scheduled banks were retained among its constituents in preparation for the day when they might take greater interest in schemes for agricultural development. The Committee of the Central Board of the Bank approved the detailed proposal for the corporation in April 1962, and a draft bill incorporating its main features was drafted and sent to the government.

The Agricultural Refinance Corporation Bill, 1962 was introduced in the Lok Sabha in December by the Finance Minister, Morarji Desai, and taken up for discussion in January the following year. Explaining the objects of the proposed corporation, Tarakeshwari Sinha, Deputy Minister of Finance, declared that it would plug a major gap in the existing institutional structure for agricultural credit. She remarked on the close interest the Bank evinced in agricultural development and in the new corporation, and noted the ways in which the latter might benefit from its close association with the Bank. The bill evoked widespread support. Some members questioned the need for the new entity when the Reserve Bank was already playing a major role in agricultural credit. Addressing these and other remarks, B.R. Bhagat, the other Deputy Minister of Finance, observed that the Bank's ability to make long-term loans was limited. There were, besides, many other claims on its resources. A separate corporation, on the other hand, would be able to raise adequate resources as it could borrow up to twenty times its paid-up capital and reserves. He defended the provision for nomination of directors by the Bank by reminding members of the Prime Minister's observation that the new corporation 'has got to be strengthened by the Reserve Bank'. The bill was passed in both houses during the budget session, and received the President's assent in March 1963.

The Agricultural Refinance Corporation opened for business in Bombay on 1 July 1963. D.G. Karve, who succeeded B. Venkatappiah as the Deputy Governor in charge of rural credit, became the first Chairman of the corporation. In his inaugural speech, the Finance Minister anticipated that the new corporation 'will ultimately relieve the Reserve Bank of its function so far as rural finance and agricultural credit is concerned'. However, at least to begin with, the refinancing corporation was very much a creature of the Bank. It had an authorized share capital of Rs 25 crores, of which shares to the extent of Rs 5 crores were issued in the first instance. The Government of India guaranteed both the principal invested in the shares and a minimum annual dividend of 4.25 per cent, thereby granting 'trustee' status to the shares of the corporation. Under the original proposal, the Bank was to take up half the share capital and central land mortgage banks and apex cooperative banks another 30 per cent between them, leaving the remainder for the Life Insurance Corporation and other insurance and investment companies. But trustee status notwithstanding, the latter institutions together failed to pick up their share of half the new corporation's equity, forcing the Bank to make good the shortfall and acquire nearly 60 per cent of its shares. In order to assist its functioning in the early stages, the government placed at the corporation's disposal an interest-free loan of Rs 5 crores, repayable after 15 years in as many equal

instalments. The corporation was also empowered to raise deposits or borrow from the Bank, the government, and others, besides issuing bonds and debentures guaranteed by the government, within a total borrowing limit of twenty times its paid-up capital and reserves.

The corporation formalized its procedures in fairly short order. The list of activities eligible for assistance was long. It included minor irrigation works, reclamation and preparation of land falling under the command areas of irrigation projects; soil conservation, dry farming, farm mechanization, and aerial spraying; development of forestry, horticulture, plantations, and animal husbandry; promoting market yards, godowns, and silos; and dairy and poultry farming, and fisheries. Its assistance was available for periods ranging from three to twenty years and could be provided in one of three ways: (a) refinance to eligible institutions, i.e. central land mortgage banks, state cooperative banks, and scheduled commercial banks who were shareholders of the corporation; (b) direct loans and advances to cooperative societies in exceptional cases, with the approval of the Reserve Bank; and (c) subscriptions to fully guaranteed debentures of eligible institutions. The new corporation was also allowed to guarantee deferred payment for capital goods imported for use in agriculture. The corporation paid special attention to promoting development in regions which had not attracted much attention earlier, and to schemes prepared for the benefit of small and marginal farmers.

In the first four years of its operation, the corporation sanctioned 38 schemes involving a total outlay of Rs 36 crores, of which its own financial commitment was of the order of Rs 29 crores. Its disbursements were, however, much lower at Rs 7 crores during the same period. While central land mortgage banks remained dominant borrowers, state cooperative banks and commercial banks soon began participating more actively. Interestingly, commercial banks, which submitted one scheme in the first two years of the corporation's existence made rapid strides in the next decade. Thanks no doubt to social control and nationalization, the total number of their schemes approved by the corporation in the later period exceeded those of central land development banks and state cooperative banks.

The Bank undoubtedly played a major role in reorganizing the institutional basis of longer-term lending in agriculture. But much of its energies in rural credit, particularly in the early years, were devoted to strengthening and energizing the apparatus for short-term cooperative credit. It is to this segment of the rural credit structure that we now turn our attention.

The Bank and Cooperative Credit

The Report of the All-India Rural Credit Survey and its vision of an integrated system of rural credit with State participation gave a powerful sense of direction to the cooperative movement. Although the measures flowing from it would themselves soon be enveloped in controversy and uncertainty, its perspective nevertheless cut a swath through earlier debates over the relative roles of cooperative institutions and the State in the field of rural credit. The Report highlighted the potential for complementarity and partnership between two entities which conventional wisdom generally viewed in opposition to each other, and pointed to ways in which only the State could contribute to the essential strengthening of the cooperative movement. At the same time the partnership would give the State a popular, voluntary, and relatively non-bureaucratic agency through which to deliver credit, and potentially other agricultural and developmental inputs, to rural areas. The Bank was the principal arm of the State in the proposed arrangement, and the support which the Survey's proposal for State partnership generally evoked among cooperators owed, no doubt, partly to their expectation that the Bank would represent the State in this alliance. The Bank appears too, to have been energized by the Report of the Rural Credit Survey and it began to transform itself from being a somewhat distant adviser and lender of last resort to the cooperative movement, to being an active participant in its reorganization and subsequent progress.

REORGANIZING THE COOPERATIVE FINANCING STRUCTURE

It is helpful to recall here that the cooperative credit structure usually followed a three-tier arrangement, with an apex cooperative bank at the top of the pyramid in each state. The intermediate level of the structure was made up of district or central cooperative banks, while primary credit societies reached out to villages and individual members. The Rural Credit Survey followed a

distinguished line of expert bodies in identifying the state or apex cooperative bank as the principal cooperative agency interacting with the Bank and routing its resources to other levels of the cooperative pyramid. But these apex banks did not exist at all in many states or were in urgent need of strengthening where they did. Hence an important priority of the Bank from the early fifties was to help establish or place on a sounder footing, these state-level institutions. This task was complicated by the reorganization of states in 1956 which necessitated the division and merger of many existing institutions. However, thanks to the efforts of the Bank, local governments, and cooperators, apex banks came to be formed in almost every state within a reasonably short time and with remarkably little controversy. Simultaneously, efforts were also made to help organize central cooperative banks in each district. The establishment of primary societies proved more contentious however, as the Bank and the government came to disagree on the principles of cooperative organization at this level. These and other differences over cooperative policy between the two agencies created some uncertainty for the cooperative movement at the time and helped slow the pace of its development.

Organizing Apex Banks

The short-term cooperative credit structure was intended to be federal in design. With the earlier debate over the relative merits of apex cooperative institutions and state-owned and managed agricultural credit corporations having been settled, at any rate temporarily, in favour of partnership between the State and the cooperative system, it was proposed following the Rural Banking Enquiry to establish state-level cooperative banks in every state. Central cooperative banks at the district level and primary societies at the village level completed the pyramid. An amendment to the Reserve Bank of India Act in 1951 brought state-level cooperative banks of the former princely states under the Bank's purview for the purpose of loans and advances under section 17 of the Act. This was of little avail to states which did not have an apex institution. Hence the informal conference convened on the heels of the Rural Banking Enquiry recommended the early establishment of apex banks in all the states of the Union. Apart from linking the cooperative movement with the Bank, apex banks were thought to be essential also because they could mobilize resources at a lower cost than smaller institutions, act as balancing centres for funds of central cooperative banks, and help coordinate and promote a measure of uniformity in cooperative banking practices.

The Bank followed up the informal conference by deputing officers to study the condition of the cooperative movement in various states. Besides, the Executive Director and the Chief Officers of the Bank's Departments of

Banking Development and Agricultural Credit initiated meetings with state governments and cooperators to formulate agreed programmes of cooperative reorganization. The programme for each state varied, inevitably, with local circumstances. In Saurashtra and Rajasthan, for example, apex banks were to be established with substantial state subscription to share capital. The state governments in both cases assisted their new apex banks by offering them a managerial subsidy in the initial years. In addition, the apex bank in Saurashtra was exempted from audit fees, while the Rajasthan government agreed to guarantee the state apex bank's borrowings from the Reserve Bank. In Madhya Bharat, an apex bank was formed by amalgamating three existing central cooperative banks. In Travancore-Cochin, cooperatives were well developed in the former Cochin state, but poorly developed in the Travancore area. With state government assistance, an apex bank was formed by amalgamating the Cochin and Travancore banks. Since cooperative institutions did not exist at the district level, particularly in the Travancore area, the reconstituted apex bank was allowed to open branches at district towns. In Himachal Pradesh a local commercial bank—the Bank of Sirmur—was converted into an apex bank; likewise in Bhopal where the Bank of Bhopal was already partly under State ownership. In West Bengal it was proposed to strengthen the existing bank, with the state government lending Rs 20 lakhs to its share capital and acquiring representation on the board. The Bank also agreed to improve the apex bank's liquidity by sanctioning loans aggregating Rs 90 lakhs against securities and guarantees of the state government. By 1954–55 thanks to the combined efforts of the Bank and state governments, apex banks were established in all eighteen Part A and Part B states and in seven of the ten Part C states. At the time of the informal conference only three years earlier, apex banks had existed in eleven Parts A and B states and two Part C states.

The birth pangs of apex cooperative banks were prolonged, however, by the reorganization of states in 1956. Apart from the Bank's own interest in the functioning of apex banks, state governments also sought its help in resolving problems arising from the redrawing of their jurisdictional boundaries. Briefly, three sorts of situations were expected to arise. The principal problem was that some apex banks, such as the Hyderabad, Madhya Pradesh, and Bombay State Cooperative Banks, would have their head offices in one state, while their members and borrowers were likely to be scattered across several others. These state cooperative banks would, almost overnight, become 'multi-unit societies' with activities spread across more than one state. But the 'multi-unit model' was not envisaged to apply to credit societies, whose operations generally required greater coordination and supervision. These could become more difficult and cumbersome in the new situation. The other

two were anomalies more than problems. Apex banks, e.g. the Saurashtra State Cooperative Bank in Gujarat, the Andhra State Cooperative Bank, and the Mysore State Cooperative Bank, existed in each of these states. But the central cooperative banks of the new territories falling under their jurisdiction would not be affiliated to them. Thirdly, the new state of Madhya Pradesh would have within its boundaries three State Cooperative Banks, viz. those of Madhya Bharat, Vindhya Pradesh, and Bhopal. It is proposed to confine the focus here to the restructuring of apex banking in the states carved out of the old composite Bombay state, since it provides a good illustration of the most important problem which the reorganization of states created for the cooperative movement, and of the Bank's role in resolving it.

According to the recommendation of the States Reorganization Commission, the old Bombay state was to be split into Bombay City, Maharashtra, and Gujarat, and some of its areas transferred to the new Mysore state. These changes were to take effect from 1 October 1956. Both the Union and Bombay governments felt that there was no need to amend the States Reorganization Bill to provide for transitory arrangements in respect of cooperative societies. The Bombay government, which held nearly 43 per cent of the share capital of the Bombay State Cooperative Bank, took the view that the latter was a 'mere voluntary ... association' in respect of which no special transitional provisions were necessary in the States Reorganization Bill along the lines of those made for state electricity undertakings, transport corporations, etc. The task firstly of attempting to minimize the effect on the cooperative movement of the impending political and administrative changes and secondly of making adequate transitional arrangements devolved, therefore, on the Bank and the leadership of the Bombay State Cooperative Bank.

The latter considered retaining the original jurisdiction of the apex bank for another year, i.e. until the end of September 1957. The term 'principal society in the state' in section 2(f) of the Reserve Bank of India Act allowed the apex bank of one state jurisdiction over a neighbour only if it was the 'principal' society in the latter state as well. But since the Bombay apex bank's presence was likely to be limited to those areas of the new states which had formed part of the old Bombay state, the legal view was that the Bombay apex bank would not, unless the Reserve Bank Act was amended, qualify as the 'principal' society for the other states. Meanwhile, a meeting of Bombay's apex cooperative institutions was held in April 1956 at the invitation of the Bombay Provincial Cooperative Institute. This meeting was attended by the Chief Officer in the Bank's Agricultural Credit Department, J.C. Ryan. There was consensus in this meeting that nothing should be done to bring about a hasty disintegration of the Bombay apex bank. It was also agreed that

the Multi-unit Cooperative Societies Act and the Reserve Bank of India Act should be amended if necessary to allow these transitory arrangements to come into effect.

The future of the Bombay State Cooperative Bank also figured in a series of discussions between the Deputy Governor, B. Venkatappiah, and R.G. Saraiya, Chairman of the cooperative bank, V.L. Mehta, Chairman, Bombay Provincial Cooperative Institute, and D.R. Gadgil. Their shared view was that the apex bank would, if not reorganized before 1 October 1956, be governed by the Multi-unit Act, with jurisdiction over parts of the new states, and the proposed Union Territory of Bombay City. But the latter Act, it was felt, suffered from some infirmities, particularly in relation to the role and effectiveness of the central Registrar of Cooperative Societies appointed to oversee multi-unit cooperatives. Whatever the nature of the eventual resolution of this problem, it was agreed that as a first step, regional banks should be formed before 1 October 1956 for those areas of Bombay state ceded to Gujarat and Mysore. These would eventually merge with their respective apex banks, but function until then as apex banks for their respective areas. It was also proposed that while the division of the common assets of the Bombay State Cooperative Bank might, if necessary, take place before 1 October 1956, the residuary organization covering Bombay city and Maharashtra districts would continue for one more year. Amendments were proposed to the Multi-unit Act and the Reserve Bank of India Act—to recognize as a state cooperative bank an institution not located within the state—besides state-level legislation for the division of the assets and liabilities of the state cooperative bank.

Keen to safeguard the integrity of the cooperative development plans it was engaged in promoting, the Bank took the initiative to convene an informal conference in May 1956 of Secretaries of Cooperation in the states, Chairmen of apex and land mortgage banks, and Registrars of Cooperative Societies to agree on some general principles of reorganization of apex banks and the legislative measures required to give effect to them. The conference endorsed the principle that each state would eventually have only one apex bank, and that no apex bank would serve more than one state. Mergers and divisions of existing apex institutions were to be completed, wherever possible, before 1 October 1956. Adequate transitional arrangements were also to be made where necessary, so that farmers were assured uninterrupted availability of credit during the reorganization phase.

The schedule for amalgamation and division drawn up at the informal conference could not however be adhered to, with the result that some reorganized states started off with more than one apex bank. While Bombay

had three apex banks, there were, to begin with, two each in Andhra Pradesh, Madhya Pradesh, and Punjab. The governments in these states declared each of these institutions as state cooperative banks within the meaning of the Reserve Bank of India Act. Apex banks in Madhya Pradesh and Punjab were merged in 1957-58. Bombay completed the process in May 1961, while it was not until August 1963 that a unified apex bank came into existence in Andhra Pradesh. While four apex banks functioning in the former princely states of Ajmer, Bhopal, Coorg, and Vindhya Pradesh were converted into central cooperative banks from 1 November 1956, new apex banks were established in Manipur and Tripura. The union territories of Andaman and Nicobar Islands and Pondicherry, however, had no apex banks. Subsequently, apex banks were formed in Goa (1964), Haryana, and Chandigarh (1966). The creation of the state of Nagaland in 1966 also led to the establishment of an apex cooperative bank in that state, bringing the total number of such institutions in the country in 1967 to twenty-five.

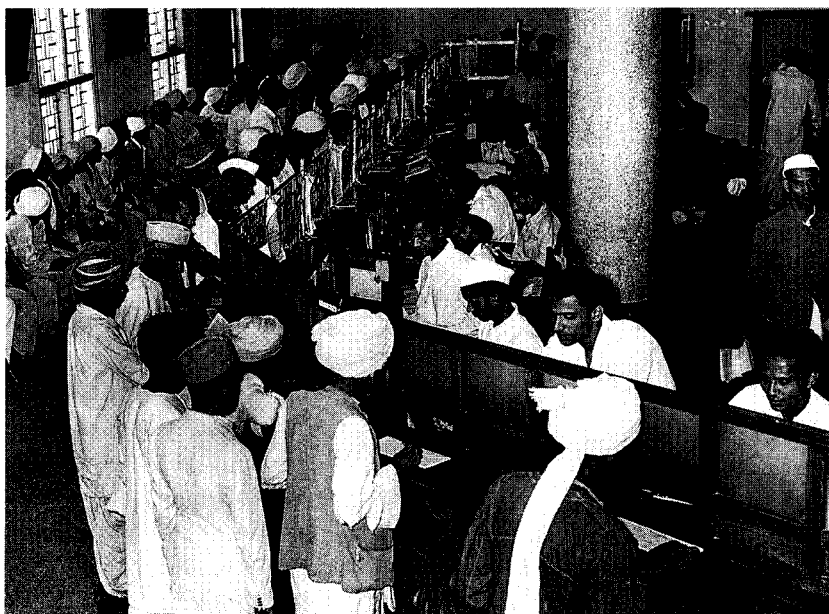
Organizing District Cooperative Banks

In general, other things such as finance, local support, and administrative efficiency being equal, the Bank preferred central cooperative banks functioning at the district level to branches of the state cooperative bank. However it was not averse to branches of apex banks being established in relatively undeveloped areas, so long as they made way in due course for full-fledged district cooperative banks.

The broad principles governing the establishment of cooperative banks at the district level were formulated at the second meeting of the Bank's Standing Advisory Committee on Agricultural Credit in April 1952. The issue came to the fore following a letter from Saraiya to Venkatappiah, that local enthusiasm for starting central or district financing agencies was often not matched by the availability of resources. He noted that many existing institutions in Mysore, Hyderabad, Travancore-Cochin, PEPSU, and West Bengal were already proving to be of uneconomic size and might soon be wound up. Saraiya therefore proposed that the Standing Advisory Committee take it upon itself to advise state governments about standards which they could adopt for recognizing central financing agencies, and cited the example of the formula used in Bombay. A subcommittee of the Standing Committee which was formed to study the issue however felt that the standards evolved for Bombay state would not be suitable for other states facing different conditions. Even in Bombay, the subcommittee noted, many district financing agencies had failed to achieve the prescribed standard of Rs 3 lakhs for share capital and Rs 20 to 25 lakhs for working capital. Rather than prescribe uniform standards,

it was felt that states should be left reasonably free to decide on viability norms for central cooperative banks on their territories. However, the Bank and the Standing Advisory Committee believed, as a general proposition, that no district should have more than one central bank. Apart from being more viable, a single central bank, it was felt, would not have to compete for the business and deposits of Zilla Parishads or District Committees. A single central cooperative bank would also find it easier to build close links with the administration of the district.

The Bank was forced to reiterate this principle from time to time, since it received several requests from state governments to allow more than one central cooperative bank to function in some districts, particularly where special development programmes were under execution. The Bank's response to these requests generally depended on whether the second central bank was likely to prove viable. In 1965, following a long-standing request from the Andhra Pradesh government to be allowed to set up two central cooperative banks in the Guntur district, of which one would exclusively serve the Nagarjunasagar project area, the Bank's Standing Advisory Committee clarified that average outstanding loans of Rs one crore represented the minimum viable level of business for a central bank.



Members of service cooperatives in Dharwar district cashing their loan cheques at the central cooperative bank

Apex and central cooperative banks were afflicted by several ills in the 1950s. These included a weak capital structure which affected their financial soundness and eligibility for credit, the practice of making advances to individuals and the consequent reduction in funds available for lending to cooperatives, and preoccupation with trading and other such activities and the diversion of available resources for non-agricultural purposes. The most important element in the programme of financial reorganization of these institutions related to the strengthening of share capital. State governments, assisted by loans from the Bank's Long-term Operations Fund, made substantial contributions towards strengthening the share capital of cooperative banks at both state and district levels. Thus while the number of apex banks rose from 17 in 1952-53 to 25 in 1966-67, their total paid-up capital rose more steeply from Rs 217 lakhs to Rs 3,116 lakhs. Following the Bank's efforts to restructure the network of central cooperative banks, the number of such banks declined from 505 in 1952-53 to 346 in 1966-67. But their total paid-up capital rose more than sixteen-fold from Rs 519 lakhs to Rs 8,599 lakhs over the same period. State governments' contribution to the share capital of apex banks went up from Rs 50 lakhs to Rs 1,035 lakhs, and to that of central cooperative banks from scratch to Rs 2,163 lakhs, over these years.

Although cooperation was a state subject, the Bank remained deeply interested in the functioning of apex and district cooperative banks. Thanks partly to its efforts—which took the form mainly of periodic inspections and exchanges with state governments—practices such as lending directly to individuals (other than against their own deposits) and combining trading with banking were largely discontinued. The Bank also exercised a close influence on the lending policies of these cooperative institutions. For example, following the growth of the Bank's concessional lending to the cooperative movement, apex banks began charging differential lending rates on their loans, even when they were all for the same purpose, depending on whether such loans were discharged out of concessional Bank resources or other non-concessional resources. This introduced an element of discrimination in the lending practices of state and central cooperative banks, which the Bank was anxious to set right at the earliest. Following its insistence, most apex and central banks began charging interest on the basis of the purpose of the loan, rather than the source of its refinancing. They also adopted the more appropriate practice of pooling their resources from all sources to arrive at a weighted average cost of funds on the basis of which an interest rate could be charged to the ultimate borrower for loans for any given purpose.

PRIMARY SOCIETIES

The base of the cooperative credit pyramid comprised numerous Primary Agricultural Credit Societies (PACS or primary societies). Primary societies were of crucial importance to the health of the cooperative movement as a whole, since their members were individual farmers—its principal intended beneficiaries. They were consequently responsible for delivering to the end-user, the services which the cooperative credit structure was geared to provide, viz. assessing a member-borrower's requirement for credit, sanctioning and disbursing the loan, and effecting its orderly recovery. But it was at its base that the cooperative structure was most in need of strengthening. In June 1951, according to the All-India Rural Credit Survey, there were 1,15,462 primary societies, with a total membership of over 5.15 million. The majority of these were 'single-purpose' credit societies of the type favoured by the Royal Commission on Agriculture (1928). But there were, in addition, also about 40,000 'multi-purpose societies'. The rapid growth in the number of societies of the latter type from about 9,500 in 1946-47, reflected the widespread view, then shared by the Bank, that primary societies should widen their activities to match the services provided by village moneylenders who were often also the source of the farmer's most essential requirements.

But numbers did not present an accurate picture of the availability of cooperative services at the village level, since a large number of primary societies were not working well. Nearly 6,900 societies were stated to be under liquidation in 1951. Further, according to the 1950-51 audit classification of cooperative societies, healthy cooperatives (conforming to audit categories A and B) were preponderant only in Bombay, Coorg, and Mysore, while a majority of the societies in West Bengal, Uttar Pradesh, Madhya Bharat, Travancore-Cochin, Vindhya Pradesh, and Saurashtra were saddled with large overdues, and were classified in audit categories D or E.¹ In addition, there was no information about the audit classification of many societies. The proportion of villages covered by primary societies was very low in some states—ranging in 1953-54 between 4 and 8 per cent in Bhopal, Assam, Rajasthan, and Vindhya Pradesh. The Rural Credit Survey Committee found primary societies, in general, to be weak and fledgling irrespective of the range of activities they undertook. In particular, primary cooperative credit societies satisfied neither the principles of good cooperation nor of sound credit, and had failed both in promoting thrift and savings, and in providing productive credit.

¹ However as standards of audit classification were not uniform, audit categories were not comparable across states.

Since the entire cooperative credit structure rested on these thousands of primary societies, their reorganization and strengthening was vital to the future of the movement. Progress in this sphere depended largely on apex and central banks, and the cooperative departments of state governments. But the Bank provided governments a realistic appraisal of the health of individual primary societies, conceptualized the pattern of reorganization which was needed, and actively helped formulate packages for restructuring potentially viable societies and amalgamating or liquidating unviable or dormant units.

As pointed out earlier, the Rural Credit Survey Committee put forward a relatively novel model of reorganization of primary societies. The Committee noted that the Reiffeisen formula of 'one society to one village and one village to one society' had failed principally because it made for numerous small and unviable institutions. On the other hand, the anticipated advantages of small societies, viz. better information and voluntary service, were rarely realized in practice. The Committee was therefore of the view that the aim of cooperative credit policy at the primary level should be to create bigger and more viable societies covering larger areas. Consequently, it recommended that wherever new primary societies were created or existing societies required to be reorganized, they should cover, 'according to local conditions, groups of villages with a reasonably large membership and reasonably adequate share capital'. The latter, the Committee also proposed, should be strengthened by contributions from the state government. Primary societies organized along these lines were to provide crop loans based on anticipated crop, rather than title to land, supply medium-term loans for productive purposes, lend against gold, jewellery, and other approved securities, and also meet their members' requirements for basic, standardized consumer goods. A few societies were also expected to be able to build small warehouses and diversify into marketing.

The cooperative credit development programme included in the second five-year plan envisaged the organization of 10,400 large-sized societies, each capable of achieving an annual business turnover of Rs 1.5 lakhs within a few years, with state governments contributing Rs 11 crores to their share capital. The total membership of agricultural credit societies was proposed to be raised from less than 6 million at the outset of the plan, to 15 million at its end. Short-, medium-, and long-term loan targets were also set at Rs 150 crores, Rs 50 crores, and Rs 25 crores respectively. The fulfilment of these targets, it was expected, would enable cooperatives to meet a quarter of the total demand for agricultural credit by 1960-61, as against 3 per cent in 1950-51. The conference of Ministers of Cooperation of state governments, which convened in Mussoorie in July 1956, resolved to accelerate this programme and fulfil its targets in four years. In all about 7,300 large-sized

societies were organized during the first three years of the second plan, some by amalgamating existing small-sized societies and others by fresh registration.

The Mussoorie conference also agreed that while the principle of state partnership and financial assistance for managerial staff would be confined to large-sized societies, small societies which showed promise of viability would continue to receive financial and other assistance as hitherto. However a few months later in January 1957, the Union Government instructed state governments to formulate schemes for strengthening existing small-sized societies and establishing new ones. These schemes were to be included in their cooperative development programmes for 1957-58. The new proposal also lowered the potential viability criteria, with societies judged capable of expanding to an annual business turnover of Rs 20,000-25,000 within three years qualifying for support from the government. In September 1957 it was decided to give such societies annual subsidies of Rs 120 to Rs 150 for three years. Although such confusing signals abounded, the cooperative development plan for 1957-58 envisaged setting up 3,025 large-sized societies, exceeding even the enhanced target of 2,684 accepted at Mussoorie in July 1956.

BANK-GOVERNMENT DIFFERENCES COME TO THE FORE

Until 1957, the Bank had a relatively free hand in managing the reorganization of cooperative credit. Thereafter, however, its role and initiatives in this area came increasingly to be contested by the government. Among other things, the Bank and the government came to differ quite substantially on the model of cooperative organization to be adopted at the primary or village level and the principles that would govern agricultural lending. These differences were not easily resolved, nor was their eventual resolution always very satisfactory from the Bank's viewpoint of building a viable cooperative credit structure. The shorter-run impact of these differences on the vigour and sense of direction of the cooperative movement was also considerable, more especially as the central government tended at this time to act first and talk later, whether with the Bank, state governments, or cooperators, even when by doing so it reversed policies of many years' standing and around which had grown a substantial consensus of official and non-official opinion. So that for a period of several months towards the end of the 1950s, the cooperative movement remained mired in some confusion and uncertainty.

Large vs. Small Societies

Expanding the cooperative movement was an explicit aspect of the government's programme for rural development in independent India. But it ranked low in its priorities until the mid-fifties. Consequently, the government

was generally content to cede initiative on the matter to the Bank, and to support the measures it took to expand and strengthen the movement. From 1957, however, interest in cooperation grew at the highest levels of government. This interest owed to several factors. Firstly, the government was becoming increasingly aware of the need to formulate a 'food policy' in the context of the programme of rapid development of heavy industry in the second plan. An immediate source of concern was the rising trend in food prices, which led the government to prompt the Bank to restrict lending against agricultural commodities. Farmers, as well as traders, were thought to be holding back crop in anticipation of higher prices, and both the Prime Minister and the Finance Minister expressed concern to the Governor, H.V.R. Iengar, over the role of cooperative credit in enhancing the farmer's ability to accumulate inventories. Reflecting a common tendency to collapse and conflate all types of cooperative activity, the Community Projects Administration of the Food and Agriculture Ministry also reported a lack of enthusiasm among the rural population for enhanced agricultural production and cooperatives. At almost the same time, the Nagpur session of the All-India Congress Committee passed a resolution envisaging the village as the basic unit of economic development, and cooperatives and panchayats as the principal instruments for accomplishing it. Following this, the All-India Congress Committee too expressed itself in favour of smaller, village-level, 'service cooperatives' (as distinct from credit cooperatives), preference for which seems to have been rather marked in Uttar Pradesh, Bihar, West Bengal, and Orissa. Although some of these states were more highly stratified and economically and cooperatively less developed than say, Maharashtra and Gujarat, it was difficult to ignore the drift of opinion in these regions in favour of local, village-level, service cooperatives.

The Planning Commission was independently dissatisfied with some aspects of existing cooperative policy, in particular the stress on large-sized societies and on State participation in their share capital. It also appears at one time to have been in favour of compulsory membership in primary societies. Consequently, the Commission initiated and led a rather furtive campaign to revise the premises upon which the cooperative movement had grown and consolidated since the turn of the decade. It argued that large-sized societies negated a basic principle of cooperation, namely that of mutual knowledge among members. Decrying the emphasis on the business aspect of cooperative activity and arguing that large-sized societies were not conducive to the village developing along democratic lines, the Commission advocated a 'one village, one society' policy.

The Bank and the Planning Commission were ranged on opposing sides of the controversy for much of the time. The Bank was convinced that the social objectives of the cooperative movement would not be achieved if the institutions which made up its foundations were not financially viable. Besides, it was keen to ensure a fair trial for the existing cooperative policy 'which had been adopted by the Government of India with the agreement of the State Governments', and was convinced that a 'policy of "chop and change" ... at frequent intervals' would be 'ruinous to [the movement's] progress'.

The Bank's objection to the new suggestions was not merely, or even principally, procedural. As Iengar clarified to the Standing Advisory Committee in July 1958, both small and large societies had a part to play in rural credit, and the Bank was as concerned with small societies as with large. But it might not be possible to revive many small societies, whatever the assistance extended to them. Besides, there were few practicable ways of assisting such societies, since the burden on state governments or other institutions of subsidizing unviable primary societies would prove unsustainable. Hence the Bank strove, though in the end unsuccessfully, to defend the existing cooperative structure and policy, and to ensure that the debate about its correctness might take place without seriously disrupting the movement's progress.

Getting wind of the Planning Commission's moves in March 1957, H.V.R. Iengar who had been in office only a few weeks, sought a meeting with the Finance Minister, T.T. Krishnamachari, to convey to him the Bank's views on the issue. At first the Finance Minister expressed himself in agreement with the Commission's perception, but appears to have changed his mind after hearing the Governor elaborate on the recent successes of the cooperative movement in Bombay. Iengar found TTK 'greatly interested' in his exposition.

Apparently somebody has been talking to him about the dangers of ... 'collectivism'. I told him that the success of the integrated credit experiment in Bombay has been due to 'cooperative' effort; and it is resulting in the elimination of the middleman. The Minister agreed that whether this is called cooperation or collectivism, it seemed a pretty good thing deserving of encouragement.

The Bank's relief was short-lived. Not only did the Planning Commission persist in its efforts to overturn the country's cooperative policy, it also seems to have attempted to bring the issue to the boil quickly by discontinuing official financial assistance to large societies. Such tidings prompted the Governor to seek the Prime Minister's intervention. Writing to him early in August 1957, Iengar recalled that

the integrated scheme for rural credit was adopted after extensive consultations at various levels. The Planning Commission and the Parliament were both parties to the programme. However, the Governor regretted, the entire issue was now sought to be reopened by the Planning Commission.

Anyone who feels strongly that a wrong step has been taken, more particularly a member of the Planning Commission, is entitled to ask that the problem be re-examined. But what has caused me concern and prompted me to seek your intervention is the ... [Commission's suggestion] ... that financial assistance to large-scale societies—without which they would not find it possible to function—should be suspended pending consideration of the whole basic issue. This is likely to bring the whole scheme to a halt; which I would consider most unfortunate.

The Governor urged the Prime Minister to ensure that the existing administrative and financial arrangements for the cooperative movement were not suspended whilst alternative policies were being debated.

The Planning Commission remained unyielding in its preference for village societies, while opinion in favour of them continued to harden in the corridors of government. Following a cursory review of cooperative policy, the Commission concluded that the establishment of large-sized societies had not proceeded on the right lines. These societies either covered very extensive areas or had been formed after compulsorily amalgamating small credit societies. The Commission pointed out, in justification, that while the second plan envisaged 10,400 large societies covering about 50,000 villages, the nearly 7,000 societies established until then covered nearly 75,000 villages. Based on this review, the Planning Commission recommended in September 1958 that large-sized societies should be confined to backward areas and that while the current annual plan for large-sized societies should be implemented, no state where a tenth of the villages were covered by cooperatives should allow large societies to be registered after 1958–59. The Commission also insisted that no primary society should cover more than four or five villages, and that existing large-sized societies should be reorganized to reduce the number of villages they covered.

If the Bank expected the Finance Ministry to join it in opposing the Planning Commission's stand, it was disappointed. A meeting in October 1958 with Morarji Desai, who had meanwhile taken over as the Finance Minister, left Iengar dispirited. As he noted in his own hand:

I am afraid he [Morarji Desai] is wholly unsympathetic to our views. He is quite prepared for us to stop further expansion of Reserve Bank credit for agricultural production till what he calls the basic objective is achieved, viz. of setting up cooperatives which can move on their own (people's) momentum, without official support or patronage. He thinks that the decisions taken on the basis of the Rural Credit Survey Committee Report were completely misconceived and that the sooner they are reversed the better. All he is prepared to do is not to break up the large-sized societies that have (unfortunately) already been set up. In view of [the] Finance Minister's attitude we must assume that Cabinet will approve ... [the] Planning Commission's views. I think we must now reconsider the entire problem of [the] Reserve Bank's policy and administrative arrangements.

Matters moved thereafter at a rapid pace and came to a head in the National Development Council (NDC) at its meeting the following month, rather than as the Governor had anticipated, in the Cabinet. Concerned over the failure of the government's food policy, the Prime Minister directed changes to be made to cooperative policy at the NDC, but neglected to spell out the reforms he had in mind. As the agency servicing the NDC, the Planning Commission wielded considerable influence over the formulation of its agenda and resolutions, and the Prime Minister's misgivings gave it the opportunity to stamp its influence on the future direction of cooperative policy. At its meeting in November 1958, the NDC recommended radical reforms in the pattern of organization of societies at the village level. It maintained that cooperation could develop as a people's movement only if primary societies were organized for individual village communities and if the initiative for social and economic development at the village level rested with the village cooperative and panchayat, both serving identical areas.

Underlying this rhetoric was a model of cooperation in which the village cooperative continued to supply credit in the form of crop loans to cultivators on the 'basis of their need' for it. But it would also carry out a wider range of functions including formulating, coordinating, and monitoring household and village-level agricultural production plans, supplying inputs and extension services, and marketing the produce. The Planning Commission also believed cooperatives had a key role in helping to realize a national 'food policy' consistent with rapid industrialization. State trading in foodgrains was an important element of the latter policy, and the Commission hoped to make cooperatives a major source of supply of food to the state sector. Consequently,

it emphasized the integration of production and marketing activities in the cooperative sector, with village societies federating into marketing unions. Once linked to a wider marketing union, village societies would coordinate production plans with a marketing programme, and also utilize the latter to effect timely recovery of their loans.

By linking marketing societies with village societies and using the latter as agencies for collection and sale at assured prices at the village level, it will be possible not only to obtain large supplies of foodgrains for meeting the needs of urban areas but also to expand greatly the credit facilities available for rural areas,

the National Development Council underlined. Its resolution visualized the cooperative movement, modelled on these lines, developing in such a manner as to bring within its fold all rural families before the end of the third plan. State governments were also asked to make special efforts to revitalize existing small credit societies, and increase the membership of cooperative societies from about 9 to 10 million to about 15 million by the end of the second plan. As credit requirements under the proposed arrangements were likely to be much larger than those visualized in the second plan, the Council recommended making suitable financial arrangements in consultation with the Bank.

His demoralizing meeting with the Finance Minister in October 1958 led the Governor to strike a rather philosophical note, and wonder whether the new policy left any role for the Bank and its Agricultural Credit Department to play in the cooperative movement. The Chief Officer of the latter department missed the speculation entirely, and proceeded to argue that the policy shift did nothing to diminish his case for more staff and branch offices at several regional centres. More heartwarming for the Bank, Ryan reported that Registrars and other officials of state governments were opposed to the new policy, which they felt could not but undermine existing plans to strengthen the cooperative credit structure.

The formalization of a new policy in the form of the NDC resolution did nothing to lift the enveloping mood of gloom in the Bank, and there was a brief moment when it looked as if it would withdraw into itself. Although there was 'no question of withdrawing cooperation' to the government, top officials of the Bank felt that they could not, in all propriety, participate in meetings at the Planning Commission to formulate annual plans for the cooperative sector, and yet avoid being implicated for the new policy. Iengar and Venkatappiah also noted uneasily that the NDC resolution advocated agriculturists being financed freely and without regard to prudent banking principles, and wondered aloud about the future of the Bank's association

with the cooperative movement. However, even the NDC had failed, apparently, to subdue Ryan, who responded to the Governor's rhetorical query by dwelling at length on the very large segment of the cooperative movement regarding which there was no dispute between the Bank and the government. Not even the Planning Commission, the Chief Officer pointed out, could possibly be unaware of the risk of the Bank reducing its exposure if 'cooperative financing banks' were not organized on the basis of State partnership, so that it was likely to leave this principle undisturbed in the case of apex and central cooperative banks. The Bank's relationship with these institutions, the Chief Officer stressed, was therefore unlikely to be immediately affected by the new policy.

J.C. Ryan's intervention had the effect, on this occasion, of presenting the new developments in a fresh and more hopeful perspective. It could also become a false one unless the Bank exerted itself more decisively to influence the outcome. The Bank was also far too closely involved with cooperation to lightly throw away the achievements of the past few years or the links it had painstakingly cultivated at every level of the movement. Iengar convened an informal meeting of some leading cooperators to discuss the NDC resolution and the Bank's future relations with the cooperative movement. This meeting, which was held towards the end of November, was attended by D.G. Karve, R.G. Saraiya, and V.L. Mehta, all leading cooperators, and M.R. Bhide, Adviser, Programme Administration in the Planning Commission. Criticizing both the substance of the NDC resolution and the procedure adopted in passing it, the Governor wondered whether the Planning Commission or any other agency had estimated the total volume of credit the Bank was expected to provide in the new dispensation and the capacity of small societies to absorb the credit. Nor had sufficient attention been paid, in the Governor's opinion, to the monetary policy implications of enhanced credit to the cooperative sector.

The assembled cooperators were unanimous in criticizing the NDC resolution as ill-considered and impractical. The plan to integrate credit and service functions in a small society attracted particular criticism. It was also pointed out that even state cooperative banks would hesitate to lend to small societies unless the state government stepped in to guarantee such loans. However, the meeting failed to produce an agreed course of action. The Governor rejected Karve's suggestion that state cooperative banks should be advised to protest the proposed changes at the political level, pointing out that it would make no impression on the Prime Minister who had already made up his mind on the matter. However, at Mehta's instance, Iengar wrote to the Food Minister, A.P. Jain, the following day, drawing attention to the

implications of the NDC resolution, particularly for the volume of credit to be provided by the Bank. The Minister responded—rather unsatisfactorily from the point of view of the Bank—by repeating that it would be consulted about any additional credit that may be necessitated by the new arrangement.

The resolution having been passed, the Planning Commission set up a Working Group to 'consider the administrative and organizational arrangements' required to give effect to it. Venkatappiah was one of its members. The Bank proposed to the government that the Working Group should be broadened by the inclusion of leading non-officials and cooperators. Although the Prime Minister supported the idea, it did not, for some reason, make headway at the official level.

The Bank had two concrete reservations about the general thrust of the NDC resolution. The first was that it threatened to sacrifice the primary society's financial viability to its compactness. The Bank was not convinced that this was the right way to pose either the issue or the trade-off. Compactness was of little use for its own sake, and it was demonstrably clear to the Bank that, whatever the criteria adopted, small primary credit societies were less effective in their intended role than large ones. The Bank's annual sample surveys and other studies showed that a greater proportion of the membership of large societies, than of small ones, was made up of medium and small farmers. Not only did large societies lend more, per member and per borrower, than small societies, the former also tended to lend proportionately more against the pledge of future crop than the latter. Sample data obtained from Andhra Pradesh showed that nearly half the loans advanced by large-sized societies were to small farmers and tenants, while data from Madras reported large-sized societies lending substantial sums even to landless labourers. In the case of one of the four Madras societies for which data were available, loans to landless persons registered an eleven-fold increase within one year of its reorganization as a large-sized society. The number of landless beneficiaries had merely trebled, so that the average size of the loans extended to landless persons had also increased during this interval. The Bank's studies also showed that having smaller portfolios, small societies were understandably more conservative and cautious in their lending policies.

Secondly, the NDC resolution sought to burden the proposed small societies with a wide assortment of responsibilities, including those for coordinating agricultural production plans in the village, distribution of seeds, compost, and manure, management of water resources, etc. In the Bank's experience, the village society was often too small to be viable even as a credit society, let alone as a service or multi-purpose agency. It was not convinced village cooperatives were effective in a wider role or that any useful purpose would

be served by expecting them to play it. In Iengar's words, cooperatives were not, as the Planning Commission supposed, 'the short-cut to the millennium'. Let alone handle wider responsibilities, cooperatives found it difficult in practice to recover their loans or fulfil even fairly ordinary marketing responsibilities. There was, according to a Bank sample study (1956) which followed up the Rural Credit Survey, a 'general tendency on the part of cultivators to withhold payment of crop loans to the extent possible'. Part of the problem, the following year's report noted, was that repayment was spread over the first half of the calendar year and societies, or their financing agencies, made no effort to recover loans immediately after the harvest. A possible solution lay in tying agricultural credit to marketing. But the Bank's officials knew from experience that cultivators were generally not 'loyal' to their cooperatives even when they were in debt to them, and needed little prodding to break their marketing agreements with them. Marketing societies were most effective in enforcing marketing contracts for sugarcane and other intermediate commercial crops which had to pass through a 'processing bottleneck'. They were virtually ineffective for food crops which could be disposed of locally, often at higher prices than marketing societies were prepared to offer. Citing examples, the Bank's officers also pointed out that state trading, with fixed procurement prices at which marketing societies bought farmers' stocks and sold them to the government, might further weaken the effectiveness of marketing cooperatives.

Once the immediate sense of outrage over the NDC resolution passed, officials at Mint Road began to recognize that, important as the principle of viability was, the Bank had also to come to terms with the government's determination, whatever its other motivations, to use cooperatives as a tool of wider policy. Nor could it continue to view cooperation exclusively through the prism of credit, while other agencies of the State took a broader view. The Bank's principal interest lay in ensuring the health of cooperative credit institutions, and not necessarily in restricting their other activities if these did not weaken the base of the rural credit pyramid. The problem, as well as the solution, lay therefore in safeguarding the viability of primary credit disbursing agencies despite cooperative societies diversifying their activities.

It fell to Venkatappiah to attempt to satisfy the political demand for 'multi-purpose' village societies without weakening the base of the credit pyramid. The Deputy Governor hoped to achieve this seemingly impossible reconciliation through his plan for credit unions. Under this plan, a few village societies would federate into unions to deal with their members' credit requirements. Freed from the burden and risks of purveying credit, village societies were to 'devote themselves to as many aspects as practicable of the

economic development of the village community as a whole'. Under this proposal, each village would have its own society unless it was too small to support one. Groups of small villages could also come together to form a society provided their combined population did not, as the NDC had suggested, exceed one thousand. The society would formulate production plans for the village on the basis of individually approved household production plans, and ensure their success by mobilizing resources and facilities to carry them out. Some of these resources, such as improved seeds, green manure and compost could be sourced locally. But others, such as credit, whether to individuals for production, or to groups of individuals for productive works like contour-bunding, soil conservation, and constructing or maintaining minor irrigation works, would normally be provided by the credit union to which the village society was affiliated. The credit union would advance credit only to members of its affiliated village societies which, in turn, were to be responsible for assessing the loan, monitoring its use, and effecting recovery, to the extent possible, through a linked marketing society functioning at the local mandi. In this way, Venkatappiah hoped, small village societies would be protected from the risks of purveying credit, while institutions performing the latter task would be large and viable enough to face them. The arrangement also conformed to the spirit of the NDC resolution, which proposed federating multi-purpose societies, while ensuring the 'viability and strength of resources so important for providing adequate credit'.

The Venkatappiah plan received considerable support in the early stages, particularly as it seemed to bridge the wide gap between the positions of the Bank and the concerned departments of the Government of India. Both the Prime Minister and the Home Minister, G.B. Pant, who took a personal interest in the cooperative movement, seemed to approve of it. However, it got mauled beyond recognition in the Working Group. Tarlok Singh, Additional Secretary at the Planning Commission, believed Venkatappiah's plan went beyond the scope of the Working Group which was set up to 'take the [NDC] resolution as a text' and draw up an appropriate programme of action on its basis, rather than to 'interpret' the resolution in different ways. Both he and Bhide, who had by now become Additional Secretary to the Government of India in the newly-created Ministry of Cooperation, insisted that small, multi-purpose, unfederated village-level units, set up without State assistance to share capital, should remain the normal form of organization of primary societies. Apart from helping to formulate and implement agricultural production plans, the latter were to undertake educational, advisory, welfare, and marketing activities. Credit unions, which were referred to as 'Alternative II' by the Working Group to distinguish them from the small society model

(‘Alternative I’), were to be the exception rather than the rule. They would be established only in backward and tribal areas, and in areas where the cooperative movement either did not exist or had become dormant. Even here, the Working Group stressed, the credit union should be a transitional form of organization which would exist only so long as village-level societies were not established.

The Bank, in particular Iengar, had been hopeful that the Working Group would help lift the pall of indecision and uncertainty which had descended over cooperative policy and activity during the past several months. The support which the credit union scheme seemed to receive from the Prime Minister and the Home Minister gladdened Iengar and may have lulled him into the hope that the Bank’s row with the Planning Commission was about to blow over. Hence the Working Group’s report came as a major disappointment to him, more so as it appeared also to implicate his Deputy Governor. Nervous perhaps that Venkatappiah’s membership of the Working Group might mislead the government into assuming the Bank’s acquiescence in its report, the Governor responded with ‘complete frankness’ to Bhide’s invitation to comment on the document. No one, Iengar said, could quarrel with the government’s efforts to organize rural economic activities, in general, along cooperative lines, nor with the view that artisans and landless workers should be brought within the ambit of cooperative organizations. But he was sure the proposals of the Working Group would ‘retard rather than promote progress’ in the cooperative sphere. The Working Group had made a dogma of the principles of ‘one village, one society’ and ‘one society, all functions’, instead of leaving the size of the cooperative and the range of its functions to be determined by ‘pragmatic considerations’. Several factors, such as ‘compactness of area, accessibility to all members and ... viability’ had to be balanced against one another in establishing a cooperative, and this was best done at the local level. Therefore, rather than promoting any one model of cooperation, government policy should, he underlined, aim to give maximum scope for local opinions and initiatives to prevail in organizational matters. Likewise there was, in the Governor’s view, no need to take a dogmatic view of State participation in primary societies. The Madras and Andhra experience showed that State participation ‘helped very appreciably in attracting deposits from the rural area ... and mobilizing rural savings’. Hence rather than ruling it out completely, State participation should be allowed wherever state governments and the local people were in favour of it.

Iengar also took the opportunity to defend the functioning of large-sized societies. Arguing that the latter were conceived as large enough to be viable

and compact enough to be cooperative and that a society's turnover rather than the area or population it covered would represent the truer index of its size, the Governor said much of the criticism of large societies was 'ill-informed' and based on ideological preconceptions rather than detailed knowledge of their working. Large societies had succeeded in providing 'adequate credit, ... attracting deposits, effecting prompt recoveries, and ... inspiring confidence and enthusiasm in the people'. A large society was also relatively free from official interference because it could afford to employ a paid secretary. In contrast, small societies depended on district cooperative banks or the cooperative departments of state governments even for routine tasks, and were consequently vulnerable to domination by officials of these institutions. Since large societies had, on the whole, performed well, the Governor hoped the government would not 'stop or curtail' the agreed programme for establishing them without first surveying their functioning.

Nor were leading cooperators greatly enthused by the Working Group's conclusions. D.R. Gadgil remarked that the report had done little to illuminate the NDC's motivations for making radical changes to cooperative policy. The Working Group seemed to regard the NDC resolution as 'an oracular pronouncement which they diffidently try to interpret' but dare not criticize or depart from. It had done nothing to dispel the impression that

cooperative policy is made not after rational, scientific study and full uninhibited participation of non-officials and officials in all the states but by fits [and] starts [and] through personal predilection or prejudice in Delhi.

Consequently, cooperative policy in India was in a 'sorry state'.

Gadgil deprecated, in particular, the tendency to lay down the pattern of cooperative organization from Delhi, since no one model could fit the needs of the entire country. He was critical of the report for having rejected the principle of State participation at the primary level. It was 'illusory' to suppose that small, village societies would be able to mobilize their own resources without 'external help'. It was only where agriculture was 'already secure and well-developed and the grip of the moneylender-trader interest ... relatively weak' that external help could be dispensed with. 'To talk of depending on internal resources from the beginning is tantamount to condemning, as in the past, all the poorer and moneylender-dominated areas to permanent stagnation', he declared. Another leading cooperator, R.K. Patil, wondered whether the NDC and the Working Group were not papering over contradictions and antagonisms in rural society and falsely assuming a homogeneous village

community where none existed. Motives which underlay the cooperative movement such as mutual benefit often broke down because of 'internal contradictions' within the village. Consequently, 'slogans' such as 'a plan for every family' were likely to prove 'exaggerated and somewhat meaningless' in practice. Other leading cooperators, including V.L. Mehta, R.G. Saraiya, G. Parameswaran Pillai, and P.S. Rajagopal Naidu, spoke out along similar lines.

These reservations notwithstanding, the NDC virtually reiterated the conclusions of the Working Group, and the Government of India issued a 'policy letter' in May 1959 making radical changes in cooperative policy. Under this policy, no new large societies were to be set up in the future, nor would the State participate in the share capital of primary societies. The latter would be predominantly small, village-based bodies, except where a village proved too small to support a society. In the latter event, a few villages, not exceeding a combined population of 1,000, could come together to set up a primary society. Primary societies were to keep their doors open to all 'eligible persons', with anyone refused membership having the right to appeal. Primary societies, according to the new policy, would not only dispense credit, but also supply inputs, market members' produce, and formulate agricultural production plans. The new policy envisaged a cooperative membership of 20 million by the end of the second plan, and making available to the movement a much larger volume of credit than the Rs 100 crores advanced in 1957-58. Hence consultations were proposed between the central government, the Bank, and state governments to consider ways in which the enhanced credit requirements might be met. Finally, the letter proposed a programme for organizing new societies and 'revitalizing' existing societies, with the State extending to each new society a 'managerial subsidy' of Rs 900 over five years.

Iengar and Venkatappiah had hoped that the government would use the Working Group's report as a basis for extensive consultations with official and non-official opinion at various levels. Although the government sought and obtained the views of the Bank and of some cooperators on the report, it thereafter paid little heed to them. In fact, initially, no effort was made even to circulate these comments. A conference of Ministers for Cooperation in the state governments was scheduled to be held in Mysore in July 1959, and the Governor had been assured in April that a final decision on cooperative policy would be deferred until the conference. Yet, the following month, the government issued its 'policy letter' making radical changes in cooperative policy. Disappointed at the government's attitude both on the substantial issue and on matters of procedure and propriety, Iengar was initially disinclined

to attend this conference. But he was persuaded to do so by S.K. Dey, the Union Minister for Cooperation, who assured him that the government did not favour a 'rigidity of approach' to cooperation, and that no decision could be 'absolutely final'.

At the Mysore conference, representatives of several state governments and many non-official participants criticized the Union government for having made major changes to agreed policies in a peremptory manner and without prior consultations with non-officials and cooperators. However, the conference generally accepted the new policy and fixed targets for establishing 20,000 new societies in 1959–60 and 30,000 in 1960–61. Following demands from several state governments and cooperative organizations, the conference decided to refer the question of State participation in the share capital of primary societies to an expert committee.

The Mysore conference did not entirely ring the curtain down on large societies. The latter were soon to make a comeback as numerous primary societies became sick or dormant and the government recognized, belatedly, the importance of taking steps to ensure their viability. The efforts once again to revitalize and reorganize the cooperative movement at the primary level are discussed below. For the moment, however, it is instructive, in laying this section of the narrative to rest, to recall the verdict the All-India Rural Credit Review Committee passed a decade after the controversy. The decision to discontinue the organization of large primary societies, the Review Committee said,

resulted in an extremely unfortunate setback to the progress which was being made at the primary level of cooperative credit. Notable among the events which contributed to this setback was the resolution on cooperative policy adopted by the NDC in November 1958.

One might add, for the sake of completeness, that M.R. Bhide, who had in the meantime joined the Bank as a Deputy Governor, and B. Sivaraman, Secretary to the Government of India in the Ministry of Food, Agriculture, Community Development and Cooperation, were members of this Review Committee.

Financing Cooperatives

It was mentioned above that the controversy over the optimal size of primary societies partly reflected concern over the basis on which large societies might evaluate and grant credit. Although the available evidence pointed to the contrary, the government believed that lacking knowledge about the borrower's character, large societies would generally be prone to lend only against the pledge of his movable or immovable properties.

Once property became the sole qualification of credit, cultivators without property would have to do without credit as well. The All-India Rural Credit Survey had anticipated and warned against this problem, while both the Bank and the government were keen to avoid it. The system of crop loans, which financed the cultivator's need for productive credit against the pledge of his future crop, was designed for this purpose. Although cooperatives were enjoined to grant as large a volume of their short-term credit as possible in the form of crop loans, this often proved difficult to implement in practice.

The government and the NDC were also both keen to liberalize cooperative credit and base it, as it were, on 'need'. The stress on more liberal lending had important implications for the Bank. The latter was the principal agency refinancing apex and central cooperative lending institutions against credit limits set at a multiple of their owned funds. The multiple chosen in each case depended on the creditworthiness—proxied by audit classification—of the bank in question. Unless more liberal lending at the primary level was matched by an increased mobilization of owned funds, the former would necessitate larger assistance by the Bank. Besides, the government's determination to limit the size of the average primary society and refuse to sanction State participation in its equity increased the likelihood of owned resources financing a declining proportion of cooperative credit, and of greater dependence upon the Bank. Hence where the Bank was concerned, the twin issues, of the size and model of organization of the primary society, and of the criteria on which lending was based, were related. Each gave an edge to the other and the Governor confessed to V.T. Krishnamachari, Deputy Chairman of the Planning Commission, whilst educating him about the rising volume of credit which the Bank made available to agricultural cooperatives every year, that his 'real anxiety' was that the Bank might be 'called upon in the future to provide a large amount of credit to societies which are structurally weak'

From early 1959 there were strong signals that the government, in particular the Planning Commission, was contemplating a radical change in cooperative credit policy. It was virtually public knowledge now that the Planning Commission was dissatisfied with the Bank's lending activities, and a paper it submitted proposed dealing with the 'problem of [cooperative] credit ... in a fundamental manner'. Accounts of a meeting at the Commission also revealed that the latter wanted the Bank to lend on a 'large scale' to new societies 'on the basis of needs and not of a multiple of the share capital and reserves'. Stressing that Bank lending should always be related to the creditworthiness

of its borrowers, Iengar explained to the Finance Minister, Morarji Desai, in April that

it would be a complete disaster to the financial reputation of India which at present is very high, if the Reserve Bank had to show in its books sums as overdues from cooperative institutions. The Bank would have to take up a firm position with regard to the grant of credit to institutions beyond the limits of creditworthiness as assessed by [it]. If the issue was forced by Government and it was decided finally that sums should be advanced against the Bank's considered judgement of the appropriate credit limits, ... it would be more appropriate if the problem were handled not by the Reserve Bank but by a separate institution to be set up for the purpose of handling agricultural credit. It would be open to Government to give such loans to this Corporation as they might consider appropriate. Eventually, of course, the money would be advanced by the Reserve Bank, but channelling the funds through a separate corporation was desirable partly to avoid the risk of the ... Bank having to show bad debts in its books and partly to indicate more clearly the nature of the transaction.

Iengar first mooted the proposal for a separate apex agricultural credit institution to his officials in October 1958. Then it was regarded as a counsel of despair. It also had some shock value, but Iengar was not keen to test the idea on V.T. Krishnamachari for fear that he might snap it up. It is in some degree a sign of the Bank's growing disenchantment with the recent direction of the government's cooperative credit policies that the Governor was willing now to talk more openly about this proposal.

J.C. Ryan pointed out to Iengar that a new corporation to finance cooperatives might 'protect the Reserve Bank, but throw the cooperative movement as a whole in danger'. Indeed the danger to the integrity of the cooperative credit movement was closer than the Bank had imagined. In the summer of 1959 the Ministry of Community Development and Cooperation came forward with a proposal to open a supplementary line of credit of Rs 8 crores for rural cooperatives. This figure represented about a sixth of the cooperative sector's outstandings to the Bank by way of short-term loans at that time. Part of a 'pilot project' intended to be implemented in 200 blocks or 4,000 villages around the country, the scheme aimed to ease the resource constraint on primary societies (whose credit limits, it may be recalled, were

typically a multiple of owned funds) and enable them to make productive loans to 'cultivators who cannot at present obtain credit' from them. The additional loans were to be made on the basis of cultivators' production plans which primary societies were to help formulate, oversee, and execute. Recovery was to be effected by moving crops through local marketing societies.

Financed by means of a medium-term loan from the government, the supplementary scheme envisaged no immediate draft on the Bank's resources. This however made little difference to the Bank's view of the matter. Opposing the scheme, the Governor pointed out to the Finance Minister that apart from being the government's statutory adviser on agricultural credit, the Bank provided the bulk of the financing which the new line of credit was intended to supplement. Yet the central government had not thought it necessary to consult the Reserve Bank. The Governor's objection was not only procedural, 'though even as a procedural matter it is one of considerable importance'. Criticizing the credit scheme as 'immature and ill-advised', Iengar underlined that it invoked a distinction between 'normal' and 'supplementary' lending which was tantamount to inviting the society to adopt 'a double set of standards for its borrowers'.

A conservative society will have every temptation to become even more conservative so far as its own risks are concerned, for it can readily relegate to the supplementary category all cases about which it has the slightest misgivings, including those which in normal circumstances it might well have considered favourably and lent from its own resources. There can be no better way of demoralizing ... cooperatives than to introduce double standards of this kind.

He added that if the government bore all the risks of the lending, recoveries were bound to be poor and arrears substantial. On the other hand, if cooperatives were expected to bear the risks of supplementary lending, 'it may be asked what there is in the project to impel central cooperative banks and primary societies to extend their lending programmes, and ... their risks so considerably'. He also pointed out that the Bank's existing credit limits themselves remained invariably under-utilized. Even the government recognized that a 'shortage of funds' was not the main reason for district cooperative banks not lending more to societies. Yet, Iengar marvelled, it went on to 'propound a remedy of which the main feature is the putting of more funds at the disposal of central banks!'



B. Venkatappiah, Deputy Governor, 1955-62

Largely at the Bank's instance, Venkatappiah, Karve, and a team of officers of the Government of India and the Planning Commission undertook a field-study of rural credit in Mysore, Madras, Andhra Pradesh, and Bombay in the summer of 1959, during which they held elaborate discussions with officials and cooperators about the government's plan for a supplementary line of credit. Almost everyone the study team interviewed was sceptical about the plan. Villages did not have production plans, nor could village societies afford to make or help implement such plans. The scheme too made no provision for engaging technical staff who could draw up production plans or otherwise support village societies in their expanded responsibilities. Further, there had

been no progress in linking credit with marketing, and marketing societies did not exist or function at most places. Finally, the scheme threatened to institutionalize an invidious distinction between two categories of farmers—those whose credit needs were met out of the village society's 'normal' funds, and others whose needs would be met from 'supplementary' funds. Echoing the findings of the study team, the Governor pointed out to the Finance Minister that the government's scheme was a 'counsel of perfection' which was silent about how it would be translated into reality. There was no suggestion for how village societies might be expected to tackle the additional responsibilities which the scheme placed on them. On the other hand, they were being required to

act as if certain assumptions were true—e.g. that village production plans exist and marketing societies are effective What is more, the society is to incur the financial risks involved in acting on these assumptions. Thus it may give a loan for production, but may find itself unable to recover it because effective marketing has not meanwhile been organized. It seems to me that, as a pilot scheme for production cum marketing cum credit, the project under discussion is wholly inadequate because it has no concrete proposals for either production or marketing.

The Deputy Governor, who in Iengar's words was a 'missionary in ... the field of cooperative credit' capable at the same time of 'keep[ing] his feet on the ground' and 'look[ing] at the stars', was regularly in the habit of touring villages 'more extensively' than any cooperative official. As such it is unlikely that the field-study revealed to Venkatappiah much that he did not already know. But judging by the radical conversion they underwent, it would appear that their rural excursion proved an educative and chastening experience for the officials of the Union government who undertook it. The study team decided after their tour to jettison, in effect, the government's proposal for a supplementary line of credit. The pilot project, it was agreed, would now be confined to providing or strengthening staff in selected villages to draw up agricultural plans. The concerned primary society would extend production credit to enable eligible borrowers to fulfil their plans, and recover it through marketing societies.

The team expected the volume of credit extended by primary societies to rise considerably in the pilot villages, but not beyond the ability of central cooperative banks, many of whom had unutilized credit limits, to finance it. Central cooperative banks would, if necessary, relax rules of access for primary societies to meet their 'genuine requirements ... in ... full', while the Bank

too, for its part, agreed to relax the former's credit limits wherever it was possible. The Deputy Governor assured the study team that the Bank would find 'all the finance required for the scheme ... on the same lines as at present' if prior conditions such as adequate staff were satisfied. In order to compensate for the higher risks associated with their expanded operations, primary societies in the pilot villages were to set up a 'bad and doubtful debts fund' out of grants from the central and state governments. A guarantee fund, to make additional payments to societies whose actual losses exceeded the grant they received on account of 'bad or doubtful debts', was also proposed. In a further affirmation of the Bank's stance, the letter announcing the revised pilot project advised state governments to select for the project only villages with 'reasonably good cooperative societies which have been in existence for some time'.

While Venkatappiah was largely successful in persuading the central government to withdraw its supplementary line of credit, he was not as successful in persuading the Planning Commission and the agriculture ministry to agree that the Bank's present arrangements for the cooperative sector sufficed to provide 'adequate finance for the country as a whole'. Hence, the Mysore conference, while approving the pilot project in its diluted form, also referred the wider issue of augmenting the resources of the cooperative credit structure to an expert committee.

BRIDGING DIFFERENCES: THE COMMITTEE ON COOPERATIVE CREDIT

It fell to the Committee on Cooperative Credit (Vaikunth Lal Mehta Committee, 1960) to attempt to reconcile the diverging views of the Bank and the government. The constitution of this committee, by the Department of Cooperation of the Government of India, was a minor victory for the Bank, which had been emphasizing to the government the need to make cooperative policy in consultation with the leading representatives of the movement. The committee, which was headed by V.L. Mehta, distinguished cooperator and Chairman, All-India Khadi and Village Industries Commission, had thirteen members of whom five were leading cooperators. Apart from Venkatappiah, the Managing Director of the State Bank of India, Bhide, who was now Secretary in the Department of Cooperation, and the Joint Secretary to the Planning Commission, the committee also included four representatives of state governments. Undoubtedly, therefore, the Committee on Cooperative Credit was the most expert body of inquiry in its field since the All-India Rural Credit Survey submitted its report in 1954.

The committee's terms of reference were to inquire into 'existing standards for credit limits' and their justification from the 'point of view of ... sound cooperative banking', 'loan policies and practices of cooperative credit institutions', measures to enhance the borrowing powers of primary societies, including revising their credit limits, so that they may finance agricultural production plans more effectively, and the desirability of share capital participation by state governments in primary societies. The committee was also set the task of studying 'a few representative societies' which had suffered losses and overdues, defaulted on their obligations, or gone into liquidation; and a 'few good societies in different states' from the point of view of 'adequacy of credit', 'coverage of families', 'inclusion of smaller farmers and tenants', extent of lending for productive purposes, recovery and repayment record, and 'deposits and encouragement of thrift generally'.

It is impossible to do justice to the committee's report within the space of a few paragraphs. Nor is much of the report really germane to our objective of following the history of the Bank's involvement with the cooperative credit movement. A brief summary of the committee's conclusions regarding the main points of the outstanding controversy between the Bank and the government which it was established to resolve should therefore suffice for our purposes here.

The Mehta Committee confirmed that village production plans did not, as a rule, exist and that it was not possible to make them without a large technical staff. It noted that almost a third of the nearly 1,66,000 primary credit societies in the country were working at a loss or were not making a profit. Many of them were burdened with overdues. Over two-fifths of the 418 central cooperative banks in the country did not come up to the minimum standards prescribed by the Reserve Bank of India. Hence, the committee concluded, it was essential to build the resources of central cooperative banks and 'rectify and revitalize' primary credit societies.

The committee recommended a 'systematic programme of rectification, consolidation, [and] revitalization of dormant primary credit societies' Societies were to be strong enough to function efficiently at the start and withstand the strains of additional responsibilities they might have to assume. Future policy, the committee emphasized, should be to build viable primary units without the latter having to cover too extensive an area. No village in a society's area of operations should be more than three or four miles from the village which served as its headquarters, and the combined population of these villages should not exceed 3,000 persons and 600 families or 500 *cultivating* families. Recommending that state governments should contribute to the share capital of primary societies which sought such contributions, the

committee stressed that all government assistance should be directed towards promoting the viability of a primary society within the quickest possible time. State governments' contributions to the share capital of primary societies should, according to the committee, range between Rs 1,000 and Rs 10,000 on a matching basis. In addition, a primary society was to raise an additional share capital of not less than Rs 3,000 within three to five years of the State entering into partnership with it. The committee also proposed that state governments should extend a managerial subsidy of Rs 1,200 to each primary society over a period of three to five years. In order to compensate societies and banks for the risks inherent in their expanded lending operations, the committee proposed the creation of special bad-debt reserves at the primary and the district level, out of contributions from the government of 3 and one per cent respectively of the *additional* agricultural finance provided each year.

The committee affirmed that individual members of primary societies should be extended credit on the basis of their 'repaying capacity'. It felt that there was no need for a general relaxation of the existing credit limits of institutions at various levels of the cooperative credit structure. However, the Registrar might, in special circumstances, permit limited liability primary societies to borrow up to 10–12 times their owned funds (against eight times currently) and unlimited liability primary societies up to one-sixth of their net assets (as against one-eighth currently). District banks were to be allowed to borrow 12–15 times and apex banks 15–20 times their own resources. As for the Reserve Bank, the committee felt that impressive as its performance had been as a lending agency, it was possible further to strengthen its refinancing role. While the cooperative structure had to be strong and viable if it was to attract the resources of the country's central bank, the former would not be self-supporting for a long time to come. Hence the committee proposed that the Bank increase its normal credit limits to central banks with superior audit classifications ('A' and 'B') to four and three times their owned funds respectively. In addition the former were to be sanctioned additional limits of twice their owned funds and the latter additional limits equal to their owned funds if they could show to the Bank outstanding loans to societies for agricultural purposes for twice the amount borrowed. In other words, the committee expected the central cooperative bank to meet half the excess of its loans for agricultural purposes over and above the normal Bank limit, out of its own resources. The committee also recommended that outstanding loans for the purpose of additional limits would be calculated after excluding loans which were overdue, thus paving the way for the concept of 'non-overdue cover' around which the Bank anchored its refinancing operations over the next few years.

The committee's report was taken up for consideration at the conference of

Ministers of Cooperation in the state governments which was convened in Srinagar in June 1960. There was a large measure of agreement at the conference around the substance of the committee's report. However, two of its recommendations stuck in the gullets of officials of the Planning Commission and the Food and Agriculture Ministry. The proposal to allow multi-village societies to cover populations of 3,000 persons was one, with officials including Shriman Narayan, Member, Planning Commission, arguing that it undermined the resolution of the NDC. The committee's endorsement of the principle of State participation in the share capital of primary societies was another, and officials of the government attempted to whittle down the recommendation and reduce the ceiling for such contributions from Rs 10,000 to Rs 5,000. Efforts were also made to relate the governments' contribution to the bad-debts reserve to *additional* finance that societies made available to 'weaker sections'.

The committee having endorsed the idea that primary societies should be viable, the Bank took a hard line and vigorously opposed moves to dilute its recommendations. The Governor, H.V.R. Iengar, declared to the Srinagar conference that the NDC could not sanctify a decision on the size of societies that experience had shown was dogmatic and unwise. The Bank also saw no reason to depart from the recommendations of the committee on the size of the state governments' contribution to the share capital of primary societies. Relating the bad-debts reserve to criteria such as lending to 'weaker sections' would, in the Bank's view, 'introduce so many complications that the scheme ... would be rendered unworkable'. Besides, the function of primary societies was to lend 'adequate amounts to all producers', and in so doing cater to smaller producers who 'can and will repay'. Alerted by the discordant but influential voices raised against it, the Bank decided that the report of the Mehta Committee should stand or fall as one whole. The report was, in the Governor's words, an 'integrated series of recommendations'. But some people, he warned, may be tempted to accept the recommendations dealing with liberalized lending while 'putting on the shelf' those parts of the report intended to safeguard the viability of cooperative institutions and tone up their functioning. Any effort to 'tear the report ... into compartments' was unacceptable to the Bank, the Governor said in a rare public display of firmness, and added that it would only 'accept this report as a whole' or not at all.

The Srinagar conference accepted the report in principle, leaving the details of its implementation to be finalized by the Bank and the government. However, the conference recommended funding the bad-debt reserve at 5 per cent of the 'additional agricultural loans advanced to the underprivileged classes'. After a series of meetings at the Planning Commission and the Ministry of

Cooperation, in the course of which the Bank repeatedly underlined its resolve not to notify the liberalized financing norms recommended by the Mehta Committee unless the government accepted its report in its entirety, the Government of India signified its acceptance of the report. Finally, at its meeting in September 1960, the NDC accepted the recommendations of the Mehta Committee, including its more contentious ones. The only exception made was in respect of state governments' share capital contributions to primary societies. The NDC set the ceiling for such contributions at Rs 5,000, though in special cases they might be increased to twice that amount. Following this decision, the Bank agreed to put into effect the liberalization of credit limits suggested by the Mehta Committee. The conference of Ministers of Cooperation which took place in New Delhi in October 1961 noted these decisions and formulated a programme for cooperative development for inclusion in the third plan.

STRENGTHENING THE COOPERATIVE SYSTEM

The Working Group on Cooperative Development for the third five-year plan concluded that about 2.5 lakh village societies were required to cover every village in the country. This involved organizing 50,000 new societies and rectifying 60,000 existing societies. In 1961, the Government of India and the Bank jointly evolved ways to rectify and revive dormant societies. However, with resources in the Long-term Operations Fund being limited, the Bank advised state governments to initially submit applications for contributions to the share capital of only 250 small primary agricultural credit societies in each state. In order to ensure that only viable or potentially viable societies were selected for participation by state governments, the Bank further confined share capital contributions from the Long-term Operations Fund to societies under audit classes A, B, or C with overdues not exceeding 30 per cent of loans outstanding, and which had collected a minimum share capital of Rs 1,500 from members. Following a decision by the conference of Registrars and Ministers held in New Delhi in October 1961, the minimum contribution to each society was reduced from Rs 2,500 to Rs 1,500. During 1961-62, ten state governments approached the Bank for loans for share capital contributions, and a sum of Rs 78 lakhs was sanctioned as contribution to the share capital of 2,445 societies.

Revitalizing Primary Societies

The question of reorganizing primary cooperative credit societies on the basis of viability was discussed in considerable detail at the conference of Ministers of Cooperation held in Hyderabad in June 1964. A primary society, according

to the criteria recommended by the conference, would be viable if it could afford to engage a full-time secretary, set up a regular office of its own, contribute to statutory and other reserves on the scales considered necessary, and pay a reasonable dividend. The survey of societies to establish their viability or otherwise plan their restructuring was left to state governments. In a development which confirmed the correctness of the Bank's judgement and marked a major revision of the position the Union government had adopted since 1957, state governments were asked to delimit areas of operations for primary societies to enable them to develop viable levels of business. Where more than one society existed in a given area, the state government was advised to select one of these as the local society, make efforts to merge or amalgamate other societies with it, and liquidate defunct societies. The viability of the primary society, moreover, was not to be sacrificed to ensure that its jurisdiction coincided with that of the panchayat. State governments were also asked to pay special attention to the difficulties of tribal, sparsely populated, or dry areas, or areas characterized by small landholdings, and to take special measures to make societies in those areas strong and viable.

Progress however remained slow and unspectacular. The responsibility for revitalizing primary societies lay with state governments, many of whom were tardy in conducting surveys and delimiting the area of operations for individual primary societies. Where both steps had been taken, programmes to amalgamate weak societies and liquidate defunct ones were either not formulated, or remained largely on paper. The annual conference of Ministers of Cooperation, which was convened in Bombay in October–November 1965, recommended completing the revitalization programme by 1966–67. The number of primary societies declined as a consequence of the programme from 2,09,622 at the end of June 1964 to 1,91,904 at the end of June 1966. Of the latter, however, nearly 24,000 societies were dormant. On the other hand, the number of villages covered by primary societies increased from 4,69,328 to 5,02,816, during the same period, leaving about 61,000 villages outside the pale of the movement. During these two years, 2.4 million additional members were enrolled, taking the total membership of primary societies to 26.1 million (including 1.5 million members in dormant societies) at the end of June 1966. Loans disbursed rose from Rs 297 crores during 1963–64 to Rs 316 crores in 1964–65, and Rs 342 crores in 1965–66. However, these achievements were well below the targets set for the third plan, of 2,30,000 societies, with a total membership of 37 million, and outstanding medium and short-term loans of Rs 529 crores. The plan had also envisaged 100 per cent coverage of villages by primary societies. In the event, the actual coverage achieved was just under 90 per cent.

There was little consolation for the Bank in the knowledge that the financial underachievement vindicated its judgement, rejected at the time by the government, that the third plan's lending targets were too ambitious and unrealistic. Nor could the Bank take much satisfaction from the fact that the accent of policy had shifted from cooperative expansion for its own sake, as reflected in the initial third plan exercise, to one based on consolidating the cooperative structure and ensuring its viability. Many precious years had been lost in the process, and the setbacks which the cooperative movement suffered during the interval were not easily remedied. Viability too remained a distant dream. Only in Gujarat, Kerala, and Manipur did the average loan business per society exceed Rs 50,000 per year in 1967-68, while recent experience indicated that even this was below the minimum level of business needed to ensure viability. The average turnover was between Rs 20,000 and Rs 50,000 in nine states, between Rs 10,000 and Rs 20,000 in six states, and below Rs 10,000 in four. Equally tellingly, the vast majority of primary societies failed a crucial test of viability: only about 27,000 of them could afford to engage full-time secretaries in 1966-67.

Standardizing Audit

Although the Bank's involvement with cooperative credit institutions expanded and diversified from the 1950s, it obtained statutory powers of control and regulation over the cooperative credit system only in 1966, when certain provisions of the Banking Regulation Act were extended to cooperative societies. Nevertheless, from the earliest stages, the Bank directed attention towards supervision, audit, and inspection arrangements of cooperative banks and societies as a means of monitoring and improving the performance both of individual institutions and of the system as a whole. Training of cooperative personnel was another aspect which attracted the Bank's attention from an early stage.

Only central cooperative banks classified under audit categories A and B were eligible to avail of Bank finance. Subsequently, the Bank agreed to allow banks in the C category into the club, on the specific recommendation of the state government concerned. However, standards of audit classification varied from state to state and were not comparable, and this created some unintended discrimination in the direction of Bank credit to the cooperative sector. The Agricultural Credit Department of the Bank therefore made efforts in the early 1950s to evolve a uniform system of audit classification. The Standing Advisory Committee discussed this in its first meeting in August 1951, and a subcommittee appointed by it recommended certain audit standards for classifying central cooperative banks. These standards were communicated

to state governments in June 1952 after they were approved at an informal conference of Registrars of Cooperative Societies. Bihar and Orissa experienced some difficulties in implementing these standards, but the Bank saw little justification for adopting different standards whilst extending accommodation to cooperative banks. But it proved impossible in practice to enforce audit standards strictly across states.

The Rural Credit Survey also examined arrangements for supervision and audit of cooperative institutions. The Committee recommended making supervision the responsibility of apex and central cooperative banks. However, governments of states where cooperation was not well developed were allowed to appoint supervisors to cooperative financing institutions. Where audit was formally the responsibility of the cooperation department, the Survey proposed making the Chief Auditor independent of the Registrar. It recommended standardizing departmental audit norms in continuation of the efforts already initiated by the Bank, and supplementing departmental audit with professional audit, concurrent audit, and interim audit.

The standardization of audit norms returned to the fore in 1960 in the context of the Standing Advisory Committee's review of the cooperative movement in Orissa. Following the Standing Committee's suggestion, the Agricultural Credit Department undertook a study of audit standards in four states, viz. Madras, Punjab, Uttar Pradesh, and Maharashtra. The study found the standards 'vague'. Nor did definite yardsticks exist for classifying societies. Classification was often distorted by subjective evaluations that were too liberal in some cases or too strict in others. The findings of this study were discussed by the Standing Advisory Committee in February 1961, which referred the matter to a working group comprising the Registrars of Cooperative Societies of the four states, the Chief Officer of the Agricultural Credit Department, and a representative of the Ministry of Community Development and Cooperation. The working group recommended evaluating a society's working under four broad heads, viz. capital structure, credit and financial stability, management, and general working. With most Registrars and the Government of India approving the proposals of the working group, the Bank advised state governments of the revised standards of audit classification of primary credit societies in November 1962. While the weight attached to each head of audit was indicated, state governments were allowed, in consultation with the Bank, to modify these weights to reflect the differential development of those particular aspects of the cooperative movement in their respective states.

In 1964, the Committee on Cooperative Administration recommended audit functions being carried out by a Joint Registrar of Cooperative Societies

subordinate to the Registrar, but heading a separate and independent chain of command for audit purposes. All state governments, with the exception of Uttar Pradesh where audit remained the responsibility of the state finance department, accepted these recommendations.

Supervision of Primary Credit Societies

The Rural Credit Survey recommended keeping audit and supervision of primary credit societies independent of each other. While audit was to be the responsibility of the cooperation department, supervision was to be entrusted to central financing agencies and central and apex cooperative banks. A subcommittee of the Bank's Standing Advisory Committee on Agricultural Credit endorsed these recommendations in 1956, following which the Bank began commending them to state governments for implementation. However in 1960, the Ministry of Community Development and Cooperation opposed following a set pattern of supervision for the country as a whole and proposed leaving decisions in this regard to state governments. While the first conference of Ministers of Cooperation held in New Delhi in 1955 supported the recommendations of the Rural Credit Survey, the Mysore and Jaipur conferences decided that existing arrangements for supervision should not be disturbed if the state government concerned was satisfied with them. The Mehta Committee reviewed the subject keeping in mind the anticipated expansion of cooperative lending activity. It recommended central financing agencies assuming responsibility for supervising the primary credit societies they financed. At the government's instance the matter was placed before the Standing Advisory Committee in February 1961, where the Governor recalled the Bank's consistent advice to state governments to entrust supervision to central financing agencies. The Standing Committee underlined its earlier view that financial supervision should be in the hands of central financing agencies. This view was later seconded by the Committee on Cooperative Administration (1963), which also urged states where supervision was carried out departmentally to transfer the function to central cooperative banks in a phased manner. While a majority of the states accepted this recommendation, Uttar Pradesh, Haryana, Himachal Pradesh, and Jammu and Kashmir preferred to exercise supervision departmentally. In Mysore and Rajasthan supervision was carried out jointly by the cooperative department and the central bank. In Maharashtra, supervisors remained government employees, but were attached to local supervising unions.

Since state cooperative banks occupied an important position in the cooperative credit structure and in the provision or channelling of agricultural finance generally, the Bank considered it useful to subject them to periodic inspections. Accordingly, at the Bank's instance, a few state cooperative

banks were inspected in the early stages by the Registrar of Cooperative Societies. The Bank drew up a detailed format for such inspections. But following the 1951 informal conference, the Bank initiated steps to inspect apex and central cooperative banks that volunteered to be inspected by it. With the Bank gaining more experience of the need for such inspections and its priorities in undertaking them, four regional offices were opened in April 1957 to facilitate regular inspections of cooperative banks. By June that year nearly 200 cooperative banks had been inspected. Of these, 31 were state cooperative banks many amongst which were inspected more than once.

Cooperation being a state subject, the Bank had no statutory authority to conduct inspections of cooperative institutions until its powers of supervision over cooperative banks were strengthened in the mid-1960s as a prelude to extending to them the benefits of deposit insurance.² Nevertheless, even in the 1950s, the Bank contrived to include periodic voluntary inspections as part of its credit agreements with cooperative banks. Well-run banks generally tended to welcome inspections by the Bank. Inspections helped improve functioning and check or correct problems at an early stage. Besides, they were also a means of affirming the creditworthiness and viability of the institution. In later years the Bank expanded the scope of its voluntary inspections to cover central land mortgage banks and apex handloom weavers' cooperative societies. Periodic meetings to finalize credit limits of individual cooperative banks, or debenture programmes in the case of central land mortgage banks, provided the Bank opportunities to monitor banks' compliance with the recommendations of its inspection teams.

THE BANK AND THE GREEN REVOLUTION

It became apparent halfway through the second plan that while food production had increased considerably, faster growth was needed to keep pace with rising consumption needs and the accelerated tempo of industrial investment. As agriculture became more central to development policy, policy to be adopted for the sector came under fierce debate. The Government of India's continuing efforts to liberalize cooperative lending, recounted earlier in this chapter, were intended to help translate the agrarian reforms of the 1950s into higher agricultural production. But debate over agricultural policy was decisively joined towards the close of the 1950s and its thrust deflected when a Ford Foundation team recommended increasing the intensity of cultivation and

² These developments are discussed in chapter 11.

yields through cultivators' adopting a package of 'improved' practices covering seeds, fertilizers and pesticides, implements, and soil and water management.

This 'package scheme' was implemented from 1960–61 as the Intensive Agricultural District Programme (IADP) in 49 of 140 blocks in seven districts spread over as many states. Since the strategy depended on the timely delivery of a package of inputs and services including credit, marketing of produce, and technical assistance to farmers covered by this programme, the Bank, together with the Government of India and the Ford Foundation, undertook studies of cooperatives in the selected districts. It identified several areas for action, including the reorganization and strengthening of primary societies and central banks, better supervision of these institutions, identifying well-run and healthy cooperatives and extending the programme to cover all their members, and timely availability of credit and marketing services. Acting on the Bank's advice, central banks in the programme districts secured special credit limits of Rs 3.57 crores to finance production plans in the first year. The Bank took the opportunity offered by the IADP to rationalize its credit policy and procedures in the package districts along the lines it had sought unsuccessfully to do earlier. In particular, it strove to link credit and production requirements by introducing crop-wise scales of finance for different areas, disbursing credit in instalments both of cash and kind, and effecting recovery through marketing societies.

Intensive Agricultural Areas Programme (IAAP)

A modified version of the IADP was introduced on a wider scale in 1964–65. The new programme was intended to increase the production of crops such as rice, millet, wheat, cotton, sugarcane, and groundnut in selected areas, once again by the coordinated use of material and technical inputs. Priority was accorded to strengthening the cooperative credit structure in the 114 districts selected for this programme, and the Bank and the government drew up an accelerated programme for the purpose in 1964.

The IAAP too gave the Bank an opportunity to put into practice and generalize its preference for crop loans as the principal vehicle of short-term credit. At its instance the basic features of the crop loan scheme were incorporated into the IAAP action plan. Short-term credit needs of members were assessed on the basis of scales of production expenditure which were fixed per acre on a crop-wise basis. Subject to a borrower's capacity to repay, these needs were to be met in full. Practical difficulties in assessing this capacity reliably, led to the latter being fixed, rather arbitrarily as the Bank readily acknowledged, at half the farmer's estimated total cash income from the sale of produce and non-farm income. Short-term loans were given up to two-thirds of this capacity, and the

servicing of medium-term debt (which was generally assessed at three to five times the residual) was expected to consume the remainder. Short-term loans were made in bundles of cash and kind, the precise proportions of the two varying between rain-fed and irrigated crops and on the extent to which the farmer moved his crop through a marketing society.

In 1964 the Bank advised state governments of its decision to evaluate applications for short-term credit limits on the basis of applicants' lending policies according with the crop loan system. Convinced that the time for firmness had come, the Bank threatened to withdraw the liberalized credit limits recommended by the Mehta Committee unless crop loans were introduced expeditiously. The enhanced limits, as the Bank reminded the states, were intended principally to finance the increased demand for credit likely to arise from the adoption of crop loans. The Bank also dropped dark hints about other punitive measures.

There were good reasons for the Bank to adopt a tough posture. Its reports revealed that the crop loans system had been implemented only in Maharashtra and Gujarat, though a beginning had been made in the IADP districts of the other states. There was evidence too, that funds released by liberalization of credit limits were benefiting larger cultivators to the exclusion of the needs of smaller cultivators and tenants. The Programme Evaluation Organization of the Planning Commission also reported that there was a misapplication of cooperative funds to the tune of 20 to 25 per cent. When the Standing Advisory Committee considered these findings in April 1965, a debate ensued on what action might be taken to popularize crop loans. While the Bank was in favour of sanctions and other punitive measures, some members advocated caution because sanctions might affect cultivators and production more than cooperative financing institutions. The wisdom of the Bank's stress on the crop loans system was also questioned by V.P. Johar, Registrar of Cooperative Societies in Punjab, on the ground that it betrayed a lack of faith in the cultivator and his ability to choose the right mix of crops. Crop loans also involved extensive paperwork and necessitated larger staff. Nor was Johar convinced that threats of reduced credit limits would force primary societies in Punjab, which generally had substantial deposit resources of their own, to adopt crop loans.

Following the Standing Advisory Committee meeting, the Government of India convened seven state-level conferences between June 1965 and March 1966 to popularize crop loans. These meetings were attended by representatives of the Planning Commission, the Ford Foundation, and the Bank. The latter prepared a manual on the crop loans system, explaining its objectives, the policy and procedure for fixing short-term and medium-term credit limits for agricultural purposes, and the administration of such loans. The implementation

of the system was reviewed regularly at several conferences of cooperators and officials and at a succession of Regional Conferences on Cooperation where it was resolved to adopt the system throughout the country by 1967–68. Yet, despite a decade having elapsed since the system was first mooted and intense efforts during the mid-sixties, progress in implementing it was uneven. It was particularly poor in Assam, Bihar, West Bengal, and Jammu and Kashmir, and remained partial in several other states.

High-yielding Varieties Programme

The High-yielding Varieties Programme (or HVP) was launched during kharif 1966–67 as part of the new agricultural strategy geared towards achieving self-sufficiency in food by 1970–71. The programme envisaged introducing the newly evolved high-yielding strains of paddy, wheat, maize, jowar, and bajra over fairly large areas. The cooperative departments of state governments recommended launching the programme in the IADP and IAAP districts since the latter had a relatively strong cooperative structure, and that the Bank should relax the terms and conditions of the credit limits it sanctioned to central cooperative banks. The Bank, for its part, assured state governments that the programme would not be allowed to suffer for want of finance and that special credit limits would, if necessary, be sanctioned to cooperative banks. The Bank also agreed to relax two conditions, viz. credit limits at a multiple of owned funds and 'non-overdue cover'. Instead, special credit limits were sanctioned subject to the condition that primary societies would not finance defaulting members and that borrowers would contribute 10 per cent of their loans to acquire shares in their societies. Loans for inputs such as fertilizers were to be disbursed only in kind, loans were to be repaid at the end of the crop season, and finally, borrowers would sell their produce through approved agencies. At the same time, at the Bank's insistence, the government agreed that farmers who were not members of cooperative societies would not be offered credit on terms more favourable than those available to members of cooperative societies. In its turn, the Government of India advised state governments to take steps to strengthen cooperatives in the HVP areas and ensure adequate and timely credit to participating cultivators. The latter once again meant crop loans, strengthening and rationalizing the cooperative structure, enrolling all farmers under the HVP programme in primary societies, and linking credit to marketing. However, of the total limits sanctioned by the Bank of Rs 17.47 crores to fifteen states, only eight availed of loans to the tune of Rs 3.36 crores under the programme during the 1966 kharif season. The poor demand for credit was found to be largely due to cultivators' resistance to new practices, lack of proper motivation and orientation amongst extension

staff, and reduced operational efficiency of central banks and primary societies.

RETHINKING COOPERATION

A strong rural credit structure was imperative to boosting agricultural production. On the other hand, the cooperative credit mechanism on which had principally rested until then the country's hopes of setting up a viable and inexpensive system of making credit available to agriculturalists, remained weak and ineffective at most places. Hence in March 1964 the Bank constituted an informal group, chaired by the Governor, P.C. Bhattacharyya, to review institutional arrangements in the field of agricultural credit. The group's report, which was submitted in January 1965, affirmed that the three-tier cooperative credit structure was the most suitable means of dispensing agricultural credit in Indian conditions. The cooperative credit policies adopted were, according to the group, generally adequate, but they were not always fully implemented. It recommended persisting with existing policies in Gujarat, Maharashtra, and Madras, where cooperation had registered impressive advances. Greater vigour in implementing agreed policy was needed in less advanced states such as Andhra Pradesh and Punjab. The group also identified a number of regions where the cooperative movement was largely sick. These included Assam, Bihar, Orissa, Manipur, Rajasthan, Tripura, and West Bengal. It was no longer realistic, the committee felt, to expect the cooperative credit structure to meet the entire agricultural credit needs of these regions. It therefore recommended the setting up of agricultural credit corporations to supplement the availability of credit in areas which were not effectively served by cooperatives. Credit corporations were however to be temporary and transitional in nature, and strengthening cooperative credit institutions in these states so that they might resume supplying agricultural credit in full, remained the longer-term object. Despite the group's temporizing approach, its recommendation reopened an issue which was thought to be settled earlier, namely the relative merits of cooperative and corporate forms of organizing rural credit services.

The Government of India accepted this recommendation and proposed to introduce the enabling legislation during the course of the year. But the conference of Ministers for Cooperation held in October 1965 revealed the existence of strong opposition to the idea because it was felt to undermine the cooperative movement. Following this conference, it was proposed to convene a joint meeting of concerned state governments, central ministries, the Planning Commission, and the Bank to consider ways in which cooperative institutions might be enabled to meet rural credit needs in areas where they were weak and ineffective. Even as this meeting failed to take place, a conference of

Chief Ministers and Agricultural Ministers convened in April 1966 endorsed the plan for agricultural credit corporations. Not long thereafter, the State Agricultural Credit Corporations Bill was passed by Parliament and it became law in December 1968.

The decision of the Chief Ministers' conference underlined the extent to which earlier hopes for the cooperative movement had given way to disillusionment, and the need for alternative ways in which to meet agricultural credit requirements. In much the same vein, the Government of India began examining the possibility of involving commercial banks and corporate institutions in rural credit. The context for this exercise was provided by plans to farm nearly 40 million acres of irrigated land more intensively, and the increased requirements they entailed for hybrid seeds and fertilizers, and consequently for credit. In general, the government felt it was necessary to review earlier estimates of rural credit requirements for the fourth plan. Besides, it wished to make an assessment of the credit required to finance both farmers and independent marketing and distribution agencies—which would handle vastly increased quantities of agricultural inputs—to fulfil the targets set by the intensive cultivation programme, and review arrangements for meeting it. Finally, the government remained convinced that the Bank had not done enough to liberalize agricultural lending and enable cooperatives to extend larger volumes of short-term credit. To consider these subjects, and more generally that of increasing the availability of agricultural credit, the Finance Ministry decided, in February 1966, to set up a committee of several officials. The committee was to be chaired by G.R. Kamat, Secretary, Planning Commission, and included M.R. Bhide, who had meantime joined the Bank as its Deputy Governor for rural credit.

The Bank was not opposed, in principle, to 'another look', as Bhide referred to it, at estimates of rural credit requirements and ways of ensuring their delivery. However it was not convinced of its necessity. The informal group had recently reviewed the problem, and its recommendations still hung fire. Besides, credit to finance the government's plans for intensive cultivation of about 40 million acres of irrigated land could be met 'well within the target for credit' worked out by the Bank and other agencies. The crop loan system remained the only 'satisfactory solution to the problem of credit for agricultural production', according to the Bank, and the principal problem here was of state governments not implementing agreed policies. The Bank urged the system on state governments 'every year but without much result'. Rather than set up a fresh committee, Bhide informed the Finance Secretary, the central government must use its energies to prevail upon state governments to implement the crop loan system in all earnestness. Bhide also acknowledged

that cooperatives could not be expected to meet the entire demand for agricultural credit. Other agencies, such as 'friends, relatives, commercial banks ... and ... moneylenders' would inevitably have to play a role, the latter for 'quite some time' and the others 'for ever'. However, there was no prospect in the near future, much as the Bank would welcome it, of commercial banks playing a significant role in providing rural credit, Bhide noted.

Visiting Delhi a few weeks later, Bhattacharyya was handed a note by the Minister for Food, Agriculture, Community Development, and Cooperation, containing the views of his Ministry on how best to ensure adequate supplies of credit for the proposed special schemes for agricultural production. The note observed that short- and medium-term credit extended by cooperatives during the fourth plan would fall short of demand, partly because of the loan policies and procedures followed by the Bank. The 'approach', the note added

has now to be need-based rather than resource-based and the Reserve Bank as the national institution for providing resources for agricultural credit will have to accept the responsibility for meeting the entire requirements minus what the cooperative credit structure has been able to raise.

The note went on to suggest a monthly review of applications submitted to the Bank for sanction of credit limits for the high-yielding varieties programme. However, the Governor succeeded in impressing the Ministers for Planning and Agriculture of the need to set up agricultural finance corporations in the states, rather than delay matters by referring the proposal to another committee. He also managed to persuade the Finance Minister of the superfluity of the proposed committee, but agreed, at his instance to set up a committee of the Reserve Bank to 'review the ... state of progress of supply of rural credit' and the role of non-cooperative institutions in this area.

The Agricultural Credit Department of the Bank also began now to take the view that cooperatives could not be expected to meet the entire credit needs of agriculture. Nor would it be proper for the Bank to go beyond the recommendations of the Mehta Committee and lend resources to cooperative institutions without heed to factors such as the extent to which the latter mobilized internal resources or recovered loans, and the inflationary potential of Bank lending. Raising the question of reviewing rural credit and the Bank's policy with regard to it at the Standing Advisory Committee on Rural and Cooperative Credit, as the body had been renamed, when it met towards the end of April, Bhattacharyya expressed concern that there was a 'certain amount of loose talk about the Reserve Bank's attitude [towards rural credit] being rigid'. A 'tripartite' forum, such as the Standing Committee which comprised

the Bank, the government, and cooperators, the Governor said, was a proper forum to discuss the merits of such a view.

The Secretary in the Ministry of Agriculture, B. Sivaraman, who was a member of the Standing Advisory Committee, reported his department's view that the credit programme for agriculture had not been 'properly evaluated' and responsibility for it 'clearly apportioned'. Suggesting that the Bank tended to view agricultural credit as being synonymous with cooperative credit, Sivaraman wanted a study of the ability of other institutions such as commercial banks to supply agricultural credit. Implicit in this suggestion was a wider shift in the approach of the government, which had tended earlier to envisage cooperatives as the principal suppliers of agricultural inputs and services. Thus, Sivaraman stressed that crucial as they were, agricultural credit had to be viewed more broadly than merely as loans to farmers. The agricultural revolution under way involved moving large quantities of new agricultural inputs such as fertilizers, seeds, and pesticides. Inventories of these goods and their movement had also to be financed at various levels, but this was not something the cooperative credit movement, as presently organized, could be expected to do. The Bank, he suggested, should therefore constitute a 'strong committee' to study agricultural credit and 'link up [its] different aspects'.

The Standing Committee approved Sivaraman's proposal, and set up a committee with the limited objective of reviewing the demand and supply of rural credit in the context of the fourth plan and the government's programmes for intensive agricultural production. Out of this decision was born, in July 1966, the All-India Rural Credit Review Committee (Venkatappiah Committee) which included the Deputy Governor, M.R. Bhide. At the Finance Ministry's instance, B. Sivaraman was also made a member of the Committee, whose detailed terms of reference included the review of the 'progress made in the supply of rural credit' by the agencies specified by the Rural Credit Survey, the supply of credit for intensive agricultural production and marketing from all institutional sources including commercial banks, working of the crop loans system, progress of rural branches of commercial banks, measures recommended by the Bank's informal group, and coordination between different agencies involved in rural credit.

The All-India Rural Credit Review Committee submitted its report in July 1969. It made a number of recommendations such as establishing an Agricultural Credit Board at the Bank to deal with all aspects of rural and cooperative credit, Small Farmers' Development Agencies in selected districts to assist small and potentially viable farmers, and a Rural Electrification Corporation to facilitate energizing irrigation pump-sets. It also proposed a more dynamic role for the Agricultural Refinance Corporation, and various

measures to ensure timely and adequate flow of credit for agriculture through both cooperatives and commercial banks. A more detailed examination of this committee's recommendations will have to await the next volume of the Bank's history.

CONCLUSION

The earlier volume of the Bank's history concluded its account of rural credit with the setting up of the All-India Rural Credit Survey. The present chapter brings the story up to the setting up of the All-India Rural Credit Review Committee. The years that separated the Review from the Survey were extremely eventful for India's rural economy, its credit institutions, and the Bank. The Rural Credit Survey gave cooperative institutions the central role in purveying organized rural credit, and an important part of the Bank's efforts during the 1950s and the early sixties was devoted towards fitting these institutions out for their expanded responsibilities. These years were not without achievement. Cooperatives now came to account for nearly a quarter of all rural credit as against the meagre 3 per cent they had supplied at the time of the Rural Credit Survey. In other respects too, the progress of the cooperative movement was impressive in quantitative terms. But the quality of this progress left much to be desired. The movement remained weak and ineffectual in many places, the position with regard to overdues and recoveries remained unsatisfactory, and strong doubts remained about the ability of the cooperative movement to serve the small farmer. The inability of cooperative institutions to raise their own resources also lent a controversial edge to the Bank's role as a financier to the movement. By the mid-sixties, patience with the cooperative movement was clearly wearing thin, and thoughts in the government and at the Bank turned towards alternative means of meeting rural credit needs. So that in some sense, the period ended on a strikingly different note from the one on which it had begun. The Rural Credit Survey had preferred cooperatives to corporations. This preference could not be expressed with as much conviction at the end of this period, and from the mid-1960s the idea of agricultural credit corporations and other institutions such as commercial banks playing a bigger role in supplying agricultural credit began to gain new adherents. In one respect, however, there was little ambiguity. The period ended as it had begun, with search resuming for an answer to the question which had last been asked in the early 1950s, of how best to purvey credit to agriculture.

The Bank's involvement in rural credit flowed from its founding statute and was a source of considerable satisfaction to it. Yet it had also to face constant

criticism for factors that often stemmed from the failure of other agencies involved with cooperation. As the country's central bank, the Bank was statutorily responsible for upholding monetary stability. On the other hand, it could not, even if it so wished, turn its back on the financial needs of the agricultural sector. Hence, while financing cooperatives, the Bank never gave up attempting to ensure that these were sound, viable, and responsible. Equally, the Bank did not wish to see its financing operations substituting for cooperatives raising their own resources. Creating a viable institutional structure was a slow and unspectacular process whose pace, or lack of it, contrasted sharply with popular expectations of rapid progress. The clash of priorities which resulted led to the Bank and the government differing quite fundamentally over the model of organization of primary societies and the principles informing the former's lending to cooperative financing institutions. The Bank largely held its own in these debates, maintaining, without however being dogmatic or inflexible, that its role as the agricultural refinancing agency had to be reconciled with its other responsibilities for preserving the country's monetary and credit stability and ensuring the health and soundness of its banking institutions. Successive committees vindicated the Bank's stand on several of these issues. Yet the pressures for liberalizing lending did not altogether cease, as various lending institutions over the next two decades would discover in different contexts and circumstances.

Table 11: Progress of Cooperative Banks

	Position as at the end of				
	1950-51	1955-56	1960-61	1965-66	1966-67
<i>A. State Cooperative Banks</i>					
1. Number of banks	15	24	21	22	25
2. Membership ('000s)	21	27	30	21	21
3. Share capital	1.58	4.37	18.24	28.82	31.18
4. Reserves	2.22	3.28	5.76	16.13	24.28
5. Deposits	22.08	36.67	72.33	146.51	147.38
6. Borrowings	8.54	19.02	125.32	198.52	199.93
7. Working capital	34.42	63.34	221.65	389.98	402.95
8. Loans & advances	42.12	67.86	258.20	474.22	513.16
9. Outstandings	17.90	34.77	166.69	307.93	325.16
10. Overdues	2.15	3.70	6.97	9.34	16.92
11. State government contribution towards share capital	N.A.	N.A.	6.46	9.86	10.35
	Position as at the end of				
	1950-51	1955-56	1960-61	1965-66	1966-67
<i>B. Central Cooperative Banks</i>					
1. Number of banks	505	478	390	346	348
2. Membership ('000s)	207	300	388	362	352
3. Share capital	4.04	4.37	18.24	28.82	31.16
4. Reserves	4.79	3.28	5.76	16.13	24.28
5. Deposits	37.79	55.71	112.02	236.59	259.32
6. Borrowings	9.75	21.80	141.17	244.99	263.34
7. Working capital	56.37	92.66	304.05	583.52	638.30
8. Loans & advances	82.84	79.83	354.38	771.66	943.53
9. Outstandings	34.14	54.34	220.03	437.72	499.35
10. Overdues	2.96	7.88	27.43	87.05	124.17
11. State government contribution towards share capital	N.A.	N.A.	10.31	19.27	21.63

contd.

Table 11: contd.

	Position as at the end of				
	1950-51	1955-56	1960-61	1965-66	1966-67
<i>C. Primary Agricultural Credit Societies</i>					
1. Number of societies	1,15,462	1,59,939	2,12,129	1,91,904	1,78,735
2. Membership ('000s)	5,154	7,791	17,041	26,135	26,709
3. Share capital	8.40	16.80	57.75	115.32	128.61
4. Reserves	8.86	12.45	17.80	33.60	36.88
5. Deposits	4.48	7.05	14.59	34.49	39.09
6. Borrowings	19.21	42.80	183.78	363.15	420.62
7. Working capital	40.95	79.10	273.92	546.56	625.20
8. Loans & advances	22.9	49.62	202.75	341.75	366.47
9. Outstandings	29.13	59.84	218.00	426.90	477.46
10. Overdues	6.38	14.96	44.30	125.36	160.15
11. Coverage					
(a) Population ('000s)	N.A.	N.A.	1,98,561	3,26,652	3,60,122
(b) No. of villages	N.A.	N.A.	4,22,818	5,02,816	5,07,212

NOTE: All amounts in Rs crores.

SOURCE: *Statistical Statements relating to Cooperative Movement in India*, various years.

Table 12: Progress of Cooperative Land Mortgage Banks

	Position as at the end of				
	1950-51	1955-56	1960-61	1965-66	1966-67
<i>A. Central Cooperative Land Mortgage Banks</i>					
1. Number of banks	5	9	18	18	19
2. Membership ('000s)	10	91	187	403	772
3. Owned funds	65	132	544	1,804	2,246
4. Deposits and other borrowings	32	226	563	1,018	909
5. Debentures outstanding	675	1,494	3,654	17,837	23,200
6. Working capital	772	1,853	4,760	20,659	26,360
7. Fresh advances	133	283	1,162	5,641	5,885
8. Recoveries	46	137	303	1,100	1,600
9. Loans outstanding	598	1,308	3,661	16,326	20,737
10. Overdues	1	115	122	305	450
	Position as at the end of				
	1950-51	1955-56	1960-61	1965-66	1966-67
<i>B. Primary Cooperative Land Mortgage Banks</i>					
1. Number of banks	286	302	463	673	707
2. Membership ('000s)	215	314	669	1,048	1,255
3. Owned funds	69	103	246	1,273	1,599
4. Deposits and other borrowings	588	1,012	2,453	12,420	15,760
5. Working capital	666	1,135	2,699	1,3693	17,359
6. Fresh advances	129	174	717	4,122	4,084
7. Recoveries	46	80	173	999	1,073
8. Loans outstanding	626	1,051	2,466	12,433	15,467
9. Overdues	8	24	64	442	574

NOTE: All amounts in Rs crores.

SOURCE: *Statistical Statements relating to Cooperative Movement in India*, various years.

Unpublished Sources

- G.8 Governor's Correspondence with Government of India,
Ministry of Finance
- AC.107.55-56 Chief Officer's Comments on the Report of the All-India
Rural Credit Survey
- RD.12(IA) Action on the Recommendations of the All-India Rural
Credit Survey
- RD.12/51-55 Action following the Conference on Rural Finance
- PR.209 Conference of State Ministers
- PR.36/57 Agricultural Credit Organization at the National Level
- PR.36/58-60 National Development Council Resolution on Cooperative
Policy
- AC.60 Loans from NAC (LTO) Fund to Various States
- PR.40 Expert Committee on Cooperative Credit appointed by
Government of India
- PR.84 Provision of Agricultural Credit by Commercial Banks
- AC.61 Reorganization of States and Division of Apex Cooperative
Institutions
- PR.7(Gen)-58 Contribution to Share Capital of Cooperative Credit
Institutions
- PR.7(Gen)-60 Loans from NAC(LTO) Fund—General

Memoranda to the Central Board and Committee of Central Board.

TOWARDS A STATE BANKING SECTOR

The formation of the State Bank group remains perhaps the most enduring outcome of the Report of the All-India Rural Credit Survey. Attention was drawn in the preceding chapters to the conclusions of the Survey and its wider recommendations. The nationalization of the Imperial Bank and the formation of the subsidiaries of the State Bank of India differed in matters of detail from the blueprint of the Rural Credit Survey. While the Bank and the Government of India agreed quickly to nationalize the Imperial Bank, they were not always of one mind about expanding the State sector of banking in the manner proposed by the Survey's Report. Discussions about the takeover of state-associated banks also raised in passing, interesting issues concerning the rights of states to own banking companies and the propriety of the Reserve Bank entering the field of commercial banking. Finally, although the State Bank group expanded greatly after it was formed, the impact of its lending activities was felt more on the small industrial sector than in the sphere of rural or cooperative credit. Nor were relations between the Reserve Bank and the State Bank always easy or free of friction, with the former at one time taking the view that nationalization had actually weakened rather than strengthened its control over the group's operations.

This part of the volume too is organized in two chapters. The first chapter covers the story of the formation of the State Bank of India, while the second narrates the takeover of the major state-associated banks.

From Imperial Bank to State Bank

The creation of the State Bank of India in July 1955 followed the passage of the Imperial Bank of India into state ownership. The nationalization of the Imperial Bank represented the culmination of a protracted debate on its role in independent India. Although debate about this role often focused on the bias the bank was believed to have towards European businesses and against indigenous entrepreneurs, and the slow pace of 'Indianization' of its senior staff and management, the Rural Credit Survey Committee saw the proposed State Bank of India as a key part of its integrated system of rural credit. Consequently, the plan to nationalize the Imperial Bank became part of a wider effort to direct the funds of the banking system into certain neglected, but important, sectors of the economy such as agriculture, and spread banking facilities in rural areas.

The Imperial Bank was formed as a joint-stock bank in January 1921 by amalgamating the Presidency Banks of Bombay, Calcutta, and Madras. This amalgamation was a response both to the felt need for a bank which would hold government balances and use them to deepen the country's financial structure, and to the threat which the Presidency Banks felt was likely to emanate from the inroads the London clearing banks were planning to make in India. Almost from its inception, the Imperial Bank had the status of a quasi-central bank, undertaking until the formation of the Reserve Bank of India in 1935, banking functions for the Government of India and other banking institutions and managing the rupee debt of the government. Progressively, from the late 1920s, the Imperial Bank of India also took over some overseas roles hitherto played by the India Office and the Bank of England. Together, these functions marked the Imperial Bank out for a certain special status and some direct and indirect benefits and responsibilities. Several of these responsibilities were transferred to the Reserve Bank of India after its establishment in 1935, and the Imperial Bank of India functioned thereafter principally as a commercial bank. Consequently, the colonial government

relinquished most of the special powers granted to it under the Imperial Bank of India Act, in particular the power to appoint its chief executives (then called Managing Governor and Deputy Managing Governor) and issue directives to the bank on matters affecting national financial policy. But with 382 offices and a third of the country's banking business in 1950, the Imperial Bank remained pre-eminent in the commercial sphere. By this time, Indian nationals owned a majority of the bank's stock, while its management remained largely in European hands.

Although no longer a banker to the government, the Imperial Bank retained and profited from many aspects of its former special status and role. It continued to manage currency chests and treasuries at many centres. This privilege, as an internal Reserve Bank note stated, enabled the Imperial Bank to operate with 'very fine balances'. Under various government rules, quasi-public funds such as accounts of minors, liquidators, local authorities, and courts, were held with the Imperial Bank. No interest was paid on such accounts. The bank was also allowed to issue drafts and telegraphic transfers on treasury offices, for which it charged and retained a commission. The Imperial Bank's close links with the government acted besides, as a magnet for private contractors and other businessmen having dealings with the government. The latter's cheques were credited the same day, while the government accepted deposit receipts of the Imperial Bank in lieu of guarantees by contractors to whom it had issued contracts. Although the Imperial Bank had never been strictly a bankers' bank, it continued to manage clearing houses and accept banks' deposits at places where the Reserve Bank did not have a presence, and grant advances to them. Therefore, the Banking Companies Act recognized the balances scheduled banks maintained with the Imperial Bank as part of the former's cash balances. The Imperial Bank's role as the bankers' bank meant, to a certain extent, that its control over the country's domestic credit system remained, even after 1935, more effective than that of the Reserve Bank.

THE IMPERIAL BANK AFTER INDEPENDENCE

Given the Imperial Bank's special, in some respects even anomalous, position and the climate of opinion in the post-independence period, demands for its takeover by the State were perhaps inevitable, and the subject was raised in the Constituent Assembly within months of August 1947. Responding to a reference from the Finance Minister, Shanmukham Chetty, in January 1948, the then Governor, C.D. Deshmukh, cautioned the government against biting off 'more than we can chew'. There was, in his view, no pressing need to nationalize the banking system or any portion of it when business and

commerce were to be left in the private sector. Major decisions on the banking system were best postponed for a year or two, while a watch was kept in the meantime on its functioning in relation to the developing economic needs of the country. But thanks to political pressures from within the Congress party, the government decided in principle to take the Imperial Bank of India into public ownership, and the Finance Minister disclosed to the Constituent Assembly his intention to do so once technical questions such as the status of its branches outside India were settled.

The government attempted over the next two years to dampen the expectations raised by Chetty's announcement. K.G. Ambegaokar, Additional Secretary in the Finance Ministry, who studied the subject in the early months of 1948, agreed with the Reserve Bank that nationalizing the Imperial Bank was neither necessary nor advisable. He saw some merit in the Imperial Bank's arguments against nationalization, in particular that the latter would remove 'an important financial link between India and Pakistan, ... [and endanger] the bank's business in India'. The government could obtain control over the policies of the Imperial Bank 'without resort to nationalization by assumption of necessary powers under the existing Act'. This view gained ground within the government in the ensuing months, and John Matthai who meanwhile succeeded Chetty as Finance Minister, declared a few months later that the government did not judge it feasible to implement Chetty's intention because of unsettled economic conditions and the likely effects of the step on the investment market. At the same time, he announced his intention to examine the provisions of the Imperial Bank of India Act in order to remove some 'unsatisfactory' features of the bank's working.

The Imperial Bank's future was debated once again in Parliament in November 1950, when some members argued that nationalization would enable credit to be channelled into agriculture and cottage industry. However at this time, C.D. Deshmukh, Matthai's successor as Finance Minister, rejected the demand as not being 'in the best economic interests of the country'.

The Rural Banking Enquiry Committee and its Aftermath

The Imperial Bank of India never therefore receded for long from the political limelight in the early years after independence. Its future role and constitution returned to the fore following the report of the Rural Banking Enquiry Committee (1950). Ironically enough, these matters were entrusted to this committee almost as an afterthought. Matthai's statement about removing the 'unsatisfactory' aspects of the Imperial Bank of India's working evoked a spirited protest from that institution. It also led besides, to a series of consultations between the Reserve Bank, the government, and the Imperial

Bank about what could be done to allay public misgivings about India's principal commercial bank. These consultations culminated in the Finance Minister, John Matthai, and the Governor, B. Rama Rau, attending a meeting of the Central Board of the Imperial Bank in Bombay in October 1949. A proposal mooted earlier to make the appointment of the Imperial Bank's chief executive officers conditional on government or Reserve Bank approval, was canvassed at this meeting and vehemently opposed by the assembled members of the Board. With informal consultations making no headway, Matthai and Rama Rau resolved to ask the Rural Banking Enquiry Committee, which the government had in the meantime decided to set up, to examine the issue. Purshotamdas Thakurdas, who was persuaded with some difficulty to head the committee, attempted from the outset to produce by negotiation with the Imperial Bank, a scheme which might secure its cooperation in the promotion of rural banking. Both he and Rama Rau therefore promoted as part of this scheme the idea of the Imperial Bank having a non-executive chairman appointed with government approval. This proposal was supported by Roderick Chisholm, Managing Director, and a few other Directors of the Imperial Bank, and approved by both Matthai and his successor, C.D. Deshmukh.

The outcome of these consultations was embodied in the report of the Rural Banking Enquiry Committee. The latter was in favour of the Imperial Bank, which was for all practical purposes 'a State-sponsored institution', retaining, and in certain circumstances extending, its pre-eminent position in treasury arrangements. However, in the committee's view, the patronage it received from the State justified the popular expectation that the bank would develop as a national organization. But nationalization was not the best means of achieving this objective. It was necessary in the country's interests that the Imperial Bank retained its commercial character, and 'existing restrictions on its business were quite sufficient' for the proposed ends. The case for bringing the bank under more effective public regulation would be met by the government resuming some of the powers over the institution which it had allowed to lapse upon the formation of the Reserve Bank of India. Whatever the final means adopted, the committee felt, they should not be such as to promote official or political interference in the routine working of the institution.

It would not, in our opinion, be in the interests of the country to do anything which will weaken or impair the organizational and financial strength of the Imperial Bank, towards the building of which the nation's efforts and resources have been spent, and in which the country could take some just pride. This Bank has been

a stabilizing factor through the years of strain and stress and has on the whole provided a healthy tone to the banking structure of the country. There is, undoubtedly, considerable criticism against certain features of the working of this Bank but such shortcomings are, in our opinion, capable of being remedied by legislative and other measures. ... after the changes in the constitution and working of the Bank on the lines suggested by us have been carried out, the present controversies in regard to this Bank will cease

The measures which the committee proposed involved, chiefly, the reconstitution of the top management of the bank. Two alternative proposals were advanced in this connection. According to the first, the Managing Director and Deputy Managing Director of the bank would be appointed with the approval of the Government of India, which would also have the right to demand their removal from office if they ceased to enjoy its confidence. In addition the committee suggested restoring the pre-1935 authority of the government in the bank's affairs, whereby its nominee on the bank's Board had the power to seek postponement or review of decisions bearing on the national policy of the government. In order to make government representation on the Board more effective, its nominees were also to have seats on the Committee of the Central Board. Alternatively, as agreed informally earlier, the Rural Banking Enquiry Committee suggested that the Central Board of the Imperial Bank should be reconstituted on the pattern of other commercial banks, with overall policy and general superintendence being placed in the charge of a Chairman, whose appointment would be subject to government approval, and a Board of Directors, two of whose members would be nominated by the government on the recommendations of the Reserve Bank. The day-to-day functioning of the bank was to be entrusted to a General Manager who would not have a seat on the Board. Responding to other criticisms of the functioning of the Imperial Bank, the committee recommended abrogating the bank's power to execute proxies on behalf of shareholders under general powers of attorney, and granting fuller representation to various regional interests on its Local and Central Boards. The committee also suggested the opening of one or two more local head offices to redress regional imbalances in its operations.

Rather to the surprise and disappointment of those who had laboured to achieve it, the Imperial Bank's management decided, largely it seems at Chisholm's urging, to repudiate the earlier informal understanding and reject the recommendations of the Thakurdas Committee. Worse, its official reaction to the committee's proposals was dismissive, even derisive. The bank's memorandum on the report protested that it could not be expected to expand

into areas where there was no demand for banking services. 'It was wrong in principle for banking facilities to precede the demand for them' The bank's policy was to 'give each place banking facilities commensurate with its importance'. The committee's proposals on banking expansion would involve the government in 'considerable expenditure at a time when the country can ill-afford it for an ultimate benefit which will be definitely long term and highly problematical'. Instead, the Imperial Bank memorandum advised the government to implement a 'scheme for productive works in rural areas' which would 'recompense (it) to a certain extent for the outlay by obtaining free labour or labour at reduced rates' (sic!). Labelling criticism of its functioning in the legislature and elsewhere as 'irresponsible and uninformed', the bank said the arrangements which it carried out on the government's account were 'unremunerative': 'we would willingly consent to our being deprived of Government business if we could do so without causing embarrassment to Government'. The bank also rejected the committee's proposal to reconstitute the Imperial Bank as likely to lead to political and governmental interference in its functioning. The liaison which the committee sought to establish between the bank and the government could be achieved through the latter's nominees on the Board of the bank. In conclusion, the memorandum extended some gratuitous advice to the government in a tone which was not calculated to allay public misgivings about the bank:

The present is no time for dangerous experiments with a perfectly sound Institution and we consider it imperative that the fullest possible consideration should be given to our representation and thereafter the Bank should be left free to carry out its part in promoting the welfare of the country.

The Imperial Bank's memorandum evoked a lengthy, 34-page response from B. Venkatappiah, who at this time was an Executive Director at the Reserve Bank. It is instructive to summarize Venkatappiah's note in some detail since it helped shape the Bank's own views on the issue. Besides, Venkatappiah was the moving spirit behind the report of the Rural Credit Survey and its proposal to nationalize the Imperial Bank, and his note offers interesting insights into the later development. Finally, as we will have occasion to observe later, there is some irony in the fact that some of the tensions between the roles of the Reserve Bank and the Imperial Bank in the Indian banking system, which Venkatappiah suggested were susceptible to resolution through greater official control over the latter institution, remained unresolved for several years after the country's pre-eminent commercial bank came under

the ownership of its central bank.

Venkatappiah was principally concerned to establish that the demand for greater State control over the Imperial Bank was both justified and necessary. In the first place, although privately owned the Imperial Bank was, as the Rural Banking Enquiry Committee implied, 'in large part the creation of the State'. The scheme by which the three Presidency Banks were amalgamated into the Imperial Bank and the new entity entrusted with the business of the government was not intended to benefit only the government. Rather, it was 'at that time a matter of vital importance to their very existence'. It consolidated these banks, stabilized their links with the government, and forestalled the possibility of the latter responding to the widespread fear of London clearing banks securing control of 'certain Indian banking interests' by establishing a State Bank to carry out government business. Finally, even at its founding, the Imperial Bank was expected to be the means of furthering the country's banking development. Its subsequent emergence as the premier banking institution in India was made possible by the 'effort and assistance' of the government both at the bank's inception, and in the course of its functioning.

But for the prestige which accompanied the entrustment to it of Government work and business, the Imperial Bank would certainly not have developed in the manner it has during the three decades of its existence.

The bank received, besides, substantial subsidies from the government to support branch expansion and derived many advantages from its association with the government. Hence there was no merit in the Imperial Bank's view that its relations with the government were 'of a purely current and contractual nature' and of limited purview, and that the services it currently provided to the government represented a 'full discharge' of its public obligations. 'The Bank cannot divest itself of [its] history'; neither could the government and the public be expected to ignore it. It was against this background, Venkatappiah explained, that the Rural Banking Enquiry Committee envisaged the development of the Imperial Bank as a truly national institution, which would deploy its enhanced prestige to extend its activities to new areas.

The note argued that debate about the necessity of bringing the Imperial Bank under greater public control tended to concentrate on matters of detail, while losing sight of 'some fundamental features of the situation'. Complaints about the slow Indianization of the bank's senior staff and management or of the bias in its activities could never be 'well-informed [or] dispassionate'. Nor could these be established without enquiry. Such criticisms, as the Rural Banking Enquiry Committee recognized, reflected a

political carry-over from the past, which will soon lose point as the changed political status of the country makes itself felt; meanwhile, what is called for is a spirit of wise patience rather than a desire to probe and recriminate. ... [besides] the real case for further control does not rest on an accumulation of detailed allegations such as these.

It stemmed instead from the 'actualities of the historical situation and from vital needs of the present' The central fact, which held the key to the whole problem, was that while the Reserve Bank was the

de jure Central Bank of the country, it is the Imperial Bank that, in certain respects and especially in the important sphere of credit, still remains the de facto Central Bank.

Between 1921, when the Imperial Bank was formed and 1935, when the Reserve Bank of India came into existence, the former was both the de facto central bank and a '*State-controlled Central Bank*'. The Reserve Bank of India Act explicitly envisaged the Imperial Bank of India as an 'auxiliary' in the discharge of its responsibilities. But at the same time as the principal was established, the government's powers

over the auxiliary were attenuated to a degree that might have been more appropriate had the auxiliary been no more than an ad hoc agent selected for the purpose of entrusting government balances.

In particular, the government allowed its powers to issue directives consonant with its financial policies to lapse after 1935. Instead, 'coordination' between the bank and the government was effected through the attendance at Central Board meetings of three nominees of the latter. Two of these nominees were non-officials, while the official nominee had no right to vote. Hence between 1935 and 1948, Venkatappiah argued, the country's central banking responsibilities, which had previously reposed in one unit, were effectively split between a '*State-controlled Reserve Bank and a virtually uncontrolled Imperial Bank*'. The anachronism inherent in this arrangement had only increased after the Reserve Bank's nationalization in 1949.

The demand for the nationalization of the Imperial Bank may be wider than the immediate needs of the situation warrant. But, in essence, it is a demand for the restoration, albeit in a modified form, of the entity which existed before 1935. Similarly, what the Rural Banking Enquiry Committee seeks to effect through its

recommendations is the restoration of the entity of Central Banking to the extent necessary for practical purposes, not indeed by the nationalization of the Imperial Bank, but by provision of such control as will ensure the requisite degree of correlation between Government, [the] Reserve Bank, and the Imperial Bank.

In Venkatappiah's view, greater control and coordination were necessary to achieve at least six objectives, some of which were essential even from the point of view of enabling the Reserve Bank to properly discharge its central banking responsibilities. In the first place, control was necessary to enable the Reserve Bank to regulate credit to the best advantage of the country. Although the Reserve Bank, as the central bank, controlled currency, 'credit is largely controlled by the Imperial Bank as the *de facto* bankers' bank'. With its limited presence, the Reserve Bank 'cannot properly regulate credit', and hence there was need for an 'auxiliary' like the Imperial Bank to assist it. Credit was, at present, largely

disbursed by the Imperial Bank to serve its commercial, and not necessarily the larger national, interests. This position is fundamentally unsound, and must be corrected if the Reserve Bank is to play properly its assigned role of the Central Bank of the country.

Secondly, the Imperial Bank, 'which must necessarily be motivated by the desire to earn maximum profits for its shareholders', was capable of neutralizing the central bank's open-market operations. While under the present set-up, the latter could enlist the former's cooperation in undertaking certain specific measures, this was 'basically and legally' an 'unsatisfactory position'. In this regard as well, the additional powers proposed by the committee would ensure that the Imperial Bank's commercial operations would be consistent with the policy objectives of the Reserve Bank. Thirdly, greater control should, as the Rural Banking Enquiry Committee envisaged, enable the expansion of the banking network to under-banked rural areas 'without undue expense to the country', even if it was at some sacrifice to the commercial interests of the Imperial Bank. The proposed arrangements would also ensure that in the event of a national crisis or emergency, the Imperial Bank cooperated positively and effectively with the government without taking shelter behind a 'legalistic attitude', rather than merely abstaining from doing something detrimental to the country's interests. They would further enable the Reserve Bank to mould the policy of the Imperial Bank more effectively in relation to the needs of the Indian banking system, unlike as at present, when

the Reserve Bank is not always able to enforce its views on the Imperial Bank even in such minor matters as the provision of adequate facilities for the exchange of notes and coins to other banks, and the opening of accounts of other banks at the Treasury Pay Offices of the Imperial Bank.

Finally, Venkatappiah argued, greater powers of control would be a 'guarantee against any discrimination by the Bank against Indian business vis-a-vis foreign business'.

The proposal to reconstitute the management of the Imperial Bank was the 'most important' recommendation of the Rural Banking Enquiry Committee, 'and its rejection would amount to the rejection of the whole scheme' put forward by it. In fact, Venkatappiah pointed out, what the committee proposed was for the government to resume its former powers over the Imperial Bank in an extremely attenuated form. Until 1935, the government was empowered to *nominate* two Managing Governors (corresponding to Managing Director and Deputy Managing Director), and issue directives to the bank. The committee did not propose to return the latter power to the government. Even in the former respect, the committee was quite explicit that the initiative to propose candidates for the top positions would vest with the Imperial Bank rather than with the government. The committee's alternative proposal, of a Chairman appointed with government approval, went even further and left the selection of the bank's top executives entirely to its Board.

Venkatappiah felt the 'balance of advantage' lay with the committee's second proposal. The right which the committee proposed should vest with the government officer on the Board of the bank—to ask for a postponement of decisions having a bearing on the national policy of the government and for a review of such decisions already taken—was also 'in consonance with the broad objectives of control', and did not appear 'open to any valid objection'. Allowing its nominees on the Imperial Bank's Board the right to vote would merely amount to giving the government 'a voice, but not an overriding one, in the broad operation of the credit policies of the institution', and would not amount to any 'undue interference' in the bank's routine functioning. Venkatappiah also supported the committee's proposals for democratizing elections to the Imperial Bank's Local Boards to ensure that they were not the preserve of a 'few vested interests', and redressing regional imbalances in its operations. On the other hand, he argued, it was not necessary to insist on the government securing the right to remove from office a top executive of the Imperial Bank who did not command its confidence. The advantage yielded by such a power was debatable, and in any case it was not

‘as fundamental as the power to approve of the original appointment’.

The memorandum prepared for the Central Board of the Bank largely followed, in major respects, the line taken in Venkatappiah’s note summarized above. However, according to Rama Rau, the issue of whether government nominees on the board of the Imperial Bank should have the right to vote was not one of ‘much practical importance’. It was also not necessary or practicable to give them the power to postpone or review decisions on some issues, since ‘in cases of urgency they can always get in touch by telephone with the Reserve Bank, who can take appropriate action’. Nor was the Governor in favour of abrogating proxies executed on the strength of a general power of attorney. The change in the racial composition of the Imperial Bank’s Board, which this proposal was meant to achieve, he felt, could be equally well achieved by drawing the attention of the Imperial Bank to that point. The recommendation to open more regional offices, Rama Rau concluded, should also be left to the decision of the Imperial Bank.

The Governor’s memorandum for the Central Board is dated 18 December 1950. The meeting of the Central Board to discuss the Rural Banking Enquiry Committee’s report and recommendations took place five days later. It is not clear what transpired during the interval or at the meeting itself, but there can be no doubt that item no. 6 on the day’s agenda—‘Government Control over the Imperial Bank of India’—evoked fierce debate. Unusually too, the decisions of the Board differed in important respects from the proposals contained in the Governor’s memorandum. First, and most important, a ‘majority’ of the Board favoured the committee’s first alternative (which, it will be recalled, involved appointing a Managing Director and Deputy Managing Director with government approval). The ‘majority of the Board’ also sided with the Rural Banking Enquiry Committee’s view that the executive of the Imperial Bank should be barred from using general powers of attorney to vote on behalf of shareholders. However, the Governor’s recommendation that the government’s nominees on the board of the Imperial Bank need not have the power to seek postponement or review of important decisions was accepted by the Board.

With the Central Boards of the Reserve Bank of India and the Imperial Bank seemingly headed for a confrontation, Rama Rau decided to make one last effort to achieve a satisfactory resolution of the issue in concert with the latter institution. He initiated consultations with the Bombay-based Directors of the Imperial Bank, and with some Calcutta-based Directors including Paul Benthall, Badridas Goenka, and Chisholm himself. It is likely that the Governor’s hand in these consultations was, perhaps unwittingly, reinforced by the rather ‘hawkish’ mood of the Bank’s Central Board as reflected in its

resolution on the Imperial Bank. Whatever the reason and despite serious differences within the Imperial Bank, these talks appeared to yield, in the end, the fruit which had eluded Rama Rau earlier. Thus towards the end of January 1951 an informal meeting of the Directors of the Imperial Bank of India's Central Board decided, 'by a majority vote', that while a change in the bank's constitution was neither necessary nor desirable, the Imperial Bank would nevertheless offer the government and the Reserve Bank its 'fullest cooperation' in the working of the 'new arrangement on the lines suggested by the Governor of the Reserve Bank in his informal discussions' Rama Rau thereafter convened a meeting of the Bank's Central Board in February 1951 to reconsider the issue in the light of the changed situation and succeeded, with some help from Purshotamdas Thakurdas, to convert the Central Board to his viewpoint. The Board decided to endorse what had by now come to be called the 'second alternative' proposed by the Rural Banking Enquiry Committee. Justifying his stand, the Governor argued in his memorandum to the Central Board that assumption by the government of special powers of control over

a bank which is essentially a shareholders' bank, and has been divested of most of its central banking functions would partake of the nature of an attempt, as stated by the Imperial Bank in their memorandum, 'to nationalize the bank by the back-door' We require the continued cooperation of the Imperial Bank of India to the fullest extent in implementing the recommendations of the Rural Banking Enquiry Committee regarding the development of credit facilities in the country. I would not therefore recommend fundamental changes in the constitution of the bank, to which its Board are strongly opposed and which can hardly be justified under present circumstances

The Imperial Bank of India having been set up by an Act of the Indian legislature, the recommendations of the Rural Banking Enquiry Committee required to be enacted into law before they could take effect. Despite the flurry of activity which followed the committee's report and changes to the Imperial Bank's bye-laws to provide for an expanded government presence on its Boards, the legislative changes needed to change the constitution of the bank hung fire for several months. In the meanwhile, however, relations between the government and the Imperial Bank took a sharp turn for the worse. By January 1953, Roderick Chisholm's term as Managing Director of the Imperial Bank was approaching its end, and thoughts within the bank turned towards nominating a successor. Although no formal legislative changes had yet been made, the Reserve Bank and the government expected, against

the background of the earlier discussions about the bank's constitution and proposals for greater government involvement in the selection of its chief executives, to be consulted about Chisholm's successor. Indeed, according to the impression Rama Rau carried of his conversations with some Directors of the Imperial Bank, the latter had assured him of the bank's intention to keep the Finance Minister in the picture on the matter. But not only was this expectation not fulfilled, there appears to have been a clumsy attempt by the bank to keep the government's nominees on its Central Board in the dark, and to present them with a *fait accompli* when they arrived in Calcutta to attend the meeting of the Board. Their protests on this procedural issue and against the large salary proposed to be paid to the new Managing Director, were not even recorded in the Board's proceedings, much less heeded. The Imperial Bank also rejected as 'impracticable' the government's subsequent suggestion, conveyed to it by Rama Rau, that its decisions on Chisholm's successor and his salary should not be implemented until the Finance Minister had had an opportunity to meet with some members of the bank's Central Board in Bombay the following week. Chisholm's response to the Governor's letter conveying this suggestion ended on a somewhat defiant note.

... I would say that there has recently been a recrudescence of rumours regarding nationalization of Banks and Insurance Companies while in connection with the two appointments under reference there has been a good deal of propaganda and canvassing on behalf of outside aspirants. All this unwarranted and undeserved publicity is already having its effect on this Bank's credit and standing and it is now, in my opinion, abundantly clear that, if Government nationalizes us it will undoubtedly accomplish the Bank's almost immediate ruin. We have had threats held over us for over five years and the cumulative effect of this uncertainty is beginning to show in spite of our hitherto strong position. If Government wish to nationalize the Bank they should now proceed to do so as we cannot wage an incessant struggle to protect our name and credit but if not they should clearly say so and leave us free to restore our position. It cannot be gainsaid that the Bank holds the bulk of India's trade together at the present time and has a great part to play in the fulfilment of India's five year plan but, if Government's present policy is persisted in, it can only result in our deposits being withdrawn and our business ruined.

The Bank, and in particular Rama Rau, attempted as in the past to apply the emollient. These efforts included hosting a meeting between the government

and some Directors of the Imperial Bank attended by the Finance Minister, C.D. Deshmukh. At the same time, however, the Bank's attitude towards how best the Imperial Bank could be persuaded to undertake a more active role in promoting banking in rural areas began to undergo an important shift prompted at least in part by the bank's tardy expansion into rural areas and its often blunt refusal to cooperate with the Reserve Bank even on questions such as better facilities for the circulation of currency and coin in the more far-flung regions. Remarking on T.T. Krishnamachari's proposal that the government should legislate to implement the 'first alternative' proposed by the Thakurdas Committee rather than the second, Rama Rau told the Finance Minister in August 1952 (some months before the controversy over Chisholm's successor erupted) that the Imperial Bank's Indianization programme was proceeding on schedule. Neither was there any evidence that it favoured European firms in granting advances which, in any case, were being monitored by the government director on the bank's board. The unfair advantage of remittance and other facilities which the Imperial Bank was earlier said to enjoy was now a thing of the past, as following the recommendations of the Rural Banking Enquiry Committee, other scheduled banks too could avail of remittance facilities. However, the Governor emphasized, it was necessary to examine the role of the Imperial Bank in relation to the needs of the planned development of the country. The pace of its expansion in rural areas, for example, remained slow mainly because of 'considerations of possible losses'. The 'influence of the profit motive' was

inevitable so long as the Directors and Executive Officers are responsible to the shareholders for the management of the Bank. If a partial nationalization is to be undertaken for a rapid expansion of credit facilities, the proposal for the appointment of the Managing Director and the Deputy Managing Director by Government would not achieve the object, for these officers would still be responsible wholly or partly to the shareholders. Indeed, their position would become impossible if they have divided responsibilities to the Government and the shareholders. If control by Government is to be effective, the Government must hold, at any rate, a majority of the shares, if not all the shares.

The Governor told the Finance Minister that the time had therefore arrived to

consider the question of the nationalization or radical changes in

the constitution of the (Imperial) Bank from the point of view of planned development of the country

and promised him that he would

re-examine the whole issue afresh from the point of view of development of banking and credit facilities after I have had the Report of the Rural Credit Survey, which ... is considering the question of the lines on which credit facilities should be extended to rural areas.

The Rural Credit Survey Report and the Imperial Bank

The Report of the Rural Credit Survey proposing among other things the nationalization of the Imperial Bank, was drafted in the early months of 1953 largely by B. Venkatappiah and A. D. Gorwala. Venkatappiah's note on the Imperial Bank of India, which was summarized at some length above, was clearly a major influence helping to form Rama Rau's latest views on the appropriate context within which to re-examine the future of India's largest banking institution. Although he made a formidable case for bringing the Imperial Bank under public ownership, Venkatappiah was clearly constrained at this stage by the recommendations of the Rural Banking Enquiry Committee and the prior agreement regarding the bank's future constitution which Rama Rau, Thakurdas, and Matthai had worked out in consultation with Chisholm. With the Rural Credit Survey examining the issue afresh, Venkatappiah may have felt more free to develop the arguments in the note to their logical conclusion. Thus as early as February 1954, he had made up his mind that the objective of expanding rural credit and banking could not be met without nationalizing the Imperial Bank.

Yet in doing so, Venkatappiah was moving ahead of opinion within the Bank and the government. Visiting Delhi in March that year, Rama Rau was told by S.G. Barve, Joint Secretary in the Ministry of Finance, about 'certain rumours' he had heard of 'drastic proposals' the committee reportedly had in mind for the Imperial Bank of India, and that the Finance Minister was 'rather disturbed' by them. Writing to Venkatappiah on the basis of this conversation, the Governor reminded him of the advice he had given earlier, that the committee should

as far as possible ... indicate what additional functions or responsibilities the Imperial Bank should undertake in connection with the financing of rural areas, and ... leave it to the Government and the Reserve Bank to decide what changes in the constitution

of the Imperial Bank should be made with a view to the implementation of your proposals.

Rama Rau added that he would appreciate an opportunity to discuss the issue with Venkatappiah and 'perhaps' the other members of the committee 'before you finalize your recommendations in regard to the Imperial Bank'.

It is not clear whether such a meeting took place and whether Venkatappiah and other members of the committee persuaded the Governor, and he the Finance Minister, that it was necessary to bring the Imperial Bank under public ownership before it could be expected to play its due role in the economic development of the country. But what is clear is that the Governor did not have the opportunity he had earlier anticipated of being able to determine the future constitution of the Imperial Bank, and that he quickly fell in line with the Rural Credit Survey Committee's State Bank plan. By July 1954 Rama Rau had received a draft report of the committee, which included the State Bank plan. Not long thereafter, he forwarded the draft report to the Finance Minister chiefly in order to ascertain whether its proposals

particularly those relating to the State-domination and partnership of an important sector of commercial banking would embarrass [the] Government if they were to be made in the final report of the committee.

The government decided, after a brief consideration of the various issues involved, that it could not take an immediate view on the merits of the proposal, and to confine its preliminary response to seeking formal consultations with the Bank in advance of the formal publication of the report.

In the event, the Report of the Rural Credit Survey Committee proposed bringing the Imperial Bank of India into public ownership and entrusting it with the responsibility for spreading banking facilities to the remoter regions of the country. To this end, the committee recommended the formation of a new bank, to be called the State Bank of India, by amalgamating the Imperial Bank of India with the ten major banks associated with the former princely states. (The ten major state-associated banks were the State Bank of Saurashtra, Bank of Patiala, Bank of Bikaner, Bank of Jaipur, Bank of Rajasthan, Bank of Indore, Bank of Baroda, Bank of Mysore, Hyderabad State Bank, and Travancore Bank.) The State Bank of India was to be the principal instrument for extending modern banking to the rural areas, and of linking it with the needs of cooperative credit and marketing institutions. Hence one of the first tasks of the new bank would be to draw up a programme for expanding its

presence in rural areas.

The response of the financial press to the State Bank proposal was far from warm, and contrasted quite markedly with the reception accorded to the other recommendations of the Credit Survey Committee. To *The Hindu*, the State Bank proposal was another proof of the 'Statist' approach to cooperation which the report in its view embodied, while *Capital* criticized the committee for overreaching itself and providing 'uncertain crutches' to an 'ancient and unwarranted proposal':

That the largest joint-stock bank in the country should fall under State-control, that the whole structure of commercial banking should thereby be disrupted and that a formidable blow should be struck at the confidence of private industry, all in order that remittance facilities be improved in the backwoods is an astonishing suggestion to issue even from so academic and unpractical a quarter.

The government's prompt acceptance of this recommendation, which, as discussed below, was announced in the Parliament at the same time as the Report of the Rural Credit Survey Committee was made public, also came in for comment. *Eastern Economist* believed the former had thereby 'dramatized its interest' in the proposal, while *Capital* saw the move as part of the government's 'lurch to the Left' which had left businessmen 'confused and uncertain'.

CREATING THE STATE BANK OF INDIA

Whatever his earlier reservations, Rama Rau appears to have been converted to the arguments of the Rural Credit Survey Committee regarding the necessity for bringing the Imperial Bank under public ownership. In the course of a seventeen-page letter written on 10 December 1954, the Governor informed the Finance Minister, C.D. Deshmukh, of his support for the recommendation and advised him to make an early announcement of the government's intention to implement the State Bank proposal. It was 'imperative' for the success of the Credit Survey's wider proposals that there was 'effective control over the ... Imperial Bank' so as to ensure that its policies were 'in consonance with ... national policies' The Imperial Bank's refusal in the past to cooperate with the government and the Bank in spreading banking facilities suggested, in the Governor's view, that it would otherwise be impossible to implement the Rural Credit Survey's comprehensive scheme for rural credit. According to the Survey, a major obstacle to the establishment of cooperative banks in

rural areas was the absence of facilities for the cheap and ready remittance of cash. 'Only the Imperial Bank (through the currency chests it gets from the Reserve Bank) can offer such facilities'.

In Part A and Part C states alone, according to the Rural Credit Survey, the Imperial Bank had no presence in more than ninety district towns where treasury work continued to be managed by state governments. In addition, there were 210 subdivisional treasuries at centres where the Imperial Bank had no branches, which were managed by state governments. It was vital to convert these non-banking treasuries into banking treasuries as soon as practicable, both to facilitate the expansion of commercial and cooperative banking into rural areas, and to enhance the 'efficacy of ... management of the Reserve Bank's currency chests'. Only the Imperial Bank was equipped to carry out this task. But since it would not voluntarily open branches in undeveloped areas, it had to be '*made*' to undertake the responsibility. This would, however, be possible only if the State assumed 'major ownership, and along with it effective control ...' over the Imperial Bank. More generally, Rama Rau argued, it was essential for India's planned agricultural and industrial development that the Reserve Bank should be supplemented by a powerful commercial banking structure, which was under the effective control of the State, and positively aligned with its aims and objectives.

The Governor observed that 'effective State control' could not be secured unless the government held at least a majority of the shares, and appointed the majority of the Directors and the top executives, of the proposed bank. The Survey report proposed vesting majority ownership in the government by issuing additional capital, and without disturbing the ownership of the existing share capital. In this way, what would come into existence was not a 'fully "nationalized"', but a "State-partnered" banking institution in which there will be a mixed pattern of shareholding ... with the State as the major partner'. Rama Rau however differed from the Rural Credit Survey Committee in his belief that it might not be practical to integrate, in one quick and comprehensive operation, the Imperial Bank with the other state-associated banks. Hence he proposed that the former should first be taken up for reconstitution, while similar arrangements could be worked out in relation to the other banks which also differed significantly among themselves, once the creation of the State Bank was out of the way.

In accepting the Credit Survey proposal, the Governor added, the government would merely be reaffirming 'the essence of previous decisions on this subject'. He also proposed that the government's announcement of its decision to nationalize the Imperial Bank should coincide with the publication of the Report of the Rural Credit Survey Committee. Such a course would

help eliminate any uncertainty in the minds of its shareholders, constituents, and others regarding the bank's future, and enable the detailed issues to be settled speedily and with minimal dislocation. Possibly expecting some opposition to the move from members of the Reserve Bank's Central Board, Rama Rau also suggested that an early decision by the government would 'assist' the Board in its deliberations on the issue. He cautioned the Finance Minister, however, that in announcing its decision to acquire control of the Imperial Bank, the government should also make clear its intention to leave the 'private shareholder ... in undisturbed possession of his existing shares or their equivalent'

There were a number of reasons why the Bank thought that the prudent course lay in the government signalling its intention to protect shareholders' interests in the Imperial Bank. The latter had a total paid-up capital of Rs 5.625 crores, made up of 75,000 fully paid shares of Rs 500 each, and 1,50,000 partly paid shares of Rs 125 each. According to the committee's proposals, existing Imperial Bank shares would be replaced by State Bank shares of the same face value. These were to be designated as 'A' shares. A further series of shares, designated 'B' shares, would be issued at par to the government and the Reserve Bank. These were to be non-transferable and carry a maximum dividend of 5 per cent, but would give the government a disproportionately large voting power in relation to its stake, since the 'A' shares were trading in the market for Rs 1,700.

There was some apprehension that these terms might, on becoming more widely known, cause an adverse movement in the market for Imperial Bank shares. All but a very small fraction of the shares of the Imperial Bank had been bought by their present holders in the secondary market. About two-thirds of the bank's shareholders held less than ten shares each and another quarter held fewer than a hundred shares. Hence, apart from suffering capital losses, there was a risk that the smaller shareholders might make distress sales of their holdings in a falling market. There was consequently some nervousness that a fall in the prices of its shares might erode confidence in the bank and lead to a run on its deposits. Although a run might be checked easily enough through central bank intervention and assumption by the government of responsibility for the bank's deposits, it would still mean a poor advertisement for the new institution and the government.

Hence the Bank proposed that the government should affirm its decision to compensate the shareholders of the Imperial Bank on the basis of the market value of their shares. There was little debate on this issue either within the government or between the government and the Bank. Shanmukham Chetty's announcement in 1948 had already promised compensation to shareholders

based on the market value of their holdings in the event of the government taking over the Imperial Bank. The Law Ministry confirmed that any other method of calculating compensation ran the risk of being bad in law. The Finance Ministry too took the view that compensation at prices below those prevailing in the market would be unjust to the bank's shareholders, who by and large were not speculators, and shake popular confidence in the capital market which was already very narrow in India. Finally, in the Ministry's opinion, it was essential to accomplish the 'boldest act of economic statesmanship ... in our planning effort ... with the minimum gratuitous disturbance', and any controversy over compensation would cast doubt over the whole scheme, and the government's motives for undertaking it.

In addition to reassuring shareholders, the Bank was also keen to calm fears that the State Bank would not make adequate credit available to the established constituents of the Imperial Bank, or that government ownership might impair the confidential relationship between banker and client. Hence it wanted the government's announcement of the State Bank scheme to be accompanied by an assurance that it would allow unimpaired credit and banking facilities generally enjoyed by commercial and other institutions, and that it would not attempt to undermine the usual confidence between the bank and its clients.

Although the notice given to it for such a major decision was rather short, the government accepted the principal recommendations of the Credit Survey Committee about the Imperial Bank of India in time for the report's scheduled release. Announcing its decision shortly before the report's release during a debate on economic policy in the Lok Sabha on 20 December 1954, the Finance Minister said this was the first step towards establishing an integrated commercial banking institution catering to the entire country. He also affirmed the government's intention not to disturb other parts of the banking system which would continue to remain in private hands. Clarifying that the decision to take over the Imperial Bank was based on economic, rather than doctrinaire, considerations, he announced that shareholders of the Imperial Bank would be compensated at market value, with the first Rs 10,000 being paid in money and the remainder in the form of redeemable government securities. He also held out the assurance that commercial and other interests would continue to receive the highest consideration at the new bank which would preserve the usual confidential relations with its clients. It is interesting to note that despite these assurances, the deposits of the Imperial Bank of India fell from Rs 203 crores in January 1955 to Rs 184 crores in June 1955, before recovering to Rs 202 crores in December.

While accepting the Rural Credit Survey Committee's recommendations in principle, the government had a number of misgivings about the shareholding pattern it proposed for the State Bank of India. It sought the Bank's opinion on whether, in the case of mixed shareholding, the State's shares would be held by the Bank or by the government. There were also questions as to whether private shareholders would be individuals, or banks and financial institutions. Besides, doubts were raised about the manner in which the government might acquire its majority stake in the new bank. The suggestion to acquire all partly paid shares, and thereby secure two-thirds voting power, was believed by officials in the government to be tantamount to acquiring majority control with minority investment. This might be regarded as 'depriving' other shareholders in the bank of their property rights. The Law Ministry also opined that the committee's proposal, for the new bank to issue fresh capital at par to the Bank and the government to give them a majority stake and controlling interest, might violate Art. 31(2) of the Constitution. As mentioned above, the Bank was in favour of leaving private shareholders in undisturbed possession of their shares, and of allotting additional shares so that not less than half the expanded share capital vested in the central government or with itself.

In the end, however, the ownership pattern of the new bank's shareholding and the manner of its functioning were left to the Reserve Bank to determine. The only condition imposed by the government on the Bank was that the State should, at all times, hold at least 55 per cent of the shares of the State Bank. The relatively free hand it was given in the matter originated in the government's belief that thorny questions of the relations between the State and the private sectors in the banking industry were best left to the Bank to resolve. Besides, the latter would also be able to safeguard the new institution from political and administrative pressures and ensure its adherence to sound banking principles and high standards of business even while orienting its policies broadly towards the desired ends.

The management of the Imperial Bank was, naturally enough, unhappy with these unfolding developments. Its Central Board met early in January 1955 to 'respectfully' protest against a decision which had been reached without giving the bank a chance to be heard on the matter. The Board regretted that the Imperial Bank was not given an opportunity to place its views before the Rural Credit Survey Committee, and that the latter did not adequately explore the possibility of establishing a suitable machinery for meeting rural banking needs without the State assuming control over the Imperial Bank. But bowing to the inevitable, the chief executives and the Bombay- and Madras-based Directors of the Imperial Bank called on Rama

Rau to discuss the modalities of the proposed takeover. They represented that shareholders of the Imperial Bank should be compensated on the basis of share prices ruling at the time when Shanmukham Chetty first announced the government's intention to nationalize the Imperial Bank. They also proposed that the State should avoid doing anything to dilute the dividend on Imperial or State Bank stock. Should voluntary sales by existing shareholders prove insufficient to give the State major ownership, the latter should take recourse to compulsory acquisition of existing shares, rather than issuing new capital. The risks to private shareholding, in general, of such a precedent, they felt, were worth taking in order to prevent any dilution in the dividend of the Imperial Bank. The Directors of the Imperial Bank were also of the view that the State should sell its stock in excess of what was required to give it control, to private investors without laying down any precise rule for their distribution to banks and other financial institutions.

The Central Board of the Bank met on 24 and 25 January 1955 to consider the State Bank proposal. In his memorandum to the Board, the Governor suggested that the State should acquire all the shares of the Imperial Bank, with compensation being paid in the form of money, redeemable bonds, and to a limited extent, shares of the new State Bank. Though the Rural Credit Survey Committee envisaged shareholding in the State Bank to vest partly with the government and partly with the Reserve Bank, the Governor proposed that it should vest in the latter alone. He cited precedents of central banks in other countries having a majority stake in major commercial banks in their country. As the Bank's Department of Banking Development which now held operational responsibility for effecting the transition of the Imperial Bank to public ownership saw it, there were several advantages to such a course. Ownership by the Bank would prevent the State Bank degenerating, despite any separate corporate existence it might have, 'into a Department of Government subject to its traditional and rigid restrictions'. It would enhance public confidence, prevent governmental interference in the bank's daily business, and enable it to 'retain ... operational and financial initiative'. Moreover, it was logical for the State to become a 'partner' of the new bank through the Reserve Bank, since under the arrangements proposed by the Rural Credit Survey and following which the State Bank scheme was being implemented, the latter would serve 'more or less as the agent' of the central bank in several spheres of activity.

The Governor accordingly proposed that on 1 July 1955, the Reserve Bank of India would acquire full ownership of the State Bank, and that at no time thereafter would it hold less than 55 per cent of the share capital of the bank. It was proposed that the new bank should have a minimum paid-up capital of

Rs 5.625 crores and a maximum of Rs 12.5 crores so that, should all existing shareholders of the old bank opt for taking their entire compensation in the form of shares in the new and the government accede to their demand, additional shares could be issued. The authorized capital of the new bank was to be Rs 20 crores. There were differences within the Bank on the principle, as the Department of Banking Development called it, of 'compartmentalization of the share capital reserved for private investors' since it would affect the popularity of these shares and, by leading to a certain degree of concentration, militate against the idea of spreading the State Bank's ownership widely across the country. But the Governor appears to have been persuaded of the advantages of encouraging important clients of the Imperial Bank to acquire a voice in the running of the State Bank, while at the same time preventing any single voice from drowning those of other private shareholders. Consequently, he proposed that the bulk of the 45 per cent of the share capital which might not be held by the Bank, would be held by scheduled banks, insurance companies, financial institutions, etc., subject to prescribed limits for each category. In order to encourage institutional investment in the shares of the new bank, he proposed a minimum dividend of 4 per cent. In addition to the Bank's regulatory and supervisory powers, the government, in consultation with the Governor and the Chairman of the State Bank, was to have powers to issue directives to the latter on specific matters of policy. The public objectives for which the new bank was being set up required a programme of rapid branch expansion, particularly in the rural areas, which might conflict with sound commercial banking practices. Hence it was decided to establish an Integration and Development Fund out of the Reserve Bank's share of the dividends declared by the State Bank to meet annual losses in excess of Rs 15 lakhs on the proposed branch expansion programme.

There was some criticism in the Central Board of the move to nationalize the Imperial Bank. Lala Shri Ram, for example, thought the step was 'unwarranted by the grounds adduced' and 'definitely prejudicial to the private sector of industry, trade, and commerce' whose confidence in the government's policies was thereby 'badly shaken'. However, perhaps because the government's decision in regard to it was already an established fact when the Board convened, there was, other than this, little discussion of the merits or otherwise of the State acquiring control over the Imperial Bank. Discussion centred instead around the pattern of shareholding in the State Bank, the compensation package, and the composition of its Board of Directors.

The Board welcomed the Governor's proposal to vest the major ownership of the share capital of the State Bank wholly, rather than partly, in the Reserve Bank. The proposal to prescribe category-wise limits for the ownership of the

minority stake in the new bank evoked some criticism, with members such as B.M. Birla arguing that these limits would affect the marketability of the bank's stock. Birla also did not favour stipulating a guaranteed minimum dividend on these shares, since in practice, the ceiling on the dividend would be set at this 'minimum' level. Besides, the stipulation could enhance the risk of political intervention in the bank's affairs since, in some years, a government subsidy may be needed to give effect to the guarantee. Birla also suggested that compensation should be based on the average market value of the Imperial Bank's shares over two years rather than one year as proposed, and that the bonds proposed to be given in compensation should be of relatively shorter maturity. Purshotamdas Thakurdas suggested that stamp duty, transfer fees, or other charges should be waived in cases where compensation partly took the form of shares in the new bank. Following these interventions, the Board elected to recommend payment of 'fair compensation' to shareholders of the Imperial Bank.

There was also some discussion of the composition of the Board of Directors of the new bank. The Central Board noted that the State Bank's board would eventually comprise fourteen nominated and six elected directors. Six of the former would be officials and executives of the bank, so that eight of the fourteen non-official directors would be nominated, and only six elected. Birla thought it was unnecessary to load the State Bank board with so large a nominated element, since the State would always own 55 per cent of the new bank. Both Rama Rau and D.R. Gadgil pointed out that nominated non-official directors would be experienced men connected with commerce, industry, banking or finance, with at least two of the six members being experts on cooperation and the rural economy. These members would have no mandate from the government to vote in a particular way and could be trusted to exercise their votes in the best interests of the institution they led.

With the Central Board approving the State Bank plan, work began in earnest on the modalities of implementing it. The Bank sought legal advice on whether its acquisition of the shares of the Imperial Bank could be challenged in court on the ground that it would not be for 'public purposes' and that it would benefit an individual corporation rather than the State. The opinion it received was that the extension of banking facilities in rural areas could be justified as directly fulfilling a public purpose. The Bank was also advised that the acquisition of the shares of the Imperial Bank would be on the basis of a 'valid classification' and not violative of Art. 14 of the Constitution. Of the two possible courses, namely continuing the corporate character of the Imperial Bank while changing its name to State Bank of India, and that of creating a new corporation in which would vest the assets

and liabilities of the older bank upon its ceasing to exist as a legal entity, the Bank's legal advisers preferred the latter. The same statute in their view, should authorize the Bank to acquire by purchase all the shares of the Imperial Bank. The counsels also agreed with the Bank that market value represented 'fair compensation' which could be paid in cash and bonds, and at the option of the individual seller, partly in the form of shares in the new bank.

The draft State Bank legislation was framed on the basis of these opinions. Following discussions between the Bank and the government, it was decided to compensate shareholders of the Imperial Bank at the average of monthly opening quotations for a period of twelve months preceding Deshmukh's announcement in Parliament of the government's intention to acquire control of the Imperial Bank. Accordingly, shareholders were to receive about Rs 1,765 for every fully paid-up share of Rs 500, and about Rs 431 for every partly paid-up share of Rs 125. Shareholders whose names stood registered in the books of the Imperial Bank through the period from 19 December 1954 to 30 June 1955 would be entitled to receive up to Rs 10,000 of their compensation in cash. The remainder of the compensation was to take the form of 3.5 per cent National Plan Bonds 1965, and at the option of the shareholder, up to 200 State Bank shares at Rs 350 per share.

The State Bank bill, drafted with some despatch, was considered by the Bank's Board in February 1955. The Board suggested that of the state-associated banks, only the State Bank of Saurashtra, the Bank of Patiala, and possibly the Hyderabad State Bank should be considered for amalgamation with the new bank at the present stage, and that it was not necessary for the central government to guarantee the new bank's deposits. It also recommended the setting up of an Executive Committee to deal with policy matters, which would have a wide membership covering all regions. Besides, as part of the effort to secure a balanced regional dispersal of the activities of the country's pre-eminent commercial bank, the Board proposed the formation of a Loans Committee, with local directors as members, which would meet frequently in the area served by the branch register. Among other things, this arrangement was expected to afford the Directors of the State Bank opportunities to participate in meetings at places where the full board of the bank was unlikely to meet.

For a number of reasons discussed elsewhere, the Bank and the government decided to proceed, in the first instance, with the takeover of the Imperial Bank, and defer for the time being the takeover of banks associated with the princely states. The bill to constitute the State Bank of India and to transfer to it the undertaking of the Imperial Bank of India was introduced in the Lok Sabha on 22 April 1955. Introducing the bill, the Minister of State for Revenue

and Defence Expenditure, A.C. Guha, stressed that the purpose of the bill was not merely to take over the Imperial Bank, but to 're-create our rural life, to vitalize and strengthen our peasantry, and to rejuvenate ... rural areas'. Referring to the funereal remarks which the head of the Imperial Bank addressed to his Board at its last meeting, Guha said no swan song or funeral oration was warranted. Though the Imperial Bank had served the interests of the country, it had outlived its utility in its present form.

The bill was generally welcomed by the House, though some members such as Asoka Mehta took the opportunity to demand the nationalization of all banks and insurance companies. Some members also thought the compensation terms far too generous. Intervening in the debate, the Finance Minister, C.D. Deshmukh, defended the government's decision to honour the assurance given in 1948 that compensation to shareholders of the Imperial Bank would be based on the market value of its shares. While observing that the government would not always be bound by this precedent, he pointed out that the formula was justified in the case of the Imperial Bank as the majority of its shares were in the possession of small holders. Besides, the bank's intrinsic worth was greater than the proposed compensation. Striking a more modest note than the one struck by his colleague earlier, Deshmukh cautioned members against harbouring exaggerated hopes for the new bank. Rural credit would not be its only function, neither was it a proper agency for long-term credit to agriculture. If the bank expanded into the rural sector, 'we shall have various advantages like marketing and when warehouses come up we shall be able to take even crops against pledge loans'. At the same time, it was important that members did not 'overestimate our intentions in starting this particular bank'.

The bill was passed by Parliament on 30 April 1955, and received the President's assent on 8 May. The location of the headquarters of the bank aroused some discussion. In one of its last meetings, the Board of the Imperial Bank, while decrying the takeover move and resolving to represent against it to the government, also took the time to pass a resolution asking the Finance Minister, oddly enough, to persist with the practice of rotating the Central Office of the bank between Calcutta, Bombay, and Madras. It is not clear whether this resolution was an effort to draw attention to the parochial origins of the Imperial Bank, or whether some members of its Board hoped thereby to provoke a controversy that might dissipate the takeover exercise. The subject was also raised in the meeting of the Reserve Bank's Central Board by Dharendra Nath Mitra. The Chief Minister of West Bengal, B.C. Roy, too, objected to the bank's head office being shifted to Bombay since the Calcutta circle dominated the other circles (viz. Bombay and Madras) in deposits,

advances, and branches.

In the end the issue was resolved smoothly enough. The balance of advantage was judged to lie in favour of a settled rather than a migratory head office for the new bank. Defending the idea against Roy's criticism, Rama Rau argued that a mobile central office would weaken coordination between the Reserve Bank and the State Bank which was needed to implement the recommendations of the Rural Credit Survey Committee. The Bengal circle's domination owed to the larger area it covered and the proposed creation of a local head office in Delhi covering the northern parts of the country, he explained, would present Calcutta's former pre-eminence in a proper light. Moreover, apart from being the country's principal financial and investment centre, Bombay was host to nearly three-quarters of the Imperial Bank's shareholders. A similar pattern would also obtain in respect of shareholding in the State Bank. All these factors, in the Bank's view, made Bombay the logical place at which to locate the head office of the country's largest financial institution. The Governor also stressed that local head offices, local share registers, and a large measure of delegation of power to local boards would ensure that the interests of the other regions were not ignored. Finally, he pointed out, Directors on the Central Board of the State Bank would be nominated after taking into account regional and territorial considerations, and that meetings of the Board would frequently take place outside Bombay. The Bank's intervention proved decisive, and the State Bank of India's headquarters came to be located in Bombay where Deshmukh inaugurated it on 1 July 1955. John Matthai, who as Finance Minister (1949-51) had attempted to harness the Imperial Bank in ways which stopped short of nationalization, was appointed its first Chairman.

Only a small proportion of the Imperial Bank's shareholders opted to receive shares of the State Bank. As a result, at its inauguration, 92 per cent of the shares of the State Bank of India were held by the Reserve Bank. The State Bank's statute contemplated and provided for private shareholding, and the remaining shares were distributed amongst private shareholders in Bombay, Calcutta, Madras, and New Delhi, with the Bombay register accounting for 4.8 per cent of them, and the Calcutta register for 1.8 per cent. Private shareholders were entitled, so long as their combined holdings did not exceed 10 per cent, to elect two representatives on the bank's Central Board. (The statute provided for three elected Directors if private shareholding was above 10 per cent but below 25 per cent, and for a maximum of four elected Directors in the event of the proportion of privately-held shares exceeding 25 per cent.)

State Bank shares were soon listed on the stock exchanges. Although

trading remained thin, thanks to the steady progress in the bank's business and regular dividends of 16 per cent, evidence emerged of a growing demand for its shares. The Bank briefly considered diluting its stake in the State Bank to take advantage of a rising market. According to one account, some shares were sold and the Bank's stake brought down to 85 per cent in January 1956, but according to another, more contemporary account, the Bank decided against diluting its holdings, and continued to own 92 per cent of the State Bank stock even in December that year. However, it persisted with the practice of selling fifty 'qualification shares' to elected members of the Central Board and ten to members of Local Boards, usually at Rs 100 per share (against a presumed market value of Rs 350 per share) with the dividend being shared between the Bank and the elected member in the ratio of 5:2 (or in some cases for Rs 350 per share with the buyer retaining the entire dividend) and on the condition that these shares were resold to the Bank at the end of the term.

Some thought was also given in December 1956 to the idea of the Bank buying small lots of State Bank shares 'unobtrusively' and 'without any special effort'. Since it held more than half of all privately-held shares, Bombay had an overwhelming voice in the election of Directors of the Central Board of the bank, and in the opinion of K.G. Ambegaokar, Deputy Governor, if the Bank bought some Bombay shares, it might help 'avoid [an] election' at that centre and 'the unnecessary trouble and expenses' that went with it. But he was overruled by Rama Rau, who argued that while it would be acceptable for the Bank to buy State Bank shares with a view to preventing its price from falling below Rs 350, it should not carry out these purchases 'with the object of influencing the voting strength'. The price of State Bank shares often went below Rs 350 during subsequent years, in fact remaining below that figure throughout 1967. But the Bank did not intervene as a buyer, even though relatively small purchases would have sufficed to drive up the stock.

The minority private stake in the State Bank of India came up for discussion once again in April 1969, when the Deputy Prime Minister, Morarji Desai, responded to pressures from private shareholders for a higher dividend by suggesting that 'it might be best for the Reserve Bank of India to acquire all the shares'. But the Bank considered the suggestion and concluded that it would not be possible to adopt this course without changes to the State Bank Act. In the meantime, intervention by the Reserve Bank to pick up shares was, given the poor availability of scrips and thin trading, likely to increase the quotation, depress the yield at the present dividend, and stimulate fresh demands for a higher dividend.

Although the State Bank of India came into existence as envisaged in July 1955, the life of the Imperial Bank was prolonged by legal hurdles in the way

of transferring the assets and liabilities of its overseas branches to its successor. With barely six weeks to go for the State Bank's opening, the Colombo branch of the Imperial Bank informed its head office that a foreign act providing for the transfer of its assets and liabilities to the new bank would have no force in Ceylon. The Imperial Bank would have ceased to exist on 30 June, after which there would be no authority competent to perform any act on its behalf. But the Imperial Bank's assets could not be transferred to the State Bank of India before 1 July 1955, when it would come into existence as a corporate body. Following this information, inquiries were also made in other countries. In England too, a similar problem was anticipated, since the provisions of the State Bank of India Act relating to the dissolution of the Imperial Bank of India would be effective under English law, but not those relating to the automatic transfer of its assets to the new bank. As a result, the assets of the older institution would come to vest in the Crown as *bona vacantia*.

A simple solution to this problem was to allow the Imperial Bank to exist as a corporate entity until the new bank came into existence and the assets of its foreign branches were effectively transferred to it. Accordingly, the dissolution of the Imperial Bank was postponed through an ordinance promulgated on 23 June 1955. Once the shares of the Imperial Bank of India were transferred to the Reserve Bank and replaced by shares of the State Bank of India, the former's body corporate was to consist of the Chairman, Vice-chairman, and Managing Directors of the new bank. To satisfy statutory minimum capital requirements for the conduct of banking business prevailing in countries where the Imperial Bank had its branches, the latter was to have a capital of Rs 10 lakhs advanced to it by the Reserve Bank.

The new bank was affected by problems of a different sort in Pakistan. Although, following a request from the Governor to his counterpart Abdul Qadir, the State Bank of India was quickly issued the authorization necessary to conduct banking business in Pakistan, it was given permanent licences only for three branches, viz. Karachi, Chittagong, and Naraingunge. Since Pakistan followed a policy of confining foreign banks to port towns, the Lahore, Lyallpur, Hyderabad (Sind), Mirpurkhas, and Dacca branches of the State Bank were issued temporary licences for one year. The Dacca and Lahore branches of the bank were, however, subsequently licensed for three years, and allowed thereafter to continue indefinitely. With the outbreak of hostilities between the two countries in 1965, the assets of the State Bank of India in Pakistan were taken over by the Custodian of Enemy Property, thereby bringing to a premature end the bank's association with the country's principal South Asian neighbour.

In the meantime, a wrong mutation of a plot of land belonging to the Imperial Bank in Lahore had led, by the 1960s, to a civil litigation in that country, which thereafter acquired a life all its own. In addition, hurdles persisted in the way of the legal conveyance to the State Bank of India of premises registered in the name of the Imperial Bank at Rangoon and Colombo. These were further complicated in the former case by the nationalization of the bank's assets in Burma. Thanks to such difficulties, the Imperial Bank, threatened with dissolution since 1955, continued to lead a charmed life and survived as a corporate entity until the 1970s. As an internal note of the Reserve Bank certified as late as November 1971, '... the continued existence of the Imperial Bank of India is ... necessary ... for completing the transfer, to the State Bank of India, of the property of the Imperial Bank of India' Few amongst those who helped draft and promulgate the temporizing ordinance of June 1955 could have wished for so striking a consummation of their efforts to prolong the life of the Imperial Bank of India.

STATE BANK OF INDIA: THE EARLY YEARS

It was not altogether easy to realign the former Imperial Bank with its new role and responsibilities. The controversy which erupted over the salaries paid to its top managers is symptomatic of the difficulties the Bank and the government faced in reforming the institution. These salaries, which Prime Minister Jawaharlal Nehru described on one occasion as 'fantastic', aroused considerable public and Parliamentary criticism. But the government's hopes of bringing them down to more realistic levels in the State Bank were not easily realized. More so as even nominated directors of the new bank (such as Sachindra Chaudhuri who was himself later to become Finance Minister) began apparently, according to Venkatappiah's account to Rama Rau of a meeting of its Central Board, to make common cause with directors and officials opposed to the proposed reform. Matthai and the central government also did not see eye to eye on bonus and allowances to officials. Though the issue of pay and allowances was important for its own sake in the austere climate of the times, differences here also reflected wider divisions over the freedom allowed to the State Bank to balance business and public policy considerations, and led to Matthai's resignation as Chairman within months of the new institution coming into existence.

Early troubles notwithstanding, the State Bank of India expanded swiftly during the next few years. The bank fulfilled the target set for it of opening 400 branches within five years from July 1955, as well as other branch expansion targets it set itself in subsequent years. The number of branches of

the State Bank rose from fewer than 500 in 1955, to 1468 in 1967. Its deposits rose steadily from Rs 226 crores in 1955 to nearly Rs 960 crores in 1967, and its advances from Rs 106 crores to nearly Rs 600 crores. Its credit-deposit ratio fell sharply from 55 per cent in the last year of the Imperial Bank to 29 per cent in 1959, but rose thereafter to well over 60 per cent by 1967.

The rapid expansion of the State Bank was partly financed out of its Integration and Development Fund to which accrued the dividends paid to the Reserve Bank on its shares up to a maximum of 55 per cent of the total issued capital of the bank. The fund remained the property of the Reserve Bank, which endeavoured to ensure that it promoted the expansion of the State Bank into rural areas without diminishing the incentive to make the new branches profitable within a reasonable period. The formula agreed on between the Reserve Bank and the State Bank was that the fund would meet, for a five-year period beginning 1 July 1955, four-fifths of the net losses of the new branches opened after that date in excess of Rs 15 lakhs. A total of 429 branches were opened during the period (of about 63 months) covered by this agreement, at a total cost to the fund of over Rs 75 lakhs. Of these, 337 branches were making losses in 1960. From 1 July 1960 the losses of these branches were entirely borne by the State Bank of India. Besides, the latter and its subsidiary banks, which (as discussed separately) had meanwhile been set up by transferring banks associated with the princely states to public ownership, proposed to open 300 new branches in the five years ending 30 June 1965. However, at the Reserve Bank's instance, the State Bank group agreed in July 1962 to open an additional 319 branches at the relatively more important treasury centres in India. The Bank agreed to debit to the Integration and Development Fund the entire loss incurred by these new branches in the first five years of their existence. Thereafter, the subsidy was to be tapered evenly to cease at the end of the tenth year of a new branch's existence.

This new formula was, in essence, similar to the one adopted to support the branch expansion plans of the subsidiary banks of the State Bank of India. At the latter's request, the Bank also agreed in July 1963 to dip into the fund to finance half the training and control and supervision costs arising from the new branches for twelve years. The State Bank opened 304 new branches until 31 December 1966, as part of its second expansion programme. Of these, 278 branches continued to make losses at the end of 1966. An internal study by the bank of 130 of these new branches revealed that their performance in deposit mobilization compared favourably with that of branches opened outside the subsidy programme. The new rural branches were relatively slow to consolidate their business mainly because of rising interest rates on deposits

and establishment costs.

Relations between the Reserve Bank of India and the State Bank remained close during these years. There was some movement of top *functionaries* between the two organizations in the first decade of the State Bank's existence. For both H.V.R. Iengar and P.C. Bhattacharyya, the chairmanship of the State Bank was a stepping stone to Governorship. Venkatappiah, who became the Deputy Governor of the Reserve Bank in 1955 with responsibility for overseeing its expanding involvement in the sphere of cooperative credit, became in his turn, the Chairman of the State Bank of India in March 1962.

Although the Bank owned the majority of the State Bank, the latter retained its functional autonomy. In fact so great was this autonomy that on more than one occasion, the Bank and its auxiliary failed to see eye to eye on important policy issues, and even on the role of the two institutions in the sphere of rural credit. Thus, closely as the two institutions worked, relations between them also betrayed the strains and tensions of proximity. To some extent these strains arose because of the sheer weight of the State Bank of India in the country's banking system and the Reserve Bank's reluctance to treat it, in matters of banking operations, differently from other banking institutions over which it exercised supervisory and regulatory authority as a central bank. But the dividing line between different forms of control being thin in practice, the Bank's reluctance to intervene, in its capacity as majority owner, in the operations of the country's principal commercial bank may have enabled the latter, paradoxically enough, to test the central bank's regulatory and supervisory regime rather more successfully than other commercial banks. Thus the possibility of conflict between the Reserve Bank and the Imperial Bank over credit policy, which Venkatappiah had cited in 1952 as an argument justifying greater State control over the latter institution, did not entirely cease when it came under the ownership of the country's central bank. In fact, the State Bank's potential to threaten the efficacy of the Bank's credit policy grew more formidable as its operations and resources expanded rapidly following nationalization.

From being a possibility, conflict became a reality in 1964 when the Bank began to use access to its accommodation as a device of monetary policy. The State Bank and its subsidiaries had at this time considerably lower credit-deposit ratios than other commercial banks. Their 'net liquidity ratios' (which, as defined and elaborated earlier in chapter 4, were adopted as the benchmark for regulating access) were also higher. Consequently, banks in the State Bank group remained eligible for additional accommodation from the Reserve Bank when other banks had ceased to be so eligible except at penal rates of

interest. At this stage, individual members of the group began using their resources, augmented by liberal access to Bank accommodation, to on-lend funds to other commercial banks, re-emerging in the process as an informal lender of the last resort to the country's commercial banking system. The Bank's efforts to persuade the State Bank to retire its outstanding advances promptly in the 1965 slack season were also not conspicuously successful. With a breach appearing imminent in the ceiling on the Reserve Bank's net domestic assets set as part of a standby agreement between the Government of India and the International Monetary Fund, the Ministry of Finance had to step in, in April 1965, and ask the State Bank of India to reduce its level of advances outstanding from the Reserve Bank.

Differences also arose regarding the roles of the Reserve Bank and the State Bank in the sphere of rural credit. These began, innocuously enough, with a note by R.G. Saraiya suggesting that the State Bank of India should expand its activities by advancing funds, if necessary, directly to central and urban cooperative banks. Opinion within the Bank, particularly in its Agricultural Credit Department, was that the proposal would, if accepted, damage the 'integral character of the cooperative banking system' and inhibit the capacity of apex banks to act as a 'balancing centre' for the funds of the cooperative movement within states and coordinate the activities of central cooperative banks. Proposals such as those mooted by Saraiya had previously been aired in informal meetings between executives of the two banks, where the State Bank was, in general, keener to take on a wider financing role for cooperatives than what the Bank considered justified from the point of view of the movement's integrity and the relative advantages of the two institutions. Largely at the initiative of H.V.R. Iengar, then Chairman of the State Bank of India, the matter soon came to be raised at the highest level within the Bank and at the Finance Ministry. The Finance Minister, T.T. Krishnamachari, was also in favour of the Bank devoting all its attention to 'high finance' and playing an advisory role in relation to the cooperative movement while leaving its financing in the hands of the State Bank, on the ground that the responsibility for providing credit to agricultural cooperatives conflicted with the Bank's wider constitutional role for regulating credit. Largely at the Finance Ministry's instance, an informal ad hoc committee of the Reserve Bank (comprising the Governor and both Deputy Governors, the Chairman of the State Bank, and D.R. Gadgil, who was a Director of both institutions, and some officials) was formed in March 1957 to define the future priorities of the State Bank of India, including in relation to 'agricultural finance'. Ironically, by the time this committee met for the first time on 20 March 1957, Iengar had moved from the State Bank to the Reserve Bank. Even as this committee's

deliberations were at an advanced stage, Krishnamachari announced in Parliament, towards the end of May 1957, his decision to transfer to the State Bank 'functions ... of a commercial nature, like affording agricultural cooperative credit' His intention, the Finance Minister said, was to free the Reserve Bank from responsibilities of a 'commercial' nature while ensuring that it remained the 'top-most financial institution in the country controlling every movement in finance'. The Minister's views on the matter were well known in the Bank and outside. Yet the announcement, made as it was without prior consultation, came as a surprise to the Bank, Governor Iengar learning of it only from the newspapers the following morning.

Clarifying his position to Iengar who chided the Finance Minister for having made a precipitate announcement on a subject which the ad hoc committee was still engaged in considering, TTK observed that he was 'increasingly of the view that the hasty implementation of the perfunctorily conceived recommendations ... [of] the Rural Credit Survey Report has done us a lot of harm'. The Minister's precipitate announcement certainly lent greater edge and urgency to the deliberations of the ad hoc committee. But it failed to influence the final shape of its report. Apart from considering the technical and institutional issues involved, the committee met a large number of cooperators who were nearly all opposed to any diminution of the Bank's role. In addition, it also appears as if P.C. Bhattacharyya, Iengar's successor at the State Bank, was generally lukewarm towards the idea of his institution playing a more active role in financing agriculture. Consequently, the ad hoc committee had little difficulty in presenting a unanimous report rejecting the proposal to divest the Reserve Bank of its responsibility for financing agricultural credit cooperatives.

The Bank's lending to the cooperative sector was really analogous to the refinancing of commercial banks under the bill market scheme. In both cases, the Bank's role as the principal refinancing agency complemented, rather than conflicted with, its role as the controller of credit. The State Bank of India, the committee felt, had as yet little expertise to undertake the expanded responsibility for providing direct finance to agriculture, nor could it in the midst of a hectic expansion programme spare and train specialized staff for the purpose. On the other hand, the State Bank might be encouraged to play a more active and direct role in lending to cooperative institutions in areas where central cooperative banks were non-existent or sick. However, in order to protect the integrity of the cooperative movement and prevent wasteful competition, it was agreed that the State Bank would step into the shoes of central cooperative banks only as long as necessary and in consultation with the apex cooperative bank in the state and the Reserve Bank. The committee

was also of the view that the State Bank's expertise in financing the movement of goods could be put to good use in the financing and development of agricultural marketing and processing cooperatives. Enclosing this report to the Finance Minister, the Governor assured him that the ad hoc committee did not take a *non possumus* approach towards the issue, but one based on the relative abilities of the Reserve Bank and the State Bank to effectively address the problem of rural credit.

Following TTK's announcement, Iengar took steps to tone down the ad hoc committee's draft report. In particular, the passages dealing with the relative advantages of the Reserve Bank and the State Bank in dispensing credit to the cooperative sector were edited to present the case for the State Bank's role 'in greater detail and more sympathetically'. The 'case against the proposed transfer', the Governor insisted, was also to be argued with 'greater moderation in language than in the present draft'. But these stylistic changes did little to placate the Finance Minister who found the final report of the ad hoc committee not to his liking. He also felt the report's recommendations 'put (him) in difficulty vis-a-vis Parliament and the general public'. Advising the Finance Minister that he had no reason to be defensive about the committee's conclusions, the Governor emphasized that the demarcation of responsibilities the committee proposed gave the State Bank, which could never match the rediscount subsidy of 2 per cent that the Reserve Bank allowed on agricultural bills, a wide field for 'developmental' activities.

The ad hoc committee's recommendations did not put an end to the debate over the roles of the Reserve Bank and other institutions in the sphere of rural credit which, like the committee itself, endured for several more years. Indeed, in discussing its report with the Finance Minister, the Governor conceded that the issue of whether 'promotional and developmental activities ... in respect of agricultural credit societies or marketing or processing societies should be handled by one organization' could not be satisfactorily resolved except in the light of new experience.

Taking a view of the future, there are grounds for thinking that such an organization might appropriately be a subsidiary of the Reserve Bank; in that case that would constitute one wing dealing with agricultural credit operations and the State Bank would constitute another wing dealing with ... private (as opposed to cooperative) commercial operations. I do not think however that the time for considering ... a new organization is yet ripe. Whatever view one may take about ... decisions taken in the recent past, frequent chopping and changing about would be unwise.

As envisaged by the Rural Credit Survey and the ad hoc committee, the State Bank extended a number of facilities to cooperative institutions over the next few years. These included advances against government securities and repledge of goods, remittance facilities, and purchase and collection of bills. A substantial proportion of its advances were made at a concessional rate. Moreover, the bank also provided long-term credit for agriculture by subscribing to debentures of land mortgage banks. Branches of the bank were given discretion to grant advances to cooperatives against the security of debentures of land mortgage banks, which were declared trustee securities. In order to assist coordination, the bank's principal 'Agent' (as branch managers were then called) in a district was allowed to be an ex-officio director of the central cooperative bank of that district. The bank provided finance directly to societies in states where cooperative central financing agencies were not well developed, and liberalized its operations to a few selected institutions in areas or states where these agencies were sufficiently developed. Within a couple of years of its founding, the State Bank also began to grant advances to cooperative marketing and processing societies, and by 1958 endeavoured to establish branches at centres where warehouses of the central or state warehousing corporations were located, and to take the lead by granting advances against warehouse receipts. In order to achieve better coordination, senior executives of the bank were nominated as directors of central and state warehousing corporations. By 1960, the State Bank had also begun to lend to industrial and consumer cooperatives.

For all this, however, and even after having allowed for the relatively limited field of operations available to it, the State Bank's achievements in the sphere of cooperative credit were quite modest. The bank's outstanding advances to all cooperative institutions rose to Rs 4.7 crores, or 2 per cent of all advances, in 1960. Advances continued to rise steadily in absolute terms until the mid-1960s, peaking at Rs 22.3 crores in 1966 before dropping off sharply to Rs 13.4 crores the following year. Advances to cooperatives as a proportion of all advances peaked in 1964 at 5.4 per cent, falling to just over 2 per cent in 1966. In pointed contrast, the State Bank's advances to the small-scale industrial sector rose more steadily from less than one crore rupees in 1958 to Rs 43.4 crores in 1967, advances to this sector as a proportion of total advances rising from about 0.5 per cent in the former year to a rather respectable 7.3 per cent in the latter. Coming at the instance of the Reserve Bank, this expansion was one of the more positive aspects of the cooperation between the two institutions to channel credit into hitherto neglected sectors of the economy. The relative lack of success attending the efforts of the Bank and the State Bank to increase lending to the rural cooperative sector during

these years have to be sought principally on the demand side, i.e. the deteriorating overall health and effectiveness of the cooperative sector, and its failure to grow and diversify as anticipated.

Unpublished Sources

- G.8 Governor's Correspondence with Government of India, Ministry of Finance
- S.74 Nationalization of Imperial Bank of India
- C.668 Government Control over Imperial Bank of India
- PR(R)2 Formation of the State Bank of India
- SB14 Transfer to the State Bank of India of the Assets and Liabilities of the Imperial Bank in Foreign Countries
- PR(R)-18 Future Role of the State Bank of India
- SB 35 Coordination of Policies of SBI and Cooperative Banking and Credit Structure
- SB 28 Sale of State Bank of India Shares to Public
- SB 13 Payment of Compensation on Imperial Bank Shares—Procedure
- PR(P)-51 Integration and Development Fund—Drawing upon the Fund in connection with Branch Expansion of SBI

Memoranda to the Central Board and Committee of Central Board

Subsidiaries of the State Bank

The integration of the banking systems of the princely states merging into the Indian Union acquired importance soon after independence. Several of these states had banks associated with them which discharged important banking and treasury responsibilities on their behalf. One of them, the Hyderabad State Bank was earlier a bank of issue in the Nizam's dominions. Many of the other banks too, were important in their own right or were the most significant local banking institutions in the areas where they operated. Inevitably, given the diversity of circumstance, forms of ownership, and organization, relations and functional arrangements between governments of the princely states and their associated banks varied widely. Some of the former princely states owned banks which they ran as government departments, while others owned a major portion of the share capital in their 'state' banks. In a few cases, state-associated banks were almost entirely privately-owned, in one case—that of the Krishna Ram Baldeo Bank, Gwalior—by the ruler himself. Some states had banking arrangements with commercial banks and conducted treasury work, either wholly or partly, through government departments. Diversity also marked the constitution of these enterprises. Some state banks were constituted by acts passed or promulgated locally while the Bank of Baroda, notably, was incorporated under the Companies Act of the Baroda state. At the other extreme, the Bank of Patiala was set up by a firman of the ruler while the Sri Ramchandra Laxman Bank, Dungarpur, which too did not have a written constitution, was probably set up on the basis of a verbal order of the ruler.

There were, according to the Bank's admittedly incomplete count, fifty-four 'state-owned or controlled' banks (hereafter referred to as state banks or state-associated banks) of various sizes in March 1952. In the changed political conditions, governments of states as they were constituted in independent India came to inherit the interests which the former princely states held in these institutions. State banks varied enormously in size, with the Bank of Baroda which was the largest of them all having, for instance, deposits running into

several crores of rupees. At the other extreme, the aggregate deposits of the Bank of Barwani amounted to a princely sum of Rs 3,000.

After 1950 it became possible to distinguish two categories of state banks. The first category comprised institutions, too numerous to list here, whose governmental responsibilities largely fell into disuse following the amalgamation of the states of which they were bankers with existing or new states of the Union. A relatively large number of the smaller state banks in this category were weak, moribund, or on the verge of liquidation, and securing the orderly winding-up of their affairs or amalgamating them with stronger banks became an important focus of the Bank's efforts in relation to these institutions. Until such time as this segment of banking was reorganized, the Bank had also to regulate its functioning from the point of view of safeguarding the interests of depositors and minimizing the contingent liabilities of state governments which held an interest in these institutions.

The second category comprised the larger state banks. Not only did these banks retain a major presence in their respective states particularly in the non-urban areas, they also continued to discharge some governmental banking functions even under the new political arrangement. Such banks were expectedly fewer—about fourteen—in number. Regulating their functioning was no doubt important, but the Bank's approach to the latter set of institutions was also informed by its efforts to promote sound banking treasury and currency chest arrangements in the regions covered by them.¹ Hence it was thought necessary to align the constitution of these institutions in such a way that while centre-state financial relations and government operations were facilitated, the structure, policies, and operations of the banks would be subject to control by the central government and the Reserve Bank of India. This realignment had to be achieved, moreover, in the context of extending banking facilities, particularly to the rural and semi-urban areas of the country.

REGULATING THE STATE BANKS

The classification of state banks attempted above also helps us track the Bank's objectives and actions in relation to these institutions. As we will observe below, not all banks in the second category were well-run institutions, but the Bank's principal concern in relation to banks in the first category was that of regulating their activities from the point of view of protecting the public interest. The latter partly represented the interests of the depositors. But equally, several banks had managed to gather deposits on the strength of

¹ For a short description of these arrangements, see footnote 2 in chapter 6.

their association with princely states or that of guarantees offered by them. Following the political reorganization of 1947–49, these liabilities passed, willy-nilly, to the respective state governments. Once undertaken, public responsibilities of this nature could not easily be shed without causing dislocation and uncertainty, even perhaps a banking panic. On the other hand, legal opinion at the time held that state governments exceeded their constitutional and legal powers in owning or operating banks. Neither did they possess the ‘requisite equipment’ to effectively oversee their functioning in the public interest. The Reserve Bank’s ability to intervene in the affairs of these institutions too, was weakened by legal obstacles. Given the manner of their incorporation and their constitutions, these banks did not generally come under the scope of the Banking Companies Act which had meanwhile been extended to the new states, nor could they be wound up under the Indian Companies Act. Consequently, many of the state banks were ‘free to operate in any manner they choose, and ... to open branches ... without any restriction whatsoever’. Let alone overseeing their working or subjecting them to statutory inspection or regulation, the Bank in 1949 did not even possess a complete list of state-owned and controlled banks.

As a first step towards gaining an understanding of the working of these institutions, the Bank encouraged some of them to volunteer to open their books to its officers for inspection. The Bank’s inspections revealed, in several cases, an alarming state of affairs. Many of these banks followed unsound, or at any rate ‘unorthodox’, banking practices. Long-term advances to industry and public utilities were not uncommon, while few state banks respected the distinction between long-term and short-term lending, or that between agricultural and commercial finance. The staff of these banks were, as a rule, poorly qualified and trained. In the case of one state bank, the Bank’s inspectors discovered, several years had elapsed since its accounts were audited.

The Reserve Bank’s counsel had already been sought by the Saurashtra government in 1949 for reorganizing banks associated with the princely states of Saurashtra. At the Bank’s instance, the Bhavnagar Darbar Bank was constituted as the State Bank of Saurashtra and three other former state banks in the state merged with it. The new bank came into existence early in 1950. At a later stage, steps were taken to merge two more minor state banks with the State Bank of Saurashtra. The Bank’s ability to adopt this solution more widely was affected by legal and constitutional uncertainty over whether state governments could own and operate banks, since banking was in the Union list. The Attorney-General whose advice was sought by the Government of India opined that central and state governments were not ‘competent’ to own or operate industrial or commercial undertakings unrelated to matters within

their legislative competence. This particular obstacle was not overcome until later in the decade.

In the meantime, the Bank sought to achieve a measure of reorganization of state banks, and some control over their working. Following the Bank's recommendation, the assets and liabilities of four small banks in Rajasthan were transferred to the Bank of Rajasthan. In a few other cases, the Bank recommended the merger of state-associated banks with joint-stock banks. Some state banks, such as the Bank of Kurundwad (Junior), the Bank of Sirmur, and the Bank of Bhopal were converted into land mortgage and central or state cooperative banks, and incorporated under the relevant Acts of their respective states. While the Bank remained willing whenever its advice was sought, to explore various possibilities, in general it took the view that some state banks might 'die a natural death'. Some moribund or 'merely ornamental institutions' might have to be wound up, while others would be absorbed by one or the other of the existing joint-stock banks. Very few state-associated banks, the Bank felt, could afford to retain an independent existence.

Whatever the longer-term solution, however, the Bank recognized that the former state banks represented an 'important link in the chain of Indian banking' which could not afford to 'remain unregulated for long' The Law Ministry in the Government of India suggested a 'simple enactment' to authorize the Bank to examine the constitution and financial position of each state bank in order to determine its future. An amendment to the Banking Companies Act to bring these banking institutions specifically under its purview, as was done earlier in the case of the Imperial Bank, was also briefly considered. But legislative measures were rejected on the ground that they would consume too much time. Besides, an amendment to the Banking Companies Act might turn out to be unnecessary in the event of a majority of these institutions failing to survive the changed political circumstances in their present form. Hence the Bank pursued a two-pronged policy, one prong of which was to persuade state-associated banks to voluntarily bring themselves under the purview of the Banking Companies Act. This strategy was quite successful and by the end of March 1952, twenty-nine of the fifty-four state-associated banks had come within the scope of this Act. Six of the remaining banks had either ceased to exist or were in the process of being wound up, while the ownership of three small state-associated banks was in dispute. However, the remaining sixteen banks, which included some of the larger state-associated banks such as the Bank of Patiala, the Hyderabad State Bank, the State Bank of Saurashtra, the Mayurbhanj State Bank, and the Bank of Baghelkhand, could not be

brought under the Banking Companies Act without amendments to their constitutions.

The second prong of the Bank's strategy of dealing with state-associated banks was therefore directed mainly at these sixteen institutions. The Bank sought a temporary solution in their case whereby these banks volunteered to conform to the operational provisions of the Banking Companies Act and subject themselves to the essential disciplines and requirements of the legislation without, at least yet, coming under its formal purview. It advised the central government to take up with state governments the question of state banks under their administrative jurisdiction submitting to regular inspection by the Bank's officers, furnishing periodical returns as required under the Banking Companies Act, and supplying to the Bank any further information it required. Apart from enabling it to secure a proper understanding of their position and functioning and recommend corrective measures, regular inspections and returns were also expected to help the Bank formulate ways in which individual state banks may be 'integrated with the Indian banking system'. Under the informal and transitory regulatory regime which the Bank envisaged for them, state banks were also to desist from extending their operations beyond the borders of the state or union of states in which they were located.

State governments were not always ready to accept these conditions. The Punjab government, for example, looked the other way when the Bank of Patiala opened branches outside the former PEPSU region in 1957. Nor were the Bank's efforts to ensure that state banks submitted periodical returns to it entirely successful to begin with. Twelve of the sixteen banks whose constitutions required to be amended before they could be brought under the Banking Companies Act did not readily submit to the regime of voluntary returns proposed by the Bank. While the state governments concerned had already initiated measures to reconstitute, liquidate, or amalgamate eight of these twelve banks, the Bank had to make additional efforts to persuade the remaining four banks to submit voluntary returns to it. Notwithstanding such hurdles, by 1954 a problem which had seemed large and rather intractable barely two years earlier was well on its way to acquiring more manageable dimensions.

REALIGNING MAJOR STATE-ASSOCIATED BANKS

The Indian States Finances Enquiry Committee (V.T. Krishnamachari Committee, 1949) which went into the question of federal financial integration remarked on the unsatisfactory nature of banking and treasury arrangements

in the former Part B states and underlined the need to study them separately with a view to bringing these arrangements in line with those prevailing in the 'provinces' of the Union. A review of the treasury arrangements in force in the Part B states was accordingly made part of the terms of reference of the Rural Banking Enquiry Committee (Purshotamdas Thakurdas Committee, 1950). In particular, the committee was asked to examine the extent to which the management of cash work in government treasuries and subtreasuries could be entrusted to one or more of the existing commercial banks, and to make recommendations in regard to the banks which were already handling treasury work in the Part B states.

The Rural Banking Enquiry Committee found that while the Imperial Bank of India carried out some treasury and banking functions for governments of the Part B states, the latter had entrusted a major part of these functions to one or more local banking institutions. Among these were the newly-formed State Bank of Saurashtra, and to some extent, the Central Bank of India in Saurashtra, and the Bank of Mysore in Mysore State. In Rajasthan, the Imperial Bank of India, the State Bank of Bikaner, the Bank of Jaipur, and the Bank of Rajasthan shared the banking and treasury business of the state government. In Hyderabad, the Hyderabad State Bank was entrusted with treasury and banking work, as also that related to the management of public debt and currency, while the Imperial Bank of India too fulfilled a limited set of treasury functions. In Travancore-Cochin, the Imperial Bank of India did the central government's treasury work at Trivandrum, while the state government's cash work was undertaken by the Central Bank of India at Ernakulam. The remaining treasury work was done departmentally by the state government which also had remittance arrangements with some banks. In PEPSU, while the Bank of Patiala and the Imperial Bank of India managed the banking work, the state government also maintained accounts with other banks both in the state and outside. In Madhya Bharat, on the other hand, the bulk of the government work was undertaken by the Bank of Indore, with the Imperial Bank of India playing little or no role in the arrangements.

The committee endorsed the view that banking and treasury arrangements in the Part B states should be brought in line with those in the Part A states. This raised two main issues: (a) the appointment of the Reserve Bank of India as sole banker to the Part B states, and (b) the appointment of agents of the Reserve Bank for managing the government's cash business in those areas. The committee felt that the Bank's appointment as banker to all the states of the Indian Union was basic to the whole scheme of federal financial integration, and should precede any attempt at uniformity in banking and treasury arrangements across the length and breadth of the country. As regards

the second issue, the committee came to the conclusion that with the exception of the Hyderabad State Bank, no other state bank had the resources, standing, or organization to be considered for appointment as the Bank's agent. However, the committee was averse to existing arrangements being disturbed greatly for a period of five years. The Imperial Bank of India, it felt, was unlikely to devote its limited energies to expanding significantly into the Part B states. Besides, sudden withdrawal of state support might inflict serious damage upon the banks associated with them, result in the curtailment of banking facilities to the state government and the public, and cause financial loss to governments which had a substantial interest in them. The standstill period of five years from April 1950, the committee suggested, should be utilized to gain a proper appreciation of the financial and other aspects of the working of each bank and determine its suitability for agency work.

Taking into account the views of the state governments, the Bank and the Government of India came to the conclusion that little would be gained by dogmatically setting aside the claims of banks which had developed in close association with state governments. Moreover, appointing a state bank already doing treasury work as the Bank's agent was judged to be preferable to the alternative of such work being undertaken departmentally. On the other hand, it was not considered practicable to appoint, as some state governments proposed, more than one state bank as agents of the Reserve Bank in any one state. Consequently, it was decided to adopt a differentiated approach to the delegation of agency functions in the Part B states. The State Bank of Saurashtra and the Hyderabad State Bank were to be offered agencies by the Bank in Saurashtra and Hyderabad, respectively. In Rajasthan the role was to be offered to a bank formed by the amalgamation of the Banks of Rajasthan, Jaipur, and Bikaner, provided this was effected within a year, during which interval the status quo would be maintained in regard to treasury and banking arrangements. In Travancore-Cochin and PEPSU, decision regarding the appointment of the Travancore Bank and the Bank of Patiala respectively as agents of the Bank was to be deferred for three years. The Bank of Mysore was to be entrusted agency work in that state after a suitable interval at the Bank's discretion. However, none of the existing banks in Madhya Bharat, including the Bank of Indore, were considered large enough to shoulder agency responsibilities.

Placing the recommendations of the Rural Banking Enquiry Committee before the Central Board in December 1951, the Governor, B. Rama Rau, expressed his intention to conclude and bring into force by April 1952, agreements with state governments appointing the Bank as their sole banker as well as, wherever practicable, consequent subsidiary agreements for

appointing state banks as its agents. He also outlined the rules state governments would bind themselves to observe in respect of minimum balance and ways and means advances, the conditions a state bank had to accept before it could be appointed an agent of the Bank, and the steps that were proposed to be taken to ensure that there was minimal dislocation in existing arrangements. Once the Bank assumed the role of banker to a state government, the latter was expected to transfer its balances entirely to the Bank. But it was proposed to achieve this gradually, and in such a manner as to prevent any sudden erosion of the deposits of banks holding such balances.

The Governor also underlined to the Central Board that the appointment of banks as agents of the Reserve Bank of India necessitated a greater measure of control over their working. Apart from submitting themselves to inspection by the Bank, they were expected to observe certain restrictions on the types of business they could undertake, appoint chief executives only with the approval of the central government, and accept on their Boards a nominee of the Bank and another of the central government. The latter official was to have powers to demand postponement of decisions affecting the government's financial policies or the safety of its monies. Further, it was proposed not to entrust currency chests to these banks unless (a) they were located at a few agreed places of importance in the beginning, (b) the concerned banks accepted restrictions on the use of chests for the banks' own working, and (c) state governments guaranteed the safety of the money held in them.

The Bank commenced its role as banker to governments of Part B states in July 1952. The takeover was completed in November 1956. The process might have lasted even longer had some Part B states not been extinguished in 1956. In the first stage, the Bank became banker to the governments of Madhya Bharat and Travancore-Cochin in July 1952. Agreements with Hyderabad and Mysore followed soon thereafter. The Hyderabad State Bank and the Bank of Mysore were appointed agents of the Bank in Hyderabad and Mysore in March and November 1953 respectively.

In contrast to these four states, the Bank's path in Saurashtra, PEPSU, and Rajasthan was far from smooth. As noted above, the State Bank of Saurashtra, which conducted banking business on behalf of this state government at a majority of the important centres, was constituted by the amalgamation of a number of small units discharging similar responsibilities in the component states. The ordinance which the state government promulgated to bring the new bank into existence was, however, incomplete in some important respects. For example, it did not even specify the businesses which the bank might or might not transact. Nor was the bank a joint-stock institution incorporated under the Banking Companies Act, 1949. Pending the reconstitution of the

State Bank of Saurashtra along suitable lines, the Reserve Bank was appointed sole banker to the state in 1954.

In PEPSU, differences surfaced between the Bank and the state government over the role of the Bank of Patiala. The latter had led a chequered career since it was founded in 1917 on the basis of a firman of the Maharajah of Patiala. A department of the government in all but in name, the Bank of Patiala did not have an independent constitution. Though it held some balances of the state government, it did not discharge any treasury functions on the latter's behalf. The PEPSU government insisted on the Bank of Patiala being appointed as the Bank's agent, while the Bank was willing to consider the suggestion only after observing the bank's affairs closely for some considerable length of time. As already noted, once the Bank took over as banker to the state government, the latter would be bound by stipulations regarding the deployment of its funds, ways and means advances, and minimum balances. The state government was unwilling to accede to these conditions and sought special powers to keep its monies with the Bank of Patiala without any restrictions. With neither side relenting, the issue of appointing the Bank as banker to the PEPSU government remained unresolved until 1956 when, following the reorganization of states, PEPSU was merged with Punjab to whose government the Bank was already the banker.

In the case of Rajasthan, the Rural Banking Enquiry Committee had recommended that the state government should take over treasury arrangements and manage them departmentally at centres where the Imperial Bank of India was not entrusted with these responsibilities. In agreements reached between the Bank and the state government, existing treasury arrangements with the Bank of Rajasthan were allowed to continue for one more year. Thereafter, as pointed out above, the institution emerging out of the merger of the Banks of Rajasthan, Jaipur, and Bikaner was proposed to be appointed as the Bank's agent should it by then be in place. On the other hand, the state government was expected to organize its own treasuries with currency chests if efforts to merge the three banks failed to bear fruit within one year. In the latter event, the state government's treasuries were to be supplemented by the Imperial Bank of India which would be appointed as the Bank's agent. Several efforts were made to secure the merger of these three banks. Initially, the Bank of Bikaner was cold to the idea, and when that bank came round later, the Bank of Rajasthan changed its mind and desired to be left alone. With neither the Bank's intervention nor that of the state government making any impact on the Bank of Rajasthan, it was decided in 1954 to merge the Banks of Bikaner and Jaipur and thereafter renew efforts to rope in the reluctant institution. The proposal to merge the two banks also secured the Bank's consent, but

languished for several more years after the situation changed with the publication of the Report of the All-India Rural Credit Survey and, thereafter, that of the States Reorganization Commission.

RURAL CREDIT SURVEY AND ITS AFTERMATH

The Rural Credit Survey, it will be recalled, recommended the amalgamation by statute of ten major state banks and four minor state banks with the proposed State Bank of India. The major state banks recommended for amalgamation were the State Bank of Saurashtra, the Bank of Patiala, the Bank of Bikaner, the Bank of Jaipur, the Bank of Rajasthan, the Bank of Indore, the Bank of Baroda, the Bank of Mysore, the Hyderabad State Bank, and the Travancore Bank. While identifying the Sangli Bank, the Manipur State Bank, the Bank of Baghelkhand, and the Mayurbhanj State Bank as the four minor state banks which could be brought into the fold of the State Bank of India, the Report of the Rural Credit Survey also advised the Bank and the government to explore the possibility of merging some of the remaining minor state banks with the State Bank of India.

In his letter to the Finance Minister, C. D. Deshmukh, in December 1954 about the State Bank of India plan, Rama Rau expressed himself in 'substantial agreement' with the Report of the Rural Credit Survey. However he pointed out that while the creation of 'an integrated State-controlled banking structure for the whole country covering the Part A, Part B, and Part C States ... should be the eventual aim of policy', the details of the reform, the manner of its implementation, and its timing required more careful consideration. The Government of India also took the view that the takeover of the Imperial Bank of India was the 'first step' towards setting up the 'integrated commercial banking institution' and that the other 'details of ... the manner and phasing of so important a measure of reform' deserved to be examined with 'great care and deliberation'. In the event, this reform took over five years to materialize, and was buffeted in the meantime by disagreements between the Bank and the Government of India, political, constitutional and legal changes, and consequently by some indecision and uncertainty.

Even within the Bank, opinion on the second stage of the State Bank plan was far from united. The Department of Banking Operations fired the first salvo in the debate which was soon to rage within the Bank with a note which represented that the Government of India had 'accepted the principle' merely of nationalizing the Imperial Bank and that the next question to be considered was 'whether and how far and in what manner' the government should accept the committee's recommendation concerning the major state

banks. The note then proceeded to advance several reasons why these banks should not be amalgamated or transformed in the near future into subsidiaries of the State Bank of India. In the first place much of the energies of the Reserve Bank and the State Bank would be devoted in the latter's early years to placing the new institution on a sound footing. Besides, as the pay structure in the banking industry was linked to the size of the employing bank, the amalgamation scheme could lead to higher establishment costs and to the State Bank of India having to curtail plans to extend its activities. The Department of Banking Operations then went on to argue that the nationalization of banking was a relatively 'new experiment' in democratic India. The functioning of banks owned by the princely states had been far from satisfactory. Many of them had granted advances on 'other than purely commercial banking' considerations while not all the banks selected for amalgamation by the Rural Credit Survey were financially sound.

Apart from financial conditions, accounting and supervisory practices and standards of efficiency also varied considerably among and between the major state banks and the Imperial Bank. The rate which the Imperial Bank offered on its deposits was lower than that offered by the state banks, and amalgamation, the Department of Banking Operations argued, might lead to the withdrawal of the bulk of their deposits. Besides, most of the advances which the major state banks had made at higher rates of interest would be unsuitable for the State Bank of India's portfolio. The ten major state banks had 273 offices of which 178 offices were in centres with populations below 30,000. The fall in deposits, advances, and earnings might make it uneconomic for the State Bank of India to operate offices at these smaller centres and lead, contrary to the expectations nurtured by the Rural Credit Survey, to their closure. The amalgamation scheme would, if implemented, also lead to a concentration of the offices of the State Bank of India in the Part B states and in the western parts of the country, leaving the eastern regions including large tracts of Madhya Pradesh, Bihar, Orissa, West Bengal, and Assam with relatively few offices of the bank. The Rural Credit Survey's objectives of securing the expansion of banking facilities in rural areas and improved remittance facilities, the note observed, would 'obviously be better achieved' by the State Bank of India opening offices in the eastern states than by taking over the ten state-associated banks.

Proposing that the move for 'further nationalization' of banking in India should be deferred for some years, the note recommended keeping a close watch in the meantime, on the functioning of the reformed Imperial Bank. It warned:

Nationalized commercial banks were no doubt functioning in other countries, but India is still a very young democratic country and how far Parliament or the Government of the day will interfere with the soundness and working of the State bank ... will have to be watched.

In the meantime amalgamations should proceed if at all on a voluntary basis. While including a provision for voluntary mergers in the State Bank of India Act, the note recommended that the government should also announce its intention not to take over any state-associated bank for the next five years. The powers given to the Bank under the Banking Companies Act would suffice, in the meantime, to serve the object which the Rural Credit Survey had in view.

This line of attack drew a spirited response from the Department of Banking Development with whose assistance Venkatappiah drew up the State Bank plan. Outlining the background to the Rural Credit Survey's recommendations, the Department of Banking Development pointed out that the establishment of currency chests and the conversion of non-banking treasuries into banking treasuries in the Part B states would be hampered if their state banks continued as separate, ill-equipped, and poorly run units answerable only to their respective boards. Nor would it be possible to align the policies of these institutions with national objectives. Nationalization, the Department of Banking Development pointed out, would not necessarily lead to higher operating costs, since state banks would continue to be treated as separate units for purposes of labour awards if they were run as subsidiaries of the State Bank of India. Although many of the state banks were financially weak, none was insolvent. In fact the case for amalgamation rested on the weaknesses of individual state banks and the ability of a strong, well-integrated bank to remedy them. Amalgamation, which was 'merely the principle of achieving strength through unity', this department's note declared, was the only means by which the Bank could get a 'stable and reliable agent in Part B states'.

As for differences in the interest rates offered by the Imperial Bank and the state banks, the Department of Banking Development pointed out that it was a truism that the bigger and stronger the bank, the lower its deposit rates. Even the Imperial Bank did not offer uniform rates across the country, and should it face an erosion of deposits, the State Bank of India too could offer higher rates at some centres. In any event, the question of harmonizing interest rates would not arise so long as the major state banks were run as subsidiaries of the State Bank of India. Amalgamation (or takeover of the state banks), it

argued, would facilitate the expansion of banking facilities rather than hinder it. Not only would nationalization encourage the Imperial Bank and the state banks to look beyond short-term profitability considerations in expanding their presence in under-banked areas, the resulting rationalization would release trained staff and other resources for opening new branches. According to Banking Development, the

case for integration of banks is the same as that on which political and financial integration of Part B states was based. The aim is to unify the banks and thus create the framework we want.

The Bank's Central Board met towards the end of February 1955 to discuss the subject. Rama Rau's own preference, expressed in his memorandum to the Central Board, was for a temporizing approach. Converting the Imperial Bank into the State Bank of India, he believed, was the first step. It would be a 'distinct advantage' to the new institution if 'for an initial and reasonably long period' it was not 'burdened' with the responsibility for integrating the state banks. Thereafter, 'such of the State-associated banks as we may select' could 'in stages' be brought under the 'direct control (and where necessary, ownership) of the Reserve Bank'. In the meantime, the Bank should secure a gradual extension and expansion of the powers of control it already exercised over the Hyderabad State Bank, the Bank of Mysore, and pending its reorganization, the Bank of Patiala.

More or less analogous control, including the power to approve the appointment of the Managing Director or General Manager, could, as the first step, be assumed by the Reserve Bank in respect of each of these banks; and subsequently, at an appropriate stage, each bank *as a unit* could be taken over by the Reserve Bank in much the same way as the ownership and control of the Imperial Bank is proposed to be vested in the State. The integration of these individual banks with the State Bank of India will then be a matter for consideration after sufficient experience has been gained. [Emphasis in the original.]

The advantage of this course of action, Rama Rau emphasized, was that it would guard against any abrupt increase in establishment costs and allow a lengthy interval during which to assimilate the policies of the smaller banks to those of the Imperial Bank of India. Whatever their other consequences, Rama Rau's views persuaded those in favour of the integration project to lower their sights and consider the possibility of the State Bank of India managing the state-associated banks as its subsidiaries.

Rama Rau's suggestions were intended to be tentative and merely offer a basis for discussion. Rather unusually too, his memorandum to the Central Board on the subject was not accompanied by a draft resolution. In the event, the Central Board accorded a cool reception to the Rural Credit Survey's integration proposal. An account of its deliberations on this issue is available in the form of a note which H.M. Patel, Principal Secretary in the Finance Ministry and member of the Central Board, prepared for the Finance Minister. Non-official members of the Board, with the exception of D.R. Gadgil and Dharendra Nath Mitra, appear either to have generally opposed the integration plan or taken the view that most state banks should be left out of it. Gadgil's reminder that the Government of India had already accepted the plan in principle and that the Central Board was merely required to advise the government on the means of giving it effect, cut little ice with the other non-official members. The Board consequently resolved to advise the government that it would be 'undesirable to provide for the compulsory acquisition of the ten State-associated banks [in the proposed State Bank of India Bill]' Should further experience reveal the 'utility and practicability' of integrating any bank, such integration was 'best effected on the basis of voluntary negotiation'. 'In general', the resolution declared, amalgamation may be 'necessary and expedient in a few instances only ... mainly for constitutional reasons'. Constitutional considerations might dictate the takeover of the State Bank of Saurashtra and the Bank of Patiala, which were wholly owned by the respective state governments 'and possibly, the Hyderabad State Bank of which the major portion of the share capital vests in the State Government'.

Following the meeting of the Central Board, Rama Rau advised Patel that the government should proceed on the assumption that the State Bank of India bill would be confined to the Imperial Bank of India. While restating his view that integration should be brought about in stages, the Governor felt another piece of legislation could be introduced later to take over some state banks. In the meantime, the state governments concerned could be consulted on the subject.

Finance Ministry officials were dismayed by this turn of events. They accepted the Governor's plea to defer the legislation on the future of the state banks and consult state governments, but maintained that the latter's reaction would not be the 'main factor' determining the course of banking integration. Banking was a Union responsibility, and 'while informal consultations need not be ruled out, the decision would have to be related to the policies formulated' by the central government. Patel's note for

the Finance Minister pointed out that, thanks to the Central Board's posture, the initiative on the matter had passed to the Government of India.

The Board of the Reserve Bank having reached the conclusions it did, it is clear that ... the whole matter ... stand(s) remitted to Government and that it will now be for Government to take decisions on all the broad issues arising from the policy already announced. It is unfortunate that these decisions have to be taken without the type of assistance, by way of formulation of criteria, modes of implementation etc., which, it was hoped, could be obtained from the ... Board of the Reserve Bank. I think the primary initiative and responsibility in respect of the consultations with State Governments should now be assumed by the Finance Ministry.

Not having yet ruled out including in the State Bank bill which was soon to come up before Parliament, provisions to amalgamate or take over the ten state banks, the Government of India proceeded with some urgency to initiate discussions with state governments. But the Finance Ministry's attitude towards these consultations came as a disappointment to the Bank. Communicating to Rama Rau the government's plan of action and asking him to spare some officers of the Bank for talks with the states, Patel observed that the letter to the state governments would be so 'worded as to avoid giving the impression that the principle of integration ... [was] open to argument'. This drew a sharp response from Rama Rau who remarked to Patel that it was 'equally necessary to avoid giving the impression ... either in your communication ... or in the subsequent discussions' that the government was 'finally and irrevocably committed' to the 'principle of integration'. He also pointed out that the government was merely committed to establishing a 'countrywide State-controlled banking structure ... with the Imperial Bank as the nucleus', and not as such to the 'integration' of state banks with the latter institution. There were different ways of establishing this countrywide banking structure, the Governor pointed out. The Central Board of the Bank had already rejected one of these, viz. 'compulsory acquisition' of the state banks. If talks were to be of 'real use', they should cover other alternatives such as expanding the State Bank of India to the states, the possibility of 'voluntary amalgamation', and in the latter event, the question of whether the bank concerned would be a subsidiary of the State Bank or of the Reserve Bank.

The practical implications of all the alternatives will have to be ascertained from the point of view of the State Governments and incidentally, of the banks themselves, with a view to deciding final policy ... [and this] object cannot be achieved if the discussions take place on the basis that 'integration', in the sense of compulsory acquisition, is a settled principle on which no views are to be expressed by the State Governments.

The Bank's officers were, as noted above, associated with officials of the Finance Ministry in their talks with state governments. According to an interim report of these consultations prepared at the end of March 1955 by S.G. Barve, state governments did not object to the principle of integrating their state-associated banks with the proposed State Bank of India. They had, in fact, received the recommendations of the Rural Credit Survey, including that for an integrated State Bank, 'with general agreement ... even enthusiasm'. While expressing a 'lively hope' that the new institution, and the proposed reform of rural credit generally, would improve the availability of finance for agriculture and for small and cottage industries, ministers and officials of state governments also recognized that the State Bank's expansion into their regions or states 'could not but affect very adversely the position of the State-associated banks'.

The chief executives of the major state banks, who were consulted informally, were divided over the integration plan. There were objections from some to the principle, deriving either from ideological positions or from the prospect of being deprived of positions of 'patronage and importance', while others endorsed the idea. Nor was there any 'opposition on the political plane' to the idea of integration; on the contrary there was a 'modest enthusiasm' for it. However, there was some anxiety over the methods that would be used to estimate compensation, the future of the staff of these banks, transitional dislocations, the new institution's readiness to sustain the services provided by the local bank, and its responsiveness to local needs.

Pointing out that the concerns voiced by non-official members of the Reserve Bank's Central Board did not find any echo in the states (there was not, for example, 'such a screech on the ground of local sentiment' even among directors of state-associated banks), Barve also took the opportunity to reject the Central Board's argument that the integration plan should be deferred because of the scale of the administrative effort involved. The programme of cooperative organization proposed by the Rural Credit Survey required even greater effort, and having decided on these measures in principle, the government should not be found wanting in implementing them.

Barve was also convinced that the Central Board's opposition to the integration plan stemmed from its 'ideological preference for the private sector in banking'. Having, in the course of his report, disposed of the Bank's reservations about the integration plan, Barve proceeded to examine the reconstitution of the state banks. In his view, there was no advantage to the banks being converted into subsidiaries of the Reserve Bank rather than of the State Bank, since in the latter case it would be possible to bring about the 'ultimate integration' of these subsidiaries with the parent institution. He did not think wage costs would be very different under the two arrangements. In any case, he argued, 'it would be unusual and probably embarrassing' for the Reserve Bank to have fully-owned commercial banking subsidiaries. Finally, Barve proposed that the government should announce in unambiguous terms its decision to 'compulsorily' acquire and integrate the state banks during the debate on the State Bank of India bill, and bring forward the legislation necessary for the purpose.

Barve's report amplified the distance between the Bank's and the government's approaches towards the state banks. The Department of Banking Operations minuted in response to Barve's interim report that the government appeared to have decided, in principle, to proceed with the integration of the state banks without effectively addressing the many doubts and reservations raised about the proposal. It pointed out that state banks had not worked at all well in India due to governments interfering with their operations on 'grounds other than financial'. The central government had made public its intention not to interfere with the working of the State Bank, but it remained to be seen how far this pledge was upheld in practice. In any event, the Department of Banking Operations observed wryly, the government's summary rejection of the recommendations of the Central Board of the Reserve Bank was 'not a good omen in this direction'.

Rama Rau also reacted to Barve's recommendations by noting that nationalization was not the only means of exerting public control and supervision over the state banks. Objecting to the reference to the Bank being motivated by its ideological preference for the private sector, the Governor wrote to Barve to demand that the accusation should be deleted from any notes put up to the Cabinet. Opposing Barve's suggestion that the Finance Minister should announce the government's decision to take over the state banks in the course of the debate over the State Bank of India bill, he repeated the Bank's view that it was necessary to carry out a detailed investigation of each of the state banks in order to determine which of them could be 'integrated' and how. 'I will of course discuss this, and the other issues, with the Finance Minister', Rama Rau added.

No record exists at the Bank of what transpired in these discussions, but clearly, the Bank managed to restrain the government's enthusiasm for an immediate takeover of the state-associated banks. By April 1955 the government grew resigned to the inevitable, and decided to limit the State Bank of India bill to the Imperial Bank of India. As debate raged over the manner in which public control and supervision could be brought to bear on the state-associated banks, it grew clear that the Rural Credit Survey's proposal to integrate them with the proposed State Bank of India had few supporters. Even Venkatappiah appears to have resiled from his original integration plan, preferring instead an arrangement which would preserve the identities of the state-associated banks. The residual argument in favour of the original integration plan was the practical one of using it as a means of securing public control over the Imperial Bank of India. With the Bank and the government deciding to buy out the Imperial Bank's shareholders, even this argument for integration disappeared. The most that almost anyone was willing to contemplate was the State Bank managing state-associated banks as its subsidiaries. Consequently, the bill to set up the State Bank of India included an enabling provision authorizing the new institution to own and manage other banking institutions as subsidiaries.

STATE-ASSOCIATED BANKS IN REORGANIZED STATES

The State Bank of India came into existence on 1 July 1955, and within days of this event the Finance Ministry returned to the charge, with H.M. Patel once again writing to Rama Rau urging an early decision on the state-associated banks' future, since they could not be left 'in suspense for long'. Seeking the Governor's recommendations on the basis of the Bank's inspection of the state banks, Patel informed Rama Rau that his Ministry had already taken preliminary steps to sponsor a bill on state banks in the monsoon session of Parliament. But the Bank's inspection reports were still being compiled. Moreover in the Governor's opinion, the next moves on state-associated banks would have to await reconsideration by the Central Board of its original resolution on the subject, and consultations with the Board of the State Bank of India. But clearly, as a minute by the Chief Officer of the Department of Banking Operations observed, Rama Rau did not share the government's urgency in regard to the state-associated banks. He also seems to have grown doubtful of the merits of integration even in extending banking facilities in the country, and apprehended that it

might, in fact, result in restricting [credit] facilities as neither the State Bank nor a subsidiary of the State Bank working on the basis of rigid statutory regulations would be prepared to provide the type of finance which the various State-associated banks are providing at present.

Even as the Bank deliberated the future of the state-associated banking sector, the Report of the States Reorganization Commission was published. As Rama Rau anticipated, the dust raised by the Report had to settle before any further progress could be made in dealing with state-associated banks. At the same time, the imminent reorganization of states helped frame the considerations underlying the next stage of the integration exercise in a new light. The Commission's Report held several implications for the future role of state banks. Of direct concern to the integration project were the Commission's proposals to abolish the distinction between Part A and Part B states, merge PEPSU with Punjab and Saurashtra with Bombay, and incorporate princely Mysore and Madhya Bharat into the new states of Karnataka and Madhya Pradesh respectively. The disappearance of Part B states also promised to help complete the process of appointing the Reserve Bank as banker to state governments.

The most serious repercussions of the Commission's proposals for the functioning of state-associated banks arose in regard to Hyderabad. Large parts of the state were to be included in Karnataka and Bombay, and this was expected to create serious operational difficulties for the Hyderabad State Bank. Besides the possibility of the assets and liabilities of the bank (in which Hyderabad state held 51 per cent of the share capital) having to be shared with the other two states, there was uncertainty regarding which state government would have eventual responsibility for the bank, particularly in the event of the residuary state of Hyderabad opting, after the proposed interval of five years, to merge with Andhra Pradesh. None of the states in which the bank's branches fell would have any interest in its working and future. As the Reserve Bank noted, the Hyderabad State Bank already followed unsound practices and there was the risk that these might get worse following the dismemberment of Hyderabad state. The latter also threatened the Reserve Bank's treasury and currency chest arrangements in the area. Fourteen of the thirty-three centres in which the Hyderabad State Bank handled government business fell outside the proposed residuary Hyderabad state. The Bank had reservations about having more than one agency bank in any state. If it allowed these branches to handle government business as before, there would be the further anomaly of a bank whose control vested in one state government

conducting business on behalf of another. The future liability at these fourteen centres for the guarantee given by the Hyderabad state for the security of currency chests in the possession of the Hyderabad State Bank was also unclear, since the governments of Bombay and Karnataka could not be expected to uphold guarantees given by another state, particularly in respect of chests located in a bank over which they had no administrative control. As an internal note of the Department of Banking Development pointed out, the Commission's proposals for Hyderabad state would 'seriously dislocate the existing basis and set-up' of its state bank. Hence urgent steps were necessary to 'ensure that our interests and those of Hyderabad State Bank's depositors do not suffer as a result of the proposed reorganization of the State'.

The reorganization proposals created complications for the other state-associated banks as well. Constitutional doubts raised earlier about the powers of state governments to own and operate banking companies would be reinforced in the case of the State Bank of Saurashtra and the Bank of Patiala, since the circumstances in which these banks were founded and run by their respective state governments would have disappeared once the states of Saurashtra and PEPSU lost their identity. The future of the agency role of the Bank of Mysore too would come under a cloud since the Imperial Bank of India already functioned as the Bank's agent in the other regions of the proposed new state of Karnataka. Likewise the future roles of the State Bank of Saurashtra and the Travancore Bank in their new states. Besides, taken individually, many state-associated banks were not strong enough to be entrusted with a large number of currency chests. The reorganization of states might weaken them further if it led to the withdrawal of government deposits. More broadly, officials in the Bank's Department of Banking Development felt, unless local state-associated banks were reorganized and placed on a sounder footing, the justification for appointing them in agency roles in states might weaken as the states which had helped set them up themselves disappeared. That would leave the State Bank of India as the 'only suitable institution for carrying on our agency functions in the territories now comprising Part B states'. But that, as Venkatappiah pointed out in a 24-page note, would be an 'extremely slow and expensive' process. On purely practical grounds therefore, state-associated banks in Part B states remained the most 'obvious choice' as the Bank's agents and as custodians of currency chests. Urging a 'pragmatic rather than an ideological approach' to the problem, Venkatappiah's note underlined that the importance of safeguarding and expanding existing agency, currency chest, and treasury arrangements in the emerging circumstances indicated the urgent need for establishing 'some organic relationship' between state-associated banks and the 'Reserve Bank and/or the State Bank'.

From the very outset, i.e. since the discussions preceding the Central Board meeting in February 1955, it had been decided to leave the Bank of Baroda out of the list of state-associated banks recommended for takeover by the Rural Credit Survey. Although it had a history of state-association, the Bank of Baroda withdrew from undertaking treasury functions on behalf of the government after the expiry of its agreement with the Baroda state government in 1953. Ever since, it discharged this work only at one centre, and that at the request of the Bombay government. Consequently, the best legal opinion held that the Bank of Baroda was a commercial bank rather than a 'state-associated' bank *currently* fulfilling responsibilities on behalf of a government, and that its takeover could not be justified for the purposes in view. With the Bank, and later the Government of India, accepting this opinion, nine state-associated banks were now left in the fray.

Venkatappiah divided these nine banks into three categories. The first category comprised the State Bank of Saurashtra, the Bank of Patiala, and the Hyderabad State Bank. The first two were wholly owned by the respective state governments, while the Hyderabad state government owned more than half the share capital of the last-named bank. In other ways too, state control 'had been a feature of ... (the) development' of these banks. The second category comprised the Travancore Bank and the Bank of Indore, in both of which the governments concerned owned nearly a third of the share capital. It was expected that once the new states of Kerala and Madhya Pradesh came into existence, branches of the Travancore Bank in the former state and that of the Bank of Indore in the latter would be outnumbered by those of the State Bank of India. The third category comprised the other four state-associated banks. While essentially complementing the State Bank of India rather than competing with it, these banks represented a more widespread presence than the former in their respective areas of operation.

Responding to the view expressed in some quarters that the State Bank of India's energies and resources were already being strained by its heavy expansion programme and that it was not in a position yet to undertake major new responsibilities, Venkatappiah proposed bifurcating the takeover project from a 'pragmatic point of view'. According to his proposal, the State Bank of India would only take over state-associated banks in which the state governments already held a third or more of the capital, while the other four banks would be taken over by the Reserve Bank, both institutions running these banks as their subsidiaries and giving them the maximum possible autonomy to manage their operations under the supervision of local boards. Venkatappiah believed this solution would be acceptable to governments both at the centre and in the states, as well as to the wider community.

Public confidence in the banks will not only be preserved [thereby] but enhanced and the undesirable consequences which might arise if the State Bank [of India] were required to open a large number of branches, in the area of the respective States, could be avoided. Further ... the stage will have been set for pursuing a more rapid expansion of the currency chest system, and a basis laid, without sacrificing the good features of individual institutions, for the establishment of a ... strong countrywide banking structure

Rama Rau, who did not share Venkatappiah's enthusiasm for the takeover of all the nine state banks, favoured a more modest agenda. He proposed confining the takeover plan at least initially to the so-called Group I banks, i.e. the State Bank of Saurashtra, the Bank of Patiala, and the Hyderabad State Bank. The need for action in the case of the other six (Group II) banks, Rama Rau argued, was 'less urgent', and in the first instance the Bank might consider taking steps for 'more effective control' over these institutions while retaining them as its agents. Alternatively, he proposed that the State Bank of India could be allowed to extend to the major district towns in the Part B states, with the concerned state-associated banks existing as 'more or less "private" commercial banking institutions with little or no special control by the State'. The Governor preferred vesting the ownership and control of the Group I banks in the Reserve Bank, particularly as the State Bank which was already committed to opening 400 new offices within five years might be unable to cope with the additional responsibility. Clarifying his rather unusual suggestion to the Central Board later, Rama Rau pointed out that the State Bank's 'salary structure' being 'unduly high', takeover by it might greatly increase the establishment costs of the three banks. Local opinion too would feel more assuaged if these institutions maintained direct links with the Reserve Bank. However, the Governor was not averse to the State Bank of India taking over the Group I banks if it was 'willing and able' to do so.

Even as the government was considering Rama Rau's views, public and political interest in the future of state-associated banks was heightened in January 1956 when, at a meeting of the Standing Committee of the National Development Council, D.R. Gadgil deplored the delay in implementing the 'publicly announced policy decision' to establish an integrated State Bank covering the whole country. Gadgil's outburst and the Finance Minister's promise to the Standing Committee of early action appear to have persuaded the Finance Ministry to reject the Governor's watered-down plan and come down instead on the side of his deputy's revised plan of bringing all the nine state banks under the ownership and control of the Reserve Bank. Writing to

Venkatappiah soon afterwards, Patel regretted that the Bank and the government placed different levels of emphasis on the 'main considerations' involved. Not only was the Government of India committed to taking over all the state banks, particularly after the Finance Minister's reply to Gadgil, the former also felt, unlike Rama Rau, that the reorganization of states was 'virtually the most important and compelling reason for ... immediate action' covering all nine banks.

If we decide not to take over these banks and allow them to be converted into ordinary commercial banks, the State Bank will have to open branches in these areas and in particular at important centres at which these ... banks are functioning at present. The latter will thus have to meet severe competition which ... might easily endanger their stability, the more so as most of them will lose Government funds and patronage. ... the necessity for opening branches in these areas would also throw considerable additional strain on the State Bank and ... reduce the pace of expansion of the branches as a whole.

Patel's letter to Venkatappiah concluded by requesting him to obtain the Governor's orders 'quickly' and draw up a bill to nationalize all nine banks which could be introduced when Parliament convened for its budget session.

However Rama Rau dug in his heels and refused to yield on the future of his Group II banks. Seeking a 'reconsideration' of the recommendations of the Rural Credit Survey, he pointed out to Patel that nationalization of the state banks was only a means to an end, which was the 'acquisition of control over these institutions with a view to implementing government policies effectively'. But nationalization did not always translate into control: although the Imperial Bank had been nationalized, the Reserve Bank's control over it was 'less effective ... than over other scheduled banks'. The absorption of state banks into the Imperial Bank was earlier considered necessary as the means of acquiring a 'controlling interest in the Imperial Bank'. But with the Imperial Bank having come into public ownership through more direct means, state banks were no longer an intrinsic part of the integration plan. Secondly, once the State Bank of India emerged as a major presence in the reorganized states of Karnataka, Madhya Pradesh, and Kerala, the Mysore, Indore, and Travancore banks would cease to be vital to the programme of banking integration. In fact, he suggested, the latter could now be better achieved by establishing the State Bank of India's presence in the new areas of these states than by allowing state-associated banks to expand into them. The State Bank of India's expansion would not, contrary to the government's fears,

threaten the stability of these state-associated banks, the Governor argued, since it would not be in direct competition with any of them. The former did not for instance pay interest on deposits and maintained besides, 'very high standards' in the selection of loans for its portfolio. Reiterating his preference for confining immediate measures to the Group I banks, he adverted to the possibility of subjecting the Group II banks to greater control by the Bank so long as they conducted business on its behalf. Banks acting as the Reserve Bank's agent, the Governor suggested, should cede to the latter institution the power to appoint and remove their chairmen and chief executives, the right to secure and ratify amendments to their Memoranda and Articles of Association, and finally, powers to issue instructions on policy matters and impose special restrictions on the nature of the business they might undertake.

Rama Rau followed this up with a meeting with the Finance Minister early in February 1956. The Finance Minister initiated the discussion at this meeting by pointing out that the object of the Rural Credit Survey in proposing the takeover of state-associated banks would not be met by the State Bank of India expanding to the areas covered by them, since this would lead to avoidable duplication of banking facilities in some areas and reduce the overall extension of banking facilities. Nor could there be any question of Group II banks being allowed to withdraw from treasury and other state responsibilities. The State Bank's expansion to 'cover *new* areas' was necessary to promote currency chest arrangements, and nothing should be done to force it to spread its resources too thinly across areas where other banks were better placed to offer similar facilities. Besides, once the legal classification of state-associated banks (that they should have a history of association with states *and* be currently undertaking treasury and agency work on behalf of governments) was accepted as a basis for action, the Finance Minister pointed out, 'all ... banks falling within the definition should be taken over without exception'. Rama Rau did not depart from the views he had communicated to Patel and insisted that practical considerations prevented the Reserve Bank from taking over more than three banks in the immediate future. The Finance Minister argued that the Bank's preference pointed in the direction of a narrow and exclusive definition of state-associated banking and that once accepted, this definition could not be widened to cover the other six banks. Bearing in mind the Governor's practical difficulties, however, the Finance Minister proposed a twofold classification of state-associated banks: one category comprising banks in which the state governments concerned owned half or more of the capital and the second category comprising the other six banks. He yielded to the Governor's view that the latter category of banks should not be taken over immediately, but insisted on their being classified as 'state-associated' banking

institutions so that the government remained free to review their position at a later stage if circumstances so warranted.

Soon after this decision was taken, the Attorney General advised the government that while the State could take over the Hyderabad, Patiala, and Saurashtra banks, it could not arm itself with special powers that would be confined in their application to the remaining six (i.e. Group II) banks. The situation thus created was discussed at a meeting between Rama Rau and Deshmukh towards the end of March 1956, at which the latter pointed out that the Attorney General's view left the government with two alternatives—'to leave these banks alone or take them over'. Rama Rau, who had 'enough on his plate', remained unrelenting in his preference for the former course. Nor was he averse, he told Deshmukh in answer to a 'direct question', to Parliament being told that these banks were not being taken over because the 'Reserve Bank did not feel confident' of managing them. Finally, however, the Governor and the Finance Minister agreed that while immediate legislative action would be confined to the Group I banks, the position of the other six banks should be reviewed at the end of one year, and that a 'formula' would be drawn up to enable the government to take the latter over 'if and when' it decided to do so. It was also agreed that the State Bank of India would not open any branches in the areas covered by these banks in the meantime, and that the Reserve Bank would enter into agency arrangements with the Mysore and Travancore banks.

Towards the end of May 1956 the Union Cabinet approved in principle the decision to take over the ownership and management of the Hyderabad, Patiala, and Saurashtra banks and entrust these institutions to the Reserve Bank of India. The Bank's Central Board also approved the proposal in June 1956 and the bill to take over the three state banks was quickly drafted. Though prolonged by differences regarding methods of valuing the three banks, consultations with state governments over compensation also reached a decisive stage. At this point the Prime Minister, Jawaharlal Nehru, intervened to suggest that the legislation covering these institutions should contain a clause enabling the government or the Bank to take over the other (Group II) banks 'whenever ... necessary'. On being apprised of the latest turn of events, the Governor advised the Finance Ministry that apart from the merits of the question, any effort to widen the scope of the bill would delay legislation since it would now have to be extensively redrafted to include another definition of state-associated banks and some indication of the basis on which shareholders of the remaining six institutions would be compensated. The delay, the Governor pointed out, would come in the way of the three banks being taken over before the states were reorganized, and this would have particularly serious

implications for the Hyderabad State Bank and for the banking and treasury arrangements managed by it.

As events transpired, however, the original bill to take over the Hyderabad, Patiala, and Saurashtra banks had to be narrowed rather than widened. Parliament had before it a bill for amending the Constitution to enable state governments to carry on any trade or business relating to matters included in the Union list. Once approved, the amendment was expected, among other things, to remove the constitutional difficulty which the original bill to take over the Group I banks was intended partly to address. Hence, as a memorandum to the Union Cabinet pointed out, the decision to abandon the 'experiment of decentralized nationalization of banking' in Patiala and Saurashtra and take the two state banks into the Reserve Bank's ownership, deserved to be 'reconsidered'. Local opinion too, favoured retaining the banks under their present owners; while the chief ministers of the two states agreed to the Banking Companies Act and the Reserve Bank of India Act being extended to these institutions, and to the State Bank of India extending its activities to their states. However, the memorandum maintained, it was necessary to proceed with the nationalization of the Hyderabad State Bank as originally proposed since it was 'on a wholly different footing'. Unlike the other two banks, the Hyderabad State Bank was not a 'well-conducted concern'. Besides, since Hyderabad state would soon be split into three parts, the division of its assets and liabilities and the transfer of its management presented major difficulties; the division of the state would also throw its 'financial and banking machinery ... out of gear'. These contingencies would be averted if the central government took over the bank, the memorandum argued.

The same memorandum to the Union Cabinet was also in favour of the government declaring its policy towards the Group II banks in 'somewhat more definite terms' than was proposed earlier. The Reserve Bank, it admitted, was 'never happy about the proposal to take over the State-associated banks'. There was 'no compelling necessity' to acquire these banks to extend rural credit nor for the Reserve Bank to spend its limited manpower resources to take over and run these institutions. Nor was it 'quite appropriate for [the] Government to keep the banking companies, in question, in a state of suspense'. Hence the memorandum advised the Cabinet to decide against 'proceed[ing] further' with nationalizing the other six banks too 'for the present'. These proposals were 'seen and approved' by the Prime Minister.

The Cabinet met on 27 August 1956 to approve the decision to take over the Hyderabad State Bank, the proposal to pay compensation to the bank's shareholders at the rate of about Rs 94-4-6 for each share having a face value of Rs 85-11-5, and that to leave the Patiala and Saurashtra banks to be

managed by their respective state governments. Despite the Prime Minister having earlier approved the proposal, the Cabinet turned down the recommendation of the Cabinet Memorandum concerning the Group II banks and decided that their nationalization 'may be further examined later in consultation, if necessary, with the State Bank of India'.

The draft bill for taking over the Hyderabad State Bank was ready, but a heavy parliamentary schedule prevented it from being taken up for consideration. At the Bank's recommendation, the government promulgated an ordinance in September 1956, taking over the bank from 22 October the same year, and vesting its ownership and management in the Reserve Bank. The State Bank of Hyderabad bill came up for consideration in November 1956 and was passed the same month by both houses of Parliament.

THE AD HOC COMMITTEE'S PROPOSALS

Within months of this, however, debate revived about the future of state-associated banking. Rama Rau's resignation in January 1957 marked a decisive shift in the balance of opinion on the issue within the Bank. Venkatappiah had always been an enthusiastic advocate of takeover, and it was his view which now began to prevail in the corridors of the Bank. K.G. Ambegaokar, who held the fort for some weeks after Rama Rau vacated office, did not have strong views on the subject, and appears to have been willing to be guided in regard to it by Venkatappiah; while H.V.R. Iengar, who succeeded Rama Rau as Governor after having earlier been the Chairman of the State Bank of India, was sufficiently impressed by its 'new look' to support a scheme intended to strengthen his former institution's ability to expand credit to agriculture and small-scale industry. T.T. Krishnamachari, who stepped into Deshmukh's shoes as Finance Minister after a short interval, was initially averse to taking over state-associated banks. But he soon changed his mind, and once convinced of the necessity of bringing these banks under public ownership, Krishnamachari infused the whole endeavour with his characteristic sense of urgency and purpose.

Secondly, whether or not it was so intended by TTK who was the force behind the move, the future of state-associated banks dovetailed quite neatly into a new exercise aimed at equipping the State Bank of India to function as an 'instrument of national policy' rather than merely as a commercial bank. An ad hoc committee comprising senior officials of the Bank and the State Bank of India was set up to prepare proposals towards this end, but this committee also helped lend focus to simmering apprehensions within the Reserve Bank about the uncertainty and complications arising from existing

forms of ownership and regulation of the major state banks and of their association with banking and treasury arrangements in the states. As Venkatappiah wrote to H.M. Patel towards the end of February 1957, the problems which cropped up in several of the states in which the major state-associated banks and the State Bank of India operated could not be resolved unless their relative roles were defined with greater clarity. For example, the Punjab government which now owned the Bank of Patiala wanted the latter to be appointed as the Bank's agent in the former PEPSU area. The Bank felt the state government's suggestion could not be examined except with reference to the State Bank of India's place in the area and the advisability of entrusting currency chests to a state government or a 'banking institution under its control'. In Kerala and Mysore too, uncertainty over the roles likely to be assigned to the respective state-associated banks in different parts of the two states inhibited the State Bank of India's expansion into them. While banking and treasury arrangements might eventually have to be entrusted to more than one bank in some of these states, the Rajasthan government, on the other hand, was finding the 'present complex arrangements for the management of Government accounts through several banks ... highly inconvenient'. Since the State Bank of India could not reasonably be expected to cover the whole state except after great delay and expense, the state government proposed reviving earlier efforts to amalgamate the major state-associated banks in the state.

In addition, the Bank was already experiencing difficulties in regulating the activities of the Patiala and Saurashtra banks which did not bode well for the future. It transpired that, contrary to an undertaking given by the former PEPSU government that it would confine its activities to the former PEPSU area, the Bank of Patiala opened a branch at Chandigarh without consulting the Bank. It required the central government's intervention to put an end to the bank's plans to expand to several other centres outside the PEPSU region. Similarly, the State Bank of Saurashtra was 'no longer content' to confine its operations to the former Saurashtra state, and was making efforts to expand to centres such as Bombay and Ahmedabad. Besides, the bank continued to hold large government balances, albeit as a transitional measure, contrary to the agreement between the Bank and the Government of Bombay.

In the Bank's view as it prevailed and was communicated to the Government of India at the end of February 1957, three sets of issues hung fire. The first related to agency arrangements, particularly in the former Part B states. The case for appointing state-associated banks as agents in the latter states had no doubt weakened following the reorganization of states. On the other hand, these banks served in agency roles at nearly two-thirds of the treasury and

subtreasury centres in the five states where they operated—Punjab, Bombay, Mysore, Kerala, and Rajasthan. The second pertained to the State Bank of India's expansion programme, involving the opening of 400 branches in five years. This target was fixed on the assumption that the state-associated banks would be integrated with the State Bank of India. If the former were 'left out' of the integration scheme and the main burden of expanding rural credit facilities entrusted to the State Bank of India, it would have to divert some of its energies to opening branches at the 163 treasury and subtreasury centres where the former alone had a presence. Consequently, even after 400 new branches were opened, the goal of an integrated 'countrywide [banking] network' would remain elusive.

The third issue related to the need for developing currency chest and remittance facilities and the desirability of transferring responsibility for managing the former from state governments to the State Bank. Progress in opening currency chests in the former Part B states remained very slow, largely because state-associated banks were generally not 'strong enough to assume the ... risks and responsibilities' of managing currency chests. Once again, therefore, the situation pointed in the direction of taking steps to strengthen state-associated banks and equip them to complement the efforts of the Reserve Bank and the State Bank of India to expand credit to small borrowers in rural and semi-urban areas, provide efficient remittance facilities, and manage agency and treasury arrangements.

The ad hoc committee, which comprised the Governor, H.V.R. Iengar, as its chairman, Deputy Governors Ram Nath and Venkatappiah, D.R. Gadgil, and P.C. Bhattacharyya, Chairman of the State Bank of India, finalized its report in June 1957. It recommended extending the pattern of agency and treasury arrangements obtaining in the Part A states to the former Part B states. It rejected the idea of state governments continuing to maintain deposits and independent relations with banks for transacting government business, except as a purely transitional measure, and recommended the termination of such arrangements where they existed. The committee believed the three issues which the Bank raised with the government in February 1957 were best addressed by utilizing the 'existing machinery' of state-associated banks 'to as large an extent as possible' in order to supplement the activities of the State Bank of India. Towards this end, the committee recommended the transfer of the control of state-associated banks to the central government or an institution controlled by it. It was also in favour of preserving the functional autonomy of these banks whilst bringing their operations under the control and supervision of the State Bank of India.

In practical terms, this meant converting all the major state-associated banks into subsidiaries of the State Bank of India. The committee viewed the Reserve Bank's ownership of the Hyderabad State Bank as a 'stop-gap' arrangement and saw no reason why this bank too should not be transferred to the State Bank of India and constituted as its subsidiary. The plan to constitute the major state-associated banks as subsidiaries of the State Bank of India would secure for the country 'one integrated, centralized organization for the management of treasury arrangements and currency chests' while retaining 'all or ... most of the advantages that are available at present to the people of the areas ...' covered by these banks. However, for practical and administrative reasons and so as to avoid any 'psychological effect of the wholesale implementation of the policy on the general economic situation in the country', the committee recommended carrying out the reform in stages. In the first stage, state-associated banks in which state governments owned a quarter or more of the capital (the Bank of Patiala, the State Bank of Saurashtra, the Bank of Indore, the Bank of Jaipur, and the Travancore Bank) were to be taken over and reconstituted as subsidiaries of the State Bank. The question of integrating the remaining three banks (the Bank of Bikaner, the Bank of Rajasthan, and the Bank of Mysore) was to be 'considered in due course but without undue delay'. In the meantime, the State Bank of India was free to negotiate the takeover of these institutions by mutual agreement. While allowing existing treasury and currency chest arrangements to continue in the areas served by these three banks, the committee declared that 'eventually, no bank other than the State Bank, together with its subsidiaries, will be allowed to act as the agent of the Reserve Bank or to retain currency chests'.

Communicating the main recommendations of the ad hoc committee to the Finance Minister, Iengar suggested that the next step of framing the necessary legislation should be taken up after the Central Boards of the Bank and of the State Bank of India had had a chance to consider the report. The Deputy Governor followed this up by adding that local sentiment in Mysore actually favoured the takeover of the Bank of Mysore as a subsidiary of the State Bank of India, and that the Government of India should take this 'marked feeling' into account in its deliberations.

With plans afoot to introduce legislation in the monsoon session of Parliament to implement the first stage of the ad hoc committee's reforms package, Iengar convened a special meeting of the Bank's Central Board in July 1957 to discuss it. The Governor's memorandum pointed out to the Board that the committee's recommendations were not a 'prelude to the nationalization of commercial banks in the country'. Unless they were

implemented, it would not be possible to set up a countrywide banking network nor create a banking institution which could act as an 'instrument of national policy'. Iengar also underlined that the setting up of currency chests and provision of remittance facilities were being hindered by the absence in many areas of suitable banking institutions, and drew attention to some 'highly dangerous' trends in state governments' handling of currency chests. 'Unauthorized raids on these chests are already considerable and it looks as if with deficit budgets, such raids may become larger and more frequent in future.'

The Board refused to withdraw from its earlier position on the takeover of state-associated banking. It accepted a part of the committee's recommendations and agreed that the Patiala, Saurashtra, and Hyderabad banks should be constituted as subsidiaries of the State Bank of India. While five members of the Board agreed with the proposal to nationalize the Bank of Indore, the Bank of Jaipur, and the Travancore Bank and constitute them as subsidiaries of the State Bank of India, six other members felt 'compulsory legislative action' was 'undesirable' for the end in view, and that 'acquisition or taking over of control of these banks should be settled by negotiation'. The Board also asked to be consulted before fresh legislative measures were undertaken to deal with the Mysore, Rajasthan, and Bikaner banks. As the Governor explained the reasoning of these six members later to H.M. Patel, they regarded the proposal as 'merely the thin end of the wedge towards nationalization of banks'. They also felt 'compulsory legislative action [was] "undemocratic"—whatever that means'. According to Iengar, some members advised the Bank and the government to buy up the shares of state governments and of private shareholders willing to sell, and thus come into the ownership of a majority of the shares. Although, under the Banking Companies Act, this would not translate into actual control, they felt the government would nevertheless be justified thereafter in converting these banks into subsidiaries of the State Bank of India.

Remarking to Patel on the sharp divisions within the Board, Iengar felt opposition to the ad hoc committee's proposals might reflect wider opinion in the country and could have some effect on overseas reactions as well. It would not have been difficult for him to 'brandish the big stick' and get the Board's approval. 'A couple of members would then have changed their votes'. But he refrained from such tactics since he wanted the Board to 'express its views with complete frankness and freedom'. With the State Bank Board having agreed to the proposals, the government was free to go ahead with the necessary legislation. 'If it were purely a domestic matter, I would have strongly recommended ... taking such a course because I do not think the six members ... are really right.' However it was also necessary to

consider the effects of such a move on 'opinion in places like London, New York and Washington ...' which would depend to some extent on the reaction within India.

If some of our people said the ... step was unwise and was a prelude to [the] nationalization of commercial banks, the cry would be taken up in foreign centres and that, however misguided, would be most unfortunate from our point of view.

Underlining the importance of devoting some thought to the 'public relations aspect' of the takeover, Iengar pointed out that little would be lost in deferring the move for the time being since in any event, Parliament would have no time to pass the legislation in the current session. In the meantime, he proposed, the Life Insurance Corporation should be told to purchase shares of the Jaipur, Indore, and Travancore banks 'in suitable lots (as and when they become available) at reasonable prices, and without undue publicity'.

Following the Bank's advice, the government decided initially to bring forward a bill to take over only the Saurashtra, Patiala, and Hyderabad banks. The Bank drafted the necessary legislation in August 1957. But even as this piece of legislation was receiving finishing touches in November, T.T. Krishnamachari expressed surprise that it 'left out' the Jaipur, Indore, and Travancore banks. According to the Finance Minister, 'a slight delay' in moving the legislation was a 'small price to pay for avoiding the trouble of having to pilot two bills through Parliament' in quick succession. Since it was proposed to take over all the six banks, the Ministry demanded 'one consolidated bill'. This request reached Bombay on 12 November and without it appears much demur, the Bank drafted and despatched the modified bill to New Delhi on 23 November. However, in a personal meeting with the Finance Minister in Madras early in December 1957, Iengar impressed upon him once again the need to educate the public about the 'special reasons' for the bill, and for 'disabusing them of any impression that this was the beginning of a programme of nationalization of commercial banks'. Iengar also agreed to 'help [the government] in this public relations task'.

This exercise also ran into rough weather almost at the outset. The Punjab government opposed the move to take over the Bank of Patiala which it said was a scheduled bank adhering to all the relevant provisions of the Banking Companies Act and functioning efficiently under the supervision of the Reserve Bank whose nominee sat on the Board of Directors. Describing the decision as a 'rude shock', the Punjab government maintained that takeover by the central government or any of its agencies would rob the Bank of Patiala of its regional character and 'upset the economy of the area with whose prosperity

... [it] has been so closely linked for over 40 years'. As it happened, however, this piece of legislation never made it to law. It was tossed aside by the storm created by the Mundhra affair which also swept T.T. Krishnamachari and H.M. Patel out of office. The new Finance Minister, Morarji Desai, was not as enthusiastic as his predecessor about nationalizing privately-owned state-associated banks (viz. the Jaipur, Indore, and Travancore banks) against their will, so that once again the search began for other ways in which these institutions could be brought under public ownership.

VOLUNTARY TAKEOVER OF STATE-ASSOCIATED BANKS

One idea which was canvassed was for the State Bank of India to acquire a majority stake in these institutions by purchasing their shares. This was quickly rejected as impractical. There was no market as such for the shares of some of these banks. In other cases, the market was thin or the shares were very tightly held. Although state governments and publicly-owned institutions such as the Life Insurance Corporation held a significant interest in many of these banks, the State Bank would still have to make substantial purchases of stock from the market where one existed, to acquire majority ownership. Such purchases, the Bank's Department of Banking Development calculated, would range from 17 per cent of the stock in the case of the Bank of Indore to 51 per cent in the case of the Bank of Mysore and the Bank of Rajasthan. However discreet the intervention, purchases on this scale would inevitably publicize the State Bank's interest and drive up the prices of these banks' shares 'to fantastic levels'. Even should the State Bank succeed in acquiring 51 per cent of a bank's stock, it would, unless exempted from its provisions, be prevented by the Banking Companies Act from exercising 'effective control' over the working of such a bank.

The other solution proposed was to take over the state-associated banks with the consent of their shareholders. Strongly advocating this course after being told of the impracticability of the State Bank acquiring the stocks of these institutions from the market, Iengar noted in June 1958 that 'two points' were 'clear' to him. The first was that the idea of the State Bank operating state-associated banks as subsidiaries should not be 'abandoned'. The bank, which had begun taking an interest in the cooperative movement and in small industries, now had a 'new look' about it. Other banks could not be expected to organize their affairs to support government policies in the same way. Areas covered by state-associated banks could also benefit from the presence of the State Bank of India if it started opening branches there, but that would

be a 'lengthy and difficult' route to adopt. Therefore he was 'driven to the conclusion that the State Bank must get control over the functioning of these banks'. The only way of doing so was to acquire a 'controlling interest in the share capital of these institutions'.

At the same time, 'if it is possible to avoid compulsion, it is better to avoid it ... as a matter of public relations' Hence Iengar turned, with the Finance Minister's agreement, towards the possibility of persuading shareholders of state-associated banks to pass resolutions consenting to their institutions being taken over by the State Bank and operated as its subsidiaries. Two alternatives were canvassed in this connection. The first proposal, which found favour with the Bank's Legal Division, was for the banks concerned to move the courts under section 391 of the Companies Act for an 'arrangement' between themselves and shareholders to transfer 75 per cent of their stock to the State Bank of India. The State Bank of India responded with little enthusiasm for this scheme which it felt was 'full of uncertainties and ... obstacles at each stage'. It was far from certain that courts would intervene in the affairs of banks which were not suffering from 'mismanagement or malpractice', or that they would regard it 'in the public interest' for shareholders of a bank to 'part with their investment'. Even should a court yield to the State Bank's plea on both counts, the right of appeal could not be denied to a shareholder. Unless terminated by legislation of the sort which the Reserve Bank and the State Bank wished now to avoid, the proposed course would lead to litigation and put off indefinitely the consummation of the whole project. The task of imposing some uniformity on the banks' constitutions and organizations after they were taken over would also be prolonged by wrangling and litigation. According to Bhattacharyya, these obstacles were potentially so formidable that he was prepared, should recourse to the Indian Companies Act offer the only way of achieving their voluntary takeover, to leave the privately owned banks 'altogether' out of the integration scheme and expand the State Bank's activities 'to cover the areas in question within a reasonable period'.

The State Bank's own preference was for proposing to all banks that they should pass shareholders' resolutions 'indicating their willingness to be taken over as subsidiaries of the State Bank of India' and stipulating broad conditions about compensation and the size of the 'minority' stake. Banks which passed resolutions agreeing to the takeover, Bhattacharyya proposed, could be included in the existing draft legislation. This proposal would give all subsidiary banks a statutory character and uniform constitutions without recourse to prolonged legal or other action, and ease the State Bank's task of administering them. In conveying this proposal, Bhattacharyya suggested informing state-associated

banks that they stood to lose government business and balances if they insisted on retaining their present ownership and management, and face competition from the State Bank of India in their areas of operations.

Iengar was quick to spot the merits of Bhattacharyya's proposal and commend it to the Finance Minister. The government's 'good offices', the Governor told Desai, was 'required in very large measure' to persuade the banks to pass the intended resolutions. With the Finance Minister also accepting the proposal, Bhattacharyya wrote to the six privately owned state-associated banks explaining the features of the latest takeover scheme and suggesting that they secure appropriate resolutions from their shareholders. The Bank of Rajasthan, the majority of whose shares was closely held by a few members of one family, was determined to avoid the State Bank's embrace. But shareholders of the other banks passed resolutions as suggested. There was a minor scare in the case of the Bank of Mysore after some shareholders, led apparently by three directors of the bank, changed their minds and demanded to reconsider the earlier decision favouring the takeover plan. But the Chief Minister and Finance Minister of the state remained firmly committed to the original resolution, while it also turned out that the new demand was not as representative as it had seemed earlier. In the event, the resolution opposing the takeover was not pressed when the extraordinary meeting convened. At the same time, a petition in the local High Court disputing the takeover was also withdrawn.

The State Bank of India (Subsidiary Banks) Bill, 1959 was introduced in Parliament on 4 March 1959, and was referred to a Joint Select Committee at the end of April 1959. The bill, as amended by the Select Committee, was passed by the Lok Sabha on 12 August 1959 and by the Rajya Sabha the following week. With the President assenting to the legislation early in September 1959, the decks were cleared at long last to take over the major state-associated banks, vest their ownership in the State Bank of India, and reconstitute them as its subsidiaries. Having already come under the Bank's ownership, the State Bank of Hyderabad presented the least complications. It was the first state-associated bank to be reconstituted as a subsidiary of the State Bank of India, commencing business in that capacity on 1 October 1959. The State Banks of Bikaner, Indore, and Jaipur came into existence on 1 January 1960, and the other subsidiary banks were established during the course of the next few months. The State Bank of India's holdings of the shares of the new institutions ranged from 100 per cent in the State Banks of Hyderabad, Patiala, and Saurashtra, to just over 81 per cent and 75.5 per cent respectively in the State Banks of Indore and Travancore, and about 58.5 per cent in the State Bank of Mysore.

As proposed by the ad hoc committee, compensation for the banks taken over was negotiated on the basis of their net worth. In the Governor's words, the compensation amounts as finally determined were 'virtually in the unanimous opinion of the shareholders concerned ... exceptionally fair, if not generous'. The ad hoc committee had suggested three ways in which to finance the State Bank of India's acquisition of the six state-associated banks which were originally proposed to be taken over. The Bank's Central Board recommended that the State Bank should raise the entire amount by issuing shares with a face value of Rs 100 to the Bank at a premium of Rs 250, and credit the realized premium to its Reserve Fund. The State Bank, on the other hand, was keen to avoid financing the entire take-over by raising fresh capital and proposed instead to raise Rs 75 lakhs in the form of fresh capital contributed by the Bank, and borrow the remainder from the latter in the form of long-term deposits. The State Bank's plan was also approved by the central government.

However, circumstances had changed considerably by the time the take-over scheme came to fruition. The number of banks intended to be taken over increased to eight, and in the case of five of these banks, the Subsidiary Banks Act allowed private shareholding of up to a maximum of 45 per cent. The State Bank of India also having stepped up its dividend in the meantime from 16 per cent to 20 per cent, it was apprehended that its dividend liability on the additional shares might substantially exceed its income from the subsidiary banks. Therefore it was decided that the Bank would place the entire compensation amount, as and when it became payable, in the form of long-term deposits with the State Bank of India at rates of interest to be determined after some idea had formed of the latter's likely income from its subsidiaries. The committee of the Bank's Central Board was not enthusiastic about this suggestion and expressed surprise that the State Bank could not find the necessary resources on its own without recourse to the country's central bank. But with the Government of India also approving this arrangement, the Reserve Bank agreed to finance the State Bank's acquisition plans in the manner suggested by it.

The first request for a long-term deposit was for Rs 80 lakhs to acquire the State Bank of Hyderabad which, until then, was owned by the Bank. In all, the Bank placed with the State Bank fixed deposits aggregating Rs 6.8 crores, representing the compensation paid by the State Bank of India to shareholders of the eight state-associated banks. In 1961 and again during the following year, the Bank briefly considered converting the deposits gradually into shares of the State Bank, but this proposal appears not to have found favour with the latter institution. It was decided thereafter to arrange for the deposits to be repaid at

an early date, but repayment too was put off as a concession to the State Bank's view that the deposits should be maintained until the subsidiaries started yielding a steady return in the region of about 6 per cent per year. Finally in 1965, the Bank decided in consultation with the State Bank to withdraw these deposits in a phased manner. Withdrawal commenced in January 1967 in three roughly equal annual instalments, and was completed in January 1969.

When the time came to determine the interest payable on these deposits, the State Bank took the view that apart from being reimbursed for the expenditures it incurred in taking over and administering its subsidiaries, it was also entitled to be remunerated for the management services it provided to them. After allowing for both, it proposed paying the Bank an interest of 1.5 per cent on its deposits. Justifying the demand for remuneration, the State Bank argued that its superior management equipped the subsidiaries to discharge government business and treasury functions. Besides 'the entire ramifications' of the bank were placed at their disposal, and the 'cost of these services' could not be estimated. The State Bank's association was also a source of strength to the subsidiaries and gave them access to 'tangible facilities and concessions'. Therefore remuneration accorded with 'normal business principles'. Although the State Bank would have preferred a remuneration of 5 per cent of the dividends accruing to it from the subsidiaries, that would have left it just enough to offer the Bank a mere quarter per cent on its deposits in 1960-61. Hence it proposed remunerating itself to the extent of 2.25 per cent of the dividends it received from the subsidiaries, so that the Bank might be paid an interest of 1.5 per cent on its deposits.

Many officials of the Bank felt the latter rate was unjustifiably low, more so as the State Bank's proposal amounted to remunerating itself for running the subsidiaries before paying its creditors their dues. Questioning the 'basic philosophy' underlining its arguments, the Chief Accountant noted that it should pay the Bank a rate of interest closer to what it would have paid other depositors lending for a similar term. The subsidiaries the State Bank had acquired were 'running concerns having a large network of branches' which would increase its future 'strength and earning capacity'. Therefore, the Chief Accountant remarked, the

basis on which the rate is now being calculated, viz. that the State Bank is managing these subsidiary banks not as Principal, but something like Managing Agents entitled to their charges and commission from the very outset of the setting up of the businesses even by depriving the creditor of a 'fair' return on the funds lent by it, hardly appears appropriate to the circumstances of the case.

The Bank accepted the State Bank's proposals, including those for management remuneration, in 1961. However, following extensive internal discussions, it decided in 1962 that while the State Bank could reimburse itself for the cost of running the subsidiaries, it was not entitled to be 'remunerated by way of commission for looking after the subsidiary banks'.

SOME SUBSIDIARY ISSUES

Soon after they came into existence, the Bank's attentions were engaged by the need to consolidate the subsidiary banks in Rajasthan. Inspections by both the Reserve Bank and the State Bank revealed the weak position of the State Bank of Jaipur and its inability to bring about immediate improvements and survive viably as an independent unit. Besides, Rajasthan was the only state to have two subsidiary banks of the State Bank of India and diseconomies arose from the fact of both institutions having offices at several common centres. The combined unit, it was also expected, would become the largest of the State Bank's subsidiaries and offer an attractive magnet for other weak banks in the area to merge with it.

As the State Bank held 94 per cent of the equity of the Bikaner bank and 98 per cent of that of the Jaipur bank, the two institutions could in principle be amalgamated under Section 38 of the State Bank of India (Subsidiary Banks) Act. Talks to consolidate the Rajasthan subsidiaries began not long after they changed status, but the State Bank of India preferred to defer any action on them until the reforms it contemplated in the management and working of the State Bank of Jaipur had had some chance to take hold. Finally towards June 1962, the State Bank sent the Reserve Bank a draft scheme proposing amalgamation of the two institutions through one of the banks acquiring the business of the other. But the Bank's Legal Adviser believed this course to be fraught with legislative and legal complications. Following this, the State Bank proposed amalgamating the two institutions as in its original proposal, while deferring consequential amendments to the Subsidiary Banks Act to a later date. The new Governor, P.C. Bhattacharyya, felt any legislation necessary should be enacted promptly and that it would not be wise in its absence to extinguish the Bank of Jaipur. Finally, after some deliberation, it was decided to adopt the scheme for amalgamation proposed by the State Bank and take up with the government the question of amending the Subsidiary Banks Act, so that both the amalgamation and the amended legislation came into effect on a common date. It was agreed in discussions between the Governor, the Finance Minister, and the Chairman of

the State Bank of India to name the new bank the State Bank of Bikaner and Jaipur, and locate its headquarters at Jaipur. With the Boards of the two banks agreeing upon the new name in September 1962, the government formally sanctioned the amalgamation scheme in December and specified 1 January 1963 as the takeover date. The necessary legislation, which included among other things provision for the orderly winding up of two minor state-associated banks, viz. the State Bank of Dholpur and the State Bank of Kurundwad (Junior), came into effect in December 1962. The Bank of Rajasthan however stood its ground and survived as a private sector bank.

Once the process of taking over the state-associated banks was completed, proposals were mooted to merge the subsidiary banks with the State Bank of India. Although the Reserve Bank and the State Bank of India discussed the issue in 1963–64 and the matter was raised in Parliament in 1964, the issue came to the fore in 1967 after a private member's bill proposing the merger of the subsidiary banks with the State Bank of India was tabled by Ramkishan Gupta. The Bill was referred to the Bank for its comments. The State Bank of India, whose views were also sought, recalled the background to the conversion of the Imperial Bank into the State Bank in 1955, the creation of the subsidiary banks, and the consideration given to the subject jointly in discussions with the Bank in 1963–64. Following these discussions, a tentative scheme was prepared to merge the subsidiary banks. This was shelved subsequently in favour of amending the State Bank of India Act to give wider powers to local boards. Replying to the debate on the State Bank of India Amendment Bill, 1964, the Finance Minister, T.T. Krishnamachari, pointed to reports he had received that customers got better facilities from the subsidiary banks than they did from the State Bank of India. In general too, there had been a palpable improvement overall in the functioning of the subsidiaries both in their conventional operations and in the extent of their involvement in developmental activities. It was felt no significant purpose would be served by merging the subsidiaries with the State Bank of India. These matters have remained until this day.

With the extension of the Reserve Bank of India Act to the whole of India, the question of the Bank undertaking banking business for the Jammu and Kashmir state government came up for consideration. When the question of entering into an agreement with the state government under section 21A of the Bank Act was considered in 1959, the Bank and the Government of India concluded that 'it would be unwise' to entrust currency chests to the state government and place 'banking arrangements with the state on par with those of other states' until its administration 'particularly the treasury and accounting side ... settled down'. Besides, in the Bank's view, agreements with other

states were not working 'quite satisfactorily', and state governments were using the Bank for 'unregulated overdrafts'. Hence the Bank felt it was 'not desirable to place this temptation in the way of the Jammu and Kashmir State'.

The Jammu and Kashmir Bank was the banker to the state government. A non-scheduled bank incorporated in 1938, nearly two-thirds of its paid-up capital was contributed by the Jammu and Kashmir government. The latter had three nominees on the bank's Board, one of whom was its Chairman. A government company under the Companies Act, 1956, the bank had entrusted to it the state government's treasury work at Srinagar and eight other places in the state. The government and institutions associated with or controlled by it also held substantial deposits with the bank and borrowed funds from it on a large scale. Successive inspections by the Bank's officers revealed that the financial position of the Jammu and Kashmir Bank was extremely unsatisfactory. In 1959 the Bank found that the Jammu and Kashmir Bank's paid-up capital and reserves (including undistributed profits) amounting to nearly Rs 15 lakhs had been wiped out, and that its deposits had been affected to the tune of Rs 6.72 lakhs. The inspection also revealed major defects in the bank's investment and advances portfolio, earning capacity, and head office supervision and control over its branches. Apart from issuing directions, the Bank also deputed an officer to the Jammu and Kashmir Bank to study the latter's working and recommend ways of placing the institution's administration on a sounder footing. Little came of this, however, as the bank took 'no concrete steps ... to implement' the officer's recommendations. The Bank's subsequent inspections revealed no improvement in the affairs of the Jammu and Kashmir Bank, and the latter was then judged ineligible for a licence under the Banking Companies Act.

The situation in Jammu and Kashmir was thus quite anomalous. However its affairs were conducted, the Jammu and Kashmir Bank was in almost every sense of the term a 'state-associated' banking institution. But not only had this institution not benefited from the organizational and operational reforms carried out of the other major state-associated banks, the State Bank of India, which did conduct the central government's treasury business to a limited extent in Jammu and Kashmir, was a relatively negligible presence in the state. The possibility of the State Bank of India taking over the Jammu and Kashmir Bank was raised by the state government with the State Bank Chairman, P.C. Bhattacharyya, in October 1961. In deliberating upon this suggestion, the Reserve Bank concluded that in principle two distinct questions had to be tackled: firstly, whether it should agree to become banker to the state government, and secondly whether it should appoint the Jammu and

Kashmir Bank as its own agent in the state. In practice, however, it was impossible not to conflate the two issues since in the event of the Bank agreeing to become the banker to the state government, it could not depart from the convention it had adopted in the other states of appointing the local state-associated bank as its agent, particularly once it was taken over by the State Bank. Should the precedent adopted in other states be followed in Jammu and Kashmir as well, it would be 'difficult to resist the J & K Bank having charge of the currency chests'. By now state governments' overdrafts had become a major problem and the Bank would soon consider relinquishing its role as banker to chronically overdrawn states. As the Governor, H.V.R. Iengar, put it, the Reserve Bank already had

so much trouble with other State Governments regarding the misuse of the currency chests that it is undesirable to add one more State to our list if we could possibly avoid doing so.

Hence the Bank and the Government of India decided that the State Bank of India 'might go slow in the matter of ... taking over the J & K Bank as a subsidiary'. In the event, the preferences of the Bank and the Government of India coincided with those of the Jammu and Kashmir government. A committee appointed by the latter to examine whether the Jammu and Kashmir Bank should be reconstituted as a subsidiary of the State Bank of India did not favour the proposal on the ground that a local institution such as this bank was needed to finance the trade and commerce of the state. It also recommended that the state government should continue to conduct its business through the Jammu and Kashmir Bank.

EPILOGUE

The prolonged process of reorganization of the former state-owned banking institutions drew to an end with the merger of the Bank of Baghelkhand, the Mayurbhanj State Bank, and the Manipur State Bank with the State Bank of India. The Sangli Bank, on the other hand, followed the example of the Bank of Rajasthan and decided to plough its own furrow as a private commercial bank.

The activities of the subsidiary banks of the State Bank of India expanded rapidly after they came into existence. Starting out with 328 offices, they opened, between themselves, over 430 new branches between 1960 and 1967. Aggregate deposits rose from Rs 103 crores to Rs 280 crores and total advances from Rs 59 crores to Rs 162 crores between 1960 and 1967. Advances to the agricultural sector rose steeply from about Rs 62 lakhs in 1960 to Rs 2.17

crores the following year. It stayed at that level for the next two years, and after hovering around Rs 3.5 to 3.75 crores between 1964 and 1966, rose once again to Rs 6 crores in 1967. Advances to the cooperative sector rose from a mere Rs 94 lakhs in 1960 to nearly Rs 6 crores in 1967. As in the case of the State Bank of India, the subsidiary banks' performance with regard to small-scale industry too, was more impressive, advances to this sector rising from Rs 1.87 crores to Rs 15.7 crores, or to nearly 10 per cent of all advances, between 1960 and 1967.

Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
PR(R)27	State-associated Banks—Constituting them as Subsidiaries of SBI
PR(R)28	State-associated Banks—General Correspondence
PR(R)32	Constitution of State-owned and State-controlled Banks
C.265	State-owned and State-supported Banks in India
PR(R)20	State Bank of India (Subsidiaries)—Legislation
HB.1	State Bank of Hyderabad—Legislation
SBS.5	Finance for the Acquisition of the Capital of the Subsidiary Banks by SBI
SBS.14(10A)	Amalgamation of State Bank of Bikaner and State Bank of Jaipur
SBS.23	Proposal for Constituting the Jammu and Kashmir Bank Ltd. as a Subsidiary of SBI
G.D.13(4)A	Bank of Rajasthan, Bank of Bikaner, and Bank of Jaipur

Memoranda to the Central Board and Committee of Central Board

BANKING DEVELOPMENTS

The Reserve Bank inherited a fragile and unwieldy banking structure when the Banking Companies Act, passed in 1949, entrusted it with the responsibility for overseeing the health of India's banking system. This piece of legislation replaced the Banking Companies (Inspection) Ordinance and the Banking Companies (Restriction of Branches) Ordinance, both of which were promulgated in 1946. The earlier volume of the Bank's history has dealt at some length with the history of this enactment, its more important features, and the considerations weighing with the Bank and the government in giving it final shape. Here we may merely note that, though many years in the making, the Act was passed in the midst of a severe banking crisis in Bengal and a less severe one in Punjab which saw several small banking companies bite the dust, and its principal object was to protect the interests of depositors through timely regulation of the working of banking companies. As originally passed, the Banking Companies Act authorized the Bank to license banks, inspect them regularly and act on the basis of inspection reports, call for periodic returns from banks, determine their policy on advances, prohibit banks from undertaking particular transactions, and assist in proposals to amalgamate them. The Banking Companies Act revealed many inadequacies in practice and had to be amended at frequent intervals during the next few years. But at the time they were passed, the act and the ordinances preceding it significantly augmented the Bank's powers of regulation and supervision over commercial banks, which until then derived solely from section 42 of the Reserve Bank of India Act dealing with the Bank's powers to include or exclude a bank from its second schedule.

The immediate effect of the Banking Companies Act was to expand the responsibilities of the Bank in two directions: (a) supervising the working of banking companies and detecting and correcting deficiencies in their functioning, and (b) licensing banks. Inspections, needless to stress, soon became a routine and ongoing responsibility of the Bank. The second responsibility, that of licensing banks, was a particularly demanding one in the early years. Until the passage of the Banking Companies Act, there was no system of licensing banks. Under this Act, however, a new bank was obliged to obtain a licence before commencing business. But existing banks, which were required to apply for a licence within six months of the Act coming into force, could carry on business until they were formally refused one. As a result, the Reserve Bank had to review the working of each bank to determine its eligibility for a licence. The Bank found many institutions wanting in important respects, but rather than deny them a licence and force their closure, it preferred to help remedy their working and monitor the improvement in their affairs. Therefore, at least for the first few years after the Banking Companies Act came into force, inspections and licensing went hand in hand in the case of a majority of banks, the former providing the Reserve Bank the means to acquaint itself with the condition of individual components of the banking system, and the latter helping to give the system of inspection some extra teeth until amendments to the Banking Companies Act added progressively to its powers to re-order the affairs of weak, unviable, or badly-managed banks. It was, however, as an instrument of banking consolidation that its licensing powers came fully into play during the years covered by this volume. Therefore, while the first of the two chapters in this part of the volume discusses the Bank's regulatory activities and initiatives, a fuller discussion of the licensing of banking companies is reserved for the second chapter which deals largely with the Bank's contribution to consolidating the Indian banking system.

The Banking Companies Act was amended on no fewer than ten occasions between 1950 and 1967. Many of these amendments are of relatively minor significance even though some had the effect of increasing the extent of the Reserve Bank's powers over commercial banks;¹ while some others, dealing with the amalgamation or liquidation of banking companies are discussed in the chapter on banking consolidation. Though ownership was not yet so controversial as it was soon to become, banking legislation in our period also grew more attentive towards certain features of organization, management, and control of banks in India. In the chapter which follows, we will be

¹ For a comprehensive list of such amendments, see *Trend and Progress of Banking in India*, an annual publication of the Bank.

concerned mainly with legislative measures which either significantly augmented the Bank's powers of supervision and control over banking companies or were intended to ensure that the latter undertook measures which, while protecting the interests of depositors, redounded to the credit of their institutions and to the overall strength of the Indian banking system. In September 1965, the Banking Companies Act was amended to extend certain of its provisions to cooperative banks. These developments, which originated initially as an adjunct to efforts to extend insurance cover to deposits of cooperative banks, later took on a life of their own and are also discussed in the first chapter.

In 1963, the Reserve Bank of India Act was amended to give the Bank powers to regulate the deposit activities of non-banking financial and other companies. These amendments, which complemented the Bank's powers in relation to banking companies and were welcomed by joint-stock bankers feeling threatened by the rapid growth of non-bank deposits, were intended to protect holders of the latter class of assets and help assert the central bank's influence over a rapidly expanding segment of financial intermediation in the Indian economy. The Bank began to deploy these powers in 1966 but the steps it took in this direction remained experimental in form if not in intent, with discussions about the most effective ways in which to regulate the activities of non-banking companies continuing until the end of the period covered by this volume. While the larger part of the next chapter deals with the regulation of the country's banking system, both commercial and cooperative, it is convenient to round it off with a brief account of the Bank's efforts to tackle the challenge posed by non-banking companies during the 1960s and bring them under some form of control.

The second chapter traces the evolution of the legacy the Bank inherited from the past in the form of a fragile and unsound banking structure. It contains an account of the banking crises in some parts of the country at the outset of our period and subsequently, the Bank's response to them, and its attempts to place Indian banking on a sounder footing. The collapse of the Palai Central Bank in August 1960 was widely regarded as an instance of regulatory failure. The Reserve Bank's handling of the affairs of this institution is discussed in an appendix. Apart from triggering a public controversy and a banking crisis in Kerala, the Palai collapse spurred the Bank's determination to strengthen the banking system and safeguard against similar crises in the future. Deposit insurance, which the Bank introduced in 1962, was an important outcome of these events, and is also discussed in this chapter. To help place the Bank's exertions in perspective, the second chapter concludes with a brief survey of Indian banking growth during our years.

Regulating Banks and Deposit Institutions

The first challenge the Bank faced following the passage of the Banking Companies Act was that of building a team of skilled inspectors. The Bank was not altogether a stranger to inspections: banks in the second schedule of the Reserve Bank of India Act already came under its gaze, while some others voluntarily subjected themselves to scrutiny by its inspectors. But frequent and regular inspections of a few hundred banks was another matter altogether, more so as it was decided quite soon after the passage of the Banking Companies Act that banks would generally not be issued or denied licences until their affairs had been inspected in detail. Besides, not only was it necessary to speed up inspections if they were to be effective, the Bank had also to set at the same time, enduring standards of inspection. Balancing these demands was not easy, and the Governor, B. Rama Rau, devoted a considerable amount of time and energy in the early months of his tenure to the organization of the Bank's inspection activities. The person overseeing these activities within the Bank, Rama Rau felt, should be senior and experienced enough to deserve a status equivalent to that of a Deputy Governor of the Bank. He was keen to engage K.G. Ambegaokar, who had earlier worked at the Bank and was currently Additional Secretary in the Ministry of Finance, to organize the Bank's inspection work and develop the new system. But this proposal foundered on the government's refusal to spare Ambegaokar, and the Bank re-employed Cecil Trevor (Deputy Governor till 1949) for three months 'on Special Duty', to set up its inspection arrangements. Trevor was soon succeeded by Ram Nath, who joined the Reserve Bank in 1935 from the Imperial Bank. Ram Nath went on to become a Deputy Governor of the Bank in 1951 at which post he remained until nearly the end of the decade. Ram Nath oversaw the country's commercial banking system on behalf of the Bank and was very largely instrumental in establishing its apparatus of banking regulation and supervision during this crucial period.

INSPECTING BANKS

Since it suffered from shortages of trained staff in the early years, the Bank was forced to commence its inspection activities on a modest scale. When the Banking Companies Act was still in draft form, bankers had opposed giving the Bank, or any other agency, powers to inspect the working of their institutions on the ground that inspections were liable to trigger panic among depositors. Hence before initiating inspections under the Act, the Bank took care to inform banks and the public through a press note that until trained staff became available to inspect banks on an annual basis, it would only inspect as many banks as it found possible to do, but that inspections would not be confined merely to institutions whose working was believed to be unsatisfactory. Indeed, in an act that can only be seen as an effort to grab the bull (of presumed public mistrust of bank inspections) by its horns, the Bank issued a press note in March 1950 listing the names of banks it would inspect during the year in alphabetical order! With bank inspections becoming routine thereafter, this practice was dispensed with in later years. By the end of 1954, the first round of inspections of Indian commercial banks was practically complete. In addition five state-owned banks, which were not covered by the provisions of the Banking Companies Act, had also been inspected with their consent. In 1958 the Bank felt able to step up the frequency of inspections to one of each bank every year. From 1960, foreign branches of Indian commercial banks were also brought within the scope of the Bank's inspections.

Inspections by the Bank concerned themselves with virtually every aspect of the functioning of commercial banks. The efforts of the Bank to improve the capital funds ratio of banks and their liquidity position are discussed below. Inspections and scrutiny of banks' statements helped monitor banks' compliance with evolving conventions and statutory requirements in these respects. The Bank liked to keep a close watch on the trend of banks' earnings, frequently studying costs, intermediation margins, and global ways to regulate them, both in order to check profiteering at the expense of capital users and the erosion of banks' profitability to a point where they found it difficult to add to reserves or service their capital.

The Bank's moves towards regulating deposit and lending rates (discussed in chapter 4) originated partly in the close interest it took in banks' earnings. It also used the opportunity afforded by inspections to advise individual banks to reduce unnecessary expenditure, especially on unremunerative branches; and against offering high rates of interest to attract deposits, since it might predispose them to greater asset risk, lower earnings, and impair their ability to strengthen reserves. Likewise, while exploring general ways of

persuading or compelling banks to improve their reserves, the Bank utilized inspections to penetrate beyond the window and verify banks' balance sheet figures to satisfy itself that they gave a true picture of their financial condition. Where banks' provisions for bad debts were judged inadequate, they were advised to make the necessary provisions and appropriations, if need be by reducing or omitting dividends. In general too, inspectors tended to alert banks to the longer-term advantages of a prudent reserves and dividend policy, and although the Bank was averse to suggestions—mooted with some intensity in the mid-1950s—to regulate or restrict the dividends of banks and helped stiffen Finance Minister C.D. Deshmukh's resolve to resist them, from the late 1950s banks placed under observation were routinely asked to obtain Mint Road's approval before declaring dividends. In the 1960s the Bank began using its powers to regulate dividends more freely.

As discussed below, the Bank also took a keen interest in the managerial aspects of banking in India. However, advances and asset quality were by far the most important focus of the Bank's inspection exercises. Particularly in the early years, inspectors found many problems with banks' portfolios. These included, apart from a high advances-to-deposits ratio, illiquid assets; large investments in shares and debentures of joint-stock companies, and in unquoted scrips and scrips of companies owned or managed by the bank's directors; loans to the latter, their relatives and their concerns; concentration of a substantial proportion of loans in the hands of a relatively small number of borrowers; large unsecured advances or advances against real estate; and a high level of irregular and dormant advances and decreed and doubtful debts. In addition to routine inspections covering all aspects of a bank's functioning, the Bank sometimes undertook special inspections of its advances portfolio—the object usually being either to safeguard against a further decline in the quality of the bank's portfolio or to appraise its progress towards satisfying the Bank's conditions or directives relating to advances. Instances were also not unknown of the Bank ordering inspections of individual branches of banks on the basis of reliable information that came its way regarding a bank's advances to one or more borrowers. For example, the Bank launched a special investigation, assisted by inspections, of the exposure of selected Indian and exchange banks to the concerns owned or managed by Haridas Mundhra, and these investigations were among the first to lift the veil of secrecy and mystery hanging over the affairs of this entrepreneur.

Inspections completed, the Bank might deny a commercial bank a licence in extreme cases where the latter was judged to be 'beyond redemption'. In a few cases, banks also had their scheduled status and licences withdrawn. Other extreme measures included publishing the Bank's inspection report or

extracts from it in the official gazette of the Government of India and making an application to a court to wind up the affairs of a badly-run bank. In the case of a large number of banks, particularly in Kerala in the late 1950s, the Bank was forced to hold its hand even when some of them appeared to it to be beyond repair. In the early 1960s, on the other hand, inspections were used to facilitate schemes of arrangements or amalgamations involving relatively small and less viable banks.

Generally, however, the Bank preferred to adopt a calibrated response that sought to safeguard the interests of depositors of banks following unsound banking practices while the institutions themselves were allowed to function under closer supervision and made to undertake suitable corrective measures. Sometimes this response, as stated above, took the form of advice. At other times, banks with major defects were asked to submit reports to the Bank at regular intervals indicating the progress they had made in correcting them. Where such defects persisted, the Bank might impose 'conditions' requiring the bank concerned to take specific measures and submit periodic reports of compliance. Until January 1957, conditions could not be imposed on an affected bank until the latter formally accepted them. This sometimes led to an impossible situation as banks, while not formally rejecting the central bank's conditions, adopted obstructive tactics intended to deter or delay their imposition. Hence by an amendment to the Banking Companies Act passed in December 1956, the Reserve Bank acquired the powers to issue directions to banks, in their own interest, on matters of policy or administration. The same Amendment Act also empowered it to appoint observers on the boards of directors of banks to report on the conduct of their affairs. Until this amendment, the Bank's power to appoint an observer hinged on the consent of the board of directors of the concerned bank, and both in the case of the Punjab National Bank and the Palai Central Bank, such consent was not forthcoming. Observers, according to a memorandum submitted to the Central Board in 1965, played a positive role in the affairs of banks to which they had been deputed, not only preventing 'at source transactions of an undesirable nature', but also giving 'proper guidance' to them.

Besides appointing observers and issuing directions, the Bank could, under the 1956 Amendment Act, also refuse to approve the appointment of a chief executive officer and reduce the remuneration proposed for any bank official. However, in a significant check on its authority to regulate the functioning of the banking system, the Bank agreed not to use its new powers against medium- and large-sized banks (having deposits of Rs 10 crores or more) except in consultation with the government. H.V.R. Iengar, who took office days after this agreement with the government was formalized, chafed at this

restriction on the Bank's powers and attempted, within months of the Amendment Act coming into force, to review it. But the Bank's plea to the government to limit consultations to cases where a bank's deposits exceeded Rs 25 crores met with the response that the Government of India liked to 'have some idea of the working' of 'intermediate-sized banks' and that it hoped thereby to widen the range of its 'knowledge and awareness of current problems and questions generally'.

In August 1960, following the closure of the Palai Central Bank, Prime Minister Jawaharlal Nehru and Finance Minister Morarji Desai discussed with the Governor, H.V.R. Iengar, 'the more effective use of the powers of the Reserve Bank following inspections of banks'. Little came of these discussions directly. However, the new powers the Bank acquired in September 1960 to enforce amalgamations and the speedier 'de-licensing' of banks in the mid-1960s (on which more below) helped give more teeth to its inspections. On the other hand, the failure of the Palai Central Bank, and particularly of the Laxmi Bank where the management was reported to have misappropriated depositors' funds, alerted the Bank to the need to 'improve the inspection machinery' so that it could 'undertake surprise inspections of banks or even of some of their branches alone', and thereby 'detect frauds ... at the appropriate time'. In 1961 the Bank inducted D.R. Joshi, who until then was Secretary and Treasurer of the Bengal Circle of the State Bank of India, as an Executive Director, principally to reorganize and strengthen its inspection arrangements. Bank inspections now began to cover many more branches than in the past, and they were also widened to include elements of selective audit.

It is worth noting, in passing, that the Bank adopted certain other measures to help the banking system safeguard the quality of its assets. Following suggestions mooted by the Indian Banks' Association in 1950 and others subsequently, the Bank decided to set up an organization to collect information from member banks about the banking commitments of individual borrowers, and make it available to banks wishing to ascertain a large borrower's aggregate banking debts. Though there was some scepticism among banks about the utility of a scheme which would inevitably be prone to delays in securing and relaying the necessary information, the Bank decided to proceed with the legislative enactments which it was advised were needed for the proposed scheme to come into operation. These legislative changes, which took the form of a new chapter (IIIA) in the Reserve Bank of India Act, were carried out in September 1962. Following the enactment, the Bank decided to collect credit information about borrowers with sanctioned secured limits of Rs 5 lakhs or more and unsecured limits of Rs one lakh or more. Compiled on a borrower-wise basis, the information was made available to banks and

institutions seeking it. The names of the banks submitting the information were, however, withheld from its users. The credit information bureau, as this arrangement was sometimes referred to, proved a timely initiative, with the Bank receiving over 1,500 requests for information about individual borrowers in 1963—the first year the information became available. By 1967, the number of requests from banks and financial institutions for credit information had grown to over 2,700.

Towards the end of our period, the Bank also began to monitor scheduled banks' growing contingent liabilities (or 'off-balance sheet' items). In May 1967, it laid down guidelines for the conduct of guarantee business, and advised banks that besides asset portfolios, their soundness would be judged also by the size and nature of their contingent liability commitments.

EVOLVING CAPITAL ADEQUACY NORMS

According to the Banking Companies Act (section 11) as originally enacted, a bank, having a single place of business, could be started with as little as Rs 50,000. This figure, incidentally, was fixed in 1936 when banks were governed by certain provisions of the Indian Companies Act. Minimum capital requirements for a bank were thereafter related to its area of operation, the number of offices it opened, and whether any of these were in Calcutta or Bombay. A bank with aggregate paid-up capital and reserves of Rs 10 lakhs could, in principle, open offices in all parts of the country including its two largest urban centres. Section 17 of the Act regulated banks' provisioning for reserves, and as framed originally, required banks to transfer a fifth of their annual profits to a reserve fund until the latter equalled the paid-up capital.

The paid-up capital and reserves of a banking concern together comprise a guarantee fund safeguarding to some extent the interests of its depositors, and enable a bank to undertake certain types of business which the short-term nature of its deposit liabilities might otherwise preclude. By almost any reckoning, the provisions of the Banking Companies Act relating to capital and reserves were extremely modest. Nor did they, except in the case of small banks willing to forego current dividends for rapid expansion and higher returns in the future, encourage banks to maintain their owned funds in some reasonable relation to their deposit liabilities. These limitations became apparent in the wake of the rapid growth of bank deposits in the 1950s. As a result of this growth and inadequate provisioning by banks, the ratio to deposits of paid-up capital and reserves of Indian banks fell from a respectable 9 per cent in 1951 to 7 per cent in 1956, and further to 4 per cent in 1961. The fall in this ratio was even sharper in the first period for scheduled banks, and by

1961 the ratio of owned capital to deposits of these institutions too had fallen to 4 per cent.

The question of capital adequacy was first raised within the Bank in 1954 at the instance, interestingly enough, of the Chairman of the Indian Banks' Association. The latter's memorandum to the Shroff Committee adverted to 'currency and deposit inflation since the war', and suggested that it had become necessary to quadruple the minimum capital and reserves of banks, from Rs 5 lakhs to Rs 20 lakhs in the case of scheduled banks, and from Rs 50,000 to Rs 2 lakhs in the case of non-scheduled banks.

The object of this suggestion was not far to seek, and the Bank too had little reason at the time to follow it up. A note of the Research and Statistics Department prepared in September 1954 examined the Indian Banks' Association's proposal in some detail. While acknowledging that the need for 'adequate capital for banks cannot be overemphasized' since it was in the nature of their business to maintain relatively low ratios of own to total resources, this note attempted to form some idea of the dimensions of the problem. Were the proposal outlined by the Chairman of the Indian Banks' Association to be implemented, it estimated, banks would have to find additional resources of Rs 5.26 crores. The bulk of the shortfall (Rs 3.07 crores) was accounted for by the scheduled banks, few among whom could be said to pay out excessive dividends. A policy of limiting dividends to boost reserves, on the other hand, would make it difficult for banks in general to raise fresh capital. The note also considered alternative measures of capital adequacy in vogue in other countries, including relating capital to deposits and 'risk assets' and concluded that there were few advantages in forcing banks to increase either ratio. Apart from the difficulty of raising the amounts required to meet the shortfall, relating capital to deposits or 'risk assets' might make the bigger banks 'less willing to accept fresh deposits' and deter the expansion of credit and banking facilities in the country. Rejecting as well the need for raising the minimum for capital and reserves, the note argued that the 'safety of depositors' money' depended largely on the

quality of bank management, the composition of assets and efficient control and supervision over banks. The Banking Companies Act has ... gone a long way in meeting these needs and the implementation of the scheme of deposit insurance outlined by the Shroff Committee will be an additional safeguard

Deposit insurance, in the event, was not instituted for several years after these lines were written. But similar views were voiced four years later in another note prepared in the Research Department. This note, however,

acknowledged the need to raise the minimum capital requirement as a means of 'ensuring that the activities of a bank do not go beyond what its resources warrant'. But it also warned against attaching 'too much importance to capital funds', since in the 'ultimate analysis', it was not 'so much the capital cushion but the liquidity position of a bank that makes for its survival and progress'. Warning against fixing 'arbitrary standards' of capital adequacy, this note too echoed the earlier one in suggesting that 'regulatory provisions ... in regard to banks' employment of funds ... and the close scrutiny in the conduct of banks' business' that inspections made possible reduced the 'emphasis on capital funds as a guarantee against loss of deposits'.

There is other evidence too, that the Bank was complacent about capital norms in the 1950s. For example, there was a sharp fall in the prices of government securities following the Bank rate increase in November 1951, and banks apprehended that they would be forced to declare lower dividends if they were required to provide for the depreciation of these assets according to the Banking Companies Act. Following representations from them, the Government of India decided, with the Bank's concurrence, to exempt banks from having to show the market value of their investments on the last day of 1951 in their balance sheets and profit and loss accounts as required by law, and to waive the application of sections 15 and 17 of the Banking Companies Act. The section 15 waiver enabled banks to pay dividends without writing off the depreciation in the value of their investments in approved securities so long as they did not capitalize the depreciation or account for it as a loss. Apart from helping banks out of a temporary difficulty, this waiver was justified on the ground that banks generally held government securities till maturity. Consequently, it was argued, any depreciation their values suffered in the meantime was 'notional' rather than real. The original section 17 of the Banking Companies Act was thought to prevent banks from making appropriations from reserves to write off losses on their investments until the former equalled or exceeded the paid-up capital. This provision too was relaxed through an executive order in the wake of the fall in security prices in 1951 to enable banks to write off the depreciation if they so chose.

Apart from being of some relief to banks in their embarrassment, an important object of these exemptions was to 'create a steady incentive for investment in government securities'. Although the need for them diminished as the maturity structure of banks' investments in government securities grew shorter, both exemptions were renewed from time to time thereafter. Finally in 1959, section 15 of the Banking Companies Act was amended to give statutory sanction to the dividend practices banks had adopted since 1951; while at the same time section 17 was amended to enlarge on recent practice

and allow banks to draw on reserves not only to cushion the impact of a fall in the value of their investments in approved securities, but also for all types of contingencies with little restriction on the nature of the losses they could set off against their reserves. In pushing for this amendment, the Bank argued that the 'reserve fund would have no meaning' if it could not be 'drawn upon for meeting unforeseen losses' and that 'what was important was not the reserve fund itself but the real or exchangeable value of the assets' of a bank. The Division of Banking Research, which appears not to have been consulted about these amendments, opposed both amendments after they were passed, and pressed for their 'reconsideration' and 'repeal'. As a note prepared in the division by D.G. Borkar and S.L.N. Simha remarked, even though the two amendments only acknowledged existing practice, they violated the sound banking principle of setting off losses on investments and advances against current earnings and would only help to lower the 'reserve standards' of the banking system. Barely two years after they came into force, the Division of Banking Research noted that the amendments, in particular the one to section 17, had 'had the effect of lowering the magnitude of transfers to reserves' of several banks.

The collapse of the Palai Central Bank in August 1960 affected several aspects of the Bank's policy towards commercial banks. Capital standards was one such aspect, with Governor Iengar himself taking direct personal interest in evolving capital adequacy norms for Indian banks. Unfortunately, unlike deposit insurance which was the other major reform he initiated to strengthen the Indian banking system after the Palai crisis, Iengar's achievement in the sphere of capital adequacy did not outlast his tenure at the Bank.

By an odd coincidence, a bill to amend the Banking Companies Act to protect banks from disclosing their secret reserves to labour tribunals was under discussion in Parliament when the Palai Central Bank collapsed. This bill, which in the event was passed in the middle of August 1960, might no doubt have been expected to boost banks' reserves indirectly. But more direct measures were called for in the wake of the Palai crisis, and the first suggestion thereafter to review capital adequacy norms for Indian banks came in a speech Iengar made to the Institute of Economic Growth in Delhi in September 1960. The Governor followed up this speech with a note to the Executive Director, B.K. Madan, which also suggested that the Bank should 'see that the increased income' accruing to commercial banks from the higher rates on advances announced for the 1960-61 busy season was not 'frittered away in additional declaration of dividends'. 'I think we should pursue this point actively now' the Governor reiterated early in November 1960, and suggested that 'one possible way of dealing with the matter' might be to issue a directive to banks asking them to take the Bank's approval before increasing their dividend rate.

There was little agreement within the Bank on the Governor's suggestion to regulate banks' dividends by a directive. Officials felt it was 'difficult' to devise a formal directive since rates of dividends were 'very disparate'. Besides, Madan remarked,

requiring formal approval of the R[eserve] B[ank] in every case assumes that we have cut-and-dried principles ... to fit all cases into a few well-defined categories; otherwise our judgement replaces the banks', which is not a very good thing in relation to the banking system as a whole.

Dividend restriction, he suggested instead, was a fit case to try out 'moral suasion', 'though psychological pressures are being built up against its use generally'.

In the event, little came of Iengar's suggestion to limit banks' dividends. Apart from the inherent difficulties of implementing it, dividend limitation held little appeal for officials who were more preoccupied with following up the Governor's other suggestion, viz. leveraging up the capital funds of banks. Apart from everything else, a policy of restricting dividends would throw the onus of increasing capital funds entirely onto reserves and this, as officials at the Bank soon realized, was not a practicable solution to the problem of capital inadequacy.

The Governor's speech to the Institute of Economic Growth led the Division of Banking Research to undertake a comprehensive study of the adequacy of capital funds of twenty-eight Indian scheduled banks. This study, which was conducted principally by D.G. Borkar and S.L.N. Simha and completed early in November 1960, recommended that rather than making banks approach the market for fresh capital, the Bank should concentrate on persuading them to strengthen their reserves. Not only was the latter easier than the former to accomplish for the banks themselves, strengthening reserves also meant 'inculcating prudence in management'. Besides, an increase in capital might actually reduce transfers to the reserve since banks were generally loath to reduce their dividend rates which tended to remain stable or increase slightly even in years of lower profits. The study also showed that though their gross profits margin had tended to be unsteady of late, banks deployed a smaller proportion of their profits than in the past to boost their reserves. Dividend payments had made 'heavy inroads into the transfer to reserves' in the case of a majority of the bigger banks, while some large banks, whose reserves equalled or exceeded their paid-up capital, had altogether stopped transferring any amount to their general reserves. Smaller banks tended to

retain a larger proportion of their profits than larger banks, but even here the share of retained profits was on the decline. Prevailing reserve policy, the note argued, was 'essentially of a minimal character' introduced at a time when there were a large number of 'submarginal units' following the abnormal wartime expansion of Indian banking.

Now that the greater part of the essential process of consolidation of the banking system has been completed and ... taking into account the changing character of the banking business towards greater assistance to industry, the reserves policy will have to be shifted towards the prescription of still better standards for even the strongest and largest units

Both Borkar and Simha, and a subsequent note by Madan, pointed out that linking reserves to paid-up capital was a major drawback since the latter was generally 'static' and bore 'no relation to the dynamic expansion of liabilities of banks as a sequel to the increase in economic activity'. Besides, if paid-up capital was low, reserves were likely to be low as well, and the existing provision may have had the effect of further discouraging banks from raising their paid-up capital. Borkar and Simha therefore favoured legislation to ensure that banks continued to set aside a fifth of their profits to reserve until the ratio of paid-up capital and reserves amounted to 5 per cent of their deposits. Subsequently, the Division of Banking Research also made a case for retaining, in addition, the clause requiring banks to add to reserves until they equalled their paid-up capital since the real value of capital funds of most of the small banks and some of the medium-sized banks was much lower than their nominal value, and their 'apparently high' capital funds ratio was 'illusory'.

The Departments of Banking Operations and Banking Development, for their part, favoured stiffer capital norms: and the higher figure of 7.5 per cent of deposit liabilities or 10 per cent of risk assets was suggested as a benchmark, with banks being allowed five to seven years to meet these standards. Relating capital to risk assets was thought, however, to be impractical since the latter were subject to seasonal fluctuations. After reviewing its earlier conclusions with the two banking departments, the Division of Banking Research too came to favour a 7.5 per cent norm. But the higher norm also meant banks could not be expected to achieve it within a reasonable period through more prudent management alone. Many banks, Banking Research acknowledged in a note written in January 1961, would be unable to meet the proposed higher norm for another ten years if they relied simply on augmenting reserves, or venture in the meantime into 'less orthodox forms of finance' such as term-

lending and underwriting of shares. Therefore, according to this note, banks should be made to increase their paid-up capital as well through an amendment to section 11 of the Banking Companies Act.

Recommending, besides, the repeal of the amendments made to sections 15 and 17 of the Banking Companies Act in 1959 since they had the effect of 'lowering reserve standards', the Borkar-Simha note also suggested that banks should be encouraged not to fritter away in dividend pay-outs, the higher profits likely to result from the increase in lending rates announced in September 1960, but use them instead to build reserves. Finally, it recommended persuading banks, if necessary through tax concessions, to make adequate provisions for secret reserves against bad debts and security depreciation, and to credit realized capital gains to security reserves. The latter proposals did not find much support elsewhere within the Bank.

Following these consultations, the Bank sent the Government of India a detailed sixteen-page note in April 1961 which made three proposals for Indian banks. The first was to increase the minimum capital for establishing a bank from Rs 50,000 to Rs 5 lakhs and to double the capital requirement to Rs 20 lakhs for banks having offices either in Bombay or Calcutta. The second proposal envisaged compelling Indian banks to transfer a fifth of their 'net profit before taxation' to reserves until the 'reserves and share premium account' equalled the paid-up capital, and the ratio to deposits from the public of both taken together reached 7.5 per cent. Thirdly, the Bank sought powers to compel banks to increase their paid-up capital. Finally, the Bank proposed that capital funds of foreign banks should equal or exceed 5 per cent of their deposit liabilities, subject to a minimum of Rs 15 lakhs, with the latter requirement rising to Rs 20 lakhs for foreign banks having offices in Bombay or Calcutta.

With only a few months left for the elections, the government's mind happened to be elsewhere. Iengar felt the Bank should nevertheless take the initiative to submit concrete proposals to the government and utilize the interval to consult Indian and exchange bankers about them. At the same time, the Bank also contemplated increasing banks' statutory cash and liquidity ratios, and its proposals in all these respects were communicated to the Indian Banks' Association and the exchange bankers in the summer of 1961. The Bank's views on the liquidity ratio are discussed below, and its evolving approach towards the question of capital adequacy of Indian and foreign banks forms the subject of the remainder of this section.

Not surprisingly, bankers were unenthusiastic about the Bank's proposals for augmenting capital. They felt the current trend of rising profits was a temporary one which would come to an end as wages increased, banks'

earnings dropped as a result of the new liquidity requirements that were on the anvil, and deposit rates increased. A 20 per cent transfer rate, banks felt, would mean smaller allocation to secret reserves and lower dividends. The latter, in turn, would make it difficult for banks to raise capital. A capital-deposits ratio of 7.5 per cent also did not receive much support. The proposal was thought to be unfair to banks which had built up secret reserves. Besides, banks argued, a higher ratio of capital funds was not a safeguard against bad management: a mere increase in paid-up capital was useful only if a bank failed and the object of policy should be to *prevent* bank failures. They also confessed to fears about maintaining and servicing even the existing capital base, let alone widening it in the future. The proposal to establish a parity between paid-up capital and reserves also 'bothered' some bankers. Finally, banks objected to the Bank acquiring powers through legislation to direct them to raise capital in the market either through new issues or calling up unpaid capital if their 'own' resources appeared inadequate. The exercise of such powers, they argued, was fraught with risks. Despite the best information available it was not possible to be certain about the response new issues would evoke in the market, and a failed stock issue would cause 'incalculable harm' to the bank concerned and affect banks of similar size. Rather than resorting to legislation, banks preferred the Reserve Bank adopting moral suasion whenever it felt the paid-up capital of a bank was too low in relation to its deposits.

The Bank's proposals formed the basis of informal discussions between the Governor and representative commercial bankers in November 1961. At these discussions, the Chairman of the Indian Banks' Association, Tulsidas Kilachand, pressed the case for reducing the capital adequacy ratio to 5 per cent and questioned the need for legislation to bring it about. Whereupon the Governor too pointed out that 'he would much rather avoid going to the legislature' if bankers agreed to implement the Reserve Bank's proposals voluntarily. A fortnight later, early in December 1961, Kilachand wrote to the Governor reiterating his association's reservations about the Bank's proposals, but also suggesting 'as a practicable proposition' that banks might be allowed gradually to raise their owned funds to a 'target' of 6 per cent of deposits. This target, the banker insisted, should not be laid down by statute but achieved by all banks 'by means of an understanding with the Reserve Bank' which should also view with sympathy cases of banks having difficulties in meeting it.

The Governor thought this a 'satisfactory response' and responded three weeks later with a circular to all scheduled banks advising them to 'aim to achieve a ratio of 6 per cent of capital funds to deposits' by transferring a fifth of their declared profits to their published reserves and taking

'supplementary action' in the form of calling up unpaid capital or applying for fresh capital in the market. At the same time, with the Governor himself being of two minds regarding the advantages of prescribing capital adequacy norms for foreign banks operating in India, it was decided, willy nilly, to postpone imposing additional capital requirements on exchange banks until their position had been studied more closely.

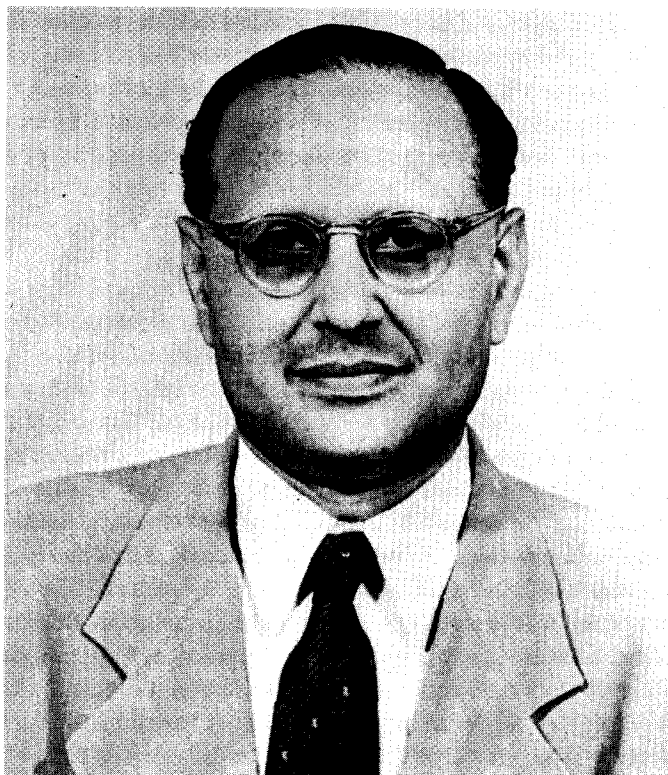
A review of banks' reserve practices in May 1962 revealed that the Governor's circular letter to scheduled banks had evoked an excellent response. Thirty-two of the sixty-four banks for whom data were available had a capital funds ratio below 6 per cent. Of these, all but two banks transferred 20 per cent or more of their profits to the reserve in the year ending December 1961. A large number of banks transferred a substantially higher proportion of their profits to the reserve, eight banks transferring over 50 per cent, four banks 40–50 per cent, ten banks 30–40 per cent, and another eight banks 20–30 per cent more than they had done the previous year. Sixteen banks, it also turned out, had obtained sanction for new issues totalling Rs 11 crores, while there were others whose applications were under consideration. Banks had also generally maintained their dividends at the 1960 level despite earning higher profits in 1961. These developments were all the more satisfactory, the study remarked, because the Governor's circular was issued at the fag end of the year and left banks little time to adjust to the new situation created by it. A note by A. Raman declared, banks had 'kept their faith'

But the convention came under pressure from the larger banks no sooner Iengar departed the Bank. At a meeting with his successor, P.C. Bhattacharyya in April 1962, representatives of three large banks wanted a 'review' of the '6 per cent ... requirement'. Bhattacharyya thought 'it was hardly appropriate to reopen an agreed formula', but agreed to consider allowing banks different periods of time within which to achieve the target. At almost the same time, the Department of Banking Operations too appears to have developed second thoughts about the capital adequacy ratio which it said was 'too high for the large banks and too low for the small ones' whom the department 'frequently advised ... to raise their reserves even if their capital funds had attained a ratio of 8 to 9 per cent'. At a meeting held to discuss these developments, both B.K. Madan and D.R. Joshi, Executive Directors, maintained that the ratio of capital and reserves to deposits represented an important 'guidepost' which should not be dispensed with. Whereupon Banking Operations suggested that small banks satisfying both the proposed criteria (of a 6 per cent capital funds ratio and parity between capital and reserves) should be asked to continue transferring a fifth of their declared profits to their reserves until the latter and paid-up capital amounted to Rs 5 lakhs.

Nothing much came directly out of this meeting since the overwhelming feeling at this stage was that the new convention should be allowed a year's time before it was amended in any way. But barely two months later different ideas had taken to the air, not it seems without many officials within the Bank expressing their reservations about them, and proposals to amend section 17 of the Banking Companies Act governing banks' reserve provisioning norms began to be openly discussed. And by September 1962, the Banking Companies Act had been amended to require Indian banks to transfer a fifth of their annual profits to a reserve fund, regardless of whether it was less or more than the paid-up capital, before declaring a dividend. Banks incorporated outside India were also required to deposit with the Bank a fifth of their profits from their business in India. At the same time, the minimum paid-up capital for an Indian banking company commencing banking business was raised from the prevailing level of Rs 50,000 to Rs 5 lakhs.

The reasons for abandoning the convention so soon after it was adopted are not clear. Despite noting that the capital funds ratio of scheduled banks was, at 4.2 per cent, 'on the low side', the memorandum to the Central Board on the proposals to amend the Banking Companies Act in 1962 (and the related notes) passed over the convention in silence, merely declaring the Bank's intention not to fix a 'rigid upper limit' on the capital and reserves of banks. The memorandum gave no reason for not prescribing a minimum *floor* ratio of capital and reserves to deposits, but almost certainly, the convention of December 1961 was abandoned because of growing recognition of the difficulties banks faced in meeting the 6 per cent norm at a time of rapid deposit growth and shrinking intermediation margins, and the apprehension that too rigid a norm might actually weaken banks' incentive to boost their deposits and impede the expansion of the banking system. The Bank too may not have been unmindful of the paradox that a rigid capital adequacy norm might actually help promote the growth of small, overcapitalized, and badly managed institutions to the detriment of bigger and sounder banks, and ultimately of the banking system.

Madan, who had played a major role in preparing the earlier proposals on capital adequacy, was far from happy at this turn of events. Feeling that the legislative amendments of September 1962 did not provide 'sufficient incentive to banks to build up their owned funds', he considered soon afterwards smuggling more stringent capital adequacy norms in through the back-door by relating banks' quotas for borrowing from the Reserve Bank under the recently introduced slab-rate system to their owned funds rather than their statutory cash reserves. But this idea was soon abandoned as studies showed that 'for most of the Indian scheduled banks and a number of foreign ...



B. K. Madan, Deputy Governor, 1964-67

banks', quotas for borrowings on the basis of owned funds 'would be more favourable than on the basis of statutory cash reserves'.

The subject of capital funds receded into the background for some years after the 1962 legislation. Some five years later, in November 1967, the Economic Department conducted a quick review of the capital funds ratios of Indian banks at the instance of the Deputy Governor, B.N. Adarkar. Summing up the review, the Economic Adviser, V.G. Pendharkar, remarked that caught between mounting costs in the industry, which affected the accumulation of internal resources, and the doldrums of the capital market, banks had failed 'to show much improvement in the matter of strengthening their capital base'. This was an understatement, the ratio of paid-up capital and reserves to deposit liabilities of all but three of the sixty-one Indian scheduled banks in respect of which data were collected actually having fallen sharply between 1961 and 1966. The three banks whose ratios went up were all small banks

which were overcapitalized even in 1961 and had become more so five years later. The average capital funds ratio of all the sixty-one banks fell during these five years from 3.9 to 2.9 per cent. Interestingly enough, since the norm accepted in December 1961 appears to have been revoked at the instance of the bigger banks, the ratios of medium-sized banks dropped faster and lower than those of the larger banks.

IMPROVING BANKS' LIQUIDITY

For obvious reasons, as India's central bank, the Reserve Bank took a continuing interest in the liquidity position of commercial banks operating in the country. Commercial banks in India have traditionally been subject to two types of reserve requirements. Under section 24 of the Banking Companies Act, all banking companies were required to hold at least a fifth of their time and demand liabilities in India in the form of cash, gold, balances with the Reserve Bank, current account balances with other banks, money at call and short notice, and approved unencumbered securities. The latter principally comprised medium- and long-dated government securities. The chief object of this stipulation was to ensure that banks had enough liquid reserves to meet a drain, should one arise, on their resources. The practice of regarding medium- or long-term government paper as liquid assets was, no doubt, an unusual one. But its origins can be traced to the paucity of good quality commercial bills in India and the view that gilt-edgeds were the easiest stock to liquidate in a crisis. In 1960, scheduled commercial banks were also required, under section 42 of the Reserve Bank of India Act, to maintain with the Bank minimum balances which the latter could vary between 5 and 20 per cent of their demand liabilities and 2 and 8 per cent of their time liabilities. Section 18 of the Banking Companies Act required non-scheduled banks too, to hold cash reserves of similar proportions to their demand and time liabilities. The latter reserve was referred to at the time as the statutory reserve or the statutory cash reserve, but also as the cash reserve by which nomenclature it is most commonly known today. Until 1962, the cash reserve formed part of the overall liquidity ratio.

The cash reserve ratio was intended essentially as a tool of monetary policy. But it had implications for a bank's liquidity position, and liquidity issues took the forefront in discussions about banks' cash reserves during 1960-62. Conversely, while the overall liquidity ratio prescribed by the Banking Companies Act was intended essentially to secure the liquidity of banks, it was not without implication for their ability to expand credit. Nor was the exercise to increase banks' overall liquidity ratios entirely insensitive,

both during 1960–62 and in later years, to the need to create a protected market for the government's long-term debt. Indeed, while interest within the Bank in the liquidity position of the Indian banking system deepened after August 1960 as a sequel to the failure of the Palai Central Bank, it came under scrutiny also following the success of the banks in shifting the impact of the variable reserve requirements imposed earlier that year disproportionately onto investments in government paper.² In the process, a few banks came perilously close to the statutory minimum of 20 per cent written into the Banking Companies Act.

The liquidity position of Indian banks came up for discussion first at a meeting of the Committee of the Central Board towards the end of August 1960. In the course of making some general observations about the banking system, Iengar referred, innocuously enough, to the 'very low liquidity ratios' of certain Indian banks. Upon this, J.R.D. Tata, a member of the Committee who was closely associated with one of the banks named by the Governor, asked him about the liquidity positions of banks in the USA and the UK. Comparisons with banks' liquidity and advances-to-deposits ratios in Britain and the US revealed that Indian banks maintained lower liquidity ratios and higher advances-to-deposit ratios than their counterparts in these countries. The Committee of the Central Board returned to deliberate on the subject the following week, and the upshot of it was a review within the Bank of the adequacy of existing liquidity provisions in the Banking Companies Act and the Reserve Bank of India Act.

Two aspects of banks' recent functioning featured prominently in this review which was taken up in October 1960 and completed by February the following year. The first was the steep and almost continuous decline in the average overall liquidity ratio (i.e. the ratio of cash and balances with the Reserve Bank, gold, and unencumbered government securities to total deposit liabilities) of scheduled banks excluding the State Bank of India, from 43.3 per cent in 1951 to 33.1 per cent in 1960. The overall liquidity ratio in April 1960 of banks excluding those in the State Bank group averaged about 30 per cent, with several major banks having liquidity ratios of 28 per cent or less. The ratio of cash (i.e. cash and balances with the Reserve Bank of India) to the total liabilities of these institutions fell from 5.4 to 3.1 per cent over the same period. The credit-liabilities ratio of banks (again excluding the State Bank of India) rose from about 61 per cent in 1951 to 69 per cent in 1960, while their credit-deposit ratio hovered in the neighbourhood of 75 per cent.

² For a discussion of the Bank's experiment with varying marginal reserve requirements, see chapter 3.

In the future too, the Bank apprehended, the 'rising tempo of private investment' in the economy might cause the demand for bank credit to outpace the growth in deposits and further erode the liquidity position of the banks.

While it is necessary to provide for all genuine credit requirements of the economy, it is essential in such a situation ... to safeguard the soundness of the banking system through measures to raise somewhat the minimum requirements in regard to both cash reserves and liquid assets

This, Madan who piloted the proposal within the Bank argued, might also stimulate more 'effective mobilization of resources by banks to meet expanding credit needs'.

The second feature of the slide in the banks' overall liquidity ratio was the steady decline in their holdings of unencumbered government securities, from 34 per cent in 1951 to about 23.5 per cent in 1960. This fall was even steeper in the case of foreign banks, from 28 to 15 per cent. The tendency to get out of government securities or borrow against them from the Bank grew particularly marked in 1960 as banks attempted to relieve the pressure on their resources caused by higher marginal reserve requirements imposed during that year. The Bank's internal exercises to reconsider liquidity provisions were partly a response to this development as well, its officials seeking to

refine the cash reserve provision ... to provide for minimizing the impact on security holdings of any future action to raise reserve requirements by ensuring that with every rise in reserve requirements, the liquidity requirements can also be raised correspondingly.

It also became apparent by the end of 1960, that the higher cost of Bank accommodation which followed the recent introduction of the quota-slab system did little to enhance the attractiveness of government paper, with banks preferring outright sale of securities to borrowing from the Reserve Bank at the new rates. With the result, the aggregate investment-deposits ratio dipped sharply from 48.4 to 38.4 per cent between the end of 1959 and a year later.

Madan's proposals for revising banks' cash reserve and liquidity requirements, which he suggested should be related to total *deposits from the public* rather than banks' *liabilities*, came against this background. He proposed a minimum overall liquidity ratio of 27.5 per cent, and 'automatic variation in the liquidity ratio of scheduled banks for any change in the cash reserve ratio' by splitting the liquidity ratio into two parts, viz. the cash reserve component,

and other liquid assets. He also proposed, besides, assimilating the different reserve ratios currently prescribed for time and demand liabilities into a single reserve ratio applied to a bank's total deposits, with the Reserve Bank having the power to vary this ratio between 5 and 15 per cent. The proposal for a unified cash reserve ratio was intended to guard against demand deposits being switched into time deposits if the latter continued to be subject to a lower cash reserve ratio.

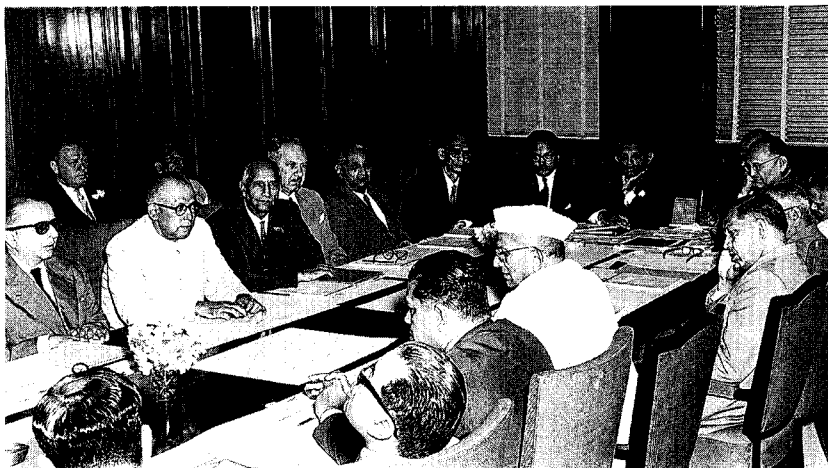
The Division of Banking Research prepared a sixty-page note elaborating on the reasoning behind Madan's proposals. A higher cash ratio, the note argued, was necessary because the turnover of current deposits had grown sharply from 22 per cent in 1945 to 58 per cent in 1960. Besides, fixed deposits were no longer 'as fixed as they used to be', with their average usance period having fallen from 6.5 months in 1935 to 2.8 months in 1960. The amounts of cleared cheques and the rate of turnover had also increased sharply during the 1950s.

With growing economic activity ... there is bound to be an even more rapid increase in the volume of banking transactions that will be settled through clearing and therefore through adjustments in banks' reserves with us. The present norm was fixed in 1935 and is clearly inadequate in the context of current and future needs.

Moreover with the decline in the cash balances of banks during the 1950s, the note declared,

a corrective in the form of higher basic statutory balances with the Reserve Bank becomes both desirable and inevitable in order to step up the overall cash reserve ratio to the minimum extent warranted by the current requirements of liquidity.

Since the liquidity ratio was also being raised simultaneously, banks might not be able to raise cash reserves without immobilizing their deposits. The Division of Banking Research therefore proposed giving them even two years, if necessary, to comply with the new requirements. This would also have the advantage of ensuring that banks that had a higher investment ratio than the 22.5 per cent proposed to be imposed did not rush to meet their additional cash reserve needs by selling securities. 'Since the primary objective of our new proposal is to ensure that future reserve increases are achieved without any pressure on the security markets', nothing should be done to provoke banks into liquidating government securities in large quantities.



Morarji Desai, Union Finance Minister, meeting bankers in New Delhi,
12 March 1961. Iengar is on his right.

A higher liquidity ratio, on the other hand, the Division of Banking Research indicated, was dictated primarily by the need to safeguard the liquidity of the banking system and enable it to withstand the strains of a sudden increase in withdrawals. As Iengar told the bankers when he met them in November 1961 to discuss the Bank's proposals, liquidity ratios in India were among the lowest in the world and deserved to be increased for their own sake. Besides, the present 'psychological atmosphere [of nervousness] ... might continue ... for some years'. Since 'liquid assets served as a buffer in absorbing shocks', the Governor argued, it was necessary to strengthen them.

Fearing the immobilization of a greater proportion of their deposit resources, banks in general were not very enthusiastic about these proposals. They suggested a maximum overall liquidity ratio of 25 per cent including the cash reserve component, and counting treasury bill holdings and balances with the State Bank of India towards cash reserves, and trade bills towards the overall liquidity reserve. The exchange banks too, objected to the proposals, arguing that their banks, which had 'very great funds abroad always at their support' were being made to pay the price for the 'weakness of a small section of the banking system'. If the Bank insisted on raising liquidity requirements, the exchange bankers argued, they should be allowed to deposit foreign securities with the Bank's office in London equivalent to 7.5 per cent of their deposit liabilities in India. This would put them and the Indian banks on a level playing field since the latter, unlike the exchange banks, could count the

proposed capital funds ratio (of 7.5 per cent of deposits) towards their liquid resources. Nothing, in the event, came of the latter suggestion since, as discussed above, the convention to relate capital funds of Indian banks to their deposit liabilities was abandoned no sooner was it adopted.

Nor was there much sympathy within the Bank for the changes proposed by Indian bankers. Their first suggestion, officials felt, was little more than a reformulation of the traditional demand of bankers for the central bank to pay interest on statutory cash reserves. The Bank, for its part, was determined to stick to the principle that statutory balances were a form of 'till money' banks maintained 'in the interest of their own liquidity', and that it was inappropriate to pay interest on them. Allowing banks to hold their statutory reserves with the State Bank and trade bills in their overall liquidity reserve, the Bank also felt, would weaken its ability to use reserve ratios as an instrument of credit policy. The proposal to set a unified reserve ratio on both time and demand deposits also evoked opposition, some bankers suggesting that it was unfair to institutions which had a large proportion of their liabilities in the form of time deposits and would discourage them from mobilizing deposits in the countryside where, apparently, time deposits were preferred to demand deposits. But the Bank did not go back on its view that time deposits should be treated on par with demand deposits for reserve norms because of the fall in their average maturities.

The Bank's liquidity proposals too were discussed at the November 1961 meeting with the banks. However, unlike in the case of capital funds where it helped narrow differences between the two sides and despite appearances to the contrary, the meeting did little to bridge the gulf that had developed between the Bank and joint-stock banks over liquidity requirements. In fact the letter Tulsidas Kilachand wrote to the Governor early in December 1961 proposing a compromise on capital funds—which in the event the Bank accepted—insisted that time and demand deposits should continue to be treated differently for fixing the cash reserve ratio, and that the overall liquidity ratio, including remittances through notified banks, should not exceed 25 per cent of total deposits.

Despite the distance still separating the Indian Banks' Association's views from those of the Bank, the Governor appears to have been keen to conclude a liquidity convention as well, even if it was only possible along the lines suggested by the association. Officials at the Division of Banking Research were, however, less enthusiastic. In particular they were puzzled by the association's view that the convention should fix the minimum liquidity requirement at a quarter of total deposits. Apart from the fact that a convention had to be 'within the four corners of the existing legislation' which specified

liquidity requirements in relation to total liabilities, the division believed the association was having second thoughts about the liquidity ratio it had more or less accepted at the meeting, of a quarter of a bank's total liabilities which was close enough to the Bank's (original) target of 27.5 per cent of total deposits. The division was also averse to the association's suggestion, which the Bank had rejected earlier as well, to include remittances through banks in the overall liquidity ratio. Remittances, a note by K.N.R. Ramanujam pointed out, might vary between 0.5 to 2 per cent of deposits. Including them in the overall liquidity ratio and fixing the latter at 25 per cent of deposits would mean 'maintaining the status quo' on banks' liquidity requirements.

The Indian Banks' Association's letter evoked serious misgivings about its intentions at other levels of the Bank as well. Madan noted that if the Governor's letter to banks establishing the new convention was based only on the changes the Indian Banks' Association appeared willing to accept, the proposal to alter liquidity requirements would have been 'watered down' to a point where it involved little change in existing liquidity provisions. Given the 'limits of moral suasion in this sphere, particularly ... on the eve of the busy season', Madan commented, it would be better to confine the Governor's letter, and the convention, to the 'capital funds problem'. Iengar too, saw Madan's point and agreed to defer efforts to alter banks' liquidity requirements till the end of the busy season.

Matters concerning the liquidity ratio had reached something of an impasse in December 1961 after the association's letter. As pointed out above, by June 1962 the Bank and the government had decided to moot legislation to replace the capital funds convention of December 1961. This amendment bill also presented the Bank with an opportunity to break the impasse and to put the revised liquidity requirements it envisaged for banks in the statute book. The proposals ventured in this connection in June 1962 differed little in substance from those considered earlier. The idea of separating the cash reserve ratio from the liquidity ratio was persisted with. So too plans to fix a single reserve ratio for both time and demand liabilities. However, the proposal to relate reserves to demand and time deposits, rather than demand and time liabilities, did not endure. The proposed legislation also shifted the balance between the cash reserve ratio and the liquidity ratio in favour of the latter. The minimum cash reserve ratio proposed was lowered from the 5 per cent discussed in 1961 to 4 per cent, while the liquidity ratio suggested was raised from the 22.5 per cent that the Bank had had in mind in December 1961 to 25 per cent in the amendment bill. When carried out, this change promised to enable banks to earn a return on a higher proportion of the liquid resources they were required to hold under the law, and boost the demand for government securities.

But the Indian Banks' Association was far from satisfied. It returned to the charge in July 1962, once again arguing that the proposed increases would impose 'too heavy a burden' upon banks which were now having to pay a premium to insure deposits under the new deposit insurance scheme introduced earlier in the year, and higher corporate taxes. The association also apprehended the effects of the impending wage award on banks' profitability, and of the proposal to compulsorily transfer a fifth of their disclosed profits to the reserve fund on banks' ability to service their existing and new capital base. The Bank once again relented, deciding to lower the proposed minimum cash reserve ratio further to 3 per cent. This level, incidentally, was lower than the cash reserve ratio actually prevailing in 1960 when the Bank initiated its moves to raise liquidity requirements! But the Bank refused to yield in its desire to peg the new liquidity ratio (excluding the cash reserve ratio) at 25 per cent. It was also proposed, as part of the same amendment bill, to allow the Bank to vary the cash reserve ratio of scheduled banks between 3 and 15 per cent, and amend the Banking Companies Act to require non-scheduled banks to hold minimum cash reserves of 3 per cent.

The necessary legislation was passed in September 1962 and came into force the same month. At their request, banks were allowed two years to come up to the new liquidity standards, which therefore formally took effect in September 1964. In the meantime, the chairmen of some Indian and exchange banks attempted in 1963 to persuade the Bank to refine the concept of liquidity further to ease the effect of the new regulations on their profit margins and on bank credit. The Indian Banks' Association too, made similar representations, suggesting that medium-term advances of banks should be treated as liquid assets, presumably because they were eligible for refinance under section 24 of the Banking Companies Act. But the Bank saw little reason to heed this suggestion.

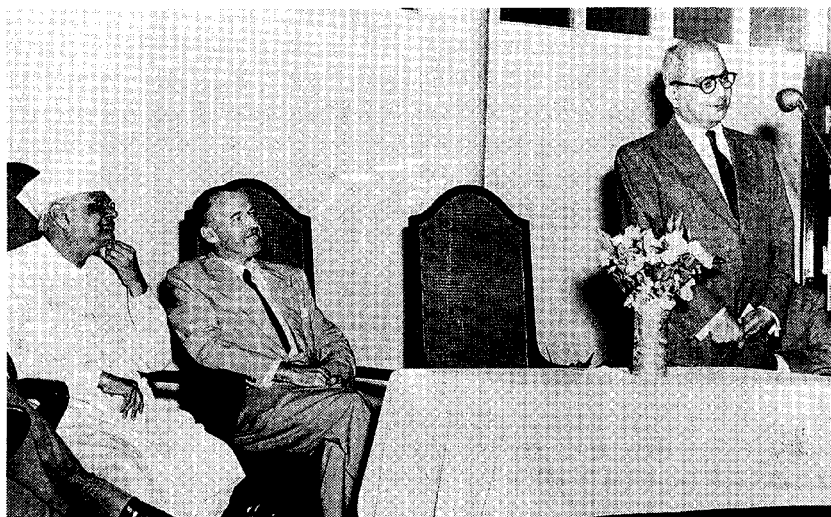
MANAGEMENT AND CONTROL OF COMMERCIAL BANKS

The Bank's interest in the way commercial banks were ordered and managed arose in two contexts. The first related to the implications for the soundness and stability of the banking system of the way banks' affairs were conducted. The other was the considerable public concern voiced in India, as in some other countries, over the control that identifiable business families or groups exercised over them. Such control, of course, raised wider issues extending well beyond the Bank and the period covered by this volume. Whatever its views on them, the Bank had good reasons of its own to take note of the apprehension that a few business houses might acquire control over a

significant proportion of the country's banking assets through the banks associated with them: besides raising questions about access to bank credit, such control might also jeopardize the interests of depositors if, as a consequence, banks became overexposed to individual firms or business groups.

Though no doubt the most public, control was not the sole context in which issues of management arose. Banks which were not controlled by any particular group were liable to be badly staffed or managed, and (as the adventures of Haridas Mundhra who did not control any banks reveal) liable to make badly-judged loans to one or more borrowers. Hence, tempting though it is in retrospect to view the issues addressed in this section as deriving their main salience from the public resonances they generated, the anxieties they reflected, or the course of public policy in later years, it is worth bearing in mind that the Bank's efforts to regulate the management and control of banks were also rooted in its concern for the institutional efficiency and stability of the banking system.

Thus soon after its inspections got under way, the Bank found that a large number of banks faced problems of a managerial nature and that many of them carried unqualified or inexperienced managers. Starting out as small and extremely local institutions, some of these banks had grown rapidly and expanded their area of operations during the second world war and the post-war boom. But they continued to be managed in traditional ways by persons who had either founded them or had been closely associated with their founders



Rama Rau inaugurating the Bankers Training College

and who had no formal exposure to modern banking methods. Besides coming in the way of banks adopting modern banking practices, such managers were often also a law unto themselves, even allowing their boards little say in their banks' affairs. The Bank attempted to strengthen and broaden the composition of the boards of such banks, often suggesting names of suitable directors. It also urged banks to engage trained and experienced bankers for key positions, generally professionalize the management, and structure the rewards of top managers in such a way as to avoid waste and give an incentive to qualified managers. Not infrequently, however, these suggestions fell on deaf ears, as managements of banks were loath to appoint an 'outsider' to important positions, much less as the chief executive or to their boards.

The more serious handicap facing banks in India was the shortage of 'trained and experienced' professional managers. Hence as early as 1953, i.e. even before the first round of bank inspections was complete, the Reserve Bank resolved to repair the gap as quickly as possible through a scheme to train managerial personnel of Indian commercial banks. After consultations with the major banks the Bank set up a committee of bankers under Deputy Governor Ram Nath to prepare the scheme, and sponsored the visit to India under the Colombo Plan, of two senior executives of London clearing banks. By the middle of the same year the Bank's plans had advanced sufficiently for the formal decision to be taken to set up a training college 'for the purpose of imparting training to banking personnel and improving the quality of the management' of banks in India. Under the original plan the expenses of setting up and running the college were to be shared by the Bank and the participating commercial banks. But with the latter soon balking at the commitment, the Bank decided to meet the 'entire expenditure' of establishing and maintaining the training college. This, Rama Rau argued in a memorandum to the Committee of the Central Board in August 1953, was 'reasonable' since, 'as the central banking authority', the Reserve Bank was 'interested in the orderly development of banking in the country' The Bankers Training College came into existence in 1954.

To some extent, of course, issues of management were difficult to separate from those of control. Public concern had been widespread in many parts of the world since the late nineteenth century over the access business groups might acquire to large deposit resources through their control of banking institutions. In India too, the possibility of individual business groups taking control of banks was anticipated even at the time the original Banking Companies Act was passed. Section 12 of this Act contained a safeguard which took the form of restricting the maximum voting power of any single shareholder of a bank to 5 per cent of the total, regardless of the size of his or

her stake in the institution. But by the mid-fifties, there were apprehensions of *benami* shareholdings being used to maintain or extend control over banks. Besides, 45 scheduled banks and nearly 250 non-scheduled banks which were incorporated before January 1937, when the Indian Companies Act was extended to banking companies, were exempt from the section 12 restrictions. Several of these banks were quite large ones, and there was some evidence too of concentration of voting power in these institutions. Therefore, the Banking Companies Act was amended in 1956 to extend the section 12 restrictions to the older banks as well. Secondly, as a means of making it more difficult for interested shareholders to circumvent these restrictions through the *benami* route, the Banking Companies Act was amended to accord recognition, except where genuine transfers had been made or the real owner was a minor or a lunatic, only to a person registered as a shareholder in the bank's records, even if the title to those shares was vested in another person.

The 1956 amendments also sought to address the phenomenon of interlocking of banks and non-banking companies. Section 16 of the Banking Companies Act, which stipulated that no individual could be a director in more than one *banking* company, was ineffectual in checking this, intended as it was merely to prevent the interlocking of two banking companies. Hence this section of the Act was strengthened by making it unlawful for a bank to have among its directors, individuals who happened also to be directors of companies controlling among themselves a fifth or more of the total voting rights of its shareholders.

The amendments carried out to the Banking Companies Act in 1956 helped strengthen the Bank's influence over the managements of commercial banks in other ways as well. As discussed elsewhere, the amended Act now empowered the Bank to give directions to commercial banks which it judged were necessary to safeguard the interests of depositors, and to depute observers to banks with rights to attend meetings of their boards and committees. Another amendment passed at this time gave the Bank the power to call for information on the shareholdings of the chairmen, managing directors, and chief executive officers of banks. Mild as these amendments might appear in retrospect, they nevertheless aroused considerable controversy at the time. This was particularly true of the amendments empowering the Bank to issue directions and appoint observers. While some members of Parliament felt these did not go far enough, others suggested, no doubt with some exaggeration, that the amendments amounted to 'nationalizing banks through the back door'. Appointing an observer, a few members also felt, would merely hasten a bank's destruction.

Soon after they were passed, the Bank felt the 1956 amendments gave it a degree of 'control ... over commercial banks' which was 'comprehensive and wide enough to ensure high standards in their methods of operations'. But less than three years later, the Bank utilized a suggestion by the government to review the Banking Companies Act as part of an overall exercise to examine the adequacy of the country's company laws in general, to widen its authority over banks, particularly in spheres related to their management. Thus, while in 1956 the Bank had acquired powers to approve the appointment of the managing director and other whole-time directors of a banking company, through another set of amendments moved in 1959, the Bank's powers in this respect were extended to cover all directors of a bank including those liable to retire by rotation. The 1959 amendments also gave the Bank powers to remove from office the chairman, director, and top executives of a bank if they were found by a judicial authority to have contravened the provisions of any law, and the Reserve Bank felt their continued association with a commercial bank was not in the latter's interest.

The next set of legislative amendments relating to the management and control of banks was taken up in response to the banking crisis of 1960. These amendments and the background to them are discussed in the next chapter. Thereafter, however, public and parliamentary opinion and the government set the pace for legislation intended to regulate the management of banks and reduce the possibility of abuse by business groups of the control they might exercise over them. By 1963, public interest in the management of banks had quickened to a point where the question of their ownership was beginning to come to the forefront of public debate; and in March the same year the government responded to a non-official resolution moved in the Lok Sabha by Subhadra Joshi, a member of the ruling Congress party, for the nationalization of banks with the assurance that it would bring forward amendments to the Banking Companies Act to further regulate the control that particular individuals or groups exerted over some banks.

The bill to amend the Banking Companies Act which the government sponsored soon afterwards reflected the concerns raised in the course of the debate on Subhadra Joshi's motion, and contained some radical proposals. Under the proposed amendments, chairmen and chief executive officers of banks could no longer be appointed for indefinite periods and were to be bound by five-year terms in office. The bill empowered the Reserve Bank to remove from office any director, chief executive officer, or any other officer or employee of a bank in the public interest, if it judged such action necessary to prevent the bank's affairs from being conducted in a manner detrimental to the interests of depositors or in order to ensure its proper management.

The draft bill also contained a provision authorizing the Bank to appoint up to five additional directors for renewable terms extending to three years. In August 1960, S.L.N. Simha, the Deputy Economic Adviser, had proposed that the Bank should acquire the power to nominate one non-voting director to the board of each bank. Simha's suggestion was made in the background of the scheme for deposit insurance that was being discussed within the Bank at the time and which, he argued, imposed 'greater responsibility' on the central bank. While outsiders, Simha implied, could be nominated to the boards of the smaller banks, officers of the Bank should be nominated as directors of the larger ones, since the Bank would then learn 'a lot of things' about such institutions 'on a continuing basis'.

The proposal has also some disadvantages; in particular, the RBI will be blamed for the acts of commission and omission on the part of a bank. However, even otherwise the RBI has to share the blame if the affairs of a bank go wrong. It is better we have the close association through our nominee so that we can take steps to correct undesirable practices at an early stage.

Better supervision over banks lay at the heart of Simha's suggestion. But in advocating the appointment of senior officers of the Bank as directors of commercial banks, Simha was clearly looking to the future. 'If nationalization should come about', he added, 'this experience will stand us in good stead'. Simha's suggestion evoked little response elsewhere within the Bank, and nothing came of it at the time. But it was a sign of changing attitudes that only three years later, proposals were mooted to give the Bank powers to appoint as many as five directors to the board of a bank.

Another important legislative change proposed in 1963 was to section 12 of the Banking Companies Act, further restricting the voting rights of the larger shareholders of commercial banks. The proposal emanated from a quick study the Division of Banking Research conducted in 1960 at the Governor's instance, of the concentration of ownership of bank capital on the basis of information contained in inspection reports of banks. A limited survey conducted by the Bank earlier in 1954 of eighteen banks revealed a concentration of their shares in a few hands. The findings of the 1960 study underlined these conclusions. Concentration of shareholding was reported in twenty-three of the sixty-four banks examined, including three major ones having deposits of over Rs 25 crores each, with directors of these banks and their associates holding shares in excess of 30 per cent of the total share capital of these institutions. The study however felt preventing the concentration of banking capital was easier said than done. For one thing, start-up capital

requirements for banks were relatively low. Although, as discussed above, these were raised for new banks in 1962, little could be done to increase the capital of existing banks except in the very long term. Nor would issues of fresh capital lead necessarily to the dilution of ownership since the Companies Act allowed pro rata allotment of new capital. There were also limits to the action the Bank or the government could take to restructure managements of banks paying regular dividends, without evoking opposition from shareholders and the public. Hence the Bank judged the practical solution to the problem of concentration of bank ownership to lie in further separating ownership from control, by reducing the maximum voting right of any individual shareholder from the prevailing 5 per cent of total votes, to 3 per cent. In the event, the government decided to limit the maximum individual voting right even further, to one per cent.

The 1963 bill also contained a number of provisions relating to the credit exposure of banks. The earlier prohibition (section 20) on granting unsecured loans to directors of banks and to private companies in which they were interested was extended to cover public limited companies in which the chairman of a banking company was interested as chairman, director, or managing agent. It was also proposed to institute stricter control over banks writing off advances to companies in which their directors were interested, by subjecting such write-offs to prior approval by the Bank. Following an initiative by the Governor, P.C. Bhattacharyya, the Bank considered stipulating ceilings on the individual and group exposures of banks. There was little enthusiasm within the Bank for the move. Existing and proposed legislative provisions relating to unsecured advances and the close scrutiny which banks' advances attracted during inspections, officials within the Bank argued, rendered such ceilings superfluous. Besides, credit ceilings would make it difficult for large industrial units and corporations in the public sector to arrange bank finance. However, the Economic Adviser, V.G. Pendharkar, pleaded strongly for such ceilings, stressing that it was undesirable in principle for a bank to tie up a large proportion of its resources in the business of a single borrower or a small group of borrowers. In the end, rather than amending the Banking Companies Act directly to set a limit on the individual and group exposure of banks along the lines of the legislation in other countries, it was decided to amend section 21 of the Act to authorize the Bank to stipulate the maximum amount of advances or other financial accommodation and guarantees that a bank could make to an individual, firm, association of persons, or a company.

Expectedly, the 1963 bill ran into fierce opposition from the banking community, some of which echoed through the Board Room of the Reserve

Bank. The Indian Banks' Association protested the move to further limit the maximum votes an individual shareholder could exercise, since among other things as its chairman, Tulsidas Kilachand argued, it would make it harder to get competent and experienced persons to stand for election as directors of banks. The Central Board of the Bank, which met in November 1963 to consider the draft bill, agreed that this proposal deserved to be reconsidered since it would serve no useful purpose. The association also opposed the proposal to empower the Bank to remove officials of banks without giving them an opportunity to represent their case since it could lead to arbitrary and undemocratic consequences, while the provision to appoint five nominee directors on a bank's board without considering the latter's strength, it was felt, could lead to the virtual takeover by the government of the management of a bank. The association suggested that officials facing action by the Bank should be given a right to be heard; besides, the vacancy caused by their removal should not be filled by the Reserve Bank, as it was originally proposed, but by the concerned bank's board of directors in consultation with the former. Finally, representatives of banks argued that prohibiting unsecured advances to some borrowers (section 20) would adversely affect many firms of sound financial standing. Moreover, advances against government supply bills and trust receipts for clearing imported goods were treated as unsecured advances, and the Bank could not interfere with a commercial bank's best judgement of unsecured advances or credit and guarantee limits of individual borrowers without causing needless hardship to them and hampering the country's industrial development. As the Indian Banks' Association declared,

Indian Banking has come into its own and made rapid strides in development only since independence and ... if it is to make further rapid progress, its freedom, initiative, and spirit of enterprise should be allowed as much scope as possible.

These arguments did not altogether go unheeded. The Reserve Bank conceded the association's demand that a bank official facing action should have a right to represent his or her case and file an appeal to the government. The Bank also decided to limit the number of directors it could appoint to the board of a bank to a third of its original strength, and to exempt advances against commercial bills of exchange, trust receipts, and government supply bills from the scope of unsecured advances under section 20 of the Banking Companies Act. But the Bank refused to resile from the proposal to limit the maximum votes an individual shareholder could command, arguing that it would help democratize the management of banks and encourage competent

persons enjoying the confidence of shareholders but not owning large blocks of shares to stand for election as directors of banks.

Some of these revised amendment proposals also came in for criticism in the *Central Board of the Bank*. R.G. Saraiya, who did not attend the meeting of the Central Board held early in November 1963 to discuss these amendments, felt the ban on extending unsecured advances to public limited companies in which a bank's directors held an interest would lead to a divorce between industry and banking with unfortunate consequences for both. A 'pure banker', Saraiya argued, 'cannot often see the difficulties of a pure industrialist and vice versa'. He also criticized the move to empower the Bank to regulate the accommodation granted by a bank to an individual borrower as one which imposed an 'unnecessary obligation on the Reserve Bank' and reduced the 'flexibility of ... operations of the banking system. After all, a banker is supposed to use discretion and have a sense of responsibility' Saraiya's views were not unrepresentative of those held by other members of the Central Board, and gave expression to the reservations that many among them harboured about a bill containing proposals which were felt to be *too radical* for their times. In an unusual move, the Central Board of the Bank passed a dissenting resolution which, apart from opposing the proposal to reduce the maximum votes of an individual shareholder of a bank to one per cent, characterized the extension of the existing section 20 provisions dealing with unsecured loans to public companies as 'inopportune' and likely to 'hamper industrial development'. Besides suggesting some minor changes to the bill, the Board also insisted that the Bank should exercise its powers to give directions to banks about the maximum financial accommodation they could give to any single borrower (or 'party') only after it was satisfied that it was 'desirable to do so in the interests of the depositors'.

The Banking Laws (Miscellaneous Provisions) Bill, 1963 was introduced in the Lok Sabha on 26 November 1963 and taken up for consideration towards the middle of December. The government championed these provisions of the bill in Parliament as a part of its efforts to free commercial banks from the influence of big business. Consequently, much of the debate on the bill ran along ideological lines, with some members of the opposition, notable among whom were Himmatsingka and M.R. Masani, protesting that the proposed measures amounted virtually to the government or the Reserve Bank taking over the management of the country's commercial banks. Masani, in particular, argued that the bill proposed to concentrate more powers in the hands of the Reserve Bank than it could handle without sacrificing the 'quality of supervision and leadership' it was set up to provide. Suggesting the postponement of the bill, Masani demanded the establishment, in the meantime,

of a high-level commission to go into the management of the banking industry. Cherian J. Kappen, the Member of Parliament from Muvattupuzha in Kerala where the Reserve Bank had become the target of campaign by some interests since 1960, thought the bill amounted to nationalization 'by proxy' of commercial banks. It also gave the Bank such wide powers that 'even God in heaven may become jealous of the Reserve Bank'. On the other hand, some members of the ruling Congress Party and the left-wing parties felt the bill gave too few powers to the Bank and the government, and that the test of the effectiveness of the intended provisions would lie in the manner in which they were utilized. The debate also became the occasion for the demand, which by now had become something of a ritual during parliamentary discussions on banking and financial matters, to nationalize banks in India. The bill was passed by the Lok Sabha on 20 December 1963 and the Rajya Sabha three days later. It received the President's assent on 30 December 1963, and its provisions came into effect on 1 February the following year.

This piece of legislation was, however, far from being the last word on what was to prove a contentious political issue during the second half of the 1960s. The debate over social control in 1967 revived some of the matters



Bhattacharyya (second from left) talking to a group of bankers at a dinner in Bombay, July 1966

thought to be settled earlier, while another kind of a denouement was reached in 1969 with the nationalization of fourteen of the largest Indian banks that year. Both developments lie outside the scope of this volume.

REGULATING COOPERATIVE BANKS

Regulating the activities of India's cooperative banks first came into focus as an adjunct to the extension of deposit insurance to this sector of banking. During discussions about the Bank's schemes for deposit insurance, fears were voiced in many quarters including the central government and the Agricultural Credit Department of the Bank, about the consequences for cooperative banks' deposits of a scheme devoted solely to protecting depositors of commercial banks. On the other hand, there was little prospect of the proposed Deposit Insurance Corporation providing cover to the former so long as the Bank had no statutory powers to control or regulate cooperative banks. There was little agreement among state governments and cooperators over the manner in which insurance or guarantees might be extended to depositors of cooperative banks. But there was general consensus, evident for example at the meeting of the Standing Advisory Committee on Agricultural Credit held in June 1962, that the arrangements to insure their deposits should be in line with those for overseeing, regulating, inspecting, and if necessary winding up, the affairs of cooperative banks.

The Governor, P.C. Bhattacharyya, sought to break the impasse by attempting to place the issue of cooperative banking regulation itself in a wider context. At the end of June 1963, the total liabilities of primary non-agricultural credit societies and the total credit extended by them were estimated at about 8.5 per cent and 9.5 per cent respectively of scheduled banks' aggregate liabilities and credit. Cooperative banks also played a prominent role in financing certain sensitive sectors of the economy in lending to which scheduled banks were bound by selective credit control regulations. Hence, addressing the Standing Advisory Committee in July 1963, Bhattacharyya remarked on the 'important bearing' operations of cooperative banks had on the 'currency and credit situation'. These banks not only received 'substantial funds by way of created money from the Reserve Bank', they also accepted deposits from the public and financed agriculture, industry, commerce, and trade. Besides, with the State committed to a policy of 'positive support to cooperative bodies', the impact of cooperative credit institutions on the monetary and credit situation would 'become more and more significant' over time. Therefore it was necessary to bring cooperative banking institutions 'within the ambit of statutory control of the Reserve Bank', and to give the latter powers over

cooperative banks 'analogous' to those it enjoyed over joint-stock banks. As well as *strengthening* the cooperative banking sector, Bhattacharyya stressed, this would also allow the Deposit Insurance Corporation (whose setting up is described in the next chapter) to extend protection to depositors of cooperative banks.

These ideas formed the basis of a note the Agricultural Credit Department formulated in August–September 1963 dealing with the extension of the Bank's statutory control to cooperative banks and the legislative measures needed to bring this about. While the Reserve Bank of India Act and the Banking Companies Act would doubtless have to be amended, the central question concerned the implications of the 'duality of statutory control' to which these institutions might have to be subject by virtue of the administrative sway state governments held over them. The Agricultural Credit Department also pointed out that the existing body of laws dealing with licensing, amalgamation, or liquidation of joint-stock banks would have to be adapted before they were applied to cooperative banks. A *joint-stock* bank was merely 'one among many'. In contrast, there was only one state cooperative bank in each state, and it was rare for a district to have more than one central cooperative bank. A large number of the latter were unviable and were likely to remain so in the near future, but the Bank would find it difficult to deny any of them licences. Neither could the Bank deny a licence to a central cooperative bank, or withdraw one, without making other arrangements to finance the district's cooperative societies. Most important, the Bank had powers to wind up or amalgamate a *joint-stock* bank it found unsuitable for a licence. But it had no powers in either regard over cooperative banks which were governed by the laws of the state government and the orders of the Registrar of Cooperative Societies.

The choice before the Bank, the Agricultural Credit Department argued, was whether it should rely on the Registrar to implement its recommendations as to the future of a cooperative bank and its management without itself acquiring any powers to enforce them, or whether it should acquire powers to direct cooperative banks to wind up operations, amalgamate with other institutions, and supersede their managements. The latter course, the Agricultural Credit Department noted, would require amendments not merely to central laws, but also to cooperative societies acts in the states, and it was 'doubtful' whether many legislatures would surrender any of these powers to the Reserve Bank. Pleading therefore for 'complete understanding' between the Bank and state governments, the Agriculture Credit Department insisted that the Bank (and eventually the Deposit Insurance Corporation) should recognize 'collaboration' with state governments as an 'essential part of the

scheme to ensure good management of cooperative banks. Although the 'working understanding' that existed currently between the Bank and Registrars had not been 'wholly satisfactory in practice', they or their governments were unlikely to disregard the Bank's advice on rehabilitating or winding up a cooperative bank. 'From the point of view of the banking structure as a whole', the Agricultural Credit Department remarked, the situation created by a Registrar's 'failure' to take 'logical steps' to wind up, amalgamate or supersede the management of a cooperative bank along the lines suggested by the Bank 'would be as much a matter of concern to the State Government as ... to the Reserve Bank'. Therefore, a written 'undertaking' by a state government that it would heed the Bank's advice and a 'working agreement' between the Bank and the Registrar would suffice 'for the present'.

Such views found little support outside the Agricultural Credit Department. Although the Governor had attempted to separate the two issues in the remarks he made to the Standing Advisory Committee in July 1963 and this separation was later to be reinforced at the legislative stage, the shadow of deposit insurance still loomed over these discussions. The consensus of opinion at a meeting to discuss the regulation of cooperative banking held early in September 1963 and attended by the Governor and all three Deputy Governors was that it would be inappropriate and 'discriminatory' to expect the Deposit Insurance Corporation to provide cover to the deposits of cooperative banks 'knowing fully well that the Reserve Bank ... would not have powers for amalgamation or liquidation of a cooperative bank'. If the Bank could not be vested with these powers through a central legislation, the meeting felt, each state would individually have to undertake amendments to the local cooperative act in the manner suggested by the Bank before securing the 'benefit of insurance' for its cooperative banks.

On the basis of these guidelines, the Agricultural Credit Department formulated draft amendments to the Reserve Bank of India Act, the Banking Companies Act, the Deposit Insurance Corporation Act, and the cooperative acts of state governments. These amendments were discussed at another meeting attended by the Governor and the three Deputy Governors a fortnight later. The amendment that expectedly evoked the most discussion at this meeting concerned empowering the Bank to require the Registrar to supersede the management of cooperative banks. These powers were handy in dealing with sick cooperative banks. They gave the Registrar, who already had them, a useful means to correct the working of cooperative banks and a practical alternative to dissolving them. Nor was there much dispute within the Bank about the need for similar powers for itself. But as those present at the meeting observed, the Bank did not enjoy analogous powers over joint-stock

banks, and Bhattacharyya and M.V. Rangachari, Deputy Governor, believed the Bank should not order the supersession of managements of cooperative banks except in the event of their deposits being eroded. Therefore, while it would be of positive benefit to cooperative banks if governments ceded this power to the Bank voluntarily, the Governor, in particular, felt it should not be made a precondition for extending deposit insurance to cooperative banks.

The legislative amendments needed to extend the Bank's statutory powers of control and deposit insurance to cooperative banks were discussed at a meeting of the Standing Advisory Committee on 25 October 1963. At the Governor's instance, the Standing Advisory Committee decided to place these proposals before a specially convened conference of representatives of the Government of India and state governments, Registrars of Cooperative Societies, chairmen of state cooperative banks, and members of the Standing Advisory Committee.

This conference took place on 19 November 1963, less than four weeks after the decision to convene it. Addressing the conference, Bhattacharyya spoke about the growing importance of cooperative banks, the impact of their operations on the Bank's monetary and credit policies, and the necessity for regulating their functioning. It would be possible to regulate the working of cooperative banks with little or no damage to the autonomy and integrity of the cooperative movement, he argued, merely by extending to them certain provisions of the Banking Companies Act. Cooperative banks had 'come of age', and deserved to be treated as an integral part of the banking system. Commercial banks had benefited enormously by becoming scheduled and licensed institutions, and the 'time was ripe to remove the differentiation' between them and cooperative banks by granting to the latter the 'appropriate status of scheduled and licensed banks'. Should cooperative banks come under the statutory control of the Reserve Bank, the Governor added, 'it would follow as a natural corollary' that they would also be admitted to the benefits of the Deposit Insurance Corporation. The Governor's remarks were endorsed by V.L. Mehta and D.R. Gadgil both of whom also underlined the expanded responsibility the Bank was now proposing to shoulder, not only in financing cooperative banks but also in assisting their development along sound lines.

Some state governments and state cooperative banks favoured the Governor's proposals, and several others were undecided. On the whole, however, according to the Bank's record of the proceedings, the response of state governments was 'not encouraging'. The conference witnessed intense debate over the virtues of vesting in the Bank powers to liquidate a cooperative bank or supersede its management, with the Madras government, in particular,

marshalling ideological, constitutional, and practical arguments against the idea. Mysore joined Madras in suggesting that regulation by the Bank was too high a price to pay for extending insurance cover to deposits of cooperative banks. Representatives of the Ministry of Cooperation in the Government of India threw their weight behind the Bank's proposals but maintained it should take 'only the minimum powers' needed to develop cooperative banks as sound banking institutions. Speaking in his 'personal capacity', M.R. Bhide, the Ministry's top civil servant who would soon come to the Bank as Deputy Governor, argued that cooperative banks would find themselves unable to mobilize adequate resources to expand their lending activities unless they submitted to the central bank's regulations. Greater control by the Reserve Bank, Bhide also suggested, would enable cooperative banks to resist political pressures.

As Gadgil, Mehta, and Bhide underlined, besides enabling cooperative banks to insure their deposits, the Bank's desire to see a better regulated system of cooperative banking also signalled its willingness to play a bigger role in the development of this sector. Registrars of Cooperative Societies and officials of state governments continued, however, to nurse reservations about the implications for the cooperative movement of giving to a central agency powers of control over cooperative banks, and the manner in which this agency would exercise its new powers. The Bank made strenuous efforts to dispel these reservations, its officials clarifying that the Bank would advise the state government and the Registrar whenever it contemplated taking serious action against a cooperative bank. The Governor too assured the conference that the Bank would entrust its powers to regulate cooperative banks only to the Agricultural Credit Department which was familiar with the working of these institutions and sensitive to their special needs. Besides, the Bank's regulatory standards and practices would be adapted to the distinct motivations and objectives of these institutions, and 'administrative arrangements for statutory control' would be such as to preserve the 'autonomous ... and voluntary character of the cooperative movement'. Finally, the Governor clarified, state governments having 'conscientious objection' to the proposed amendments did not have to carry them out so long as they were prepared to forego the benefit of deposit insurance for their cooperative banks.

Despite the delay in many state governments communicating their final views on the proposals discussed at the November conference, the Bank resolved to press forward with the necessary amendments to the Reserve Bank of India Act, the Banking Companies Act, the Deposit Insurance Corporation Act, and the cooperative acts of the states, and these were discussed within the Bank and with the Government of India during the next few

months. It was originally proposed to bring under the statutory control of the Bank all primary cooperative societies functioning both in the urban and rural areas with owned funds of Rs one lakh or more and which mainly did banking business. However, S.K. Dey, Union Minister for Community Development and Cooperation, saw no reason to include rural credit societies at all in the proposed legislation. There were, he pointed out, only about three hundred large rural credit societies with owned funds in excess of Rs one lakh each and their total deposits, a major part of which was in the form of fixed deposits not withdrawable by cheques, amounted to Rs 2.5 crores. (This represented one per cent of the total deposits of the cooperative banking system of Rs 250 crores.) Following suggestions made by Gadgil and others earlier, the Bank had withdrawn a proposal to bar agricultural credit societies with owned funds of less than Rs 50,000 from undertaking banking business. The Bank also did not consider it feasible, administratively, to cover all non-agricultural credit societies numbering about 13,000. As a sequel to Dey's intervention, therefore, the Bank decided in April 1964 to leave rural credit societies out of the bill altogether unless these institutions chose to style themselves as primary cooperative banks, and to confine its ambit to state and central cooperative banks. The bill also covered a limited category of 'primary' cooperative credit institutions, viz. non-agricultural credit societies with owned funds of Rs one lakh or more, which mainly undertook banking business, and whose bye-laws did not permit the admission of any other cooperative society (except, as the Bank clarified later, subscribing central and state cooperative banks) as a member.

The Ministry for Community Development and Cooperation also opposed the clause authorizing the Bank to issue directives to cooperative banks in the 'public interest', on the ground that these powers were too wide and that only the legislature could define what constituted the 'public interest'. Bhide, who had moved meanwhile to the Bank, told his former colleagues that similar provisions existed in several statutes and that it was not practical to approach the legislature every time the Bank contemplated action against a cooperative bank. However, he assured the Ministry, the Bank would adopt the convention of consulting the Standing Advisory Committee in such matters; nor did it have any objection to the Registrar of Cooperative Societies also instituting proceedings against cooperative banks on his own initiative.

Following these discussions the Bank sent the Government of India a draft amendment bill in May 1964. But with consensus among state governments still proving elusive, the Government of India decided in September to take up the legislation in two stages, deferring for the time being the proposal to

extend deposit insurance to cooperative banks since it involved changes to states' acts, and confining the proposed legislation to extending certain central laws to cooperative banks. Thus in December 1964, the government introduced the Banking Laws (Application to Cooperative Societies) Bill to extend to state cooperative banks, central cooperative banks, and primary cooperative banks, certain provisions of the Reserve Bank of India Act and the Banking Companies Act. Land mortgage banks, all primary agricultural credit societies and non-agricultural credit societies having paid-up capital and reserves of less than Rs one lakh were excluded from its purview, while cooperative banking institutions such as industrial cooperative banks could be covered under it once state governments deemed them to be state or central cooperative banks. Non-agricultural societies not defined as banks under the bill were to give up their banking business before the expiry of a transitional period of one year. The bill required primary credit societies which became primary cooperative banks after its enactment to apply for a licence within three months of becoming a primary bank. Cooperative banks, other than central cooperative banks, could no longer open new branches except with the prior permission of the Reserve Bank. Every cooperative bank, excepting a scheduled state cooperative bank, had to maintain either with itself or with a higher financing agency, a cash reserve of at least 3 per cent of its total demand and time liabilities, and liquid assets, including the minimum cash reserve, of not less than 20 per cent of its total time and demand liabilities. The bill prohibited cooperative banks from combining trading with banking, holding non-banking assets, creating a floating charge on assets, and required them to obtain the Bank's approval for investment in shares of cooperative concerns that were not within their areas of operation.

The bill also provided for amending the Reserve Bank of India Act to enable the Bank to include state cooperative banks in its second schedule. Each scheduled cooperative bank was to maintain with the Bank a minimum average daily balance of 3 per cent of its total demand and time liabilities, as against the requirement of 2.5 per cent of demand and one per cent of time liabilities in the case of banks which were not scheduled but nevertheless took advantage of the Bank's remittance facilities.

This bill was moved in the Lok Sabha on 17 December 1964 and taken up for discussion in February 1965 only to be deferred indefinitely. In the meantime, the board of the All-India State Cooperative Banks' Federation met in Bangalore in February 1965 to discuss the proposed legislation. Representatives of several state cooperative banks expressed their misgivings about a piece of legislation which extended Reserve Bank control over them without offering any tangible benefits such as deposit insurance in return, and

the federation's board unanimously resolved to ask the Government of India to modify the bill to provide insurance to deposits of cooperative banks of states agreeing to amend their cooperative acts suitably. Responding to the memorandum presented to him by the conference's chairman, D.R. Gadgil, Finance Minister T.T. Krishnamachari expressed himself willing to renew in Parliament the government's earlier assurances of its intention to extend deposit insurance to cooperative bank deposits, but maintained that the initiative now lay with state governments who had first to amend their enactments along the lines recommended by the Bank. Cooperators, the Finance Minister told Gadgil, could play an important role in educating state governments about the importance of deposit insurance and in removing their misapprehensions about the proposed amendments.

The draft legislation was also criticized by urban cooperative banks, particularly in Maharashtra, which wanted a better recognition of their place in the cooperative credit structure, concessional finance from the Bank, and the right to open branches within their areas of operation without the Bank's prior approval. The All-India Federation of Industrial Cooperative Banks apprehended, for its part, that the new laws would inhibit the financing of cottage and small industries. The federation also maintained that cooperative banks should not be evaluated on the basis of standards set for commercial banks, and that the Bank should exercise its regulatory powers only in consultation with state governments.

The Banking Laws (Application to Cooperative Societies) Bill finally came up for consideration in the Lok Sabha on 18 August 1965 and, for all the controversies to which it had given rise, was passed the same day. The bill was introduced and passed in the Rajya Sabha on 9 September 1965 and received the President's assent on 25 September. The Act came into force from 1 March 1966 from which date the Banking Companies Act was also rechristened the Banking Regulation Act. The Bank followed the enactment of this legislation with detailed instructions to Registrars of Cooperative Societies about the definition of the terms 'bank', 'banker', and 'banking' under the new Act; and to urge them to ensure that cooperative banks answering to the definition of banks obtained a licence from the Bank, and that those not satisfying that definition gave up banking business within a year of the Act coming into force. The Bank also framed the Banking Regulation (Cooperative Societies) Rules, 1966 and brought them into force from December the same year. Some minor amendments to the Banking Regulation Act and the Reserve Bank of India Act were moved in 1967 and passed in 1968 with the object of easing the hardships experienced by cooperative banks in the transition to statutory control by the Bank.

REGULATING NON-BANK DEPOSIT INSTITUTIONS

Banks were not the only institutions to accept deposits from the public in India. Several trading and manufacturing companies, notably textile mills in Bombay and Ahmedabad, had long followed the practice of financing a portion of their working and block capital requirements through deposits from the public. According to the findings of the Central Banking Enquiry Committee, public deposits in Bombay, where they financed working capital needs of industrial companies (mainly textile mills), were accepted for durations of six months to a year at interest rates ranging from 4.5 to 6 per cent. In Ahmedabad, in contrast, deposits could be for as long as seven years, and depositors often had a share in the commission of the managing agency. Although initially deposits were held mostly by friends and relatives of the firm's promoters or managing agents, thanks to the higher rates they offered, these companies soon began to attract the interest of the wider public in these areas. The 1950s also witnessed the expansion of the lending and deposit activities of 'hire-purchase finance companies' specializing in making loans to finance the purchase of trucks and motor vehicles. Though precise figures were still lacking, the growth of non-bank deposits during the 1950s was palpable and raised two issues of importance. The first related to protecting the interests of the depositing public which put its money into these companies, while the second concerned the implications for the Bank's credit policies of the existence of a large volume of unregulated deposits outside the banking system. The first consideration preyed on the minds of the Bank and the government during much of the 1950s, and remained the overwhelming one during the rest of our period. The latter consideration, however, began coming to the fore during the 1960s when the Bank acquired powers to regulate the deposit-related activities of non-banking companies.

The problems of depositors of 'concerns other than banks and insurance companies' came to the Bank's attention in January 1953 following a representation by the *Thevidar Parishad* (Depositors' Association) in Poona to the government alleging that a large number of firms which accepted deposits from the public had gone into liquidation or were not in a position to meet or service their deposit liabilities. At the Finance Ministry, D.L. Mazumdar, the Officer on Special Duty, and the Secretary, K.G. Ambegaokar, who examined the representation at the instance of the Finance Minister, C.D. Deshmukh, were both in favour of prohibiting joint-stock companies from accepting deposits from the public.

Officials at the Bank felt deposits from the public were not 'desirable' from the point of view of the borrowing firms. With the Industrial Finance

Corporation enlarging its activities, state financial corporations coming into existence, and the growing possibility of floating shares and debentures to meet fixed capital requirements, officials hoped, firms would reduce their recourse to fixed deposits from the public which, according to the Central Banking Enquiry Committee, were often in the nature of 'fair weather friends'. However, before considering any statutory action, the Bank felt, investigations were needed to ascertain whether the failure of companies to repay deposits was widespread or was a feature confined to Maharashtra. Statutory prohibition, the Department of Research and Statistics of the Bank pointed out, would divert the deposits of companies to banks.

It may be observed in this connection that during the years 1947-1952 the total number of banks ... which have failed is 159. We cannot, therefore, say that deposits with banks are much safer than deposits with private companies, especially as we have not heard of defaults on any appreciable scale ... in other parts of India.

Finally, the Bank felt, the explanation to section 5(1)(c) of the Banking Companies Act, which excluded from the definition of banking the acceptance of deposits from the public by a trading or manufacturing company for the purpose of financing its own business would have to be dropped in order to stop the practice, but this had been 'specifically inserted by the legislature' at the time the Act was passed, 'since the practice of financing by means of deposits was very widespread in India' and had apparently not led to any serious abuses.

Following the Bank's suggestion, the Government of India decided to obtain from state governments information available with them about the extent of the deposit liabilities of industrial companies, and of the nature of abuses that had crept into the system. The data received from state governments revealed that while the practice of trading and manufacturing concerns accepting deposits from the public was fairly widespread, 'cases of abuses' were 'very few' and were 'practically confined' to the Poona District of Bombay state. Hence, even in the government's view, there was 'no strong case' to prohibit firms from accepting fixed deposits. As Deshmukh himself remarked in August 1954 in the course of these deliberations, 'a modicum of caution on the one hand and honesty on the other are necessary for business contracts. Where they are lacking no legal safeguards will be of any use'. He however wondered whether it should not be made illegal for companies formed in the future to receive deposits from the public.

The Bank saw little merit in the Finance Minister's suggestion. There were

no good reasons to stop a practice which had spread widely because companies and the depositing public found it convenient for their respective purposes. Besides, as the Department of Banking Development pointed out, while firms were free to float debentures rather than raise deposits, they preferred the latter course to the former because it was a more flexible source of finance. Deposits were, in effect, an 'additional facility' available to firms to gather resources in circumstances when it was not always easy for the private sector to approach the capital market. In fact, as Ram Nath noted, an advantage for a firm of raising funds on deposit was that it left it 'free to mortgage its immovable assets or pledge or hypothecate its movable assets for raising its ... credit requirements'. However, in order to safeguard the interests of depositors, the Bank appears even in 1955 to have been willing to consider preventing companies from accepting deposits in excess of their paid-up capital. Little came of this proposal immediately as the Bank's own study of the published balance sheets for 1957 and 1958 of 1,001 public limited companies (which formed over three-quarters of such companies excluding banks, insurance companies, and other financial institutions) revealed that their total public deposits amounted to Rs 24 crores in 1958 (as against Rs 21 crores in 1957) and accounted for only a little over one per cent of their total liabilities.

After 1960, deposits of non-banking companies began to rise substantially, and according to a Bank estimate, the public deposits of the corporate sector alone amounted to Rs 56 crores by 1962–63. Moreover, it transpired that in wooing depositors aggressively, several joint-stock companies issued advertisements promising high rates of interest but containing little information of value about their financial position or management. The diversion of deposits to the non-banking sector and the proliferation of institutions depending substantially on public deposits but not subject to any kind of financial or monetary discipline also became matters of some concern. Bankers, who feared diversion of their deposits to non-banking companies, pointed out to the Governor at a meeting with him in January 1963, that besides carrying higher rates of interest, deposits of companies were often repayable on demand. They sought suitable action from the Bank in the form of reserve requirements on such deposits.

The initiative to entrust to the Bank powers to regulate the deposit activities of non-banking companies came, in the event, from the government which was engaged in September 1963 in considering measures to adopt stricter control over private sector banks. Although the Company Law Department was considering amending the Companies Act to regulate corporate advertisements soliciting deposits from the public, the Department of Economic

Affairs sought a more comprehensive regulation of such activity through amendment to 'our own laws'. The Bank's draft bill, which was sent to the government in October 1963, proposed adding a new Chapter (IIIB) to the Reserve Bank of India Act dealing with non-banking companies. But the government favoured strengthening the Bank's proposals further, and envisaged among other things, a system of licensing and inspection of financial institutions by the Bank. The final draft bill, framed in consultation with the government, authorized the Bank to regulate the issue of prospectuses soliciting deposits and specify the terms and conditions relating to them. The Bank was not at this stage in favour of licensing financial institutions. It was content, instead, to have powers to call for information about their deposits from all institutions accepting them, and from investment and hire-purchase companies even when these did not accept deposits, and to issue directions to them. Finally, the draft bill also contained provisions enabling the Bank to conduct inspections of all such companies and to impose penalties on institutions that did not comply with its directions.

These amendments were introduced in Parliament as part of the wider Banking Laws (Miscellaneous Provisions) Bill, 1963 in November 1963. When the bill was taken up for discussion the following month, R.R. Morarka moved an amendment seeking to exclude from its purview firms with paid-up capital of less than Rs one lakh. The government accepted the amendment and, as noted above, the bill was passed by the two houses and received the President's assent towards the end of December 1963. From conception to fruition, this section of the bill dealing with the deposits of non-banking companies had taken only about three months.

The first step the Bank took on the basis of this legislation was to collect information on deposits of joint-stock non-banking companies. In May 1964, soon after the bill came into effect, the Bank issued orders requiring companies that were not banking companies, companies involved in hire-purchase business or financing such transactions, and those engaged in lending or investment operations, to furnish information to the Bank on their deposit-related activities. The orders did not apply, however, to government companies, companies limited by guarantees, and non-profit associations registered under the Companies Act. Of the 2,300 companies that submitted returns for the five years ending 31 March 1964, 1,789 companies reported deposits. The total volume of deposits of non-banking companies came to Rs 186 crores. This was considerably larger than earlier estimated and amounted to about 8 per cent of the deposits of scheduled banks. Besides, as the survey revealed, spurred by interest rates that were much higher than those offered by the major scheduled banks, non-banking deposits had grown very rapidly in recent

years, and by some 21 per cent during 1963–64 alone. In contrast, deposits of scheduled banks had grown by about 12 per cent during the year. Firms in Maharashtra were the biggest borrowers in the market for non-banking deposits, followed in that order by those in West Bengal, Madras, Delhi, and Gujarat. About a third of the deposits were accounted for by firms in the cotton textile industry, while trading companies accounted for another 10 per cent.

Most worrying for the Bank, the survey also found that more than half (52 per cent) of the non-banking deposits had no fixed maturity and could be withdrawn on demand or at the end of a specified notice period, while a third were held for one year or less. Hence, as the Bank noted, about 85 per cent of non-banking deposits were of the 'short-term' variety 'which may be considered as directly competitive with the banking system'.

Following these findings, in particular the last, the Bank felt the need to take steps to control the deposits business of non-banking companies, both to 'provide a measure of protection to ... depositors and to facilitate regulation of the credit system....' The initial proposals, made by the Deputy Economic Adviser, K.N.R. Ramanujam, and the Economic Adviser, V.G. Pendharkar, in June 1965, envisaged (a) disallowing demand and notice deposits and term deposits of less than one year, (b) restricting the permissible *public* deposits (i.e. deposits excluding those of managing agents, secretaries and treasurers, and other companies) of a company to a fifth of its owned funds, (c) prohibiting companies which had incurred losses for three successive years from accepting deposits, and (d) prescribing the minimum information that a firm soliciting deposits must furnish to the public. In addition, the Bank intended restricting the total borrowings of hire-purchase companies to a maximum of five times their 'net capital', and stipulating a 'liquidity ratio' of at least 8 per cent of their assets in the form of cash or as balances with banks and at least $6\frac{2}{3}$ per cent of their assets in the form of aggregate monthly receipts due under hire-purchase contracts.³ In the course of preliminary discussions within the Bank and with the government, it was also proposed to make it obligatory for all companies accepting deposits to furnish to the Bank their audited balance sheets once a year and their interim accounts every six months, and to reduce the minimum period for which hire-purchase companies could accept deposits from one year to six months.

These regulations did not apply to other financial companies, such as investment companies, *nidhis* (mutual benefit or 'permanent' funds dealing only with their members), and loan companies, since their financial positions

³ 'Net capital' represented the excess of a company's paid-up capital, reserve funds, and balance of profit and loss accounts over its fixed assets, unquoted investments, goodwill, and capitalized expenses.

were, in the Bank's view, 'fairly sound'. While the affairs of chit funds were 'far from satisfactory', the Bank felt it was necessary to study their position more closely over some years to ascertain 'the vulnerable aspects of their working' before considering ways to regulate them.

Ramanujam's proposals ran into trouble at the very outset, both within the Bank and with the government. R.K. Seshadri, who represented the Government of India in these discussions, felt the move to limit deposits of non-banking companies to a fifth of their owned funds would be too harsh in its impact on public companies whose deposit record was generally good. Officials within the Bank considered raising the limit to 30 per cent and later 35 per cent, and making it applicable to all deposits. But the Deputy Governor, B.N. Adarkar, felt the new proposal meant a 'substantial weakening of control over public companies' (for whom the actual overall ratio was 13 per cent) and 'immediate hardship to private companies' (with a ratio of deposits to owned capital of 47 per cent). The modifications, according to Adarkar, also involved

directing our attention from the starting point of attracting deposits to the banking sector to a *new* objective of driving deposits from private to public companies. At a time when companies are unable to expand their equity base, I wonder whether we should not explore the alternative of regulating interest rates as a means of controlling the growth of deposits ... of companies.

Following Adarkar's intervention, the Governor decided in August 1965 that the Bank's directives to non-financial companies should be confined to stipulating the minimum period for which they could accept deposits and the minimum information they should furnish in their advertisements.

Adarkar and Seshadri also objected to the liquidity ratio for hire-purchase companies, in particular to the one stipulating that their monthly receipts should equal at least $6\frac{2}{3}$ per cent of their outstanding contracts in the previous year. Since this was thought to be too rigid, Pendharkar and Ramanujam revised this ratio downwards to half-yearly receipts of a quarter of outstanding contracts. But even this, Adarkar felt, implied that hire-purchase companies would generally be unable to provide credit for more than twenty-four months. The Bank, he argued, should 'strike a balance between the interests of the companies, the depositors, and the consumers'. Of the three, 'the last category was by far the most numerous':

By prescribing a ceiling of twenty-four months for the average term of a hire-purchase contract ... we may be discouraging sales

of essential items like trucks or agricultural tractors or other agricultural machinery Our objective is to safeguard depositors' interests, and not to limit consumer credit.

The former, he suggested, could be more simply achieved by making deposit rules more rigid, for example by restoring the minimum period of deposits to one year, than by imposing requirements that affected the duration of the loan facilities that hire-purchase companies extended to their enterprising borrowers.

It transpired on closer examination that Adarkar's understanding of the '25 per cent of half-yearly receipts' requirement was based on some incomplete figures compiled by the Economic Department. His objections and the Economic Department's efforts to answer them help, nevertheless, to illustrate the various considerations weighing with the Bank when it decided to exercise the powers given to it under the 1963 legislation to regulate the functioning of hire-purchase companies. In the event, the final proposals that emerged from these discussions in November 1965 envisaged a minimum maturity of one year for deposits of non-financial companies and six months for those of hire-purchase companies. They also advocated a 'selective approach in the control of non-financial companies' and a 'more detailed' form of control over hire-purchase companies which 'might also include inspection'. Hence it was intended to ask all non-banking companies to provide to the Bank audited balance sheets every year and provide interim half-yearly accounts. They were also to provide information regarding their management and finances in their advertisements soliciting deposits. The financial information required to be advertised included profits during the three years preceding the advertisement, dividends declared, paid-up capital, free reserves, deposits, and any other secured or unsecured loans and advances obtained by the company. Hire-purchase companies were subject to some additional restrictions. Their maximum borrowing limit (both secured and unsecured) was set at five times the 'net capital'. They were to maintain as cash, current account balances in scheduled or notified banks, and central, state, and trustee securities, at least 9 per cent of their assets in India. Hire-purchase companies were also to so order their contracts that their half-yearly receipts were at least a quarter of the value of the contracts outstanding at the end of the previous year.

Although Bhattacharyya wanted the Bank's new regulations on the deposits of non-banking companies to be announced at the same time as the 1965-66 busy season credit policy, formal consensus within the Bank and with the government over their substance proved elusive until the end of 1965. Finally, the Bank's two notifications regulating the deposits of non-banking (non-financial) companies and hire-purchase companies, and containing the final

proposals summarized above, were issued early in January 1966. Subsequently, these notifications were amended in minor respects in April 1966, while at the end of June 1966 the Bank issued a modified directive to hire-purchase companies accepting public deposits, asking them to maintain a liquidity ratio of 10 per cent of their outstanding public deposits.

The response of the non-banking companies to the new regulations was relatively muted because they were so long in coming and had been attenuated in various ways to minimize the hardships they might cause. Predictably, however, the Indian Banks' Association welcomed the two notifications. Addressing the association in April 1966, its Chairman, K.M.D. Thackersey, welcomed the measures as a 'good compromise' which allowed banks to compete among themselves for shorter-term deposits, and promoted competition between banks and non-banking firms for the medium- and longer-term savings of the public. 'Regulated competition' of this nature, he suggested, might

enable the Reserve Bank to achieve an orderly pattern and realistic structure of interest rates, under which the spread between short-term, medium-term, and long-term rates of interest [was] satisfactory, nominal rates being allowed for short-term deposits which would remain with the banks and the market rate ... being offered for ... medium and long-term savings.

No reasons were explicitly set forth by the Bank for choosing not to regulate the interest rates offered by non-banking companies. But Thackersey's appraisal of its initiative appears on the whole to have been a realistic one. By allowing non-banking companies to compete directly with banks in the market for longer-term deposits, the Bank might have hoped, incidentally, to help relieve the dampening effects on the mobilization of longer-term savings of interest regulation in the banking sector and of the rising cost of banking intermediation. Against this background, regulating the activities of non-banking companies was vital to stabilizing the market for long-term deposits and reducing the risks on them; and though many officials at the Bank would no doubt have liked to impose other conditions (including a ceiling on deposits individual non-banking companies could accept and restraining loss-making companies from soliciting deposits), the outcome that emerged represented a compromise between the Bank and the government which favoured, at least for the present, relatively light regulations on non-banking deposits.

The directions of January 1966, which among other things required non-banking companies to submit annual audited balance sheets and interim half-yearly accounts to the Bank, led to some expansion of the central bank's

responsibilities. It had now to make arrangements to study the information submitted by non-banking companies, conduct surveys of deposits of these institutions, supervise their functioning and carry out inspections, and review the impact of regulatory measures. Ramanujam, who oversaw non-banking companies on behalf of the Bank in the early years, therefore proposed the creation of a division within the Economic Department to undertake the new responsibilities. But at the instance of the Governor, the Bank decided in January 1966 to establish a full-fledged Department of Non-banking Companies. This department came into existence in March 1966 in Calcutta where office space, which proved to be in short supply elsewhere, was found for it in the new building of the Bank.

A review by the Bank of the working of these regulations in August 1966 led, in the event, to the revival of some of the regulatory proposals that were abandoned two years earlier. The review revealed that company deposits had grown in the meantime to Rs 230 crores. While some of the increase was no doubt accounted for by better reporting, officials at the Bank were concerned that the deposits of non-banking companies continued to grow faster than those of banks. It also became apparent that poorly managed, smaller private companies tended to rely on deposits to a much larger extent than their capital base justified. Some private companies which had accepted deposits from the public were also reported to have failed in the Delhi area.

Ramanujam, who had played a major role in drafting the original proposals in June 1965 which were successively watered down in the following months, argued on the basis of the review that it would not be possible to restrain the growth of non-banking deposits and protect depositors lured by the high rates of interest offered by unsound private companies, unless interest rates were regulated and a ceiling imposed on the volume of deposits a company could accept. Other officials at the Bank felt companies offering up to 12 per cent on deposits mopped up resources that would otherwise have flowed into longer-term savings schemes of banks and the government, while Seshadri, who had meanwhile joined the Bank as an Executive Director, now argued that the unlimited access companies had to public deposits adversely affected monetary and credit management. Generally, the view prevailed that in the absence of restrictions on the deposit rates of the smaller scheduled banks and non-scheduled banks, little could justifiably be done to restrain companies offering high interest rates. A ceiling on the volume of deposits they could accept was felt however to be a more practical proposition, and after reviewing the rising debt-equity ratio of firms in a large number of industries, the Bank favoured limiting the public deposits of a firm to a quarter of its paid-up capital and reserves.

Following these discussions, the Bank framed a new set of directions applicable to all specified financial companies whether or not they accepted deposits, including loan companies, hire-purchase finance companies, housing finance companies, investment companies, *nidhis* and mutual benefit funds, and the non-chit financial businesses of chit funds. A second set of directions framed at the same time applied to non-financial companies collecting public deposits, including those belonging to the government. The two directives provided for controlling the terms and conditions of deposits largely along the lines enunciated earlier, restricted the volume of deposits of companies (excluding those in the housing finance and hire-purchase sectors) to a quarter of their paid-up capital and free reserves, prescribed liquidity requirements for hire-purchase and housing finance companies of 10 per cent of their outstanding deposits, and sought the collection of hire-purchase debts within a reasonable period. All financial companies were also required to supply to the Bank detailed information about their operations, while non-financial companies were to provide information about their deposits and hire-purchase transactions.

Despite receiving no word from the government about these directions which were sent to it in September 1966, the Bank decided to issue them at the end of October 1966 for bringing into force from 1 January the following year. These regulations, particularly that limiting the volume of deposits a company could mobilize, came in for criticism from representatives of trade and industry. They argued that it would starve companies of funds and proposed raising the ceiling to 100 per cent of paid-up capital and free reserves, the latter defined rather more liberally. The Bank's directions allowed two years for over-borrowed companies to reduce their outstanding deposits, and demands were voiced to raise this to five years.

The Bank's directions also stipulated that no interest should be paid on deposits withdrawn prematurely. This rule was made with two objects in view. The first was to prevent companies and depositors from circumventing restrictions on the minimum periods for which non-banking deposits could be accepted. Secondly, non-banking companies (with the exception of hire-purchase companies) not being subject to any liquidity requirements nor being eligible to draw emergency accommodation from the Bank, the restriction was intended to help forestall the eventuality of a run on their deposits. The Bank however retained the power to sanction exceptions to this general rule, as a result of which it was inundated by representations from many non-banking companies seeking permission to repay deposits prematurely with interest. Following these requests, the Bank decided in April 1967 to issue modified orders stipulating that no interest would be payable on deposits

withdrawn before the minimum deposit period (of six months for hire-purchase companies and one year for other companies) had expired, as also the minimum and maximum rates payable on deposits withdrawn prematurely beyond this period.

However, a few weeks later in June 1967, the Deputy Prime Minister and Finance Minister, Morarji Desai, suggested a further relaxation of these terms which he felt were 'onerous and should not be imposed' on non-banking companies. He also sought measures to liberalize the other directives issued in October 1966, and a ceiling on the rate of interest companies could offer on their deposits. In the discussions which followed, the Bank failed to convince the government about the necessity of an interest ceiling on premature withdrawals which was lower even than those applicable to banks, particularly since, unlike in the case of the latter, the interest rates companies could offer on their deposits were completely unregulated. Finally, as its differences with the government were resolved in August 1967, depositors withdrawing their non-banking deposits during the minimum period were allowed the same rate of interest as commercial banks offered for the corresponding period, while deposits withdrawn prematurely after the minimum period had elapsed were to be paid interest at one per cent below the agreed rate for the full term. The Bank stuck to its view that the upper limit on the volume of deposits a company could accept should not be raised. However, it agreed to increase the time companies were allowed to comply with this directive from the prevailing two years to five, provided they were financially sound, maintained a good dividend record, and had adequate unencumbered fixed assets to cover unsecured loans and deposits. The Bank also managed successfully to resist the government's suggestion to regulate interest rates on the deposits of non-banking companies.

Unpublished Sources

- G.8 Governor's Correspondence with Government of India, Ministry of Finance
- C.233 Suggestions for Amending the Banking Companies Act, 1949
- C.312A Strengthening Paid-up Capital and Reserves of Commercial Banks
- B.2.0040 Reserve Funds and Capital Requirements
- B.2.0050 Capital Funds of Banks
- B.2.3060 Deposit Growth of Scheduled Banks
- C.442 Bringing Cooperative Banks under the Statutory Control of the Reserve Bank

A.1	Application of the Banking Companies Act to Cooperative Banks
C.371	Governor's Conference with Bankers
ORG.66	Organization of the Department of Non-banking Companies
Con.30	Non-banking Companies' Deposits
C.334	Acceptance of Deposits by Industrial Concerns
MRC.95	Collection of Statistics under the Banking Laws (Amendment) Bill, 1963
Con.12	Issue of Notifications and Correspondence
<i>Memoranda to the Central Board and Committee of Central Board</i>	

Crisis, Consolidation, and Growth, 1951–67

The Banking Companies Act was passed in 1949 towards the end of a decade that witnessed a large number of bank failures in India. No fewer than 365 banks, with aggregate paid-up capital of Rs 68 lakhs, failed during the second world war. The post-war years were also years of severe stress for the Indian banking system as 207 banks went out of existence between 1946 and 1950. Of particular concern, the banks that failed during the later period were generally larger in size than those failing earlier, these 207 banks having an aggregate paid-up capital of Rs 5.33 crores. The year 1948 was the worst year for the relatively larger banks, the paid-up capital of the forty-five institutions which closed down that year, for example, averaging about Rs 4 lakhs each.

Thanks to Partition, the post-war banking crisis was especially severe in West Bengal and Punjab. Two hundred and five of the 634 banks that went out of business during 1940–51 did so after 1947. Of these, no fewer than eighty-three banks, having outside liabilities of Rs 26 crores, were from West Bengal alone. Some of these were listed in the second schedule of the Bank Act at one time or the other and included such well known names as the Nath Bank. But the large majority of the banks failing in this eastern state were little more than loan companies that had over-reached themselves by opening more branches than they could sustain on the strength of their resources and by making large loans against property or inadequate security.

Fewer banks (twenty-four) failed in Punjab during 1947–51. But at Rs 62 crores, the outside liabilities of these institutions were considerably larger. Thirty-two banks from Madras and twelve from Bombay, including the Exchange Bank of India and Africa which faced a run mainly on its foreign branches, may be added to this list, but the total outside liabilities of these institutions were of the order of only about Rs 3 crores.

The pace of bank failures did not immediately abate following the passage of the Banking Companies Act, fifty-three banks downing their shutters in the year in which the legislation was passed, another forty-five the following

year, and a further sixty-two in 1951. A positive feature, one however which *understandably* did little to diminish public concern, was that the banks which ceased to function during 1949–51 were generally smaller than those that failed in the three years immediately preceding this period. Besides, by 1951, the worst had perhaps been overcome, with more than half the banks in existence in 1940 having collapsed by then. Yet at the end of that year, there were still as many as 566 banks in existence in India. Of these, only seventy-six Indian banks qualified for inclusion in the second schedule of the Reserve Bank of India Act. There were, in addition, sixteen foreign banks. Besides not being eligible for inclusion in the second schedule, the majority of the remaining 474 banks were small, unsound, and poorly managed institutions which, even with the greatest goodwill in the world, had little chance of surviving for any length of time as viable, independent banks.

Hence, even though the bank failures of the 1940s might be said to have greatly eased the task of consolidating the banking system and placing its institutions on sound foundations, the latter was still by no means easy of accomplishment. More so as the Bank had little prior experience in the area. The passing of the Banking Companies Act in the midst of a crisis raised public expectations from the legislation and the Bank, particularly in some areas where the state of banking panic bordered on hysteria, but it was largely an untested instrument at the beginning of our period. The Bank, according to the public view, was now sufficiently well armed to prevent commercial banks falling like ninepins as they had done in the 1940s. The most significant new feature of the Banking Companies Act, and the most important instrument potentially of banking consolidation, was the power it gave the Bank to license commercial banks. But as we note below, the Bank could not use this power lightly to put out of business, in one fell swoop as it were, all banks whose affairs were not in order, and the constraints it had to negotiate and the dilemmas it had to resolve gave its licensing policy a somewhat double-edged character. Moreover, until the 1960s, despite affirmations to the contrary, the Bank's powers to effect the consolidation of the weaker elements of the banking system were not commensurate with the challenges it faced in this area. These powers were wanting in two important respects, as the Bank could neither declare a moratorium on a bank nor enforce the compulsory amalgamation of unwilling banks. As later events proved, these powers were a necessary complement to the *Bank's licensing regime, and the pace of banking consolidation* picked up considerably in the 1960s after it acquired them in the aftermath of the collapse of the Palai Central Bank.

For all the diffidence and indecision of the 1950s, therefore, the period covered by this volume saw the Bank achieve major success in weeding out

unsound institutions and giving a semblance of soundness and solidity to the Indian banking system. An unwieldy banking edifice of 566 banks of all descriptions in 1951 had been pared down by 1967 to a more homogeneous and manageable arrangement comprising ninety-one banks, all but twenty of which qualified for inclusion in the second schedule. In illuminating contrast, only ten banks went out of business during the two decades after 1967. Although there were some notable failures during 1951–67 such as those of the Palai Central Bank and the Laxmi Bank, both in 1960, one or two relatively minor banking panics, and some banks had to be placed under moratoria, the consolidation process was accomplished in an atmosphere free from any prolonged and widespread fear of bank failure. Indeed, thanks to the measure of consolidation achieved and the introduction of deposit insurance in 1962, by 1967 the phenomenon of large-scale bank failures and of the public losing the larger part of its deposits was largely relegated to the past.

CONTROVERSIES OVER THE BANKING SITUATION IN WEST BENGAL

Some idea was given above of the extent of the banking crisis in Bengal in the latter half of the 1940s. By the time the curtain rang down on the period covered by the last volume of the Bank's history, the worst of the crisis had clearly passed. There had been some positive developments as well. In December 1950 four banks in Bengal, viz. the Bengal Central Bank, the Comilla Union Bank, the Comilla Banking Corporation, and the Hooghly Bank, faced a run on their deposits in the uncertainty that followed the failure of the Nath Bank. By March 1951 these four banks had been amalgamated with some assistance from the Reserve Bank to form the United Bank of India. This was the first major banking amalgamation to take place after the Banking Companies Act came into force. The United Bank of India quickly earned the confidence of West Bengal's banking public, its deposits and liquid funds rising by a few crores of rupees within the next few months.

But there was still the detritus from the past. In 1951, according to the Bank's rough count, proceedings were under way to liquidate at least fifty banking concerns which went out of business between 1947 and 1950, involving deposits of about Rs 30 crores. Proposals mooted by Bengal politicians and officials to establish a 'reconstruction bank' in the state to take over the business of some of the banks under liquidation or working under schemes of arrangement foundered on the recognition that the financial position of these institutions, which were also characterized by a high proportion of illiquid advances, was 'extremely unsatisfactory'. A 'reconstruction bank',

the Bank informed the government in June 1951 in response to its suggestion, was not a 'feasible' idea in West Bengal.

Liquidation was therefore the only means of salvaging at least some portion of these banks' assets for distribution among their depositors. But since 1948, the feeling had grown in West Bengal that proceedings to liquidate banking companies were extremely elaborate, involved considerable delays, and worked against the interests of their creditors. The state government appointed a committee in March 1949 to devise ways in which to expedite liquidation proceedings in the interests of a bank's creditors. This committee suggested some legislative amendments and executive actions by the High Court and the government. Following this the Banking Companies Act was amended in 1950 to facilitate swifter winding up proceedings by conferring exclusive jurisdiction on High Courts to decide all claims involving banking companies and to try 'in a summary way', offences such as misfeasance or malfeasance committed by directors and officers of banks under liquidation. The new enactment also laid down the procedure for the amalgamation of banks.

In practice, however, the 1950 Act did little to speed up liquidation proceedings or relieve public unease in the state. This for two reasons. More than a year after these provisions came into force, several High Courts, including all importantly that in Calcutta, had failed to frame the rules for the new procedure which, as a result, remained inoperative in most states. The Calcutta High Court was also remiss in other respects, having failed to recommend the appointment of a special liquidator for banking companies in the state, or other staff to assist the special liquidator and supervise the financial management of banks under liquidation.

More importantly, the new legislative provisions related mainly to a summary procedure for suits against banks' borrowers that would help liquidators make recoveries without having to file regular suits. But liquidation proceedings remained vulnerable to many other legal, procedural, and official delays. Writing to P.C. Bhattacharyya, Joint Secretary in the Ministry of Finance, towards the end of August 1951, the Deputy Governor, Ram Nath, identified ten points at which liquidation proceedings tended to be held up. Appointing the liquidator, for instance, could take several months. At the other end of the tunnel, legal provisions inhibited courts from enforcing a liquidator's decision to call up unpaid share capital from contributories, were it to be challenged in court by even one shareholder refusing to admit the liability.

Public anxiety in West Bengal over the delays attending banks' liquidation proceedings was compounded by the failure of liquidators to realize a substantial proportion of the assets of many banks, and the high costs relative

to assets realized, of their legal services and proceedings. According to an official of the Bank well versed in these matters, of the eighty-two banks that suspended payments in Bengal during 1947–50, only thirteen banks working under schemes of arrangement had made ‘small payments’ to their depositors. ‘Nothing whatever’ had been ‘paid by way of dividends’ by any of the other banks, including those under liquidation. The negligible dividends depositors received fuelled public resentment in West Bengal against the prevailing banking and legal systems. As an elderly resident of Sukhchar in the 24-Parganas remarked in a letter she wrote to Jawaharlal Nehru in 1950, middle-class and rural depositors who lost the moneys they put into banks ‘scheduled and affiliated [sic] by the Reserve Bank’ had come to the conclusion that the central bank was ‘only meant for the Big Pandas who ... only know how to squeeze’ the poor and who were ‘sleeping with oil in their noses’. Loss of public faith in the government and its institutions, the letter concluded, would force the people of the region to court their ‘worst fate’ and ‘join ... hands’ with the communists.

The Bank's Role in Liquidation Proceedings

Ineluctably then, the Bank was dragged into the fray. More so, as the view prevailed even among informed officials who might have been expected to know better, that it had somehow a major role to play in speeding up liquidation proceedings, even those who did not lay the blame for their slow progress at the Bank's door insisting that matters would be helped if the latter became the official liquidator of banks in India.

The proposal to make the Bank the official liquidator of banks was of long standing, and at one stage had Mint Road's blessings. In 1939, when proposals for a comprehensive banking legislation to protect the interests of depositors were first mooted, the Bank had suggested simplifying liquidation procedures and designating it by statute as the liquidator. This was the Bank's response at the time to the concern voiced even then, over the ‘high cost’ of banks' liquidation proceedings when these were carried out under the ‘ordinary company law’. This suggestion was largely repeated when efforts were next made in 1944 and subsequently to frame banking legislation in India. The clause assigning to the Bank the duties of official liquidator ‘in all proceedings ... for the winding up by the court of a banking company’ was retained in the bill that was moved in the Constituent Assembly in 1948. Soon thereafter, however, brought face to face with the magnitude of the banking liquidation problem and the paucity of trained staff, the Bank began to harbour second thoughts about this provision. The Banking Companies (Control) Ordinance, which was promulgated in September 1948 in the wake of the anticipated

delay in passing the Banking Companies Bill, allowed the Bank considerable latitude in the matter, providing for its appointment as official liquidator only upon the Bank applying to the court for such an appointment.

Feeling it 'impracticable for the Reserve Bank to undertake the liquidation of all banking companies required to be wound up', the select committee on the 1948 bill elected largely to retain the formulation contained in the ordinance. It was also now felt that besides encouraging the public to nurse unrealistic expectations, putting the Bank in charge would actually drive up the cost of liquidations and lower the dividends payable to depositors of small banks. Hence the Bank took the view that it should only take up the liquidation of 'big banks with deposits of Rs 5 crores or over'. The demand to make the Bank the sole official liquidator of banks was also raised during the debate on the bill in the Constituent Assembly. Though an amendment to that effect moved by Naziruddin Ahmed, a member from Bengal, was defeated and clause 38 (as it then was) passed into law unchanged, Finance Minister John Matthai's speech to the Assembly appeared to imply that clause 38 was intended as a transitional arrangement to be superseded 'as soon as possible' once the Bank was in a position to take over as the official liquidator. In the meantime, according to excerpts of the speech the government sent to Mint Road, Matthai offered that the Bank would apply to be appointed as the official liquidator 'not only on its own initiative but also when pressed by the public' or by the government acting on 'public representations'. The Bank, which until the early 1950s was willing to undertake the liquidation of banks holding 'large public funds' did ask to be appointed the liquidator of the Nath Bank. But the latter still owed the Bank Rs 72.5 lakhs lent to it in the form of emergency financial assistance in September 1948, and a petition before the Calcutta High Court drawing attention to the likely conflict of interests between the roles of the Bank as creditor and as liquidator ended the brief experiment and led to the appointment being withdrawn.

There was no such conflict of interest in the case of a majority of the banks under liquidation in West Bengal. 'Public representations' were also not hard to come by in the charged atmosphere prevailing in 1950-51. The tardy progress and the less than satisfactory outcome of liquidation proceedings was raised more than once in Parliament and outside by representatives from West Bengal, in particular by A.C. Guha, MP, who took something of a crusader's interest in the issue. Writing to the Finance Minister, C.D. Deshmukh, in August 1951 some months after the Calcutta National Bank filed for liquidation, Guha accused the Bank of having 'shirked its responsibilities' in earlier bank failures, and hoped the Finance Minister would 'at least this time ... make the Reserve Bank not ... betray the cause of the depositors'. Some

officials in the *Government of India*, including Bhattacharyya and S.K. Sen, Deputy Secretary in the Finance Ministry, complemented Guha's zeal with some of their own, and attempted in their own ways 'to try and give effect' to the purported 'intention of the legislature' to involve the Bank more closely in liquidation proceedings. Dharendra Nath Sen, a member of the Central Board of the Bank, also added his voice to the chorus, pleading with the Bank 'as the custodian of the entire credit structure of the country' not to allow either the 'enormity of the task' or the 'cost involved' to stand in the way of carrying its responsibility for protecting banks' depositors 'to its logical end'. Consequently, the Bank came under intense pressure during these months to act against its better judgement and become the sole official liquidator of banking companies at least in West Bengal.

On the other hand, the very features of prevailing liquidation proceedings others cited to justify the Bank taking them over appeared to the latter to reinforce its case for adopting the contrary course of action. These features derived largely from factors which were outside the powers of the Bank to influence. As Ram Nath informed Bhattacharyya in August 1951 in the course of a detailed, seven-page letter giving 'cogent reasons for not placing this responsibility on the Reserve Bank', regardless of who undertook banking liquidations 'under present conditions', delays in realizing assets and distributing them to creditors were 'unavoidable'. Not only had several High Courts, 'including the Calcutta High Court', failed to frame the rules needed to bring into operation amendments to the Banking Companies Act passed in 1950, a recent study of liquidations under way showed that delays occurred 'at almost all the stages' of the proceedings. Listing ten bottlenecks in the smooth progress of liquidation cases, Ram Nath pointed out that unless 'necessary legislative and procedural changes were devised', the 'Reserve Bank would be just as helpless as any other liquidator'. At the same time, however, it would be exposed to public criticism for faults which lay either in the nature of liquidation proceedings or of the assets the failed banking companies had on their books. 'The longer the liquidation lasts the higher would be the costs and the greater the dissatisfaction of the creditors'. If the Bank undertook the liquidation of all banking companies, 'creditors would expect quick and high dividends'. But they would almost certainly be 'severely disillusioned'; and however undeserved, criticism by 'disgruntled creditors' could not but damage the Bank's prestige.

Rather than react to criticism and adopt ad hoc solutions, the Deputy Governor advised the government to carry out an urgent review of existing legislative provisions dealing with the liquidation of banking companies and of procedures followed by High Courts. The problem of banks going out of

business, he warned, would extend beyond West Bengal 'during the next few years' as several small banks might suspend payment upon finding themselves unable to satisfy some provisions of the Banking Companies Act. The government should therefore set up a committee comprising one or two eminent lawyers, representatives of the government, and an official of the Bank to investigate bank liquidation proceedings and devise reforms which would enable banks to be wound up and their assets realized more speedily. The scope of the committee's investigation, Ram Nath also proposed, should extend beyond legislative changes to include the framing of uniform rules governing liquidation procedures in various High Courts and suggesting an administrative machinery which could work closely with the liquidators.

The government accepted the Bank's suggestion to set up the committee three months later in November 1951. But this did little to ease the pressure on the Bank to play a more active role in liquidating banks in West Bengal. The campaign in the press continued, with one newspaper issued from Calcutta even carrying the gist of the Reserve Bank's communications to the government on the subject. In December 1951 the Bank advised the government to exclude the question of what role it should play in liquidation proceedings from the terms of reference of the inquiry. The proposed committee, Ram Nath told the government, was mainly concerned with matters of a 'technical character' and the issue of which agency, if any, would undertake bank liquidations had little bearing on the 'fundamental problem' of how to make them 'more prompt and less expensive'. The committee, he suggested, might however consider whether some 'statutory relationship' should not be established 'between the Bank and liquidators of banks' to enable it to 'keep in touch with the progress of bank liquidations and tender suitable advice in the interests of the depositors'.

The Bank had hoped the committee proposed by it would complete its work within a few weeks. But for various reasons, the government was unable to constitute the committee until July 1952, when Dhirendra Nath Mitra, Legal Adviser to the Finance Ministry, was appointed to head it. R. Mathalone, a lawyer who was also the Court Receiver and Liquidator attached to the Bombay High Court, and R.C. Deb, another lawyer from Calcutta, were its other members; while R.K. Desai, the energetic and knowledgeable Deputy Chief Officer of the Department of Banking Operations in Calcutta with long experience of dealing with bank liquidations in Bengal and the original author of the proposal for the committee, was appointed its Member-Secretary. Not only did the government overrule the Bank and ask the committee to report on the advisability of 'establishing statutory relations' between the Bank and banks in liquidation, its chairman, D.N. Mitra, was himself 'anxious' that the

Reserve Bank should play a more active part in bank liquidation proceedings. As late as November 1952, barely a month before the Mitra Committee submitted its findings, reports that Pakistan's new central bank had set up a separate *Liquidation Section* to undertake the winding up of eight of the ten banks that had filed for liquidation in that country and of the offices of banks that had gone into liquidation in India added to pressure on the Bank to follow suit.

The Dhiren Mitra Committee (which was formally referred to as the Banks' Liquidation Proceedings Committee) submitted its report at the end of December 1952. It contained a scathing indictment of the prevailing state of banking liquidation in India. The committee estimated that as many as 321 banks were under liquidation in various parts of India in 1952. Schemes of arrangement had succeeded at only a few places, notably in Punjab where at least two-thirds of the funds of depositors of the affected banks were said to be safe. Elsewhere, liquidations were the norm. But liquidation proceedings promised little to depositors. Of the seventy-eight banks under liquidation in Calcutta, only one bank had declared a dividend to depositors, and that of a paltry 10 per cent. The cost of management of these banks, excluding legal expenses and liquidator's commission, was also extremely high, accounting in some cases for as much as four-fifths of the recovered assets. The committee also reported that liquidators found it impossible to recover the *benami* assets of officials of the failed bank who had misappropriated its funds.

The committee made a number of recommendations both to deter banks from being mismanaged and to expedite the winding up of failed banks and the recovery of their assets. Suffice it to note here that the committee did not, in the event, recommend entrusting to the Bank the task of undertaking bank liquidations, feeling it was neither 'desirable nor feasible' to do so. Even the more limited idea, of entrusting to the Bank the responsibility for inspecting banking companies which were being liquidated by private liquidators, was watered down at the draft stage as the Bank felt it did not have the resources to inspect the books of the few hundred banks falling in this category. However, the committee was in favour of enabling liquidators to seek advice from the Bank on matters which lay within its competence, and of empowering the Bank to obtain from liquidators any information it required about the affairs of banks under liquidation and about their winding up proceedings. The Bank actively favoured the latter recommendation: neither it nor the government had any means at present of gathering information about banks under liquidation and the absence so far of information about them was proving to be a source of much embarrassment to both. Another major recommendation of the committee directly of concern to the Bank related to the elaboration of

section 45 of the Banking Companies Act dealing with its consent to a scheme of arrangement. The committee was of the view that the Bank's decision on a scheme of arrangement presented to it should turn on whether in its view grounds existed, 'prima facie', for a probe into the conduct of its directors. Opposing the suggestion, the Bank argued that the 'past sins of the persons in charge of the management of ... banks should not be visited upon ... depositors'. The Bank, moreover, could not possibly detect and report all acts of misfeasance by the directors of a bank. Officials at Mint Road also privately alerted the committee to the dangers, which bodies such as the Indian Banks' Association and some members of the Central Board later highlighted, of its recommendation to place the burden of proof on directors and officers of banks charged with malfeasance, fraud, or negligence having the effect of deterring competent persons from entering the banking profession or becoming directors of banks. But the committee persisted with this recommendation in its final report, its chairman arguing that directors of banks in India did not properly understand their responsibilities and that even after the proposed recommendations were adopted, sufficient legal redress remained open to them.

Another issue where the Bank's views differed from those of the committee and the government concerned the recommendation that entries in the books of accounts of a banking company were sufficient as proof of the 'matters therein recorded', i.e. principally of the debts of its borrowers. Initially the Bank saw considerable merit in the suggestion. Subsequently however, it came round to the view that the recommendation, if implemented, 'would place the debtors and other respectable constituents of a bank in a most helpless position'. It was not possible for any borrower to have conclusive proof that he was not liable, or if he was liable, to establish the exact extent of his indebtedness. On the other hand, the recommendation opened the doors to mischief by directors opening fictitious loan accounts in the names of the bank's constituents before filing for liquidation or helping themselves to the bank's resources while debiting them to the loan accounts of its other borrowers. At Dhiren Mitra's instance, the government proposed to confine the evidentiary value of such entries to establishing the indebtedness only of directors of the bank under liquidation and not of its other debtors. But refusing to 'resile from the stand' it had taken in the matter, the Bank informed the government in July 1953 that there was 'no justification' for subjecting even directors of banking companies to these unjust provisions. The Bank's opinion had, however, little influence on the government.

The Bank's views on the committee's recommendations and the legislative measures needed to give effect to them were otherwise largely favourable,

and these were communicated to the government in the summer of 1953. The pressure of parliamentary business however came in the way of passing the necessary amendments to the Banking Companies Act, and at the instance of a member of Parliament who, according to a note by the Private Secretary to the Finance Minister, was 'very much interested in getting the Bank Liquidation Bill passed as early as possible', the government decided, against the Bank's advice, to promulgate an ordinance in October 1953 to realize some of the 'important, non-controversial, and benevolent recommendations' of the committee. This ordinance, which was issued on 24 October 1953, was replaced by a bill less than a month later, when Parliament reconvened. The task of moving the bill through Parliament fell fittingly enough on A.C. Guha who had campaigned tirelessly for some of its provisions and who had in the meantime become the Deputy Minister of Finance in the central government. Guha's moment of triumph was not, however, without its ironies. Not only had success eluded his campaign as a backbencher to put the Bank in charge of proceedings to liquidate banking companies, Guha was now in the awkward position of having to explain to his former colleagues the government's reasons for rejecting a demand he had done more than anyone else to promote. The liquidation bill passed the Lok Sabha on 3 December and the Rajya Sabha on 15 December 1953, and received the President's assent two weeks later.

Mystery of the Missing Banks

Even as legislative measures were being contemplated to speed up banks' liquidation proceedings, controversy erupted between the Bank and the government over West Bengal's allegedly 'untraceable banks'. On a visit to Calcutta in June 1953 Guha, who had recently been appointed Deputy Finance Minister, sought and obtained a 'personal note' from R.K. Desai according to which 146 of the 194 non-scheduled banks listed with the Bank at the end of March 1953 were 'defunct or untraceable'. A letter written around the same time by B.C. Roy, the Chief Minister of West Bengal, to Guha suggested that 'in many cases' the Bank advised non-scheduled banks to 'give up banking and go to something else' after suitably altering their memoranda of association. But the change in their declared line of business did nothing to prevent such institutions from 'all the time cheating the depositors'. Soon afterwards on his return to Delhi, Guha remarked that the situation pointed out in Desai's note was 'scandalous'. It was no use 'citing legal and technical difficulties' and this state of affairs 'should be stopped at the earliest', he minuted.

The Governor, B. Rama Rau, to whom the government forwarded Guha's remarks, took exception to their tone and substance. The view within the Bank was that Guha's minute, and his approach to the issue raised in it, was

somewhat disingenuous. Although Ram Nath, who directly oversaw banking, was in Calcutta at the same time as Guha and was in fact working in a room adjoining Guha's own, the minister had not thought it fit to meet him. Nor had he sought information officially from the Bank or discussed the issue with its senior executives, but had chosen instead to form his own conclusions on the basis of a 'personal note' solicited from an official of the Bank.

Arguing that it was 'not usual for a responsible member of the government to use in relation to ... the Reserve Bank such expressions as "scandalous" on the basis of an unofficial note given to him', the Governor sent Deshmukh a lengthy, seven-page memorandum dealing with the subject of Guha's minute. The note pointed out that the 'so-called scandal' was not of recent growth but was a legacy of the period before the Banking Companies Act came into force. A majority of West Bengal's banks, Rama Rau informed Deshmukh, were loan companies lending against property—a form of business that well run commercial banks were loath to enter. These banks offered, besides, very high rates of interest to attract deposits, 'spent lavishly on advertisements and opened numerous branches'. They made rapid progress during the war when 'the public had large surplus funds for investment', but failed to use their resources wisely. The few inspections conducted in 1946 of these banks showed that their financial position was 'very unsatisfactory', and little improvement had taken place since.

In the last three years, Rama Rau pointed out to the Finance Minister, the Bank had managed to inspect those of West Bengal's non-scheduled banks which it could trace. Even the Registrar of Joint Stock Companies in the state, whose cooperation the Bank sought, confessed his inability to find all but a few of these banks. 'If the Registrar with the assistance of the administrative machinery of the West Bengal Government cannot trace these banks, the Reserve Bank cannot obviously locate them.' Reacting to Roy's suggestion that the Bank should appoint a special inspector to scrutinize the affairs of the missing banks, the Governor pointed out that while the Bank had an efficient system of inspecting banks, it was not possible to inspect banks which were either 'defunct or untraceable'.

We do not know of any remedy, legal or otherwise, by which we can resurrect for inspection and appropriate treatment a bank which has been dead for some time. Nor is a post-mortem examination possible until the corpse can be found.

As for the apprehension that the conversion of banking companies into non-banking companies was prejudicial to the interests of the depositors of such concerns, the Governor noted that it must be presumed that those who

initiated the Banking Companies Act had satisfied themselves that such would not be the case. It was their 'intention—of which the public no less than the banks must be deemed to have been aware—that some banks will be weeded out'. The advice the Bank tendered to banks seeking to become non-banking companies was not only a continuation of earlier policy, it was 'also implicit in the Act'. The Bank's legal advisers were also of the view that the change in the business of a former banking company would not affect the rights of its depositors, except in one 'minor procedural' respect that the company could no longer honour cheques issued by them. Nor was it practicable, as the internal notings in response to Guha's intervention established, for the Bank to impose restrictions on banks that had become trading concerns. There were, as Ram Nath noted, already two sets of banks under the Banking Companies Act—*licensed and unlicensed*—and once the Bank attempted to 'control banks which have become trading companies', it would 'get drawn into the business of controlling other trading and industrial concerns that accept deposits'.

The Governor's long note caused considerable confusion in the Finance Ministry. The Secretary, K.G. Ambegaokar, who would join the Bank as a Deputy Governor in March 1955, was caught between the loyalty he owed his minister and the strength he recognized in the Bank's view. He thought there was nothing in Guha's note to which Mint Road could take exception since it represented

a statement of fact and did not impute any reflection on the working of the Reserve Bank. It cannot be denied that the actual position is "scandalous" and some remedy has to be found for it.

But he also added that there appeared to be no obvious remedy. Nothing could be done about these companies until they were traced, and the next step therefore was for the West Bengal government to take. Perhaps pulled up by Deshmukh, Guha disclaimed any intention of 'putting the blame on the R[eserve] Bank'. However, he maintained that both the Bank and the Registrar of Joint Stock Companies in West Bengal 'appeared to have been fooled' by 'those people' (meaning presumably the missing banks), while the Chief Minister of West Bengal too could not 'suggest any redress'.

While the mystery of the missing banks was put on the back-burner for want of any obvious means of solving it, the Bank considered whether anything could be done to safeguard the interests of depositors of former banking companies. The problem, as an internal note pointed out, was that a banking company did not need permission under the Banking Companies Act to convert

itself into a non-banking company. On the other hand, there was no advantage to be gained from liquidating these small companies 'since their assets are generally frozen and the liquidation charges may ... be more than the realizable value of [their] assets' Nor was it practical to ask a bank seeking conversion to pay off its depositors in full since this might force its liquidation; whereas as a 'going concern', the company may be able to 'realize most of its assets in due course'. The Bank also felt the position of the depositors of the converted companies would be no different from that of depositors in 'industrial concerns in Maharashtra and elsewhere in the country' The Bank briefly considered adding a new section to the Banking Companies Act to make the conversion of banking companies into non-banking companies conditional on the Reserve Bank certifying that it was not 'detrimental to the interests of the depositors' of the company. But the move was quickly abandoned.

Following this controversy, the Bank ordered an investigation into the position of non-scheduled banks in West Bengal which revealed that of the 165 non-scheduled banks reported to exist in the state at the end of June 1954, the whereabouts of 107 banks were not known. The investigation recommended that all but six of the 165 banks could be refused a banking licence without any noticeable void being created in the availability of banking facilities in the state, and that the Registrar should strike off the names of banks which had become defunct.

LICENSING BANKING COMPANIES IN THE 1950s

Under section 22 of the Banking Companies Act, 1949, every bank was required to hold a licence from the Reserve Bank. This measure was intended to check the mushroom growth of unsound banks of the kind that Bengal and other parts of the country had witnessed during the war, and promote a sound banking system. According to the Act, no new bank could be set up after it came into force, without a licence from the Bank. While this was simple enough, the licensing of existing banks was a slow and laborious process which took the best part of two decades to be completed. Initially, the Bank used licensing as an instrument of banking regulation, hoping to get individual banks to bring a semblance of order to their affairs by dangling before them the carrot of a licence or brandishing the stick of denying them one and putting them out of business. But complemented by other powers the Bank acquired in 1960, licensing became part of the arsenal it deployed more actively during the course of the decade to eliminate weak and unviable banks, and consolidate the banking system through the creation of a relatively small number of sound banks.

Before granting it a licence, the Bank generally sought to satisfy itself, usually through an inspection, that a commercial bank was in a position to pay its depositors in full as and when their claims accrued, and that its affairs were not being conducted in a manner detrimental to their interests. At the beginning of our period, only some banks satisfied both conditions. There were also banks which were intrinsically so unsound—for example the small banks in West Bengal—that the Bank had little doubt about their unsuitability for a licence. But there was little progress towards ‘de-licensing’ in the early years because the Banking Companies Act prohibited the Bank from denying a licence to an existing bank within three years of its coming into force.

The Bank’s main dilemma thereafter arose, however, from the large number of banks which did not belong to either extreme. These were typically institutions whose finances and functioning needed remedying, but the interests of whose depositors were not in any immediate or fundamental jeopardy. As pointed out already, such banks were required merely to apply for a licence within six months of the Act coming into force, and were allowed to carry on business until formally denied one by the Bank. The Bank felt such institutions could not be given a licence yet because the public would justifiably see it as ‘a seal of approval by the Reserve Bank of the soundness of the bank’s financial position and banking methods’. On the other hand, neither could they, in the Bank’s judgement, be formally denied a licence and forced prematurely to close down, since many of these banks were capable, given time and guidance, of qualifying for a licence in the not too distant future. In any case, the Bank felt, denying licences to institutions that were not intrinsically unsound without giving them a chance to rectify their affairs was not in the best interests of their depositors and of the Indian banking system. A precipitate policy of ‘de-licensing’, the Bank apprehended even in 1949, could lead in particular to ‘small traders and interior localities’ being ‘denuded’ of banking facilities.

Since the banking habit is still in an embryonic stage in India and there are not enough banks in relation to the population, we have to try and strengthen those banks which are not beyond salvation. Action under section 35 [i.e. denial of a licence] will, therefore, have to be taken with great circumspection.

Besides, as the Bank noted four years later in the context of the banking situation in West Bengal, ‘any large scale refusal of licences in any particular area would undermine the confidence of the depositing public in banks in that area’. Its role, the Bank moreover felt, ‘should not merely be to discharge “police” functions but to guide banks to ... adopt sound banking practices’.

Consequently, five years after the Banking Companies Act came into force, the Bank had issued licences to thirty-three banks. But only sixteen banks were denied admission to this privilege. In addition, as we noted above, many banking companies converted themselves into non-banking companies in order to avoid attracting the provisions of the Banking Companies Act.¹ The pace of licensing picked up somewhat in the next two years, with the number of licences issued to banks rising to forty-nine at the end of 1956. Seventy-seven banks had been denied licences until then, while a licence granted to a bank in 1950 was revoked in 1956.

The delay in the licensing of banks evoked comments more than once in Parliament and from the government, but the Bank refused to be hurried, arguing that while issuing licences liberally would vitiate the object of developing a sound banking system, refusing them on a large scale would do more harm than good. Thus between 1957 and 1961, only twenty-five more institutions were added to the list of licensed banks, while sixty-two banks were denied banking licences.

Clearly as later events revealed, the Bank's attitude towards awarding banking licences was poised on a knife-edge in the 1950s. The blade, moreover, grew sharper every passing year as many of the banks allowed to flourish without licences increased their deposits on the back of an expanding economy and attractive interest rates. Some of these institutions were also extremely tardy in carrying out the reforms recommended by the Bank, and their affairs showed little improvement over time. Consequently they were no nearer securing a licence in 1959 than they had been at the beginning of the decade. On the other hand, although the Bank was empowered to prohibit a banking company from receiving fresh deposits, it could not use these powers lightly where it still hoped to turn a bank around. It was not unknown for the Bank to ask institutions in the latter category not to open new branches, propose new deposit schemes, or advertise their deposit facilities, but it could do little directly to prevent them from accepting fresh deposits unless it was prepared to see them close down. As can easily be imagined, the growth of these unlicensed banks with each passing year lent greater piquancy to the Bank's task of dealing with them.

The Bank's dilemma, though it is moot whether contemporary officials saw it as such, was particularly acute in the Travancore-Cochin region of Kerala. For reasons that need not detain us here, the economic landscape of Kerala, and in particular its Travancore-Cochin region, was dotted by numerous

¹ Banking was defined in the Banking Companies Act, 1949, as 'accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order, or otherwise'.

small banks. In 1955, there were 163 banks in this region, of which no fewer than 148 were local institutions. Barely a handful of these were scheduled or licensed institutions. According to a survey conducted by the Travancore-Cochin Banking Inquiry Commission in 1956, of the 136 banks that responded to its questionnaire, sixteen had working funds in excess of Rs 40 lakhs, while as many as ninety-five banks had working funds of less than Rs 10 lakhs. Thirty-nine of these banks had paid-up capital and reserves below the minimum applicable to them under section 11 of the Banking Companies Act which was extended to the region from 1 April 1955. Twenty-one of these banks continued to operate on the basis of special individual exemptions from the Reserve Bank. As for the other eighteen, let alone increase their capital and reserves, they had not even made applications to the Bank to be allowed to carry on banking business with their present level of owned resources!

The Travancore-Cochin Banking Inquiry Commission noted that a large number of these 136 banks had been set up in 'mere hamlets'. On the other hand, a majority of them, including more than half the smallest banks, had been in existence for more than a quarter of a century. The 136 reporting banks had 571 offices in 1955, of which more than a third (197) were in centres with populations below 10,000, the corresponding figure in Bombay and Madras being 13 per cent and 18 per cent respectively. It was, in the words of the Travancore-Cochin Banking Inquiry Commission, 'indeed commendable' that the region's villages had witnessed 'wide-scale expansion of banking activity' even before the Rural Banking Enquiry Committee underlined the importance of spreading the banking habit to rural areas.

Commendable as this progress was, it did little to ease the Bank's difficulties. A majority of these banks, big and small, originated in *kuris* or *chit* funds which continued to remain an important part of their business, and followed unsound banking practices. Much of the blame for the latter, according to the Travancore-Cochin Banking Inquiry Commission, could be attributed to bad managerial policies. The Commission also recognized that many of the 136 reporting banks were weak and possibly unviable institutions. Yet while urging the Bank to exercise 'vigilance and be strict whenever the occasion demands', it warned against 'drastic measures' against small banks and 'extreme steps' in the case of the larger banks 'that would lead to their closure'. The Commission even proposed that banks whose paid-up capital and reserves were lower than the minimum applicable to them under section 11 of the Banking Companies Act should be allowed up to the end of March 1960 to make up the deficiency. Following this report and representations from the Travancore-Cochin Bankers' Association that their clients were growing nervous about the prospect of the region's banks being refused

licences, in May 1957 the Bank resolved to 'go slow' with the refusal of licences to Kerala banks and to keep in abeyance the tentative decision it had taken to refuse licences to eighteen banks in the state. The Committee of the Central Board reviewed the Bank's 'go slow' policy in Kerala in February 1960 and decided to persist with it. According to the memorandum submitted to the Committee, of the 108 banks in existence in Kerala at the end of 1959, 103 were non-scheduled and a hundred banks operated without a licence. In the Bank's opinion, eighty-seven of these hundred banks were likely to qualify for a licence within a few years. But the collapse of the Palai Central Bank some months later in August 1960 and the changes in public opinion and banking legislation that followed in its wake led to a period of large-scale amalgamation of banks which reduced the number of banks in the state to less than a tenth of the number that existed before that fateful August day.

Elsewhere in India, the Bank faced fewer problems. In December 1957 it decided to refuse licences to twenty-one non-scheduled banks because they were thought to be beyond repair. Eight scheduled banks and fifty-four non-scheduled banks whose financial position and working were judged to be satisfactory were allowed more time to repair their position, while four scheduled banks with total deposits of nearly Rs 13 crores were advised amalgamation with other banks. The Bank's decision to deny it a licence was challenged in Court by a small family-owned bank which operated out of a suburb of Madras until March 1957, on the ground that section 22 of the Banking Companies Act was unconstitutional and that the Bank had been arbitrary and unreasonable in the exercise of its power under this section. This challenge was unsuccessful. Nevertheless, the frenetic activity of 1957 was followed by two years of relative lull which was relieved only by the Bank's energetic response to the banking crisis of 1960.

THE BANKING CRISIS IN KERALA AND AFTERMATH

The year 1960 was one of great stress for the Indian banking system. At the end of May that year, the Bank filed an application in the Bombay High Court for winding up the Laxmi Bank, Akola, a scheduled bank with deposits of over Rs 3 crores, in the wake of a run on the bank and reports of misappropriation of funds by its top management. Barely ten weeks later on 8 August 1960, even before the waters could fully settle over the Akola bank, the Bank approached a High Court once again, this time in Ernakulam, to wind up another scheduled bank, the Palai Central Bank. While the failure of the Laxmi Bank evoked relatively little comment, the collapse of the Palai Central Bank sparked off controversy, especially in Kerala where it remained

You Said It

By LAXMAN



**I became so nervous reading about
that bank crash that I went and
withdrew my savings from our bank!**

— *Tol.* 20 Aug. 1960

a major political issue for some time. The bank failures also ushered in a brief period of banking uncertainty which coincided with a decline in the volume of bank deposits during 1960.

The Palai Central Bank was the largest bank to fail in independent India and the second major bank to suffer that fate in the Travancore-Cochin region within a quarter of a century.² Its failure brought to an end a decade of

² In 1938, the Travancore National and Quilon Bank (TNQ Bank), which was the largest bank at the time in the area with over 75 offices and deposits of more than Rs 3.5 crores, was forced to close down. For details, see pp. 183–90 of the earlier volume of the Bank's *History*.

relatively trouble-free growth of the Indian banking system beginning with the easing of the banking crisis in West Bengal after 1950. Virtually coinciding with the first decade of the Banking Companies Act, these years saw the Bank nurse a number of weak banks to health and to licensed status. But the Palai Central Bank, which came up and flourished when there was little or no regulation over the functioning of banks and followed banking methods that were, to say the least, unorthodox, was in many respects untypical of the institutions which proved amenable to the Bank's efforts to rehabilitate them. For one, though badly managed, it was Kerala's largest bank and among the country's twenty-five largest, with deposits of over Rs 9 crores and a network of twenty-five offices including several outside the state at the time of its collapse. Not only had it withstood the depression, the banking crisis of 1938 when the much larger TNQ Bank went under, and the post-war banking crisis, its deposits continued to grow during these years and after. By the 1950s, the Palai bank had become a considerable presence in the Travancore-Cochin region where, as already noted, the majority of the over 150 banks dotting the landscape were minuscule institutions. Reform was not easy as the bank's size and presence emboldened its management to resist the Bank's efforts in that direction. Until the moment it became inevitable, on the other hand, winding up appeared to be the counsel of despair, particularly from the point of view of the depositors of the troubled institution. The Palai Central

Too Late



—Shankar's Weekly, 28 Aug. 1960

Bank thus presented the most serious challenge and dilemmas to the Bank's regulatory authorities.

The Bank's handling of the Palai Central Bank right from the time the institution first came to its notice in 1948, to its final days as a functioning entity in July–August 1960, is discussed in some detail in appendix C. The remainder of this section deals with the fallout of the collapse of the Kerala bank, the Bank's efforts to contain it, and the legislative and other measures adopted to ensure that Palai became the last of the major bank failures in India.

The failure of the Palai Central Bank inaugurated a period marked by a number of minor banking panics in several parts of the country. Far away in Delhi, five banks (the Punjab National Bank, the Oriental Bank of Commerce, the New Bank of India, the Lakshmi Commercial Bank, and the National Bank of Lahore) experienced unusually heavy withdrawals of their deposits at various times during the remainder of the year. The Madras-based Indian Bank too, was caught up in the panic. Though symptomatic of the nervousness that prevailed among depositors after the collapse of the Palai bank, none of these scares was directly connected with the events in Kerala. Nor, once they broke out, did they take long to subside. In contrast, the incidents of 8–9 August 1960 led to a prolonged banking crisis in Kerala, particularly in the Travancore region, which culminated in moratoria being imposed on several small banks in the state and eventually in the amalgamation and consolidation of its numerous banking institutions.

There were 103 functioning Kerala banks (i.e. banks incorporated in the state) at the time the Palai Central Bank downed its shutters. These had between them 476 offices. Only five of the 103 banks (which accounted between them for 128 offices) were scheduled and eight banks (with sixty-two offices) were licensed. But ninety-two banks were neither scheduled nor licensed. The total deposits of these 103 banks in July 1960 amounted to about Rs 50 crores. This figure fell by about Rs 6.68 crores between the end of July 1960 and the end of November that year. The bulk of the fall (to the extent of about Rs 4.25 crores) took place in August and September. Five banks in the Travancore region, viz. the Travancore Forward Bank, the Kottayam Orient Bank (which were both scheduled banks), the Bank of New India, the Trivandrum Permanent Bank, and the Seasia Midland Bank, felt the brunt of the losses, their deposits alone going down by nearly Rs 4.8 crores between July and November. The other banks hit badly by the panic also belonged mainly to the 'central Travancore' area, and were based in Kottayam where the Palai Central Bank had many branches. It was reported that while a large part of the funds withdrawn from these banks was 'hoarded', the State

Bank of Travancore, the State Bank of India, and twenty-two other banks experienced a growth in their deposits during these months. However, if the experience of the State Bank of Travancore which saw an absolute decline in time deposits and a rise in demand deposits is anything to go by, the maturity structure of the deposits of even these banks may have grown shorter during these months.

The Kerala banking crisis was not entirely unanticipated. The run on Palai began late in June, and the Bank had been alert to the likelihood of its spreading to other 'Kerala Banks'. It devoted close attention to the possible effects on them of any steps to wind up the troubled institution. A note by the Department of Banking Operations of 5 August pointed out that time deposits represented 'a major portion' of the deposits of Kerala banks. The only exception to this was the Palai Central Bank itself, less than half of whose deposits were in that form. Besides, their 'unencumbered liquid assets ... generally cover[ed] a major portion, if not the bulk of their demand deposits'. This note, which was seen the same day by C.S. Divekar, the Executive Director dealing directly with the emerging crisis in Kerala, and the Governor, H.V.R. Iengar, appears to have reassured them that while the Bank might have to step in to invoke section 18 of the Reserve Bank of India Act to extend emergency assistance to banks in Kerala, 'in theory at least', the banks were 'in a position to absorb the shock'. Nevertheless, the Bank issued a press statement on 9 August reassuring the public that despite Palai, there was no occasion for a banking scare in the state, and that it stood by to grant assistance 'with utmost expedition' to any bank whose affairs were 'satisfactory'. The procedure for granting emergency advances as laid down in 1947 was somewhat elaborate, and contemplated among other things, an inspection of the applicant bank. This requirement, a carry-over from its early days, had considerably delayed the Bank's ability to help the TNQ Bank in 1938 and occasioned much comment at the time. Officials now proposed that in the event of the Governor certifying that a banking emergency had arisen in Kerala necessitating emergency advances from the Reserve Bank, they could dispense with inspections and instead undertake a 'rapid examination' of the books of accounts of banks applying for assistance. It was proposed, besides, that the Bank should not insist on applicant banks complying strictly with certain provisions of the Banking Companies Act if they could satisfactorily explain their violations and were able to offer an 'adequate quantum of eligible assets'.

Although the Governor was willing to invoke section 18 of the Bank Act even on 9 August 1960, the anticipated banking emergency did not arise until eight days later. In the meantime, the Bank despatched M.V. Rangachari,

Deputy Governor, to Trivandrum to take stock of the situation. On 13 August 1960, two scheduled Kerala banks (the Travancore Forward Bank and the Kottayam Orient Bank) and two non-scheduled banks (the Bank of New India and the Seasia Midland Bank) applied to the Trivandrum office of the Reserve Bank for emergency assistance. According to officials of the Kottayam Orient Bank, it had lost deposits of about Rs 40 lakhs since the fall of the Palai Central Bank. They feared the outbreak of a 'general crisis' within a few days and for their ability to weather it despite being in possession of substantial liquid resources. The Bank, for its part, felt that there was nothing yet in the nature of a run on any bank in Kerala, but that the press and the politicians in the state were working up an atmosphere of crisis which might precipitate a flight of bank deposits. Five days after the two banks made their applications, on 18 August, M.L. Gogtay, the Deputy Chief Officer of the Bank in Trivandrum, urged the Bank that the time had come to invoke section 18 of the Bank Act, and the Governor accordingly passed orders the same day, in words which were cleared earlier with the Bank's legal advisers, that a 'special occasion' had arisen which made it

necessary and expedient for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture, that action should be taken under section 18 of the Reserve Bank of India Act, 1934.

Following this, the Trivandrum office of the Bank was asked, in the first instance, to grant accommodation 'against the applicant bank's advances secured by the pledge of government and other trustee securities, quoted shares and debentures and gold ornaments including bullion'. Requests for accommodation in respect of advances secured on pledge of merchandise were to be entertained only in special cases, with Bombay's prior approval. Banks were to be lent up to 70 per cent of borrowers' outstanding balances against these securities. Earlier, the Bank had appeared willing to consider granting advances against the pledge of 'immovable property mortgaged to ... banks or owned by them', but the instructions to Trivandrum remained silent on this aspect. The Deputy Chief Officer of the Bank in Trivandrum was authorized to sanction advances up to Rs 5 lakhs in anticipation of approval from Bombay, while advances for larger amounts required prior approval by the central office. The first advances under section 18 were made on 29 August 1960, and the final advances two months later. In all five banks took emergency loans from the Reserve Bank aggregating Rs 1.03 crores during these weeks. Of these five banks, the two scheduled banks accounted for over three-quarters of the advances, the Travancore Forward Bank alone accounting

for over half. The Bank of New India borrowed Rs 22 lakhs by way of emergency advances, the Seasia Midland Bank, Rs 3 lakhs, and the Venadu Bank, Rs one lakh. These advances were repaid by December 1960.

Legislative Enactments, September 1960

In the public and parliamentary outcry that followed the collapse of the Palai Central Bank, the issue of speeding up the liquidation of banks once again came into focus. Initially it was suggested both in Parliament and in the press, and also by a number of Kerala ministers, that it would be simplest for the State Bank of India to take over the assets and liabilities of the failed bank. The Advocate-General of Kerala too, suggested that the State Bank should take over the 'good and readily realizable assets' of the bank at a valuation which provided for immediate payment, and the other assets at some reduced value to be paid as and when they were realized. The Bank, as Iengar informed the Central Board at its meeting on 17 August, was not averse to the idea. But the State Bank of India refused to entertain it since, according to its Chairman, P.C. Bhattacharyya, the bank's founding Act allowed it to take over only the business of 'surplus banks', i.e. banks whose assets exceeded their liabilities. Bhattacharyya also insisted that 'under no circumstances' would the State Bank of India or the State Bank of Travancore take over assets which were not good or easily recoverable. Nor did an unorthodox proposal by the Canara Bank—involving no 'scheme of arrangement' much less one to reconstruct or amalgamate the Palai bank—to advance 25 paise in the rupee to the latter's depositors on behalf of its liquidator against proceeds from the sale of the bank's assets, get off the ground.

Thoughts then turned towards other ways of providing early and suitable relief to depositors of the closed bank. There was broad consensus among officials of the Bank, the Government of India, and the State Bank that 'immediate and suitable legislation' was required to cut out of liquidation proceedings steps which were 'purely formal and time-consuming', and promote swifter realization and distribution by the liquidator of the bank's assets. One such step related to priority creditors, for example holders of trust accounts, who were entitled to preferential treatment. Kerala's Advocate-General proposed granting such claimants a fixed time limit within which to lodge their claims, and the Bank and the government accepted this suggestion. It was also proposed that once preferential payments or adequate provisions for the purpose were made, depositors with savings accounts should be paid the balance to their credit up to a maximum of Rs 250. (The prevailing limit was Rs 100.) Besides, under the existing law, other depositors were not entitled to preferential payments. This was now proposed to be changed to

enable them to receive up to Rs 250 after the preferential claims of holders of savings accounts were met or provided for, and in priority to all other debts.

Liquidation procedures, the role of the State Bank in them, and ways to protect the small depositor were the major talking points at these discussions. But they also paved the way for legislation on other issues of importance including some which had eluded agreement earlier. As banking law and practice had evolved up to that point, the Bank might respond to a severe run on a banking institution by making emergency advances to it or by applying to the High Court to take it under liquidation. The former could be extended only up to a point, or sometimes as in the case of the Palai bank, not at all, the decision whether to make emergency advances and in what quantity turning on the Bank's judgement of the quality of the assets of the banking institution needing them and of its ability to pay off depositors in full. On the other hand the alternative, of applying for liquidation, not only tended to be harsh on depositors, it might also be unnecessary in circumstances where only the difficulty of realizing its assets immediately prevented a bank from meeting a panic withdrawal of deposits. An intermediate measure, such as a moratorium intended to stop the run whilst allowing the bank facing it to make certain preferential payments to depositors according to the law, conserve its assets in their interest, and seek assimilation within a larger institution, it was felt, would better enable small banks to withstand panic and realize their assets.

Moratoria were possible before 1960, but only at the instance of a bank which felt unable to meet its obligations temporarily. The Bank itself could not impose or apply for one, and giving it the power to do so might obviate liquidation and reduce or prevent depositors' losses in many cases; more so if it could be combined with that to ensure compulsory amalgamation of banking institutions judged by the Bank to be unviable and which failed to enter into voluntary merger arrangements. The moratorium proposal was first made by Dhiren Mitra at the meeting of the Central Board on 17 August 1960, and the Bank lost no time in pursuing it with the government. In contrast, proposals to give the Bank or the central government the power to enforce compulsory mergers of banks were urged at various times during the 1950s and as recently as 1959. The Bank even more than the government was cold to the idea on these occasions, but their resistance did not survive the shock-waves emanating from Kerala in 1960.

Initiated in the third week of August, i.e. within a few days of the crash of the Palai Bank, these proposals made it to law in the span of about one month as the Banking Companies (Second Amendment) Act which came into force on 19 September 1960. At first blush it seemed the new provisions might save

the Palai bank from liquidation. A plan was put forward to amalgamate it with the Punjab National Bank, while the Palai bank and some of its creditors too, applied to the High Court separately to be allowed to reconstruct the failed bank. But these hopes died a quick death after the Bank, which examined these schemes at the High Court's instance, certified that they were neither feasible nor in the interests of the Palai bank's depositors. Although of little immediate assistance to the unfortunate creditors of the Palai Central Bank, final payments to whom were settled in December 1987 at 67.75 paise per rupee of their 1960 deposits, these legislative enactments helped the Bank check the banking panic in Kerala and reorganize its smaller banks and others elsewhere in the country.

Reorganizing Kerala's Banks

Thanks to its recent banking history and its numerous small and unviable banks, Kerala was on everyone's mind when the amending legislation of September 1960 was passed, and it was to Kerala that the Bank first turned after arming itself with new powers. Ten days after the amendments came into force, Divekar arrived in Trivandrum to examine the possibility of banks in the state entering into voluntary mergers and amalgamation. He was prepared for a cold, 'even hostile' reception. Rumours were afoot that the Bank was determined to use its new powers to enforce compulsory amalgamation of smaller banks in the state. These were as grist to the mill for the region's bankers who, apart from being 'strongly individualistic', were 'well entrenched in their present positions and in the political life of the State' and had a 'vocal press at their command'. But to his surprise, Divekar found a 'majority of the bankers' in a 'pensive mood'. Though some banks insisted 'even now' on maintaining their separate identity, in general the 'amalgamation idea' had 'been favourably received' in the state, and the state government too was willing to give it 'a good measure of support'. Being himself a strong advocate of an early consolidation of Kerala's banks, Divekar urged immediate action. However 'formidable' the difficulties, he warned Iengar, the Bank should be prepared to take steps to protect the interests of depositors in the state, 'even if in the process we are subjected to all sorts of calumny'. Urgent action was needed, Divekar felt, because Kerala's banking crisis threatened to spread, with the Kottayam Orient Bank likely to find itself unable to stand the strain of withdrawals 'beyond another six weeks or so'.

When Divekar returned to Kerala in the middle of October 1960, 'propaganda against amalgamation' resumed, with 'politically powerful ... interested parties ... apprehensive of losing their hold on [the] power and patronage' control over banks gave them, stoking fears that the Bank intended

to amalgamate Kerala's over one hundred banks into six big units. Such rumours fed public apprehension that credit facilities would be curtailed in Kerala's rural areas. Nevertheless, *public opinion in the state* had grown 'critical of bank managements and appreciative of the Reserve Bank's action' in closing down the Palai Central Bank. Many of the other banks, Divekar also reported, were in a 'bad way', and their managements in a 'less recalcitrant mood'. The Chief Minister and the Deputy Chief Minister of the state too, were of the view that the Bank should not 'hesitate to proceed with schemes of amalgamation'. 'We should take immediate advantage of the situation', Divekar proposed, 'and merge or reconstruct' the weaker banks. The Bank, he also felt, had done enough by way of 'preliminaries'. The 'time ... for action' had come, Divekar exhorted, and there was no longer any need to hold further discussions with the state's bankers.

There were, besides the Kottayam Orient Bank, six other banks (the Bank of New India, the Seasia Midland Bank, the Martandam Commercial Bank, the Trivandrum Permanent Bank, the Venadu Bank, and the Travancore Forward Bank) which officials felt were in deep crisis and in need of urgent action by the Bank. Some of these banks, as Iengar informed Finance Minister Morarji Desai in October 1960, were 'afraid to publish the latest statements' of their position since they would 'show a heavy fall in deposits' and were urging the Bank to take action before the end of the year when their annual statements would have to be finalized.

By December 1960 the mood in Kerala had undergone another shift. The immediate reason for this appears to have been a rumour, which once again had little foundation, that the Bank proposed to declare a widespread moratorium on banks to expedite their amalgamation. These rumours, *in turn, fuelled something of a banking panic* in the state. At the same time, as Rangachari found when he visited the state on 5 December 1960, some banks which had earlier been receptive to proposals for their merger had begun to have second thoughts. In particular, the Travancore Forward Bank believed it 'had turned the corner' and 'should be left alone', and this view was backed by some senior officials of the State Bank of India and the State Bank of Travancore. The Chief Minister of the state, P. Thanu Pillai, and the Finance Minister too, impressed on the Deputy Governor the depth of feeling *within the state against merging* some of its banks with the State Bank of India, and the uneasiness that prevailed generally about the likely consequences for the state's economy of the disappearance of its smaller banks. The moratorium which would

precede banking amalgamation, they also appeared to feel, would further upset the economy of the state, shake wider public confidence in its banks, and lead to a run on sound banks as well. The Deputy Governor, who was accompanied to the meeting by Bhattacharyya, assured Pillai that the Bank did not propose to impose a general moratorium and that voluntary mergers of banks whose deposits were intact could be put through without one. Moratoria, he stressed, would be necessary only where banks' deposits had been eroded and it had become necessary to write off a portion of their deposit liabilities before amalgamation. Notwithstanding these assurances,

the Ministers ... again and again came back to the point that it may be best in all the circumstances to leave the situation as it is with the vigilance of the Reserve Bank securing that things do not go wrong any further.

'This attitude', the Deputy Governor remarked, created a 'somewhat difficult situation' that required 'careful handling'. Following consultations between Iengar and Rangachari, the Bank decided on 10 December to leave the Travancore Forward Bank to its own devices 'for the time being' and proceed with efforts to amalgamate the Kottayam Orient Bank and the other three banks.

But rumours of a moratorium refused to go away. Indeed, they had become self-fulfilling by 8 December when a run began on some banks in the state. This run soon 'assumed the proportions of a panic', with the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India, and the Seasia Midland Bank losing additional deposits of nearly Rs one crore during the course of the following week. On 15 December, Gogtay wrote to Bombay warning of the rumours and to advise against the imposition of a moratorium unless one became absolutely unavoidable, since otherwise the Bank's action would only confirm public suspicions and trigger fresh panic. But the same day, the Governor received a telephone call from the Chief Minister of Kerala that he had been informed by his 'banker friends' that 'a serious crisis' had developed in the affairs of the Travancore Forward Bank and the other three banks. This, according to the Chief Minister, called for an 'immediate moratorium' and a scheme of amalgamation which the Reserve Bank should undertake and complete 'in 4 or 5 days'. The Governor felt the Bank had been placed in an 'impossible position' by the Travancore Forward Bank which made 'extravagant' claims about its soundness and profitability one day and declared itself facing a crisis the next. While there was no dearth of 'panicky messages', the facts were still cloudy. The Chief Minister was

not fully aware of either the legal position or even of the actual facts of the situation in Kerala. The Ministers themselves have been subject to as many swings of opinion as the banking community in Kerala. However, while this merely adds to our difficulty, it is clear that we have to take a decision on the best judgement that we ourselves make.

But the Bank's decision was made for it by the four Kerala banks who, unable to withstand the run on their deposits, themselves applied for a moratorium which was then imposed on 18 December 1960. The Venadu Bank also came under moratorium the same day.

Contrary to the 'expectations of some Jeremiahs', the moratorium did not lead immediately to a run on the other banks in Kerala. Although initially, the 'unnatural calm' which settled after the moratorium was feared to portend deeper turmoil in the future, and rumours abounded over the next fortnight about runs on banks in various parts of the state and of more banks, including some from outside the state, being placed under moratoria, the scale of panicky withdrawals that followed was controlled with relative ease. The runs which did arise were relatively minor and confined to four or five banks. While some of the affected banks hinted at the possibility of drawing emergency assistance from the Bank, none, in the event, proved necessary. Subsequently, two other small non-scheduled banks in the Travancore area, the Catholic Bank of India and the Anthraper Bank, faced a run and asked for a moratorium which was granted from 7 January and 19 February 1961 respectively. According to Gogtay, the effect of the moratorium of 18 December on public confidence was not more severe or widespread because it 'did not come as a surprise'. These banks had lost deposits soon after the crash of the Palai bank and again in December, and their 'vulnerability ... had ... become more or less known to the public'. Nevertheless, he advised, the Bank should strive to avoid giving the impression that 'more and more banks are going to be placed under moratorium', by not resorting to compulsory amalgamation unless they became 'inevitable'.

The moratorium was not, however, without controversy. There were many complaints that it affected the availability of bank credit to plantations, especially to growers of rubber, pepper, tea, and cardamom. An inquiry carried out by an official of the Bank at the end of January 1961 confirmed that the moratorium had led to a 'temporary cessation of banking facilities' to plantations, since there was no other bank in many of these areas 'to fill ... the void' created by the closure of the Travancore Forward Bank and the Kottayam Orient Bank, and the 'one or two local banks still functioning in a few places'

were 'cautious not to increase [their] advances portfolio on account of the uncertain conditions'. Allegations abounded, including one from a member of the state's Legislative Assembly belonging to the Congress Party, that Kerala's banks 'which were managed efficiently' had been 'deliberately ruined' by their managements and by 'the authorities of the Reserve Bank' who had little 'goodwill' for these institutions, and that the moratorium was an 'act of revenge' on the people of Kerala. Bankers and others in Kerala also raised the spectre of the state's banks, which were described as the 'key to our granary', being taken over and run by outsiders.

It was fairly clear to the Bank and to everyone else who took an interest in Kerala's banking affairs that the moratorium could not be lifted without the affected banks being strengthened through mergers and amalgamations. But the managements of these banks appear to have taken advantage of the breathing space yielded by the moratorium to indulge in fresh bickering about their relative positions in the new bank that was expected to be formed by merging them. Some newspapers in the state also made out that the banks under moratoria were 'financially ... sound' institutions and that amalgamations were 'intended only to reconstruct them'. This increased the likelihood that 'the blame for scaling down' the deposits of these institutions would be 'laid at the doors of the Reserve Bank', more so as the state's bankers sported 'an air of injured innocence'.

Despite the controversy it evoked, the December moratorium gave a fillip to plans to amalgamate Kerala's banks. The Bank's original proposals involved merging the five banks granted moratoria in December 1960 into one unit, but these foundered on opposition from the constituent banks, in particular the Travancore Forward Bank. It was then proposed to reconstruct the other four banks and merge them to form one unit through a scheme involving writing down the deposits of three of these four banks and compulsorily converting deposits to the tune of over Rs 17 lakhs into share capital. But these two features of the scheme did not find favour with the state government which expressed itself willing to contribute the additions necessary to the share capital of the new bank and to place a substantial long-term deposit with it. This proposal evoked opposition even within Kerala, with some opposition parties charging the state government with attempting to rescue the bank's incompetent management at the cost of public funds. The Bank's Local Board in Madras and the Committee of the Central Board also had little hesitation in turning down the state government's suggestions which, by implying that amalgamations should not involve scaling down of deposits, would make them 'virtually impossible in many cases'. On the other hand, allowing the state government to invest in the share capital of the new bank

too involved reversing past policy which had resulted in the conversion of former state-associated banks into subsidiaries of the State Bank of India. Nevertheless, the Bank decided to explore the possibility of amalgamating these four banks with 'another (large) bank without any scaling down of deposits', and to take a 'firm stand' if the Kerala government 'objected subsequently to a particular bank selected for the purpose'.

In the event, the Travancore Forward Bank, the Kottayam Orient Bank, and the Bank of New India were merged with the State Bank of Travancore in June 1961. In order to enable this merger, the Banking Companies Act was amended, first through an ordinance promulgated in February 1961 and then by an Act of Parliament passed the following month, to empower the Bank to prepare schemes for amalgamation involving the State Bank of India or its subsidiaries as the 'transferee bank'. The Bank of Kerala and the Seasia Midland Bank were merged with the Canara Bank, which used the opportunity presented by the banking crisis in Kerala to pursue an 'aggressive' takeover policy, in May and June 1961 respectively. The Venadu Bank was taken over by the South Indian Bank in June 1961.

BANKING CONSOLIDATION IN THE 1960s

The moratorium and consequent amalgamation of these Kerala banks inaugurated a period of rapid consolidation of the Indian banking system. Between 1960 and the end of the period covered by this volume, as many as 204 banks were either merged or their assets and liabilities transferred to other banks. Fifty-seven banks were also placed under moratorium during these years. Of the 204 banks, twenty banks preferred voluntary amalgamation to the stigma of a moratorium and compulsory merger. The Bank encouraged voluntary amalgamation, making available to banks a detailed note on the procedure involved, keeping itself regularly informed of their progress in this regard, and persuading them to speed up the process wherever possible.

Forty-five of the 204 banks were compulsorily amalgamated under the new powers granted to the Bank. Thirty of these compulsory mergers took place in 1961 alone, and by the middle of that year misgivings were voiced in some quarters about the effect on the banking structure of compulsory amalgamation. The Bank was sensitive to these apprehensions, and as the Governor informed L.K. Jha in July 1961, the 1960 amendments to the Banking Companies Act were not intended to do away with 'small banks, as such' and encourage 'only big institutions'. The Bank and the government were, however, out of step with each other, and Morarji Desai and Iengar met in July 1961 to discuss the issue. It was suggested to the Bank at this meeting that it should

'go slow' with the amalgamation of banks whose positions had not worsened in recent years and give them a chance to improve themselves. Though it continued to disagree with the government, the Bank volunteered to undertake a thorough study of the position of small banks based on recent inspections, as a prelude to reviewing its policy on banking consolidation.

Following the study, the Governor proposed to the government that compulsory amalgamation should be confined only to banks which were 'grossly mismanaged', had failed to carry out the Bank's directions, or had lost (or were about to lose) a part of their deposits. The Bank, as Iengar informed the government, would also 'hold its hand' unless banks themselves approached it for a moratorium as they had done in Kerala, or a run on a bank made one 'inescapable'. Nor would it frame new proposals for amalgamation until the government had taken a policy decision in regard to the circumstances in which they could be resorted to.

On the whole, big, if ever it was, had ceased to be beautiful, and the pace of compulsory amalgamation now slowed to a crawl.³ Only one bank was amalgamated compulsorily in 1962 and 1963, nine in 1964, and four in 1965. No banks were compulsorily amalgamated in the two remaining years covered by this volume. Interestingly, depositors of thirty-one of the forty-five banks which were compulsorily amalgamated received full credit for their deposits. However, the significance of the new section 45 of the Banking Companies Act empowering the Bank to enforce mergers extended beyond the number of institutions directly attracting its provisions. As the Bank and the government recognized at the time and as hinted at above, the threat of compulsory amalgamation spurred banks to enter into other arrangements such as voluntary amalgamation and transferring their assets and liabilities to other banks under section 293(1)(a) of the Companies Act, 1956.

The latter was, in fact, the most popular route for banks going out of business, no fewer than 122 banks taking it during 1960-67. More than half of these (62 to be exact) went out of existence in 1964 alone. Forty-five of these sixty-two banks were from Kerala where the business of many of the so-called 'gold loan banks', which were institutions lending mainly against the pledge of gold ornaments, suffered greatly from the imposition of the Gold Control Order in 1962. Besides voluntary amalgamation, compulsory amalgamation, and transfer of assets and liabilities, seventeen banks were merged with the State Bank of India or its subsidiaries. Many of these were minor state-associated banks such as the Bank of Baghelkhand and the State

³ As discussed below, the Bank's policy on branch licensing too, changed in 1962 to protect the interests of the smaller banks.

Bank of Mayurbhanj, the reprieve they gained as the Bank fastened its attention on the Imperial Bank of India and the major state-associated banks in the wake of the Report of the Rural Credit Survey not enduring the events of the early 1960s and the drive towards banking consolidation resulting from them. In addition, forty-five banks went into voluntary liquidation, and twenty banks were compulsorily liquidated.

The process of banking consolidation was accompanied by a somewhat more active licensing policy. One of the first responses of the Bank to the Palai bank crash was to review its earlier approach towards licensing banks. Reacting to a note he saw on the subject in September 1960, Iengar deplored the existence, after so many years, of more than 250 unlicensed banks in the country. According to the note, fifty of these banks might qualify for a licence in two or three years, nearly 170 banks might require five to ten years, while some forty to fifty banks were unlikely ever to graduate to the status of licensed banks. This, according to the Governor, was 'clearly a most unsatisfactory position'. The 'solution', he argued, did not 'lie in ... lowering ... standards to any substantial extent'. It lay instead in eliminating

institutions which have no chance of survival and in the energetic exercise of the powers newly conferred on Government by the recent amending Act. The objective should be to have, within a relatively short period, say 2 to 3 years, a smaller number of banks which would be viable and qualify for a licence. We must really aim at seeing that thereafter there are no unlicensed banks at all.

It was also desirable, he felt, to move towards abolishing the distinction between non-scheduled and scheduled banks. 'This may well happen if the process of amalgamation is successful on any large scale.'

As discussed above, aided by stronger legislative provisions, greater effort on the Bank's part, and some fortuitous developments, bank amalgamation picked up momentum in the aftermath of the Palai crisis. But with the government preferring a cautious approach, the Bank was to never fully shed its earlier diffidence, the Central Board taking the view even in 1965 that it was largely up to the banks themselves to speed up licensing by improving their working and coming up to the requisite standards. So long as the interests of depositors were in no immediate danger, a Board memorandum argued, the balance of advantage lay in giving banks time to improve their working and qualify for a licence, or failing that to enter into schemes of arrangement or mergers. Nevertheless, the pace of 'de-licensing' accelerated unmistakably during these very years. No fewer than 139 banks were formally denied

licences to operate between 1962 and 1967, taking the tally of such institutions for the whole period 1951–67 to 278. Of these, sixty-two banks—the largest number in any single year—were denied licences in 1964 alone, and sixty-seven banks during 1965–67. On the other hand, only fifteen banks were awarded licences between 1961 and 1967.

Unlicensed banks were not the only ones to undergo mergers and amalgamation in the 1960s. A number of licensed banks also went the same way, so that although the Bank issued about eighty-nine licences in all since the time the Banking Companies Act came into force, only fifty-seven licensed banks (six of them non-scheduled) were in existence at the end of 1967. In the same year, there were thirty functioning banks which had neither been granted a licence nor yet denied one by the Bank. These institutions were, however, of little significance overall, accounting as they did for a mere 2 per cent of the deposits of the Indian banking system.

But there was little room for complacency. Many of the units which survived the consolidation or grew stronger as a result of it had also to be nursed, suffering as they did from common deficiencies such as poor management, ineffective branch control, and a shortage of trained staff. The Bank continued to keep a close watch on their operations through periodic scrutinies, formal and informal observation, and of course, inspections at regular intervals. The Bank also began using its powers to appoint chief executives more freely now, and resorted sometimes to regulating banks' dividends.

BRANCH LICENSING DILEMMAS

The Banking Companies Act (section 23) obliged banks to obtain the permission of the Reserve Bank before opening a new place of business. Permission to open new offices depended in principle on the financial position of the applicant bank, the general quality of its management, the adequacy of its capital structure, its future earning prospects, and on whether public interest would be served by the opening of the proposed branch. Simple as this seemed, the Bank's branch licensing policy gave rise, however, to persisting controversy. At its heart was the apprehension that by discouraging the expansion of unsound or poorly managed banks, the policy discriminated in favour of the larger, all-India banks and against weaker regional and other smaller banks. This sentiment proved hardy enough to survive the thrust towards banking consolidation after 1960 and pose a dilemma to the Bank which it resolved in favour of a more 'equitable' branch licensing policy in 1962. Besides, the Bank discovered that while it was easy enough to deny banks permission to open branches at places of their choice, it was far harder

to encourage them to extend their operations into 'unbanked' areas. The Bank's licensing policy was reviewed several times between 1956 and 1965 in the light of these considerations, until it was decided in the end to adopt a differentiated approach towards branch expansion by various categories of banks and formulate coordinated medium-term branch expansion programmes for individual banks.

The first review of branch licensing policy took place in 1956 against the background of the criticism that existing practice favoured big, all-India banks at the expense of regional or local institutions. According to this review, there was no substance in the criticism, nor any evidence to show that the Bank's branch banking policy tended to divert business from smaller banks towards the relatively bigger ones. Nothing came of this review and the Bank's executives elected to wait until the Travancore-Cochin Banking Inquiry Commission, whose recommendations might have some bearing on the future of small banks elsewhere in the country, returned its report. But branch licensing policy was liberalized in December 1956 to help sound banks open more branches at the smaller urban centres. As discussed elsewhere, the newly formed State Bank of India was embarked on a speedy branch expansion programme at this time. Important as the success of this programme was to the development of banking facilities in large parts of the country, the Bank could not ignore the desire of other banks to expand their operations. Hence it decided not to reject applications from other commercial banks to open branches at the same centres as the State Bank, but merely inform them of the latter's plans. Unlicensed banks satisfying the conditions laid down by section 23 of the Banking Companies Act too, were to be allowed to open branches more freely than in the past.

The charge that the Bank's branch licensing criteria would end in the elimination of the smaller banks revived in 1959 along with the demand to classify banks into three categories: all-India, regional, and district banks. The last were to be encouraged to set up branches at small locations, all-India banks at the district centres, and regional banks in the other towns. In 1956 the Bank had opposed reserving spheres of operation for banks since it would prevent the dispersal of banking risk and lead to the Bank being associated too closely with business decisions of commercial banks. The Bank broadly stuck to this view in 1959, but acknowledged the strength of its critics' argument by reducing the population norm for a new branch from 10,000 to 5,000 for a small bank expanding its operations into an adjoining area. Besides, while adhering broadly to section 23 of the Banking Companies Act, the Bank decided to take a more relaxed view of the standards used to judge the financial position of such banks. There was some tightening of this policy in

June 1960, with applications from licensed or unlicensed banks submitting progress reports to the Bank on major deficiencies and those from banks marked by poor head office control over branches now coming under closer scrutiny.

If the object of the liberalized policy was to promote the expansion of banks into hitherto 'un-banked' areas, it ended in failure. Although nearly a third of the new offices opened between 1957 and 1961 were at centres without banking facilities, the overwhelming majority of such offices were opened by the State Bank of India. Besides, nearly 1,400 of India's 3,018 towns still lacked banking facilities. This failure occasioned a reappraisal of the role of smaller banks in extending the reach of modern banking to new places, at almost the same time as the latent sentiment in influential circles against rapid banking amalgamation began to come into the open. The review that followed of the Bank's branch licensing policy in 1962 led to the virtual overturning of past practices, and the threefold classification of banks mentioned above now became part of the official policy. Cities and the bigger centres (having populations of one lakh or more) without banking facilities were now the responsibility of the larger banks, regional banks were allowed to expand within their traditional areas of operation, particularly into 'un-banked' towns and those with populations in excess of 50,000, while the less populous centres within their respective areas were to be the preserve of the smaller banks. However, in an apparent signal of its continued commitment to banking consolidation, the Bank proposed to permit only licensed banks and those likely to receive licences within the next few years to open new offices.

Another important change introduced in 1962 was the replacement of the relatively opaque and asymmetric queuing system with one where the Reserve Bank endeavoured to extend the reach of the banking system in a more planned and transparent manner on the basis of three-yearly expansion programmes formulated by individual banks. The first three-year cycle lasted from August 1962 to July 1965 during which fifty-nine banks submitted their expansion plans. The number of centres allotted to each eligible bank depended on its size, resources, and past performance in opening new offices. Within their overall quotas banks were allowed to open offices at two banked centres for every office at an 'un-banked' centre. Of the 606 branches opened under this programme during these three years, 231 were at 'un-banked' centres.

The success of this programme encouraged the Bank to extend it for two more years from August 1965 with some important modifications. The criteria for distinguishing between small and regional banks was further refined,

while the practice of not allowing larger banks into towns with populations below one lakh was abandoned in favour of one which allowed them to enter such places provided they were 'un-banked' and no small or regional bank proposed to open an office there. Regional banks were similarly to be allowed into towns with populations above 25,000, while small banks remained free to open offices at 'un-banked' or 'under-banked' centres in their areas of operation with fewer than 50,000 inhabitants. As there were still some 900 centres, according to the Bank's estimate, with no access to banking facilities, the practice persisted of linking licences for offices in 'banked' centres with those for offices at centres without any banking facilities. Since states such as Assam, Bihar, Jammu and Kashmir, Orissa, Madhya Pradesh, Uttar Pradesh, and West Bengal continued to be 'under-banked', with each office of a bank serving a population in excess of one lakh, all-India banks were asked to ensure that one in three of their new branches was located in these states. The larger regional banks were also asked to adopt a similar course wherever possible.

Four hundred new branches were opened in the last two years of the original three-year programme ending in July 1965. The two-year programme commencing in August 1965 envisaged opening 600 new branches. While the Bank approved 663 applications, including 239 for offices at 'un-banked' centres, shortages of accommodation and trained staff meant that only 370 offices could be opened until June 1967.

Finally, a few words while we are still on this subject, on the licensing of foreign banks which also saw some changes of policy during these years. Until 1959 the Bank followed the restrictive policy suggested by the Central Banking Enquiry Committee (1931) of confining foreign banks to port towns. In 1959, however, the Bank decided to place exchange banks on the same footing as Indian banks: not only did the policy of discrimination go beyond the guidelines offered by the Banking Companies Act, international economic relations being reciprocal in nature, little, it was felt, would be gained by discriminating against foreign banks at a time when Indian banks wishing to expand overseas were not subject to similar barriers and India needed the goodwill of the international community to ensure the success of its development plans. Thanks to the liberal policy adopted in 1959, the number of offices of foreign banks in India, which had largely been stationary for some time, increased from sixty-six in that year to seventy-four in 1961.

But this liberal regime soon came under a cloud. The policy of non-discrimination was turned on its head by those who argued that no country with the exception of the United Kingdom (which however was the major country of domicile for the majority of the exchange banks operating in

India) freely opened its doors to banks of other nationalities. Nor did foreign banks in India offer services Indian banks could not reasonably provide. The expansion of the former's business, it was moreover argued, would result in outflows of foreign exchange in the form of repatriated profits. Consequently, in 1962 the Bank resumed its earlier policy of confining foreign banks to port towns, but also decided to consider their request to be allowed to open new offices only after the foreign exchange situation eased. This policy was renewed in 1965. Despite the more restrictive policy, foreign banks expanded their presence in India greatly after 1961, the number of offices rising to 111 by 1967. In contrast, the number of offices of foreign banks had increased from 64 in 1951 to 74 in 1961.

INTRODUCTION OF DEPOSIT INSURANCE

The Deposit Insurance Corporation, and with it the insurance of bank deposits, came into existence in 1962, directly as a consequence of the crash of the Palai Central Bank. The idea had first cropped up in India in the late 1940s in the context of the banking crisis in Bengal, and again in the early 1950s when both the Rural Banking Enquiry Committee and the Shroff Committee adverted to the advantages of insuring bank deposits. Since the late 1950s, opinion within the Bank came to favour deposit insurance as a means not only of protecting depositors, but also of helping to consolidate and strengthen the banking system. Hence the Bank responded quickly to the banking crisis of 1960 with a blueprint for insuring bank deposits. But its implementation foundered on misgivings among the larger Indian banks and the exchange banks, and nervousness about the effect on cooperative bank deposits of confining the scheme to commercial banks. The Deposit Insurance Corporation Act, which was finally passed by Parliament and received Presidential assent towards the end of 1961, came into force from 1 January 1962 when the Deposit Insurance Corporation was established under the Bank's aegis with authority to extend insurance protection up to specified amounts for the deposits of all functioning commercial banks in the country. India as it happened, was only the second country in the world, after the United States of America, to provide insurance cover to bank deposits.

The introduction of insurance cover for deposits of commercial banks intensified fears about the implications of the scheme for the deposits of cooperative banks, and a strong demand came to be voiced to extend a similar facility to the latter's deposits. But this was easier said than done since the Bank had few powers to regulate or oversee the functioning of cooperative banks and it was loath to burden the Deposit Insurance Corporation, and

indirectly the commercial banking system, with blanket liability on account of cooperative banks over which it had no control. On the other hand, state governments which were entrusted with the power to regulate cooperative institutions in their states were not keen to relinquish it to a distant and central authority. Therefore, extending deposit insurance to cooperative banks had to be preceded by extensive negotiations between the Bank, the central government, and state governments, and a series of important legislative measures. The latter, as pointed out above, included the addition of a new part (Part V), dealing with cooperative banks, to the renamed Banking Regulation Act, amendments to the Reserve Bank of India Act, the Deposit Insurance Corporation Act, and finally to the cooperative acts of state governments. This process was inevitably time-consuming, so that it was not before the end of 1965 that the Bank acquired some powers to regulate the functioning of cooperative banks, and it was not until 1968 that these institutions were brought within the purview of the Deposit Insurance Corporation Act.

The Beginnings

The idea of deposit insurance was first mooted in 1948 in the background of the widespread failure of small banks in West Bengal. But it did not progress very far since the Bank felt the proposal was premature and Indian banking too poorly developed for deposit insurance to be viable. As the Governor, C.D. Deshmukh, told the government when the subject was raised again the following year, deposit insurance should wait until the Reserve Bank had a better picture of the health of commercial banks in India. The Bank had only recently acquired powers to inspect and regulate commercial banks under the Banking Companies Act, and the Governor wished at least one round of inspections to be completed before it could, with confidence, 'advise on the inclusion of a maximum number of banks in the scheme'. The Rural Banking Enquiry Committee (1950), which also gave some thought to this issue, felt the time was not ripe for such a scheme, and proposed that once the Bank's control and inspection machinery had developed fully and a sufficient number of banks been issued licences, it should set up an expert committee to consider 'whether a scheme limited to banks holding a licence ... cannot be put into operation'

The Bank had made only modest progress towards satisfying these preconditions when the Committee on Finance for the Private Sector (or the Shroff Committee, 1954) considered a deposit insurance scheme prepared by B.K. Dutt, one of its members and the General Manager of the United Bank of India which, readers will recall, was a child of the recent banking crisis in

Bengal. Though stopping short of endorsing Dutt's scheme, the committee urged the adoption of deposit insurance as a means of strengthening the banking system and increasing public confidence in it, provided banks agreed amongst themselves about its advantages. Placing the recommendations of the Shroff Committee before the Central Board in June 1954, the Governor, B. Rama Rau, reported that according to the evidence collected by the committee, the leading banks were 'sharply divided' on the 'desirability of deposit insurance'. Since the scheme involved the payment of premia by banks, Rama Rau suggested, commercial banks should first agree amongst themselves before the Reserve Bank or the government moved in the matter. The question of deposit insurance, he also proposed, should be taken up for consideration '*after the process of licensing banks has been completed*'. After unsound banks have been weeded out by refusal of licences, it would be easier to organize such a Corporation [emphasis in the original].'

Within two years of this, however, the Bank was forced to re-examine its earlier view that the consolidation of the banking system should precede the adoption of deposit insurance. The context was provided by a letter from the Ministry of Finance in March 1956 asking the Bank to give 'active consideration' to a 'scheme for ensuring the safety of the money of the small depositor'. Such a scheme, the Ministry suggested, would support the 'accepted policy to develop banking in the rural areas and ... encourag[e] savings', and should not be deferred until the process of licensing of banks, which was 'bound to take time', was completed.

The Department of Banking Operations decided to address the sequencing issue head on. Its lengthy note, running into twenty-five pages, contended that the school of thought which held that deposit insurance should precede the strengthening of the banking system through the weeding out of unsound banks, assumed that conditions in India in the mid-1950s were similar to those that prevailed in the United States before that country introduced a similar scheme. Nothing, Banking Operations argued, could be further from the truth. Unlike in the US before the Federal Deposit Insurance Corporation was brought into existence, there was no 'general loss of confidence in banks' among depositors in India. On the contrary, deposits were increasing rapidly. Bank failures in India arose from the 'individual weakness of the concerned banks', rather than due to generalized panic. Better control and supervision was therefore the more suitable remedy, and the Bank's efforts had already done much to improve the situation in this regard. In any case, the Department of Banking Operations maintained, the success of deposit insurance depended ultimately on the soundness of individual banks. Therefore, far from being an end in itself, deposit insurance would have to

be accompanied, as in the US, by 'rigorous control and comprehensive supervision' of banks' affairs.

Remarking on the state of commercial banking in India, Banking Operations pointed out that since inspections began the Bank had inspected 580 banks at least once. Of these 329 banks had been 're-inspected'. However, the Bank found only forty-four scheduled and two non-scheduled banks eligible for a licence under section 22 of the Banking Companies Act. The affairs of the remaining banks remained unsatisfactory, and as many as 405 of them had been asked to submit quarterly or monthly reports of their progress in removing the defects detected in their working. The position of these banks was such that while some would be able to improve their affairs and qualify for a licence in due course, 'many others would be unable to do so and may, therefore, have to be eliminated from the banking field'.

In the context of such a position, where the continued existence of a number of banks which have not been found eligible for a licence is itself in doubt, or where even their ultimate disappearance would ... seem to be almost certain, the introduction of a scheme of deposit insurance on a nationwide scale would hardly seem to be justified

At the present stage of banking development in India, deposit insurance could only mean 'acceptance by the State of the responsibility of repaying the deposits of ... banks, a large portion of whose assets is known to be irrecoverable'. The total burden devolving thereby on the State, the note continued, 'would be disproportionate to the results ... achieved'. A smaller scheme confined to sound and well-managed banks, on the other hand, would hardly help strengthen public confidence in the banking system or be of any practical significance. In any case, licensed banks already accounted for 91 per cent of the total bank deposits in India, and as such the proposal to insure bank deposits had little 'immediate practical utility'.

Views in the Division of Banking Research were closer to those of the ministry. According to a note by K.N.R. Ramanujam, Director of Banking Research, deposit insurance should not await the completion of bank licensing which was 'bound to take a long time'. The objective of mobilizing resources for the second five-year plan necessitated the acceleration, in the meantime, of the pace of banking development, especially in rural areas, and a 'scheme of deposit insurance will be of immense aid in fostering public confidence in the safety of ... (bank) deposits'. Besides, deposit insurance should itself be seen as part of the process of consolidating the banking system, since the agency entrusted with the scheme would inevitably place greater emphasis on

keeping 'troubled' banks in operation through reorganization and mergers. Such a 'constructive and more positive attitude' would bring about 'at a quicker pace than at present', the 'strengthening' of the Indian banking system. Elaborating on this argument, Ramanujam pointed out in another note that the proportion of bank deposits to money supply had actually declined in the recent past. This was possibly because the recent growth in incomes had benefited those sections of the community who remained diffident about banking their resources. Deposit insurance, he contended, was just the measure needed to overcome the 'traditional reluctance of people in rural areas to have recourse to banks for placing their funds'. Although it was not an 'integral part of banking development in most countries', deposit insurance should be regarded in India as 'one of the essential services to be rendered by the State' for developing the banking habit in rural areas.

The Director of Banking Research also pointed out that although licensed banks accounted for 91 per cent of total deposits, nearly a third of the depositors held their deposits in smaller banks having total deposits of less than Rs 5 crores each. This proportion would be even larger if depositors of banks numbering 230 having aggregate deposits of less than Rs 5 lakhs each were also taken into consideration. 'Protection afforded to these depositors scattered all over the country would create confidence and cannot but redound to the prestige of the entire banking system' Ramanujam also put forward a tentative scheme providing cover of up to Rs 500 per account which would extend full protection to an estimated 61 per cent of the accounts of all banks and partial protection to the rest whilst covering only about 10 per cent of the total deposits of the Indian banking system. In order to help spread the risk and keep the incidence of premia low (the figure proposed was a twelfth of one per cent) in relation to banks' net profits, the scheme proposed to cover all banks large and small, with the exception of those found to be beyond redemption. The views of the Department of Banking Development were also largely along the lines of those of the Division of Banking Research.

Faced with a divergence of views on the subject within its portals, the Bank decided in February 1957 to send the Government of India a reply in rather general terms which recalled the Shroff Committee's view that deposit insurance had 'useful potentialities' in India and said the proposal was 'worth further examination' in the context of efforts to mobilize resources for the plan. Promising to give 'close attention to the proposal', the Bank told the government that it would formulate its final views on the subject after discussions with bankers. In the event, bankers were not consulted about the scheme until 1960, when the deposit insurance scheme was revived at the highest levels of the Bank under rather different circumstances and auspices.

In the meantime, the informal committee of the Bank constituted to consider the programme and priorities of the State Bank of India examined the issue of depositor confidence in July 1957 in the limited context of the new institution's role in realizing the frozen assets of moribund banks and of measures to simplify bank liquidations to minimize depositors' losses. Though exercises continued within the Economic Department and the Department of Banking Development to finalize a deposit insurance scheme, the issue appears generally to have been put on the back-burner until 1960. Interest in the proposal revived in April that year following a reference in Parliament, and gathered momentum in the wake of the failure of the Palai bank and the resulting banking uncertainty.

The New Push towards Deposit Insurance

The Division of Banking Research responded to the parliamentary reference in July 1960 with a revised scheme of insurance that would be compulsory for the State Bank and its subsidiaries and all licensed banks, but voluntary for other banks. This avoided the risk inherent in the earlier scheme, of banks whose deposits were denied cover suffering an immediate erosion of public confidence and a run on their deposits. Voluntary admission, the note by the Division of Banking Research argued, would not only largely eliminate this risk but would also ensure reasonably comprehensive coverage as banks, whether scheduled or not, would be attracted to the insurance scheme by the prestige and protection it offered. A scheme of this nature would also be simpler to administer. In forwarding the note, S.L.N. Simha, who had meantime become Director of Banking Research, maintained that the proposal for deposit insurance would encounter opposition from the major banks unless the Bank threw its own weight behind it. Drawing attention to the substantial assistance the scheme would require from the Bank in its initial stages, Simha suggested setting up a deposit insurance fund on the lines of the agricultural credit funds.

Banking Research's proposals hung fire until the Bank was galvanized into action by the events of August 1960. The Palai Central Bank downed its shutters on 8 August, and within the next week, Iengar had informally canvassed C.H. Bhabha, the chairman of the Indian Banks' Association, about a deposit insurance scheme. Though he anticipated 'difficulty from several banks', Bhabha apparently promised the Governor 'full support' if he decided to promote such a scheme. Following his meeting with Bhabha, Iengar minuted that 'we should go as fast as we can' in finalizing a plan for deposit insurance. The issue also appears to have been raised informally at a meeting of the Board on 17 August, and the next day Iengar constituted a working group

comprising a representative each of the Economic Department and the Departments of Banking Operations and Banking Development 'to prepare within a week a tentative scheme of Deposit Insurance'

The report of this working group acknowledged that recent bank failures had focused attention on the need to ensure the safety of deposits of 'vulnerable' banks, and the prompt payment of deposits in the event of liquidation 'particularly to persons of small means'. Apart from protecting the small depositor, insurance would 'inspire confidence in the banking system' and help sustain deposit growth. The working group prepared an insurance scheme administered departmentally by the Bank and open in principle to all banks. It proposed a maximum cover of Rs 1,000 per depositor which would fully protect nearly 80 per cent of account holders (this estimate was later revised to 72 per cent of deposit accounts) and secure 15 per cent of deposits. Since it was necessary to keep the premium as low as possible 'so as not to scare away the big banks' who felt they could afford to do without insurance, the working group proposed a levy of two naye paise per Rs 100 of total deposits. The Bank was also to contribute a sum of Rs 5 crores to the corpus of the scheme.

The proposals of the working group were immediately taken up at the highest levels of the Bank, somewhat to the chagrin of departmental heads who felt left out of the process, and sent to the Indian Banks' Association and the Exchange Banks' Association at Bombay for their reactions. They were also discussed at a meeting with bankers held in September 1960 and attended by the Finance Minister. At this meeting, Bhabha acknowledged the scheme to be 'necessary on merit and in the present context inescapable'. The Central Board of the Bank too, approved the draft outline of the deposit insurance scheme in general terms at its meeting in Madras in October 1960, and left it to the Committee of the Central Board to modify it in the light of comments received from the banks.

The formal response of the Indian Banks' Association to the deposit insurance scheme was, however, less positive than the Bank had hoped. The association apprehended that besides being incapable of preventing bank failures arising from bad management, deposit insurance would encourage unsound banking practices and encourage complacency in the supervision of banks. It also objected to putting well managed and badly managed banks on the same footing for the purposes of the scheme. Finally, the association wanted deposit insurance to be managed by a separate organization rather than by the Reserve Bank whose officers, it alleged, were likely to be prey to 'preconceived ideas ... embodied in ... inspection reports'. The Exchange Banks' Association's response was more positive. But it favoured calculating banks' premium liability on the basis of insurable deposits rather than total

deposits, since otherwise larger banks would be 'heavily subsidizing' the insurance scheme on 'behalf of the smaller banks'. Besides, the exchange banks argued, the Bank should also play a more active role in regulating deposit rates and helping to rehabilitate and control 'sub-standard' banks.

The government's reactions to the scheme, oddly enough since it had earlier endorsed the principle of deposit insurance if not the actual proposals *under consideration*, echoed the views of the bankers and came as an unpleasant surprise to the Bank. In two letters written to the Governor in October 1960, K.P. Mathrani, Additional Secretary in the Ministry of Finance, said the government was not 'committed' to the idea of deposit insurance which had not been 'tried on any large scale outside the United States' and was likely to arouse opposition within the country, and that a 'final view' on the 'desirability or practicability' of the scheme would have to await a 'fuller discussion' of the issues involved. In another letter, Mathrani also communicated the Finance Minister's view that the process of 'reconstruction and amalgamation' should precede the adoption of a deposit insurance scheme and that the Bank should take into account the reactions of the banks to the scheme.

The Finance Ministry's latest stand appears to have incensed the Governor who felt it put him in a 'very false position'. North Block's response was 'extraordinary' also because it presumed to teach him 'the pros and cons of the insurance scheme'. Besides, it was 'curious' that the Finance Ministry's arguments, though couched in more polite language than the note of the Indian Banks' Association which was 'offensive' in its reference to the Bank's officers, were identical to those of the bankers' body. 'I feel wedged between the Finance Ministry on the one side and the Indian Banks' Association on the other, and feel I ought to let the Minister know about my feelings on this subject', Iengar remarked bitterly. The Indian Banks' Association 'pretended to speak for the banking community in general', but it represented the views 'merely of a clique of bankers in Bombay'. The Governor had been informed by a number of bankers that they supported the deposit insurance scheme, while some others had written to the Bank on their own volition to press for it. But the association persisted in taking a 'contrary line'. He therefore proposed writing directly to individual banks for their views on the draft proposals. *Informal inquiries* made by the Bank also elicited the information that the Indian Banks' Association's response to the scheme was formulated at a meeting of its management committee where *most of the big banks*, spearheaded by Homi Mody, opposed the scheme. The smaller banks were 'nowhere in the picture'. But Bhabha himself continued to stand by his earlier views, and at his request, Iengar decided not to address individual banks until the association had had another chance to consider the subject.

Following this, Iengar wrote pointedly to L.K. Jha in December 1960 and January 1961 informing him that having discussed the issue with the bankers, the Bank was now in a position to prepare the details of a deposit insurance scheme. Before it did so, however, it was necessary to 'ascertain from [the] Government whether in their view, as a matter of policy, such a scheme is necessary at all at this stage'. The letters traced the background to the scheme, emphasized the urgency it had acquired in the context of recent bank failures, and cleared the air about the criticisms voiced against it. Iengar argued that deposit insurance was essential to promote the 'investment habit and mobilization of resources' and a banking structure which was not dominated by a 'small number of large institutions' but consisted of a 'number of medium banks of reasonable size in which the smaller people could deposit their savings'. In recent months there had been a 'steady erosion of deposits from the banking system' due to 'apprehensiveness among ... small depositors' arising from recent bank failures and moratoria on bank payments. The recent runs on the Punjab National Bank and the Indian Bank had shown that 'even the bigger banks' were not 'as invulnerable as ... generally claimed'. A measure of depositor protection in the event of bank failure, the Governor insisted, was necessary to restore confidence in the banking system. Finally, deposit insurance would give a 'fair start to the schemes of amalgamation' the Bank proposed to take up. In the prevailing state of public nervousness especially in Kerala, new banks born of amalgamation schemes might face a run on their deposits immediately. These new units would have to be 'nurtured' in the beginning and 'protected against unreasoned fits of nervousness' to which the 'depositing public ... has become more susceptible of late', and a scheme of deposit insurance would be an important aid in this task, Iengar concluded.

Jha responded in February 1961 to inform Iengar that the government viewed the scheme 'with sympathy' and that there were 'weighty' arguments in its favour. Soon afterwards, the Bank sent the government the final outlines of its plan for deposit insurance. This plan proposed a separate corporation under the auspices of the Reserve Bank, which would put up the initial paid-up capital of Rs one crore and an interest-free, ten-year loan of Rs 5 crores. The scheme would cover all institutions defined as banks under the Banking Companies Act, including the State Bank of India and its subsidiaries, and all types of deposits other than deposits of governments (central, state, and foreign) and inter-bank deposits. Deposits were to be insured to the extent of Rs 1,000, the liability arising only when a banking institution went into liquidation or a scheme of reconstruction or amalgamation involving scaling down of deposits was taken up. To start with, the premium rate was fixed at Re 0.05 per Rs 100 to be charged on aggregate deposits and payable quarterly. The

corporation, which would be staffed initially by the Bank's staff, was to be primarily concerned with the overall administration of the scheme and would make use of the existing Bank machinery for supervision and inspection.

The Deposit Insurance Corporation Act

This plan, which was sent to the government in February 1961, progressed quite swiftly through Delhi's corridors. The following month, the Finance Minister held a meeting with some bankers in the course of which he told them that he was 'personally in favour of deposit insurance', and that the Cabinet's orders would soon be taken on the matter. The government's approval too followed shortly in May 1961. The scheme as approved underwent some modifications, relating mainly to the paid-up capital of the new corporation and the loan it would receive from the Bank. The original Cabinet decision excluded the State Banks from the scheme, but this was quickly reversed. The bill to set up the Deposit Insurance Corporation was introduced in the monsoon session of Parliament. It was passed by the Lok Sabha in September 1961 and by the Rajya Sabha in November the same year. The President gave his assent to the legislation early in December, and the Deposit Insurance Corporation Act was brought into force from 1 January 1962 when the Deposit Insurance Corporation came into existence, two months before Iengar's term as Governor ended.

Under the Act, all functioning banks were to be categorized as insured banks. Insurance protection to a depositor was limited to Rs 1,500 or the total amount deposited, whichever was lower, and the premium was fixed at Re 0.05 per Rs 100 of total deposits in India less some specified deposits.⁴ The corporation had a capital of Rs one crore which was fully paid-up and allotted to the Bank. The Act required the corporation to maintain two funds, the Deposit Insurance Fund and the General Fund, and the Bank was authorized to advance to it a maximum of Rs 5 crores towards augmenting the former fund. The first Board of the corporation comprised the Governor as its Chairman, a Deputy Governor nominated by the Bank, a nominee of the Government of India, and two non-officials nominated by the Government of India in consultation with the Bank. The latter were to be selected from among persons who were familiar with banking, commerce, industry, or finance, but were not actively connected with any banking company. The Deposit Insurance Corporation was required to invest its funds entirely in the securities of the central government.

⁴ The limit of the insurance cover was raised to Rs 5,000 from January 1968, thereby fully insuring over 91 per cent of all deposit accounts and half of all assessable deposits at the end of the year.

Since all functioning banks were to be registered as insured banks and the Reserve Bank's powers of supervision and control under the Banking Companies Act extended to all of them, it was not considered necessary to assign any of these functions independently to the corporation which, it was envisaged, would function in close coordination with the Department of Banking Operations of the Bank. When the Deposit Insurance Corporation came into existence, all 293 banks which were then in existence were registered as insured banks under intimation to them. Of these 219 banks were unlicensed, twenty-one of whom, accounting for a total deposit liability of Rs 67 crores, had faced some erosion of their deposits. It transpired, however, that five of the 293 banks had ceased to transact banking business and one had gone into voluntary liquidation shortly before the establishment of the corporation, so that there were in all 287 banks whose deposits were covered by the insurance scheme when the latter got under way.

There were 55.42 lakh fully protected accounts (i.e. accounts with balances below Rs 1,500) at the outset of the scheme, accounting for 78.5 per cent of all deposit accounts. The proportion of fully protected accounts was higher (86.1 per cent) in the case of smaller banks, i.e. banks with aggregate deposits of Rs one crore or less. The number of fully protected accounts more than doubled to 118.7 lakhs by September 1967 at which stage they represented about 76.4 per cent of the total number of accounts. The proportion of insured to total deposits was about 23.1 per cent (roughly about Rs 392 crores) when the scheme began in January 1962. This proportion had risen to 26.2 per cent (or about Rs 943 crores) by September 1967. The Deposit Insurance Fund amounted to Rs 8.59 crores at the end of 1967, constituting 0.24 per cent of assessable deposits and 0.91 per cent of insured deposits. In the first six years of its operations, the Deposit Insurance Corporation cancelled the registration of 198 banks with total assessable deposits of Rs 52 crores. The corporation was not required to make any payment in respect of 187 of these banks since they either discharged their deposit liabilities in full before downing shutters, or transferred them to other banks. The corporation attracted a total liability of about Rs 57 lakhs on account of the other eleven banks. These included the Habib Bank, which involved the largest single gross liability of Rs 17.63 lakhs, the National Bank of Pakistan, and the Bank of China whose licences were cancelled for reasons that had little to do with their viability. The net liability (i.e. the corporation's payments to depositors less the reimbursements received from the concerned bank or the official liquidator) on account of these eleven banks amounted only to about Rs 24 lakhs. This, according to the corporation, indicated a 'favourable risk experience'.

Nor did the fears expressed earlier by exchange banks and several officials within the Bank, that deposit insurance would persuade depositors to move their funds from the bigger and sounder banks, which paid lower interest, to smaller and weaker banks offering higher rates of interest materialize despite the insurance scheme being introduced, unlike in the USA, without any regulation of the interest rates banks offered on deposits. Indeed, as discussed elsewhere in this chapter, the impressive growth in deposits and deposit accounts during this period was accompanied by a large number of small banks going out of business in a relatively orderly fashion, and the number of registered or insured banks declining sharply from 287 in January 1962 to ninety-one at the end of 1967.

Insuring the Deposits of Cooperative Banks

During deliberations on the Bank's draft schemes for deposit insurance, fears were voiced in many quarters about the consequences for cooperative bank deposits of a scheme devoted solely to protecting depositors of commercial banks. The issue was first raised within the Bank in July 1960 by S.L.N. Simha, who however observed that cooperative institutions had made so little progress in raising deposits that there was 'no danger of any diversion' of their deposits to commercial banks. The consequences for cooperative banks' deposits of the proposed insurance scheme were also discussed following Mathrani's two letters to the Governor and a letter he wrote to the Deputy Governor, B. Venkatappiah, at the end of October 1960.

The reaction to the insurance scheme of the Agricultural Credit Department largely echoed Mathrani's fears. J.C. Ryan believed there was little chance of cooperative banks (including urban cooperative banks and apex and central cooperative banks) increasing their deposits if the insurance scheme was restricted to commercial banks; the expansion of cooperative credit, he feared, might consequently come largely to depend upon Reserve Bank finance. The Agricultural Credit Department was also concerned about the impact of insuring commercial banks' deposits on the 'integrity' of the cooperative movement. A sizeable portion of the surplus funds and reserves of cooperative societies were kept with central and state cooperative banks. Cooperative institutions already flouted the law requiring them to seek the permission of the Registrar of Cooperative Societies before lodging their funds in commercial banks, and once the latter's deposits were insured, this law, Ryan warned, would be 'more honoured in the breach'. He therefore proposed that if it was not feasible to include all cooperative banks under the scheme, a beginning might be made with a few selected state, central, and urban cooperative banks.

On the other hand, there was little prospect of cooperative banks' deposits being insured so long as the Bank had no statutory powers to control or regulate these institutions. This, in the event, was the Bank's view. Venkatappiah also told Mathrani informally that insuring the deposits of cooperative banks raised many complex issues that required to be considered carefully, and that a scheme for commercial banks should not be held up in the meantime. Besides, as the Governor informed L.K. Jha, the cooperative movement was already under so much 'State guidance and supervision' that insurance may actually turn out to be 'unnecessary'. But, he hastened to add, there was no need to take a 'final view just now'; better to watch the effects of the proposed insurance scheme on cooperative deposits and 'make up our minds later'.

Several members remarked on the exclusion of cooperative banks from the ambit of the Deposit Insurance Corporation Bill when it was moved in Parliament. The bill's passing into law did little to quieten the clamour for extending some form of deposit insurance to cooperative banks, and the issue figured prominently at meetings of the Standing Advisory Committee on Agricultural Credit in December 1961 and in February and June 1962, with several members echoing the views of V.L. Mehta that the Bank should 'speed up the examination of the type of protection that should be given to depositors in cooperative banks before the effect of the present scheme [of insuring deposits of commercial banks] spreads'.

There were essentially two approaches to insuring cooperative deposits. The first was to offer some form of depositor protection at the state level, rather than centrally, with individual state governments, who alone had powers to regulate cooperative banks, playing an important role in the arrangements. Earlier in 1959-60, some state governments had proposed guaranteeing the deposits of cooperative banks in the same way they guaranteed the debentures of central land mortgage banks, to help them mobilize resources. But cooperators generally looked askance at such measures, and the Committee on Cooperative Credit (V.L. Mehta Committee, 1960) rejected the principle of State guarantees which it said was not 'practicable' without 'much greater control' by governments over cooperative banks than was 'desirable'. Most state and central cooperative banks received substantial share capital contributions from state governments. Depositors were generally aware of this fact, the Mehta Committee noted, and concluded that State participation in equity was sufficient to 'inspire the necessary confidence' in depositors' minds. On the other hand, though many cooperators preferred the second approach, of having the Reserve Bank undertake, singly or along with the central and state governments, responsibility for protecting depositors of

cooperative banks, the Bank had no statutory powers to inspect and regulate the working of these institutions. It was also far from clear that state governments would easily relinquish these powers to the Bank. Hence, as pointed out in the previous chapter, the only consensus that emerged from the meeting of the Standing Advisory Committee in June 1962 was reflected in B. Venkatappiah's *opinion that whatever the arrangements to insure deposits of cooperative banks, these should be in line with those for overseeing, regulating, inspecting, and if necessary winding up, the affairs of cooperative banks.*

At the Standing Advisory Committee's suggestion, the Bank appointed a working group headed by the Deputy Governor, D.G. Karve, to examine the insurance of cooperative deposits in some detail. This group considered three alternatives, viz. organizing the insurance of cooperative deposits *centrally*, at the level of individual states, or through a combination of central and state-level agencies, but refrained from making its own preference explicit. The Standing Advisory Committee, on the other hand, felt it was impracticable, for reasons of its cost, to insure cooperative deposits at the state level. At the same time, although several ideas were floated in this regard, few in the Bank or outside were clear yet about the means by which the Deposit Insurance Corporation or some other central agency would protect depositors of cooperative banks.

In the meantime, despite the Mehta Committee *frowning upon the practice*, some state governments moved in the direction of guaranteeing the deposits of cooperative banks in their states. The pioneer in this respect was the Madras government, which decided in December 1961 to guarantee, up to some limit, three-year and longer fixed deposits of state and central cooperative banks offering interest of 5 per cent or more. Explaining this initiative, R. Tirumalai, an official of the Madras government, told the Standing Advisory Committee in June 1962 that the guarantee was a sequel to the 'acute shortage of medium-term resources ... for agricultural purposes'. The guarantee, he pointed out, had a positive impact on deposit mobilization by cooperative banks and the state government's action was 'justified by its results'. He also held out the possibility of the state government extending the guarantee to depositors of urban and other cooperative banks. The Bank did not favour such guarantees, and appears to have felt the Madras government's initiative would adversely affect its market borrowings. The effects of the guarantee were discussed during the Deputy Governor's annual meetings with officials of the Madras government in 1964 and 1965, when the latter confessed that the guarantee was introduced without a full appreciation of its implications. But the government also felt it could not be withdrawn without confusing

depositors and provoking a flight of deposits from cooperative banks to commercial banks.

Despite this experience, the state government soon approached the Bank with a proposal to increase guarantee limits (which were earlier set at Rs 125 lakhs for the state cooperative bank and Rs 30 lakhs for each central cooperative bank) in order to enable cooperative banks to mobilize larger resources for financing agricultural production. The Bank's Agricultural Credit Department opposed the proposal, arguing that the state government's action in guaranteeing deposits for three years and longer had caused a disproportionate growth in such deposits and induced cooperative institutions to lock up their resources in long-term or medium-term loans. In addition, the higher interest cost on these deposits eroded the profitability of cooperative banks in the state. The Standing Advisory Committee, which met in June 1965, also expressed itself against the state government's proposal to enhance guarantee limits.

The Madras government's example was quickly copied by some other state governments. But the Bank managed, on the whole, to check the enthusiasm of state governments for deposit guarantees from spreading too far. The Andhra Pradesh government, which had earlier decided to guarantee cooperative banks' deposits in the state, heeded the Bank's advice and withdrew its proposals in July 1963, while Mysore was persuaded not to renew its guarantee. The Orissa and Bihar governments too were dissuaded from going down the path taken by the Madras government.

Meanwhile, the Government of India's assurance to Parliament that it would soon bring forward legislation to extend deposit insurance to cooperative banks languished, since state governments were not keen to cede to the Bank powers to wind up or reconstitute cooperative banking institutions. In April 1965, S.K. Dey, the Minister for Community Development and Cooperation, wrote to chief ministers urging them to respond to the suggestions the Bank had made at the November 1963 conference and its draft amendments to various central enactments and the cooperative societies acts of state governments. The Bank too followed this up with letters to state governments explaining the amendments it proposed to the latter. Soon afterwards in September 1965, as seen in the last chapter, the Bank's efforts to separate the two issues and move towards regulating the banking activities of cooperative institutions without waiting for agreement on a mechanism for liquidating and amalgamating cooperative banks and extending insurance to their deposits bore fruit, with the Banking Companies Act being amended to make certain of its provisions applicable to cooperative banks. Spurred possibly by this legislation, chief ministers of three states wrote to the Government of India approving the deposit insurance scheme in principle.

But doubts endured. As the Bank anticipated, some state governments were uneasy about the diminution of their role in determining the future of cooperative banks. The Orissa government suggested that the Registrar should have the power to liquidate a cooperative bank even without the prior consent of the Bank, while the Madhya Pradesh government sought the power to entertain appeals against the supersession of a bank's board. The idea was also canvassed of entrusting arbitration to an 'independent third party', whenever the Bank and the state government differed over the future of a cooperative bank. The Governor was quick to scotch this proposal which, if accepted, might lead to the management of a cooperative bank using the arbitration period to water down its assets. He maintained that while there should be no legal obligation on the Bank to consult the state government before initiating action against cooperative banks, it would, in practice, take the local authorities into confidence before doing so. In any case, the Governor argued, a state government could hardly disregard the Bank's expert opinion on the soundness of any banking institution and the best means of safeguarding the interests of its depositors. Though some dissenters remained, in due course five other states and union territories indicated their agreement with the Bank's proposals, and after weighing their responses the Government of India decided to go ahead with the legislation to extend deposit insurance to cooperative banks.

The Deposit Insurance Corporation (Amendment) Bill, which, among its other provisions, vested in the Bank powers to order the reconstruction, amalgamation, winding up, or supersession of the management of cooperative banks, and increased the paid-up capital of the Deposit Insurance Corporation from Rs one crore to Rs 5 crores and the number of directors on its Board from five to eight, was introduced in the Lok Sabha in July 1967. It came up for consideration on 20 November 1968 and, for a piece of legislation that had been more than six years in the making, was passed in the Lok Sabha the very next day with surprisingly little ado. Requesting state governments to amend their cooperative societies acts in the manner suggested by the Bank, the Minister of State for Finance, K.C. Pant, assured the House that the Bank would always keep in mind the special features and needs of the cooperative banking system and act in close consultation with its institutions. The bill was adopted by the Rajya Sabha at the beginning of December 1968 and came into force from the end of the same month.

TRENDS IN INDIAN BANKING, 1951-67: AN OVERVIEW

Thanks to large public investments, rising incomes, structural changes in the economy, and the growth of the banking habit, Indian banking witnessed steady

expansion during these years (table 13). It was pointed out above that the number of banks in India fell sharply from 566 in 1951 to ninety-one in 1967. But the number of their offices rose from 4,151 in 1951 to 7,025 in 1967. This growth was even more impressive in the case of scheduled banks. In 1951, the ninety-two scheduled banks in existence had between them 2,647 offices, while the remaining 474 non-scheduled banks functioned out of 1,504 offices. The number of scheduled banks fell to seventy-one by 1967, but they now accounted for 6,816 offices, while the twenty non-scheduled banks still in existence had only 209 offices between them. Though more numerous at the beginning of our period than scheduled banks, non-scheduled banks accounted for a mere 4 per cent of total deposits and 6 per cent of the advances of Indian commercial banks in 1950. These proportions had fallen sharply to 0.7 per cent and 0.5 per cent respectively by 1967, deposits and advances of non-scheduled banks declining even in absolute terms from Rs 36 crores and Rs 29 crores respectively in 1951 to Rs 26 crores and Rs 13 crores in 1967.

The expansion of the branch network of Indian banks outpaced the rapid growth of population, so that the average population per branch fell from about 87,000 in 1951 to about 73,000 in 1967.⁵ There were however considerable inter-state variations, the union territories of Chandigarh and Delhi having a branch of a bank for 8,000 and 14,000 inhabitants respectively, while Tripura, also a union territory, had one branch serving as many as 2,77,000 of its population. Among the major states, the reach of the banking system extended farthest in Madras which had a population of 39,000 per office in 1967. Gujarat with 41,000 and Mysore with 43,000 people per office were not far behind. Kerala, Maharashtra, Punjab, Haryana, Himachal Pradesh, Pondicherry, and Goa, Daman & Diu were the other states or union territories with populations per bank office below or equal to the national average. On the other hand, Tripura, and among the states Orissa, where each office of a bank catered to the needs of 2,27,000 people, were the most under-banked areas of the country, followed by Bihar (2,18,000), Assam (1,99,000), and Jammu and Kashmir (1,26,000). However, to put Orissa's banking development during these years in perspective, it is useful to note that each office of a bank in the state served a population of about 1.2 million in 1951. In Bihar, in contrast, the number of people served by a branch of a bank fell only modestly from about 320,000 in 1951 to 218,000 in 1967.

Given the relative insignificance of non-scheduled banks, it is proposed to confine the remainder of the discussion of banking trends in this section to scheduled commercial banks.

⁵ The population per branch office of a scheduled bank in 1951 was 1,36,000.

Aggregate deposits of scheduled commercial banks in India rose rapidly from Rs 822 crores in 1951 to Rs 3,763 crores in 1967. The share of deposits of commercial banks to aggregate monetary resources climbed from 44 per cent in 1951 to 51 per cent in 1967. Despite the apparent incongruity of the stock-flow comparison, we may also note that bank deposits rose from 9 per cent of the national income to 12 per cent over the same period, and from 12 to 38 per cent of the gross savings of the household sector. The growth of deposits was accompanied by a broadly corresponding rise in the deposit accounts of banks from about 32 lakhs in 1951 to 140 lakhs in 1967. Although the proportion of personal accounts to total accounts fell, the share of personal deposits increased from 47 per cent to 57 per cent, while that of business deposits fell from 37 per cent to 25 per cent. Government and other deposits made up the remainder. This shift from business to personal deposits was mirrored in the composition of deposits as well. Demand deposits, which accounted for 55 per cent of total deposits in 1951, lost ground continuously to time deposits. As the former fell to just under 24 per cent in 1967, the proportion of time deposits increased from about 28 per cent in 1951 to over 55 per cent in 1959, before settling down at about half of the total at the end of our period.

Savings deposits, whose share of total deposits was in the region of about 16 per cent during 1951–56, declined in importance during the next four years, but thereafter registered continuous growth to reach a level of over a quarter of total deposits in 1967. While the shift from demand deposits towards time and savings deposits was stimulated by the increased spread between the interest rates offered on these types of deposits, the trend towards savings deposits after 1960 was due to a number of other factors as well. These included partly the banking uncertainty of 1960 (when as pointed out above the maturity structure of deposits generally grew shorter), growth of the banking habit among personal-account holders, the tightening of rules for time deposits, the liberalization by banks of rules governing savings accounts to make them almost as easy to operate as current accounts, and their growing popularity among personal-account holders wishing to store their transaction balances.

On the flip side, the growth in the deposits of the Indian banking system was not distributed evenly across the country, inter-state variations here mirroring those in the development of banking facilities. Deposit growth was most pronounced in a few advanced states such as Maharashtra, West Bengal, and Madras, and within them in the metropolitan centres of Bombay, Calcutta, and Madras. Other states such as Gujarat, Mysore, Punjab, Uttar Pradesh, and the union territory of Delhi also witnessed rapid deposit growth, while Madhya

Pradesh, Assam, Orissa, and Jammu and Kashmir were the laggard states. However, the wider geographical dispersal of the banking habit was also unmistakable, deposits in smaller towns and rural and semi-urban areas rising steadily during these years. Deposits at centres with populations below one lakh, for example, rose from Rs 126 crores, or 16 per cent of total deposits, in 1951 to Rs 815 crores, or 29 per cent of total deposits, in 1966.

Scheduled bank credit rose faster during our period than deposits, from Rs 585 crores at the beginning to Rs 2,727 crores at its end. Though the shift in the sectoral distribution of bank credit is somewhat overstated due to some categories of advances being reclassified during these years, it is difficult to ignore the rise in the share of industry in total scheduled bank credit from 34 per cent to 64 per cent. The share of bank credit going to commerce fell from 40 per cent to 19 per cent, while that of agriculture remained more or less steady at around 2 per cent. The credit-deposit ratio of scheduled banks fluctuated in the 1950s between 52 per cent and 71 per cent, but steadied in the 1960s around the upper limit of this range. To some extent, banks could afford to maintain a high credit-deposit ratio because of their access to Reserve Bank credit, the ratio of their investments to deposits falling more gradually than the rise in the former, from 38 per cent in 1951 to around 33 per cent in 1967. The cash reserve ratio of scheduled banks also fell from 11 per cent in 1951 to 7 per cent in 1967.

Despite the Bank's efforts, particularly after 1960, to persuade commercial banks to increase their capital and reserves, the expansion of the assets and liabilities of the banking system summarized above was accompanied by a mere 30 per cent rise in aggregate paid-up capital (from about Rs 35 crores to Rs 45 crores) and a doubling of reserves from Rs 26 crores to Rs 52 crores. In the upshot, the ratio of capital funds (paid-up capital and reserves) to deposits of scheduled banks fell from 9 per cent in 1951 to 3 per cent in 1967. To a large extent, this fall owed to the rising operational expenses of banks, particularly during the 1960s. The reported current earnings of scheduled banks increased some 7.4 times from Rs 45 crores in 1951 to Rs 335 crores in 1967. Higher credit-deposit ratios and lending rates were reflected in the share of earnings from loans and advances rising from 60 per cent of reported earnings in 1951 to 71 per cent in 1967. Earnings from investments in government securities, on the other hand, fell from 18 per cent to 12 per cent over the same period. The increase in current earnings of banks was more than offset, however, by that in their current operating expenses which rose nearly tenfold from Rs 31 crores in 1951 to Rs 298 crores in 1967. This rise was particularly sharp between 1961 and 1967 when the operating expenses of banks increased by a factor of three. Thanks to higher deposit rates, interest payments rose from 17 per cent of

earnings to 43 per cent between 1951 and 1967. After declining from 34 per cent in 1951 to 29 per cent in 1961, the share of establishment expenses rose on the back of an expanding branch network, additions to the workforce, and higher salaries to exactly a third of total earnings in 1967.

Thus, despite the impressive expansion of banking facilities, or perhaps because of it, the profitability of banking declined markedly during these years, pre-tax profits of banks falling from 29 per cent of reported current operating earnings in 1951 to 13 per cent in 1967. Even after allowance is made for the slight encouragement banks were given after 1960 to build secret reserves, there was an unmistakeable erosion in their profitability during our years. *But shareholders of banks who had bought their shares in 1951 or before had little reason to complain.* Dividends paid to shareholders went up from 19 per cent of pre-tax profits in 1951 to 22 per cent in 1956, and thereafter fell more or less steadily to 13 per cent in 1966, before rising to 15 per cent in 1967. But aggregate dividend pay-outs rose some 140 per cent from Rs 2.5 crores to Rs 6 crores over these years when, as pointed out above, aggregate paid-up capital had risen by only 30 per cent.

Table 13: Progress of Banking

	1951	1956	1961	1966	1967
1. Number of banks	566	423	292	103	91
(a) scheduled	92	89	82	76	71
(b) non-scheduled	474	334	210	27	20
2. Number of offices	4,151	4,067	5,012	6,637	7,025
(a) scheduled banks	2,647	2,966	4,390	6,416	6,816
of which—SBI and subsidiaries	643	850	1,436	2,076	2,219
—foreign banks	64	67	74	106	111
(b) non-scheduled banks	1,504	1,101	622	221	209
3. Paid-up capital and reserves	62	60	71	97	99
4. Ratio of paid-up capital and reserves to deposits	9	7	4	3	3
5. Aggregate deposits					
(a) scheduled banks	822	1,052	1,835	3,378	3,763
(b) non-scheduled banks	36	73	39	25	26
6. Aggregate advances					
(a) scheduled banks	585	745	1,277	2,434	2,727
(b) non-scheduled banks	29	43	25	15	13
7. Credit-deposit ratio	71	71	70	72	72
8. Classification of advances (% of total)					
(a) industry	34	37	51	63	64
(b) commerce	40	41	31	24	19
(c) agriculture	2	2	3	2	2
(including plantations)					
9. Total investments	328	395	652	1,154	1,233
of which—in Govt. securities	306	364	577	952	1,006
(as % of total)	(93)	(92)	(88)	(83)	(82)

contd.

Table 13: contd.

	1951	1956	1961	1966	1967
10. Investment-deposit ratio	38	35	35	34	33
11. Cash and reserves	89	91	156	249	277
Cash ratio	11	9	9	7	7
12. Total earnings	45	65	123	291	335
13. Total expenses	31	51	94	255	298
14. Share of earnings from loans and advances to current operating earnings (%)	60	62	66	71	71
15. Share of earnings from investment in government securities to current operating earnings (%)	18	16	14	13	12
16. Share of interest on deposits to current operating earnings (%)	17	26	34	44	43
17. Share of establishment expenses to current operating earnings (%)	34	34	29	31	33
18. Pre-tax profit (% of current operating earnings)	29	21	23	14	13
19. Dividend to shareholders (% of profit before taxes)	19	22	16	13	15

NOTES: (1) All amounts in Rs crores; unless otherwise specifically mentioned, the figures relate to scheduled banks.

(2) The table is only indicative of general banking trends. Some figures may not be strictly comparable over time because of changes in classification and coverage. Intra-quinquennial variations may also be substantial in a few cases.

SOURCE: *Trend and Progress of Banking in India* and *Statistical Tables Relating to Banks in India*, various years.

Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
C.183	Banking Crisis in Bengal
C.183A	Committee appointed by the Government of West Bengal to Report on Expeditious (Bank) Liquidation Proceedings
C.183B	Banks' Liquidation Proceedings Committee
PF 21	Licensing of Banking Companies
PF 8	Branch Licensing
C.183K	Banks in Kerala: Advances under Section 18(1)(3) of the RBI Act, 1934
C.208(MA)I	Banking Situation in Kerala
C.208(7)	Reconstruction/Amalgamation of Banks in Trivandrum Area
C.208(C)	Amalgamation of Banking Companies under the Banking Companies Act, 1949
PR.(P)47	Introduction of Deposit Insurance
B.2.3060	Deposit Insurance Corporation
C.263	Deposit Insurance Corporation
A.1	Application of Banking Companies Act to Cooperative Banks

Memoranda to the Central Board and Committee of Central Board

FINANCING INDUSTRY

In the early 1950s, industry was a more familiar terrain for the Bank than Agriculture. Indian commercial banks, and through them the Reserve Bank, already had some experience of financing the working capital requirements of industry. The problem of making long-term funds available to industry was comparatively a more recent one, but even here the Bank could draw upon the experience of development banking since the Macmillan Committee in the United Kingdom reported in favour of specialized term-lending institutions, and more particularly since the end of the second world war. Facilitating industrial investment also involved deepening the capital market. Here the Bank already had some expertise of its own, and access, besides, to the evolving practices of central banks and financial institutions all over the developed world.

For all these reasons, the sphere of industrial finance did not pose the same sort of challenges, nor give rise to the controversy, that accompanied the Bank's involvement in expanding the availability of agricultural credit. Progress in this realm was also relatively more continuous. The government took steps to establish a number of industrial development institutions in the first half of the 1950s. More preoccupied thereafter with the problems of financing its own investment plans, the government ceded initiative to the Bank, which consequently came to play an important role in helping to create a wide network of institutions to finance the longer-term credit needs of industry. Some of these institutions were born from within the Bank. In the case of others, the Bank played midwife, facilitating and coordinating the initiatives of central and state governments and international agencies to establish

development banking institutions. As well as contributing directly towards their finances, the Bank offered advice in the matter of raising resources, and helped coordinate investments of institutions such as the Life Insurance Corporation and commercial banks in them. In addition, it provided technical and managerial assistance to these bodies many of which started off on the strength of trained personnel from the Bank.

The main elements of the story of the Bank's involvement in financing industry are narrated here in two chapters. The first chapter begins with a brief account of the work of the Committee on Finance for the Private Sector which the Bank constituted in consultation with the government. Popularly known as the Shroff Committee, its report marked an important stage in the evolution of ideas about increasing institutional financial support for the non-agricultural sector. The Bank's contribution to setting up national industrial financing institutions such as the Refinance Corporation for Industry and the Industrial Development Bank of India, and the Unit Trust of India, is then discussed. The second chapter in this section deals with the Bank's more important initiatives to meet the credit needs of small industries and exporters. It outlines the Bank's role in facilitating the operations of industrial finance corporations in the states, promoting the supply of credit to small industrial borrowers, and expanding credit facilities for exporters.

Building an Institutional Infrastructure

India's economic policy-makers were exercised at the beginning of our period by the problem of mobilizing resources for industrial investment in the private sector. The first five-year plan envisaged a relatively modest outlay of Rs 613 crores for private sector investment in industry. Of this, Rs 233 crores were expected to be spent in the first two years of the plan. However, there were apprehensions already by the end of 1952, that investment by the private sector might fall short of plan estimates. These led to suggestions from departments of government and others for an examination of the possible ways in which resources available for investment by the private sector could be increased. The Governor, B. Rama Rau, to whom many of these suggestions were addressed, was initially reluctant to engage the Bank in such an exercise. But by the middle of 1953, he too came round to the view that this problem was of 'great importance', and that it should be investigated by a 'small expert committee'.

THE COMMITTEE ON FINANCE FOR THE PRIVATE SECTOR

In the beginning, the Bank and the government appeared to disagree on the scope of the study. The Bank had in mind a comprehensive investigation of the financial requirements of the private sector. The Finance Minister, C.D. Deshmukh, on the other hand, preferred the study to be confined to 'bank finance alone for industry, especially the small man in West Bengal and elsewhere'. The Governor's communication to the Finance Minister proposed a small three- or four-member committee comprising A.D. Shroff from Tata Sons, J.V. Joshi from the Reserve Bank, a prominent banker, and perhaps an official of the Planning Commission. But Deshmukh preferred a bigger committee including an economist, the Managing Director of the Industrial Finance Corporation of India, 'a representative of a medium-type bank in

West Bengal', and a businessman with some experience of running small-scale units. In the end, the committee was formed largely by merging the personnel proposed by the Governor and the Finance Minister. A.D. Shroff was appointed its chairman.

Sponsored by the Bank, the Shroff Committee was asked to examine ways in which increased finance, in particular bank finance, could be made available to the private sector of industry.¹ There was some anxiety that the terms of reference of this committee would clash with those of the Taxation Enquiry Commission (chaired by the former Finance Minister, John Matthai) which was engaged at this time in examining the effects of the structure and level of income taxes on capital formation and productive investment. Hence the Shroff Committee was asked to confine its attention to areas and methods which were not already under investigation by the Matthai Commission.

The principal method of inquiry adopted by the Shroff Committee was that of holding discussions with concerned interests in government, industry, the banking and insurance sectors, and agents involved with the capital market. The committee also received over seventy memoranda and notes. As it was represented that banking development was being retarded by the absence of adequate remittance facilities and the steep rise in operating costs arising from wage awards of industrial tribunals, the Shroff Committee appointed two subcommittees to go into these aspects. After taking into account the latter's recommendations, the Shroff Committee submitted its Report in April 1954, i.e. some months before the completion of the Report of the All-India Rural Credit Survey.

The Shroff Committee's Report made a detailed appraisal of the overall climate for private sector investment in India and suggestions for improving it. The committee apprehended that the prevailing climate of opinion in the country 'discourage[d] and discredit[ed]' private enterprise. The private sector was merely tolerated rather than welcomed as an instrument of development, and legislative and other measures in recent years had helped foster an impression that it was incapable of discharging its social responsibilities. The threat of nationalization implicit in the Industrial Policy Resolution of 1948 and the Industries (Development and Regulation) Act, for example, dampened

¹Apart from Joshi, the other members of the committee were S. Anantharamakrishnan, a Madras industrialist and a member of the Bank's Local Board at Madras, C.W. Middleton, Secretary and Treasurer of the Imperial Bank of India, V.R. Sonalkar, Managing Director of the Industrial Finance Corporation, and B.T. Thakur and B.K. Dutt, General Managers respectively of the United Commercial Bank and the United Bank of India. M.S. Nadkarni and K.S. Krishnaswamy of the Bank functioned jointly as secretaries of the committee.

the enthusiasm of both domestic and international investors, and the committee demanded immunity from nationalization for large industry. While generally accepting the principle of a mixed economy and the regulation and control which it entailed over entrepreneurship, the Report demanded an end to hostile discrimination against the private sector with regard to pricing, grant of licences, and operation of controls. Unless the overall climate for private sector investment was improved, multiplying or strengthening agencies supplying finance to industry would not produce any results.

The committee also highlighted the existence of irritants in the form of licensing requirements for starting, expanding, or modernizing industry, issuing capital, importing machinery, and securing foreign exchange, and their effect in delaying and retarding private investment. Citing examples, it deplored the amount of time and resources entrepreneurs were required to devote to establishing and maintaining contact with government departments in order to secure various licences, and the scope for corruption in this situation. It also stressed the enormous change that had overcome conditions in the labour market as a result of legislative measures adversely affecting employers' freedom to adopt flexible labour practices, rationalize to step up productivity, or even to discipline their workforce. The Report criticized the low return allowed on capital while giving wage awards, and the implications of this policy for industry's ability to expand or rehabilitate capacities; and complained of the practice of even banks and insurance companies being required to produce original books of accounts for scrutiny before wage tribunals, without any regard to the confidentiality of such information. Observing the need to strike a balance between improving the conditions of labour and providing adequate incentives for private investors, the committee urged immediate steps to 'remove the confusion and uncertainties in regard to labour legislation and Awards and to ensure that a rise in the rewards of labour does not run ahead of the increase in the productivity of labour'. Besides, authorities could not persist in their inquisitorial inquiries against banks without affecting the development of the banking sector. Finally, the committee also noted that the private sector itself was prey to several weaknesses. Entrepreneurs, it felt, could inspire greater confidence in the public by observing a proper code of conduct and eliminating unhealthy practices.

Recounting the steps already taken by the Bank to facilitate the flow of credit to the private sector and promote industrial finance corporations in the states, the committee recommended enabling commercial banks and other financial institutions to make larger investments in industry through suitable adjustments in the Bank's lending and rediscount practices. It felt commercial

banks should not make their medium- and long-term advances to industry conditional upon refinance being available from the Reserve Bank. They could provide indirect financial support to industrial concerns and finance corporations by subscribing to their shares and debentures and providing larger advances against such securities. Commercial banks could also extend assistance to the private sector by forming a consortium under the leadership of the Imperial Bank of India to underwrite and invest in new issues. The other recommendations relating to commercial banks concerned the appointment of an expert committee to examine ways of rationalizing wages and salaries in the banking sector, liberalizing facilities under the bill market scheme and providing medium-term finance too, through 'similar facilities', better remittance arrangements, recognition by the Bank of shares and debentures of the Industrial Finance Corporation and state financial corporations as eligible securities for granting advances, financial assistance to licensed scheduled banks opening branches under an approved expansion programme, and providing security to banks in smaller towns and rural areas. The committee was also in favour of examining the feasibility of introducing a deposit insurance scheme, taking punitive action against persons drawing cheques without sufficient funds in their accounts, and forming an all-India association of banks. It recommended linking indigenous moneylenders with the organized credit market, more liberal facilities from the Industrial Finance Corporation, setting up a special development corporation for financing small-scale industries under the aegis of the Reserve Bank, expeditious payment by the government of its bills to the private sector, improving collection of data relating to joint-stock companies, and establishing specialized institutions such as issue houses and investment or unit trusts.

There survive, in the Bank's files, internal notes and memoranda dealing with sixty-six recommendations of the Shroff Committee. Some of these were of little practical value, while several others were such that few could object to them. Therefore no purpose is served by recounting the Bank's response to every one of the committee's recommendations, and we focus here on a few major issues which the committee's report brought to the attention of the Reserve Bank.

The Shroff Committee reported in favour of greater commercial bank support for the longer-term credit needs of industry. This proposal was not altogether new. The Bank's Central Board had rejected a similar proposal in February 1948; Shroff had himself campaigned for it the following year; while the West Bengal committee on the state's Industrial Finance Corporation and the IMF Mission headed by Edward Bernstein advanced similar suggestions in 1951 and 1953, respectively. In each instance, the Bank took the view that the Indian

banking system responded 'adequately to the requirements of trade and industry consistent with the funds at its disposal', and that it was 'well ahead' of banking systems in other countries in this respect. Besides, given the nature of their liabilities, banks could not be expected to make long-term loans to industry. Apart from the risk arising from the relative illiquidity of such assets, as a Bank note reacting to inquiries from the West Bengal committee argued, it was not appropriate for banks to extend long-term loans since their position would then be that of partners who shared 'only the losses and not the profits'. 'If ... industry makes profits, the banks only get the interest'; should it suffer losses, banks could 'lose their principal as well as ... interest'.

Despite this history, the Bank decided to reject the Shroff Committee's proposal for medium-term bank lending to industry only after some internal debate. By 1954, moreover, the Bank had itself travelled some distance towards making medium-term credit available, for example, by rediscounting bills maturing within twelve months drawn to finance the production and marketing activities of small and cottage industries, making limited advances (not exceeding Rs 3 crores in the aggregate) for periods up to eighteen months to the Industrial Finance Corporation, and advancing loans aggregating to a maximum of Rs 5 crores for periods up to five years for agricultural purposes. Hence one view within the Bank, canvassed by the Department of Research and Statistics, was that a provision similar to the latter could be made for industry as well. However, in order to ensure that the Bank retained the flexibility of its monetary policy and its ability to contract credit adequately, this department argued for restricting aggregate medium-term advances to all sectors to a maximum of five years and to a total figure in the region of 5 per cent of the aggregate liabilities of the Banking Department. Besides, medium-term industrial refinancing should be confined to small plant extensions and renovations, and to a few major banks, with the Bank having pre-emptive rights over the assets of borrowing industrial firms going into liquidation.

Such views encountered stiff opposition elsewhere. The Department of Banking Operations drew attention to the apparent abundance of medium- and long-term finance and the poor demand for it. It pointed out that industrial financial corporations, for example, had failed to use up their resources which were invested in government securities or kept as deposits with banks. Under these conditions, it was

undesirable to encourage commercial banks in India, which have yet to consolidate their wartime expansion, to finance industry on a larger scale than at present, particularly as (their) ... proportion of advances ... to ... total deposits is already on the high side

Inspections had also shown that the quality of many commercial banks' advances was not 'first class'. Besides, many loans which were put down in the books as demand loans were carried over indefinitely 'without substantial reduction', and were 'in practice ... more or less long-term advances'. 'Any further encouragement to banks to reduce the liquidity of their advances should, therefore, be deprecated', the department remarked, and concluded by suggesting that the Bank should allow the new and proposed industrial term-lending institutions to function for some length of time before exploring whether commercial banks could do anything to supplement the availability of longer-term finance for industry. In the meantime, according to another departmental note, banks could extend support to industries by purchasing shares, debentures, and bonds of industrial finance corporations, and through investment trusts 'which may be floated on a larger scale ... by honest and competent industrialists'. Similar views were expressed by the Deputy Governor, Ram Nath, so that the Bank decided to discuss the whole issue in some detail with the bigger banks before taking a final view on it. However, as the later developments surveyed in these pages show, the Bank's attitude towards meeting the longer-term financial requirements of industry grew progressively more liberal over the years.

The Shroff Committee's proposal for unit or investment trusts too evoked a tepid response in the beginning. Such institutions could not be expected to provide risk capital to entrepreneurs. More inexplicably, the Bank felt they could not be of much help to investors lacking knowledge of the investment market. On the other hand, there was little the Bank could do here: there was no suggestion yet that it (or the government) should promote such trusts, and initiative in the matter belonged properly to agents in the private sector. The idea of a special development corporation for small-scale industries did not evoke much support either, since it would merely duplicate the functions of financial corporations coming up in the states. The opposition of the Rural Credit Survey, which submitted its recommendations a few months after the Shroff Committee, helped bury the latter's proposal to allow indigenous moneylenders access to the resources of the commercial banking system. More generally too, the Rural Credit Survey's scheme to expand the reach of the banking system by transferring the Imperial Bank of India and the state-associated banks to public ownership superseded the Shroff Committee's more modest proposals in this respect. Finally, while the Shroff Committee adverted to the advantages of insuring bank deposits, the factors leading to the institution of deposit insurance in 1962 have already been discussed at some length in chapter 12.

The Central Board considered the Shroff Committee's recommendations at a meeting in Bangalore in June 1954. Of the numerous recommendations made by the committee, three were taken up for immediate implementation. In July 1954, the Bank went further than the Shroff Committee's recommendations to extend the bill market scheme to all licensed scheduled banks, and to reduce the minimum amount prescribed for individual advances from Rs 25 lakhs to Rs 10 lakhs and for individual bills from Rs one lakh to Rs 50,000. The minimum amount of individual advances was further lowered to Rs 5 lakhs in February 1957. The Board turned down the Shroff Committee's recommendation for abolishing statutory restrictions on the holdings of shares in the Industrial Finance Corporation and the state financial corporations since it would 'defeat the objects ... which the Government and Parliament had in view in organizing these institutions'. Apart from the possible consequences of control over these institutions passing into the hands of bodies of private shareholders, the Bank apprehended at the time that privately owned financial corporations risked losing access to World Bank (IBRD) loans since the latter required the guarantee of the government. However, in June 1954 the Bank decided to accept the Shroff Committee's recommendation to treat the shares of the Industrial Finance Corporation and state financial corporations on par with government securities for making advances to scheduled banks under the Reserve Bank of India Act. It was not clear how the private sector was likely to benefit from this step, but the Bank felt it was justified by the wider consideration of encouraging commercial banks to invest in the stocks of state financial corporations. From November 1955, the Bank and the State Bank of India, which had come into existence in the meantime, also began implementing the Shroff Committee's suggestion for more liberal remittance arrangements. In actual fact, remittance facilities extended in subsequent years to scheduled and cooperative banks went far beyond the recommendations of the Shroff Committee in this respect.

The Shroff Committee's recommendation favouring the creation of a consortium of banks and insurance companies under the leadership of the Imperial Bank of India to underwrite or invest in new issues of shares and debentures of industrial companies was based on a suggestion made originally by the Indian Central Banking Enquiry Committee. Two of the three major Indian banks consulted by Rama Rau supported the recommendation. With consultations necessary with insurance companies as well, the Central Board decided to set up a committee comprising the Managing Directors of three Indian banks and the two principal insurance companies to prepare for its consideration, 'a detailed scheme for the creation of a consortium or syndicate'. This committee, chaired by S.K. Handoo, Managing Director of the Imperial

Bank of India, was set up in July 1954 and submitted its report three months later. The report recounted the problems which a consortium of the type proposed was likely to face. These included the inexperience of banks and other institutions in India in meeting the longer-term financing needs of industry and their lack of expertise in assessing industrial projects and issue prospects, the damage that might be caused to a bank's image should any of the issues it underwrote evoke an inadequate response in the market, the generally speculative nature of the share market, and legal restrictions on the participation of insurance companies. Hence, while the idea of establishing a consortium was 'a step in the right direction', it should be undertaken with caution. The Handoo Committee therefore proposed a consortium in the form of a voluntary association, rather than as a company under the Indian Companies Act, of eight to ten leading banks and insurance companies under the leadership of the Imperial Bank of India. Individual members of this consortium would be free to decide whether or not to underwrite or invest in a particular issue, and no restrictions were intended to be placed on the sale of issues underwritten or purchased by any member of the consortium. To begin with, the proposed consortium would deal in new issues of debentures, and consider the question of dealing in shares after it had been in existence for a year. Finally, the committee recommended certain amendments to the Imperial Bank of India Act and the Insurance Act which it felt were necessary to get the consortium off the ground.

The consortium proposal made little headway thereafter. Although C.D. Deshmukh was initially supportive of the idea, he changed his mind after the Imperial Bank of India was nationalized and moves were initiated to bring the life insurance sector under public ownership. Besides, as he noted in a minute written in December 1955, the 'general economic climate' was turning 'more favourable for investment in the private sector'. Therefore, according to the Finance Minister, a consortium was neither 'necessary nor feasible' and banks could 'go forward if they like[d] without life insurance funds'. The Finance Ministry appears, in addition, to have been of the view that the involvement of life insurance companies in the proposed consortium would disproportionately benefit 'big business' within the insurance sector, since only the larger companies had the resources to undertake underwriting work to the satisfaction of the Controller of Insurance. Within the Bank, opinion was divided, the Department of Research and Statistics seeing little substance in the Finance Ministry's argument against the consortium. Nevertheless, the Bank's general view, at any rate in 1955-56, was that a 'strong presumption' existed within the government and elsewhere 'against a departure ... from ... conservative tradition[s]', and that this militated

against insurance companies joining the proposed consortium. As for the involvement of commercial banks, the Department of Banking Operations successfully poured cold water on the idea by highlighting the mismatch that might arise between the structures of their assets and liabilities and suggesting that banks' role in underwriting work could wait until institutions better suited to carrying it out, such as the ICICI and the industrial finance corporations, began to run short of resources. The emergence of the State Bank of India under a statute which authorized it to invest in the debentures of limited companies also blunted somewhat the sense of urgency behind the consortium idea.

THE REFINANCE CORPORATION FOR INDUSTRY

The Shroff Committee, it will be recalled, had recommended that the Bank should undertake to refinance term loans advanced to industry by commercial banks. Initially, the Bank was not keen to lock up its resources in the form of block capital loans to industry, whether these were advanced through term-lending institutions or by commercial banks. The Bank also sympathized with the reluctance of banks to add medium-term industrial loans to their portfolios. 'Investment of short-term funds in long-term commitments' was not likely, in its view, to foster public confidence in the banking system, and efforts to meet the long-term capital needs of industry were 'more properly ... devoted to aiding the recovery of the capital market'. Disposed to see a *modest* role for itself in the latter regard, the Bank nevertheless maintained a close interest in the activities and needs of industrial term-lending institutions. As discussed below, the Bank also played midwife in the birth of the Industrial Credit and Investment Corporation of India.

The Reserve Bank's initial reluctance to commit medium-term funds to industry gave way gradually under the force of circumstances. An opportunity to reconsider its earlier stand on medium-term lending by banks, as also to lend coherence and a sense of direction to a policy marked in recent years by improvisation more than deliberation, came the Bank's way following an agreement concluded between the Indian and US governments under P.L.480 (Public Law 480) in August 1956. The agreement, which provided for the supply of surplus American agricultural produce valued at Rs 172 crores to India over a three-year period, envisaged earmarking Rs 111 crores from these proceeds for financing development expenditures in India. Of this, Rs 26 crores were to be lent to private enterprise through established banking channels. Inevitably, the Bank was called upon to play a major role in determining the use of these resources.

The prospect of utilizing P.L.480 resources for industrial development was, of course, an attractive one. But the Bank's decision to assist medium-term lending by commercial banks to industry despite the well-advertised dangers of such a practice stemmed also from its changing recognition of the role that 'multi-purpose' banking institutions were capable of playing in India. The State Bank of India was already being equipped to function as an 'instrument of national policy' even though this involved modifying conventional banking principles. There was, in the Bank's still evolving view, no reason why other commercial banks too should not be encouraged to follow the State Bank for some distance of its way, so long as modifications to these principles were undertaken with suitable caution and an understanding of the risks involved. As an article by B.K. Madan in the June 1957 *Bulletin* of the Bank noted, a multi-purpose banking structure could contribute usefully to development if adequate safeguards existed to prevent banks' liquidity from being impaired. Citing recent developments in banking practices in Europe and elsewhere, Madan advocated a measured policy stance based on examining how far these developments could be adapted to the Indian context through 'cautious modification, rather than thoughtless abandonment' of 'conservative ... banking practices'.

Cautious as the Bank was in giving expression to such views, they nevertheless marked an important departure from the position it had adopted in the immediate aftermath of the Shroff Committee. Several events had occurred during this interval to give shape to the Bank's new line of thinking. The conditions in the Indian capital market ruled out term-lending institutions such as the Industrial Finance Corporation and state financial corporations raising large sums of money through public issues for some more time without assistance from the Bank, commercial banks, and insurance companies. The decision, taken in the early fifties, to advance interim loans to the Industrial Finance Corporation against its own bonds and debentures inevitably ended up deepening the Bank's interest in that institution's ability to raise longer-term resources. It was a short step from here to taking a wider interest in the longer-term resource needs of term-lending institutions; particularly since, as discussed in the next chapter, state financial corporations too soon appealed to the Bank to help them raise resources from the market. Gradually a stage came when the Bank began to encourage commercial banks (and insurance companies) to invest in the long-term paper offered by these term-lending institutions. Although these assets were guaranteed by the Government of India and the respective state governments, it was becoming apparent that traditional banking practices were coming under some strain in the face of necessity. When the American proposals for using a part of the P.L.480

resources for industrial development came up, therefore, the Bank had already resiled considerably from its earlier opposition to involving the banking system in medium- or long-term lending to industry.

The Bank considered various means of routing the American loan. The Americans themselves preferred the Bank to hold these funds and oversee their distribution through selected scheduled banks. In their view, advances under the scheme should not be made 'on the basis of cold calculations' of assets 'by a faraway central agency', but by local branches of banks having 'personal knowledge about the integrity and reliability of the borrowers'. Loans made in this way, American officials felt, would also be more visible and transparent to the American tax-paying public and their representatives in Congress. The Bank was not enthusiastic about these proposals. It pointed out to the American aid delegation that few commercial banks allowed their local offices to advance large loans. Besides, 'most ... banks were linked ... with ... business houses', and the additional resources placed in their hands were unlikely to be 'distributed fairly or widely' if banks were 'left entirely to themselves'. Industrial finance corporations, on the other hand, would be able to achieve a wider dispersal of P.L.480 funds, particularly if they could be used to support lending to small industries. Making a case for including small-scale industries in the proposal, the Deputy Governor, B. Venkatappiah, also counselled that whatever the scheme adopted to channel P.L.480 funds, it should help foster, rather than undermine, existing initiatives and programmes of term-lending institutions and promote the accepted 'pattern of banking development' in India. The Bank also held to the view that the organization chosen or created to distribute P.L.480 resources should have the freedom to handle funds from other sources as well and be able to survive independently even after the American funds were exhausted.

Not long after these proposals were first mooted towards the end of 1956, another Deputy Governor, K.G. Ambegaokar, held a conference with bankers to discuss them. The bankers did not believe there was any danger of the additional resources being monopolized by a few interests, particularly since the amounts involved were relatively small and no bank was likely to get more than Rs 3 crores under the scheme. After this meeting, Ambegaokar too was inclined to follow the bankers in taking a 'less alarmist' view of their ability for 'mischief' in the distribution of the P.L.480 funds. But the view prevailed that the latter should be channelized through a central agency rather than directly to the banks or through the Reserve Bank. The Bank felt none of the existing agencies, namely the Industrial Finance Corporation, the National Industrial Development Corporation, the Industrial Credit and Investment Corporation of India, the National Small Industries Development Corporation,

and the state financial corporations, were suited to undertaking the additional responsibility. These institutions were set up for specific purposes and were bound by their constitutions. Besides, the functioning of the Industrial Finance Corporation had come under close scrutiny and attack in Parliament and elsewhere, and prospective borrowers hesitated to approach it for fear of adverse publicity. Many of these corporations, including the private sector Industrial Credit and Investment Corporation, also had surplus funds at this time in the form of deposits with banks or as investments in government securities and little purpose would be served by adding further to their resources.

Therefore, in the Bank's view, the balance of advantage lay with 'having an altogether new agency' to advance funds made available under the aid agreement with the United States government. It was originally proposed to set up a refinancing corporation, as a public limited company under the Companies Act. After further reflection, the Bank decided to set up the new entity as a private company (since this arrangement provided greater flexibility) jointly with the Life Insurance Corporation, the State Bank of India, and fourteen other major scheduled banks selected on the basis of their deposits.² Explaining the Bank's justification for this shortlist of participating banks, the Governor, H.V.R. Iengar, pointed out that these banks were being asked to undertake a 'novel' activity which was 'contrary to traditional conceptions of banking in our country'.

If there was any risk of loss—and in prudence we must always provide for such a risk—I was anxious that it should fall on the bigger banks who would find the incidence of the loss to be of small proportions rather than the smaller banks on whom the burden might be serious.

While the selected Indian banks readily agreed to participate in the proposed corporation, the four foreign banks were torn between their reluctance to foster the new company and a desire to maintain 'friendly relations' with the Bank and the Government of India. They also wanted to avoid appearing to be 'dragging their feet'. With the Americans finally coming round to the

² The fourteen banks were the Central Bank of India, Punjab National Bank, Bank of India, Bank of Baroda, National Bank of India, United Commercial Bank, Lloyds Bank, Allahabad Bank, Chartered Bank, Indian Bank, United Bank of India, Mercantile Bank, Devkaran Nanjee Banking Company, and State Bank of Hyderabad. The fifteen banks together accounted for nearly 80 per cent of the total advances of all licensed scheduled banks and 91 per cent of their industrial advances.

Bank's proposals for a new refinancing agency to channel P.L.480 resources, the foreign banks also fell in line. Their inclusion caused 'some rumbling of discontent' in Indian banking circles, but the Bank maintained that these institutions were not included in the scheme as exchange banks but on the strength of their deposits in India, and that it was bound by the government's policy of not discriminating between foreign concerns established in India and locally-owned enterprises.

According to the final proposals, the Refinance Corporation for Industry was to be set up as a private limited company with an authorized share capital of Rs 25 crores. The issued share capital of Rs 12.5 crores was to be distributed principally between the Bank (Rs 5 crores), and the State Bank of India and the Life Insurance Corporation (Rs 2.5 crores each). The remaining capital, of Rs 2.5 crores, was to be allotted to the fourteen other participating banks, their individual contributions ranging from Rs 10 lakhs to Rs 25 lakhs. The corporation's Board of Directors was to consist of seven members, with the Governor of the Reserve Bank as its Chairman, and one of the Deputy Governors, the Chairmen of the State Bank of India and Life Insurance Corporation, and three representatives of member banks as directors. Each of the participating banks was to be allocated a quota from the corporation's total funds of Rs 38.5 crores, comprising the issued capital of Rs 12.5 crores and a long-term loan of Rs 26 crores from the American counterpart funds of the Government of India. The State Bank's quota was fixed at Rs 5 crores, while the quotas of the other banks varied between Rs one crore and Rs 3 crores. Loans given by member banks to medium-sized industrial concerns for amounts not exceeding Rs 50 lakhs and for periods ranging from three to seven years were eligible for refinance within the quota specified for each bank. These loans were to be made for the purpose of increasing production, primarily to industries included in five-year plans. In order to ensure that medium-sized firms benefited from the lending facility, a ceiling of Rs 2.5 crores was stipulated for the paid-up capital and reserves of borrowing concerns. Lending banks were to assume the full credit risk on loans submitted to the corporation which was not expected ordinarily to concern itself with details such as the creditworthiness of borrowers or the adequacy of their collateral. Member banks were to be allowed a maximum spread of 1.5 per cent between their borrowing and lending rates.

The Committee of the Bank's Central Board approved these proposals in May 1957. The new corporation necessitated a few amendments to the Reserve Bank of India Act to enable the Bank to subscribe to its share capital and grant short-term advances of up to ninety days to institutions specified by the government. These amendments too, were shortly approved by the Committee

of the Central Board. Amendments were also considered necessary to the State Bank of India Act to enable the State Bank to extend term loans for periods exceeding six months. The two bills were taken up for consideration towards the end of May 1957, and passed by Parliament the same month. With this, the decks were cleared for the Bank to participate in the new institution.

The founding of the corporation had however to await the resolution of some uncertainties pertaining to the audit of P.L.480 funds, and it was not until June 1958 that the Refinance Corporation for Industry was registered as a private limited company. The corporation began operations in an office within the Bank's premises in Bombay, with T.K. Ramasubramaniam, Chief Officer, Industrial Finance Department, as its first General Manager. The corporation became a public limited company in March 1961 following an amendment to the Companies Act which automatically converted into public companies all private companies in which a quarter or more of the paid-up capital was held by corporate bodies.

The corporation's early performance fell below expectations. In the first two years, i.e. until May 1960, it managed to draw only Rs 5 crores from P.L. 480 funds, having sanctioned twenty-one loan applications for a sum of Rs 4.26 crores to five member banks. The Bank's review of its operations revealed that they were hampered by inflexibility. Hence it canvassed several proposals intended to enhance the operational flexibility of the Refinance Corporation. These included extending refinancing facilities to a larger number of banks without requiring them to become shareholders of the corporation, removing bank-wise refinance quotas, allowing the corporation discretion to determine which industries were eligible for refinance, dispensing with the limit on the maximum paid-up capital and reserves of borrowing concerns, raising the loan ceiling from Rs 50 lakhs to Rs one crore, and allowing banks freedom to set lending rates. These suggestions were discussed at meetings between representatives of the American Technical Cooperation Mission, the Government of India, and the Bank in January 1960. Though the Americans accepted most of these proposals, they did not favour raising either the ceiling on loans to individual borrowers or that on the latter's paid-up capital and reserves. The mission also suggested that the corporation should reduce the rate of interest on its loans from 5 per cent to a minimum of half a per cent above the Bank rate, refinance loans made to small-scale industries—a reform the Reserve Bank had favoured even in 1957—and extend its facilities to state financial corporations and apex cooperative banks.

Following these discussions, the corporation liberalized its refinance facilities in October 1960. Despite opinion within the Bank being sceptical

about the uses of the proposed reform, refinance facilities offered by the corporation were now extended to forty-three more banks and fifteen state financial corporations without requiring any of them to become its shareholders. The extension of refinancing facilities to state cooperative banks had engaged the Bank's attention since 1957 when R.G. Saraiya, Chairman of the Bombay State Cooperative Bank first raised the subject. Saraiya's view, that state cooperative banks should be included in the scheme since they lent substantial amounts to meet the longer-term needs of food-processing industries such as sugar, also had the support of the Bombay government. The Bank was not disposed to modify the scheme at the time, particularly as resources available under the Indo-American aid agreement were limited and state cooperative banks were already being financed or refinanced by the government or by other state-sponsored financial institutions. Besides, the Bank was uncertain whether cooperatives formed a distinct sector or were part of the private sector, some government documents such as those of the second plan, for instance, appearing to support the former interpretation. Clarification from the government that cooperatives indeed formed part of the private sector came almost at the same time as recognition dawned on the Bank that the 'outgo of funds' from the Refinance Corporation was 'extremely slow', and in March 1959 officials at the Bank toyed with the idea of allotting a quota of Rs 2 crores to all state cooperative banks and state financial corporations without making any of them members of the corporation. But citing the 'special position and needs of the cooperative movement', the Board of the Refinance Corporation opposed proposals to include apex banks in its refinancing scheme. The corporation appears subsequently to have been encouraged by the changed context to modify its views, since the state cooperative banks of Maharashtra, Madras, and Andhra Pradesh were admitted to its refinance facilities in October 1960. More state cooperative banks were added to the list later.

As part of the effort to promote the activities of the Refinance Corporation, it was also decided to widen the list of eligible industries and refinance loans to small-scale industries covered by the Credit Guarantee Scheme.³ The maximum period of loans eligible for refinancing was increased to ten years, and the assets ceiling of Rs 2.5 crores allowed to be relaxed in deserving cases. Bank-wise quotas were also removed and the rate of interest was left to be determined by the lending institution.

These initiatives were complemented by efforts to diversify the range of the corporation's refinancing activities. From 1961, it arranged to provide

³ For details of the Credit Guarantee Scheme, see chapter 14.

foreign currency loans through the ICICI, the Commonwealth Development Finance Company, and the International Finance Corporation to industrial concerns obtaining rupee finance from its constituents. Refinance facilities were further liberalized in 1961–62 by extending them to cover long-term loans made jointly by two or more banks or term-lending institutions, the medium-term part of such loans being defined as comprising instalments payable within seven to ten years, and to private sector coal-mining units receiving assistance from the World Bank. Following suitable modifications to the agreements on the basis of which it was founded, the Refinance Corporation introduced a scheme in January 1963 to refinance medium-term export credits extended by banks for periods from six months to five years at a concessional rate of 4.5 per cent on the condition that the financing bank did not charge more than 6 per cent from the borrowing firm. The interest charged on other exports and industrial loans remained at 5 and 5.5 per cent respectively. To assist small exporters shipping orders in several consignments, the corporation also agreed to refinance individual export credits of less than Rs one lakh each, provided the 'relative export contract' was for at least that amount.

The liberalization and diversification measures of 1960–61 appear to have succeeded in achieving the intended object of stepping up the pace of the corporation's activities. Applications it received for refinancing increased steeply from twenty-five (for Rs 4.6 crores) in 1960 to sixty-nine (Rs 11.27 crores) in 1961, eighty-eight (Rs 13.77 crores) in 1962, and 221 (Rs 29.96 crores) in 1963. Applications sanctioned also climbed from fourteen (Rs 1.75 crores) to fifty-nine (Rs 10.71 crores), seventy-three (Rs 10.63 crores), and 171 (Rs 24.09 crores) during the same years.

With the setting up of the Industrial Development Bank of India (IDBI) in July 1964, the Refinance Corporation had little reason to exist as a separate entity. The IDBI Act provided for taking over the business of the Refinance Corporation, and with the concurrence of the American authorities, the latter undertaking was transferred to the new institution in September the same year. The IDBI paid the Refinance Corporation Rs 2.5 crores (this equalled its paid-up capital) as compensation for distribution to shareholders in proportion to their contributions to its paid-up capital. The Refinance Corporation for Industry was dissolved on 26 July 1965.

Since its inception in June 1958, up to the end of August 1964, the corporation received in all 577 applications for Rs 88.15 crores under its refinance schemes. Of these, the corporation rejected twenty-four applications for Rs 4.49 crores. Refinance disbursed totalled Rs 42.25 crores, or nearly two-thirds of the amount sanctioned. The total refinance outstanding at the

end of this period amounted to Rs 36.72 crores. Apart from the initial allocation of Rs 26 crores out of P.L.480 *counterpart funds*, the corporation also received Rs 10 crores from the Government of India on an ad hoc basis pending an agreement with the US government for another line of P.L.480 credit. Although state financial corporations and state cooperative banks too received accommodation from the corporation after 1960, the overwhelming proportion (about four-fifths) of the refinance it made available went to commercial banks. Besides testifying to their success, the sharp increase in the 'outgo of funds' from the corporation after the liberalization and diversification measures of 1960-61 signified the *accelerated tempo* of private investment activity in industry and helped illustrate the latent demand within the country for an expanded industrial financing agency. The Industrial Development Bank of India was designed to meet this demand.

THE INDUSTRIAL DEVELOPMENT BANK OF INDIA

The idea of an industrial development bank is almost as old as the history of planned development in India. Two competing proposals were advanced in the early fifties. The first came in August 1953 from T.T. Krishnamachari, then Minister for Commerce and Industry in the Government of India, while the other proposal was advanced a few weeks later chiefly at the initiative of the American administration and the President of the World Bank, Eugene R. Black.

Krishnamachari's proposal was a relatively unusual one. He advocated extending the government's efforts to promote industrial development beyond establishing a 'few odd enterprises' and helping private enterprise 'in conventional ways ... to somehow do whatever else is needed'. Financial assistance to private enterprise might suffice in situations where entrepreneurs had already finalized their projects and were only attempting to raise the necessary resources. But where entrepreneurs were shy, Krishnamachari stressed, the State would have to take the initiative to set up industries, jointly if necessary, with private investors. But the 'ordinary machinery' of the government being unsuited to entrepreneurial tasks of this nature, TTK proposed an industrial development corporation comprising government nominees, scientists and engineers, and industrialists of 'proven reputation'. This corporation would have a wide brief: plan and initiate projects, coordinate investments, provide technical and managerial expertise, and help raise resources for undertaking these investments. Commending his proposal as the only way out of the 'present paradox of shortage of internal resources while we are adding to our idle assets abroad', Krishnamachari insisted that the

assets created by this corporation should, in due course, be sold to the private sector. Maintaining that it was necessary to look beyond 'traditional investors' who were both 'shy and dry', he argued in a follow-up note that his plan would attract the support of those who lacked 'faith in paper prospectus' and were unaccustomed to investing in shares, but who may be 'prepared to put their money in a going concern'. Apart from helping to widen the pool of private savings available for industrial investment, regular sales by the corporation of its assets would also help mop up the 'inflationary forces' generated by public investment and keep deficit financing in check. Since a statutory corporation would take time to establish, Krishnamachari proposed that the industrial development corporation should first be set up as a company under the Companies Act and converted in course of time to a statutory corporation.

Though it felt the proposal should properly be examined by the Shroff Committee, the Bank, when consulted by the Finance Ministry, was quite supportive of the idea of the government assuming an 'entrepreneurial role' through the proposed corporation and 'endeavouring to make good the deficiencies of private enterprise' But it felt the corporation's role would be a 'modest one until the resources available to it can be increased through an expansion of private savings'. It could not depend on banks to finance its activities since the Indian banking system already had as high a ratio of advances to deposits as was consistent with 'any assurance of safety'. Nor could the Bank provide long-term finance to the corporation through the banking system without hampering the flexibility of its monetary policy and assisting 'inflationary creation of credit'. Turning the proposal on its head, the Bank stressed that the corporation would be useful in 'promoting development where the obstacle ... is not so much the lack of material resources as the psychological inertia of the private sector'.

Even as the Government of India was engaged in considering this proposal, in October 1953 Eugene Black at the World Bank mooted the idea of setting up a privately owned and externally assisted industrial development banking institution in India. The precise antecedents of this proposal are not altogether clear. At a dinner meeting in Washington earlier the same year, the Governor, B. Rama Rau, aired the idea of setting up in India an institution modelled somewhat along the lines of the Commonwealth Development Finance Company in the United Kingdom. The audience included George Woods of the First Boston Corporation who, according to Rama Rau, was 'rather attracted by the idea'. At the same time or shortly thereafter, the US administration came up with the idea of using the counterpart rupee funds of a \$15 million steel loan to set up a development bank in India with assistance from the

World Bank. The proposal appears to have undergone extensive modifications at the World Bank where opinion favoured an institution owned very largely by private Indian investors (with some proportion of the equity held by overseas investors), and which would open a line of credit with the World Bank and confine its assistance to the private sector of Indian industry. It was in this form that the proposal was presented to the Government of India, and Black who, in B.K. Nehru's words, was 'most surreptitiously enthusiastic about the scheme', quickly followed it up by despatching a delegation comprising George Woods, Robert Craft (American Securities Corporation), and Joseph Rucinski (World Bank) to India at the end of January 1954.

As K.G. Ambegaokar, Secretary in the Finance Ministry, confided to the Governor, the Black proposals were based on what would go down best with the US Congress when it discussed American aid to India. The official Indian opinion on them remained divided. B.K. Nehru, who was in Washington at this time, was its most enthusiastic advocate, while Krishnamachari felt it would be difficult in Delhi's prevailing climate to adopt an idea based on American aid 'primarily and secondarily on aid from the IBRD which, though an international institution, has its policies tuned to the prevailing opinion' in the United States. Nor was he convinced that the Indian private sector was in a 'mood to invest ... money in a bank of this nature'. Although the Black proposals may have originated with him, Rama Rau's initial reaction to them was that ad hoc initiatives such as these ran the risk of preventing a unified view being taken of the needs of the private sector and of the means to mobilize private resources for investment. The Governor had good reason to be concerned, since the Black and Krishnamachari proposals threatened between them to dig up the landscape the Bank had entrusted to the Shroff Committee to survey. Misgivings were also expressed at the official level about the relative roles of this bank, the industrial development corporation proposed by T.T. Krishnamachari and approved in principle by the Cabinet, and the Industrial Finance Corporation. In particular, some officials apprehended that a soft loan to the proposed bank from the government may have the effect of diverting available private capital to 'productive industries in which the private sector is ordinarily interested', leaving the industrial development corporation to 'take over all the unproductive' or 'lame-duck' enterprises. However, a committee comprising Ram Nath and Secretaries to the economic departments of the Government of India which considered the proposal agreed generally that there was enough room for all three institutions to exist side by side, with the development corporation initiating and taking up new industries, the private bank assisting industrialists in their schemes, and the Industrial Finance Corporation financing existing industry.

Black's envoys stopped at London on their way to India. It had earlier been expected that the Commonwealth Development Finance Company (CDFC), a privately owned but State-assisted undertaking in the United Kingdom, would pick up part of the equity of the proposed development bank and thus help stimulate investor interest on Wall Street. But the Black proposals received a cool reception in London. Officials there were wary of an arrangement in which the CDFC undertook the risks of equity ownership while the World Bank made guaranteed loans to the development bank. Apart from some nervousness about the consequences for the sterling area balance of payments of higher levels of investment in India, London appears also to have been somewhat protective of its special position in India. These reservations were tempered to some extent by the view that refusal to assist the project might be construed in Washington and elsewhere as proof that Britain preferred to confine its development assistance to countries that were part of the empire. But officials in London steadfastly refused to commit themselves to the project. Krishnamachari was not alone in supposing that the Indian private sector would not subscribe much capital to the project. Opinions in London, which held that Indian businessmen were incapable of cooperating with one another in the public interest, and those of Indian officials such as B.K. Nehru in Washington, also ran along similar lines, so that when the World Bank team arrived in India after having failed to set the Thames on fire, a major unspoken question mark hung over the project for a development bank.

In the event, the delegation's visit to India was an unqualified success. The Government of India was quick to accept the principle of a privately owned institution to finance private sector investment. Differences persisted over the terms on which it would lend the counterpart rupee funds (\$15 million or Rs 7.5 crores) to a private company and over the World Bank's insistence that the chief executive of the proposed institution should be a foreigner capable of establishing its independence from contending business groups in India and facilitating the technical assistance that the international institution hoped to provide to it. But these differences were not allowed to hold up progress which was rapid. Following discussions with the government, it was agreed to set up an investment corporation (the idea of a 'bank' having earlier been abandoned since the term had a restrictive meaning under the Banking Companies Act) to stimulate the creation of new industries and expansion and modernization of existing ones, and promote the participation of private capital, both domestic and foreign, in Indian industries. In order to attain these objectives, it was intended that the corporation would provide capital assistance either in the form of loans or equity, and provide managerial and technical support. The subscribed capital of the corporation was to be of the order of

Rs 5 crores (\$10 million), the majority of which would be Indian. The World Bank agreed to make a long-term foreign exchange loan to the corporation of a similar amount, while the Government of India agreed to lend to the new entity counterpart funds of Rs 7.5 crores (\$15 million). The latter carried no interest, and repayments on the loan were not to begin until fifteen years had passed. The corporation was thus expected to start operations with total resources of Rs 17.5 crores. *Largely at the Bank's instance and in consultation* with Indian business interests, a steering committee with Ramaswami Mudaliar as chairman, and G.D. Birla, Biren Mookerjee, A.D. Shroff, and Kasturbhai Lalbhai as members was formed to help the project get off the ground and propose the initial composition of the corporation's Board of Directors.

The institution, finally christened the Industrial Credit and Investment Corporation of India Ltd., came into existence in January 1955, barely sixteen months after the first proposals for the institution were put forward. P.S. Beale, a former Secretary of the Bank, was appointed its first *General Manager*. The issued capital of Rs 5 crores was taken up by Indian banks and insurance companies, directors of the corporation and their associates (Rs 2 crores), British exchange banks and UK and other commonwealth insurance companies (Rs one crore), and American nationals and corporations (Rs 50 lakhs). Shares aggregating Rs 1.5 crores were offered to the Indian public in February 1955. The issue was oversubscribed.

T.T. Krishnamachari's proposal for an industrial development corporation, too, became a reality in October 1954 with the formation of the National Industrial Development Corporation as a *private limited company* with an authorized capital of Rs one crore, and a paid-up capital of Rs 10 lakhs provided entirely by the Government of India. The NIDC was authorized to issue shares and debentures, and to provide finance to industries related to planned development, in particular those manufacturing capital goods, machinery, and equipment. As well as taking up plans to study industrial schemes and manufacturing possibilities, the NIDC, it was expected, would also set up *greenfield projects involving ancillary linkages with the private sector*.

THE BANK'S SCHEME FOR A DEVELOPMENT BANK

If the institutional developments of the 1950s arrested some of the momentum towards setting up a fully-fledged development banking institution in India, the success of the Refinance Corporation for Industry in the early 1960s drew attention to the latent demand for long-term funds to finance industrial investment. Krishnamachari had mooted the idea of an industrial development bank to the Governor, H.V.R. Iengar, and others in 1956–57, and he resumed

his close interest in the subject early in his second stint as Finance Minister. He apparently felt the Industrial Finance Corporation of India (IFCI) was hampered in its operations because of being government-owned, and that a new development bank owned by the Reserve Bank, and thus free from political pressures, should be set up. According to some accounts, he brought up this subject almost without warning during a meeting with the Governor, P.C. Bhattacharyya, and after some discussions the latter communicated to the Finance Minister the general outline of the proposed development bank towards the middle of November 1963.

According to the Governor, the 'general conception of the new institution' was that it should be able to take a 'coordinated view of the problem of industrial finance in all its aspects in the context of planned industrial development'. Existing institutions financing industry were short of resources and were finding it difficult to raise resources on their own. Increasingly, therefore, they required access to the government or 'some central financing or refinancing institution'. The new institution, the Governor argued, should be able to provide additional finance through 'commercial banks and ... existing long-term lending agencies on a coordinated basis', after taking account of plan priorities and the relative needs of small-, medium-, and large-scale industries for medium- and long-term loans. The government, for its part, should discontinue its practice of lending to term-lending institutions except through this apex development bank.

In addition to refinancing, the proposed institution was expected directly to finance investments in strategic sectors that were beyond the abilities of 'normal lending institutions'. It would also undertake a 'positive promotional role' by commissioning research and techno-economic surveys to evaluate investment prospects in relation to plan programmes, and thereby stimulate investment and entrepreneurship in new lines of activity. It would engage a central pool of technical consultants to service term-lending institutions, particularly state financial corporations, which might not otherwise be in a position to engage such specialist advisers.

The Governor proposed that the new bank should have an authorized share capital of Rs 50 crores and a paid-up capital of Rs 5 crores distributed to existing shareholders of the Refinance Corporation and other financial institutions such as state financial corporations, the Industrial Finance Corporation, and the ICICI. The Bank, he suggested, could contribute any unsubscribed part of the capital offered to these institutions and the balance of the increased capital.

Bhattacharyya envisaged five sources of finance for the new bank. Funds under the P.L.480 programme would be routed through this

institution. Secondly, the government was to make an initial interest-free loan of Rs 10 crores to the development bank along the lines of that given to the ICICI. In addition, it would place new funds intended as special assistance for priority projects in a Development Assistance Fund which the development bank would administer as an agent of the government. For its part, the Bank might set up out of its profits a National Industrial Credit (Long-term Operations) Fund from which advances could be made to the development bank for long-term lending and to acquire shares and debentures of both industrial borrowers and long-term lending agencies. The Reserve Bank, the Governor proposed in a significant departure from past policy, should also rediscount eligible paper based on the development bank's loans to direct lending institutions for periods up to five years. Remarking that the Bank had not felt compelled to extend this step to the Refinance Corporation since it had access to other resources, the Governor pointed out that other central banks too had taken 'quite unorthodox initiatives in the field of industrial finance, and this departure from orthodox central banking canons is clearly justifiable in our conditions'. Finally, the development bank could raise funds of its own in the market with or without government guarantee.

The management of the new institution, the Governor suggested, should be integrated at the top with the structure of the Bank to ensure better policy coordination. To this end, he proposed that the Bank Act should be amended to provide for an additional Deputy Governor who would be the ex-officio Chairman of the development bank. Finally, although there was something to be said for calling the new institution the Development Corporation for Industry owing to the indirect character of its lending, the Governor said he preferred calling it the Industrial Development Bank of India to highlight its close association with the Reserve Bank. The Industrial Development Bank of India, the Governor stressed, would 'indeed be the reserve or apex bank of industry'.

The next steps were taken with the utmost despatch. The government's intention to establish the Industrial Development Bank of India was signalled in the *Economic Survey* for 1963-64, while the Finance Minister's budget speech for 1964-65 included a proposal to introduce the necessary legislation for bringing the bank into being. The Industrial Development Bank of India Bill was introduced in the Lok Sabha on 30 April 1964 and passed the same day. It was passed by the Rajya Sabha on 7 May, and secured Presidential assent on 16 May. The Industrial Development Bank of India Act came into effect on 30 June 1964, and the IDBI came into existence on 1 July 1964, i.e. within eight months of the Governor submitting the blueprint for such an institution to the Finance Minister.

Organization and Early Operations

The IDBI was a fully owned subsidiary of the Bank, with an authorized share capital of Rs 50 crores which could be raised to Rs 100 crores with the prior approval of the central government. In a departure from the original blueprint, the issued capital of Rs 10 crores was wholly contributed by the Reserve Bank. At the IDBI's instance, the Bank made a further subscription of Rs 10 crores to the share capital of the IDBI in June 1967, and its resources were also augmented by an interest-free loan of Rs 10 crores from the government. Apart from its own resources and the interest-free loan from the government, the IDBI was allowed to raise resources from the market by selling its own bonds and debentures with or without the guarantee of the government, and accept deposits from the public for periods of not less than one year, borrow from the Reserve Bank for periods up to ninety days against trustee securities and up to five years on the security of bona fide commercial bills or promissory notes of industrial concerns, and receive gifts, grants, donations, and benefaction from the government or any other source. It was also empowered to borrow, with the previous consent of the central government, foreign currency loans from any bank or financial institution in a foreign country.

The affairs of the IDBI were vested in a Board of Directors which was identical with the expanded Central Board of the Bank. The Governor of the Bank became the ex-officio Chairman of the IDBI, and a Deputy Governor was nominated by the Central Board as Vice-Chairman. (B.K. Madan was nominated the first Vice-Chairman of the Board of Directors of the IDBI.) The Bank also provided the bulk of senior staff for the IDBI in its early years. In June 1967 the IDBI comprised five main departments—Appraisal, Economic and Planning, Operations, Refinance, and Administration and Board. The Legal Department of the Bank attended to the legal needs of the IDBI. Considering the size of projects which required the IDBI's assistance, particularly in core sectors such as fertilizers, petrochemicals, machinery manufacture, cement, etc., the need was felt to strengthen the bank's technical staff to evaluate projects and better monitor the end-uses to which its assistance was being put. The Bank took charge of recruiting the necessary technical staff either directly from the market or on deputation from the government.

The IDBI took over the business of the Refinance Corporation for Industry from the beginning of September 1964. It also acquired the shares of the government and the Bank in the Industrial Finance Corporation, and together with a fresh issue to it of shares worth Rs 1.34 crores, the IDBI came to acquire 50 per cent of the shares of the latter corporation in August 1964. The

IDBI was also given financial and supervisory powers over the Industrial Finance Corporation. These powers had earlier vested in the central government. The Bank's Industrial Finance Department too, transferred some of its work to the IDBI. As the apex institution in the field, the IDBI was now given primary responsibility for providing financial assistance to other term-lending institutions and to individual medium and large industrial units. The needs of small industries, the study of industrial finance in its different aspects, and of gaps in its structure continued to be looked after by the Industrial Finance Department of the Bank.

Simultaneously with the founding of the IDBI, a new long-term fund known as the National Industrial Credit (Long-term Operations) Fund, as proposed by Bhattacharyya, was established by the Bank with an initial contribution of Rs 10 crores. The Bank made annual allocations to the Fund out of its surplus profits before these were transferred to the government. This Fund was utilized to finance the IDBI's subscriptions to the shares, bonds, and debentures of the Industrial Finance Corporation of India, state financial corporations, and other financial institutions notified by the central government such as the ICICI, and purchase by the Bank of bonds and debentures issued by the IDBI. The total contribution to the Fund at the end of June 1967 was Rs 30 crores, out of which the IDBI availed loans of over Rs 5 crores.

The explanatory memorandum to the IDBI Bill drew attention to the practice followed in other countries of governments placing at the disposal of their development banks counterpart, trust, or other funds for supplementing resources normally available to them. Accordingly, the IDBI was appointed the agency for administering and applying the Development Assistance Fund which the central government instituted in March 1965 to assist essential *industrial concerns* which were not attractive to commercial banks and other financial institutions, but were nevertheless of strategic national importance. The resources of this fund comprised *contributions from the central government* or any other source by way of loans, gifts, grants, and donations. Losses arising out of the fund's operations were to be charged to it, while the IDBI was reimbursed expenses of operating the fund. The total assistance sanctioned and disbursed since the inception of the fund and up to the end of June 1967 amounted to Rs 33 crores and Rs 26 crores respectively, the beneficiaries being two fertilizer companies. The latter amount also represented the IDBI's *total borrowing from the government* towards this fund which showed a profit of Rs 40 lakhs over these three years.

As anticipated, the IDBI quickly became the *pre-eminent* industrial term-financing institution in India. In 1966–67, for example, over Rs 62 crores of the total assistance disbursed by industrial term-financing institutions that

year of Rs 134 crores, was accounted for by the IDBI.⁴ The IDBI's dominance was particularly pronounced in respect of rupee loans (Rs 48.6 crores out of Rs 89.1 crores). It disbursed, besides, Rs 6.5 crores by way of subscriptions to shares and debentures of industrial concerns and Rs 7.1 crores as subscriptions to shares and bonds of other financial institutions in 1966-67. The setting up of the IDBI also marked a sharp upswing in refinancing operations. The total volume of refinancing made available by the Refinance Corporation for Industry since it was founded in 1958 and merged with the IDBI in September 1964 was about Rs 39 crores. Refinancing disbursed by the latter institution, on the other hand, averaged over Rs 20 crores in each of the first three years of its existence. Direct assistance sanctioned too was substantial, amounting to Rs 33.8 crores during the year ending June 1967, of which nearly Rs 10 crores were by way of underwriting assistance and guarantees. Total direct assistance sanctioned was of the order of Rs 75 crores during the three years ending June 1967, while the volume of underwriting assistance sanctioned during the same period aggregated Rs 16.3 crores. The total financial assistance outstanding to the IDBI as at the end of June 1967 amounted to Rs 144 crores.

THE UNIT TRUST OF INDIA

The Shroff Committee, it will be recalled, recommended the establishment of investment trusts in the public and private sectors to promote industrial investment. At the time when the proposal was first made, the Bank was distinctly unenthusiastic, preferring initiative in this respect to come from the private sector. In reporting to the Central Board on the recommendations of the Shroff Committee, Rama Rau acknowledged that the 'unit form of investment' would help small investors who had 'little or no knowledge of the investment market'. But there was little that either the Bank or the government could do about setting up unit trusts, he suggested, except perhaps to give 'consent to the issue of the capital applied for'.

The Central Board endorsed this position, and there the matter rested for some years. However, at the staff level the Bank never completely lost interest in the idea of unit trusts, some of which was reflected in two studies conducted by its Economic Department in January 1959 and June 1960. The latter study by K.M. Hanifa, which was published in the Bank's *Bulletin* in October 1960, reviewed the progress of investment trusts in Britain and the USA. Incomes of unit trusts, it pointed out, commonly enjoyed immunity from taxation

⁴ Industrial term-financing institutions here include, apart from the IDBI, the Industrial Finance Corporation, the ICICI, and state financial corporations.

provided they were overwhelmingly distributed among unit-holders. In the United States, for example, a trust had to distribute 90 per cent of its income before it could claim tax immunity. Tracing the evolution of ideas about *investment trusts in India*, the study recalled Manu Subedar's minority report as member of the Indian Central Banking Enquiry Committee (1931) in which he urged the creation of these trusts as vehicles for financing investment in industry. Manu Subedar's plea was not altogether wasted, as the colonial government soon decided to exempt investment companies from super-tax. Despite this concession, there were only a handful of such companies in India; and only two of them could be regarded as investment companies in the proper sense of the term. Many investment companies were promoted 'only to collect public money ... for employment to the advantage of the *management and directors in their speculative activities*'. Investments of several such companies, the study emphasized, were concentrated in the shares of a few joint-stock companies which were often either 'private companies' or those whose shares were 'not quoted on the Stock Exchanges'. Many investment companies, moreover, also counted direct loans and advances among their assets. The study found that the investments of a majority of these companies were not, by and large, 'sufficiently diversified ... or strictly disinterested'. Only two investment companies, the *Industrial Investment Trust* associated with the stock-broking firm of Premchand Roychand and the *Investment Corporation of India* (controlled by the Tatas) held reasonably large and well-diversified portfolios of securities, the former having deployed over Rs 1.25 crores in 200 different securities and the latter Rs 3.5 crores in twice as many securities. Echoing the recommendation of the Shroff Committee, the article noted the wide scope that existed for large industrial or financial houses to form unit trusts. The State, it suggested, should encourage the process and regulate the functioning of these intermediaries from the point of view of *safeguarding the interests of their investors*. Unit trusts, the article concluded, would help mobilize the resources of small savers for industrial investment and democratize industrial share-ownership as envisaged in the directive principles of the Indian Constitution.

Both while in Commerce and Industry and as Finance Minister in 1956-57, TTK had been casting about for ways to boost public confidence in the stock markets. He was an enthusiastic advocate of the newly-established Life Insurance Corporation playing a more active role in promoting the demand for industrial equities. TTK's unfortunate decision to invest the organization's funds in the concerns of Haridas Mundhra partly reflected this wider motivation, but he also appears to have given some thought to setting up a mutual fund in the public sector. This idea had not taken any concrete shape

when TTK resigned as Finance Minister in February 1958; while the circumstances attending his departure rendered inopportune any effort to press ahead with the formation, particularly in the public sector, of institutions designed to mobilize and move large resources into securities offered largely by privately owned enterprises.

Two factors appear to have come together in the early 1960s to give fresh impetus to the formation of unit trusts. The accelerated pace of public investment and industrialization during the second plan and the early years of the third plan created conditions for stepping up private investment in industry. At the same time, the dust raised by the Mundhra affair, following which investment decisions of the public-owned Life Insurance Corporation of India came under intense public scrutiny, had begun to settle. With little prospect in sight of private interests establishing genuine investment companies, the government decided in the early part of 1963 to take the initiative to form a unit trust in the public sector. TTK was once again the moving spirit. As Minister for Economic Coordination, he is said to have sent the proposal to the Prime Minister who, in turn, pressed it on the Finance Minister, Morarji Desai. Intervening in the debate on the 1963–64 budget, Finance Minister Morarji Desai disclosed to the Lok Sabha his intention to set up an investment trust which would afford the ‘common man a means to acquire a share in the widening prosperity based on steady industrial growth’, that combined ‘security and a reasonable return’.

Events thereafter moved swiftly, at any rate within the Bank to which the task of preparing the blueprint for the unit trust and the draft legislation was, naturally enough, entrusted. As it happened, the Economic Adviser, V.G. Pendharkar, Hanifa, and other officials at Mint Road had been working on just such a scheme, and following discussions between Bhattacharyya, the Deputy Governor, M.V. Rangachari, the Executive Director, B.K. Madan, and the Legal Adviser, B.N. Mehta, a draft bill called the Unit Investment Trust of India Bill was drawn up as a basis for discussion, and sent to the government in July 1963. Unlike elsewhere such as in the United Kingdom, the proposed trust was designed both to manage its business and hold securities. It was to have an initial capital of Rs 5 crores, half contributed by the Bank and the other half by the Life Insurance Corporation, the State Bank of India and its subsidiaries, the Industrial Finance Corporation, the ICICI, and scheduled banks. The Board of Trustees was to have six members, with a Chairman and one trustee nominated by the Bank and the remaining trustees nominated by the other subscribing institutions. The proposal envisaged the trust having powers to borrow from the Bank against government and trustee securities. The income of the trust, it was proposed, would be allocated between

unit holders and subscribing institutions in the proportion the face value of the unit capital bore to the original fund. The actual cost of managing the unit scheme was not to exceed 5 per cent of the income allocated to the unit capital. Other costs, such as interest charges on any sums borrowed by the trust and any other necessary provisions, were also limited to 5 per cent, so that at least 90 per cent or more of the notional income allocated to unit capital was available for distribution to unit holders. The blueprint also suggested a number of tax concessions to assist the new institution and enhance the attractiveness of units as a form of investment. As a 'conduit company', the trust was to be exempted from paying any tax on its income or capital gains. This was done to avoid double taxation. More importantly, members' dividends were not to be subject to tax at source since the average unit holder, who was likely to be a small saver, would find it irksome to claim credit for the deduction; as a further incentive to small unit holders, incomes on units up to Rs 1,000 were to be free from tax; and finally, *transfers of units did not attract stamp duty.*

The Government of India decided to discuss the blueprint with an expert on unit trusts whom the World Bank proposed to depute. This meant some delay, but in the meantime, the committee of economic Secretaries of the Government of India approved the essential elements of the Bank's plan in October 1963 and decided to press ahead with it. Besides venturing a few suggestions of its own the committee also took decided views on issues which the Bank's plan had steered clear of. Chambers of Commerce, for example, had suggested to the government that the proposed unit trust legislation should be of a permissive character applicable to trusts both in the public and the private sector. The committee dismissed this suggestion on the plea that privately run unit trusts might, much in the manner of investment companies before them, come under the influence of managing agency houses and business groups. Intense competition between trusts for the limited amount of business that was likely to be available, it was feared, would also affect the viability of all of them. Besides, it would be necessary to provide for appropriate supervision and control over privately managed unit trusts. The committee also balked at the prospect of extending tax concessions to privately owned institutions whose business was not effectively 'supervised and directed by agencies acceptable to Parliament and the public'. Except for that relating to viability, the committee's other concerns regarding privately run unit trusts could have been addressed through appropriate regulatory and supervisory measures. But it appears to have rejected the latter approach, preferring instead to establish the Unit Trust of India as a de facto public sector monopoly. The Bank, on the other hand, preferred the more open stance of first watching the

working of the proposed trust before determining whether other similar public or privately owned institutions should be allowed into the business. The World Bank consultant, one Mr Sullivan as the Bank's records refer to him everywhere, also apprehended that the government intended to create a public sector monopoly, but the Indian authorities maintained that while unit trusts could exist in the private sector, they should not expect to receive the tax concessions proposed to be granted to the Unit Trust of India.

The committee of Secretaries was also in favour of the government having the power to nominate two trustees, issue directions to the trust on matters of policy involving the public interest, and approve regulations framed by the trust. Senior officials at the Bank, including Pendharkar, believed these provisions excessive in relation to the concerns they might be intended to address. The bill provided for the trust being run along business lines and it was unlikely, in their view, that the objectives of the trust would conflict with the public interest. The Bank managed to bring the government round to its point of view, with the committee of economic Secretaries clarifying subsequently that directives would be issued to the trust in consultation with the Bank and

that in its administration the Trust should not function like a Department or like a statutory Corporation; it should be run more like a Company, and the best available talents in the investment field should be secured to maximize the efficiency and profitability of the Trust.

As a further step towards ensuring that the trust functioned according to business principles, the committee wanted it explicitly clarified that it was not intended to promote 'the cooperative movement or the development of backward areas'. The committee also rejected the idea of placing any ceiling on the number of units owned by any single individual since such restrictions might militate against the objective of promoting savings in the community. The trust, the committee agreed, would invest its funds only in listed securities, and could underwrite issues of new capital with the prior permission of the Bank. Units, it proposed, should have the status of trustee securities and their ownership should be confined to individuals.

The consultant from Washington, Mr Sullivan, was a close friend of the World Bank President, George Woods, and the former head of a medium-sized US mutual fund. Sullivan and his wife arrived in India in October 1963. Apart from indulging the amateur interest he and his wife had in archaeology, Sullivan had two comments to offer on the Bank's unit trust

plan. Confining the ownership of units to individuals, he suggested, was unnecessary and restrictive, and he urged India to adopt the practice of small US pension funds in this respect. The trust, Sullivan also suggested, should have powers to suspend its repurchasing obligations in the event of emergencies, such as stock exchange closures, when it might not be in a position to realize its investments.

Neither suggestion found much favour with the Bank. Pendharkar, who played the major part in giving practical shape to the idea of a unit trust, was inclined to make light of the particular threat Sullivan apprehended, since the proposed trust was to have the power to borrow from the Bank for up to eighteen months. Nor did he see any advantage in allowing corporate bodies to hold units. Not only would the latter's motives for doing so have little in common with the trust's objective of promoting a new vehicle for household savings, their operations might be such as to promote instability in the price of this asset. While such risks were negligible in the case of small firms, Pendharkar felt there was little point in partners of such firms being allowed to own units in that capacity, rather than as individuals. In the end, however, the government decided to overrule the Bank and not to restrict the ownership of units to individuals. This freedom became a source of some embarrassment to the Unit Trust within three years of its coming into existence, and on other occasions thereafter.

The Unit Trust of India Bill, 1963, as drafted by the Bank and amended in line with the views of the committee of economic Secretaries and in some other respects, was introduced in Parliament on 26 November 1963 by T.T. Krishnamachari who in the meantime had become the Finance Minister. In the debate on the bill, members expressed apprehension that the investment policy of the trust might come under the control of large business houses or the Finance Ministry, or that 'pro-government companies' might walk away with a lion's share of its investments. Some members expressed concern for small investors who might suffer capital losses and adverted to the possibility of speculative transactions in the absence of limits on the ownership of units. Questions were also raised about the trust becoming a state monopoly and the possibility of establishing similar institutions in the private sector. Replying to the debate, the Finance Minister clarified that the government did not intend to interfere in the investment policy of the trust and that it was not practical to limit the holding of units by individuals. The question of unit holders being represented on the Board of Trustees of the trust was raised in both houses, with the government holding to the view that the nomination of such representatives was best left to the Bank. An amendment to add 'or Calcutta' after Bombay in the clause dealing with the location of the head

office of the trust was not accepted on the ground that the new institution would be managed by the Bank which had its head office in Bombay. The bill, which passed the Lok Sabha on 5 December and the Rajya Sabha on 12 December, received the President's assent on 30 December 1963. It came into effect on 1 February 1964 on which date the Unit Trust of India came into existence as an offshoot of the Bank. Soon after its inception the Trust opened branch offices in Calcutta (1964), Madras (1965), and Delhi (1967).

Set-up and Organization

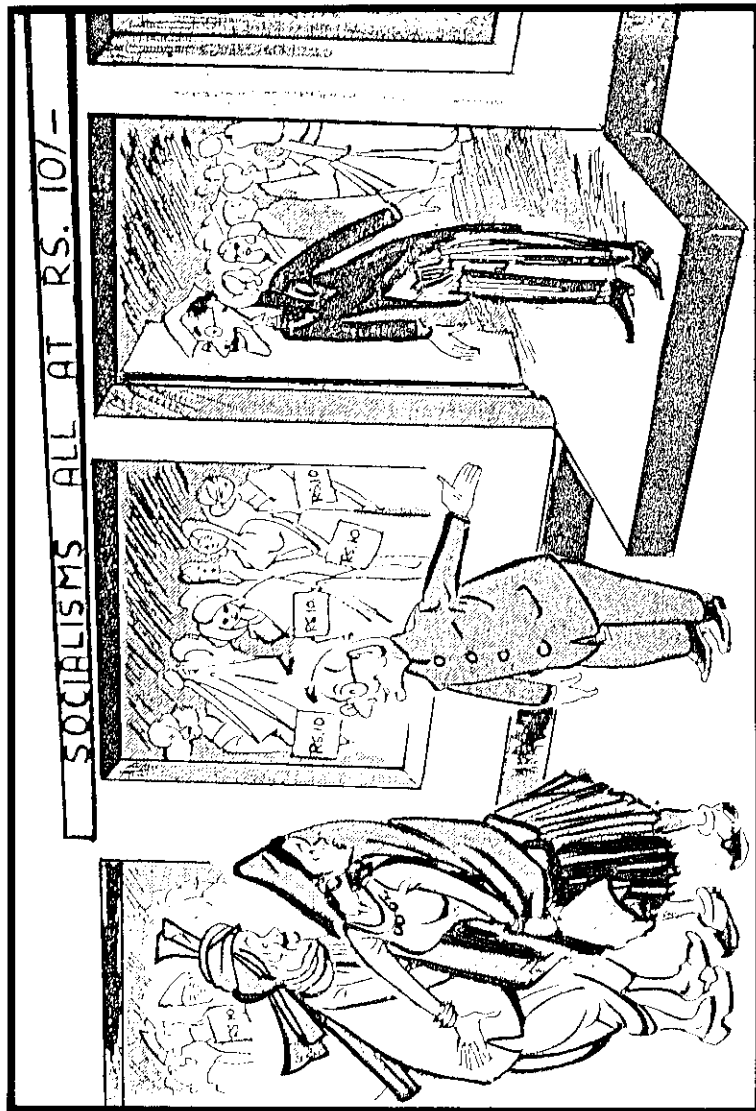
The Unit Trust of India came into existence with an initial capital of Rs 5 crores allocated between the Reserve Bank (Rs 2.5 crores), the Life Insurance Corporation (Rs 75 lakhs), and the State Bank of India and its subsidiaries (Rs 75 lakhs). Scheduled banks and other financial institutions were allocated Rs one crore, despite their subscriptions exceeding this amount by about 10 per cent. Almost all foreign scheduled banks in India contributed to the initial capital. The Industrial Finance Corporation (Rs 25 lakhs), the ICICI (Rs 15 lakhs), and the Bank of India (Rs 10 lakhs) between them accounted for half the contribution from scheduled banks and other financial institutions. The Trust was allowed to raise resources by borrowing from any person or institution in or outside India other than the government or the Bank. It was also authorized to borrow from the Bank for short periods up to ninety days against trustee securities and for the medium-term up to eighteen months against the security of its bonds, with the approval and guarantee of the central government. The Unit Trust Act, as originally passed, allowed the organization to float only one unit scheme. However, in 1966 this limiting provision was relaxed to enable it to borrow against any other securities specified by the Bank for schemes other than the first unit scheme, subject to a ceiling of Rs 5 crores for each such scheme and Rs 10 crores in all.

According to the Unit Trust of India Act, the general superintendence and management of the Trust was vested in a board of ten trustees, of whom the Chairman, the executive trustee, and four other trustees were nominees of the Bank. While the Life Insurance Corporation and the State Bank of India would each nominate a trustee, two others were to be elected by the other contributing financial institutions and scheduled banks. The first Board of Trustees was constituted on 1 February 1964 with R.S. Bhatt, who was then the Executive Director of the Indian Investment Centre, as the whole-time Chairman. Bhatt narrates a business meeting in October 1963 with Bhattacharyya at the end of which he was asked his opinion on the best person to head the new Trust. Bhatt apparently named himself and H.T.

Parekh, at that time General Manager of the ICICI, as the 'only two persons who can handle the job'. The Governor confessed to Bhatt that he had these two names in mind but that every time he mentioned them to G.L. Mehta, who was chairman both of the ICICI and the Indian Investment Centre, 'he hits the roof'. Apparently at Bhattacharyya's instance, Krishnamachari spoke to Mehta about sparing Bhatt's services. Mehta, according to Bhatt, relented under pressure from a 'firm and determined' Krishnamachari who was insistent that his nominee 'should take charge of the Unit Trust in Bombay' right from its inception.

Bhatt served as the Chairman of the Trust for a little over eight years, until the end of April 1972. The Bank's Economic Adviser, V.G. Pendharkar, was appointed the first executive trustee on a part-time basis till the end of July 1964 after which he became a trustee in place of B.K. Madan who was elevated as Deputy Governor. Pendharkar was succeeded by R.C. Sachdeva, and he in turn by S.D. Deshmukh. The Chairman, the executive trustee, and two other trustees constituted the executive committee of the Trust. Competent to deal in all matters handled by the Board, the executive committee functioned practically as the investment committee of the Trust. The general regulations of the Trust, which were framed by the Bank, laid down that the Trust's investment in any one company should not exceed the lower of 5 per cent of its total investible funds or 10 per cent of the securities issued and outstanding of the company. Debentures were, however, excluded from the purview of this regulation in August 1964. As it had done for the Refinance Corporation and the Industrial Development Bank of India, the Bank once again provided the new institution with trained and experienced staff, particularly in its early years. The Bank arranged to undertake 'integrated recruitment' of personnel *for itself and the Trust*. This practice, of the Trust's officers and staff coming to it on deputation from the Bank, continued beyond the end of the period covered by this volume. As Bhatt acknowledged on the eve of laying down office as Chairman at the end of March 1972, this arrangement placed at the Trust's disposal 'highly trained and experienced officers and personnel from the ... Bank' and enabled it to cope successfully with a 'growing and diversified volume of work'. More broadly, as Bhatt pointed out to the government in 1970 in the course of representing to it that the Trust should not be brought under the jurisdiction of the Comptroller and Auditor General of India, although a 'statutory corporation' the Unit Trust worked 'in fact ... nearly as a department of the Reserve Bank and directly under its control'. Sponsoring the Trust as part of the Bank's family of financial institutions, Bhatt maintained, gave it a sound start and enabled the relatively new concept and institution to get off the ground smoothly.

Salesmanship



Mr. Krishnamachari said, the Unit Trust scheme aims at ushering in socialism.

—Shankar's Weekly, 12 July 1964

Business Activities

The first scheme of the Unit Trust of India, called the Unit Scheme 1964, was launched in July 1964. Prepared following a study by Pendharkar of the operation of similar schemes in the United Kingdom, it was framed more or less on the lines of a Trust Deed issued by unit trusts in the United Kingdom defining and regulating the rights and obligations of trustees and unit holders. Gazetted on 30 May 1964, the scheme came into operation on 1 July 1964 when it was inaugurated by the Finance Minister. Adopting the technique of block offer, units were offered at a face value of Rs 10 for a period of four weeks initially. Bowing to public demand, the Trust extended this period by another two weeks up to 14 August 1964. Thereafter, units were available at prices which reflected earnings on them since July. Contributions amounting to Rs 17.37 crores were received during the initial offer period, while contributions during the rest of the first year of the scheme amounted to Rs 1.77 crores.

Unit sales which amounted to Rs 19.14 crores in the first year, declined to Rs 2.15 crores in the next year, but picked up in 1966–67 to reach Rs 9.24 crores. The principal reason for the decline in 1965–66 was that the dividend of 6.1 per cent declared by the Trust for the first year appeared low against the background of a rising trend in yields which followed the hike in the Bank rate from 5 to 6 per cent in February 1965. The Trust declared a higher dividend of 7 per cent in 1965–66, and sales of units responded almost immediately. Besides, with the merger of super tax and income tax, the tax benefits available on incomes from units up to Rs 1,000 also became available more widely.

At the Bank's instance, participating commercial banks agreed to act as selling agents of the Trust. Later, post offices were brought into the picture, and registered brokers of stock exchanges and scores of individuals were appointed agents. A study by the Bank revealed that nearly two-thirds of the units sold up to the end of 1965 were concentrated in the five major cities of Bombay, Madras, New Delhi, Calcutta, and Ahmedabad. Further the bulk of the applications came from middle-income investors for lots of one hundred units or less. Salary and wage earners accounted for about half the applications received.

The Trust's repurchase operations commenced in November 1964. Prices of units were fixed daily, based on the net asset value of the underlying securities with reference to the closing stock exchange quotations of the preceding day and the income flowing into the Trust's coffers each month. There was a difference of 5 per cent between the sale and repurchase price of units. Repurchases in the early years were of the order of 4.5 per cent of units sold, compared with track averages of 6 to 7 per cent in the United States and

the United Kingdom. There was some speculation in the press about the price of units rising when the index of share prices was nudging downwards. Clarifying this seeming paradox in a letter to the Editor of the *Financial Express* which commented upon it, Bhatt pointed out that the value of the Trust's portfolio fluctuated much less than the index of share prices because the former was dominated by cash, rather than cleared, securities. Besides, unit prices reflected not only the underlying value of securities (less expenses) but also the accumulated income of the Trust.

Investment Policy

The Trust's investment policy was based on the need to balance security of capital and that for an adequate return 'including reasonable capital appreciation'. At their first meeting, the trustees decided to invest about 15 per cent of the initial corpus in government securities or other trustee securities and in cash, a quarter in debentures or cumulative preference shares, and not more than 60 per cent in first-class equities of companies. Since a considerable length of time might elapse before they managed to distribute the initial corpus along the intended lines, the trustees wished to invest the entire corpus immediately in short-dated securities and requested the Bank to extend to their institution the same facilities (of buying back securities at the prices at which it sold them) available to the Deposit Insurance Corporation and other organizations. The Bank demurred, feeling that the Trust should function on commercial and business lines and that it should not benefit from hidden subsidies such as a waiver of commission or the cushioning of investments from the ordinary fluctuations of the market. However, it agreed to charge the Trust for a limited period of three months commission at one-sixteenth of one per cent on sales and no commission on repurchases. The Trust also entered into an arrangement with the Bank to buy and sell government securities at the prevalent market rates.

The Unit Trust of India decided to invest not less than a fifth of the capital of the first unit scheme in government and other trustee securities and cash or debentures, and the remainder in equities and cumulative preference shares of sound companies with good dividend record and growth prospects. In order to achieve a balanced portfolio, it also decided to invest 55 to 60 per cent of the unit capital in fixed interest bearing assets and the rest in variable dividend securities or equities. The executive committee approved the list of eligible securities and implemented the investment policy of the Trust. The depressed conditions of the stock market in 1965-67 proved a blessing in disguise as it provided the Trust with an opportunity to build a sound portfolio of stock at attractive prices. The Trust's total investments at the end of March 1967

aggregated Rs 29.8 crores. Of this, ordinary shares of corporate enterprises accounted for Rs 13.4 crores (44.8 per cent), preference shares for Rs 3.6 crores (12.1 per cent), debentures for Rs 12.1 crores (40.7 per cent), and bonds of financial corporations and electricity boards for Rs 72 lakhs (2.4 per cent).

Floating New Schemes

Early in 1965, the Trustees began thinking about formulating other unit schemes and amending the Unit Trust of India Act which, as originally framed, limited the Trust's activities to the one scheme. The committee of Trustees set up for the purpose recommended that the Trust should be enabled to float new unit schemes. This was approved by the Bank. But other recommendations of the committee, such as utilizing P.L.480 funds for augmenting the Trust's capital and declaring units as trustee securities, did not find much favour. The committee also proposed a reserve fund to provide for possible future losses arising out of a fall in security prices while the Trust continued to repurchase units at a price not lower than their face value. The Bank, for its part, endorsed the idea and volunteered to contribute to the fund out of the income it received from the initial capital subscribed by it. In February 1966 Parliament passed the bill amending the Unit Trust of India Act allowing it, among other things, to float other unit schemes. Following this, the Trust announced a 'Reinvestment Plan' in July 1966 offering unit holders the facility of automatically reinvesting the income they earned from units. At the Trust's urging, the Bank appointed a working group in June 1966 under Pendharkar to formulate a scheme offering both savings and insurance benefits. This group, which also comprised representatives from the Posts and Telegraphs Board and the Life Insurance Corporation, formulated the Unit Linked Insurance Plan which the Trust introduced in October 1971.

Unpublished Sources

- | | |
|----------|---|
| G.8 | Governor's Correspondence with Government of India, Ministry of Finance |
| B.2.1070 | Shroff Committee Report—Comments of RBI on Certain Recommendations |
| BR.89 | Committee on Finance for the Private Sector—Governor's Memorandum to the Central Board |
| C.326A | Committee on Finance for Private Sector |
| SC 16-54 | Shroff Committee Report—Observations and views of the various departments of the Bank on the recommendations of the committee |

SB-113	Implementation of the Recommendations of the Shroff Committee—Remittance Facilities
B.2-1010	Role of Commercial Banks in Industrial Finance
B.2.1080	Handoo Committee Report on the Formation of Consortium for Underwriting New Issues
C.376	Refinance Corporation for Industry
B.2-1010	RCI Private Ltd—Documents and Memoranda
C.250	RCI—Correspondence with
GD-100	Proposal for the Setting up of an Industrial Refinance Corporation
RCI-1	Setting up of an Industrial Refinance Corporation
C-270 A	Industrial Development Corporation
C-271	IDBI—Investment Policy
HC/IDBI/I	IDBI Bill, 1964—Discussion in Parliament and Other Relevant Papers
HC/IDBI/II	IDBI—Memoranda to the Board
C 270	Unit Trust of India—Investment and Other Correspondence
C 270 A	Appointment of Chairman—UTI
C 403	Investment Trusts
HC/UTI/I	Investment Policy, Correspondence with Government on UTI
HC/UTI/II	Summary for Cabinet, Amendment to UTI Act, etc.
HC/UTI/III	Material obtained from UTI on UTI Bill, Review of UTI Schemes, etc.

Memoranda to the Central Board and Committee of Central Board

Financing Small Industries and Exports

The development of small-scale and cottage industries has remained an integral part of India's strategy for industrialization. A network of institutional agencies was set up during and after the first plan to accelerate their development. Yet, as late as 1962 despite nearly a decade of vigorous promotional efforts, institutional financial support for this sector remained unimpressive, with small industries accounting for a negligible proportion of the total credit extended by scheduled banks. Even state financial corporations (SFCs), which were set up principally to cater to their financial needs, hesitated to get too closely involved with them. This was mainly because banks and corporations tended to regard small-scale industries as rather bad credit risks. The relatively low stake entrepreneurs held in their enterprises and their inability to provide adequate security were other factors tending to increase the perceived risks of lending to this sector. The Bank played a key role in establishing or supporting institutions intended to enlarge the flow of credit to small industries and in encouraging existing institutions, notably the State Bank of India, to launch more liberal schemes to finance small industries in collaboration with state-level institutions. With these initiatives not yielding results, the Bank stepped up its engagement with the needs of this sector from the late 1950s. It took the lead to put in place and administer a scheme to guarantee institutional loans to small-scale industries and began refinancing commercial banks' lending to this sector at concessional rates of interest. The labour-intensive handloom industry was also accorded special treatment. Thus the Bank not only gained first-hand experience of the problems of financing small-scale industries, but also played a major role in attempting to resolve them.

THE BANK AND STATE FINANCIAL CORPORATIONS

Reference was made in the earlier volume to the Indian Central Banking Enquiry Committee's recommendation to set up industrial credit corporations

at the national and provincial levels, and to the formation, following an Act of the Constituent Assembly, of the Industrial Finance Corporation of India in July 1948 with Ram Nath, then Secretary of the Bank, as its first Managing Director. Piloting the motion to refer the IFC bill to a Select Committee, the Finance Minister, *Shanmukham Chetty*, informed the Constituent Assembly of the government's intention to follow up this piece of legislation with efforts to persuade provincial governments to establish similar institutions in the provinces, particularly to finance small-scale industries. Soon thereafter, in March 1949, the Government of Madras established the Madras Industrial Investment Corporation Limited. Incorporated under the Indian Companies Act, this corporation was modelled on similar institutions in the United Kingdom.

Other provincial governments too, favoured the establishment of industrial finance corporations in their provinces. The Bombay government was keen to set up a corporation by special statute to ensure that it could hold majority ownership, guarantee its debts, and restrict the distribution of its profits. The statute would also assign to the proposed corporation prior claim over the assets of its borrowers in the event of recovery proceedings being launched against them. Under the Government of India Act, 1935, the incorporation, regulation, and winding up of trading corporations fell within the purview of the central legislature. Consequently, the Union government, to whom the Bombay proposal was addressed, initiated consultations about it with the Bank and the Industrial Finance Corporation.

The Bank generally supported the idea of setting up provincial financial corporations. Existing arrangements to give loans to private industries, under the State Aid to Industries Act were, in its view, extremely limited in scope. Aid under this Act took the form of direct loans repayable in a fixed number of instalments at rather high rates of interest. The Act made no provision for working capital loans, nor for underwriting share issues or guaranteeing interest on debentures. It also assigned to state governments the responsibility for processing applications and sanctioning and disbursing loans. This inevitably led to lengthy delays. Besides, the Bank felt a specialized corporation would be more equipped than a government department to evaluate proposals from the technical and business points of view. While the Industrial Finance Corporation was better placed to advance loans to large industries, corporations were required at the state level to finance small and medium industries, particularly in the rural and semi-urban areas. Establishing corporations in the states was also superior, in the Bank's view, to the alternative of allowing the Industrial Finance Corporation to open branches in state capitals because the former would attract support from state governments and local institutional

investors whose resources might otherwise not be available for industrial development.

Doubts however persisted over the ability of provincial governments to raise the necessary share capital, and over the merits of granting these shares, which were unlikely to command a wide market, the *status of trustee securities*. Despite such doubts, it was felt no harm could arise from the passage of an Act that merely enabled provincial governments with the necessary resources to set up local corporations, and the Government of India expressed itself willing to sponsor the necessary legislation.

Discussions between the Bank, the Government of India, and the Industrial Finance Corporation culminated in the State Financial Corporations Bill. A draft of this bill was circulated in April 1950 and considered at length by the Bank's Central Board in November 1950. The Board made a number of suggestions, one of which was to throw open the share capital of SFCs to members of the public. While some of the changes proposed by the Bank were incorporated in the draft bill, the latter remained silent about the Board's proposal to set a ceiling on the Bank's contribution to the equity of these corporations or include a provision for determining the Bank's share capital contribution in consultation with it. Remonstrations with the government about this omission yielded an assurance that the latter would unfailingly consult the Bank before arriving at the distribution of a state financial corporation's share capital.

The State Financial Corporations Bill was introduced in the Lok Sabha towards the end of April 1951 and referred to a Select Committee. The revised bill, with amendments to more than half its forty-eight clauses, was tabled in the Lok Sabha in September. Debate on the bill in the Lok Sabha threw up the suggestion that SFCs should utilize the agency of commercial banks for dealing with borrowers in the more physically inaccessible areas. According to one version of this proposal, commercial banks would contribute the initial subscription towards industrial debentures and restore their own resources by selling or transferring these assets to state financial corporations. However, the proposal remained ambiguous in important respects. In particular, it was not clear whether loans would be selected by commercial banks or by financial corporations. The Bank canvassed commercial banks about the proposal and found the latter divided in their appraisal of its merits. While the Bank was not opposed to involving commercial banks in the activities of the proposed corporations, it was unwilling to support the idea in its present form. For example, it was not evident to the Bank's officers that the objects in view, viz. proper selection and effective supervision, would be met if commercial banks had the right to effect compulsory sales of their debentures

to the state corporation at prices that enabled them to recover their outlay on these assets. Nor was it clear which agency would supervise a loan after it was transferred to the state corporation. On the other hand, encouraging commercial banks to accumulate long-term industrial loans was not only imprudent, it would also defeat the intended objectives of SFCs. The Bank's own preference, therefore, lay in the direction of merely including a provision in the bill enabling SFCs to make loans to industrial firms in the more remote areas through the agency, should they wish to utilize it, of commercial banks and cooperative institutions.

The State Financial Corporations Act came into force on 1 August 1952. It authorized SFCs to grant loans or subscribe to debentures of industrial concerns repayable within twenty years, and guarantee loans floated by industrial concerns in the open market that were repayable within the same period. State financial corporations could also underwrite issues of stocks, shares, bonds, or debentures of industrial concerns, provided the assets thus acquired were disposed of within seven years. Loans and advances were to be fully secured. In order to ensure a balanced dispersal of their resources, SFCs were prohibited from lending to a single concern amounts in excess of a tenth of their paid-up capital or a maximum of Rs 10 lakhs. Shares of SFCs, which would have the status of approved and trustee securities, were to be distributed between the state government, the Bank, scheduled and cooperative banks, insurance companies, and other financial institutions. Unlike in the case of the Industrial Finance Corporation, the public was allowed to hold up to a quarter of the shares of SFCs. The Act obliged state governments to guarantee repayment of the principal and dividend at prescribed rates not exceeding 5 per cent. Dividends were not to exceed the guaranteed rate until a corporation had accumulated a reserve fund equal to its paid-up capital, and repaid the state government any subventions it had made towards fulfilling its guarantees. State financial corporations were also allowed to mobilize additional resources by issuing bonds and debentures, guaranteed by the state government up to five times their paid-up capital and reserves. They could, besides, accept deposits from the public up to the limit of their paid-up capital for a minimum period of five years. According to the Act, each state financial corporation was to be managed by a board of ten directors, of whom four, including the Managing Director, were to be nominees of the state government. A director each was to be nominated by the Industrial Finance Corporation and the Central Board of the Bank. Four nominees were to be elected by the other shareholders.

Punjab was the first state to set up a corporation under the Act in February 1953. Five more corporations followed in the course of the next year, and by

1960 sixteen corporations had been brought into existence. The reorganization of states in November 1956 led to the reorganization of SFCs as well. The financial corporations of Bombay and Saurashtra, and Andhra and Hyderabad were amalgamated in November 1956. In 1956 the State Financial Corporations Act was amended to allow joint financial corporations to be formed covering two or more states, and existing corporations to undertake activities in adjoining states which did not possess financial corporations of their own. Following this amendment, the Punjab corporation extended its activities to cover Delhi (1957) and Himachal Pradesh (1962), the Assam corporation to cover Tripura (1960) and Manipur (1963), and the Maharashtra corporation to cover Goa, Daman, and Diu (1964). The Gujarat State Financial Corporation was established in May 1960 after the bifurcation of the Bombay State Financial Corporation, and its activities were allowed to extend to Dadra and Nagar Haveli. The Madras Industrial Investment Corporation was brought within the scope of the State Financial Corporations Act in 1961 for the limited purpose of allowing inspections by the Bank and submitting returns to it. This reform enabled the Madras corporation to avail of assistance from the Refinance Corporation for Industry. With the division of Punjab in 1967, separate financial corporations were formed in Haryana, Himachal Pradesh, Chandigarh, and Delhi. The total share capital of fourteen SFCs at the end of March 1963 amounted to Rs 14 crores. The Bank's holdings of the shares of these institutions amounted to Rs 2.44 crores, about 17.5 per cent. State governments held about 46 per cent of the equity of SFCs, while scheduled banks and insurance companies held about 32 per cent. Other institutions, including the public, held a mere 3.7 per cent.

Although financial corporations functioned directly under the supervision of their state governments, the Bank was closely involved in monitoring their working and in devising ways to enhance their effectiveness, particularly in regard to the mobilization and utilization of resources. The annual conferences which the Bank convened of these institutions helped it build closer working relations with them and helped identify issues calling for its attention. These conferences were also attended by representatives of the Government of India and the Industrial Finance Corporation (and later by those of the Industrial Development Bank of India). The first such conference, which was convened in 1954, recommended amending the State Financial Corporations Act to bring it more in line with the Industrial Finance Corporation Act. The proposals emanating from the conference included allowing state corporations to finance new units (until then only existing units could be assisted), enabling joint financial corporations for two or more states to be set up, and extending to state corporations the facility available to the Industrial Finance Corporation

of being able to borrow for short periods from the Bank against government securities. Some of these amendments were incorporated into an amendment bill—the Industrial and State Financial Corporations (Amendment) Bill—which was passed by Parliament in its 1955 monsoon session. The State Financial Corporations Act was amended once again within a year, among other things, to allow the formation of joint corporations, and allow state corporations to borrow from the Bank against state or central government securities for up to ninety days. The legislation also made it mandatory for the Bank to be consulted before state governments issued policy directions to their state financial corporations.

Quite early in the career of SFCs, the Bank was called upon to intercede in the matter of the deployment of the resources of these institutions. The issue arose directly out of the proposal, incorporated in the 1956 bill, to allow SFCs to borrow short-term funds from the Bank. The Bank permitted SFCs to invest their surplus funds (i.e. funds not required for current business) in government securities or deposit them with commercial banks, often in the form of three-month deposits on which they earned an interest of 3 per cent or more per annum. The actual deployment by state corporations of their surplus resources varied considerably. In August 1956, for example, the Saurashtra corporation had all its surplus funds in government securities, while at the other extreme its Assam counterpart had its surplus funds entirely in the form of deposits. In the aggregate, at the end of August 1956, nearly a third of the paid-up capital of SFCs was held in the form of bank deposits.

In September 1956, the Finance Ministry wrote to state governments objecting to this practice and proposing that surplus resources of SFCs should be invested in government securities and treasury bills as the 'major portion' of their capital was subscribed from 'public funds'. The Ministry cited the precedent of the Industrial Finance Corporation which divided its surplus funds between treasury bills and demand deposits and suggested SFCs do the same. The new legislative provision allowing these institutions to borrow short-term funds from the Bank, the Ministry maintained, eliminated whatever inconvenience they may have earlier faced in investing surplus resources in government paper.

The Bank did not see much merit in the Finance Ministry's suggestion. Advising the government against insisting upon SFCs switching all their surplus funds from bank deposits to government securities, the Deputy Governor, K.G. Ambegaokar, alerted the Principal Secretary in the Finance Ministry, H.M. Patel, to the dangers of state corporations having to sell or borrow against these assets at regular intervals. State financial corporations,

the Deputy Governor underlined, should be allowed to maintain a working balance adequate for a year's lending requirements with banks, and invest their remaining funds in government securities of relatively shorter maturities. This would enable the corporations to have liquid resources at their command as and when they needed them and minimize the risk of capital losses. Following this intervention, the Finance Ministry advised state governments to allow their financial corporations to invest their funds along the lines recommended by the Bank.

In the early years, SFCs faced the problem of finding suitable projects to finance. But by the middle of 1956, some state corporations began turning their attention towards ways of augmenting their lending resources. The Travancore-Cochin Financial Corporation, which was the first to raise the issue, pointed out that it had unutilized resources of Rs 18 lakhs, while loans sanctioned and awaiting disbursement amounted to over Rs 20 lakhs. Applications for loans to the tune of Rs 24 lakhs were also under consideration. The Bombay, West Bengal, and Madras corporations were also expected soon to find themselves in a similar situation, while the Punjab corporation anticipated a shortage of resources arising from the expansion of its area of operation to cover Delhi.

It was not, on the face of it, clear how these additional resources could be raised. Additions to share capital were expensive. State governments had guaranteed tax-free dividends of 3.5 to 4.5 per cent. With corporations paying the income tax on dividends, the effective charge on capital raised by issuing shares was much higher. Nor did it appear possible to issue bonds at less than 4.5 per cent, an issue by the Madras corporation of guaranteed bonds for Rs 25 lakhs at 4.25 per cent having largely to be retained by the underwriters. With state financial corporations lending their resources at 6 to 7 per cent, they could not offer higher rates without increasing the already substantial subventions paid to them by their respective state governments. The stipulation forcing SFCs to accept fixed deposits of a minimum maturity of five years was also said to be hindering their efforts at resource mobilization.

Faced with this situation, SFCs made a number of suggestions to the Bank, including compulsory subscription by the Bank and nationalized insurance companies to their bonds. The Bank saw little merit in this suggestion. The precedent of its subscription to the debentures of land mortgage banks could not be used, in the Bank's view, to justify subscription to debentures of SFCs, since the Bank already contributed substantially to their share capital. Internal Bank notings also referred to the rejection in 1952 of a request from the Industrial Finance Corporation for loans from the Bank for two or three years against its bonds on the ground that such bonds would be no different from

ad hoc securities. Besides, as officials at the Bank underlined in 1956, making long-term loans to SFCs would 'in effect amount to our providing block capital to industries'

Officials were also unenthusiastic about other suggestions from state financial corporations to raise additional resources, including that for the Bank to undertake joint issues of bonds on their behalf at a uniform rate of interest and persuading nationalized insurance corporations to acquire these securities. According to one official, in the prevailing conditions of the money market, there was no alternative to SFCs raising their lending rates and matching their advances against the repayment of old loans. Nor could SFCs 'get away', in K.G. Ambegaokar's words, 'from the responsibility of raising ... money from the market' He pointed out that while it might be possible to make temporary arrangements with banks and insurance companies to lend resources to SFCs, the initiative and responsibility for mobilizing resources in this way rested primarily with the corporations themselves. Should all other courses of action fail, Ambegaokar suggested, the Bank might have to recommend to the government the case for extending, as a last resort, special accommodation to state financial corporations.

The problem of raising additional resources featured prominently at the third annual conference of state financial corporations in 1956. The subcommittee appointed by the conference to consider the issue took note of the prevailing high interest rates and the 'keen competition for funds' and felt 'conditions [were] ... not propitious' for state corporations to approach the capital market. Bond flotations during the year had amounted to a mere Rs 36.14 lakhs, and there was no immediate prospect, according to the subcommittee, of a significant improvement in the climate for these assets. Hence it proposed that corporations having an urgent need for funds should be accommodated by the central government, if necessary through the utilization of counterpart P.L.480 funds. In the longer run, the subcommittee felt, while there was no alternative to the capital market, the government might consider subsidizing the interest burden of SFCs. Besides, institutions such as the Life Insurance Corporation should be persuaded to be of 'substantial assistance' to these corporations by subscribing to their debentures. The conference endorsed the views of the subcommittee, though the Governor, who chaired the former, disassociated the Bank from the subcommittee's proposal for an interest subsidy.

The following year (i.e. 1957-58) was a much better year from the point of view of resource mobilization by SFCs, bond flotations rising steeply to Rs 3.17 crores. Yet the question (of additional resource mobilization) remained high on the agenda of the fourth conference held in November 1957, which

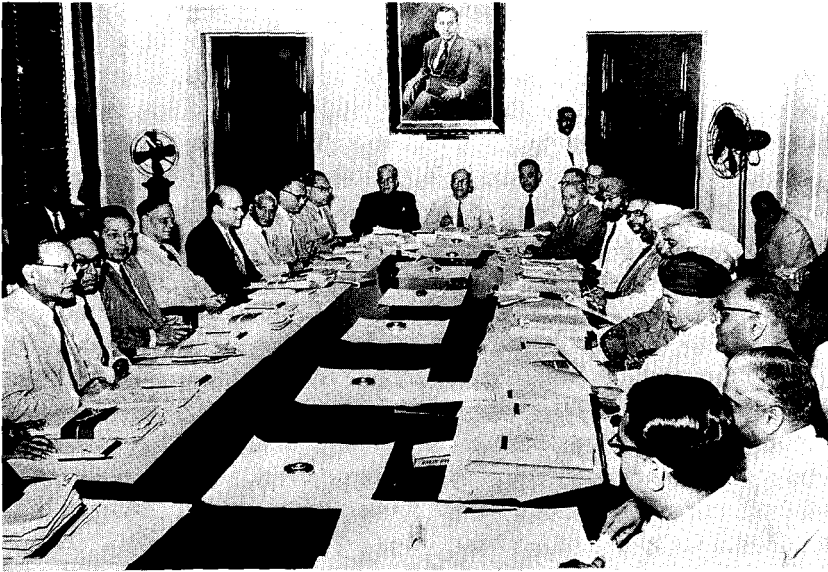
made a number of suggestions. These included allowing SFCs to borrow resources from the Bank for periods of up to eighteen months against government securities or their bonds and debentures, reducing the minimum period for which they could accept fixed deposits from five years to three and permitting them to accept deposits of governments and local authorities, providing state government guarantee for all deposits, and allowing financial corporations to borrow from their state governments and from scheduled banks against government securities. The Bank's attitude towards such proposals softened perceptibly after this conference. It had already initiated steps to administer the existing ninety-day limit for borrowing by SFCs flexibly and allow these institutions the same privileges in regard to such borrowing as state governments and scheduled banks. Overcoming earlier reservations about lending block capital to SFCs, the Bank now viewed the proposal for extending the period of their borrowing from it to eighteen months with greater sympathy. Such a practice already obtained in the case of the Industrial Finance Corporation which was also entitled to borrow against its bonds and debentures. The Bank's officers were originally in favour of lending to SFCs for the longer period only against government securities. The ease with which it could borrow from the Bank against its own bonds and debentures and renew such loans was felt to have discouraged the Industrial Finance Corporation from raising loans in the market, and officers at Mint Road were naturally wary of putting a similar temptation in the way of state financial corporations. On the other hand, as Ambegaokar took pains to stress, state corporations would soon run out of government securities to pledge, and the balance of advantage lay in allowing them to pledge their bonds, so long as these were guaranteed by state governments, against loans on which they could be charged a higher rate of interest. The Bank accordingly proposed inserting a new clause in section 17 of the Reserve Bank of India Act. This proposal was approved by the Central Board in August 1958.

The Bank also favoured reducing the minimum period for fixed deposits to three years. Shorter maturities had been envisaged in 1951 when the State Financial Corporations Bill was in draft. But it was not included in the final legislation as the then Finance Minister, C.D. Deshmukh, preferred a more cautious provision which made adequate allowance for the risks of undertaking longer-term financing operations on the basis of shorter-term funds. However, many corporations experienced difficulties in attracting deposits for five years, while the Madras Industrial Investment Corporation had shown that it was possible to attract deposits for durations of one to three years. The Madras corporation's success also owed to its deposits being guaranteed by the state government. Since deposits could be a flexible source of funds for corporations,

the Bank favoured reducing the minimum period and extending to them the same sort of guarantees available to bonds and debentures of state financial corporations. The Bank however rejected the proposal for SFCs being allowed to borrow funds from scheduled banks since, in the event of the proposed amendments to the Reserve Bank of India Act and the State Financial Corporations Act being passed, it would be in a position to extend accommodation to these institutions at lower rates of interest than commercial banks.

Keen to strengthen the financial position of SFCs, the Bank responded favourably to a proposal mooted first in 1956 and canvassed subsequently by many state corporations to forego its share of dividends from SFCs to enable them to set up special reserve funds. Having failed to meet their guaranteed dividend liabilities, many corporations had not managed to build up adequate reserve funds on their own. A committee set up by the 1956 conference pointed out that the 'high incidence of [income and super] taxation' reduced the net profits of SFCs 'to a figure which was inadequate to pay the minimum guaranteed dividend'. It underlined the increased risks inherent in long-term lending and the imperative need for SFCs to build reserves 'if for no other reason, then for ... (their) security ... as financial institutions ...', and endorsed, by a majority, the idea of transferring the Bank's and state governments' share of their dividends to the reserves of these institutions. However, the minority report, presented by the representative of the Kerala corporation, contended that state governments, which were already under attack for subsidizing their financial corporations, could not be expected to forego their dividends altogether, and proposed an arrangement whereby they continued to receive at least some portion of the dividend due to them. The recommendations of the majority report were reiterated at the sixth annual conference of state financial corporations in December 1959. The Bank and the central government were already committed to surrendering their shares of the dividends of the Industrial Finance Corporation to a special reserve fund until the amounts so credited exceeded Rs 50 lakhs. With the precedent already set, the Bank had little hesitation in accepting the conference proposal and foregoing its dividends from SFCs to the same extent as the state government concerned, provided these amounts went to a special reserve fund until the latter reached a tenth of the paid-up capital of the corporation. In addition, the Bank stipulated that no shareholder other than itself and the state government would have any claim on the fund which was to be used only for purposes approved by the two contributors.

Though accepted and drafted in 1958-59, these amendments hung fire for some years and were finally moved as part of the wider State Financial



Sixth annual conference of state financial corporations at the RBI, Bombay,
December 1959, Iengar (third from left) presiding

Corporations (Amendment) Bill, 1962. Passed in March 1962 the Act came into effect from 16 April the same year. It allowed SFCs to guarantee loans raised by industrial concerns from scheduled or state cooperative banks and arrangements for deferred payment for capital goods. It enhanced the limit of accommodation in respect of public limited companies and cooperative societies to Rs 20 lakhs (while the limit of Rs 10 lakhs remained unchanged for other concerns), and enlarged the meaning of the term 'industrial concern' to include the hotel and transport industries. The earlier decision to allow SFCs to borrow from the Bank for up to eighteen months against specified securities was also included in the bill, with the proviso that such borrowing should not exceed 60 per cent of their paid-up capital. Corporations were allowed, besides, to borrow from state governments and notified financial institutions up to ten times their paid-up capital and reserves, act as agents of any financial institution notified by the central government for loans or advances granted by the institution or debentures subscribed by it, and accept deposits up to the extent of their paid-up capital and reserves for a minimum period of one year. The bill also provided for the establishment of the special reserve fund decided upon earlier.

The Bank was closely involved with the efforts of state corporations to raise resources by floating bonds and debentures. The new provision allowing

SFCs to borrow from the Bank against their own bonds may have even had the effect of intensifying the interest the latter took in the flotations of SFCs. The Bank played an important role in persuading banks and other financial institutions to subscribe to the bonds of SFCs, and in coordinating their investments. Bonds issued by SFCs and outstanding amounted to Rs 41 crores at the end of June 1967. Available data show that up to March 1963, commercial banks had subscribed to nearly 53 per cent of these bonds, and the Life Insurance Corporation to about 26 per cent. State governments (0.6 per cent), the Bank (1.7 per cent), cooperative banks (3.6 per cent), other insurance companies and financial and other institutions (10.6 per cent), and individuals (4.2 per cent) made up the remainder. Thanks to the fairly widespread institutional support that bond issues of SFCs evoked, their recourse to borrowing from the Bank remained modest. Corporations' outstanding borrowing from the Bank at the end of June 1967 stood at Rs 2 crores—these were almost entirely against government securities and ad hoc bonds—while outstandings against refinance availed from the Industrial Development Bank of India amounted to Rs 15 crores.

Following the eighth annual conference of SFCs in November 1961, the Bank set up a working group headed by K.C. Mitra, Chief Officer in the Industrial Finance Department, to review the working of these institutions and recommend ways to improve their usefulness. The group, which submitted its report in February 1964, regretted the proliferation of institutions, especially at the state level, which duplicated the functions of state financial corporations. Pleading for a check on this tendency, the working group underlined the need to coordinate the activities of various institutions, such as the Industrial Finance Corporation, state financial corporations, state industrial development corporations, and the Industrial Credit and Investment Corporation, which were all in the business of providing term-finance to industry. It also recommended that state governments should route all assistance provided to industrial concerns on a commercial basis through these institutions. An earlier committee set up by the 1956 conference had envisaged SFCs diversifying into underwriting and equity financing. Reiterating this recommendation, the Mitra Working Group also stressed the need to strengthen the capital base of SFCs to enable them to undertake these additional activities. The working group felt resource mobilization could be assisted if SFCs floated bonds of shorter maturities. It also proposed allowing them to borrow from the Bank to the full extent of their paid-up capital, investing a portion of provident funds in the bonds of these institutions, and establishing a National Industrial Credit (Long-term Operations) Fund at the Bank.

By June 1967, there were eighteen financial corporations, including the Madras Industrial Investment Corporation Ltd., covering all the states of the country. Their outstanding loans amounted to Rs 73 crores. In 1966–67, SFCs were the third most important term-lending agency for industry, accounting for Rs 22 crores, or 17 per cent, of the total assistance of Rs 127 crores sanctioned by all industrial term-lending institutions that year. Nine corporations had diversified into underwriting, with total investments in shares and debentures of Rs 9 crores. Four SFCs also extended deferred payment guarantees for purchase of indigenous machinery, and their outstanding guarantees aggregated Rs 4 crores. Eleven SFCs were by then acting as agents of their respective state governments for routing concessional finance to small-scale industries under the State Aid to Industries Act, the loans so outstanding under these agency arrangements amounting to Rs 3 crores.

THE BANK AND SMALL INDUSTRIES

Small-scale and cottage industries were accorded an important place in successive five-year plans. The first plan provided Rs 27 crores for the sector which the plan document regarded as being integral to the wider industrial development of the country. The plan paid particular attention to the conditions of rural artisans who, besides possessing limited resources, could offer little by way of security, and championed cooperative organization to overcome these handicaps. It envisaged a network of institutions for promoting village and small industries. As well as establishing specialized bodies to encourage handlooms, other handicrafts, khadi and village-level manufacturing, sericulture, and coir-based activities, the government also set up a National Small Industries Corporation, the Small-scale Industries Development Board, and four regional Small Industries Service Institutes to provide technical assistance and advice to small industries. The second plan too, accorded an important place to the small manufacturing sector and envisaged cooperatively organized village and small industries as major sources of employment and consumer goods. In addition to providing Rs 200 crores for the sector, it assigned key roles to the Bank and to the newly-formed State Bank of India in evolving an integrated scheme for financing the needs of small-scale industries. At the urging of the National Development Council, the Planning Commission set up a Village and Small-scale Industries (second five-year plan) Committee under D.G. Karve to advise it on how best to utilize the plan resources earmarked for the sector. This committee stressed the need for coordination between the Reserve Bank, the State Bank of India, state financial corporations, and central cooperative banks in evolving a coherent financial

policy for small industries. The Industrial Policy Resolution (1956) also underlined the role of small industries in producing consumer goods and the importance of strengthening their competitive position by improving and modernizing techniques. A working group set up by the Ministry of Commerce and Industry to evaluate small industries development programmes and make suggestions for the third plan deplored the inadequate performance of SFCs and the general preference corporations and banks showed for lending to medium-sized units. Making a bigger provision for the State Aid to Industries Act, the plan once again stressed the need for stepping up financial assistance to the sector. It envisaged an outlay of Rs 264 crores for the sector in the third plan against an actual expenditure of Rs 180 crores in the second plan and Rs 43 crores in the first.

The State Bank of India Pilot Scheme

By the middle of the 1950s, financial assistance to small industries was available, at least in principle, from a variety of agencies. Apart from specialized institutions such as SFCs and the National Small Industries Corporation set up during the decade, the central government provided grants and long-term loans to state governments to enable them to assist small-scale industries under the State Aid to Industries Act. In a broad sense, these initiatives were intended to be complementary, rather than competitive. State aid, it was mainly hoped, would partake of the nature of 'risk' capital. The Small Industries Corporation and SFCs were concerned with medium and long-term loans. While industries in the cooperative sector could approach their apex institutions for working capital needs, commercial banks continued to be regarded as the proper source of working capital for other small industries. In practice, however, commercial banks did not lend much to small industries. In addition, a variety of factors, not the least of which was the absence of coordination between the many agencies involved, persisted in impeding the flow of finance to small-scale industries. Small industrial borrowers were also often in the situation of having to approach different sets of agencies or lenders for equipment loans and for funds to meet working capital requirements. This resulted in needless duplication of effort by the borrower and of credit investigation by the various lending agencies. Not only did all this push up the cost of loans, the multiplicity of credit agencies led to different types of capital being provided in a 'haphazard manner' and discouraged lenders from taking an integrated view of the financial requirements and prospects of their small borrowers. Finally, neither SFCs nor the National Small Industries Corporation possessed a well dispersed network of branches. Consequently, their services were mainly

confined to the larger centres and were not easily available to units in the more remote areas.

Two solutions were advanced to the problem of making institutional credit widely available to small industrial borrowers in a coordinated manner. One solution proposed in 1956, somewhat on the analogy of the measures taken to expand the availability of rural credit, was to disburse credit to small industry through urban cooperative banks which were either to be established or strengthened for the purpose with liberal assistance from the government. This proposal made little headway despite a measure of support for it in the Small-scale Industries Development Board and within the Agricultural Credit Department of the Bank. The principal opposition to the idea came from the Reserve Bank's Division of Banking Research, which pointed out that urban banks played such a small role in financing industry that government assistance towards setting up or strengthening these institutions was unlikely to be of much benefit to small industries. Non-scheduled banks and smaller scheduled banks, in contrast, advanced a greater proportion of their loans to small industries. The resources required to support urban banks, the Division maintained, could be better used to encourage non-scheduled banks and the smaller scheduled banks to enlarge their lending to small industries, if necessary, in collaboration with the State Bank of India. Non-scheduled banks were so far superior, in the Division's view, to existing or new urban banks as a channel for routing resources to small industries, that its note adverted to the advantages of amending the Reserve Bank of India Act to enable the Bank to extend credit to these institutions. The Banking Research Division's dim view of the potential of urban banks was confirmed by a sample survey conducted by the Bank in 1957 which found urban cooperative banking poorly developed in large parts of the country outside Bombay, Madras, Andhra Pradesh, and Mysore. Loans to small industries by these institutions, the survey revealed, also constituted a relatively meagre proportion of their total advances. In September 1957, however, the Small-scale Industries Development Board decided to utilize six urban banks in each state to route government funds. Even this plan made little headway outside Mysore state. Organizationally weak and critically dependent on government assistance, urban banks were not viable vehicles for financing small industries. But these institutions also faded into the background following the relative success of the second of the two solutions advanced to tackle the problem of delivering credit adequately to the small sector, namely the State Bank of India's pilot scheme for lending to small industries. The scheme's success paved the way, in due course, for greater participation by commercial banks in financing small industries.

The State Bank pilot scheme owed largely to the initiative of the Bank, and to that of the Deputy Governor, B. Venkatappiah, in particular. By early 1956, officials within the Bank had come round to the view that a promising approach to solving the problem of coordinating lending to small industrialists lay in a 'package approach' that enabled borrowers in this category to avail of all types of credit from a single agency. The State Bank of India was the obvious candidate to implement such a programme, and it was decided in April 1956 to utilize this institution to provide credit to small industries in a limited, but coordinated, manner. The pilot scheme required the borrowing firm to apply to the local branch of the State Bank of India or to the concerned cooperative bank, if it belonged to the cooperative sector, for its credit requirements. The application was considered by a local committee comprising representatives of the agencies working the scheme and, depending upon the type of credit required, it was referred to the appropriate lending agency. It was proposed to take up applications for loans below Rs 20,000 with the Director of Industries of the state government. Applications for loans above this amount were to be handled by the State Bank or cooperative banks if they were for working capital and by the state financial corporation if they were for medium- or long-term credit. Where credit of both types was required, it was proposed that the agencies concerned would act in coordination. The State Bank or the cooperative bank concerned assessed the borrower's creditworthiness while the technical appraisal of his proposal was provided either by the Director of Industries or by Small Industries Service Institutes. The State Bank also entered into agreements with some SFCs under which it acted as their agent in collecting credit reports, disbursing loans, and collecting instalments.

Initially introduced in 1956 at three centres in each of the State Bank's three circles, the scheme evoked a good response, with the number of applications under it rising from 161 in 1956 to 986 in 1957 and 2,165 in 1958. At the end of December that year, the State Bank had sanctioned Rs 2.4 crores, the Director of Industries of state governments Rs 58 lakhs, and SFCs Rs 74 lakhs under the scheme. The scheme was extended to fifty-three centres at the end of December 1959. With experience gained in working the scheme revealing that it would not be possible to assist small-scale units to any appreciable extent unless lending procedures and practices were liberalized, the State Bank initiated more liberal lending policies at the pilot centres. These included advancing unsecured working capital loans to small industries provided their products had an assured market or the unit agreed to undertake technical and organizational improvements under the supervision of small industry experts from the state government or from service institutes.

Small industries securing government orders through the National Small Industries Corporation were also provided finance for the full value of raw materials, with a guarantee from the corporation towards the margin. The latter arrangement was of particular assistance to engineering units.

A study initiated by the Reserve Bank evaluated the scheme as it operated until the end of 1957 at the nine centres where it was first introduced. It concluded that although the scheme's progress was not remarkable or uniform, it had, on the whole, worked well enough to be assured of a 'place in the field of providing improved credit facilities to small-scale industries'. It was also sceptical about the extent to which industrial activity could be organized along cooperative lines and about the ability of urban cooperative banks to meet the credit requirements of small-scale units. The study recommended the extension of the scheme to all branches of the State Bank. Little time was lost in implementing the suggestion. The State Bank also simplified and liberalized certain aspects of the scheme. The list of goods acceptable as security was enlarged and interest fixed at an all-inclusive rate of 6 per cent without imposing any additional charges on borrowers. The bank also agreed to consider extending medium-term loans for up to seven years to finance expansion and renovation plans of small industrial units.

The Credit Guarantee Scheme

Encouraged by the results of the State Bank pilot project, the Development Commissioner for Small Scale Industries in the Government of India, Ashfaq Hussain, wrote to thirty scheduled banks in June 1958 suggesting that they consider adopting similar schemes. A majority of the banks addressed wrote back to report that they were either already financing small industries or were willing to implement the government's suggestion. The Bank too was convinced of the necessity for measures to augment the flow of bank credit to small units. An ad hoc survey it conducted of advances extended by a selected number of offices of scheduled and non-scheduled banks to medium- and small-scale industrial units up to the end of September 1957 showed that industries in the latter category accounted for a mere 12 per cent of the industrial advances of the banking system. The Department of Banking Development held some reservations about commercial banks being made an 'important source of finance for ... small industries' at the cost of SFCs in whose establishment the Bank and the government had invested 'considerable planning ..., much thought and financial effort'. But the Bank itself had little hesitation, when the Development Commissioner approached it with his proposal in October 1958, in endorsing the principle of involving more commercial banks in financing small industries. It preferred, however, to

defer taking any steps in that direction until the conference of SFCs, which was scheduled to convene in December 1958, had had an opportunity to review the working of the State Bank's pilot scheme.

The Bank's survey also found that a major impediment remaining in the way of expanding commercial banks' involvement with small industries was the perception of the latter as poor credit risks. Even as the Bank was considering the findings of its survey, in October 1958 it received a proposal from the Government of India for introducing a scheme to guarantee commercial bank loans to small industries along the lines of a similar scheme which was reportedly working well in Japan. Though emanating from the Ministry of Commerce and Industry, this proposal was born directly of the State Bank's experience in running the pilot scheme and the recollection by its Chairman, P.C. Bhattacharyya, at a meeting of the central committee coordinating the scheme, of a suggestion made some months earlier by T.T. Krishnamachari. It was premised on the observation that lack of adequate security presented the 'main difficulty' in financing small industries. While government agencies, and even the State Bank of India, could 'at least up to a point take a promotional view and advance loans at some risk', commercial banks would not be willing to 'accept any but the normal trade risks; indeed in the beginning it will be a task to persuade them to lend money to small industrialists at all'. In these circumstances, the Commerce Ministry argued, a credit insurance scheme 'will perhaps do more to promote the growth of small industries than any other single concession so far granted by Government'. The working estimate in the proposal of the insurance premium on loans to small industries was of the order of two per cent per annum, i.e. a third or more of the interest that was then charged on such loans. This substantial additional burden, the proposal clarified, should not be passed on to borrowers but should largely be borne by the government. Forwarding the proposal, the Finance Ministry sought the Bank's views on the magnitude of the credit risk involved in lending to small industries, the necessity for insuring lending institutions against the risk, and the proper method of guaranteeing credit to the small sector.

The Commerce Ministry proposal sparked off numerous ideas within the Bank, not all of them unequivocally in its support. The Department of Banking Development, as noted above, was not altogether enthusiastic about turning to commercial banks to deliver credit to small industries if that meant bypassing state financial corporations. Nor was it in favour of the government taking upon itself 'additional (unlimited) risks or setting up new organizations' for the purpose and endowing them with financial resources. Much better, in its view, to direct attention towards improving the functioning of SFCs, assist them

financially to play an expanded role, and modify those provisions of their statute which had 'served in the past to retard their rapid development'. Should credit insurance be thought essential to encourage commercial banks to lend to small industries, the department maintained, the responsibility must be entrusted to SFCs after suitably amending their constitutions and placing the necessary funds at their disposal. SFCs, Banking Development's note pleaded, were in any case better suited than the government or a new central agency to act as credit guarantors since they had the necessary resources and expertise to investigate credit risks and maintain close contact with borrowers.

The Department of Research and Statistics, on the other hand, framed the issues underlying the guarantee proposal in a more hopeful light. Its note pointed out that the problem of inadequate bank credit to small industries arose both from the greater risks involved in making such loans and the relatively meagre resources at the command of the smaller banks which were willing to lend to the sector. The availability of finance (or refinance) and doubts over the liquidity of loans to small borrowers were the two factors constraining commercial banks from lending more actively to small industries. Hence, apart from making more finance available to this sector through new and specialized institutions, widening existing institutional facilities through guarantees and participation loans also represented a possible means of helping to meet the 'special needs of this fringe of unsatisfied borrowers'. The department's review of special facilities available to small borrowers in Japan, the United States, and the Netherlands revealed that the emphasis in these countries was as much on 'financing facilities to the primary lender as on the liquidity of the transaction'. Policy could thus take the form of either a simple insurance of the risks on a loan or of an undertaking to meet any financial inadequacy a primary lending institution may face as a result of its loans to small borrowers. The Commerce Ministry proposal, the note argued, attributed commercial banks' unwillingness to lend to small industries to their unwillingness to bear the additional risk on such loans.

If this were true, then the solution to this problem would indeed be on the lines of an insurance agency. It is, however, not clear that this is the main difficulty It would seem that the problem is as much one of finance as of liquidity; in other words, not merely must the reluctance of banks to accept such business be overcome but also steps would need to be taken to enable banks to lend by providing them more finance.

This was particularly necessary in the case of the smaller scheduled and non-scheduled banks which were more willing to lend to small industrialists but

had not benefited from the general increase in the deposits of the banking system in the past few years. Of greater relevance under Indian conditions, this memorandum urged, was a scheme which combined elements of credit insurance and, should the need for it arise, refinancing either directly or on the principle of deferred participation. The institution to undertake the twin responsibilities should bring together the government, the Bank, commercial banks, and specialized financial institutions.

The Chairman of the State Bank of India, P.C. Bhattacharyya, whose views were sought in the matter, favoured a credit guarantee corporation, with liberal support from the government, working broadly on the Japanese model. Credit guarantees, Bhattacharyya argued, were necessary to encourage banks to expand their lending to small industrial borrowers despite their inability to come up with adequate security. The Bank also despatched a team to Japan to study the practices of Japanese credit institutions in financing small industries. The report of this study team and the government's proposal for a credit insurance scheme were debated at the conference of SFCs held in December 1958. Opinion at the conference generally favoured a system of credit guarantees, but a formal decision was postponed until the following year when the Bank proposed, at the conference's instance, to convene a seminar devoted to the problems of financing small industries and ways of overcoming them.

This seminar was held in Hyderabad in July 1959. Bringing together central and commercial bankers, officials from central and state governments and specialized industrial lending agencies, and representatives of chambers of commerce and small industrialists, the Hyderabad seminar represented an important landmark in efforts to meet the financing needs of small industry. Inaugurated by the Chief Minister of Andhra Pradesh, N. Sanjiva Reddy, the seminar was presided over by Venkatappiah who set the tone for its deliberations by highlighting the paradox of the small industrial sector not developing much momentum despite abundant goodwill and an impressive network of institutions and policies to cater to its needs. Small industrial units tended to grow in a haphazard way, they suffered from high rates of mortality, a majority of them were still at the mercy of moneylenders or traders, and productivity standards remained very low, the Deputy Governor pointed out. The seminar constituted four working groups dealing with the causes of borrower resistance, factors inhibiting credit institutions from lending more freely to small industries, the role of the government in assisting small industries, and finally the resources of credit institutions and related issues. These groups were chaired respectively by R.S. Bhatt, R.G. Saraiya, A.S.E. Iyer, and B.K. Madan. Each of the groups produced elaborate reports and

made a number of suggestions which were discussed at an open session of the seminar. The seminar formulated, in all, twenty-one recommendations intended to strengthen the small industrial sector and boost institutional financial and other assistance to it.

Important as the Hyderabad seminar was, little purpose is served by attempting to summarize its deliberations or even its main recommendations here. The principal proposition to emerge from the seminar, for our purposes, related to ways in which risks of lending to small industries could be minimized. The most important recommendation to this end was the one for introducing a system of guaranteeing loans to small industries, to begin with on an experimental basis in selected areas. After deliberating on the models of small business credit risk insurance schemes operating in the US and in Japan, the seminar concluded that it was necessary, under Indian conditions, to combine features of both institutions and formulate a guarantee scheme the 'essence of which was a sharing of risks'. The guarantee, the seminar proposed, should apply to banks such as the State Bank, selected scheduled and other commercial banks, state cooperative banks, cooperative urban banks, and other cooperative banking institutions. For obvious reasons the seminar insisted that the guarantee should ordinarily not exceed 50 per cent of the loan, with the primary lending institution bearing the risk on the remainder. In exceptional cases, however, loans could be guaranteed to the extent of 75 per cent. The offer of the guarantee on a loan was also to be conditional upon the borrowing unit being inspected by the staff of the Director of Industries or of Small Industries Service Institutes and a local guaranteeing association, endowed with the necessary share capital, undertaking part of the risk. 'On the whole the request for guarantee must be supported both by local knowledge and a financial stake', the seminar recommended. In order further to spread the risks of lending to small industries, the seminar supported the idea of SFCs and banks entering into agency arrangements with each other. Banks and institutions could also extend loans to cooperative and other commercial banks on the basis of participation, whether immediate or deferred. Besides spreading risk, such arrangements, the seminar urged, would enable borrowers to deal with a single institution instead of with several agencies.

The principle of a credit guarantee on loans to small industries was thereafter quickly endorsed by the government, the State Bank of India, and several of the commercial banks. Although the seminar had envisaged the possibility of more than one guaranteeing organization, the Bank itself undertook to operate the credit guarantee scheme on behalf of the government. Following an amendment to the Bank Act in April 1960 and an exchange of letters, the Government of India designated the Bank as the guarantee organization and

authorized it to act as its agent in offering guarantees and administering the scheme. Loans to small industrial units with capital investment of less than Rs 5 lakhs and having satisfactory ratings from the Development Commissioner for Small Scale Industries were eligible for guarantees under the scheme. Up to half a loan ordinarily, and in some cases up to three-quarters, could be guaranteed against the payment of a nominal guarantee fee of 0.25 per cent, provided no guarantee was for a sum exceeding Rs one lakh. The Credit Guarantee Scheme came into operation in twenty-two districts on 1 July 1960 for an experimental period of two years. Within a year the number of districts covered by the scheme was increased to fifty-two. At the time the Credit Guarantee Scheme was introduced, ninety-five credit institutions were eligible to take advantage of it. These included, besides the State Bank of India and its eight subsidiaries, forty-nine scheduled banks, twenty-two state cooperative banks, and fifteen state financial corporations (including the Madras Industrial Investment Corporation Ltd.).

The Bank undertook a review of the guarantee scheme towards the end of the experimental period. The review showed that up to the end of March 1962 the guarantee organization had received over 2,500 applications from almost all the districts where the scheme was implemented, for a total amount of Rs 8.93 crores. Of this, the organization issued guarantee certificates for nearly 2,350 applications involving an aggregate sum of Rs 7.63 crores. Over two-thirds of the guarantees issued were for advances below Rs 25,000, suggesting that 'comparatively small units constituted the largest group to reap the benefits' of the scheme. At the end of March 1962, a total of 1,830 guarantees for a sum of Rs 5.96 crores were in force. During this period, a single claim had been admitted for the princely sum of Rs 539.55 against a guarantee for Rs 1,000.

However, a disquieting feature of the working of the scheme revealed by the review was that only twenty-two of the ninety-five specified institutions had taken advantage of it. Of these, fourteen were commercial banks. The State Bank of India alone accounted for nearly 2,350 applications covering a sum of over Rs 8 crores. The review attributed this imbalance to the excessive caution shown by the State Bank of India which had covered all its advances to small units in the eligible districts under the scheme. In contrast, other banks did not ask for cover except in cases where they considered their advances 'sub-standard or marginal' and as involving 'greater than normal risks'. State financial corporations too did not apply for cover to any great extent because their normal advances were for periods above seven years and these were, for much of the review period, ineligible for guarantees under the scheme.

The review was, however, generally positive in its evaluation of the scheme and took comfort in the observation that a 'promotional measure' such as this was 'bound to be slow in casting its influence on the minds of banks'. Two years were not long enough to 'bring about a significant change in the policies and attitudes of credit institutions whose prejudices against ... small scale industries were deep-rooted'. Commercial bankers and state financial corporations had, in general, welcomed the scheme which, they maintained, encouraged them to sanction loans to small industries where previously they might have refused. State financial corporations might be expected to make greater use of the scheme's facilities, the review anticipated, since it was now proposed to permit cover to all loans made to small industrial borrowers, irrespective of their currency, for a period up to seven years. Thanks to the scheme, the review noted, the State Bank now contemplated making clean advances for processing purposes, while several SFCs were willing to reduce their margin requirements from 50 per cent to 25 per cent for guaranteed advances. The Union Cabinet, which examined the scheme, also endorsed it and called for its extension throughout the country. Seconding the latter suggestion, the review also recommended putting the guarantee scheme on a permanent footing.

Both suggestions were implemented from the beginning of 1963. Despite the earlier optimism, however, the domination of the State Bank of India and its subsidiaries abated only slightly. They accounted for nearly 95 per cent by value of all guarantees issued by the guarantee organization since its inception up to November 1964; other commercial banks and SFCs accounted between them for about 4 per cent. Hence, despite some internal reservations within the Bank, it was decided in 1965-66 to cast the guarantee net wider to include central cooperative banks and specified non-scheduled banks. This move, which in one stroke raised the number of eligible institutions from fewer than 100 to 452, was motivated partly by the hope that smaller non-scheduled banks would be more interested in lending to small industries and by the recognition that the larger commercial banks which were already eligible for guarantee facilities were not keen to enter into participation arrangements with these institutions. At the same time as this modification was adopted, the guarantee cover was also enhanced from Rs one lakh to Rs 2 lakhs. Loans up to ten years were now eligible for cover, with the primary lender having the option of availing of it for the entire period of the loan. The definition of small industry was also revised and the maximum investment in plant and machinery raised to Rs 7.5 lakhs in March 1967.

These reforms were not altogether without effect. Between July 1960, when the scheme was introduced, and December 1967, the guarantee

organization received 64,274 applications for Rs 276 crores, and issued guarantees for 57,071 applications for a total sum of Rs 231 crores. Of the latter amount, guarantees for all but Rs 48 crores were issued in the three years after November 1964.

Special Refinancing Arrangements

A survey by the Bank in July 1961 revealed that advances to small industries by scheduled banks amounted to Rs 27 crores at the end of June 1961. This constituted less than 2.5 per cent of total scheduled bank credit. The question of providing special refinancing facilities to banks against their loans to small borrowers cropped up when the Government of India's proposal for a credit guarantee scheme was under discussion in the Bank. The issue was also raised at the Hyderabad seminar where it was suggested that while large commercial banks could substantially increase their lending to small industries without additional resources being made available to them by way of refinancing, the resources of smaller banks might need to be augmented before they could expand their involvement with the small industrial sector. Refinancing cropped up, besides, in discussions about the role of commercial banks in extending medium-term loans to small industries. The seminar, however, confined itself to recommending some relaxations in the bill market scheme, wider membership of the Refinance Corporation for Industry to include other commercial banks, cooperative banks, and SFCs, and provision by larger banks of rediscounting facilities to smaller banks along the lines of the facilities they afforded to Multani shroffs.

The expectation nurtured in the seminar that commercial banks would not be constrained by shortage of resources in lending to the small industrial sector was not borne out by subsequent developments. As the Bank tightened its credit policies in the early 1960s, particularly through the introduction of the 'quota-slab' system, it was feared that 'fringe borrowers' such as small industries would be particularly badly affected.¹ Hence it allowed commercial banks to borrow from it at the Bank rate, an additional amount, over and above its basic quota, equivalent to their incremental average lending to small industries in the first half of 1961 over the corresponding period in 1960.

Thanks, no doubt, to some of these measures, the volume of credit provided by scheduled banks to the small industrial sector, in addition to equipment finance provided by specialized institutional agencies, the State Bank of India, and its subsidiaries, increased from Rs 32 crores at the end of December 1961 to Rs 54 crores at the end of June 1964. But this growth barely outpaced the

¹ For details of the 'quota-slab' system, see chapter 3.

overall growth in industrial advances, the share of the small sector in the latter rising only marginally from 4.8 to 4.9 per cent. The number of small industry accounts rose from 13,517 to 22,800. Outstanding advances of scheduled commercial banks to small industries rose further to Rs 74 crores (26,000 accounts) in 1965 and Rs 91 crores (28,500 accounts) in 1966. They rose steeply thereafter to Rs 178 crores (51,000 accounts) in March 1967, but a considerable part of this increase was due, admittedly, to the fact that the definition of small industrial units having undergone a change in the meantime, the latter set of figures were compiled on the new basis.

Financing Handloom Cooperatives

The Reserve Bank of India Act was amended following the informal conference (on rural credit) in 1951, to enable the Bank to finance production and marketing activities of approved cottage and small industries. A conference of Development Secretaries of state governments, representatives of the Bank, and officials of the central government which was convened in July 1955, recommended that the Bank should provide concessional credit for the cooperative production and marketing of handloom cloth on the analogy of facilities it extended towards agricultural cooperatives. It also set up a committee on credit facilities for the handloom industry on which the Bank was represented by the Chief Officer of its Agricultural Credit Department. This committee estimated that primary weavers' cooperatives required working capital of about Rs 21 crores to meet their second plan production target and suggested that these funds should be obtained from the Bank. The Central Board of the Bank approved this recommendation after the Governor underlined the employment potential of the handloom sector, its higher working capital requirements, and the need to shift the main source of support to the handloom sector from the cess fund to institutional financing agencies. Following the Central Board's decision, which included making accommodation available to apex banks at 1.5 per cent below the Bank rate, the central government took steps to phase out the cess fund scheme and replace it with the Bank's scheme from April 1957. The government notification clarified that apex banks should finance weavers' societies at 3 per cent, with a subsidy of 2 per cent from the cess fund. The Bank also advised state governments that it would lend to central cooperative banks, under section 17(2)(bb) of the Bank Act, against their guarantee up to the limit of such banks' owned funds and to state cooperative banks up to thrice their owned funds. This accommodation was made available for financing solvent weavers' societies for the production and marketing of handloom cloth at the rate of Rs 300 per loom. This rate was raised to Rs 500 per loom in 1960. From April 1966 the Bank adopted a

production-oriented, rather than capacity-based, method of determining working capital requirements and societies' credit limits, with the latter being fixed at a fifth to a third of the value of the cloth produced by a society in the previous year.

Apex banks' utilization of these limits, however, fell below expectations. While the latter were of the order of Rs 1.8 crores in 1957–58, Rs 2.27 crores in 1958–59, and Rs 2.33 crores in 1959–60, actual limits utilized during these three years amounted to Rs 49 lakhs, Rs 1.74 crores, and Rs 1.73 crores respectively. The Bank therefore decided to select nine major handloom centres, in consultation with the All-India Handloom Board and state governments, where its financing programme could be promoted in a concerted manner. The Bank also constituted an Advisory Committee on Handloom Finance, with the Deputy Governor in charge of rural credit as its chairman, to review the progress of its scheme to finance weavers' societies.² The Bank attempted, besides, to simplify and liberalize the procedures apex banks were required to follow in order to avail of this facility. It advised state governments, for example, to issue blanket guarantees in advance for a period of one year rather than on an individual case basis; further in a significant departure from past practice, the Bank agreed to accept the total cash credit limits sanctioned by central cooperative banks to weavers' societies, instead of outstanding amounts, as cover for their borrowing from the apex bank. Seminars were also conducted in as many as ten centres during 1960–61 to promote the scheme and secure some feedback on its working. These steps achieved the intended effect—actual utilization in 1960–61 and 1961–62 amounting to Rs 2.4 crores and Rs 3.54 crores respectively against limits of Rs 2.95 crores and Rs 3.69 crores. So much so, by April 1965 the Bank could contemplate with equanimity the gradual reversal of some of these measures in order to prevent borrowed funds accumulating unnecessarily with central and state cooperative banks and their diversion to other uses.

The Bank's interest in artisans' and producers' cooperatives during this period was not confined to organizations of weavers. Its officials conducted extensive surveys to explore the possibility of extending similar types of accommodation to small producers in the leather, coir, fishing, and sericulture industries. But their studies revealed that these industries required to be substantially reorganized before producers, rather than middlemen, could take advantage of the type of facilities available to weavers who had had the benefit of a longer history of cooperative organization.

² This committee was merged with the rechristened Standing Advisory Committee on Rural and Cooperative Credit in April 1965.

FINANCING EXPORTS

It is widely recognized that exports did not receive much attention from the country's planners in the early years. Apart from substantial sterling balances and the relatively modest external financing needs of the development programme in the early years of planning, the emphasis of the country's policy-makers on the home market also derived from the export pessimism that dominated their outlook during these years. An Export Promotion Committee (chaired by A.D. Gorwala) was no doubt set up in 1949 to examine measures needed to achieve balanced trade particularly with hard currency areas. But the background to this was largely filled in by Britain's efforts to ration the supply of dollars to India whose external reserves were held at this time in non-convertible sterling. Besides, this committee was generally content to recommend relaxing controls on exports and reducing export duties. Even these modest reforms became hostage to the winds blowing from Korea—as India too, came under the grip of inflation, policy-makers grew keen to conserve supplies of exportables for domestic consumption. Far from being relaxed, therefore, export controls were tightened during 1951.

A number of committees were constituted after 1956 by the Bank and the government to study various aspects of export promotion and financing. Thanks to the recommendations of these committees, export credit facilities were liberalized gradually. An Export Risks Insurance Corporation (ERIC) was set up in July 1957, which was later converted into the Export Credit and Guarantee Corporation in January 1964.

The Bank's role in the export arena remained modest until the 1960s. Rediscounting facilities under the bill market scheme were extended to export advances, but little actual progress was made since the procedures, involving the creation of usance bills and their physical transfer, proved cumbersome and complicated. The Reserve Bank of India Act had, therefore, to be amended in 1962 to enable the Bank to lend for up to six months against export bills on the basis of declarations made by banks. Following the changed procedure, the volume of refinance assistance extended by the Bank increased substantially. The cost of export credit was also regulated, and this was subsequently formalized by the Export Credit (Interest Subsidy) Scheme. The scheme to refinance export credit on concessional terms was continued even during periods when the Bank was otherwise attempting to rein back its refinancing of general bank credit. In addition, pre-shipment credit was introduced and, as discussed earlier, the Refinance Corporation for Industry also stepped in to refinance medium-term export credits.

The First Steps

With the Government of India beginning to shed its earlier indifference towards exports, it set up an Export Promotion Committee in February 1957 with V.L. D'Souza as its chairman, to study all aspects of export promotion. Two recommendations of this committee were of particular interest to the Bank. The first related to popularizing the system of making advances to exporters in the form of 'packing credits' against 'trust receipts' which could be recovered, if necessary, by instituting criminal proceedings against defaulting borrowers; and the second to the possibility of the Bank refinancing or rediscounting export bills at preferential rates of interest.

These recommendations, which represented virtually the first effort to outline its role in promoting exports, evoked a mixed, and on the whole a low-key, response from the Bank. The Bank had examined the legal status of 'trust receipts' in 1954 and found it rather ambiguous. Even in 1958, it was for many officials at the Bank 'a matter of doubt whether an obligation in the nature of trust can be created over unidentified goods or goods which have not come into existence'. Despite doubts over the legal rights of those holding such securities, banks persisted in the practice of advancing packing credits against 'trust receipts' to exporters 'of undoubted creditworthiness and integrity' who had firm export orders or had bought goods to service such orders. In 1954 the Bank had rejected moves to subject trust receipts to special legislation on the ground that it would give 'undue' precedence to the rights of banks as lenders and neglect the rights of other parties dealing with defaulting borrowers. But with the Export Promotion Committee coming to the conclusion that the ambiguous legal status of trust receipts inhibited banks from advancing packing credits more liberally and widely to exporters, the Bank expressed itself willing to take a positive view of the step pressed by this committee so long as the 'adverse effects on third parties' of the special legislation were not 'large'.

The proposal to rediscount export bills sparked off a more intense debate within the Bank. The Department of Banking Operations pointed out the legal and operational difficulties that came in the way of handling bills drawn or negotiated under a letter of credit and extending refinance against export bills. Besides it was not convinced that banks experienced any special difficulty in financing exports. Foreign bills purchased and discounted by Indian scheduled banks amounted to Rs 22 crores at the end of January 1958; on the other hand, Indian banks' outstandings under the bill market scheme stood at Rs one crore against limits of Rs 82.76 crores. 'Thus the banks can without difficulty raise additional funds under the Scheme without approaching us for ... rediscounting ... export bills', this department maintained.

The Department of Research and Statistics, in contrast, advocated a wider and more positive approach. A note by V.G. Pendharkar in May 1958 pointed out that with nearly 70 per cent of the country's export bills being drawn in sterling, London remained the most important centre for financing Indian exports. While finance for Indian exports was easily available, its cost depended on the London discount rate which tended, of late, to be high and prone to frequent changes. A rise in the London discount rate lowered the earnings of Indian exporters 'for no fault of theirs' and was similar in its effect to 'the exchange rates of a number of countries' moving 'suddenly ... against ... Indian exporters' who exported to third countries 'via [the] sterling'. The memorandum argued that the mechanism for financing Indian exports should be capable of absorbing 'extraneous' shocks. Several remedies were available 'to undo the mischief' caused by shocks such as devaluation of major currencies, or against import restrictions and export subsidies implemented by other countries, but none whatever against a London discount rate hike which was 'capable of inflicting greater damage on India's exports than other more direct measures'

A possible solution was to bar (exchange) banks from fixing 'a disproportionately high rate for sterling bills' so long as the Bank rate in India was low and the Reserve Bank was ready to supply sterling to them. If the Bank satisfied exchange banks' need for sterling in a 'timely and inexpensive manner' they could not make the plea that a high rate on export bills presented by Indian exporters arose from the necessity of having to discount them in London. If banks persisted in charging high rates despite access to the Bank, it would be 'nothing short of ... profiteering ... at the expense of exporters and ... of the country' The alternative solution was for the Bank to provide a cheap source of export refinance to banks along the lines suggested by the Export Promotion Committee, provided the benefit was passed on to exporters. The practical difficulties raised by the Department of Banking Operations, Pendharkar argued, were not so serious as they appeared 'at first sight'. Drawing attention to the liberal credit facilities available to exporters in Japan and West Germany, he reiterated the necessity for India to follow the lead of these countries and take some 'bold steps' to promote exports.

The urgency of the arguments pressed by Pendharkar receded somewhat with the lowering of the Bank of England discount rate to 5 per cent, and the Bank decided, in the event, to adopt the course of action advanced by the Department of Banking Operations. While the practical difficulties in the way of rediscounting export bills would take 'considerable time' to remove, it was not necessary, the Bank felt, to accept the Export Promotion Committee's

suggestion since the 'liberal limits' granted to banks under the bill market scheme 'remained unutilized'. However, the Bank expressed its willingness to make advances under the bill market scheme against bills arising out of exports at a concessional rate of 0.5 per cent below the usual rate on its advances under the scheme. The Export Promotion Committee recommended that the State Bank of India should advance credit to commercial banks on the strength of export bills. The State Bank too turned down the suggestion, arguing that the 'grant of such a facility to other commercial banks cannot be considered ... one of its legitimate functions'. But it agreed to devote more attention to financing exports and to intensify its campaign to handle a larger share of the country's foreign exchange business.

The question of providing liberal credit facilities to exporters did not, however, go away. Even as the Bank was considering the Export Promotion Committee's recommendations, S.L. Kirloskar, noted industrialist and chairman of the Engineering Export Promotion Council, addressed the government, among other things about the adverse effects on machinery exports of the absence of any provision for medium-term export credits. Some weeks later in July 1958, another industrialist, K.K. Birla, raised the same issue in a letter to the Governor and argued that Indian engineering exporters would lose markets to foreign competitors unless they matched their medium-term credit facilities. Soon thereafter, the Finance Ministry sent the Bank a letter from the Ministry of Commerce and Industry urging the provision of adequate credit facilities for exporters and underlining an earlier recommendation of the committee of economic Secretaries of the Government of India proposing the formation of a 'committee of experts' to study the issue.

The Bank was, of course, constrained by the fact that it was only permitted to rediscount bills maturing within ninety days. Scheduled banks, on the other hand, were prevented by the absence of suitable refinancing facilities from locking up their resources in bills maturing later than six months. In considering Birla's plea, officials at the Bank took the view that refinancing export bills of longer durations did not 'legitimately fall within the purview' of central banking. This task was best left to a specialized financial institution which the Bank could, at best, support by subscribing to its shares or bonds. The State Bank of India too, maintained that it was not in a position to discount bills with usance periods longer than six months; while the Export Risks Insurance Corporation pointed out that the Export Credit Guarantee Committee, following whose report it had been set up, had not been in favour of the corporation rediscounting insured bills. It expressed its readiness, however, to undertake this activity to the extent permitted by its resources if the government instructed it to do so.

Rather than set up another committee for the purpose, the Bank and the Finance Ministry agreed that a better course would be for senior Bank officials to meet representatives of leading Indian and exchange banks to ascertain the difficulties they faced in financing exports and to discuss solutions. At this meeting, which was held towards the middle of August 1958, banks agreed to extend packing credits more freely to exporters provided policies of the Export Risks Insurance Corporation were extended to cover pre-shipment risks and the violation of trust receipts undertakings was made a criminal offence. However, as the meeting revealed, there was a further hurdle to be crossed. Exporters, it turned out, often did not declare to the corporation shipments to countries such as the UK or the USA where the risk of default was negligible, and preferred to confine declarations to shipments made to less 'creditworthy' countries or importers. This meant, firstly, that exporters could not avail of packing credits to finance exports to the more creditworthy borrowers. More importantly, banks were uncertain about the validity of the cover in such cases since the corporation might, in the event of concealed shipments coming to its notice, declare the entire policy of an exporter 'null and void'. Alive to this problem, the corporation proposed, subject to the government's consent, to cover all exports up to the limits of an exporter's policy for a specified period, whether or not the latter declared shipments to it. Backing this suggestion, the Bank informed the government that it would, if adopted, render it easier for banks to extend packing credits to exporters on the strength of their ERIC policies. The meeting also recommended that the Reserve Bank should arm itself with powers to grant to banks, in case of need, credit facilities for a period corresponding to the usance of export bills discounted with it.

Extension of the Bill Market Scheme to Export Bills

Communicating the outcome of his meeting with bankers, Ram Nath informed the government that the Bank was actively working out a 'practicable scheme' to extend the bill market scheme to cover export bills. There were certain 'technical difficulties' in the way but these 'should not prove insuperable', the Deputy Governor assured the government. Within weeks of the letter, in October 1958, the Bank decided to extend the bill market scheme to export bills for one year on an experimental basis. Scheduled banks which were authorized dealers in foreign exchange and eligible to borrow under the main scheme were allowed to avail of the facility against demand loans granted to exporters on the basis of documentary export bills with usance up to ninety days. The interest rate was the same as under the bill market scheme. The minimum advance to the borrowing bank and the value of an individual

usage promissory note acceptable as security under the bill market scheme were Rs 5 lakhs and Rs 50,000 respectively. But these were fixed at Rs 2 lakhs and Rs 20,000 respectively in the case of export credits, and were soon lowered to Rs one lakh and Rs 10,000. In January 1961 the latter threshold was lowered further to Rs 5,000. The Bank also agreed to bear half the stamp duty on the transaction, and soon afterwards the entire burden of the duty. In January 1959 the Bank withdrew the condition that exporters should obtain cover against exchange risk, and instead allowed banks to enforce a margin of 25 per cent. Even the latter stipulation was withdrawn in January 1961. The Bank also allowed borrowing banks to rediscount export bills abroad and accept export bills drawn by parties without recourse to them, provided usage promissory notes were obtained from borrowers. A further package of measures was approved in January 1961 to liberalize credit to exporters under the bill market scheme. Apart from the two reforms mentioned above, the Bank decided, as part of this package, to relax the limit of ninety days for the usage of export bills held as security provided the usage of promissory notes lodged with it did not exceed ninety days. Despite these measures, the extension of the bill market scheme to export bills evoked a poor response principally because borrowers were reluctant to execute usage promissory notes; nor was any acceptable solution in sight to the problem of having to physically transfer and re-transfer export bills held as security.

Study Group on Credit Facilities for Exporters

In the early part of 1960, Lala Shri Ram, industrialist and a member of the Central Board, raised with the Bank the possibility of relaxing exchange control regulations to allow exporters of engineering goods up to a year to realize their earnings, and making export credit available to them for the longer period. He also suggested covering the exchange risk for forward deals extending beyond six months. Fearing malpractice and delays in repatriating export earnings home, the Exchange Control Department opposed the first suggestion. However the Division of Banking Research was in favour of allowing exporters of 'a few specified items' of engineering goods a longer period within which to bring home their export earnings. The Bank was also in favour of the third suggestion, believing that since nine-tenths of India's exports were invoiced in sterling, rupees, and US and Canadian dollars, the loss to the Export Risks Insurance Corporation from covering the additional risk was unlikely to be significant.

The Division of Banking Research was more sceptical about the need for special measures to extend credit to engineering exporters for periods as long as one year. Commercial banks' deposits, it argued, had grown so rapidly in

recent years and financing foreign trade was so much more lucrative to them than financing domestic trade that banks appeared not to be in need of additional refinancing facilities for lending to exporters even for periods up to two years. The former might be far happier, the division pointed out, if the Export Risks Insurance Corporation extended to them a direct and unconditional guarantee, as was the practice in the UK and some other countries, in respect of exports of selected engineering goods. Should the need arise at a later stage to advance or refinance medium-term export credit, the division maintained, the responsibility should be entrusted to the Refinance Corporation for Industry rather than to the Bank. In any case, its memorandum argued, the availability of export finance was not so great a problem for exporters of engineering goods as the price of steel and levels of taxation.

Even as the Bank was examining Shri Ram's suggestions, the government constituted a study group in April 1960 under T.C. Kapur, Managing Director of the Export Risks Insurance Corporation, on credit facilities for exporters. The Bank was represented on this group by K.N.R. Ramanujam from the Division of Banking Research. The study group's report, submitted in February 1961, made a number of major recommendations. These included extending the usance period of export bills eligible for grant of advance by the Bank to 180 days, amending the Reserve Bank of India Act to enable the Bank to lend to scheduled banks on the security of their promissory notes, exempting export bills and packing credits from credit control measures, taking steps to grant credits to exporters of capital and engineering goods for periods up to five years, and refinancing of medium-term export credit by the Refinance Corporation. At the Governor's instance, Ramanujam returned to examining issues related to the cost and availability of export credit even before the formal receipt of the study group's report from the government. Endorsing its principal recommendations, he proposed sanctioning additional credit limits to banks at the Bank rate both against export bills and packing credit advances, and amending the Bank Act to facilitate such refinancing up to 180 days without banks having to physically lodge eligible usance bills. Departing from his earlier views, Ramanujam also underlined the need to amend the constitution of the Refinance Corporation for Industry to enable it to refinance medium-term export credits. Both the Indian Banks' Association and the Exchange Banks' Association supported these proposals, while as already pointed out, in 1962 the Refinance Corporation began refinancing export bills for up to five years.

Swift steps also followed to amend the Reserve Bank of India Act to enable the Bank to grant advances against export bills. In July 1961 the Committee of the Central Board approved the proposal to amend the Act so

as to enable the Bank to grant advances against export bills maturing within ninety days against promissory notes issued by banks supported by a declaration that they held eligible export bills of matching value. At the government's instance, the acceptable period of usance of eligible bills was extended to 180 days. These amendments, among others, were approved by the Central Board in June 1962 and, together with amendments to the State Bank of India Act to enable it to provide term finance, particularly to exporters, passed by both houses of Parliament in September the same year. The amendments to the Reserve Bank of India Act paved the way for the Bank to introduce the Export Bills Credit Scheme in March 1963. At the same time the Bank also introduced a special dispensation for export bills drawn in Indian rupees, making available to banks, under the prevailing quota-slab system of regulating their access to the central bank, an additional quota at the Bank rate against such bills, provided they passed on the concession to their borrowers. When the system of quotas was replaced in September 1964 by one of differential interest rates based on the net liquidity position of the banks, the Bank continued to allow scheduled banks to borrow from it against rupee export bills at the Bank rate.³ The Export Bills Credit Scheme made steady progress, advances to banks under it rising from Rs 12 crores in 1963 to Rs 44 crores in 1967.

Cost of Export Credit

While successive steps were taken to increase the availability of credit to exporters, banks were free, except in the case of short-term rupee export bills, to fix the interest rate on their export credits. The effective cost of export credit was reported to be higher in India than in other countries and was seen as a factor eroding the competitiveness of Indian exporters. Hence the government set up a working party on Cost of Export Credit in February 1964, under S.P. Chabiani, Kapur's successor as Managing Director of the recently rechristened Export Credit and Guarantee Corporation. This committee had a strong presence from the Bank. V.G. Pendharkar and M. Narasimham were its members, while D.G. Borkar, another officer of the Bank, acted as its Secretary. Its report, submitted in October 1964, pointed out that the rate of interest on export credit, which was fixed according to the Inter-Bank Agreement at a minimum of 2 per cent above the Bank rate, was often as high as 7 to 9 per cent and sometimes even exceeded the prime domestic lending rate. The cost of medium-term export finance too, worked out to 8.5 per cent after taking into account the stamp duty, commission, exchange, and

³ The new accommodation regime is discussed in chapter 4.

other charges. The working party had little hesitation in endorsing the view that export credit cost more in India than in other countries and more than domestic credit. The Committee on Export Finance (or the Mathrani Committee), which had reported earlier, also suggested offering cheaper credit to exporters both at the pre-shipment and post-shipment stages. On the other hand, as the working party recognized, it was not possible merely to cap the interest rate on export credit: not only did banks need to provide a reasonable spread between the cost of funds to them and the rate at which they lent them out, a cap might merely lead to banks cutting back on export credit and diverting resources to more profitable uses. Hence it underlined the necessity of complementing the cap by bringing pre-shipment credit too, under the purview of the Bank's concessional refinance facilities. The latter, it proposed, could be granted against bills drawn up by the local producer against a firm export order and discounted by his bank. It proposed a ceiling of 1.5 per cent above the Bank rate on pre-shipment export credit and one per cent above the Bank rate on post-shipment credit against export bills of up to six months. It also proposed putting the Rupee Export Bills Scheme, with its provision of concessional refinance from the Bank, on a permanent footing and extending the scheme to cover usance bills in sterling, dollar, and other foreign currencies. The maximum lending rate, the working party ventured to suggest, should no longer depend on whether or not a bank chose to refinance its advances under the scheme. As a further step towards reducing the effective cost of export credit, this committee also recommended abolishing stamp duty on all usance export bills.

The Bank was amenable to the working party's suggestion to impose a uniform ceiling on banks' advances against rupee export bills irrespective of whether they were refinanced. The Foreign Exchange Dealers' Association supported the proposal to extend the ceiling, which it wanted fixed at 2 per cent above the Bank's lending rate, to advances against usance export bills drawn in foreign currencies. But the Bank balked at the suggestion, feeling such facilities could wait until a clearer view emerged of their likely effects on the country's credit and foreign exchange situation. On the other hand, despite apprehensions that pre-shipment finance was liable to misuse and that it might prove difficult in practice to distinguish finance utilized by a borrower for exports from that for other purposes, the Bank agreed to refinance packing credit advances backed by letters of credit or firm export orders from the 1965-66 busy season. However, apart from the usual documents, it demanded and obtained from the borrowing bank an assurance that its advances towards packing credit would be extinguished by the negotiation of bills arising from the relevant exports. Besides, borrowing under this facility was placed on par

with non-priority refinancing for computing a bank's net liquidity ratio, and refinance of pre-shipment credit was included as part of a bank's total borrowing for the purpose.

These conditions, particularly the latter which pushed up the cost to banks of pre-shipment finance, and the relatively easy money market conditions, appear to have discouraged banks from making use of this refinance facility. In response, the Bank liberalized the conditions for packing credit refinance under the bill market scheme to a great extent in August 1967. Not only was pre-shipment refinance no longer taken into account whilst computing a bank's net liquidity ratio, the Bank also agreed to provide concessional finance against packing credits advanced to some categories of exporters. Thus refinance of packing credit advanced to exporters of engineering and metallurgical products attracted a concessional rate of 4.5 per cent (which was then 1.5 per cent below the Bank rate); while that of packing credit advances to other exporters was made at the Bank rate. The Bank also stipulated that interest rate charged to the borrower on these two categories of packing credit should not exceed 6 and 8 per cent respectively. The maximum usance period of the export bills lodged with the Bank as security, however, remained unchanged. Finally, in a related piece of reform, the Bank decided to continue the Rupee Export Bills Credit Scheme, and to make available to banks, without regard to their net liquidity ratio, refinance facility at the Bank rate against export bills denominated in foreign currencies. The latter facility was conditional on banks' charges on such bills not exceeding 8 per cent.

Despite these measures, complaints persisted about the cost and availability of credit to exporters, and a feeling appeared to be growing that procedural bottlenecks lessened the impact of efforts to liberalize credit facilities for this sector. Responding to such complaints the Governor, P.C. Bhattacharyya, agreed to the suggestion made in the closing weeks of 1965 to set up a committee of bankers to simplify banking procedures for exporters. About the same time, the Ministry of Commerce mooted the idea of a standing committee which would meet on a monthly basis to deal with matters relating to export finance and the impact of credit controls on exporters. Bhattacharyya turned down the government's invitation to nominate a representative to the proposed body since he felt it was inappropriate for the Bank to have to justify its credit policies to a 'roving' committee. Following the Bank's rejection of its idea for a standing committee, the government decided in March 1966 to set up another working group to consider steps to improve the utilization of facilities provided by the Bank. Five of the eight members of the group were senior bankers. In its report submitted in August 1967 this group recommended, among other things, a credit insurance scheme for export finance, simpler

procedures for refinancing packing credits, extending the period of medium-term export finance provided by the Industrial Development Bank of India from five to seven years, and a dual pricing policy enabling banks to subsidize pre-shipment credit by charging higher rates on their other, i.e. domestic, loans.

Unpublished Sources

OPR-1-51	State Financial Corporations (General)
S-48 A	State Financial Corporations (Policy)
HC/SFC/I	State Financial Corporations (Miscellaneous)
C-260 A	Seminar on Financing of Small-scale Industries
B-6-2010	Seminar on Financing of Small-scale Industries in India
B-2-1030	Provision of Credit to Small-scale Industries (General-Misc. 1956-60)
HC/SSI/I	Small-scale Industries (Miscellaneous)
C-260 B	Recommendations of the Export Promotion Committee
B.2-2020-54	Export Credit
B.2-2020-64	Export Credit
B.2-2030	Export Credit—Study Group on Credit Facilities (Kapur Committee)
B.2-2070	Export Risks Insurance and ECGC

Memoranda to the Central Board and Committee of Central Board

THE EXTERNAL SECTOR

*with C. J. Batliwalla**

The economic and financial developments taking place during our years in the external sector of the Indian economy set the context for the three chapters which comprise this part. To a greater extent than the other chapters of this volume whose approach is primarily Bank-centred, the next three chapters present a survey of the relevant developments in India's external economic policies and financial diplomacy, and an account of the Bank's role in relation to them. However, a note of caution is in order here. The wider history presented in these pages is based on materials at the Bank and those in public archives. Therefore, these chapters do not purport to offer a comprehensive, much less definitive, history of developments in India's external sector.

The opening chapter of this part (chapter 15) deals largely with issues of reserve utilization and management arising from India's membership of the sterling area and the restrictions arising therefrom. Some new material has become available to researchers after the last volume of the Bank's history saw the light of day nearly three decades ago. For this reason and in the interests of expository convenience, the chapter also gives a brief background account of sterling balance negotiations which took place in the years immediately preceding those covered by this volume. The restrictions Britain

*Chapters 15–17 and appendixes F and G have been written with C.J. Batliwalla, to whom I am grateful for painstaking research and attention to matters of fact and detail. She is the sole author of Appendix E.

imposed on India's use of its wartime sterling acquisitions were progressively relaxed at the same time as the latter were liquidated to finance the early stages of the second plan, and India's efforts to come to terms with the challenges posed by the likely and actual restoration of sterling convertibility are also documented here. Finally, the external outlook during these years was influenced by the effects on Indian trade of Britain's 'dollar shortage' problem, and a certain nervousness which surfaced from time to time about the stability of the sterling. The Indian evaluation of these factors and discussions at the Bank about the exchange rate policy India should adopt in the event of prolonged instability in the international currency markets are also covered briefly in the opening chapter.

Chapter 16 is devoted to an account of India's efforts to mobilize external resources to meet the longer-term financing needs of the second and third plans, the short-term balance of pressures to which the Indian economy was subject during these years, and the manner in which the Bank and the government sought to cope with them.

The third and final chapter in this part picks up the financing story from about 1963, when there was a perceptible deterioration in India's aid environment. The strain on the country's external finances during the next four years was worsened by the effects of severe droughts and a freeze in western aid. The resulting crisis led to the rupee's controversial devaluation in June 1966 and the inauguration of significant external sector reforms some of which had later to be rolled back or reversed because of the aid environment continuing to be adverse. Chapter 17 thus concludes with an account of the devaluation and its immediate aftermath.

There are three appendixes (E, F, and G) at the end of the book, relating to this part of the volume. The first describes the administration of exchange control in India during our period. The second discusses the country's role in negotiating quota increases at the International Monetary Fund, while the third offers a brief account of the working of India's bilateral trade agreements with the erstwhile Soviet Union and the centrally planned economies of eastern Europe.

The Problems of Plenty, 1947–56

India's wartime sterling balances amounted to over £1,134 million (Rs 1,512 crores) on the eve of independence.¹ Financing commodity imports and capital outflows, making payments to Britain for surplus military stores and pension annuities, and paying the new dominion of Pakistan its share of undivided India's external financial assets, ate into a major portion of these reserves during the next three years. But India's sterling balances still stood at a comfortable £621 million (Rs 828 crores) at the end of 1949. There followed a net accretion to the country's external reserves which lasted until the mid-fifties.

Arising as they did from India's membership of the sterling area and the resulting restrictions on its use of these resources, the main problems which Indian policy-makers faced during these years in the external sector may be more aptly described as those of plenty than of want. Though exchange controls were put on a statutory footing with the enactment of the Foreign Exchange Regulation Act in March 1947, these were dictated by India's adherence to sterling area arrangements. Planning was a goal at the outset of this period rather than yet a strategy, and despite the sterling devaluation of September 1949 having extinguished nearly a third of their dollar or gold value, the existing level of exchange reserves appeared to provide a comfortable cushion for the foreseeable future. The rupee too, was a stable currency, or as one source described it, the 'hardest of soft currencies'. Although learning their lessons from the 1949 experience, the Bank and the government evinced some interest in issues relating to exchange rate management such as wider margins, the appropriate peg, and the possibilities of pursuing independent exchange rate policies, external monetary management did not pose any fundamental problem either, during the years covered by this chapter. Sterling devaluation was no doubt a disconcerting shock, one moreover which greatly

¹ Until 6 June 1966, a rupee was worth 18 pence, and a pound equalled Rs 13.33.

complicated the country's economic relations with neighbouring Pakistan. Though it caught India by surprise, devaluation also helped calm, at least initially, further fears about the sterling's value in the near future. India's commitment to the sterling area did waver on one or two occasions because of Britain's manner of dealing with its claims. But in general the view prevailed that unless British policies and attitudes made it unavoidable, no Indian interest would be served by withdrawing from the sterling area. Once fears also ceased of Britain repudiating these balances or seeking their negotiated reduction, the best course appeared to lie in increasing India's freedom, consistent with sterling stability, to spend them as it thought fit.

The same factors limiting India's freedom to use the accumulated balances moved its policy-makers to test these limits to the utmost. In a more normal environment, the accumulation of large external reserves in the hands of the world's poorer countries, who for the most part comprised the sterling area, would have been locally and globally an expansionary influence. Though the post-war world was in dire need of some form of expansionary stimuli to ease the burdens of reconstruction, overseas sterling balances were unsuited to that task. The pound was an inconvertible currency. Sterling balances were, both in principle and effect, inconvertible. Since members of the sterling area could not use their balances freely to finance imports from hard currency areas, they were forced to erect a formidable array of exchange controls to husband the 'central reserve' of gold and dollars. There were fewer restrictions, in principle, on trade within the sterling area. In practice, however, large sterling holders were also forced to restrict imports from Britain to minimize the risk of excess demand and inflation in that country, any further worsening of its weak external position, more stringent controls on hard currency imports, and possibly, another fall of the sterling and in the value of their assets.

Even if they did not carry much conviction until the early 1950s, Britain's efforts to move towards convertibility and the American desire for an early consummation of the process were both important factors in the sterling balances controversy.² Sterling holders welcomed the prospect of convertibility, but India was not alone in feeling that Britain hoped to make the ascent on the backs of the other members of the sterling area rather than by its own sacrifices.

² Readers should note that 'convertibility' did not carry the same connotation in the 1950s as it does in the 1990s. In the 1950s, the term 'convertibility' was used in this unqualified form to represent the absence of controls over current account transactions. In this case it also meant the transferability of non-resident sterling. Not to talk of capital controls which several European countries maintained until quite recently, even some trade and current account restrictions were judged at various times during this decade to be consistent with convertibility.

The Americans focused on the sterling overhang as the major obstacle to restoring multilateral arrangements and reviving trade and growth in Europe. The existence of the sterling area was also seen to impede American exports to these areas. Therefore the US attempted to persuade Britain to repudiate its sterling balances or scale them down substantially, and in the meantime to closely regulate their releases. While London was not disposed to adopt the former suggestions, a tight sterling release regime accorded closely with Britain's own interests. The negotiation of this regime became, consequently, the principal issue in its economic relations with members of the sterling area among whom India, as the largest holder of sterling at the beginning of this period, was the most important.

STERLING BALANCES: FRAMING THE ISSUES

India's sterling balances amounted to about £1,022 million (Rs 1,363 crores) at the end of March 1945 and peaked at £1,300 million (Rs 1,733 crores) in April the following year. There was widespread hope in India at the time that these resources would form the basis upon which to carry out a programme of rapid industrialization. The Bank, and to some extent even the colonial government, were therefore anxious to reach an early settlement with the debtor country, Great Britain, on the utilization of these balances.

Signals from London and elsewhere were not reassuring. The US anxiety to move towards a multilateral trading system was well known, as indeed its view that Britain's large sterling balances posed the principal obstacle to it. Its dependence on American money, which was underlined by the lend-lease controversy and the 1946 loan agreement between the two countries, gave the US some leverage over Britain's policies. In the latter country too, many including Keynes urged cancelling or reducing these wartime debts. More sober counsels prevailed in the end and the risk of repudiation began to recede from 1946. But thanks to persistent American efforts to dismantle the sterling area and some confusion within Britain over how best to advance the international role of the sterling, the risk of inequitable arrangements to reduce or 'fund' these balances could not be fully discounted until the early 1950s.

There still remained the problem of regulating the use of these balances. Britain was obliged, under the Anglo-American financial agreement (which came into effect in July 1946 following its ratification by the US Congress), to complete within a year arrangements to deal with its debt and facilitate the pound's return to convertibility. India too, was concerned to finalize arrangements enabling its sterling resources to be used to promote economic development.

These pressures led to a series of exploratory meetings which, despite being marked by major disagreements between the two sides, culminated in an interim agreement signed in August 1947. Initially, the discussions focused on narrowing differences between India and Britain on the nature of the debt, the manner of dealing with it, and the rate at which India could draw upon its balances. Besides, with India's independence from British rule in sight, attention also centred on adjusting a portion of these assets against the value of British military stores in India and the external pension liabilities of the latter's government. The interest payable on the balances too, came up for consideration.

Briefly, the British delegation at these talks opened negotiations on the note that the balances represented war debts which should be scaled down and that India should not charge or earn any interest on the remainder. The Indian side predictably took the view that the country's sterling holdings represented payment for exports (including invisible exports) which could not be liquidated in the form of goods because of wartime conditions. India would have been better off had Britain financed its imports by raising loans in rupees. Not only had the method Britain adopted to finance imports from India intensified inflationary pressures in the colony, recourse to sterling credits represented an abuse of the Reserve Bank of India Act which obliged the institution to make unlimited purchases of that currency. India's sterling balances also arose from its membership of the empire dollar pool under whose arrangements it was required to surrender dollar earnings to Britain in exchange for sterling. Rather than partaking of the nature of an intergovernmental wartime debt on which no interest was payable, these resources (in the form of short-term sterling securities) belonged to the Reserve Bank which held them in its Issue and Banking Departments against their respective liabilities. The Indian negotiators at these talks also rejected suggestions that the debts should be scaled down. India was not bound by the Anglo-American agreement, nor would the interim government in Delhi countenance such proposals in any form. The Reserve Bank, they maintained, should also be left free to invest these resources in conformity with established central banking techniques. With little common ground emerging between the two sides, India broke off the talks in February 1947.

Exercised by the prospect of unregulated drawings by India—between May and July 1947 the colony's sterling balances fell by £41 million, among other things, to finance food imports—at a time when Britain's external payments position was deteriorating and yet the restoration of sterling convertibility under the Anglo-American agreement remained on the anvil, authorities in London were disposed to negotiate a temporary agreement.

With the impending political changes in India also dictating such a course, the two sides resumed talks in London in July 1947. These talks led to an interim agreement—efforts to arrive at a permanent settlement were put off until circumstances became more propitious—which was concluded on the eve of Britain's departure from India on 15 August 1947.

The 14 August agreement did not mandate a freeze of India's sterling assets. The same object was, however, largely achieved by splitting existing balances into a No. 1 account, which was a current account, and a blocked No. 2 account, out of which could only be made payments for purposes such as acquiring surplus military stores, discharging pension liabilities, and financing capital outflows from India to the rest of the sterling area. The current account was to comprise a working balance of £30 million and an additional release of convertible sterling for the remainder of the year of £35 million (of which £26 million had already been expended during the month ending 14 August). According to tacit agreements and letters exchanged between the two delegations, the Reserve Bank of India was also precluded from altering the pattern of its sterling investments in such a manner as to increase appreciably the interest it earned on them.

The August 1947 agreement was intended to last only until the end of the year and it became necessary to negotiate a fresh agreement early in 1948. By then, however, much had changed in the two countries. The brief flirtation with sterling convertibility in July–August 1947 ended within weeks in disaster, and with its officials mooting a fresh agreement on a 'definite dollar target for the current period', doubts even arose about Britain's willingness to acquiesce to India running dollar deficits of the amount (roughly £15 million) it had appeared prepared to tolerate in August 1947. India too, in the meantime, underwent a painful partition which, among other things, necessitated financial arrangements with the newly-created dominion of Pakistan.

The main issue in the 1948 negotiations was the size of sterling releases to India and of the latter's convertible component. With the sterling area's dollar and gold reserves down to £500 million against Britain's external liabilities of nearly eleven times that figure, the latter sought to press India to curtail imports while increasing exports to hard currency areas. India had used up more than double the 'dollar ration' of \$60 million Britain had had in mind in August 1947, and its expenditures drew adverse comment in Britain's financial press in 1947–48. The *Financial Times* commented in December 1947 in the context of Indian drawings that the sterling system was 'more a handicap than a help' in coping with Britain's payments crisis, while the *Banker* remarked in March 1948 on the large size of Britain's 'unrequited exports' to India. Arguing that Britain's position as a banker to

the commonwealth was inconsistent with the requirements of European recovery, the *New York Times* suggested blocking existing sterling balances. In what was a thinly disguised attempt to nail countries such as India to the cross of the US's strategic goals in Europe in the wake of the Marshall plan, the paper also advocated sterling loans from Britain to continental Europe. Against this background, and following a detailed inspection of India's dollar expenditures and of material concerning those aspects of its trade with the sterling area which had a bearing on the former, the British delegation threatened to impose a unilateral 'dollar ration' on the former colony. Although India had spent more dollars than earlier anticipated, its overall deficit was well within projected limits. India was also not unwilling to moderate its dollar expenditures to the extent possible. But the idea of a 'dollar ration' was anathema to its officials, as indeed it was to most other involuntary holders of sterling balances, and India threatened to leave the sterling area if Britain imposed such limits.

With differences persisting or widening, Britain preferred to negotiate another interim arrangement for 1948. Pruning India's dollar deficit to relieve the burden on the central dollar reserves of the sterling area remained Britain's principal objective, and its officials proposed an arrangement under which while an agreed dollar deficit was met from the central reserves, the balance would be financed by drawings on the International Monetary Fund. The initial British offer was a 'dollar ration' amounting to £5 million for the half year, with the authorities in London monitoring India's dollar expenditures on a continuous basis.

India's negotiators greeted both proposals with derision, and its government came closer in 1948 than at any other time before or since to considering alternatives to the sterling area. India, officials felt, could not be expected to help solve the sterling area's difficulties if the sterling system failed to address the country's relatively modest requirements. The latter had virtually no dollar reserve of its own and was precluded as a member of the sterling area from building one. India depended on London for dollars, and if these could not be secured from that source, there was little advantage to be had from continuing in the sterling area. In the forceful exchanges that followed the British proposal, this Indian view was put to its delegation in the plainest terms. With the British delegation (led by Jeremy Raisman, a former Finance Member in the Government of India) recognizing that Britain would have to pay a price to retain India in the sterling area, the half-year 'dollar ration' was raised to £10 million. In addition, £18 million were allowed to be unblocked from the No. 2 account. India, for its part, agreed to purchase dollars from the IMF to finance dollar deficits in excess of the agreed provisions, provided the charges

payable in gold against dollar drawings from the latter agency and repurchases from it were met out of the sterling area's reserves.

With short-term agreements proving inconvenient and uncertainty about the availability of dollars from year to year clouding the import and investment outlook in India, an Indian ministerial delegation led by the Finance Minister, Shanmukham Chetty, and comprising among others the Governor, C.D. Deshmukh, visited Britain in June 1948 in search of a longer, three-year agreement, and in anticipation of one, to settle issues such as the valuation of military stores and the pension annuity. Thanks to a highly restrictive import policy regime, India had meanwhile accumulated current sterling of about £83 million. While such excesses, which the Indians attributed to the uncertain outlook for import financing, underlined in their eyes the need for a longer agreement to smoothen the flow of imports, the British delegation cited the same development as proof of India's inability to absorb imports. At first the British Chancellor opposed a three-year agreement, and suggested that India should be content with the sterling already to its credit in the No. 1 account, for the year up to June 1949. He also ruled out fresh releases from the central reserves to cover the dollar deficit which he proposed should be met by drawings on the Fund. But in three weeks of intensive negotiations, the Indian side managed to wear down British resistance to a three-year agreement. It agreed, however, to smaller releases than before, with imports in the first year being financed out of existing balances in the No. 1 account. The draft on the sterling area's hard currency reserves was also to be limited to £15 million in the first year (i.e. July 1948 to June 1949), after which the position was to be reviewed. It was also agreed that should India's balances in the No. 1 account fall below £60 million at any time during the next two years, they could be reinforced to the extent of £40 million each year. Releases, it was further agreed through an unpublished letter, would be flexible from year to year and could, if necessary, be drawn in advance. Agreements were also reached about pricing and paying for military stores and pension liabilities.

The three-year agreement did not by any means signal the end of India's external financing problems. Within months of the agreement, the balance in India's No. 1 account fell to £31 million, and it was compelled despite large sterling holdings to open its drawing account with the Fund with a request for \$99.98 million, purchased in seven instalments in 1948 and 1949. Seeking to utilize the flexibility provision in the agreement, India decided to anticipate future releases. There were once again murmurs in the press about large Indian drawings, and suggestions for blocking the balances.

Fortunately, thinking in Whitehall ran along more pragmatic lines, and the British authorities did not object to the Indian request for advance drawings.

But they preferred to see India arrest the rapid liquidation of its current sterling holdings, and sought to this end to regulate the dollar ration and future sterling releases.

Recent developments, and India's continuing need to finance large import surpluses, brought home to its officials that they could not afford to be complacent nor depend on British government departments to fight India's battles. With India's sterling and dollar expenditures once again expected to figure prominently in negotiations between the two countries after Prime Minister Jawaharlal Nehru's visit to London in 1949, the Bank was asked by Delhi to assemble the basis upon which to rest India's case in these talks. This request resulted in a cogent forty-page note entitled 'India's Sterling Balances' by P.S. Narayan Prasad, Director of the Bank's newly-created Balance of Payments Division. Prasad's note underlined that the charges of excessive drawings levelled against India and the solutions advanced to deal with them reflected an insular approach based on examining the issue solely from the British point of view rather than in relation to the totality of considerations relevant to the problem. The drain on the central reserves, Prasad argued, owed largely to Britain's own external deficits. According to Britain's balance of payments statement for 1947, there was a net drain on the sterling area's gold and dollar reserves of \$1,023 million. Of this, Britain alone accounted for \$626 million, while between them India and Pakistan drew only \$55 million. India, the note pointed out, could not be expected to curtail its drawings when Britain's own deficit was so conspicuously large. The sterling area represented a cooperative pooling of dollar reserves of various countries. Contributions to it were made according to convenience, and drawings from it according to need. Given its past contributions to the pool, India could not be put in the dock if it drew a little more from the pool, in passing times of dire need, than it put in. The right to cover hard currency deficits went with the obligation to contribute dollars when in surplus. If this proposition was not accepted, Prasad maintained, it was better for India to leave the sterling area.

Prasad's note also pointed out that since Indian sterling balances were not liquidated entirely to finance exports from Britain, curtailing sterling releases would do little to assist European recovery. The effort to divert supposedly unrequited exports to rebuild Europe's productive capacity, he also argued, was intended to enable that continent to build a trade surplus with the eastern hemisphere and reduce its recourse to American aid.

By January 1949, it became evident that barring a miracle the three-year agreement would soon collapse and that fresh discussions and agreements would be necessary. But the meeting of the consultative committee of Indian and British representatives held in Delhi in February 1949 preferred not to

anticipate events, and discussed a variety of other issues. These included the effect of the Marshall plan on India, re-exports of Indian goods from Britain to the dollar area, and the effectiveness of exchange control and import licensing. There was also some debate about India's entitlement to the dollar assistance Britain received towards the sterling area's deficits.

By spring 1949, India's external payments position was beginning to get out of hand. It had virtually exhausted the second (flexible) sterling drawing of £40 million intended originally for the second year and its application to draw a further \$100 million from the IMF was encountering stiff American resistance. Recognizing the need to bring about a better fit between sterling releases and imports, John Matthai, who had meanwhile replaced Chetty as Finance Minister, revoked all Open General Licences (OGLs) for soft currency imports in June 1949 while pressing for a further release from the blocked account to finance imports in the pipeline. The latter request and those for sterling releases over the next two years formed the subject of talks between the two countries in London in July 1949. These talks, which were also framed by Britain's agreement with Egypt in March 1949 containing terms more generous than those offered to India in the June 1948 agreement, led to a fresh deal in whose making Governor Deshmukh played a prominent role. The July 1949 agreement provided for further releases of £50 million for 1949–50 and 1950–51, in addition to the 'anticipated' drawing of £80 million. A special release of £50 million was also secured to clear imports already in the pipeline. The obnoxious 'dollar ration' too, was done away with, and the two governments agreed not to renew the understanding reached through an exchange of letters in August 1947 on the maximum interest India could earn on its sterling balances. The Reserve Bank was now free in principle to invest these funds according to general central banking principles and its statutory obligations. However not all constraints on such investments were lifted, largely superfluous though these now were to Britain's needs. In a letter he addressed to the Governor of the Reserve Bank, B. Rama Rau, in October 1951, his Bank of England counterpart, Cameron Cobbold, dwelt on the expediency 'from the point of view of a central bank' of investing the Reserve Bank's funds in liquid assets and on the desirability of consulting his institution whilst taking investment decisions to minimize disturbances to the London market. The Reserve Bank was not inclined to demur to these suggestions since it had little to gain and much to lose from unstable conditions in London.

The Bank of England, which had not been taken into close confidence about the July 1949 agreement and which by now was beginning to turn its sights away from the sterling area and a little more firmly towards Europe

and the United States, found little to cheer in it. Cobbold pointed out to the Treasury that the agreement on releases would increase pressure on the sterling and make it difficult to convince the Americans that everything was being done to resolve the sterling overhang. On the contrary, it would provide ammunition to American critics to attack British policy, not without some justification, for seeking to promote exports to protected markets in the sterling area at the cost of those to hard currency markets. The Governor went as far as to suggest a review, in due course, of the new agreement if it could be done without 'inviting the charge of bad faith'.

The new deal was not the end of the problem of sterling balances which soon became hostage to fresh uncertainties besetting the future of the sterling. With Britain's overexposed external banking position still very much a cause for concern and with a devaluation of the sterling under active consideration in the summer of 1949, the Bank of England, among others, grew more attracted to radical plans to wipe the slate clean and make a fresh beginning with American aid. The Governor of the Bank of England was, according to that institution's official history, now of the view that unless Britain did something 'violent and ambitious', it would 'bleed to death'. 'I see no attraction in allowing the UK to starve in order to provide India with new railways', he is said to have remarked.³ The Bank of England worked on several plans with the sole object of persuading the Americans to take a 'big wad of old sterling off UK's back' in order to prepare the ground for a successful sterling devaluation.⁴ But little came of them since the Americans were not as keen yet to bolster UK reserves as London was to secure assistance from across the Atlantic. British proposals to encourage the restoration of sterling convertibility through American purchases of the currency also failed, understandably, to make any headway.

Seeing that the more radical plans remained on paper, Britain attempted to persuade the United States to take over and write down, with the owners' consent, a proportion of its debt and exchange the remainder for dollars. In short, the Treasury hoped, instead of channelling its aid directly to countries such as India, the United States would link its assistance to the resolution of the sterling balance problem. At talks held in Washington in August–September 1949, little support was forthcoming from the Americans or the Canadians for the British idea which, along with other proposals for dealing with sterling balances, was relegated for examination to a committee. But the sterling's

³ John Fforde, *The Bank of England and Public Policy, 1941–1958* (Cambridge, 1992), p. 269.

⁴ *Ibid.*

devaluation in September 1949 and past American advocacy of the measure led to fresh speculation about a new Washington plan on sterling balances. With the air in the US capital remaining thick over the next few months with proposals to extend dollar aid to south-east Asia partly in return for a voluntary reduction in recipients' claims on Britain, the Finance Ministry asked the Reserve Bank to conduct a detailed examination of the 'Philosophy of Sterling Balances'.

Though it was widely speculated that the British were considering or sponsoring all manner of proposals to deal with sterling balances and contemplating the possibility of reaching some agreement about them with the USA, few details were yet available. The Bank's Department of Research and Statistics therefore undertook a conjectural exercise whose conclusions were presented to the government in June 1950 in the form of a confidential paper entitled 'India's Sterling Balances and Dollar Aid Plans'. This note dealt with India's approach to the utilization of the balances, influences shaping Britain's attitude towards them, the American interest in the subject, and finally with the possible ways in which dollar aid could be linked to the resolution or mitigation of the problem.

On the first issue, the Bank cautioned against an excessively rapid liquidation of the balances and argued the wisdom of convincing Britain that India was more likely to restrain its drawings in its own interest than in response to external pressure. This, it argued, would create an identity of interest between the creditor and the debtor. On the second point the memorandum underlined the changing ownership of sterling balances since the war. Whereas countries like Australia, South Africa, and Malaya had, thanks to large capital imports, increased their balances, India and Pakistan had depleted theirs. With the latter's shares in the overall balances now appreciably smaller than in the past, these countries posed fewer problems and little potential threat to Britain's external finances. As for proposals to tie dollar aid to sterling balance agreements, the Bank counselled against schemes to adjust the balances in excess of the dollar aid received. Though unlikely, a plan which provided dollars against matching reductions in India's sterling holdings should not be objectionable since that would merely amount to the United States, rather than the central reserves of the sterling area, bearing the burden of converting outstanding sterling holdings. However, since such a plan offered no aid but merely the facility of convertibility, it would be necessary, the Bank advised the government, to ensure that the formal arrangements did not have an appearance far different from fact. And finally, any dollar aid greater than the corresponding downward adjustment in sterling balances would be in India's interest provided it came with no strings attached.

In the event, though vague ideas of 'funding' the sterling balances were mooted, little came of these and other similar proposals. India, for its part, was not disposed to grumble about the stalemate. Its most pressing financing needs were being met, there was no immediate threat of another fall in the sterling, and its officials harboured deep misgivings about plans to substitute dollar aid for sterling holdings.

However, the threat to India's sterling balances was not altogether past. An IMF staff report on European payments arrangements focused on the over-abundance of sterling as the principal obstacle to convertibility, and suggested that until the sterling overhang was eliminated or locked up, Britain would be unable to settle its current account balances in gold, abolish bilateral agreements, or (without the use of controls) expand substantially its exports to the dollar area. The weakness of the British external position, the report suggested, also hindered progress towards convertibility in Europe. The report considered three solutions: reducing the use of 'old sterling' for current transactions, reducing British capital exports, and channelling more aid to Britain. It recommended the first course.

J.V. Joshi, who was on deputation from the Reserve Bank as the Indian Executive Director at the Fund, was quick to perceive the implications of this recommendation for India. In a well-reasoned intervention at the meeting of the Fund Board convened to discuss this report, he rejected the argument that sterling area countries liquidated their inconvertible external assets at a rate which was beyond Britain's capacity to satisfy through exports of goods and services. A large part of these balances were blocked and were not available to be drawn upon at the will of the holder. Besides, the rate at which these balances were released were determined by prior agreement between Britain and the creditor country, and he wondered how mutually agreed releases could lead to the 'evil result' feared in the report. These balances, Joshi maintained, were the result of the immense privations India had undergone during the war. If the Fund recommended scaling down these debts to secure the sterling's convertibility, he declared, it would be guilty of adopting a partisan attitude for, in solving Britain's balance of payments problem, it would create fresh problems for countries such as India and Egypt. Describing the proposed solution as reflecting a 'perverted and unreasonable' partisanship, Joshi questioned the Fund's right to crucify India 'on the cross of convertibility'. Finally, he demanded that the Fund Mission to Paris should be instructed not to recommend a solution which entailed the reduction of the claims of countries such as India and Egypt. Joshi's timely intervention helped scotch the obnoxious suggestion which was deleted from the Fund's final recommendations.

THE SIX-YEAR AGREEMENT

Until 1949 India had, to quote the Governor, C.D. Deshmukh, spent its sterling balances 'as if there was no tomorrow'. These balances fell sharply from £1,254 million at the end of 1945 to £621 million at the end of 1949. More than half the fall was accounted for by the cost of the pension annuity that India bought from Britain, payment for surplus stores, the transfer to Pakistan of that country's share of sterling assets, and capital outflows. But thanks to substantial food, and capital and intermediate goods imports, India ran large trade deficits during these years, financed mainly by its sterling drawings. To some extent, no doubt, these expenditures were also motivated by fears for sterling stability and misgivings about Britain's commitment to honouring its debt.

With the pound sterling already devalued, the danger of repudiation having receded, and the steep drop in sterling balances, Indian officials launched a review of policy. The initiative for this review came from the Bank which urged the Finance Ministry early in 1950 to regulate sterling releases more closely. India's actions, the Bank argued, should not be swayed by the argument that one pound 'sterling in hand ... [was] worth two in the book'. With repudiation no longer a distinct danger, it was now in India's own interest to help the pound on the course towards convertibility. An inconvertible sterling forced India to limit purchases from hard currency markets and make them at much higher prices from the sterling area. Large releases unrelated to actual balance of payment requirements made sense only if India wished to secede from the sterling area. According to the Bank's estimates, drawings of £50 million per year would be far in excess of India's requirements and the country could, without much sacrifice, seek and spend releases of £40 million in 1951-52 and £30 million the following year.

The Bank's recommendations shaped the Indian position in the negotiations which culminated in February 1952 in an exchange of letters with the British government detailing a six-year (July 1951-June 1957) agreement on sterling balances. This agreement, whose substance was finalized after discussions between the Finance Minister, C.D. Deshmukh, and his British counterpart and presented to the Indian Parliament in December 1950, provided for a release of up to £35 million each year. Unutilized amounts could be carried forward to subsequent years and larger allocations allowed in some years after mutual consultations. The agreement also envisaged the immediate transfer of £310 million, representing the assets of the Reserve Bank's Issue Department, from the No. 2 account to the No. 1 account on the condition that it would not be drawn down except in consultation with the British government. The Indian negotiators also sought agreement to discontinue the

latter obligation at the end of six years. Their counterparts preferred to hold the matter over until this period had passed, but agreed to transfer any balance left in the No. 2 account at the end of six years to the No. 1 account. Britain also agreed to consult India before repurchasing sterling from the Fund so that it could explore the possibility of making simultaneous rupee repurchases from that institution.

The six-year agreement was, as Deshmukh pointed out in Parliament in December 1950, largely in tune with India's aspirations and interests. A large part of the balances now comprised India's currency reserve and could not be liquidated without amending the existing fractional reserve system. Though perhaps not generous, the annual sterling releases proposed in the agreement were adequate for India's immediate needs. Finally, the agreement paved the way for unblocking Indian balances.

An important issue figuring in the 1950 negotiations related to the Indian demand for paying a part of the blocked balances in gold. This arose following Britain agreeing to sell Pakistan gold to the value of £4 million to strengthen its independent reserve. Ceylon had also been allowed to retain out of the island's dollar earnings a substantial independent reserve of gold and dollars. At the Finance Ministry's instance, the Bank examined India's case for a similar agreement with Britain. India's gold reserves, the Bank pointed out, had remained largely unchanged for two decades while its external trade and domestic currency circulation had both increased substantially. There was a case therefore for strengthening India's gold holdings, not to the extent of £24–28 million as a mechanical application of the Pakistan precedent might imply since London was certain to balk at the demand, but by about half that amount. Britain, the Bank felt, was unlikely to let go of even the latter amount, but nothing would be lost by India pressing its case. Dollar balances were however another matter. Since India also ran a dollar deficit, the Bank advised the government, Britain would refuse to entertain a demand which struck directly at the root of the sterling area system.

Britain refused to help India strengthen its gold reserves. Gold sales to a sterling area country, G.R. Kamat of the Finance Ministry was informed in London by officials at the British treasury, was against the *raison d'être* of the sterling area mechanism. India, they further reminded Kamat, also ran large dollar deficits.

At a time when our need to husband our gold and dollar reserves is so critical, the UK would only view with alarm a suggestion that the Central Reserves be reduced by a further dispersal of gold to independent sterling area holdings

The Indian claim would have been difficult enough to meet in isolation, but the prospect of other members of the sterling area making similar demands made it impossible.

The Reserve Bank was aware that its case was weak on economic or technical grounds. The British treasury had been quick to point out that India's gold reserves were higher in relation to money supply and Fund quotas than those of most other countries. Recognizing the strength of the British case, the Deputy Governor, N. Sundaresan, and Narayan Prasad were reluctant to join a technical debate on the subject. Rama Rau and Kamat therefore stressed the political argument at their next meeting with British officials. India had been reticent in pressing for larger gold reserves because of Britain's delicate external position. Britain's decision to strengthen Pakistan's gold reserves amounted to rewarding the pursuit of liberal monetary policies and penalizing others, such as India, who had on the whole followed restrictive policies and ensured that there was no significant erosion in the gold backing for their domestic currency. Besides placing India in an embarrassing position, London's decision had created the impression that either Britain was 'definitely partial ... [towards] Pakistan or that the Indian authorities were not good negotiators'. Officials in London recognized the force of the Indian argument, but expectedly refused to budge from their stand that Britain's external position and the practices of the sterling area precluded the suggested course.

The six-year agreement was set to expire at the end of June 1957. With the expected disappearance of the No. 2 account and the new currency reserve provisions in India, no purpose would have been served by a successor agreement. This was, in the event, the British view which was conveyed to the Indian government a year before the 1951 agreement was due to come to an end. But Britain remained keen to ensure that no restrictions were imposed on the transfer of capital from India to the United Kingdom, and in order to allay investors' fears, sought a public and authoritative declaration from the Indian government to that effect. The Indian government was not inclined to demur. Following some preliminary exercises in the Finance Ministry and with the Prime Minister's approval, the government issued a press release announcing that the expiring agreement would not be renewed, and that the absence of a fresh agreement would neither affect India's right to draw upon its sterling balances nor those of British citizens in India to remit savings and repatriate investments. The decade-old controversy over India's sterling balances and its right to utilize them thus ended on a rather amicable note.

THE WASHINGTON BALANCES AND RESERVE DIVERSIFICATION

In one important respect, however, the course of the six-year agreement was far less smooth than the manner in which it came to an end. This agreement did not touch upon the balances of the India Supply Mission in Washington (hereafter ISM or mission balances), and not long after it was signed they became a source of misunderstanding between officials of the two countries.

Since the second world war, India had maintained a supply mission in the US capital. Until December 1947, this mission obtained its dollar requirements through the British Supply Mission at Washington and the UK payments office in Canada. Thereafter, India evolved independent procedures for financing the mission's expenditures involving quarterly dollar remittances from the reserves of the sterling area which foreshadowed estimated disbursements. But London objected to the arrangement because it meant locking up large dollar balances for several weeks when the 'sterling area's dollar position was very tight'. The Bank sympathized, and early in 1948 Delhi decided that the mission should not draw dollars from London without its approval. At the same time the Washington mission was given a working balance of \$4 million which was raised in successive stages to \$34 million to facilitate some flexibility in its operations, especially since limits were placed on India's dollar drawings from the sterling area's central reserves. In March 1951 these working balances were increased to \$50 million and to \$60–75 million in 1951–52. By 1953 they averaged \$80–90 million.

The earlier increases were necessitated by the rising prices of India's imports from the USA, and large food imports. But the size of the Washington balances also reflected to some extent India's experience with Britain's discriminatory 'dollar ration' policy. As B.K. Nehru (who handled the issue when differences between India and Britain over these balances came to a head in 1955) recalled, Britain so severely curtailed dollar drawings by India in 1948–49, that great harm was caused 'through the enforcement of too rigorous an exchange and import control with the hard currency area'. But Britain placed no such restrictions on the other countries (with the exception of Pakistan), which were left free to draw on the central dollar reserves.

We did not want to find ourselves ever again as helpless as we did in 1948–49 and gradually built up these balances as a safeguard against the recurrence of a situation in which the United Kingdom finding itself in difficulties would work to get out of them at our expense.

Apart from financing imports, the Washington balances were utilized to build India's credit in that country, assist its quest for foreign capital, and give its officials some exposure to the working of money markets in the USA. Besides in the longer run, these balances helped initiate India into the world of reserve diversification. The controversies over them in the mid-1950s, which are recounted below, also dovetailed rather neatly into discussions which India initiated in January 1957 to diversify its external portfolio. Although officials at the Finance Ministry were not averse, when it suited them, to point to the Washington balances as the first step towards reserve diversification even in 1955, there is no evidence that the increase in these balances during the early 1950s reflected India's lack of confidence in the sterling, or a desire yet to diversify its assets away from that currency. The mission's balances, which never exceeded £33 million were, after all, a bagatelle to India's aggregate sterling holdings of £542 million in September 1955; and as B.K. Nehru remarked, if India wished to diversify, 'decamping with \$20 million was hardly the way to do it. Transferring a couple of hundred million pounds from London to New York would have made sense.' But through the greater part of the fifties, the British continued to view with suspicion India's attempts to build up its dollar balances, and time and again applied pressure on its officials to reduce them.

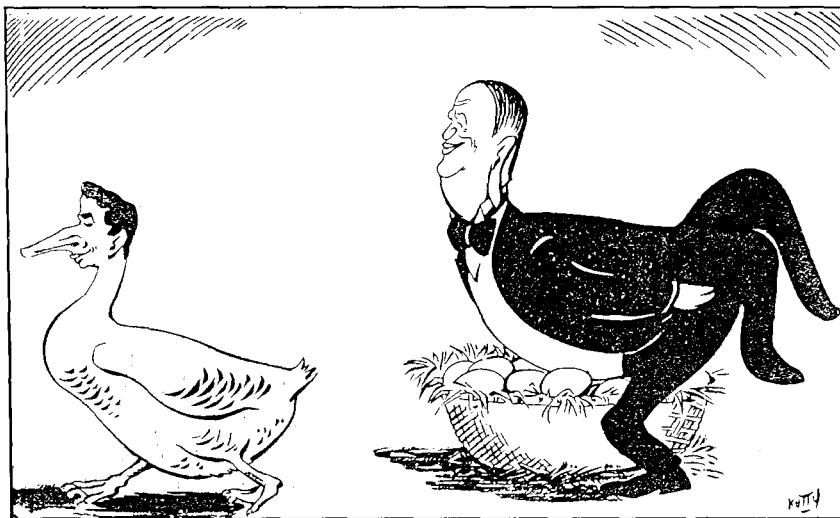
The seeds of distrust between India and Britain on the dollar balances question began sprouting freely in 1955. In September that year, Leonard Waight, Minister (Financial) at the British High Commission, confronted B.K. Nehru with a telegram from London which alleged that India had failed to keep its end of a purported agreement to pay off its debt to the Fund from the ISM balances and to keep the latter at a specified lower figure. Waight's bombshell was followed by a personal message from the British Chancellor of the Exchequer to his Indian counterpart, C.D. Deshmukh, in which he expressed concern over the erosion of the central reserves and the rise in the level of India's balances in the US which was 'much higher than is needed for a working balance'.

Britain could produce no evidence of any agreement by India to reduce its Washington balances, and its case rested entirely on treasury officials' recollections of discussions in Delhi in October 1953 between Deshmukh and senior officials of the British treasury. There was also some confusion in British minds over the precise meeting at which an agreement on India's dollar balances was purportedly reached. The records only showed that a limited understanding was reached in November 1953, after talks which Rama Rau and Ambegaokar held in London with British treasury officials, that

India would 'avoid making any dollar remittance from London during the closing months of a calendar year' to enable Britain to make payments on its Canadian and US loans.

Following this, India utilized its Washington balances to make Fund repurchases. But it drew on the central reserve to restore the balances during the early months of 1954. The latter move, British officials maintained, was contrary to the understanding. Though never actually made, accusations of bad faith hung in the air, while Indian officials objected to the self-righteous British attitude. For some weeks the issue clouded, if not relations between India and Britain, those between officials of the two countries. But as B.K. Nehru pointed out to Waight in October 1955, the only agreement between the officials of the two countries was that 'no extra burden would be thrown on the Central Reserves during the second half of a calendar year' and India had 'scrupulously kept' this promise. There was none given to reduce the balances nor was repayment to the Fund from India's Washington balances an implementation of that supposed promise. Nehru also drew Waight's attention to the fact that at \$93 million in

Hatching by Proxy



Mr. Deshmukh stated in Parliament that it was in India's interest to remain in the sterling area 'since all our eggs are in that basket'.

— *Shankar's Weekly*, 21 March 1954

September 1955, these balances were not at a higher level than in October 1953 when Deshmukh allegedly made the broken promise.

The Indian dollar balances also figured prominently in discussions between Rama Rau and the British Chancellor in Istanbul in September 1955 and in those between Deshmukh and Edward Boyle the following month. Following these discussions, India agreed to reduce its Washington balances to \$75 million on the condition that Britain would not raise the subject again in bilateral negotiations. Deshmukh also raised with his British counterpart the possibility of India maintaining 'loan reserves' in the United States and Switzerland 'in the name of the Government of India' but as part of the central reserves of the sterling area, to enable it to build credit and raise loans in these markets. But little came of this suggestion.

It was not until the Suez crisis of 1956 that India began seriously to ponder the possibility of diversifying its exchange reserve, and even then gradually and with extreme caution. Not only did the Suez crisis provoke bitter anti-British sentiment in India, London's decision to block Egypt's sterling balances drew attention to the risk of India's assets also being frozen in the event of political differences developing between the two countries. T.T. Krishnamachari, who had long been 'very bearish of sterling', had meanwhile become Finance Minister, and ever since, officials in London expected him to 'create difficulties'. While the battering the sterling took in the wake of the crisis appeared to justify his fears, Britain's handling of the Egyptian balances issue underlined in Delhi's eyes the need for early steps to promote the diversification of India's reserves.

An increase in the Washington balances was the obvious means to achieve this object. Yet it was not until January 1957, i.e. well after the immediate crisis had passed, that B.K. Nehru raised the question with Waight. As Nehru confessed to Waight, politically the authorities in India were under pressure to diversify out of sterling, and mentioned to him a figure of \$110 million—\$10 million as working balance and \$100 million as a currency reserve. The British authorities rejected the plea and argued that there was no threat to the sterling and that acceding to the Indian request would encourage other sterling holders to advance similar proposals. The action proposed, the British Chancellor also pointed out to Krishnamachari, would not serve Indian interests if it triggered a stampede from the sterling, and its devaluation. The Reserve Bank too felt there was no immediate risk to the sterling, and advised caution. Krishnamachari's own inclination was to diversify out of sterling and 'take the consequences', but he was prevailed upon in the end to hold his hand.

Fears for the sterling did not altogether cease after the January 1957 discussions. But a number of factors contributed to easing them for the greater

part of the next decade. The progressive restoration of sterling convertibility from the late 1950s was no doubt an important factor, as was the steep reduction in India's reserves after 1956. It also became clear from the early 1960s that the dollar too, was not entirely invulnerable to speculation. Besides, India's increasing dependence during these years upon external assistance helped effectively to diversify its portfolio since such assistance came inevitably in a mix of currencies. The sterling part of India's drawings from the Fund increased during the 1960s, but the Bank and the government sought better reserve diversification from the early years of this decade by deciding to meet the bulk of the country's external obligations out of its sterling holdings.

One may note, in concluding this section, that Indian nervousness about the sterling revived in 1966, and the government once again sought the Bank's advice about persisting with the prevailing reserve arrangements and about ways to insulate the country's reserves from the risks of a devaluation of the British currency. The Bank's study suggested that the policy of making external payments predominantly in sterling had already led to a sizeable reduction in the proportion of Indian reserves held in that currency. More sterling would be liquidated to meet payments falling due in the near future. While the Reserve Bank would have liked to sell pound sterling forward, the Bank of England frowned upon such transactions. Indian sales were also likely to be too large to be put through the market. There was the additional risk, besides, of a rapid liquidation of dated sterling securities inflicting a capital loss on India.

Therefore the Bank judged that the balance of advantage lay in continuing to meet non-sterling commitments through sterling sales in the spot market. Even if India was left with Rs 100 to Rs 115 crores of sterling at the time of devaluation, the Bank pointed out to the government, those assets could be utilized to make payments to the sterling area. On the other hand, the Bank could also not do without a fairly large working balance in pounds sterling and this situation was likely to continue for some more time. In a long letter to S. Bhoothalingam, Secretary in the Finance Ministry, conveying to him the Bank's views on the sterling, the Governor, P.C. Bhattacharyya, pointed out that India had done a great deal to diversify from sterling without giving rise to any instability, and that it could now afford to take a more accommodative approach towards Britain's problem.

Fears for the sterling were confirmed in November 1967 when it was devalued by about 14 per cent. But sterling assets now comprised less than a sixth of its exchange reserves and the exchange losses India sustained were, at about Rs 7 crores (or 1.6 per cent of the total reserves), relatively negligible. The larger losses, amounting to Rs 14.75 crores, arose from forward purchase contracts. Sterling devaluation also appeared to the Bank to signal the onset

of a period of wider currency instability involving the US dollar as well. These fears, which too were soon confirmed by the partial closure of the US gold window in 1968, influenced the Bank's attitude towards proposals Britain mooted about the middle of the same year for a system of sterling guarantees. The principal British object in advancing these proposals was to dispel uncertainty about the sterling's future and restore its international standing. But the Bank found little to commend in the British plan, among other reasons because the guarantee proposed was in terms of another reserve currency, viz. the US dollar whose future too was not beyond doubt, rather than in gold.

THE RUPEE IN A CONVERTIBLE WORLD

With the rupee stable and India firmly a member of the sterling area, issues of exchange rate management did not greatly exercise the minds of officials at the Bank and the Government of India in the first decade following the end of the second world war. But these were not altogether absent in their deliberations, particularly during periods when the prospects for sterling convertibility appeared to brighten and suggestions abounded of widening the band on either side of the par value of a convertible sterling. Wider margins for the sterling were, in particular, anathema to the Bank and the government. Hence the Bank began to conduct studies of the relative advantages of pegging the rupee to the sterling or the dollar, and those of following an 'independent' exchange rate policy. Not yet definitive guides to policy, these exercises were intended to equip the Bank to anticipate and prepare responses to ideas emerging globally about exchange rate management.

Restoring convertibility of the major European currencies, particularly the sterling, was the principal objective of international economic policy in the 1950s. Early in this decade, Britain recognized the merits of so arranging the advance towards convertibility and freer trade as to ensure the cooperation of sterling area countries. The 1952 and 1953 commonwealth discussions centred on the forms which convertibility might take, and proposals were mooted to allow the sterling to fluctuate within a wider band around the par than that allowed by the Fund, as the means of taking 'the strain off the reserves and put[ting] it on the rate of exchange'.⁵ As a sequel to this, Britain was anxious in 1953 to obtain a stabilization loan either from the Fund or the United

⁵ Quoted in J. Keith Horsefield, *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation*, vol. I, *Chronicle* (Washington, 1969), p. 353.

States. Though there were rumblings within, the Fund did not altogether look askance at the wider margins plan nor was any legal difficulty anticipated in extending its assistance to a member with a fluctuating currency. But, according to a report from the Indian Executive Director at the Fund, W. R. Natu, the latter organization was not convinced that the sterling was yet ready to face the pressures of convertibility. A realistic plan to make the sterling convertible was thought to depend on assistance being made available to Britain jointly by the Fund and the United States. With American support not forthcoming, however, the 1953 sterling convertibility proposals failed to get off the ground.

Modified proposals reappeared in 1954 as part of the so-called Collective Approach, whose main thrust was to enable the main European currencies to fluctuate 3 to 5 per cent on either side of their individual dollar par. As discussions on the Collective Approach continued through much of 1953 and the early months of 1954, Britain was careful to keep members of the sterling area, including India, informed of these developments. By the summer of 1954, both Washington and the capitals of Europe saw feverish activity in the shape of preparations for convertibility, and there was a shared belief that economic factors were conducive to a stable return to convertibility.

Britain's approach to convertibility favoured *de facto* or limited convertibility for non-residents with a continuation of quantitative restrictions, controls on capital movements, and a degree of discrimination against dollar trade. While domestic anti-inflationary policies were to be persisted with, fluctuating exchange rates also formed a key aspect of the British proposal. These proposals, especially the ones pertaining to discrimination against dollar trade and the continuation of quantitative restrictions on current account transactions, were not to US liking. Nor was the latter willing yet to revise its trade policies in the direction desired by the Europeans.

With Britain pressing forward with convertibility proposals despite these hurdles and seeking Fund assistance for the purpose, attention at this institution began to focus on the likely size of Britain's financial requirements and those of the other European countries. Assessing Britain's financial needs was far from easy. Besides, there were fears that Britain's request for assistance would be followed by similar requests by other commonwealth countries, and that the total assistance necessitated by the move to convertibility might be beyond the Fund's resources. Hence in June 1954, Ivar Rooth, the Managing Director of the Fund, sought the views of P.S. Narayan Prasad, who had by now become the Indian Executive Director, on the likelihood of India requiring stabilization assistance should the sterling become convertible, and its possible size. While not wishing to foreclose this option, Prasad pointed out that India had to balance its opposition to a fluctuating rate against the disadvantages of

abandoning the rupee's link with the pound sterling, and that its authorities could not take a final view until they were in a position to evaluate the 'facts and prospects' at the time convertibility became 'an actual fact'. The Fund, he told Rooth, should not therefore

be surprised if we do come up at that time with a demand on [the] Fund's resources for the support of a different exchange policy, if we should choose to have one.

Meanwhile at the Bank, Joshi and B.K. Madan began examining the issues that would arise in the event of convertibility. Madan's note addressed the nature of the exchange rate regime which might arise, the question of the rupee's convertibility, and the likely implications of policy for India's obligations under Art. XIV or Art. VIII of the Fund's articles of agreement.

As regards the first, the presumption was against the rupee fluctuating with the sterling. Nor was Madan in favour of a freely floating rupee. The balance of advantage, according to him, pointed to severing the rupee's fixed link with the sterling and maintaining the status quo whereby it moved within a narrow band representing one per cent of its dollar par. While much more needed to be known about the probable form and content of sterling convertibility before India could determine its precise approach, he recommended telling the UK authorities in clear terms that India's complaisance in this matter could not be taken for granted. Madan's note also favoured the rupee being made *de facto* convertible along with the sterling, since otherwise the odds would weigh heavily against it. The third issue, according to Madan, involved matters of strategy. Rupee convertibility, he suggested, might have to be qualified or limited by the trade and exchange restrictions needed to buttress it, and India should canvass support to enable developing countries with weaker economies to continue to take advantage of Art. XIV of the IMF articles of agreement (pertaining to current account restrictions) even after their currencies became convertible, without violating Art. VIII.

A meeting of commonwealth finance ministers was convened to coincide with the annual Fund-[World]Bank meeting in Istanbul in September 1955 at which convertibility with wider margins was a major topic of discussion. Madan's note determined the Indian view at these meetings that since convertibility was still a distant possibility and its ancillary conditions were unknown, Delhi was not yet prepared to commit itself to the course it would adopt in its event. However, Rama Rau, who led the Indian delegation in the absence of the Finance Minister, C.D. Deshmukh, took the opportunity to inform the British Chancellor of the Exchequer that it would be 'politically next to impossible, at present, to permit the rupee to fluctuate with [the]

sterling' and that the final Indian response would depend on the circumstances in which the currency was made convertible within a wider band. Elaborating on the Indian view, Rama Rau pointed out that a wider band was not in the interests of the sterling area since it combined the disadvantages of exchange uncertainty for trade with those of speculative uncertainty. Since the sterling was under pressure, he said, the markets might decide to test the bottom of the 3 per cent band so severely and persistently as to force another devaluation. The Chancellor affirmed the British determination to defend the sterling and denied any intention to devalue, whereupon Rama Rau reminded him of the role of speculation in forcing the sterling's fall in 1949 and of the latter's effect on the value of India's sterling balances. India, he pointed out, would have to guard against the risk of a sterling devaluation in the future particularly as it was about to embark on a phase of rapid planned development. To Rama Rau, as to others at the Bank and in the government, wider margins were the first step to an eventual devaluation, and he pressed on his British interlocutors the necessity for drastic internal measures to bolster international confidence in the sterling prior to embarking on convertibility within permitted Fund margins.

Taken aback by the intensity of his opposition to a wider band, Leslie Rowan, head of the British treasury's overseas division, appealed to Rama Rau not to elaborate on his arguments at the formal conference of commonwealth ministers. The Governor heeded this plea, though not before making India's objections to wider bands explicit at the formal session and then turning to the British Chancellor to enquire whether he would like him to expand on them. Rama Rau reiterated the Indian view at meetings at Whitehall and the Bank of England when he visited London from Istanbul. Discussions in London did not focus directly on the Indian response, but the Governor of the Bank of England and his aides, and later the Chancellor and his officials, underlined that wider margins would enable Britain to deal more effectively with speculators. The Fund margin of one per cent decided at Bretton Woods, officials in London insisted, was an arbitrary figure lacking any theoretical basis. These discussions ended with London urging India not to rule out wider margins and Rama Rau seeking more concrete convertibility proposals from Britain.

As Rama Rau's talks with the Germans revealed, India was not alone in opposing wider margins. The German Finance Minister made little secret of his strong opposition to wider margins, while the head of its central bank echoed Indian fears that speculative activity would force the sterling down to the bottom of the band and render its defence impossible. The Germans also shared the Indian view that more effective stabilization measures should precede sterling convertibility, which would then 'automatically follow'.

Thanks to the Istanbul and London discussions, the British treasury delegation that arrived in Delhi in October 1955 was better prepared to deal with Indian objections to wider margins. If the rupee fluctuated with respect to the sterling, British officials argued, the value of India's sterling assets would be in a state of flux. A stable rupee-dollar rate and an unstable parity with the sterling, the British side also feared, would tempt India to move her reserves into dollars. Finally, since nearly 70 per cent of India's trade was invoiced in sterling, a variable rupee-sterling rate would create greater uncertainty in the minds of traders than a variable rupee-dollar rate.

The British treasury team made little immediate impression in India but secured agreement for Cyril Hawker, executive director at the Bank of England, to visit Bombay and Delhi for consultations with officials at the Bank and the Finance Ministry. In preparation for Hawker's visit, the government asked the Bank to examine the administrative and other arrangements needed to enable India to 'manage successfully a fully independent exchange policy'. P.J. Jeejeebhoy, Deputy Exchange Controller, who was entrusted the task at the Bank, concluded that India's ability to adopt an independent exchange rate policy was limited by the size of its exchange resources. Since its trade was mainly financed in sterling and to a certain extent in dollars, reliance upon these currencies could not be eschewed. The two alternatives before India were to continue to remain within the sterling area or link the rupee to the dollar.

Jeejeebhoy underlined the advantages to India of a continued link with the pound sterling. These included administrative and technical arrangements provided by British banks and the London forward market by which the business community was able to sell and buy foreign exchange, both spot and forward. He was apprehensive that the abdication of sterling area membership might mean a drastic revision in such arrangements at least for a temporary period. Besides, India would need substantial dollar reserves to pursue a policy which was independent of the sterling, and its ability to acquire them depended on whether Britain would treat India's sterling balances differently for convertibility purposes from the manner in which it treated the balances of countries continuing to adhere to the sterling. Even from a purely ways and means angle, Jeejeebhoy pointed out, India needed larger working balances of dollars than it currently possessed.

The difficulty of fixing the daily spot and forward rates was, according to Jeejeebhoy, another argument in favour of a continued link with the UK currency. The insignificant margin which prevailed between the buying and selling rates for spot and forward sterling had so far ensured the relatively smooth financing of foreign trade. If the pound varied within a 6 per cent band and the rupee varied within one per cent of the sterling par, changes in

procedure and practice would be necessitated. The Bank would have to fix the buying and selling rates for transactions based upon the sterling-dollar rates in London in order to maintain the cross rate between the rupee and the sterling within one per cent. Fixing daily rates would not be without inconvenience to the business community. Besides, the Bank would have to intervene in both the sterling and dollar markets, since the alternative of supporting only one market would introduce uncertainty and dislocation in the other. The resulting cost to the Bank of covering its transactions was another factor to be borne in mind in adopting a different exchange rate policy.

Jeejeebhoy's note strongly underlined the perils of an 'independent' exchange rate policy. Although not without disadvantages, the option of pegging to the dollar within a narrow band still remained, and this was in the event a recommendation which emanated from the Bank's research department after a study of the subject by V.V. Bhatt. Rama Rau took advantage of Hawker's visit to pencil in the outlines of a tentative scheme along these lines in the event of the sterling moving into a wider band. The rupee, Rama Rau elaborated, 'would remain pegged to gold and, therefore, to the dollar' and fluctuate against the sterling. The Bank, he proposed, should make no change in the existing intervention practice and operate only in sterling at rates fluctuating with the sterling-dollar rate, leaving banks free to deal in dollars against sterling in the London or New York markets.

Hawker made little secret of his dislike for Rama Rau's proposal. Although the latter was better than pegging to the dollar and operating only in dollars, it would still represent a break in the uniform sterling front, influence other countries to follow suit, and damage the international role of the sterling. Besides disadvantaging India's rupee and sterling trade, the plan would create technical difficulties for exchange markets. Although not insuperable, such difficulties would still necessitate the organization of a local market and the supply of cover facilities for spot and forward risks. Complications would also arise from the difference between the working hours of the London, New York, and Bombay exchange markets which could come in the way of Indian banks covering themselves completely against exchange fluctuations.

Hawker conveyed his objections to Rama Rau's proposal also to Deshmukh when he met him in December 1955. Deshmukh assured Hawker that should a fixed rupee-sterling rate be found, upon examination, to be to India's economic advantage, the political resistance to it could probably be overcome. In the meantime, he said, India would like to 'hold its horses'.

The British Chancellor made it clear in Istanbul that the buoyancy of the British economy argued for restrictive measures and that his government,

which still had an open mind on the timing and nature of sterling convertibility, did not wish to rush the decision. This announcement was partly intended to deflect attacks on the sterling by speculators expecting the currency to be made convertible with wider bands. Thereafter, thanks to the sharp fall in sterling area reserves from the second half of 1955, hopes of an early restoration of sterling convertibility quickly faded. It also soon became apparent that there would be no general move towards convertibility in Europe until the UK took the first step.

In fact by 1956, prospects of early sterling convertibility had given way to fears for the currency's stability. As rumours regarding the sterling gained momentum and the currency came under attack in the wake of the Suez crisis, officials at the Bank and in the government began considering India's options in the event of a sterling devaluation. Even as Commerce and Industry Minister, T.T. Krishnamachari was wont to raise alarms about the sterling's future, and in July 1955 he forced the Finance Ministry, and through it the Bank, to directly address the possibility of a fall in that currency. Although Britain's economy was in a state of disequilibrium, it did not appear to officials at Mint Road and North Block that there was any imminent threat of a sterling devaluation. While dangers could arise to the longer-run stability of the currency from differential productivity growth rates within Europe, its immediate troubles were felt to be the result of reversible short-term factors. Britain, the Bank and the Finance Ministry also felt, had several measures open to it before pondering a devaluation. The only practical course, Deshmukh suggested to TTK, was for India to remain a member of the sterling area but consistent with its rules build significant dollar balances. This had already been done and it was not possible to intensify the process without evoking valid protests from Britain. Rama Rau too felt there was no immediate prospect of a sterling devaluation and that Britain was both determined and well equipped to avoid such a step.

It was pointed out above that the run on Britain's reserves in the wake of the Suez crisis led to a half-hearted effort by India in January 1957 to explore diversification possibilities in consultation with the British authorities, and that despite Finance Minister T.T. Krishnamachari being in its favour, the exercise was abandoned no sooner it began. During the preceding months, however, Indian sterling balances began to fall rapidly as imports surged on the back of rising public and private investment. Such an outcome had been anticipated by some economists within the Bank even in 1955, but little notice was taken of their views at that time. As the drains intensified, the Bank drew the government's attention to the phenomenon in December 1956. Recent sales of sterling had been as high as £6 million each week, while

weekly sales during the twenty-eight weeks ending 28 October 1956 averaged about £4 million. The rapid outflow excited widespread comment in the financial press both at home and overseas, and the Reserve Bank warned the government that this rate of drain was unsustainable. As pointed out in chapter 2, the rapid fall in its sterling reserves during 1956–57 also led to the revision of India's currency cover provisions which were modified twice within a period of about twelve months.

The reduction in India's sterling balances was greeted with concern at the Bank of England, particularly in the wake of rumours of possible diversification by India out of sterling, and Hawker returned to Bombay in January 1957 for discussions with the Bank. He talked at length about the manner in which Britain had weathered the adverse effects on the sterling of the crises of the previous year and speculative attacks on the currency. The raid on the sterling, he confessed, 'was a direct consequence of a lack of confidence' in the currency. But London had mobilized its resources and managed successfully to defend the currency and signal its resolve not to be pressurized into a devaluation. Britain, Hawker reaffirmed, was determined to avoid another change in the sterling parity since it would deal a mortal blow to the currency's international role. The Bank of England official was however principally anxious about the speed at which India was dissipating its sterling reserves. While displaying no overt concern, he sought reassurance that India had not lost confidence in the sterling and that it would not face a crisis in meeting its foreign exchange commitments in the near future. Hawker also attempted to draw out Indian reactions to the blocking of Egypt's London balances, and added that there was no cause for a 'Commonwealth country to believe that such an action would ever be taken against it'. K.G. Ambegaokar, who was the Governor during these weeks, remained non-committal. While newspapers had speculated freely about India moving out of sterling in response to Britain's action against Egypt's balances, the Bank itself had not yet 'taken any serious view of the situation'.

It was not the case, however, that the Bank suffered no attacks of anxiety about the stability of the UK currency. Several officials at the Bank were convinced that fears about the sterling were a hardy perennial that needed persistent and careful study, and Pendharkar, S.D. Deshmukh, and Bhatt were entrusted the responsibility for forming a firm outlook on its prospects. Their study of the 1956 crisis convinced the Bank that devaluation was no solution to Britain's external problems. The latter's deficit was caused by a disturbance to normal trade rather than an imbalance in relative prices, and was accentuated by leads and lags in current account transactions and

speculative outflows of short-term capital. Britain's best course, the Bank believed, lay in taking bold steps to support the existing rate. Even though it judged a sterling devaluation to be improbable, the Bank continued to study the various courses of action open to India in the event of Britain deciding upon such a policy.

The prospects for the sterling took a turn for the worse from the mid-sixties. But having already diversified the country's reserves out of the endangered currency, the Bank could afford to face the future with a certain measure of equanimity. The prospects for its trade of a sterling devaluation and its aftermath were another matter altogether, but little would be gained by anticipating events in such matters. The devaluation of the pound sterling by some 14 per cent in November 1967 did turn thoughts within the Bank towards a possible response. Ceylon (20 per cent) and Nepal (24.74 per cent) decided to follow the sterling down. But its recent devaluation still conferred some advantage, so that while resolving to keep the situation under continuous watch and modifying some export duties, India decided not to respond to the sterling's devaluation by altering the exchange rate.

STERLING CONVERTIBILITY AND AFTER

A major move towards the restoration of multilateral payments arrangements after the end of the second world war was the announcement on 29 December 1958 of the resumption of external convertibility of fourteen west European currencies including the pound sterling. The departure from prevailing arrangements signalled by the agreement was less significant for the sterling than for the other currencies, since a measure of *de facto* convertibility of non-resident holdings had already been established in February 1955 when London decided to intervene in the market for transferable sterling. The December 1958 decision meant that Britain was now able formally to unify transferable, American, Canadian, and the so-called registered accounts into a single external account. Some current account restrictions remained in place both in Britain and in the other European countries, and these were proposed to be removed when conditions permitted, as part of the process of instituting the proposed European monetary arrangements.

The Bank first learnt of the convertibility decision officially on 24 December 1958 when Cobbold cabled the Governor, H.V.R. Iengar. This was followed by another message three days later detailing consequential changes in Britain's exchange control rules and procedures governing non-residents. The most gratifying feature of the new development, from the Indian point of view, was the burial of proposals for convertibility with wider margins. Telegrams from

London made clear that the sterling would be maintained within a narrow band of \$2.78 to \$2.82, and India could set at rest its fears about the consequences for the rupee of wider sterling margins, and put on hold plans to review its exchange rate policy.

India's response to the non-resident convertibility move was prompt, and it was among the sixteen countries which took immediate steps to adjust their exchange control regulations to the new conditions. In February 1961, ten European countries including the United Kingdom decided to abolish current account restrictions and assume full obligations under Art. VIII of the Fund's Articles of Agreement. The latter step had immediate practical implications for India since with the sterling becoming formally convertible, its sterling balances began to be counted by the Fund as part of the country's monetary reserves. India had borrowed from the IMF in 1957, and under Art. V, an increase in a borrower's monetary reserves could lead to an additional repurchase obligation which was independent of the repurchase programme agreed earlier. Although there was no immediate danger of this happening, India wanted to avoid having to alter repurchase obligations as a result of a notional increase in its monetary reserves. Hence the Bank and the government decided to keep a careful watch over India's monetary reserves position and, should it become necessary, consider replenishing its working balances within reasonable limits, in order to avoid new repurchase obligations.⁶

The restoration of convertibility, if anything, increased the Bank's interest in exchange rate management. The restoration of European convertibility was followed within a matter of years by greater uncertainty in currency markets and doubts over the long run stability of the sterling and now, also the dollar. Hence the Bank took a continuing interest in evaluating alternative scenarios and policy possibilities. The events leading to the rise in the price of gold in London from the Bretton Woods parity of \$35 per ounce to \$41, the gold rush of October 1960, and the revaluation of the Deutschmark, which the Bank had earlier dismissed as improbable, sparked off studies within the Bank on the possible consequences for India of a realignment of the exchange rates of the major international currencies. These studies also focused on India's response to the development, particularly should its export rivals such as Pakistan and Ceylon also take the opportunity to devalue their currencies.

The substance of the Bank's views was summarized in a note by Madan entitled 'Exchange Values of Currencies' which was based on the considerable preparatory work done then and earlier by Pendharkar, Deshmukh, and Bhatt.

⁶ Under Art. XI(c), working balances are not counted towards reserves.

Madan's note concluded that India had no alternative to following the sterling down if the latter was devalued. This consideration applied even more strongly if both the sterling and the dollar were devalued. European revaluation, on the other hand, would be in the nature of an overdue correction involving no questions of any possible response by India. Madan felt there was no need for India to match a Pakistani devaluation since the latter's existing export incentive schemes amounted to a de facto devaluation of its currency. While the same conclusion held true in Ceylon's case as well, India, Madan argued, might need to examine specific measures for the protection of some exporters' interests. But a more detailed evaluation of the question was not possible until more was known about the precise extent and coverage (including possible offsetting export duties) of the devaluations carried out by these countries. The Indian decision would depend, besides, on the availability of foreign assistance, the course of exports during the slack season, and its success in holding the domestic price line down.

In the end, little came of these exercises. The dollar steadied during the subsequent months, particularly after the so-called gold pool, comprising several European central banks and the Federal Reserve Bank of New York, was formed in November 1961 to coordinate intervention in the London gold market. By the end of 1961, the Bank had grown sanguine about the prospects for the dollar, and studies of international monetary and exchange rate conditions took a back seat which they did not vacate until the late 1960s.

THE BANK'S ROLE

Writing in 1985 on the occasion of the fiftieth year of the Reserve Bank, B.K. Madan referred to the institution's external financial initiatives as a major source of the considerable national and international stature it enjoyed during the early post-war years. In particular the former Deputy Governor had in mind the Bank's contribution to the formulation and exposition of India's views at the Bretton Woods and Savannah conferences and its handling of the related wartime issues of sterling balances and domestic inflation.

Madan himself was closely involved with the Bank's activities in these spheres. Yet his assessment is not far off the mark. The Bank's engagement with international financial issues derived from the independent expertise its newly established research department was building up in this area, which was already superior to that available, loosely speaking, in the 'third world', not to mention the Government of India. Besides, as the sole economic and

financial policy-making body accountable in some sense to a wider public body and with an elected Central Board whose members were sensitive to 'nationalist' aspirations, the Bank's views carried a legitimacy at this time denied to those of the colonial government.

After 1947, but more especially from the early fifties, a gap opened up between the Bank's technical expertise in international financial matters and its executive responsibilities, with the latter passing increasingly into the hands of an elected central government in Delhi. This process gained pace after C.D. Deshmukh, who as Governor was an Indian delegate to Bretton Woods and the head of the Indian delegation at Savannah, became Finance Minister. Thereafter, the Bank merely provided the technical analysis and policy advice upon which the government based its decisions, but rarely itself made the decisions. Although as Governor, Deshmukh played a major role in the sterling balances negotiations and his successor often represented the government's views to other governments and central banks, the Bank's role in financial and economic diplomacy generally, and in particular on matters covered in this chapter, became increasingly subordinated to that of the government. On the other hand, the Bank's expertise in these areas remained relatively unchallenged for much longer than in others. In addition, the practice of sending its officials as Indian executive directors to the Fund and the use the government made of the Governor's contacts with other governments, central banks, and international financial institutions meant that the Bank was not entirely divorced even during these years from the management of the country's external finances.

Dealing with Scarcity, 1957–63

India's external finances began to unravel from the very first year of the second plan. Imports in 1956–57 rose by more than 40 per cent to Rs 1,100 crores from Rs 775 crores the previous year, and with exports registering a small fall, the trade deficit more than tripled from about Rs 130 crores to Rs 465 crores between the two years. Despite the imposition of stringent controls and the nearly 14 per cent decline in private sector purchases abroad, total imports rose further to Rs 1,235 crores in 1957–58 and the trade deficit to Rs 565 crores. Thanks to import compression, the trade deficit fell to Rs 455 crores and Rs 300 crores during the next two years before increasing to Rs 475 crores in the concluding year of the second plan. Unlike during the second plan, the crisis in India's external sector was contained quite effectively during the early years of the third plan. But the trade deficit ballooned again to Rs 620 crores in 1964–65 and to Rs 585 crores the following year, before rising steeply to Rs 905 crores in 1966–67. With the surplus on the invisibles account showing no significant increase or dipping sharply during these years, the imbalances on the current account largely mirrored those on the trade account.

India's current account deficit peaked at around 4 per cent of national income in 1957–58 and bottomed out at 1.5 per cent in 1959–60.¹ In no other year did the deficit amount to less than 2 per cent of the national income, and the current account deficit as a proportion of national income averaged about 2.5 per cent between 1956–57 and 1967–68. With private capital flows negligible or negative during this entire period, the deficit was financed overwhelmingly by flows of official external assistance

¹ Figures for the current account deficit are from Reserve Bank of India, *India's Balance of Payments, 1948–49 to 1988–89* (Bombay, 1993); figures for the net national product at factor cost (revised series) are from Government of India, *Economic Survey: 1989–90* (Delhi, 1990).

which amounted to over 22 per cent of the second plan outlay and 28 per cent of that of the third.²

Coping with the shortfall in external resources and mobilizing foreign assistance for the development effort and to relieve balance of payments pressures became, thus, important preoccupations for India's economic policy-makers during the latter half of our period. This chapter is devoted principally to detailing India's efforts to raise external resources during 1958–63. Although efforts to gather assistance through collective forums such as the Aid India Consortium were by far more important, bilateral trade agreements with the Soviet Union and the countries of east Europe also figured among the options policy-makers explored to help sustain India's ambitious development plans. Appendix G is devoted to the latter subject.

THE CRISIS OF 1956–58

The modest first plan was widely regarded a success. Growth rates which were respectable by recent historical standards coincided with low rates of inflation, and together with a comfortable external payments position, encouraged much optimism about the longer run prospects for the Indian economy. The IMF mission led by Edward Bernstein had already declared India creditworthy in 1953 and dispelled doubts voiced by the World Bank, among others, about whether it was 'safe' to lend it money. Bernstein also recommended untying aid so that India could use it to finance the imports needed to restrain inflationary pressures exerted by large investment outlays. Since its debt service burden was still quite small, his report suggested that India could afford to borrow abroad to finance domestic investment.

Emboldened by stable economic conditions, comfortable external reserves, and the positive attitude of the international agencies, the second plan envisaged a substantial step-up in public investment. The financing of this investment was not however fully tied up. The planners expected India to run a current account deficit of Rs 1,120 crores. Of the latter, Rs 200 crores were expected to be financed out of the reserves. The second plan document argued (p. 105) that 'the extent to which development programmes can rely upon resources from abroad can hardly be determined in advance', and while making no provision for meeting the remaining gap, suggested that the latter could be financed by drawing on unutilized credits, floating public issues in foreign markets, borrowing from multilateral institutions and foreign governments,

² Second plan and third plan external assistance figures are from the *Report on Currency and Finance, 1968–69*, pp. S.114–15.

private foreign investment, grants from friendly governments, and suppliers' credits.

Officials at the Bank were sceptical about the second plan payments projections which they felt erred on the side of optimism. The Governor, B. Rama Rau, presented a less than glowing account of the draft plan to the Central Board which discussed it informally at a meeting in January 1956 about two months before the plan was set to commence, while members of the Central Board questioned the underlying plan arithmetic. They observed that the estimate of Rs 800 crores for foreign assistance was four times the assistance received during the first plan, and that foreign private investment of Rs 100 crores was unlikely to be realized.

The views of the members of the Central Board had little impact on the government. But the crisis which they and the Bank feared came sooner than anyone anticipated, in fact, in the very first year of the plan. The immediate impact of the payments deficit that year was a steep fall in the country's exchange reserves from Rs 902 crores at the end of 1955–56 to Rs 681 crores one year later. The reserve drain in the first three quarters of the inaugural year of the plan alone exceeded the total estimated draft for the entire plan period. This necessitated urgent modifications to currency cover requirements which had only recently been revised downwards, and led to the imposition of stringent exchange controls in 1957. The plunge in reserves accelerated the following year when the draft upon them amounted to Rs 260 crores, and despite the narrowing of the deficit in the remaining three years and higher aid flows, reserves continued to fall during the remaining years of the second plan. Notwithstanding the assistance India received, the actual fall in the country's external reserves was, in the event, thrice that estimated by the framers of the second plan.

The Bank's analysis of the operational reasons for the import boom of 1956–57 was published, at V.G. Pendharkar's instance, as an article by S.D. Deshmukh in its *Bulletin* in July 1957. The import boom, the article argued, was a lagged effect of liberal licensing in 1955–56, particularly of consumer goods imports. Licences were issued freely that year partly on the premise that capacity constraints in the major industrial nations would lead to imports being staggered over a fairly long period. But thanks to some easing of these constraints and a slow-down in western economic growth, there was a bunching in the execution of these orders and a flood of imports.

The 1955–56 licensing boom became a major source of controversy within the government two years later. In a letter to the Prime Minister in January 1958, the Chairman of the University Grants Commission and former Finance Minister, C.D. Deshmukh, claimed to have been kept in the dark by the other

wings of government, in particular the Commerce and Industry Ministry, about the liberal import policy. Finance Minister T.T. Krishnamachari, who was earlier in Commerce and Industry, was not amused by the *Bulletin* article nor by the fact that it led to some uncomfortable questions being raised in Parliament. He saw Deshmukh's letter as a personal attack and argued to Jawaharlal Nehru that the crisis was a result of the Planning Commission's sloppy resources arithmetic, about which the Finance Ministry was not consulted, and the former Finance Minister's failure to spot or correct it. The Prime Minister refused Deshmukh's plea for an inquiry into the origins of the crisis, while the Planning Commission for its part blamed it on adverse changes in India's external environment caused by heavy demands for defence, larger food imports, and the impact of the Suez crisis on prices and freight rates.

Exchange Control and Withdrawal of Gulf Rupees

Almost the first response of the authorities to the payments crisis of 1956–57 was to impose stringent trade and payments controls. Until then, exchange controls were imposed as part of India's obligations to the sterling area, but in 1957 the Foreign Exchange Regulation Act, 1947 (FERA) was put on a permanent footing. Controls were now necessitated by the country's own requirements and were regarded as an essential policy instrument to restrict outflows and plug foreign exchange leaks. Very soon thereafter, a comprehensive regime of restrictions was put in place covering the transfer and use of foreign exchange, the export and import of gold and foreign currency, the sale and acquisition of foreign assets abroad, emigration facilities, and licensing of exports and imports of goods. The Bank clamped down on pleasure travel in January 1957. It was already closely involved with administering controls over flows of other invisibles and foreign investment, and with the introduction of the controversial 'P' form in June 1962 to tighten travel restrictions, the Bank became the focal point of approval for business, medical, and educational travel.

The worsening payments position and the imposition of exchange controls also brought the Indian authorities face to face with the necessity of withdrawing Indian rupees circulating in the Persian Gulf. The legal tender status of Gulf rupees was a legacy of British rule, and though it was recognized as a liability whose dimensions could only be guessed at and the Bank had drawn attention to the loophole which the arrangement provided for smuggling gold into India, the government was inclined (largely for reasons of prestige) to persist with the arrangement. The external trade of the Gulf region not being licensed for transactions within the sterling area, banks there sold pounds freely against rupees. The burden of these transactions was borne eventually

by India's official reserves since balances in non-resident rupee accounts were convertible into sterling. Worse, this loophole encouraged the unauthorized export to the region of rupees from India and their conversion into sterling. Thus sterling payments against non-resident rupee accounts rose from Rs 6.8 crores in 1956 to Rs 32.6 crores in 1957 and Rs 31 crores in the following year. With currency arrangements in the Gulf threatening to undermine the effectiveness of exchange control arrangements, and convinced now of the necessity of doing something to stem the outflows, the government sought the Bank's advice on the problem. The view of the mission the Bank sent to the region and of other officials at Mint Road was that it was not immediately practicable to replace rupees by another currency. The only immediate solution lay in issuing special rupee notes in the Gulf which were distinguishable from those circulating in India. Following discussions with the Bank of England, the Bank and the government decided to adopt this course in April 1959. Special Gulf rupees however required an amendment to the Reserve Bank of India Act which was passed the same month, and new notes with a changed legend and printed in distinctive colours were put into circulation in the region in May 1959. Thanks to this, what was earlier a virtually open-ended commitment to pay sterling against rupees was limited to the amount of special Gulf rupee notes repatriated to India. The special rupees circulated in the region until the 1960s when the Gulf states began setting up their own currency arrangements.

THE SEARCH FOR FUNDS

It was always clear to the Indian authorities that an external imbalance of the magnitude necessitated by their planning exercises could not be met by short-term palliatives, and that the availability of long-term development assistance was critical to their success. The second plan, as pointed out above, envisaged a relatively modest draft on the reserves. There was no clear outlook, besides, on the phasing of imports during the plan period. Indian officials pointed out to concerned officials in London during these months that the government anticipated the initial foreign exchange costs of its investment plans to be met largely out of the reserves. But even if the drain of 1956-58 itself may not altogether have been unexpected, its extent did catch the Indian authorities by surprise and underlined the urgency of tying up external funds for the plan.

As the magnitude of reserve losses became apparent and no end appeared in sight, the Bank grew concerned about their sustainability. By the end of 1956, the Governor and his principal advisers began examining ways in which existing economic policy instruments could be used to reinforce reserves.

While imports of goods and services judged to be unnecessary for the plan effort had to be checked—and this consideration led to the imposition of exchange controls—the more fundamental solution lay in boosting reserves which, some felt even late in 1956, would fall below the reduced minimum currency cover provisions adopted only a few months earlier. The export outlook was, however, not very promising whether in the short or medium term. Although it spoke of ‘maximizing export earnings’, the second plan did not spell out a major export effort, and its investment plans could only lead to the pre-emption of exportables. The Bank too shared the prevailing sentiment of export pessimism which was reinforced during these months by the expectation that the terms of trade during the remainder of the decade would become unfavourable towards India.

Resort to the Fund: 1957

The immediate means at hand to restore reserves lay therefore in seeking assistance from the International Monetary Fund, and this was the Bank’s advice to the government. But until February 1957, the government remained quite sanguine about what it felt was a temporary hump capable of being overcome by other measures. Recourse to the Fund was not ruled out, but was to be the last resort.

This view was based on underestimating the true extent of India’s balance of payments problems and external financial needs. But it was not altogether without justification. The attention of the international institution was concentrated during these years on the developed countries and its assistance was directed chiefly towards defending the par value system by restoring confidence in the major currencies. Not only was the Fund less familiar at this time with the problems of developing countries than it was soon to become, the rupee was also under no immediate threat. But as reserves continued to fall, the decision was effectively taken out of the government’s hands, and early in 1957 it approached the Fund for a short-term drawing of \$200 million for balance of payments support.

Though the initial reaction to the Indian request in Washington was positive, negotiations were not easy. The American Executive Director at the Fund was supportive. However the same was not true of the Treasury department which first argued that India’s drawings should be related not to its total quota but to the subscribed portion of its gold quota.³ Thus while a drawing of up to \$100

³ The total Indian quota at the Fund was \$400 million. Countries were expected to subscribe a quarter of their quotas in gold and the remainder in their own currencies. But thanks to Britain’s external financial problems, India’s gold subscription at this time amounted to only \$27.53 million. Despite quota revisions in the late 1950s and

million could be made without any conditions, larger assistance, the Treasury department suggested, should be based on an assessment of balance of payments need, domestic economic conditions, and macroeconomic policies. It was clear to the Indian negotiators that the US approach was guided by political considerations and that their request for a drawing would not be approved without some hard bargaining. The government was less inclined than the Indian Executive Director (P.S. Narayan Prasad) to join negotiations, and advised the latter to defer them until the outlook became less clouded. But seeing that several countries were planning to approach the Fund, Prasad on his own initiative began talks with its management for a standby of \$200 million.

The US Treasury department held a number of general reservations about Fund drawings, one of which was that disbursements by the two Bretton Woods agencies contributed to worsening US inflation. Besides, the Treasury Secretary was not convinced that India's payments disequilibrium was temporary, and believed it was seeking development assistance in the guise of balance of payments financing. The Indian application attracted support from the IMF staff, in particular the Deputy Managing Director, Merle H. Cochran. Other influential supporters included the US director Frank Southard who is reported to have made a dozen trips to the Treasury to argue India's case with the Secretary. In the end the Treasury left the decision to the State Department, which apparently at the instance of the Secretary of State, John Foster Dulles, decided to back the request. In February 1957 the Fund agreed to India purchasing \$200 million, of which \$72.5 million were in the nature of a standby facility.

The American Treasury's misgivings about the nature of the Indian crisis were shared by representatives of some other countries, in particular the Dutch who insisted that the deficit was a planned one, was not temporary, and that India should approach the World Bank rather than the Fund. Prasad's opening remarks in the discussions anticipated this criticism and he pointed out, somewhat disingenuously, that \$200 million represented the extent of the temporary disequilibrium arising out of the rapid depletion of inventories, while an additional deficit of \$300 million arose from the development programme. He also pointed out that the Fund articles did not preclude assistance to a member country experiencing deficits because of accelerated investment so long as the former were recognized to be temporary. In the event, only *Fórmosa* (Taiwan) abstained on the resolutions. The Netherlands supported the drawing but opposed the standby arrangement.

the mid-sixties, India's lower initial gold tranche remained an enduring disability during our period.

The 1957 drawing was only the second by India since the Fund came into existence. There were five other drawings by India during the remaining years of the period covered by this volume. Some of these are discussed later in this chapter, while the drawings of the mid-sixties are covered in the next chapter in the context of the growing crisis in India's balance of payments. We may merely note here that Indian drawings or standby agreements also coincided not infrequently with large repurchases (repayments to the Fund). This feature of the assistance India availed from the Fund may tempt one to conclude that it followed a practice of rolling over the institution's credits, and of using them really as a buffer for development assistance if not directly as such assistance.

Indeed, its repeated approaches to the Fund did intensify doubts about India's intentions in the sixties, and some officials such as Per Jacobsson, Managing Director of the International Monetary Fund between 1956 and 1963, made no secret of their suspicions. Although India was not oblivious to the distinction, it was often impossible in practice to separate payments support from development financing particularly when the latter did not materialize to the extent the planners anticipated, or arrived after some delay. Besides, payments pressures could arise, as indeed they did in the 1960s, due to the import-intensity of investments financed out of foreign aid which donors had no incentive to estimate precisely, nor India the information to do so. As the crisis of financing maintenance imports worsened from the early sixties, developed countries too, began advising India to approach the Fund to raise the necessary resources. Clearly, as many contemporaries recognized, while India approached the Fund principally to meet payments difficulties, it was also at the same time testing the limits of the existing structure of institutional financial support for its development endeavours. The expansion in later years of the Fund's medium-term lending facilities reflects to some extent wider international recognition of the view India implicitly canvassed during the late fifties and early sixties, that the dividing line between the two types of needs was often a thin one.

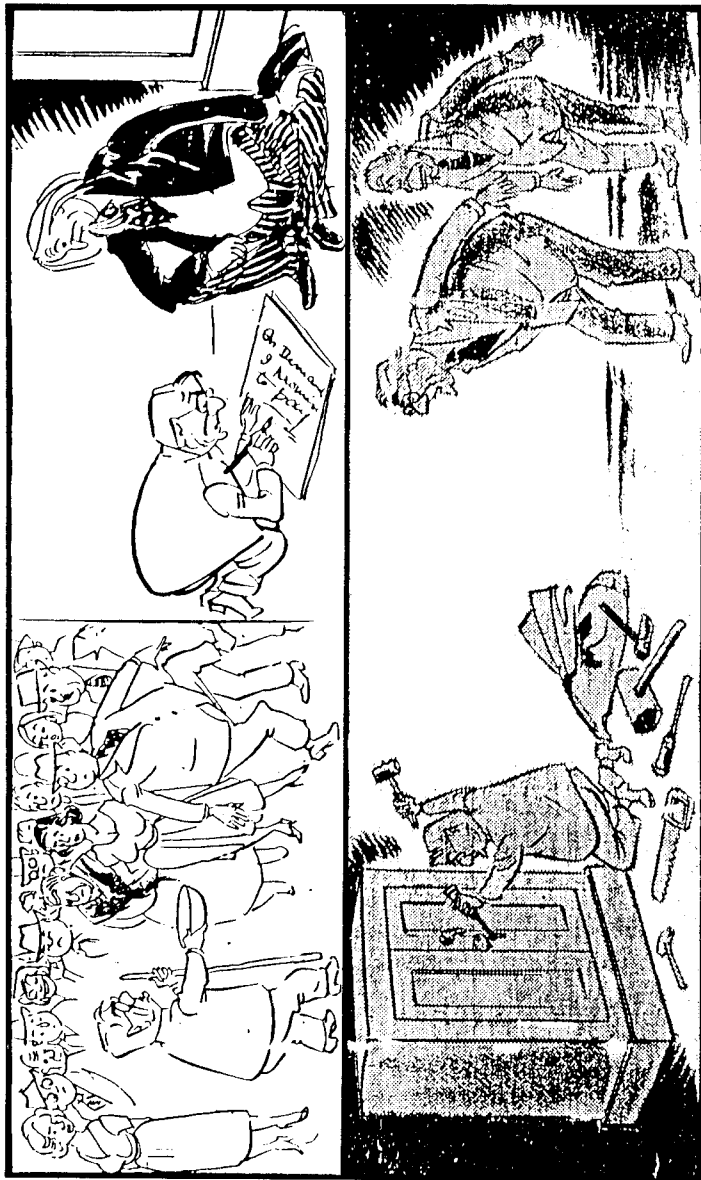
Seeking Development Assistance: Early Efforts

Even by Prasad's somewhat spurious distinction, India had to mobilize \$300 million in the form of external assistance during the second plan. This was no easy task. Apart from running reserves down by Rs 200 crores according to the Finance Ministry's estimates, India had to find \$1,400 million abroad to finance the second plan. However, until 1958 apart from specific project assistance from the World Bank and some donor countries and American wheat loans and technical credits, India had no expertise in seeking

development assistance, much less an organization capable of coordinating the effort. The planners, as pointed out above, had not cared to spell out in any detail how foreign funds would be raised, and there was inevitably a lag between the initiation of the second plan and the mobilization of external assistance to finance it. But it was longer than it need have been. Some early exercises were conducted, notably after March 1957, by the Governor, H.V.R. Iengar, and B.K. Nehru, Secretary in the Finance Ministry, to encourage the import of capital goods financed by long-term suppliers' credits. The latter were intended originally as criteria for licensing capital goods imports, and indirectly represented the first effort to source capital from abroad. But, as the Bank warned the government, not only did suppliers' credits involve 'loan tying', they also threatened to distort the plan. Besides, countries such as Britain, which faced severe external payments problems and could not afford to extend cheap or long-term suppliers' credits, objected to other European countries such as West Germany doing so, and its efforts chiefly had led by the late 1950s to an agreement between the major European industrial powers (the so called Berne Union) which restricted suppliers' credits to five years. Excessive reliance on medium-term suppliers' credit could create repayment problems in the near future. The route to solving India's external financial needs was thus seen to lie in sourcing loans and assistance rather than suppliers' credits. While untied loans or assistance best suited its needs, India was not loath to accept some tying if that was the only condition under which assistance became available.

The reserve drains of 1956–57 led to a sense of crisis, but not yet one of urgency in Delhi. The challenge of drawing the west into India's development efforts was ultimately one for the political imagination. Although P.L.480-type arrangements, technical credit missions, and tied project loans were available, large-scale transfers of development assistance were virtually unknown at the time. The problem therefore was to impress upon decision-makers in western capitals mainly, the extent of India's financial requirements without making them balk at undertaking it. Apart from financial considerations, political, strategic, and legislative factors also weighed with donor governments, and not all of these necessarily influenced events in the directions India sought. A high level of statesmanship was required, and though the country's stature and importance could not be overlooked and Jawaharlal Nehru himself commanded great international respect and goodwill, India's political relations with several western countries could sometimes be uneasy. The discourse of self-reliance too, constrained the political leadership from pursuing external assistance vigorously, while the few meetings that had taken place between Indian ministers and potential donors' representatives

Beg, Borrow, or...



Mr. T. T. Krishnamachari would explore the prospects of a loan of 500 to 600 million dollars when he visits the U.S.A. shortly.

— Shankar's Weekly, 15 Sept. 1957

failed, at best, to educate the latter about the country's aid requirements. Though the British high commissioner's conclusion—that the Indian government was 'too ready' to assume the west would 'prefer financial support to chaos' in India—was probably an exaggeration, there can be little denying the complacency which attended its early exercises to gather assistance.

Largely in order to minimize the political capital invested in aid negotiations and retain its capacity to adopt an independent posture in international affairs, India decided sometime during 1957–58 to conduct them as technical operations undertaken at official and diplomatic levels. This had the advantage, at least overtly, of de-politicizing these exercises. Some of the drawbacks of this approach would become apparent in the 1960s. An immediate one was that while India's needs were largely pressed by civil servants in the Finance Ministry and to some extent by the executives of the Reserve Bank, an impression had to be made on the political leadership of the donor nations, in particular the United States, in circumstances where public opinion in these countries did not yet favour large external financial commitments. That India's aid requirements were largely met without much controversy between 1958 and 1963 owed a great extent to the exertions of Indian officials, including to some extent Iengar and Bhattacharyya when they were Governors of the Bank, the positive role of the World Bank, in particular its President Eugene R. Black, and by 1959–60 to a distinctly favourable change in the aid climate. But for these factors, the asymmetry between India's means and its development requirements, and that between the latter and the political resources it mobilized to secure them could hardly have been redressed.

The early Indian efforts to tie up long-term external funds help illustrate the relative inexperience of its officials in this area and the optimism with which they viewed their prospects for success. Oddly, for example, central banks of the developed countries were seen (though one may add, not only in India) as a possible source of development assistance and the Bank, in general, was expected during these early months to explore the possibility of raising banking funds for the country's development needs.

The first initiative by the Reserve Bank to raise external finances for development followed the visit to Germany in October 1957 of the Finance Minister, T.T. Krishnamachari. The latter appears to have been persuaded by his hosts that while current German policy precluded a loan to the Indian government, the German central bank might be a better door to knock at. TTK thereupon asked Iengar to visit Germany and establish friendly personal contact with its central bank's President-designate, Karl Blessing, and explore with him the possibility of investments in Indian government securities.

The discussions Iengar had at the Finance Ministry before setting off on his mission led to the conclusion that accepting 'short-term' credits (defined as those repayable in five to six years) would be sheer folly, and that India should seek longer-term investment in government paper. Investments in treasury bills could be considered with a 'revolving arrangement'. The Governor was also told to offer on treasury bills, interest comparable to what India's investments earned in London, up to 5.5 per cent on long-term securities, and dollar exchange guarantees.

Armed with these elaborate instructions, Iengar embarked on a visit to Germany, Britain, Switzerland, France, and Italy in April 1958. His talks in Germany with Blessing, ministers and senior officials of the government, and commercial bankers were cordial, but yielded little immediately by way of funds. While government loans were as yet unheard of in Germany, the central bank could not invest abroad for more than three months and Iengar's roll-over proposal received only a polite hearing. Commercial banks too, spoke of their financial constraints and the undeveloped state of the German capital market. The only responsive note was struck in meetings with ministers and officials of the federal government who appeared willing to look at the Indian problem, the minister for economic affairs, for example, seeking from Iengar estimates of the assistance India might need over the next ten years to enable friendly countries to consider the forms in which they could be met. India was very far from assembling such figures. But Iengar, who meanwhile learnt that the Americans and the British were pressing Bonn to give Indian needs a careful appraisal, was reassured by the extent of the German interest, and the knowledge that it was not altogether a cold breeze blowing from the continent. The Germans were soon to react with some pique to American and British pressure to assist India, but this did not become apparent until some months later.

The response from elsewhere on the continent was less than favourable. Maurice Frere, the President of the Bank for International Settlements, threw cold water on India's chances of raising long-term credits in Switzerland and could only draw Iengar's attention to the offer he had made earlier to Ambegaokar, of his bank's willingness to buy up to \$25 million worth of three-month gold treasury bills paying 3 per cent per annum. The governors of the French and Italian central banks cautioned their Indian counterpart against expecting any help from their quarters. The two countries could for the foreseeable future use all their savings and more, while the Italian central banker advised Iengar against presenting aid estimates for a number of years since doing so might scare away, rather than attract, prospective donors.

An Indian delegation was told by the British authorities in July 1957 that there was no early prospect of raising long-term intergovernmental loans in London, and the outcome of Iengar's trip suggested that this remained the case almost a year later. His visit to Europe in 1959 however made him take a more hopeful view. Europe, he now felt, was more willing and able to assist Indian development. But such assistance would not become available until the third plan, by which time, Iengar felt, mobilizing external resources might pose fewer challenges than raising the necessary domestic resources. His advice to the government in 1958 was that since the US government too, appeared unwilling yet to take on the burden of financing India's development needs, the Finance Ministry should focus its energies on the World Bank, primarily, and the Fund, seeking if necessary appropriate amendments to their charters and functional changes to enable these institutions to play a greater role in the development processes of countries such as India.

Iengar also took advantage of a visit to the US in 1959 to tour some countries in Latin America, chiefly to study the reasons for their success in attracting American investment despite running high rates of inflation. Recognizing Latin America's place in US priorities but also sensitive to the role played by the policy environment there, Iengar suggested that India should not rule out making policy and procedural changes to attract private capital flows from abroad.

The Aid India Meeting of August 1958

To avoid the danger of running ahead of events, let us merely note here that little came out of Iengar's recommendations. Hopes in 1958 remained focused as they did for several more years afterwards, on multilateral and intergovernmental assistance, and by the summer of that year India began knocking more insistently at the doors of the major western capitals. As diplomatic cables which flowed between Delhi, London, and Washington reveal, Indian officials expected in June 1958 that the country's external reserves would be drawn down to the 'minimum safe level' by the end of the year. Iengar confided to T.T. Krishnamachari in August 1958 that the payments India owed during the remaining part of the year were so heavy that 'without further assistance, we shall run through all our sterling balances and yet be compelled to default'. The problem now was to find a 'total of Rs 560 crores, and ... a good part of it within the next few months so that we would not default on our obligations'.⁴

⁴ Rs 560 crores (or \$1,176 million) was really the Finance Ministry's estimate adjusted for the US loan, which subsequently materialized, of \$225 million.

It was felt both in India and elsewhere that the only alternative to external assistance was to discontinue issuing import licences and risk a consequent 'breakdown'. Spurred by such tidings, in June 1958 the Chancellor of the Exchequer and the Commonwealth Secretary advised the British Prime Minister, who was then in Washington, to take up the Indian crisis at the highest level and impress upon the US President the 'need, in the interests of both of us, to keep it going'.

The German disinclination at this time to come to India's assistance was no longer a secret. Although import restrictions were already hurting its industrial interests in the former colony, there was only a limited amount of money on offer yet in Britain, rather more sympathy, and now some willingness to pull wires in Washington. A possible key to resolving India's difficulties lay somewhere in Washington. But neither was this key yet in Indian hands, nor was there any assurance that substantial assistance lay behind the doors it opened. The American Development Loan Fund held the greatest promise at this time, but appropriations for it were still a matter of dispute—the Congress would soon reduce allocations from the Administration's recommended figure of \$600 million to \$400 million—and no single country was generally allowed to borrow more than a quarter of this fund. India needed much larger amounts to get through the remainder of the year without a general breakdown in its foreign trade, and the prospects for additional assistance appeared bleak in the absence of a new US aid law over which hung a dense legislative and political cloud. Since Indian hopes now rested on getting the Americans to make a substantial commitment and then using that lever to prise open European vaults, the whole aid operation appeared poised in the early summer of 1958 on the same knife-edge as the future of the second plan itself.

That the blade was blunted rather than sharpened immediately and thereafter may be attributed principally to the proto-consortium of the World Bank and donor countries which met for the first time in August 1958. The idea for several countries and the international organizations to get together appears to have cropped up at almost the same time in different capitals, so that it is impossible to suggest who, if anyone, was its author.

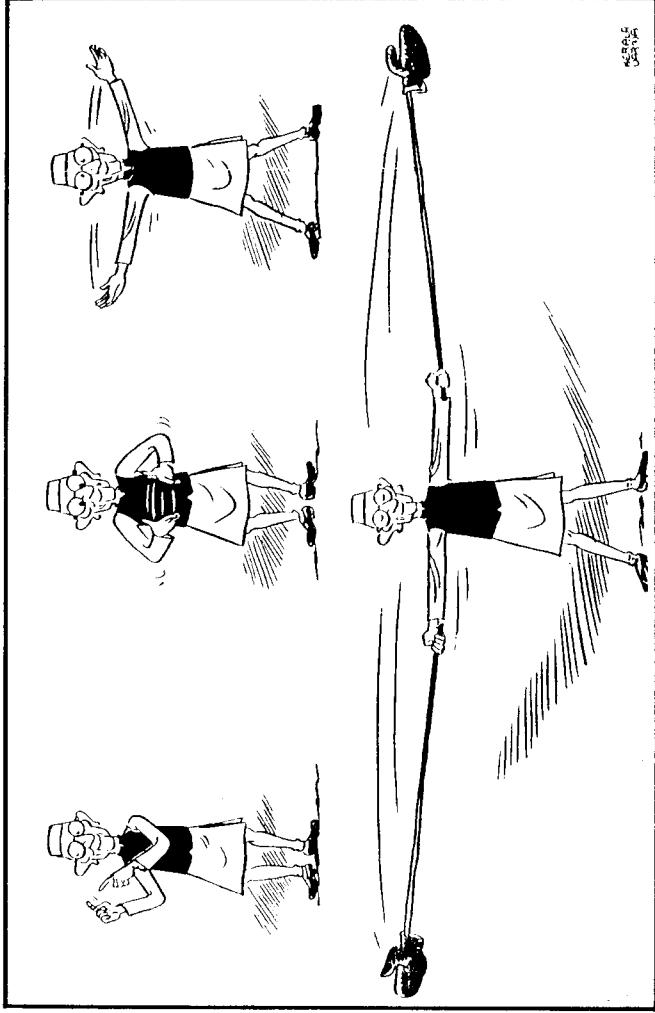
According to the recollections of B.K. Nehru, who was the principal Indian participant in the country's aid negotiations during these months, 'foreign aid was anathema' to the Indian political leadership which was also initially sceptical of raising any large amounts abroad in the form of assistance. Once Jawaharlal Nehru and the Home Minister, G.B. Pant, overcame their reluctance and the former gave him the signal which he sought to proceed, B.K. Nehru got in touch with Eugene Black at the World Bank to mobilize funds for India. According to B.K. Nehru, India did not

wish to go to 'individual creditors and ask them for money' since this would be 'most undignified and politically impossible'. The World Bank was India's 'international banker', and it was up to this institution to raise the resources it needed. This approach accorded with the earlier decision to conduct aid negotiations at the technical level. Although politics, and in particular the cold war, played a major role in influencing their attitude towards India, western governments were not disinclined during these years to keep up the appearance that external assistance was a matter to be settled between officials rather than between politicians. (For example, they made a conscious effort in August 1958 to distance the visiting Indian Finance Minister, Morarji Desai, from the first 'consortium' meeting, whose dates were so timed that he could be presented a reasonably firm aid package when he came calling at London, Washington, and other western capitals at the end of the month.) Though it would come back to haunt India before long, the decision to encourage the World Bank to play the key coordinating role in these exercises appeared to B.K. Nehru and other officials in India as the only reasonable course to follow in 1958.

Meeting the British Chancellor in London in June 1958, B.K. Nehru confided 'India's hopes' of getting a few countries to 'join with the international financial organizations in a combined operation of assistance' and reported that he was on his way to Washington to discuss the proposal with the US administration, and with the Bank and the Fund. Eugene Black, who generally supported India's development aspirations and requirements, appears to have been persuaded by Nehru and by the delay in the US voting any special assistance to India to moot the possibility of a 'meeting of the interested parties to discuss the [Indian] situation and to see if they could agree upon both the problem and the possible solutions'.

Britain too was concerned about India. The rapid reduction in its sterling reserves was a source of worry, as were the political and financial consequences of a possible default by India. Nor was politics far in the background and an economic collapse in India was feared to affect western, and particularly in the wake of the recent Suez crisis, British strategic interests in the region. On the other hand, there was little that Britain on its own could do to help. For some time past its officials had been urging India to turn to the US and Germany, and a meeting such as the one proposed by Black had the advantage of serving Britain's interests without necessitating any great increase in its financial commitments. Finally, if the international organizations were involved, they could be persuaded to 'do the shooting' and impose greater budgetary and payments discipline upon India 'without producing intolerable political friction'.

The Magnitude Of The Problem



The Finance Minister stated in Parliament that the foreign exchange gap for the remainder of the Plan period has shown a marked increase.

—Shankar's Weekly, 24 Aug. 1958

Britain was not opposed even to taking the initiative. Doing so held some risks—for instance perhaps of having to put up more money than it intended—but also offered gains in the form of better relations with the commonwealth. In an unexpected development, whose ironies Nehru and other Indian officials would no doubt have relished had they known of it, a race developed between the British and the Americans (who shared Britain's general concerns about India but wanted for domestic political reasons to cede initiative to the World Bank) and Eugene Black's invitation landed in London before officials there could send out their own. The immediate object of these exercises was to hold a meeting of donors to evaluate the extent of the Indian problem and, if possible, make tentative commitments in time for Morarji Desai's visit.

The first meeting of what was to become the Aid India Consortium three years later convened in Washington on 25 August 1958 with five countries (the USA, Britain, Canada, Germany, and Japan) and the World Bank participating. The Fund too was invited. But Per Jacobsson was opposed to participating. For one, he felt upstaged by Black's initiative. Jacobsson believed India was the Fund's problem, wanted himself to lead a mission to the country, and was reportedly annoyed at not having so far received an invitation from Delhi. He disagreed with the objects and methods of the second plan, and boasted publicly to having told P.C. Mahalanobis in Delhi in February 1958 that there were 'very few countries that he could not succeed in ruining'. Besides, participating in Black's meeting could prejudice the Fund's future negotiating position with India and its standing as the 'only body likely to bring effective pressure to bear on the Indians to put their internal financial house in order'. In the end, the Fund consented to sending an observer.

In other respects too, despite the race to convene the August meeting, imponderables overshadowed hopeful signs. France was invited but did not attend. Canada was an unenthusiastic participant, and it too consented in the end to come as an observer. The German and Japanese commitment to extend aid was uncertain and it was far from clear what, if anything, the Americans would be able to do beyond extending assistance from their development fund: much of the early pencilled arithmetic for instance, assumed no credit for US contributions. Questions hung in the air about the extent to which India's financial problems were caused by defence imports and how these should be tackled. The longer-term prospects for assistance were also not much in focus, and already there was some fear that the assured availability of longer-term credits over a number of years would encourage India's economic ambitions and demands for larger external assistance to finance them. The impact on the fiscal policies and development programmes of other

developing countries of a 'bail out' of India was another source of concern. Nor had any attention been given yet to the conditions attending any assistance promised to India. So much so, when asked a week before the meeting what he expected its outcome to be, B.K. Nehru reportedly confessed that he had no answer. Last but not least, premature leaks in the press about the meeting and its aims angered Indian officials, led to questions in Parliament, and threatened to curb their ability to express or make any commitments about the future. An advantage of the proposed consortium approach was that it spared India the necessity of approaching donor governments individually. This had several advantages, one of which was that of avoiding or minimizing bilateral tying and other pressures.⁵ But the publicity generated by the meeting appeared to bring the wisdom of this approach into question.

It was agreed between Nehru and Black that though its officials would be on hand to offer clarifications or more information, India would not be represented at the meeting. The latter practice was however soon to change. The first Aid India meeting convened as planned in Washington on 25 August 1958. It would be tedious to summarize the series of statements, some quite lengthy, which participants made. It is sufficient to note that despite the disapproving noises made by the Fund observer, India's development plans attracted a large measure of support. There was some apprehension about the soundness then and in the future of India's economic policies, and the view was pressed that the 'core' of India's investment programme should be clearly indicated to minimize any possibility of departures from it. Such a 'core' plan had already been finalized in Delhi and given its finishing touches in consultation with Black, who was therefore sufficiently familiar with the Indian financial position to distinguish between its immediate needs (covering the period up to March or June 1959) and those arising over 1959–61. The World Bank determined in consultation with Indian officials that the former were of the order of \$350 million, while \$580 million more would be required over the next two years. Commitments at this meeting fell short of the latter target with no participant other than the World Bank able to indicate yet a firm and unqualified figure, but there was time enough to meet it, and the August 1958 meeting was a useful starting point for the purpose.

Of greater immediate relevance and relief to India, the 1958–59 target of \$350 million was achieved in full, though not without some arm-twisting by Black. At the end of the first round, commitments totalled \$302 million,

⁵ In later years, however, India saw no choice but to conduct bilateral aid negotiations with donor countries prior to consortium meetings to finalize commitments, and afterwards to extract the promised aid.

Favourable Atmosphere

— *Tol*, 29 Aug. 1958

which rose to \$332 million at the end of the second. As the momentum of commitments appeared to slacken, Black underlined that the \$18 million shortfall would lead to further import curbs in India, and offered to add \$10 million from the Bank's kitty if someone else put up the remainder. This in the event Britain did to become the largest single contributor to the pool with \$108 million, followed by the World Bank with \$100 million. The US was in no position to commit anything further than what was available under its development loan fund, and this amounted to \$75 million.⁶ Germany came up with \$40 million, while Canada (\$17 million) and Japan (\$10 million) made up the rest. No political conditions were attached to the aid. The only economic condition was that the 'core' of the plan as determined by the Indian authorities and conveyed to the World Bank would be implemented. Though unexceptionable in principle, India objected to this condition being explicitly tied to the announcement of the assistance as Britain sought, and the latter had to be content when Morarji Desai visited

⁶ US P.L.480 assistance was excluded both from consortium commitments and Indian plan and official estimates of external assistance.

London a few days after the Washington meeting, with a general statement of its purpose. Desai, with not a little support from Black, also set his face against Britain's suggestion to release a summary of the World Bank's report of the negotiations.

The 1959–61 payments gap was met without much difficulty in subsequent meetings held during the next two years of the donors' group. Despite a loosening of import curbs (which some countries privately felt amounted to a minor breach of the 1958 agreement), the payments pressure also eased in India thanks to an industrial recession. Some discussion was aroused by India's desire to see a larger level of external reserves at the end of the second plan than was envisaged in August 1958, but its estimated financial requirements were largely met both in 1959 and 1960.

FOREIGN AID FOR THE THIRD PLAN

Discussions in western capitals, in particular London and Washington, about third plan estimates and their foreign exchange implications began in a desultory way from early in February 1959. There were fears in London and Washington at this time that India might feel encouraged by the favourable outcome of the 1958 meeting to raise its sights. Figures of a third plan outlay of Rs 10,000 crores were in the air in India and rumours circulated in western capitals that though the Finance Minister wished to reduce expectations about the plan and the Prime Minister himself was said to be 'irritated' by talk of the 'symmetry' of a Rs 10,000 crore plan, political compulsions might force India once again to adopt a larger plan than it could afford on the strength of its own resources. B.K. Nehru, among others, was believed in western capitals to be encouraging the planners to think big, and pressing upon them the view that he or India could mobilize aid each year of up to one billion dollars. In the beginning British nervousness about the likely direction of the third plan was matched by that in the US. The Under-Secretary of State for Economic Affairs, Douglas Dillon, confessed to the British ambassador in spring 1959 that he feared the effect on Latin America of the practice western donors followed, of leaving India free to determine its investment outlays and thereafter stepping in to help finance them.

Voices of doubt grew fainter in the next few months as the political environment for aid began to turn more favourable, all importantly in the US. The congressional resistance to foreign aid weakened at this time, and Dillon even spoke of a strong lobby of Congressmen taking a close and positive interest in the affairs of developing countries. The bill which would lead eventually to the setting up of the International Development Association was

on the drawing board and prospects for its passage were considered bright. Finally, the Kennedy-Cooper resolution (named after its movers John F. Kennedy and John Sherman Cooper) urging greater aid to India also helped focus public attention on the country's financial requirements. There was already a large body of economists based, among other places, at the Massachusetts Institute of Technology (MIT) who thought India should go in for a big, rather than a moderate, third plan, and canvassed academic and political support for the idea. The 'big-plan campaign' was believed to have the influential support of W.W. Rostow, while the Kennedy-Cooper resolution endorsed it by suggesting abandoning the existing US practice of annual aid appropriations and replacing it with one permitting a long-term commitment such as would enable India to make its investment plans in a stable and predictable external financial environment.

This thrust accorded with India's perception of its own interests. India's external reserves at the end of the second plan stood at Rs 304 crores (or the equivalent of three months' imports). As the Reserve Bank warned the government, there was now little possibility of using them even as a cushion for large, import-intensive development outlays. But the second plan gamble having largely succeeded, and encouraged by the donor response India's needs had recently evoked, some officials in India hoped now to sustain large investments by tying up foreign assistance over a ten- or fifteen-year period. At the end of this period, they and the US proponents of the 'big push' view believed, India could afford to dispense with external aid.

Economists and public figures campaigning in the US for liberal assistance to India organized a large conference in Washington in the summer of 1959. This conference was inaugurated by the Vice-President, Richard Nixon, and attracted over five hundred influential delegates including Senators John Kennedy and Hubert Humphrey, Chester Bowles, the former US ambassador to India and now a congressman, and the noted British social scientist, Barbara Ward. H.V.R. Iengar was the principal Indian participant, while many others made presentations. A crisis had broken out in Berlin and another conference was about to convene in Geneva when the India conference began. In his inaugural speech, Richard Nixon declared that posterity would regard India's economic development as having been more critical to the future of mankind than the Berlin crisis or the Geneva conference. The rhetoric no doubt reflected an ambitious politician's desire to talk up the event and his own contemporary role—only the previous day the US Secretary of State had left for Geneva in a blaze of publicity—but it nevertheless set the tone for the deliberations that followed. The Republican endorsement also gave a bi-partisan aspect to the

proceedings and firmly established Indian economic development in American external economic priorities for the next two or three years.

In another significant development, in 1960 the United Nations General Assembly passed a resolution urging developed countries to transfer one per cent of their national income as aid to developing countries. Proposed by B.K. Nehru, the motion initially evoked fierce opposition from most developed nations, and during six weeks of often passionate debate its mover was advised more than once to withdraw the resolution and avoid its defeat. In the end the Indian resolution was carried unanimously, with even the US delegation voting in favour at Washington's direction. With reconstruction largely accomplished and a certain prosperity in the air, the aid environment in Europe too, as Iengar had anticipated a year earlier, began to turn more benign at this time.

Wishing to enable it to embark on the third plan with a measure of confidence and following a suggestion embodied in the Kennedy-Cooper resolution, early in 1960 Black proposed a visit to India of a mission of three prominent bankers to report at first hand about its economic conditions. Although not everyone in India was enthusiastic and some even apprehended that the mission was intended to guide the formulation of the third plan in its preparatory stages, a team of 'three wise men' as they came to be called—Herman Abs, Oliver Franks, and Allen Sproul—visited India in February–March 1960. Following discussions with the government and the Bank and with prominent businessmen, the team endorsed the Indian view that its development programme depended on a 'very substantial increase in foreign assistance' above the amounts provided during the second plan. A large part of this, it also recommended, should be in 'the form of grants and loans, not made strictly on commercial terms'. The team's report also represented a stamp of approval on the resources arithmetic of the draft plan. According to I.G. Patel, the report of the 'three wise men' was 'one of the most heart-warming documents in the annals of international relations'.

This visit was followed by a World Bank technical mission headed by Michael Hoffman which endorsed the outlines of the third plan and its emphasis on industry. Attempting anything less, Hoffman argued, would mean admitting defeat from the outset. His report too advocated aid in the form of grants and soft loans, and cautioned that the third plan would stand or fall on the amount of foreign aid available.

Views such as these created a favourable environment for the reception of the third plan. Though at Rs 7,250 crores (this was later revised upwards) the plan was initially smaller than many had hoped or feared, Britain, which faced a deteriorating external position, appears to have been nervous about

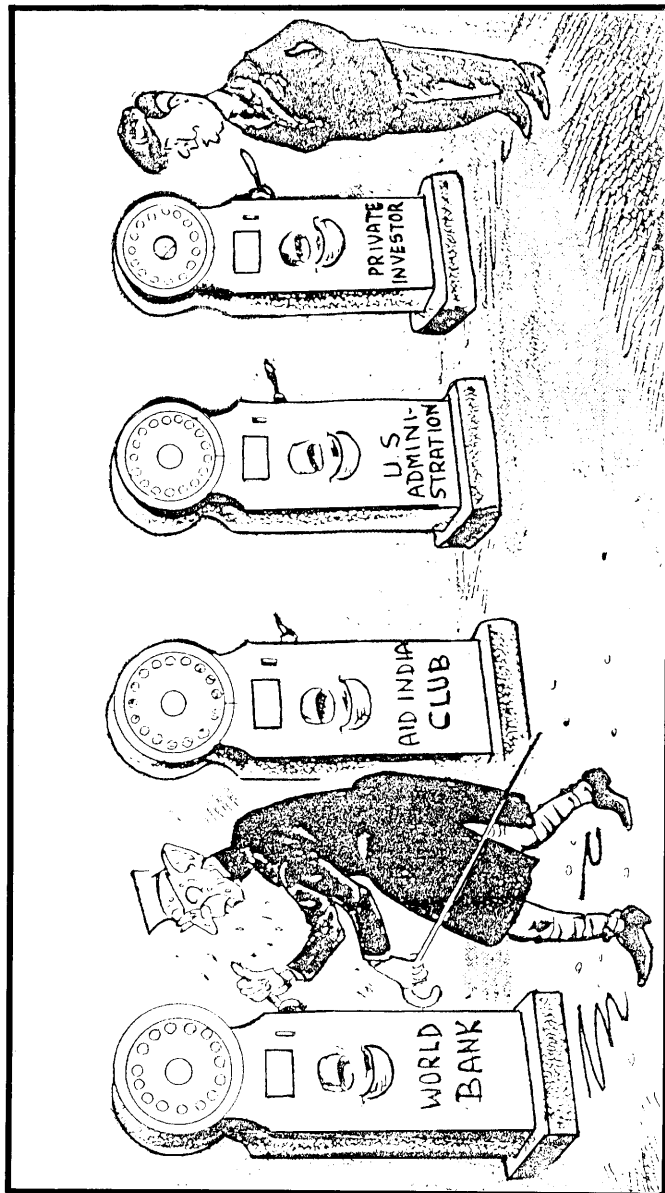
the plan assuming Rs 2,200 crores in the form of net external assistance.⁷ But the US administration felt even in September 1960 that there was no 'substantial fault' in the plan, and that the growth rates it proposed were 'minimal' and the 'least the ... Indian government could put forward'. Nor was Dillon 'unoptimistic' that the foreign assistance proposed in the plan would be forthcoming, with the US itself proposing to put up more money than before. There were some private reservations, notably about the proposal for a nuclear power reactor (opinions about which remained divided even among the member nations of the group), and open criticism of plans for a fourth steel plant and the exclusion of the private sector from new coal and oil projects. Britain attempted to cool wider western enthusiasm for the third plan and was not very forthcoming with promises, particularly of 'untied' aid. But neither factor had immediate impact on India's aid prospects. The September 1960 donors' meeting, which for the first time is referred to in some papers as a 'consortium', generally endorsed the third plan. It also encouraged the belief that the necessary external resources would be made available on relatively soft terms. In fact, the meeting explicitly urged members to eschew short-term credits, refinance short-term or medium-term credits falling due during the third plan, and ensure that the 'bulk of future aid to India' was in the form of 'long-term loans (with a maximum period of grace) not repayable in foreign exchange'.

These funds were not found without difficulty, while the rupee repayment idea was never actively pursued. Despite some misgivings about the wisdom of the consortium departing from its earlier purpose of meeting only to address severe balance of payments difficulties, the American view prevailed that the 1961 meeting should make aid commitments for the next two years. But Germany, as Iengar had already warned the government after a visit to that country, was yet unprepared to make a commitment which would satisfy the Americans, who pressed for an adjournment of the March 1961 meeting until the end of May. With Britain also taking the view that it would only match the German contribution, the early omens for mobilizing external assistance for the first year of the third plan were not very propitious. Nevertheless in a subsequent meeting, aid pledges amounting to \$2,225 million were made for the first two years of the plan, of which \$1,295 million was for the first year alone.

Next year too, it was not all smooth sailing. The US commitment of \$500 million was conditional on other countries together matching this amount.

⁷ This figure also excluded P.L.480 loans. The donor club expected India's gross external aid requirements, i.e. including P.L.480 credits and aid repayments, for the third plan to be in the region of Rs 3,200 crores.

Hit The Jackpot



The Finance Minister is in Washington attending the "Bank-Fund" conferences.

— Shankar's Weekly, 23 Sept. 1962

Were that to happen, commitments would amount to \$1,200 million (including the World Bank's own assistance of \$200 million). This was thought to be just adequate, with some possible support from the Fund, to meet plan and balance of payments requirements for 1962–63. But the May 1962 meeting of the consortium broke up over differences about Italy's contribution, and by the time the consortium reassembled in July, there was some crystallization of donors' opinion against India over Goa and the decision to buy MiG aircraft from the Soviet Union.⁸ The July meeting was however the largest until then, with a total of ten member countries attending. The combined European contribution came up to \$435 million now, which the US agreed to match. Together with the commitments of the World Bank and the International Development Association (or IDA set up in 1960), pledges for 1962–63 came up to \$1,070 million, thus bringing the total commitments for the first two years of the third plan to \$2,365 million.

This was no doubt an impressive achievement, both on India's part and that of the donors. Even at the reduced figure of \$980 million, the US contribution to this total was the largest aid commitment by that country since the Marshall plan, and clearly signalled its determination to impress upon other consortium members the importance of jointly supporting the Indian plan. When B.K. Nehru, who confided to some friendly western officials that he had become a 'missionary in the cause of foreign aid and tend[ed] sometimes to lose touch with reality', first proposed an annual aid package of a billion dollars, he was reportedly told by the World Bank President, among others, that the idea verged on lunacy. Hearing of it as a 'boast' by Nehru to encourage Delhi to launch another ambitious plan, officials in London were inclined initially to do everything possible to douse India's expectations. That India secured the commitment it sought at least for the first two years of the plan was an outcome partly of favourable political factors. But it was also a tribute to international statesmanship and India's skilful economic diplomacy.

The aid achievements of 1961–63 were not without blemish. Even after these substantial commitments, there was an estimated balance of payments gap of \$152 million in 1961–62 and \$131 million in 1962–63 (this doubled to \$260 million because of the \$65 million shortfall in European commitments and matching US reductions) which could have been met by a stepping up of what was sometimes loosely referred to as 'general purpose aid'. The

⁸ The Indian policy towards Rhodesia too was mentioned in the same context. According to a British view, which apparently evoked sympathy in the US Congress, Indian officials did not believe that aid 'could be affected by their general attitude and to disillusion them might clear the air', and help improve relations in the long run.

consortium countries were aware of this gap. Some of them even contributed to the gap by first underestimating project costs when tied aid was negotiated, and advising India only when the project approached completion that it would be 'technically unviable' unless larger allocations were made for the import of spares. Nothing was done by the consortium to address the mismatch between assistance to build capital and that to help maintain it. To some extent, the expectation was that payments problems caused by maintenance imports were for the Fund to handle. India was not unwilling to go to the Fund, and was in fact to do so not long afterwards. But wisely, it preferred to save that option for a payments crisis brought on by a drought.

To the extent the payments gap arose because of maintenance imports necessitated by investments financed by project assistance, the best way to address it would have been as part of a wider assessment of the external financial implications of the third plan. Indian planners themselves had underestimated maintenance imports, and 'allocated' only Rs 200 crores for 'components and balancing equipment'. Both they and their prospective donors thereafter lost sight of even these figures in the melee caused by the manner in which aid negotiations were often conducted—frequently despite the initial Indian aversion to them, in bilateral negotiations—more to maximize commitments than to ensure the quality of the assistance extended or received. Despite the World Bank's advice and the Indian need for untied aid, there was little wider acceptance of its necessity. No major country wanted to untie its assistance if others continued to tie theirs, on the plea that doing so would amount to diverting its expenditures to other markets. Besides, the American approach of offering matching assistance was meant to put pressure on other donors to raise their contributions. But this had the unexpected and unintended outcome of forcing India to accept unattractive shorter-term tied loans from other donors in order to reap the advantages of American matching. Despite this, as we just saw, the US willingness to pledge another \$65 million could not be translated into commitment.

It is not the object of this chronicle to estimate how far the nature of the aid negotiations and the resulting quality of the assistance received by India were responsible for the bottlenecks and underutilization of industrial capacity that became increasingly evident from about 1963–64. As the World Bank representative in Delhi confessed to his British interlocutors in 1963, the manner in which aid was made available to India led to a 'ludicrous position' in which 'it was easier for India to find foreign exchange to build a new plant than to buy small amounts of spares to make existing plants workable'. By the middle of 1963, as we note in greater detail in the next chapter, western donors began to fret about the slow pace at which the assistance given in the preceding years

was beginning to produce results. Some, especially in Britain, began to canvass the advantages now of extending balance of payments assistance to India, but at the cost of aid to finance capital building, precisely at a time when a capital goods sector was gradually coming into existence in India.

Finally, aid terms were not as liberal as India hoped or the World Bank sought. The Germans refused to extend maturities beyond twenty years while the others lagged even further behind, France seeking repayment within ten and Japan, Canada, and Britain preferring to wait upon events or tying terms to details of individual projects.

Although impressive in quantitative terms, the Reserve Bank began soon to look askance at the quality of the assistance made available to India. A working paper by V.G. Pendharkar drew attention to the preponderance of tied aid and the costs of such assistance. Tying, he pointed out, came in the way of committed assistance being utilized at all, let alone effectively or efficiently. Besides, already by 1961 there was concern within the Reserve Bank about the sustainability of India's accumulating debt burden. In a note entitled 'Some problems relating to India's capacity to bear the growing burden of external borrowing', the Bank drew the government's attention to the rapid growth since 1958-59 of service payments on external public debt from an annual average of Rs one crore in the first plan to an average of Rs 10 crores in the second. Rapid rise in the volume of debt, quicker utilization, the rise in creditor countries' domestic interest rates since 1957, and shorter maturities were responsible for this phenomenon. For instance, American wheat loans and technical credits, and the World Bank assistance obtained before 1957 had long maturities and grace periods. But loans contracted after 1957, the Reserve Bank analysis pointed out, were largely medium-term loans with relatively short grace periods. The country's capacity to earn foreign exchange through exports was therefore a crucial factor in determining its future debt servicing capacity. But with export performance lagging behind during the second plan, the debt service ratio had risen to 12 per cent of export receipts and would rise to 19 per cent at the end of the third plan. Further, with foreign assistance likely to finance over a quarter of the third plan investment, India was certain to encounter more severe debt servicing problems in the future. Since there was little immediate prospect of boosting exports and imports could not be curtailed without affecting investment, the Reserve Bank recommended securing a larger quantum of longer-term and untied aid and seeking postponement of amortization payments.

Finally, disbursements were several steps behind commitments and the tied nature of much of the assistance made it difficult for the borrower to

match inflows and outflows. In particular, there was a perceptible widening during 1961–63 of what the World Bank referred to as the ‘payments gap’, and which the Finance Minister, Morarji Desai, defined as the gap caused by ‘imports ... outside the credits available ... for machinery, components and other development requirements ... [and the] discharge of debt obligations’. A new factor which boded ill for the health of India’s external accounts was the decline in invisible receipts due to lower remittances, gold smuggling, and other ‘confidence movements’. Thanks to these factors, India continued to live from hand to mouth even during the early third plan years despite the relatively large amounts of external assistance it received, some increase in commodity exports, and lower imports.

India Returns to the Fund: July 1961 and 1962

Faced with falling reserves, an anticipated lag between aid commitments and disbursements, and a large repayment to it of the 1957 drawings, India approached the Fund in July 1961 for a drawing of \$250 million. Not only did a drawing of this size exceed India’s gold tranche and the first credit tranche and call for substantial justification, an additional complication of the proposed transaction was that it involved a roll-over of the earlier drawing. But following encouraging signals from the Fund management, India decided to lodge its request which also attracted support from a sympathetic Fund staff. Confirming that there was a ‘substantial uncovered payments gap’ for the year as a whole, the staff analysis stressed that ‘the crucial factor in the reserve situation’ would be the ‘rate of utilization of aid funds’ and that ‘any lags in disbursement of funds will add to the burden on India’s foreign exchange reserves’. This led to some rumblings in the Fund Board that India was being allowed to roll over its debt to the Fund, that it should be asked to submit a statement of intent since its request exceeded the first credit tranche, and finally that what India was seeking was development finance rather than payments assistance.

Aware of these criticisms, the Indian Executive Director, I.G. Patel, drew the Board’s attention to the unsatisfactory state of India’s foreign exchange reserves and the need to prevent any further reduction in its already depleted reserves either due to anticipated seasonal trends or delays in disbursing aid. As Narayan Prasad before him, Patel also emphasized that the Fund could not wash its hands of unexpected balance of payments difficulties merely because they arose from a member-country’s development plan. Though some members of the Board addressed mild cautionary remarks towards India in the discussions which followed, there was a large measure of support for the Indian drawing, and Per Jacobsson himself saw the Indian request as opening the door ‘for a

more liberal policy in regard to the use of the Fund's resources in the future'. Of the total drawing of \$250 million which India availed of in August 1961 in a currency mix designed more to address the lender's concerns than the borrower's needs, India utilized \$127.5 million to repurchase the amount outstanding under the 1957 drawing and the remainder to bolster its reserves.

The relief afforded to the reserves by the Fund drawings of August 1961 was short-lived. Although year-to-year variation in reserves might appear small, the weekly reductions in these balances were often substantial. After rising slowly until December 1961, India's exchange reserves began declining quite steadily until June 1962. The gold and foreign currency assets of the Issue Department of the Bank also fell steeply during these months. The latter aggregated Rs 220 crores in June 1961 of which about Rs 118 crores were in the form of gold, and the remainder in the form of foreign securities. Foreign securities held in the Issue Department dropped to Rs 93 crores (or only about Rs 10 crores above the legal minimum) the following month before recovering handsomely to about Rs 126 crores in January 1962. Thereafter they fell once more to about Rs 92 crores in June 1962.

On 4 June 1962, the Governor, P.C. Bhattacharyya, attended a meeting of the committee of economic Secretaries to discuss the precarious external financial position. He spoke to the committee at length about the decline in the foreign assets of the Issue Department. Reporting the Bank's assessment that the problem was not a 'short-term one', Bhattacharyya argued that there was 'no alternative to curtailing imports as a matter of long-term policy'. Although Bhattacharyya did not disclose this to the meeting, import restrictions were dictated also by the need to convince the Fund (which India would soon approach for a standby arrangement) that its foreign exchange earnings would suffice to meet repurchase obligations. There was, according to the Governor, still some fat that could be trimmed in the import of spares, components, and raw materials for non-essential industries, and he advocated a 'total ban on import licences for at least three months except in cases where aid was already available'. The Indian economy, Bhattacharyya argued, had withstood quite well the shortage of spares during the second world war and even managed some efficient import substitution in these goods. With the Indian industrial structure having grown more diversified in the meantime, the dislocation caused by drastic reductions in imports of spares would only be temporary. Bhattacharyya also conveyed reports of the Bank's surveys which indicated that nearly 60 per cent of those travelling abroad did not draw any foreign exchange, and that half of those so travelling stopped first in Malaya or the Middle East, 'no doubt for getting foreign exchange illegitimately'. This, mainly, had caused remittances from Malaya to dwindle from Rs 21

crores a few years earlier to Rs 3 crores at present. Another consequence of unauthorized travel was the leakage in official receipts from tourism. While inflows of tourists had more than doubled from 67,000 to 1,50,000 in recent years, official receipts from tourism were stagnant at about Rs 4.5 crores, and the Bank's estimates put the amount of tourism receipts lost to the treasury at Rs 10 crores to Rs 15 crores each year.

At Bhattacharyya's instance, the committee recommended stopping all unauthorized travel and the issue of import licences, except where imports were financed out of aid, for two months. Although there was no hint of this in the meeting of the committee of economic Secretaries, the fall in the Issue Department's reserves to about 5 per cent above the minimum currency cover appears also to have set off an unacknowledged trigger. For according to a report L.K. Jha was apparently authorized to convey to the British High Commission in Delhi, on 8 June the Union Cabinet was on the verge of suspending the minimum legal currency cover requirements. But it was argued out of this course by the 'personal intervention' of the Prime Minister, Jawaharlal Nehru, 'exercising a mainly political judgement'.

Nehru, according to Jha, wanted to delay the denouement in the hope of avoiding it altogether. In a statement he made to the Lok Sabha the same day, the Finance Minister drew the members' attention to the severity of the crisis but merely adverted to the possibility of suspending currency cover requirements. Calling for 'social discipline and solidarity ... to put our foreign exchange position in order', Morarji Desai declared that there came

a point in the history of every nation when it must demonstrate that it is prepared to take whatever action ... may be necessary to pursue the paramount objectives so vital to its sense of dignity and purpose.

But the only action he announced immediately was a ban on all unauthorized foreign travel. Further measures were announced to regulate travel for business or education, and Desai promised other measures to curb imports. It is also interesting to note here in passing, since more will be said on this subject in the next chapter, that the possibility of devaluing the rupee was considered for the first time during these weeks, though only to be rejected almost out of hand.

In the event, the foreign currency assets of the Issue Department continued to fall below the 8 June trigger level and bottomed out at about Rs 88 crores in January the following year. A recourse to the Fund was an obvious solution, but one which Delhi was reluctant to adopt since the recently incurred 1961 obligation of \$250 million was still on its books. There were suggestions that

some members of the Fund Board thought India was already over-borrowed; while Per Jacobsson was also believed likely to insist on a Fund mission for levels of drawings or standby which took India close to its second credit tranche in whose neighbourhood intending borrowers were usually asked to submit stabilization plans or letters of intent about future policies. But the initial Indian reluctance melted in June as its external reserves position deteriorated and the promise of an untied loan from Germany failed to materialize.

In favour of India's request was the fact that its balance of payments need had become suddenly more pressing because of the slow pace at which western donors moved to fulfil their aid commitments. While the US would be disposed to support the Indian application, Britain, Germany, and other members of the consortium too, would be unable to oppose it. Informal consultations with the Fund also suggested that while India would be expected to explain its reasons for not changing the rupee parity, such a request would be made largely to keep up appearances. The Fund was expected to be satisfied by the measures India had already taken at the beginning of June 1962, not without a shrewd appreciation of their possible bearing on attitudes in Washington, to restrict imports and plug leaks in invisible receipts. Some action on the monetary policy front was also called for and since the Bank and the government already had such measures under discussion, there was little delay in tightening the quota-slab system of accommodation in July 1962 and putting up the coupon rates on central government loans floated later the same month. Once these measures were adopted, India applied to the Fund for a one-year standby arrangement of \$100 million. This was sanctioned with relatively little controversy, and India drew its first \$25 million of this standby within days thereafter.

Following this drawing, India's exchange reserves began recovering from July 1962 and, despite a substantial dip in November 1962, continued to rise through the following months, thus staving off the need for the kind of drastic action contemplated at the Cabinet level in June. The pressure on the Bank's foreign exchange assets revived in 1963, and although the renewal of the July 1962 Fund standby was accomplished with little difficulty, there were now some signs that even the nominal aid outlook was undergoing some change along with the western world's attitude towards India's development needs. These and subsequent developments form the subject of the next chapter.

As an institution, the Reserve Bank played a relatively minor role in mobilizing long-term external assistance, nor indeed was this any part of its remit. Individual Governors were involved directly or indirectly with aid negotiations and were otherwise generally kept informed by the government.

The Bank's London office helped coordinate aid exercises in Europe, and its manager there, in particular V.G. Pendharkar and his successor, S.D. Deshmukh, participated in discussions with the European donor countries. But, for the most part, the Bank's exertions were confined to preparing technical material, such as balance of payments figures and forecasts. Interestingly, donors were quite willing to support balance of payments needs as established by the Planning Commission and the Finance Ministry until the early 1960s, but once external payments pressures began to worsen from about 1962–63, the Bank's estimates and forecasts began effectively to provide the test of 'need'. In fact, the balance of payments projections arising out of the mid-term appraisal of the third plan discussed in the next chapter, were worked out at the Bank which also formulated, at the government's behest, parts of the reports presented to the consortium in 1964 and 1965.

In addition, successive Governors of the Bank were engaged in a continuing dialogue both with governments and with central banks in some other countries. These efforts too were followed up and sustained, sometimes even initiated, by the Reserve Bank's office in London. Though willing partners in cooperation, central banks traditionally adopted a more conservative posture on foreign aid than their respective governments, and attempted generally to exercise a restraining influence on their enthusiasm to extend assistance. Although it was not their sole, or even main purpose, the Reserve Bank's dialogue contributed towards moderating the resistance of its counterparts to extending liberal assistance to India.

The Reserve Bank was also a key Indian interlocutor with international agencies, more so until the mid-sixties with the IMF than with the World Bank. As many aspects of the policy regime, including those relating to the monetary sector, came under closer scrutiny by the aid agencies from the mid-sixties, the Bank's function as a credible intermediary between the country and international institutions expanded in scope, and it was drawn more closely into discussions and negotiations about Indian financial requirements and policies. The Reserve Bank also played an important part in the operational aspects of multilateral lending and in ironing out creases in procedures and perceptions relating to them. Even with members of the consortium, bilateral aid negotiations were often hostage to several aspects of the contemporary policy regime and its working, and the Bank was often called upon wherever possible to address the interests of the donor nations without compromising India's interests or the integrity of the policy regime. Finally, the Reserve Bank acted at the government's urging to explore the possibility of securing official assistance and export credits from countries such as Switzerland which were not part of the existing consortium arrangements.

Crisis and Devaluation, 1963–67

The Chinese invasion in October 1962 produced a measure of sympathy and support for India in western capitals, and a modest quantity of defence assistance which the US and Britain agreed would not be counted towards consortium loans. Some British officials even pressed for the initiation of rupee payment arrangements on a small scale as a means of easing India's balance of payments problems, but the suggestion was shot down by the Bank of England.

In fact the Bank of England, principally, was engaged during these very weeks in reviewing aid policies towards India. Officials at this institution felt 'various fundamental things' were going wrong in India, 'constructive remedies' were not easy to suggest much less implement, and that the World Bank should be encouraged to carry out a 'fundamental and comprehensive review' of the current third plan position. There was also talk in Whitehall departments of how aid to India could be used as a lever to secure wider British objectives in the region. Although such issues could not be openly aired in consortium talks, some officials noted, efforts should be made before the consortium formally met to consider the 1963 aid package, to persuade India, which was now 'defensively insecure and financially sick', to reconsider its views on matters of strategic interest to Britain and the western world. At the consortium itself, according to this view, India should be asked to 'remodel' the third plan to suit 'realities'. In particular, its government should be encouraged to pause for breath and not undertake any new projects except where these might lead directly to orders for British industries with excess capacity. Other considerations, such as India's preference for pursuing new oil projects in the public sector rather than allowing the Burmah Oil Company to expand its refining capacity, also began to figure in the British calculations about this time.

While many in Britain and elsewhere felt a review of India's recent development experiences was called for and the Indian government too, would

soon carry out such an exercise, the more extreme views did not yet evoke widespread support even in Britain. India felt it needed new aid commitments of \$1,255 million for 1963–64, of which \$317 million were meant to finance the ‘disbursements gap’. British officials urged their Indian counterparts to consider whether they should not give the latter overriding priority, only to be met with the firm riposte that the overall level of commitment should also receive ‘its proper share’ of attention. For their part, the Americans continued during the early summer of 1963 to press Britain and the other European countries to make aid commitments totalling one billion dollars for 1963–64 largely in the form of long-term aid with lengthy grace periods and carrying low rates of interest, and were even willing to make approaches at the political level to secure pledges of this magnitude.

REAPPRAISING ASSISTANCE TO INDIA

Meanwhile, however, an important change was coming over the World Bank’s outlook on India. Probably underestimated at the time, this change had important consequences for India’s external aid environment during the next few years. Thanks to the Indian strategy, which was not always realized, of not pressing individual donor countries for development assistance at the bilateral political level and relegating the task of mobilizing it to the World Bank, the latter emerged during the Black years as the leading protagonist of consortium assistance to the world’s most populous democracy. This approach may have been justified in 1958–59 when western governments tended to be several steps behind the World Bank in wanting to lend large amounts to India. But the inherent paradox in the Indian aid strategy was revealed before long, as the case for assisting India came to rest most strongly on political considerations to which western capitals were more sensitive than a financial institution such as the World Bank. This was a benign paradox so long as both the World Bank and western governments recognized the imperative need to assist India without expecting too much immediately in return. But not only did donors soon begin to insist on elaborate bilateral consultations of a nature which India had earlier hoped to avoid, the World Bank-led consortium approach made the availability of western development assistance hostage to the Washington institution’s attitude towards Indian economic developments and policies. There was little the World Bank could do, even should it be so inclined, where consortium members were unwilling to grant assistance. But where the latter were willing and the World Bank was not, it was well placed thanks to its facilitating role, to apply the brakes on assistance to India.

One can detect a palpable shift in the World Bank's approach towards aid to India from 1963. This shift coincided with a change of guard at that institution. In January 1963 Black was replaced after thirteen long years by George Woods. Even in comparison with Black, Woods was probably not poorly disposed towards India, and officials (including P.C. Bhattacharyya who as Governor of the Bank was closely involved with the events described here) recall or refer to him as someone who was 'extremely friendly and sympathetic' to India. Woods also fancied himself as something of an expert on the country, having spent some time there first in 1952 as part of a steel mission and again in 1954 along with the group which went to India to give some shape to proposals for a private sector development bank. A detailed review of the World Bank's activities and commitments was perhaps inevitable after the change in its leadership. How far this review was motivated by Woods's desire to fill Black's larger-than-life absence at the World Bank will remain a subject of speculation. But undeniably, India was a big part of the World Bank's activities. Not only did Black invest a considerable proportion of the institution's energies and funds in India, the consortium approach he pioneered was now something of a model for other countries, and any review of the World Bank's approach towards its principal developing country client was bound to have an impact on its wider activities. Besides, there were also some misgivings at the World Bank about the way things were developing in India, and it would have been surprising indeed if its new head did not lend his ears to those voicing them. Among the latter were Peter Wright, who was in charge of India at the World Bank and whom Woods soon promoted to more responsible positions within the institution, and Ben King, its controversial representative in India. Whatever the underlying reasons, therefore, Woods's arrival coincided with an increasingly critical review by that body of the planning and development process in India.

Not that such a review was not otherwise indicated. Nor was it the case that critical World Bank reviews of India's economic performance were unknown before Woods. Both in 1961 and 1962 the World Bank passed adverse comments about some Indian policies. But Woods's intervention appears in the summer of 1963 to have been based on some mistaking of the nature of pressures caused notably by a poor harvest in 1962-63 and the difficulties of financing maintenance imports, to which attention was drawn in the previous chapter, as signs of a deeper malaise within the development process. Whether or not the latter betrayed such a malaise is not the issue here. But Woods's diagnosis of it at this time was general rather than yet specific or pointed. Indian economists and officials too shared many misgivings about the direction of the country's economic policies, and despite the often

politically-charged debates surrounding the issue, many in India recognized the pressing need for larger investments to boost agricultural production and strengthen the infrastructure. Headed by Woods, who had earlier been a trustee of the Rockefeller foundation, the World Bank would soon make agriculture one of its main priorities in India. But the first major initiative Woods took on India—in the form of a letter he wrote to Finance Minister Morarji Desai in June 1963—did not dwell upon agriculture. The letter spoke of the low rates of growth in recent years of the Indian economy and about promoting exports, improving the climate for private investment, pricing policies, the necessity for relaxing import controls, increasing domestic interest rates, and tackling the population problem.

Indian ministers and officials appear initially to have been baffled, even bemused, by Woods's intervention. But Desai responded politely to suggest that the Indian government kept the planning process under continuous review and that it was willing to discuss the situation in greater detail in the winter. Thanks to the challenges they posed and the increasingly adverse economic and security environment, the Indian government was inclined to subject third plan outlays to continuing review. T.T. Krishnamachari, who was soon to become the Finance Minister, even compared the plan to a child about whose changing needs a father could not be dogmatic or inflexible. But the government could not afford to suspend the plan pending the review, and Desai's letter to Woods emphasized the importance of avoiding any break in development assistance which, if anything, would have to be larger than at the beginning of the third plan. Besides meeting India's needs for non-project assistance, Desai argued, the next consortium round should make fresh commitments for development in basic sectors. The latter was a euphemistic reference to the need to step up outlays on agriculture and infrastructure.

Woods's letter, which some officials of the World Bank and western governments soon began describing as a *demarche*, spoke of the difficulties he expected in persuading members of the consortium to address themselves to a further aid request when questions were being raised about the results of past aid, the government's future intentions, and the steps it was taking to tackle the present position. In spite of aid pledges from the consortium having exceeded amounts originally contemplated, Woods pointed out, the growth of the Indian economy had fallen far short of expectations, and there was no sign yet of reduced dependence on external support. Nor did the consortium, according to the World Bank chief, have a clear idea of the Indian government's economic programmes and policies for the next three years and into the fourth plan. Declaring his interest in addressing donors' purported misgivings about continuing assistance to India, Woods sought from the government an

outline report on these issues. Whatever its overt concern, this letter was seen within the World Bank as a way of putting India 'on notice' and signalling the institution's displeasure with the government for not having responded adequately to its earlier reports.

The World Bank President's remarks about donor fatigue may not have been altogether misleading. Even in April 1962 when he was in India at the head of a World Bank team, Peter Wright spoke to I.G. Patel, Chief Economic Adviser at the Finance Ministry, about the critical attitude donor countries were more and more disposed to adopt towards 'economic conditions in India'. But the warning, however well meant, was issued so far in advance that it was almost certainly premature. It is worth noting, for example, that the US attitude as evident in its approach towards the consortium process remained highly supportive until at least 1964 while even in Britain, alarms began to be raised only from the spring of 1963. Attention has already been drawn to the expressed American determination to ensure that India received one billion dollars in the form of consortium assistance in 1963-64 and its willingness to use political levers to achieve this target. In the consortium meetings that took place over June-August 1963, aid pledges totalled \$1,052 million (against an Indian indent for \$1,255 million). Half of the former amount was expected to be lent at 'nominal interest rates', almost 90 per cent of it was on long-term, lengthy grace basis, and about two-fifths of the pledges were expected to translate into 'general purpose' assistance for maintenance imports whose financing had recently become a source of some anxiety in India. Although officials in some countries privately voiced misgivings about the prevailing economic conditions in India, the only recorded critical tone in the 1963 consortium deliberations was adopted by the World Bank representative, who drew the donors' attention to the contents of Woods's letter to Desai and proposed a full meeting of the consortium at the end of the year to consider the results of the government's review of the third plan. To a great extent, therefore, the World Bank at this stage was engaged in crystallizing donors' attitudes towards India rather than merely reflecting it.

Some may be tempted to suggest that the Finance Ministry and the Reserve Bank saw the consortium approach as a means of bringing greater financial discipline to bear on the country's planners. There is no evidence that such was the case. The Bank blended unobtrusively into the background so long as the going was good, and was only indirectly involved with aid negotiations or strategies. As for the Finance Ministry which played the principal role in these affairs, it is worth noting that some of its officials, including notably B.K. Nehru, were widely credited with promoting the idea of a 'big' third plan dependent for its success on large annual aid flows. Whatever their

earlier motivations, however, Indian policy-makers soon began to look askance at the World Bank's new approach which, along with the emerging aid environment, provoked them to undertake a detailed aid strategy review in Washington in October 1963. Discussions at this review meeting, which was attended among others by Bhattacharyya, B.K. Nehru, and L.K. Jha, were also framed by persistent suggestions from the World Bank and some western governments that the former should shed its responsibility for the consortium process and that meetings of donors should in future be organized by and in India. As pointed out in the previous chapter, when the consortium arrangement was first instituted in 1958 India was not formally represented at donors' meetings. This changed shortly when its representatives were invited to attend meetings of the consortium, much to the discomfort of some donor governments who felt the departure inhibited free debate. But taking the lead and organizing meetings of this body was another matter altogether. India was reconciled now to striking bilateral assistance deals within the consortium framework, but separate consultations with individual donors about organizing consortium meetings were an unnecessary complication capable in certain circumstances of enhancing donor leverage. Besides, officials felt, frequent consortium meetings in India (at one stage the World Bank suggested quarterly meetings) would only trigger needless publicity and controversy within the country. If adopted, the new proposals would in the short run cause a setback to aid for India. In the long run they might end the consortium approach altogether.

The Washington meeting of Indian officials took note of the decline in the consortium's interest in aid to India. With donor governments preoccupied with their own growth and balance of payments problems, east-west tensions easing, congressional attitudes in the US changing, many more developing countries queuing up for assistance, and India already receiving substantial allocations of IDA credits, some diminution in western enthusiasm was perhaps only to be expected. But the World Bank-led consortium approach too, was debated at this meeting. Believing the Washington institution to be the villain of the piece, one or two officials argued that Indian interests were better served by getting out of its clutches and seeking aid through bilateral diplomacy. As Finance Minister, T.T. Krishnamachari ventured similar views when the consortium process was suspended in 1965. Nothing came of them even then, and in 1963 the balance of advantage was judged unambiguously to lie in not allowing the World Bank to 'slide out of its responsibility for getting Consortium aid to India'.

The World Bank's efforts to promote doubts about Indian economic policies which were only privately voiced earlier, formed the background to the Indian government's mid-term appraisal of the third plan. The appraisal highlighted

some notable achievements, but was frank in admitting the slippage which had arisen because of bad harvests, poor resource mobilization by state governments, their diversion of project funds, and the shyness of private investors. India's inability to finance the faster than expected growth in maintenance imports had also led to substantial unutilized capacities in industry. Exports, on the other hand, were not as buoyant as hoped, while the decline in invisible receipts worsened the position. Finally, the appraisal referred to the administrative and managerial challenges of implementing plans and plan projects. Its medium-term forecast was however less gloomy than its evaluation of the recent past, and the appraisal anticipated higher rates of growth, if not necessarily a reduction immediately in external imbalances, over the next two or three years if harvests lived up to Indian hopes.

The mid-term appraisal, in formulating whose sections on finances, balance of payments, and foreign aid forecasts and receipts, the Bank played the major role, was published in November 1963. Thereafter until March 1964 when the consortium met in Paris to consider the report, officials of several western governments and the World Bank were closely engaged in studying and commenting on its analysis and projections.

L.K. Jha represented India at the Paris meeting, and with the appraisal already on the table, used the opportunity to press for untied aid and loan negotiation procedures which enabled some global consortium evaluation of the quality of pledged aid. He spoke of the costs of tied aid, and the World Bank representative supported Jha by pointing out that imports financed by tied aid often cost twice or three times their price in the world market. According to the record maintained by one donor participant, Jha was alternately 'conciliatory, thoughtful, adroit, and evasive' and he reportedly left his audience with 'mixed feelings of admiration for him as a performer and discontent with the net product'. There was little discussion of fourth plan assumptions and outlays other than the suggestion that the latter should be determined with abundant caution. But a notable feature of the meeting was that unlike even in 1963, there was no explicit discussion of the period over which India's development needs would have to be met, and no member dissented from the US view that 'everyone must be prepared for a long haul'.

As commitments went, the Paris meeting was not a failure. Nor was donor fatigue much in evidence yet, as pledges totalled over \$1,000 million against India's total estimated needs of \$1,150 million. In fact as late as October 1964, John Lewis the newly arrived head of the USAID mission in India who was believed by knowledgeable diplomats in Delhi to be 'close to President Johnson', is reported to have disclosed to them his view that 'India's importance was such that the volume of American aid would not fall off'.

As well as its longer-term financing needs, by the autumn of 1964 attention in western capitals began to focus increasingly on India's emerging debt repayment and servicing problem. This issue came to the fore partly because of Indian preoccupations with framing the fourth plan. Annual debt servicing and repayment obligations during the third plan years were believed to be in the region of about \$300 million, and were expected nearly to double during the fourth plan. Although the problem was not yet imminent, the absence of any definite knowledge about how these liabilities would be financed, clouded the outlook for the fourth plan and the possibility of even working towards reasonable ranges of possible investment outlays. Indian officials canvassed with their western counterparts the idea of donors 'undertaking', rather than yet 'committing', to make available net aid of \$1,000 million each year during the fourth plan. Initial exercises about the feasibility of securing more than \$1,500 million each year in the form of gross aid led to proposals for rolling over repayments falling due. The World Bank and the United States had recommended that practice to some consortium members in the early 1960s, and while not explicitly invoking this precedent, Indian officials hoped to use it to gain some breathing space and a better outlook on fourth plan financing.

Repayments owing to Britain and the World Bank were the cause of the hump immediately facing India. In fact its officials expected—wrongly as it later turned out—a doubling of the country's debt repayment obligations to Britain even between the penultimate and concluding years of the third plan, and London was therefore the first western capital at which they raised the possibility of rolling over maturing debt. British officials, who tended generally to look askance at debt roll-overs, did not demur at the principle underlying the Indian proposal. It became immediately clear to them that, however it was used, gross assistance of amounts committed or disbursed during the third plan would not go very far in the fourth, and debate centred mainly on whether these maturities should be rescheduled or debt repayments 'refinanced'. Officials in London preferred the latter because the former implied a default, but Indian officials resisted the idea for fear that the resulting increase in gross aid commitments would further fuel the resentment other developing countries were reported to feel about the size of concessional aid flows to India.

The wider differences over how to handle the Indian debt servicing problem related to timing, i.e. whether it should be taken up at the consortium level after the fourth plan was ready sometime in October 1965 or it should be tackled first to enable a clearer outlook for the planning exercise. Opinions were divided on this, and though there was some suspicion that India advocated the latter course because it wanted the debt servicing problem out of the way to better apply pressure on consortium members to make large aid contributions

to finance imports during the fourth plan, officials even in London felt there was a sound case for distancing the two questions.

There was little, however, which Delhi or London could do immediately as George Woods set his face firmly against taking up the debt problem until 1965–66. Woods's resistance arose initially because he hoped to raise capital for the World Bank in Europe's financial markets, where any talk of debt rescheduling or financing could damage his institution's creditworthiness. But soon he began explicitly to regard World Bank assistance and concessions on debt repayment as instruments of leverage with which to press reforms on India and persuade its government to formulate an acceptable fourth plan. He therefore resolved to suspend discussions about the former until his leverage package was fully assembled. In fact, as Peter Wright underlined to his British hosts who voiced some anxiety about India's debt servicing abilities in November 1964, 'it would be most unwise to pursue with George Woods [who was expected soon in London] the question of Indian debt'. Wright also told British officials that little would be gained by talking the matter over in Washington or Bonn, and that Britain should not discuss the subject with Indian representatives when they arrived to discuss aid for 1965–66. Debt rescheduling was nevertheless raised at the highest level between the two governments in the closing weeks of 1964, and officials in London anxious to avoid a crisis found Woods's approach to the problem 'disturbing' and lacking in a 'sense of urgency'. However, as a lender 'claiming a privileged position' of the one to whom the likely defaulter owed the largest repayments in the immediate future, Woods managed to have his way.

Meanwhile, Woods was also giving considerable thought to assembling his leverage package. From April 1964 he began pressurizing the Indian government to accept a strong World Bank mission to India. The Indian government ignored the suggestion for several months, but in meetings with him in August 1964 Woods persuaded the Finance Minister, T.T. Krishnamachari, to accept it. Woods agreed in return not to advertise the mission's report and to publicly disclaim any intention of dictating terms to India about the shape and size of the fourth plan. The stated purpose of the mission was to help the World Bank familiarize itself with Indian conditions, but Woods's 'deeper purpose' according to the institution's representatives in Delhi was to 'establish the faults in Indian planning procedures and Plan implementation'

In May 1964 Woods persuaded Bernard Bell, a consultant applied economist, to head the mission, which was despatched to India soon after TTK acquiesced to it. British efforts to draw the World Bank into discussions over ways to tackle the Indian debt problem coincided with Woods's growing

suspicion that Indian officials were not cooperating with his Bell mission. Speaking to London officials who insisted on tackling the subject with him when they met in December 1964, Woods expressed himself dissatisfied with the help the mission received from the Indian government and announced his intention to 'use his willingness to assume the lead in the indebtedness discussions to secure the full cooperation of the Indian authorities' in its work. Woods also apparently informed his hosts that his 'own approach to the fourth plan would be a severe one' and not be confined to 'endorsement or purely academic comment'. Besides, while acknowledging the political arguments of the US, Britain, and the others against 'any major change of policy', he declared that the World Bank's examination of the fourth plan 'might be the occasion for something of a showdown' with India. Woods also confided to officials in London that he wanted to examine World Bank loans to India in a 'very critical' manner. Among Bell's many suspicions in December 1964 was that Indian officials hid balance of payments figures from him because 'defence imports were the source of the trouble', and speaking to L.K. Jha in London over lunch the same month Woods insisted that his approach to the debt problem and to aiding the fourth plan would depend on an annual assessment of the balance of payments implications of Indian defence expenditures. As matters turned out, however, the explanation for Bell's failure to get the latest payments estimates in Delhi was that the Reserve Bank was still compiling these figures and forecasts in November 1964 from information on import licences which was in some disarray, and it would be several more weeks before they could be conveyed to his mission with any degree of assurance.

While western donors were no doubt less enthusiastic in 1964-65 than before about extending assistance to India, the World Bank appears to have been the only donor afflicted by 'fatigue' until the spring of 1965, when US resistance to aiding India became palpable. The US refused for the first time to increase its aid commitments that year, yet total consortium commitment came up to \$1,027 million, or nearly the same amount as that committed the previous year. That a large part of the commitment was not translated into credits, among other factors because of the suspension of US aid to India after September 1965, is another story.

SCRAPING THE BOTTOM OF THE BARREL, 1965-66

In the mid-sixties, India owed substantial repayments not only to the World Bank and other members of the consortium, but also to the International Monetary Fund. Under an agreement reached with the Fund in June 1964,

India was committed to repurchasing \$200 million in three half-yearly instalments between the end of March 1965 and the end of March 1966, and a further \$25 million at the end of July 1966. Unlike the previous year when they were more or less steady between June and December and rose towards March 1964, external reserves fell steeply between June and December 1964 from about Rs 278 crores to Rs 237 crores, and it became clear to the Indian authorities early in the winter of 1964 that they would not be able to adhere to the repayment schedule agreed with the Fund. About this time, Anjaria, who was now the Indian Executive Director at this institution, invited Bhattacharyya's attention to the uneasiness in Fund circles about India's economic situation and the rupee's viability.

The closing months of 1964 were a turning point also for the Reserve Bank's own role in India's external economic diplomacy. Its officials provided technical support, prepared papers for government negotiators, compiled the data on which to make decisions and projections, but contributed relatively little until this point directly to aid or external policy negotiations. The danger of external reserves breaching the minimum currency cover in the summer of 1962 spurred the government into consultations with the Bank, which was also involved in drawing up the Indian strategy for the July 1962 agreement with the Fund. Once the immediate crisis passed or officials in Delhi learnt to live with it, little time was lost in relegating the Bank to its earlier supporting role. When the World Bank left it to India to prepare the country brief for meetings of the consortium in 1964 (and 1965), the Reserve Bank deputed a senior official to help the government fill the breach. As the crisis intensified from the winter of 1964, the profile within the Indian economic policy establishment of the Governor, if not that of the Bank itself, grew considerably sharper. Bhattacharyya's intervention grew more effective and assured after TTK's star began to wane in the summer of 1965, and thereafter for the next two years, he became the key member of the small core group of officials coordinating India's external economic policies. It needs however to be stressed that few others at the Bank were directly involved in the exercises leading to the rupee's devaluation in June 1966.

To return to the main themes of this chapter, Anjaria's letter led Bhattacharyya to ask officials at the Bank to examine whether it was possible to refinance in some way the debts owing to the Fund. In a brief note, M. Narasimham pointed to the difficulties of repeating a refinance operation, and instead suggested approaching the Bank of England for a short-term line of credit that would enable India to meet its repurchase commitment. As pointed out above, thanks to Woods's resistance, Jha's recent efforts to secure some debt refinancing assistance from Britain had largely drawn a blank. But

the chances of the Reserve Bank securing a loan from the Bank of England to enable repayment to the Fund were judged to be brighter, and this was eventually one of the options which engaged the attention of the Indian authorities in 1964–65.

With reserves not showing much seasonal buoyancy and substantial repayments owing to the Fund, the situation called for some hard decisions. B.K. Nehru, who was the Indian ambassador in Washington, felt steps should be taken to suspend or reduce the statutory currency cover. But Bhattacharyya and S. Bhoothalingam, Secretary in the Finance Ministry, rejected the advice on 'psychological' grounds: with the deteriorating price situation and 'loud thinking elsewhere on the value of the rupee', it was imperative to examine other possibilities, including rescheduling the Fund repurchase obligation. Following this, Nehru and Anjaria were asked to explore with Pierre-Paul Schweitzer, Managing Director of the IMF, the course of action India should adopt to postpone its repayments, while L.K. Jha who was already in London sounded out officials at Threadneedle Street.

Jha's talks in London revealed that British support would be forthcoming for a \$150 million drawing from the Fund to tackle payments pressures arising from leads and lags and psychological factors. While his interlocutors cautioned against India seeking a re-phasing of the agreed payment schedule, the Bank of England was not averse to advancing a loan which could be utilized to repay the Fund in full. But there were doubts in London about its ability to find the currencies acceptable to the Fund unless Britain's own external position improved in the meantime, so that in Jha's judgement, India could not expect more than \$100 million from the Bank of England. There was also some crossing of wires, Jha apparently canvassing the possibility of a longer-term arrangement whereas Narasimham's proposal and Bhattacharyya's communications with his London counterpart referred to a short-term operation. Despite the resulting confusion, Bhattacharyya and the Governor of the Bank of England reached agreement on a short-term credit. But the credit was never drawn, first because the necessity for it receded after the Fund drawing discussed below, and later because of the suspension of western assistance to India in 1965.

Meanwhile consultations with the Fund revealed three alternative courses of action available to India. The first was to repay \$75 million at the end of March 1965 and apply in April for a standby of \$100 million. But the March payment too posed problems. The second option was to secure its postponement until May, in the meantime seek a standby of \$100 million after the Fund team returned from Art. XIV consultations in India, and use these proceeds to repay the amount owing in March and a portion of that falling due in

September. This alternative, it was expected, would necessitate a letter of intent from the government conveying its assessment of the future outlook of policy and trends in India. The extreme option was to seek a standby before the Fund team visited India in March 1965, but the catch here was that such a request would signal a deeper disequilibrium in the economy, necessitate 'special consultations', and entail stiffer and quantifiable terms and conditions.

Initially, Bhoothalingam and Jha were in favour of the second alternative. But with the payments situation showing no signs of improvement and reserves continuing to fall despite the export season being well under way, Bhattacharyya held a meeting at the Bank with the Secretaries of the Finance Ministry in December 1964 at which it was decided to approach the Fund forthwith for a standby, advancing the consultation, should one prove unavoidable, from March to January 1965. The Bank and the government also decided that if the reserves position became really critical, the former's gold holdings should be temporarily augmented by stocks of confiscated and indigenously produced gold, and the corresponding amount of foreign exchange released for current deployment.

Thanks to a transfer of confiscated and domestically-mined gold valued at Rs 16 crores from the government's stocks, India's official reserves of gold coin and bullion went up from Rs 117.76 crores in December 1964 to Rs 133.76 crores in February 1965. But holdings of foreign securities continued to fall, and despite the busy season having got under way, there was little sign of any sustained improvement in reserves. More than once in the past two months, the Bank and the government had considered suspending the official reserve requirement since the gold and foreign currency assets of the Issue Department barely amounted to Rs 203 crores during these weeks, but held off for fear of the impact of the move on public confidence in the rupee. The task of restoring reserves could no longer be postponed, even if it required recourse to a Fund standby accompanied by tough conditions. This recognition was followed by a frenzied exchange of cables between Bombay, Delhi, and Washington, the upshot of which was a decision to announce a few corrective measures before the proposed Fund mission arrived in India. The Finance Minister would also make a statement on the critical external payments position when Parliament opened for its budget session. As in the past, the merit of adopting such a course was that it would make it easier for the Fund management to support India's request while enabling the government to truthfully argue that these measures were not the handiwork of agencies in Washington. The Finance Minister's statement in the Lok Sabha on 17 February 1965 underlined that the foreign exchange holdings of the Reserve Bank stood at their lowest level since independence at Rs 78 crores, and that a

suspension of the official reserve requirement was averted by transferring additional gold to the Issue Department. Shortly before the Finance Minister rose to address the Lok Sabha, the Bank put up its lending rate by one full point to 6 per cent. With a repayment to the Fund imminent, TTK told the House, further recourse to its assistance and immediate fiscal and monetary measures were unavoidable. The situation facing India was so serious that 'even with temporary relief from the Fund', it would be necessary to maintain the 'strictest discipline on all fronts' to avoid the 'periodic repetition' of similar situations in the future.

The two-member Fund team arrived in Delhi four days after TTK's parliamentary statement and held discussions with officials of the Bank and the government, chiefly on the letter of intent containing a list of measures the Indian government had taken or would take to deal with the payments crisis. The technical sessions covered the government's plans for market borrowing, the quantum of credit expansion during the busy season, the projected increase in money supply, and some details of export promotion measures. With the help of their latest payments forecasts, Indian negotiators convinced the team that a standby of \$150 million would merely result in a 'shoestring' operation and that a standby of \$200 million was more in line with India's immediate payments needs.

These negotiations resulted in some broad agreements on the letter of intent. But a consensus did not altogether prove easy. The Indian effort from the outset was to take whatever fiscal and monetary measures appeared necessary. Apart from the Bank rate which was put up successively in September 1964 and February 1965, the accommodation regime introduced at the beginning of the busy season was also intended to make credit dearer to private sector borrowers. Nor were there differences between India and the Fund on the need for fiscal restraint or on fresh efforts to promote exports. A monetary budget to guide action in the forthcoming months was not as welcome to the Indian authorities, but in the end they and the Fund team worked out a mutually agreed programme. A Fund stipulation requiring fresh consultations and agreements before making further drawings in the event of India departing from agreed policies proved more contentious. In particular, Indian officials resisted the link the Fund sought to forge between the net domestic assets of the Reserve Bank being held within agreed limits and the country's eligibility to make a drawing under the standby. As Bhattacharyya wrote to Schweitzer at the beginning of March 1965 about the divergence between the Indian and Fund views on the subject, a 'direct link between credit limits only and further drawings' was unnecessary when there was already prior agreement to initiate consultations before any changes were

made to agreed policies. 'In the ultimate analysis', Bhattacharyya told Schweitzer,

relations between the Fund and its members have to be based on mutual trust and the policies that the Fund considers appropriate can be made acceptable only to the extent that member countries consider them their own rather than those stipulated by the Fund as a precondition to drawings. As you can well imagine, there is criticism here that some of the measures we have taken must be at the request of the Fund and political susceptibilities within member countries cannot be ignored when, as in our case, the Fund and the member are agreed on the substantive issue. In the present standby, we have agreed to go much further in our letter of intent than we have done in the past; and we are rather at a loss to understand why a specific binding in regard to credit ceilings is considered more important than our express intention to consult and come to mutual agreement regarding further drawings ... whenever a shift in any aspect of policy outlined in our letter of intent becomes necessary.

Bhattacharyya also asked Schweitzer not to restrict the drawing to \$125 million until the end of May, rather than the end of April as India sought, since by doing so the Fund would be defeating the 'very purpose' of the standby arrangement. India, he said, could not be sure that the present position in which 'we are just able to avoid suspending legal foreign exchange reserve requirements will not appear again in May'. A freer drawing regime would also do more to restore confidence than one which merely enabled India to live from hand to mouth.

The Board of the Fund approved the Indian request for the standby arrangement on 19 March 1965. While Bhattacharyya's request for speedier drawings was accepted, the ceiling on net domestic assets (as defined on p. 102) remained a salient feature of the 1965 standby. The agreed ceiling was set at Rs 3,044 crores until July 1965. (In February 1965 these assets stood at Rs 2,819 crores). Alongside this ceiling, the Bank also indicated to the Fund its hopes—which in the event were not realized—of contracting bank credit during the 1965 slack season by about Rs 200 crores. But thanks to faster than expected growth in bank credit and large issues of ad hoc treasury bills during February–April 1965, the Fund ceiling was in danger of being breached even before the current busy season ended. At the same time foreign exchange reserves continued to decline rapidly and it seemed only a matter of days before they dropped below the legal minimum. With little time to lose, Delhi

instructed Anjaria in Washington on 20 April to ensure that a Fund drawing was 'effectively transferred to the Reserve Bank on or before the 25th'. The government hoped the ceiling would remain intact until the drawing was made. In order to ensure that it could remain so, the State Bank of India was instructed to repay a portion of the accommodation it had earlier availed of from the Reserve Bank. Besides leading possibly to new conditions, fresh consultations necessitated by the breach could prove to be prolonged, and time was a luxury Indian policy-makers could not afford in managing the country's precarious external finances during these months.

DEVALUATION

The March 1965 standby arrangement proved rather more difficult to negotiate than earlier ones. But one of its more noticeable features was that the arrangement made no explicit reference to a devaluation. At almost the same time, however, the World Bank campaign, which led directly or indirectly to the rupee's devaluation in June 1966, was well under way. Intended as a lasting solution to India's nearly chronic external payments problems, the devaluation's positive effects were immediately swamped by those of two successive droughts and a liberalization experiment which foundered on the western inability to deliver the assistance promised to India to facilitate the reform's success.

For much of the 1950s, the rupee was a stable currency. India, it will be recalled, followed the sterling when the latter devalued in September 1949. But the boom in the prices and exports of primary products arising from the Korean war and the intensification of domestic inflationary pressures in 1951 led to calls in India to revalue the rupee. Pakistan's refusal to devalue in 1949 had had the effect of disrupting trade between the two neighbours, and the exchange rate between their rupees became another item in the growing list of disagreements between them. Consequently, many in India also saw revaluation in 1951 as an opportunity to restore India's trade with Pakistan, particularly that between West Bengal and East Pakistan.

The demand for revaluing the currency in 1951 was not confined to India or to the rupee. Governments of several European countries faced similar pressures in some form or another in the early 1950s. Preferring trade liberalization to revaluation, the International Monetary Fund opposed any change in par values, but revaluationists received powerful support from the United Nations Economic Commission for Europe. In the early stages particularly, the demand for a higher rupee was voiced most strongly in India by the *Eastern Economist*. The suggestion was considered at some length at

the Bank by B.K. Madan, who felt it was 'devoid of economic justification' and would, if adopted, harm India's trade. While the devaluation of 1949 was a 'compulsive necessity', revaluation in 1951 was not. The government accepted Madan's argument for the time being. But it also appears to have wished to keep its options open, with Finance Minister C.D. Deshmukh underlining that unlike devaluation, a 'revaluation ... could be considered at leisure'.

Indian policy-makers were inclined to suspect a degree of special pleading in the *Eastern Economist's* campaign. The latter gathered some momentum after John Matthai, Finance Minister in 1949 when the rupee was devalued, lent his support to it. Matthai saw revaluation as a 'powerful defence against steadily mounting inflationary pressures'. Apart from lowering the prices of imported foodgrains and the capital goods needed to implement India's development plans, a higher rupee would also reduce costs and prices in two of India's major industries, jute and cotton textiles. The Bank's Department of Research and Statistics, however, preferred to focus on the external arguments. Madan maintained in April 1951 that the international price and demand outlook was now uncertain. Export prices had probably hit a plateau, and the improvement witnessed in India's balance of payments in 1950 could prove temporary. Though embarrassed by his public advocacy of a dearer rupee, neither Deshmukh nor Rama Rau could make much impact on Matthai, who continued to stress the domestic arguments in support of his view. But Madan's prognosis was borne out with unexpected swiftness within days of a dinner meeting between Rama Rau and Matthai in June 1951 at which they agreed to disagree, when trade figures for April 1951 showed a deficit for the first time in several months.

With inflation a major source of anxiety at home and relations with Pakistan on the mend, Deshmukh too, appears at this time to have been attracted by the domestic advantages of a higher rupee. But apart from adverse trade effects, the Bank was also concerned that the rupee might be unable to withstand speculative bear pressures which would be more intense if it alone was revalued. If at all India wanted to revalue, Rama Rau advised the government, it should do so only after countries such as Australia and Ceylon whose financial positions were stronger, made the first move. Important as they were, nor should the Indian response be dictated solely by the need to restore economic ties with Pakistan. The latter's non-devaluation remained an aberration and although recent events might obscure the fact, its current parity would not be sustainable in the long run.

Rama Rau's suspicions of a speculative movement were reinforced by the large spot and forward sterling purchases (aggregating to nearly Rs 220 crores)

the Reserve Bank made in February and March 1951. These pressures subsided following Deshmukh's denial that the government intended to revalue the rupee, while the campaign for a revaluation died down with the easing of the Korean war boom.

Thereafter, the possibility of a change in the rupee's par value was considered in the late 1950s, but only in the context of the devaluation of the sterling or its prolonged instability. There were dissenting voices, notably that of B.R. Shenoy, a former Bank economist and Alternate Executive Director at the Fund. Shenoy argued in 1958 that the stagnation of Indian exports at the pre-war level and their declining share of the domestic product, persistent payments difficulties despite drastic controls, and the wide gulf between domestic and world prices of importables and gold, together pointed to an over-valued rupee. Around the same time, articles appeared in financial papers expressing doubts about the rupee's stability in the face of the domestic and external financial challenges of the second plan.

Responding to these doubts, the Bank initiated a study of the rupee's stability at the instance of the Governor, H.V.R. Iengar, early in 1958. Few at the Bank, including Iengar, had any doubt at this stage about the rupee's intrinsic soundness, and the study appeared to confirm that there was little or no impairment in India's export competitiveness. The general weakness of India's export performance in recent years owed more to structural causes which were not easily amenable to correction through a change in the exchange rate. There was some nervousness in the exchange markets in June 1958, attributable no doubt to the crisis in India's external finances which was coming to a head at this time. But the increase in the demand for sterling proved to be temporary, with a speech Iengar made in Bombay to the Progressive Group at the end of June 1958 helping to put the lid on rumours of a rupee devaluation.

The Bank had several means open to it of keeping a watch on the rupee's external alignment. Apart from tariffs and subsidies, neither of which were yet as important as they were soon to be, inflows and outflows of foreign exchange, rates the rupee fetched in the black market, and movements in gold prices, the Bank also kept a close watch on the utilization of import licences and the changing premiums on them. Although it was evident that the prevailing rate was not an 'equilibrium' rate in the sense the markets might regard one, the Bank remained firmly of the view that devaluation had little role to play in balancing India's external accounts. There were doubts about the responsiveness of export demand to price changes, and since a large proportion of India's exports depended directly or indirectly on agriculture, doubts too, about the responsiveness of supply to price incentives.

The relatively easy availability of long-term external assistance diverted attention from major corrective measures until the middle of 1962 when there was a renewed sense of crisis. As pointed out in the last chapter, though pledges were still in accord with requirements, there was a lag in disbursing assistance. There was a mismatch besides, between project assistance and that to finance maintenance imports, and finally a slump in India's invisible receipts. In this background and partly in anticipation of a searching examination by the Fund of the appropriateness of the prevailing exchange rate, the Bank conducted a study of devaluation as a possible solution to India's external problems. This study, which Pendharkar completed in June 1962, was largely dismissive of the benefits of a parity change. Apart from the doubts about supply and demand elasticities Madan voiced in 1958, Pendharkar pointed out that Indian manufactures whose exports could benefit from a devaluation were subject to quota restrictions in the developed world. Pendharkar was also concerned about the terms of trade effect of a rupee devaluation and its potential for triggering 'beggar-thy-neighbour' responses by India's competitors. A rupee devaluation in the present circumstances made sense only if competitors such as Ceylon or Pakistan embarked on parity changes, and not otherwise. If India devalued 'ahead of its competitors, ... she may be obliged to do it again'. Further, as L.K. Jha at the Finance Ministry elaborated on Pendharkar's note, by cheapening India's price-inelastic exports, devaluation might actually reduce and not increase India's foreign exchange earnings. Selective subsidies, both Pendharkar and Jha agreed, offered the better course to higher exports than a general instrument like devaluation which would also disrupt the third plan by putting up domestic prices and debt servicing charges in rupee terms.

The Bank of England too, appears to have thought at this time that rupee devaluation was a 'course of despair' capable of producing little beneficial effect in a planned, mixed economy in which tradable goods were pre-empted by the State to achieve plan targets. London's arguments partly reflected the fear that a rupee devaluation might inaugurate a prolonged period of instability of sterling area currencies, but appear in this instance to have helped reassure the Fund. For several months thereafter, devaluation was not actively canvassed or debated in official policy circles or in the international agencies. The Fund mooted a suggestion in February 1963, though more in the context of Pakistan than of India, for a joint devaluation of the so-called 'rupee countries' to ensure that no single country derived any competitive advantage at another's expense. But little was heard of the idea subsequently. Visiting India several months later, the Governor of the Bank of England reiterated that the proper time to consider a change in

the par value of the rupee would be when there was 'enough production in the country ... [to] generate an export surplus'

Despite the Fund's silence on the exchange rate in March, speculation about an Indian devaluation assumed significant proportions by the summer of 1965. To some extent it was sparked off by the Bell mission which was currently engaged in preparing its report. Although supposedly a secret, Bell missed few opportunities to make his preference for a devaluation more widely known in India and elsewhere. Moreover, despite drawings from the Fund of nearly Rs 24 crores in the first quarter of 1965–66 and nearly Rs 12 crores in the second, reserves continued to fall until September. India was forced to seek the postponement of its obligation to repurchase \$25 million at the end of September 1965, and this request was approved by the Executive Board of the Fund without event only because Schweitzer, who did not place it on the formal agenda, managed to see it through on a 'lapse of time' basis.

Meanwhile, early in June 1965, Bhattacharyya, Bhoothalingam, and Jha (now the key official in Shastri's secretariat) submitted a report to the Prime Minister signed by several other senior officials of the Government of India including I.G. Patel, outlining a further series of measures to restrict imports, and monitor remittance of export receipts and invisible outflows to check disguised capital flight. As well as a response to the immediate crisis, this memorandum reflected the official Indian response at this time to the Woods-Bell devaluation campaign.

The prevailing sense of uncertainty over future Indian policies led to the Fund postponing a Board meeting called for 7 July 1965 to discuss its Art. XIV consultation report on India. About the same time Bernard Bell and Andre de Lattre—a former French civil servant George Woods roped in to strengthen the World Bank in its negotiations with the Government of India—were busy presenting the mission's findings to officials of the Indian government. Bell and de Lattre pressed hard for a devaluation, but did not greatly enhance their case by threatening a cut off or reduction in assistance should India refuse. With T.T. Krishnamachari rejecting the advice and Prime Minister Lal Bahadur Shastri still supporting his Finance Minister, there was little immediate prospect of India heeding the World Bank's counsel. But the markets, if not public opinion, remained uncertain, and following discussions with Shastri and the approval of the Union Cabinet, TTK went on the air on 17 July 1965 to rule out a devaluation which he said was merely an 'opiate' and not a lasting answer to India's 'problem of living within ... [its] means'. He underlined the government's determination to 'restore strength' to the balance of payments by 'selective deployment of the instruments we have already forged'. To argue the case for a general instrument like devaluation

and against a 'discriminating approach to the problem of export promotion and import substitution' amounted to assuming that India had already arrived 'at that stage of development and technology where structural rigidities are no longer relevant' This, TTK underlined, was 'not true'. Finally, the Finance Minister called for a 'greater sense of discipline and determination ... over a period of years ... reflected continuously in our budget and credit policies and, indeed, in the size of our plans for development' to avoid similar crises recurring in the future.

The Finance Minister's broadcast advertised the willingness of those opposing devaluation to contemplate a relatively modest fourth plan. Though it did not immediately scotch the debate within India on the future of the rupee, TTK's speech helped dispel some of the uncertainty and clear the way for the Fund's Board to discuss the Indian report. At the same time, although many at the Fund felt the rupee parity was in need of correction and Schweitzer himself broached the need for radical policy measures to Bhattacharyya and Bhoothalingam when they met him in September 1965, its officials were sensitive to the Indian reluctance to devalue and looked for acceptable variants of multiple exchange rates. Thus in meetings with I.G. Patel in September 1965, Fund officials mooted a plan to replace import entitlement licences (against exports) with a system of tax credit vouchers at rates varying from 10 to 50 per cent of the foreign exchange surrendered by exporters and importantly, by recipients of remittances from abroad. Estimated to cost Rs 250 crores, Fund officials proposed an additional duty on imports (to be called a 'price equalization tax') to finance the subsidy. While leaving the exchange rate untouched and not formally constituting a multiple exchange practice, this scheme, officials at the Fund felt, had the effect of 'making a substantial move forward on lines' that were 'economically justified'.¹

This plan may have given birth to the National Defence Remittance Scheme introduced in October 1965, under which recipients of remittances from abroad were extended the benefit of import entitlement licences;² but little else since Indian government officials did not wish to raise import duties any higher than they already were. It is nevertheless useful to recall this plan here, if only to show that at the same time as Woods and Bell were talking in increasingly strident tones about devaluation, the Fund, which according to Patel was the World Bank's 'silent and ... sullen partner' at this time, was

¹ Anjaria felt Schweitzer consented to these measures, which just stopped short of multiple currency practices, in the eventual hope of convincing India to devalue.

² As mentioned in appendix E, the success of this scheme helped India weather the adverse aid environment during these critical months.

willing to consider alternative options. In fact, as late as December 1965, Schweitzer confided to B.K. Nehru that while his first preference was for a 'straightforward devaluation', the Fund was not 'dogmatic' and would be willing to accept a 'well coordinated set of measures for exports, imports, and invisibles ... which would yield the same results as a straight devaluation'.³

Although these were progressively tightened after 1956, officials at the Finance Ministry had never really been happy with controls, nor with a system of multiple exchange rates. Moreover, they were always quick to take note of the 'gentle pressure' that international agencies invariably exerted on any country which began taking recourse to export subsidies, and by 1965, it was becoming amply clear that only a devaluation could unify India's multiple exchange rates. The demands of the third plan prevented them from pressing their views insistently upon their political masters. But this plan was due to end in March 1966. Besides, although the World Bank's bullying approach made devaluation unpalatable, it was perverse to reject the policy merely on that account if Indian interests independently dictated otherwise. An early and precise appreciation of the policy changes needed to overcome the external crises in an enduring way would also give the Indian authorities some control over the timing and sequence of devaluation and connected measures. Thus by the winter of 1965, a distinct change overcame the official Indian attitude towards devaluation.

This change owed in considerable measure to growing unease about the efficiency costs of the controls regime. But there was scepticism too, about the incentive effects of import entitlement and other subsidy schemes. Although the latter amounted to devaluation, neither the government nor intending exporters could precisely estimate its extent which varied with the size of the subsidy and the premiums at which import licences could be sold. The success of such schemes also hinged on high import premiums, or on imports remaining scarce. On the other hand, difficulties in securing imports affected output and capacity utilization in industry. Considerations such as these motivated a searching internal examination within the government of India's exchange rate policies following which Bhattacharyya, Bhoothalingam, and Jha, who together formed a closely knit core team handling economic affairs at this time, moved quickly to abandon the step-by-

³ Arguing the case for devaluation, Schweitzer reportedly told Nehru that from the 'political point of view' too, the 'present time might be appropriate' to devalue, 'since a combination of several unfavourable circumstances—Pakistan, China, the drought, and maybe, even the Americans—could be blamed for the present impasse and the need for resolving it in a manner that would help the economy to conserve and produce more foreign exchange'.

step adjustment of the existing system of controls and incentives they had sponsored earlier, in favour of a more realistic exchange rate and liberalized trading arrangements. As the Finance Ministry observed in one of its notes, the current method of taxing imports and subsidizing exports had a number of loopholes, and the overwhelming body of opinion among economists about the means by which to deal with India's external imbalances 'pointed in one direction—that is making foreign exchange worth more in rupees than before'. The political opposition to devaluation too, weakened quite suddenly in December 1965 following the resignation of T.T. Krishnamachari, who B.K. Nehru suggests was eased out by the Prime Minister, Lal Bahadur Shastri, to make way for the reform.⁴ And by the end of 1965, according to Patel's recollections, the government had made up its mind to devalue. Shastri's unexpected death in Tashkent in January 1966 had little impact on this decision, as the new Prime Minister, Indira Gandhi, was quick to grasp its necessity.

Accompanied by Patel, Bhattacharyya flew to Washington in February 1966 to explore a possible drawing from the Fund and discuss with Woods a timetable for meetings of the aid consortium. To India's discomfiture, in December 1965 it breached the net domestic assets ceiling agreed under that year's standby arrangement. But with reserves still precariously placed and large repayments falling due, India was faced with little other choice than going to the Fund for a straight drawing arrangement. At first Schweitzer felt the budgetary and monetary outlook precluded the suggestion, and himself proposed India securing some temporary relief—either in the form of a postponement of its immediate repurchase obligations or an emergency drought-related payments assistance of \$100 million repayable in one year—followed by a substantial line of credit in the region of \$300 to \$400 million on the basis of an agreed programme. Bhattacharyya and Patel resisted this offer and maintained their preference for a normal three- or five-year drawing of \$200 million. A one-year loan, in their view, would do little to solve India's problem, while postponing repurchase obligations would only raise fresh doubts about India's future intentions. A large loan of the size Schweitzer proposed would inevitably bring pressure on India to review its exchange rate, and although a decision in this regard had already been made, Indian officials were keen to avoid any link being drawn between the government's move on the exchange rate and the Fund drawing. Although the \$200 million sought by the Indian team was known to be inadequate for the country's payments needs, the difficulty of reaching agreement on fiscal and monetary matters made a larger

⁴ B.K. Nehru, *Nice Guys Finish Second: Memoirs* (New Delhi, 1997), pp. 447–48.

arrangement unlikely. 'At the back of our mind', Bhattacharyya noted in his record of discussions with Schweitzer which he sent to the new Finance Minister, Sachindra Chaudhuri,

there was also the consideration that agreement with the Fund on a programme relating to fiscal and monetary matters might prove difficult as long as we have not been able to make satisfactory arrangements to ensure greater fiscal discipline on the part of the State Governments.

Besides, what India really needed was 'long-term money for import liberalization'. Bowing to the Indian argument, Schweitzer agreed to sponsor as a special case, a drawing of up to \$200 million repayable by December 1967, if India could demonstrate that the total impact of the drought exceeded that amount. India accepted this stipulation, thereby signalling its recognition of the 'special character' of the proposed drawing.

Bhattacharyya expected Schweitzer to present to the Fund's Board a proposal to allow India to draw \$150 to \$175 million. In the event, a proposal envisaging a drawing of \$187.5 million came before the Board for approval on 23 March 1966. Not wishing to encourage a protracted debate, Frank Southard, Schweitzer's deputy who chaired the meeting, acknowledged that the drawing was meant to meet an emergency and that it did not conform to 'established policies' of the Fund for drawings in the higher credit tranche. However, the principal justification for the proposed transaction was that, but for it, urgently needed 'policy adaptations' could be delayed by a worsening economic situation.

Deliberations at the Board were not altogether critical of India. But members were worried by the precedent of India making a drawing in the higher credit tranche without a mutually agreed reform programme. The rupee parity also figured prominently, with several speakers stressing the need to find a lasting solution to India's recurring payments troubles through exchange rate adjustments and vigorous export promotion measures. A devaluation was very much part of Bhattacharyya's brief in February 1966 and he was authorized to inform Schweitzer during the loan negotiations that 'the Government of India have decided in favour of a formal change in the par value of the Indian Rupee to be made in June 1966'. But with talks at the Fund making good headway without any assurance of a devaluation, and sensitive to the difficulties of a new government which was still feeling its way, Bhattacharyya refrained from conveying the Indian decision himself, or during his talks at the Fund. India, the Governor was content to explain to the Managing Director of the Fund, recognized that there was a 'continuing

foreign exchange problem'. It was still involved in 'examining ways and means of solving ... [its] chronic difficulties' and proposed to 'remain in continuous touch with the Fund' in its search for an 'enduring solution'. But after having secured agreement on the drawing arrangement, Bhattacharyya instructed Anjaria to inform Schweitzer orally whilst transmitting the formal request for the drawing, that

the Government of India have accepted the advice of the Governor, Reserve Bank of India that the official par value of the rupee has to be changed, and that the timing of this will be around June this year.

Across the street at the World Bank, prospects looked dim for an early resumption of consortium meetings. With India's debt problem still hanging in the balance, the World Bank offered to explore possibilities of refinancing or postponing repayments owing to the 'original members' of the consortium who accounted for the bulk of India's debts. There was some discussion of whether these arrangements should not cover only the repayment of principal. While India wished interest payments also to be covered, Bhattacharyya conveyed his preference for 'new loans which would enable ... [it] to repay the amounts due', over a mere postponement of its obligations. Aware that India's repayment obligations to the World Bank could not be refinanced directly, Bhattacharyya and Patel sought and obtained from that institution a loan of \$50 million to finance the 'import of industrial components and materials'. This amount equalled the principal due on World Bank loans in 1966-67, and the loan was extended on terms which avoided any repayment obligations during the fourth plan.

The Government of India's *Economic Survey* for 1965-66, which was presented to Parliament on 15 February 1966, referred in rather guarded terms to the possibility of a devaluation. The problem of achieving balance of payments 'viability' the *Survey* said, 'was a '... basic one' which required 'continuing effort on a variety of fronts'. This failed however to throw inquisitive members off the government's trail, and a barrage of questions followed in both houses about its plans for the rupee. While the Minister of State for Finance refused, understandably, to confirm or deny members' allegations, the Planning Minister, Asoka Mehta, denied that the government was 'considering the question of devaluation'.

As already pointed out, Prime Minister Indira Gandhi was converted soon after she entered office to the idea of a devaluation. Yet, anticipating opposition from within her party and the government in an election year, Indira Gandhi not only chewed patiently on the arguments Bhattacharyya and Jha gave her

in favour of the course, she also invited leading economists to advise her on the implications of the step. In addition, according to the recollections of some officials, she formed a secret committee early in 1966 to examine all options and report about their likely economic consequences. Besides Indira Gandhi herself, the committee comprised Sachindra Chaudhuri, Asoka Mehta, Food and Agriculture Minister C. Subramaniam, and Bhattacharyya. Bhoothalingam, Jha, Govindan Nair, Patel, and V.K. Ramaswami were the other members. Few outside it were aware of the committee's existence or its remit, and no one from the Reserve Bank other than the Governor was involved in the exercise. This committee came out in favour of devaluation accompanied by appropriate policy changes, including liberalizing trade.

In March 1966, Indira Gandhi visited the United States. Her visit was preceded by that of a technical mission comprising I.G. Patel, M.R. Shroff, and V.K. Ramaswami which held discussions with the Fund and the World Bank. The climate for it was vitiated somewhat by a senior US official telling the *New York Times* that the US and other donor countries believed the rupee was overvalued and that the matter was under discussion with the Indian government. In a conscious decision to underplay the devaluation angle, Govindan Nair was the only Finance Ministry official chosen to accompany Indira Gandhi to Washington.

Discussions Indian officials now held at the Fund centred largely on the size of a possible rupee devaluation. Some thought had been given to this in India in February, when it was felt that 'an increase of 50 per cent in the rupee value of foreign exchange' was the maximum extent of devaluation necessary. This figure was based on 'two considerations'. The first was that of increasing the rupee receipts of exporters sufficiently as to enable existing export subsidies to be eliminated and 'leave a margin of extra-competitiveness' to take care of any 'additional difficulties ... in the future'. Here cotton textiles, on which subsidies ranged from 30 to 40 per cent, were regarded as a 'crucial area'. The second consideration was to prevent so large a rise in the rupee price of imports that it became necessary to 'lower customs duties to an extent which would have serious repercussions on ... [the] budgetary position'. For tactical reasons, it was decided to advance the case for devaluation by a third, rather than by half, and this was the view Bhattacharyya pressed on visiting Fund officials in March. However, the brief for Indian officials also cautioned that 'any suggestion of a change of the order of 50 per cent should not be resisted too stoutly'.

Some preliminary discussions at the Fund suggested that it would be satisfied with a rate of Rs 6 against the prevailing one of Rs 4.76 for the US dollar. Though it is possible that the new exchange rate was in the end set at a much

lower level to scotch speculation about another devaluation and to better mobilize assistance for the fourth plan, official records throw no light on when and why it was decided to fix the rupee at Rs 7.50 to a dollar. According to one account whose reliability cannot be verified, Indira Gandhi chose the lower rate in the course of a meeting with Schweitzer who reportedly told her that six rupees to the dollar 'would be good. Seven would be better. Seven and a half would be fantastic.'⁵ According to Schweitzer's opening remarks at the special meeting of the Fund's Board convened on 5 June 1966 to approve the Indian devaluation, the latter was not a sudden or unprepared move but one preceded by 'continuing discussions' with the Indian government. Nor was the new parity a 'negotiated compromise'. The Indian government, Schweitzer declared, had 'fully followed the advice of the Fund management and staff'.

To return to events taking place in the spring, Asoka Mehta visited Washington in April 1966 to negotiate future levels of consortium assistance with the World Bank, only to draw a blank at that institution. Already smarting under the embarrassment of leaks to the US media about a forthcoming rupee devaluation, Indian officials were not amused when Woods raised with Mehta, purportedly in his capacity as the chairman of the consortium, the subject of India's defence spending. Unhappy at getting advice instead of aid commitments at the World Bank, Mehta met Schweitzer to sensitize him to the domestic political dangers of devaluing the rupee, and impress upon him the importance of larger external assistance in making the decision more acceptable within India. India, Mehta is reported to have told Schweitzer,

could be a great stabilizing force in the world in ten years; if, however, the situation were not handled with understanding and finesse, and if, because of pressures, or lack of faith of the donor countries, the present Government lost in the 1967 elections, India could become a major destabilizing force in the world.

Referring also to the 'critical situation in some of the key areas like Bengal', Mehta warned his interlocutors at the Fund against adopting a 'complacent' attitude towards India and underlined the need for 'understanding and an element of faith' in the ability and desire of the country's present leadership to 'bring about the desirable modifications required for India's economic growth'.

⁵ 'The Reminiscences of Gregory Votaw', George B. Woods Oral History Project, Columbia University, p. 46, cited in Robert Oliver, *George Woods and the World Bank* (Boulder, 1995), pp. 141–42.

It is not clear whether Mehta was sent to Washington to explore the possibility of a postponement or temporary abandonment of the devaluation decision. But his visit does appear to have conveyed confusing signals, notably about whether India wanted assistance from the Fund to precede or coincide with the devaluation, or still sought, as Bhattacharyya had argued earlier, to separate the two measures. Faced with Mehta's request for assistance to enable the Indian authorities to liberalize imports, Schweitzer and Southard, according to one account of their meeting, 'fidgeted visibly'. Confusion appears to have arisen between the two sides because while Mehta spoke about assistance in general terms, Schweitzer and Southard interpreted his remarks to refer to that available from the Fund.

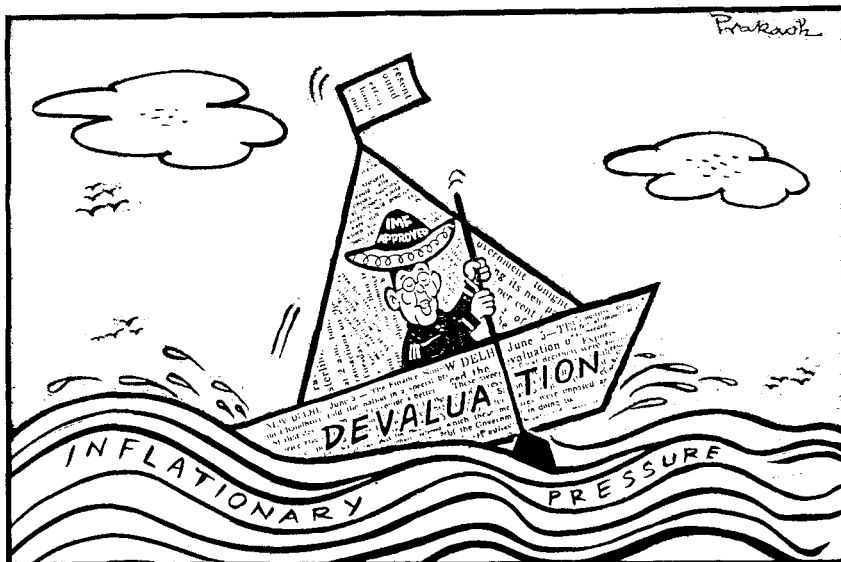
Meanwhile, the Indian authorities put together a package of measures comprising devaluation, import liberalization, elimination of export subsidies, and greater fiscal discipline, whose details were finalized during the course of May 1966. No one at the Bank, other than Bhattacharyya, knew yet about the impending change in the rupee's par value. It should not be supposed for that reason that opinion at the staff level opposed a devaluation. On the contrary, by 1965 many staff notes and memoranda began referring in guarded terms to the advantages of one, and despite the decision's great unpopularity subsequently, few senior officials of the period recall having been sceptical of the move. It was not until late in May 1966 that Bhattacharyya confided the devaluation decision to two senior officials of the Bank with whom he had a chance meeting in Delhi. One of them is reported by the other to have asked the Governor whether it might not be wiser to postpone the decision until more was known about the progress of the monsoon, only to be told in reply that events had moved too far for the decision to be delayed. With devaluation on the anvil, Bhattacharyya took even closer interest than usual in framing a restrictive credit policy for the 1966 slack season, which aimed principally to immobilize Rs 200 crores or so of additional deposits. He had been engaged for the past several months in urging greater restraint on governments' expenditures, and he now underlined to the Finance Minister that strong action was necessitated on the monetary front because the central and state governments continued to run large deficits.

The meeting of the Union Cabinet to formally decide on the devaluation was convened for the morning of Sunday, 5 June 1966, so that the decision could be communicated to the Fund and its agreement obtained before the news was made public. The Cabinet approved, not it seems without heated debate, the proposal to devalue the rupee by 36.5 per cent from 0.186621 gram of fine gold to 0.118489 gram. As a result, the rupee price of a US dollar and a pound sterling rose respectively from Rs 4.76 and Rs 13.33 to

Rs 7.50 and Rs 21. Devaluation was accompanied by the levy of export duties on a dozen commodities and the scrapping of import entitlement schemes and tax credit certificates for exports, so that the combined effect was to render the effective devaluation less than the nominal one, and greater for imports than for exports.

Following the Cabinet decision, officials of the Finance Ministry fanned out to the states as emissaries of the Prime Minister, and delivered to their chief ministers a sealed 'top secret' envelope with instructions to open it only after six that evening. Although cypher facilities existed, they were eschewed in this instance to avoid the news leaking before midnight. Anjaria was informed by cable and he, in turn, informed Schweitzer who convened an unscheduled meeting of the Board the same (i.e. Sunday) morning. Schweitzer commended the Indian decision to the Board and concluded with the hope that 'the momentous decision would pave the way for the foreign aid necessary for trade liberalization'. Having secured the Fund's approval, Sachindra Chaudhuri announced the devaluation in a special broadcast to the nation at 9.00 p.m. on Sunday. The new parity was to take effect from 2.00 a.m. on Monday, 6 June 1966. As standard practice obtained in these matters, the Reserve Bank also issued a notification closing banks to the public for two days.

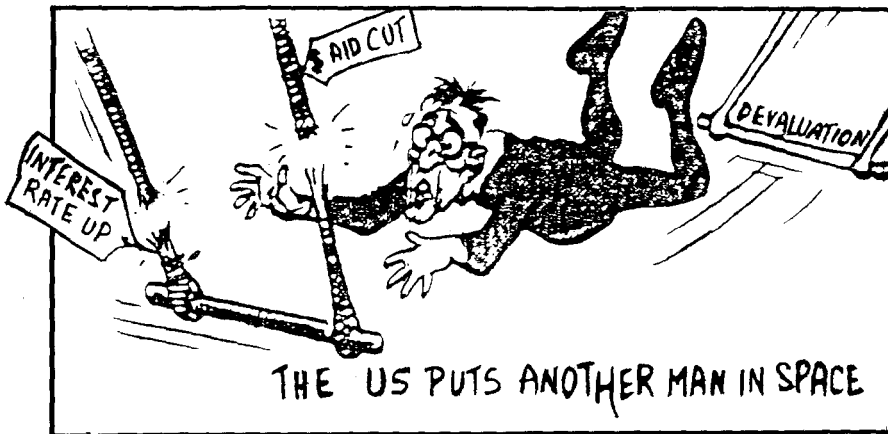
The devaluation of the rupee in June 1966 evoked a largely critical political and public reaction at home. The measure was preceded by persistent denial by the government of any intention to devalue the rupee. Such denials were unavoidable, but they also meant that the decision, when it came, took the public by complete surprise. The press reaction to the devaluation was almost uniformly adverse, even financial newspapers describing it variously as an 'ill-advised plunge', a 'leap in the dark', and an 'escape from reality'. Many commentators were openly sceptical that a cheaper rupee would boost exports, while most feared its effects on domestic prices. Representatives of industry spoke of the cascading effect of higher import prices and of their having to recast their investment and profitability calculations as a result of the government's decision. There was little support for the decision even within the ruling Congress party. The Commerce Minister, Manubhai Shah whose opposition to devaluation was public knowledge, was reportedly kept in the dark until the Cabinet meeting. K. Kamaraj, the party's strongman in the south who was soon to face a crucial electoral test in the former Madras state, smarted at not having been consulted about the decision. Nor was his opposition weakened by the efforts of a Tamil-speaking economist who was despatched urgently to explain the decision to him. Kamaraj refused to meet the economist, and afterwards gave expression to a widespread sentiment when



— Shankar's Weekly, 12 June 1966

he condemned the devaluation 'as a sell-out to the Americans'.

Though closely associated with the devaluation, the Governor chose to greet its formal announcement in Calcutta, rather than in Delhi or Bombay. Reacting to speculation about a possible devaluation in Calcutta in May, the Finance Minister had denied that the government was contemplating any such move; and it fell to Bhattacharyya, who until the decision was announced purported to be on a personal visit to the metropolis, to explain the latest turn of events to its bemused public. Meetings and press conferences which the Finance Minister, the Governor, the Deputy Governor B.N. Adarkar, and Bhoothalingam addressed individually or jointly with other ministers of the Union Cabinet or with chief ministers of states such as Maharashtra over the next few days, helped sow doubts in the minds of those who had earlier opposed the move, the *Economic Times* for example drawing back from its earlier attitude of open opposition to one which suggested that the decision placed the government of the day and its policies on severe trial. Bhattacharyya and others also used their speaking engagements to dampen expectations of inflation and to urge captains of commerce and industry to ensure that prices were not raised on stocks of goods finished or imported at pre-devaluation costs. Not only would the liberalization of imports help keep prices in check, Bhattacharyya argued in an effort to dampen inflationary expectations and speculative behaviour, higher imports would also boost domestic output through



— R.K. Laxman in *Tol*, 24 July 1966

better utilization of installed capacity in industry.

By common consent, the devaluation of 1966 failed, or it did not immediately achieve its objectives. According to the Reserve Bank's explanation at the time, the 'adjustment in relative prices, costs, and pattern of investment' necessitated by the devaluation proved 'even more difficult because of the serious drought' which affected the Indian economy for the second year in succession. The World Bank attributed the failure of the economy to respond to policy adjustments to some 'historical accidents' such as the drought-induced recession, the sharp decline in US aid, (which was virtually frozen during the critical post-devaluation period), and the protracted replenishment negotiations which greatly delayed India's receipts of the fifth and sixth IDA credits.

The package of policy measures announced in June 1966 reactivated the aid process, but aid commitments never approached the levels which the Indian government had earlier been given to understand it could expect from the World Bank and the other members of the consortium. There were definite indications in the run-up to the 1966 decision that liberalization and assistance were linked, and that the former's extent would depend on how well it was supported financially by additional non-project assistance. India and the World Bank were also agreed on the need for non-project assistance of \$900 million annually for three years after the devaluation, in addition to project assistance of \$300 million, and the latter committed itself to raising this amount.

In the event, the promised aid did not materialize. The first \$900 million was slow in coming, and it was not till November 1966 that the

financial package for 1966–67 was announced as committed. Then commenced protracted delays in committing funding for the second year, resulting from delays in IDA replenishment, President Johnson's perverse aid policies, and his insistence on counting America's P.L.480 aid commitments as part of consortium assistance. World Bank records suggest that its officials expected India to require aid of the order of \$900 million each in the first two years, and a billion dollars in the third. But when non-food imports fell as a result of the recession induced by the drought and the decline in public expenditure, these amounts were scaled down to \$600 million in the second year (1967–68) and \$900 million in the third. At the November 1967 consortium meeting, the World Bank presented an aid estimate of \$750 million for 1967–68 and \$820 million for 1968–69. While members of the consortium felt this was reasonable, chances of achieving this level of commitment for 1967–68 receded with every delay in IDA replenishment.

Meanwhile, with aid disbursements remaining slow and the drought of 1966–67 having contributed to worsening the trade position, Indian officials began once again to apprehend a serious external crisis. In fact, they expected in February 1967 that India's reserves would dip sharply in dollar terms unless import controls were restored or liberalization did not lead immediately to higher imports. Nor had India any resources of its own to repay the substantial Fund maturities falling due in December 1967, so that it was forced for the third successive year to knock at that institution's doors. After some protracted negotiations, in December 1967 India drew \$90 million under the new Compensatory Financing Facility and managed, after some considerable difficulty and firm handling by the management, to secure the Board's approval for a postponement of the repurchase of \$387.5 million due that month.

At the May 1968 consortium meeting, non-project commitments amounted to \$295 million, leaving \$1,275 million to be found in 1968–69. What eventually came through was about half that, \$642 million. Many knowledgeable officials warned that the reversal in World Bank and consortium commitments would undermine the liberalization process India was embarked upon, but to little avail. Not surprisingly, Indian government officials who were involved closely with the devaluation discussions and the talks on aid which preceded the decision felt let down by the outcome and believed India had been swindled. Its government had entered into the 1966 transaction in good faith, but the World Bank and the leading consortium members, in particular the US, did not keep their end of the bargain. Indian policy-makers felt so chastened by their 1966–69 experiences in dealing with the World

Bank and the leading members of the consortium, that these inevitably had a bearing on the country's relations with the international institution for the next few years and its economic policies during the next two decades.

With the devaluation being followed by the second drought in two years, prices in India rose steeply in 1966–67 and again the following year. The rate of growth of industrial production dropped from 3.4 per cent (pre-devaluation) to 2.3 per cent in 1966–67, and to barely 1.4 per cent in 1967–68. Nor did exports grow as expected, and the trade gap was wider during June 1966–May 1967 than during the corresponding period of the preceding year. The bulk of the export shortfall was accounted for by jute manufactures, tea, tobacco, and cotton textiles. According to a study by the Bank's Economic Department, jute and tobacco exports declined because of lower output, while weak international demand accounted for the lower exports of tea and pepper. Another Bank study pointed out that nearly 60 per cent of India's exports were now subjected to duties of up to 40 per cent of their pre-devaluation f.o.b. prices, and with earlier export incentives abolished, their competitive position had not improved to the same extent as the devaluation. But the study cautioned against reducing duties of items where India was a major exporter, since it would merely precipitate a fall in the unit value of exports. On the other hand, duty reductions could be considered where supply conditions were favourable and for markets where India was a small supplier. The study also expected the 10 per cent of exports which received cash subsidies, such as steel, chemicals, and engineering goods, to fare better in the new environment.

On the import side, devaluation was accompanied by significant liberalization measures. Special arrangements were made to import sizeable quantities of fertilizers to support agricultural production. Raw materials required for export production were allowed to be imported under open general licence. Imports were liberalized to enable full capacity utilization in fifty-nine industries. But imports failed to revive because of higher prices, the slow-down in public investment, and lower consumer demand. While imports of capital goods, in particular, were affected by the cutbacks in public investment, the Bank's assessment was that the other imports were probably being replaced by cheaper domestically produced substitutes.

Finally, the failure of the devaluation package and of aid promises to materialize led to a slowing down of the reform process. It also spurred the government to adopt modest growth targets in practice, if not always on paper, so as to minimize external imbalances and recourse to foreign aid. As a result of modest public investment and expenditure policies, the revival of the monsoon, and higher agricultural output thanks to the green revolution,

the trade gap narrowed appreciably after 1968. The ratio of foreign borrowing to the budget deficit was also brought down sharply and although the planners projected a 5.5 per cent growth rate, the actual performance projection was based on a much lower level of foreign aid and public investment. Thus during 1968–70, the Indian authorities planned for a modest recovery consistent with an import surplus which could be financed by the lower levels of aid that were now available. Despite the luckless devaluation, therefore, India achieved a measure of external economic equilibrium at the cost of reduced public investment and lower growth rates in the economy.

Compensating Gulf Rupee Holders

The rupee's devaluation in 1966 also had some unexpected effects on rupee payment arrangements with the socialist bloc and India's financial relations with neighbouring regions where the rupee was or had recently been circulating as legal tender. While the former are discussed in appendix G dealing with bilateral trading agreements, the latter are discussed below.

It was pointed out in the last chapter that fears of foreign exchange leakages motivated the Bank and the government to replace the Indian rupee circulating as legal tender in the Persian Gulf kingdoms with special Gulf notes in 1959. Rising nationalist sentiments, weaker trade and commercial links with India, the oil boom, and the overt encouragement they received from British banking interests in the region led these states to review their currency links with India. Kuwait became the first country to replace the special Gulf rupee in May 1961, with the Kuwaiti dinar. Bahrain, which accounted for nearly half the special Gulf notes put into circulation in 1959, sought to follow suit two years later. The rupees in circulation in these countries were issued against sterling surrendered to the Reserve Bank, and the latter estimated its probable sterling liability for Bahraini rupees alone at Rs 12.5 crores and that for the entire region at Rs 26 crores. Repudiation was unthinkable, but in the light of the country's external payments position, so was a one-time payment of this magnitude. It was public knowledge at the time that the efforts of the region's rulers to modify domestic currency arrangements had the active support of British commercial and financial interests in the Gulf. The first indications of Bahrain's intention to adopt a new currency emanated from the Bank of England. But efforts to rope Britain into a constructive engagement on this subject drew a blank, with its officials maintaining that they were only the messenger boys. The redemption of Gulf rupees circulating in Kuwait had taken the form of a loan repayable in 11 annual instalments, but Bahrain and India agreed on a down payment of the lower of £2 million or one third of the redemption,

with the remainder to be paid over ten years. The maximum redemption in any single year was also set at £0.4 million.

The currency changeover was set to commence in October 1965, with the debt being fully redeemed in 1975. Fearing exchange losses, Bahrain sought a guarantee clause which India successfully resisted. Conversion operations began in October 1965 when a new currency—the Bahraini dinar—was introduced. Gulf rupees withdrawn from circulation in Bahrain amounted to Rs 7.86 crores or £5.9 million at the prevailing rupee–sterling parity.

In the third phase of the rupee's withdrawal from the Gulf, the sheikdoms of Qatar, Dubai, Sharjah and Kalba, Ras-al-Khaimah, Umm-ul-Awain, Ajman, and Fujairah moved over unilaterally to the Saudi rial, while Abu Dhabi adopted the Bahraini Dinar. Now Muscat and Oman were the only sheikdoms where the special Gulf notes were legal tender. India's likely redemption liability in the third phase was about Rs 13 crores, and pending a settlement of the terms, these territories sought and obtained a suspense account arrangement with India.⁶

The rupee's devaluation in 1966 greatly complicated ensuing negotiations. In representations forwarded to India through the British government, the remaining sheikdoms where the rupee was still in circulation insisted that their legal tender should not be affected by the devaluation, and drew a distinction between an 'internal' rupee which India was 'legally and morally entitled to devalue' and an 'external' rupee which she could not, since it was 'issued against ... foreign exchange' provided by the people of these 'overseas territories'. The sheikdoms also complained at not having been consulted in advance about the devaluation. Initially, the Indian government maintained that there was only one currency, i.e. the rupee, printed in two distinct styles for operational convenience. There was no undertaking from India to maintain convertibility at any particular rate, nor was it practicable to consult overseas rupee territories before the decision to devalue was taken. Where India was concerned these initial exchanges drew lines in sand. Discussions which followed with a joint delegation of officials of the Gulf sheikdoms led by Hassan Kamel, Director-General and Legal Adviser of Qatar, turned largely on whether the 1959 decision on Gulf notes amounted to introducing a currency differing in standing from the rupees circulating earlier in the Gulf. Indian negotiators pointed out that Gulf rupee notes were introduced after an amendment to the Reserve Bank of India Act, and any intention at the time to treat them differently from the other liabilities of the Reserve Bank would have been manifest in an amendment to section 33 of the Act dealing with the

⁶ Rupees in circulation in the two sheikdoms were estimated at Rs 3.51 crores.

assets of the Issue Department. The Gulf delegation pointed out that the failure to promote such an amendment was a lapse on the part of the Indian authorities and that the sheikdoms could not be made to bear its consequences. The mere fact that Gulf notes were legal tender only in that region and not in India sufficed, in their eyes, to distinguish them from rupees circulating within India.

At this stage the Finance Ministry decided to refer the legal aspects of the case to the Solicitor-General. But notwithstanding the precise legal position, opinion also veered round to favour an ex-gratia payment to the Gulf states to help resolve the dispute amicably and with minimal dislocation to Indian interests in the region. If this payment took the form of exports of products of industries affected by recession, it might even open up long-term possibilities for increasing India's exports to the region. After further discussions, the two sides came to an agreement in March 1968 by which the total liability resulting from the repatriation of the rupee notes was put at Rs 12.88 crores. Besides a down payment of a fifth of the resulting sterling liability, £7.2 million was treated as a sterling loan carrying an interest rate of 5.5 per cent per annum, repayable in eleven equal annual instalments commencing January 1969.

CONCLUSION

Where the external sector is concerned, the period covered by this volume began with India in possession of large sterling reserves and facing pressures for a revaluation of the rupee. By the end of this period, the Indian development effort was gasping for the oxygen of external assistance on which it had grown to depend for the greater part of a decade. Thereafter, however, not nearly enough assistance was forthcoming from the World Bank and western donors despite a devaluation, the most important justification for whose timing was the promise of liberal western assistance to India. The failure of the promised aid flows to materialize was a sobering experience for India's policy-makers which reinforced their determination to reduce the country's dependence on external assistance to the greatest extent possible. The Indian leadership was willing in return to pay the price of more stringent controls over the external sector and lower rates of growth of output and income. The growth and financing assumptions and hopes of the late fifties and the early sixties had evaporated, but not, ironically as it happened, the trade regime which had accompanied these hopes and for liberalizing which aid and devaluation were the necessary preconditions. With one precondition, devaluation, satisfied and the other, aid, not, the events of 1965-67 mark this period down as one when the Indian economy missed a crucial turn for the better. Not because it could

not or did not back into the correct street, but because those entrusted with the responsibility for paving the street chose instead to dig it up after India had already gone down it a considerable part of the way.

Table 14: Foreign Exchange Reserves

Year	March	June	September	December
1955	892 (+3)	877 (-15)	882 (+5)	889 (+7)
1956	902 (+13)	839 (-63)	769 (-70)	684 (-85)
1957	681 (-3)	606 (-75)	505 (-101)	448 (-57)
1958	421 (-27)	372 (-49)	335 (-37)	344 (+9)
1959	379 (+35)	356 (-23)	352 (-4)	388 (+36)
1960	363 (-25)	327 (-36)	308 (-19)	319 (+11)
1961	304 (-15)	282 (-22)	293 (+11)	317 (+24)
1962	297 (-20)	241 (-56)	246 (+5)	244 (-2)
1963	295 (+51)	289 (-6)	267 (-22)	289 (+22)
1964	306 (+17)	279 (-27)	251 (-28)	237 (-14)
1965	250 (+13)	247 (-3)	241 (-6)	285 (+44)
1966	298 (+13)	581 (+283)	493 (-88)	456 (-37)
1967	478 (+22)	461 (-17)	434 (-27)	497 (+63)

NOTES: (1) All amounts in Rs crores.

(2) Includes gold held by the Reserve Bank of India, foreign assets of RBI, and government balances held abroad. Net borrowings from IMF have been included, wherever applicable.

(3) Figures in brackets are increase/decrease in reserves.

SOURCE: *India's Balance of Payments, 1948-49 to 1988-89*, pp. 476-78.

Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
HC/WB/IMF	Material Collected from the World Bank and IMF Archives
BFF-1	Correspondence with IMF
E.S.P.	Letters from ED (IMF)
HC/IMF/ED	Letters from ED (IMF)
BFM.39	Letters from ED (IMF)
MF	Letters from ED (IMF)
BFF-14	Report of the IMF Mission to India—Bernstein Report
CDN(O)8	IMF Consultations with India—1962
HC/IMF/DISC	Record of Discussions between Indian Representatives and: <ol style="list-style-type: none"> 1. de Lattre and Bell in July 1965 2. IMF staff in September 1965
HC/S.65	Notes/Correspondence Regarding IMF Standby for 1965
Sy.69	RBI Act—Suggested Amendments
Sy.97	Monetary and Exchange Agreements
HC/SA	Notes Prepared by DDBF & DIF on UK and the Sterling Area
BPF-32	Material Relating to Sterling Balances Negotiations
Conf:BP.60	Convertibility—Correspondence with Government 1955
E.S.P.32	Convertibility
HC/ISM	India Supply Mission (Washington) Balances
FE(N)-4	Balance of Payments Forecasts—Transmission to Government etc.
BPE-110/55	Taking over of Balance of Payments Compilation Work from ECD
DEIO-138(33)	Devaluation of the Indian Rupee in Terms of Gold and Non-devaluation of Pakistan Rupee
HC/N.P.C.	Newspaper Cuttings on Devaluation of Rupee—1966
BP.Com.C-11A	Withdrawal of Special Gulf Notes from Bahrain
BP.CDN(R)-20	Material and Correspondence with Government Relating to Import of Currency Notes etc.
HC/BOE	Material Collected from the Bank of England Archives
CDN(R)-17	Miscellaneous Correspondence

The Bank and Governments

The nature and scope of the regulatory functions discharged by central banks and their relations with other economic policy-making bodies, in particular the government, have been debated for the greater part of this century. The enduring interest in these subjects derives from the belief that the institutional organization of economic policy-making and the manner in which the several bodies entrusted with responsibilities in this sphere relate to one another exert a crucial influence both on the policy-making process and on the effectiveness and credibility of economic policies. Debates about central banking, both in India and elsewhere, have also been animated by political-economic considerations. These have, however, been relegated to the background in recent years by the popular distaste for inflation and the growing consensus over the intrinsic merits of central banking independence.

Central bank independence is usually understood to imply the freedom of the central bank to frame monetary policies. But there are no settled views about the institutional arrangements within which such freedom should be secured or exercised. Similarly, there is much more consensus now than in the past that monetary policy should aim at price stability, but little over the means of reaching this objective. The debate is thus by no means over.

This concluding chapter offers an interpretative account of the evolution of relations between the Reserve Bank and the governments in India during the years covered by this volume. Unlike a majority of central banks, the Reserve Bank of India undertakes a variety of 'developmental' functions. It remains debatable whether a wider set of responsibilities helps enhance the autonomy of a central bank in relation to the government and other institutions or limits

it, and it is not the object of this chapter to resolve the debate one way or the other. It is sufficient for the present to note that it is often not possible to separate the scope of a central bank's often conflicting responsibilities from any meaningful discussion of the degree of freedom it possesses, or its ability to exercise that freedom. Hence, while the narrative in this chapter will focus principally on the evolving relationship between the Bank and the central and state governments, the former's widening sphere of activity during these years is an important part of the context and background to it. However, we shall largely steer clear of a discussion of the merits or otherwise of the Reserve Bank of India undertaking a variety of regulatory and developmental roles, except to the extent that these might be said to have compromised the independent outlook of the Bank in relation to its principal objective—preserving monetary stability.

II

The most important aspect of its relations with the government generally concerns the central bank's role as the monetary policy authority. It is as the principal regulator of monetary and banking aggregates that the central bank influences macroeconomic variables in the economy. The government too, is not without influence over these aggregates through its public expenditure and financing decisions. The central bank's powers to moderate the latter's effects are limited. Nor can these powers always be exercised without distorting in some sense the allocation of financial resources in the economy. Besides, closely as the government and the central bank may attempt to coordinate policy, their views of policy and its objectives can often diverge. The resulting pluralism is not without its uses: it lends some richness to the economic policy discourse and may help modify the policy course in a timely manner and without recourse to excesses in either direction. At the same time, however, it portends a certain degree of friction, if not always of conflict, in relations between the two institutions.

Conventional wisdom suggests that governments, particularly in systems where the popular mandate to rule has to be renewed at regular intervals, tend to take a relatively short-term view of economic problems. Besides, in the division of labour that is generally thought to prevail in many parts of the world, governments are expected to concern themselves with domestic economic stability, which for the larger part of the last five decades has meant maintaining low levels of unemployment, while the central bank sees to the rate of inflation and to maintaining some notion of external stability. Neither view survives close scrutiny without damage. Central banks have not been

indifferent to short-term considerations especially given the close, lively, and everyday interest they take in the operations of the money market. Nor have they always been indifferent to problems such as unemployment or even to those of a deeper structural nature; while governments, especially in recent years, have themselves learnt to be more concerned than in the past about inflation. Furthermore, even today in a world used to floating exchange rates, few finance ministers can survive prolonged spells of external instability without damage to their political careers. The enduring faith in the division of labour referred to above rests not so much on empirical knowledge or presumptions about the natural dispositions of governments and central banks—which are not cast in stone—but to shared academic views about the relative efficacy of various policy tools in relation to the problems of unemployment, and inflation and external stability. Whatever its basis, however, it is useful whilst discussing the history of relations between the Reserve Bank of India and governments to keep this distinction in mind, since the former is entrusted by its statute with responsibility for ‘securing monetary stability in India’.

III

Until the 1920s, there were only about two dozen recognizable central banks all over the world. Until the first world war, central banks and treasuries of the countries of industrial Europe operated in a relatively simple environment. The two decades preceding the war were generally marked by price stability in these economies. Governments were expected to balance their budgets, there being no notion yet of an active fiscal policy, and this task was less difficult at this time than it was to prove later. Central banks, for their part, set their eyes firmly on the external account. Although price stability was not yet an explicit objective of policy, the commitment to fixed par values produced that outcome indirectly. Interest rate changes, as many contemporaries recognized, were not without their influence on economic activity at home. But with levels of unemployment generally low, rates were lowered or raised principally to repel or attract short-term inflows and reverse capital outflows. Interest rate movements in response to payments pressures did not always accord with the so-called ‘rules of the gold standard game’. The degree of central bank activism and of domestic resistance often varied, the greater volatility of the London discount rate, for instance, contrasting with the enviable stability of the Paris rate, since the authorities at the latter centre used a variety of ‘gold devices’ to stem outflows.

The extent of institutional interdependence between central banks under the pre-1914 gold standard is debatable. Keynes described the system as an

'international orchestra' conducted by the Bank of England, implying thereby that the other central banks responded more or less passively to signals emanating from London. But recent research suggests that central banks (or analogous contemporary institutions) were not really free to set interest rates, so great was the degree of convergence in the world economy at the time. While this was unambiguously the case for central banks (or analogous institutions) of small, open economies so long as their governments were committed to maintaining free trade and capital flows, doubts have been expressed even about the ability of the Bank of England to follow an 'independent' discount rate policy. If at all the Bank of England held the baton, this research suggests, it wobbled in its hands in response to the notes and cadences coming from the first violinists situated across the waters on either side of the British Isles.

The gold standard central banks may not have been independent of one another. But they were largely independent of their governments. Since interest changes took place principally in relation to external influences about which they understood relatively little, most governments were generally content to leave bank rate decisions to the central bank. According to a senior Treasury official who joined the Bank of England in 1927, 'a change in the bank rate was no more ... the business' of his former department before 1914 'than the colour which the Bank painted [on] its front door'. This was an exaggerated, and possibly interested view, and there is much evidence to the contrary. But few will dispute that gold standard arrangements and the priority given to free capital movements (or 'gold payments' in contemporary parlance) gave the central bank a relatively free hand in monetary management vis-a-vis the government.

The scope for independent monetary policies was greatly reduced in the interwar environment of high unemployment, particularly in the major European economies. Interest rate policy grew more contentious domestically even as higher interest rates were necessitated by the prevailing climate of international monetary instability marked by the collapse of the gold standard, and then by the laborious and ill-timed efforts to restore it. At the same time, the grip the gold standard, and in the British case the pre-war exchange rate, exercised over the imaginations of policy-makers in these countries was so complete that few among them explored alternative options until the 1930s. France was almost the sole exception as she floated the franc in the mid-1920s. Britain and several other countries had to undergo severe deflation before they could return durably to the gold standard at their chosen parities. But while remaining committed to a general policy of deflation, governments in these countries sought to regulate its intensity and speed with an eye

to the public mood. As Winston Churchill, the British Chancellor of the Exchequer in the mid-1920s, put it, the object of his policy, which in the event was not realized, was to see 'Finance ... less proud' and 'Industry ... more content'. Consequently, decision-making in regard to monetary policies, which had previously rested mainly with central banks, passed unambiguously into the hands of governments. The great depression, the collapse of gold standard arrangements, and the urgent need to boost recovery underlined this shift to the further disadvantage of central banks.

The economic role of governments expanded in the aftermath of the second world war. Even if this did not necessarily lead directly to central banks being relegated to the margins of policy-making, it nevertheless further diluted their role in the conduct of monetary policy. With the developed countries generally committed to full employment, their external transactions were regulated to varying extents, and conflicts between external and domestic balance considerations were resolved increasingly in the expansionary world economy of the 1950s and 1960s through greater policy coordination. Although the Basel club, which comprised some central bankers, played a useful role in ensuring international monetary stability under the Bretton Woods system, governments became more deeply involved than central banks in these coordination exercises. This situation changed but little following the collapse of fixed parities, the regime of floating rates actually giving governments of the developed countries a further degree of freedom which many freely abused. It is only since the middle of the 1980s, when something akin to a coordinated managed float regime was inaugurated in a climate of more liberalized capital flows, that a few central banks have begun to come rather more into their own. Since then the trend towards central bank autonomy has gained momentum from a variety of factors, including the move towards monetary union in Europe, the so-called globalization of many national economies, and not least, recent research findings about the impact on longer-term growth of high rates of inflation and of stop-go measures to regulate them. Even now, however, governments in several countries continue to retain an important say in matters that are more commonly regarded as falling within the purview of central banks.

To the extent it exists in any coherent form, the doctrine of central bank independence was formalized in the troubled 1920s. Although the Brussels and Genoa financial conferences and the League of Nations bestowed their legitimacy on the idea, the moving spirit behind it was clearly Montagu Norman, Governor of the Bank of England, who was ironically enough during these years presiding over an institution which was increasingly ceding its

autonomy, though not yet its judgement, to Whitehall. The propagation of the doctrine coincided with the spread of popular government in Europe and elsewhere, and one of its principal objects was to insulate monetary policies, particularly in the context of the restored gold exchange standard, from the pulls and pressures of domestic politics. Consequently, the creation of independent central banks became an important plank of the European financial stabilization programmes that Britain, in particular, underwrote or participated in during the decade.

Political considerations played the pivot in shaping the constitution of the Reserve Bank of India when it was founded in 1935. The political landscape of the period was dominated by the prospects for constitutional reform and, where the British financial stake in India was concerned, by the growing shadow of representative, if not popular, governments coming to power at the centre. Fearing the effects on 'currency and exchange' of entrusting these subjects to a minister answerable to an elected legislature, the colonial authorities preferred to set up, singularly in opposition to the dominant sentiment in India at the time, a privately owned and managed Reserve Bank as part of the new constitutional arrangements. But the colonial government in Delhi and London had little use for an independent Reserve Bank after it became clear that the Finance Department would remain, even in the reformed dispensation, in the hands of a non-elected European official responsible to the Viceroy rather than to the legislature, and that far from returning members disposed to side with the government uncritically, elections to the Central and Local Boards of the Reserve Bank had led to these bodies being dominated by 'nationalist' businessmen. As some recent research reveals, the measures the colonial government took thereafter to rein the Reserve Bank in and curb its capacity for independent action included getting rid of Osborne A. Smith, the first Governor of the Bank, and threats to supersede the Bank's Board should it recommend monetary and exchange rate policies unpalatable to the government or to the authorities in London. By the time the war ended, however, a privately owned central bank had become an anachronism. The Bank of England was taken into public ownership by the post-war Labour government in 1946, and the Reserve Bank of India too, was taken over by the Government of India about three years later.

IV

The post-independence government in India could not afford to remain indifferent to the challenge of rapid economic development. As its spheres of engagement with the economy widened, so did the Reserve Bank's, and the

latter was called upon increasingly to advise the government or take initiative on matters lying outside the traditional domain of central banking, such as the planning process, organization of agricultural credit, development of cooperative organizations, term financing of industry and financing of exports, the development of handloom and small industries, the administration of exchange control, and even the promotion of tourism. The logic underlying the Bank's vision of its wider responsibilities has been spelt out elsewhere. Let us merely point out here that the resulting widening of the Bank's sphere of activity greatly increased the range of its contacts with both the central and state governments. Although the Finance Ministry remained its most important link with the government, the Bank also worked with the Planning Commission, and the ministries of agriculture, cooperation, and industry and commerce.

Likewise, the Bank was called upon to conduct state governments' banking operations, make advances to them, deal with the problem of states' overdrafts, and also help them raise loans in the market. These functions, which in some respects were unique among central banks to the Reserve Bank of India, and its responsibilities in the sphere of rural credit which was properly a subject for the states, brought the institution into close contact with their governments. Relations with the latter were beset, moreover, by political considerations and the proclivity of central agencies such as the Planning Commission to step up states' investment outlays. Enforcing a measure of financial discipline on state governments was complicated by a variety of factors, and the Bank was consequently drawn once again to work closely with the Finance Ministry of the Government of India to tackle this problem. Generally too, for reasons discussed below, the widening of the Bank's ties with various departments of governments produced the paradoxical effect of reinforcing its ties with the Finance Ministry.

The Administrative Reforms Commission set up a working group to study the working of the Reserve Bank in 1969. Describing the Bank's 'promotional and developmental' responsibilities as a 'historical accident', the working group's report argued that these 'did not go well with its role as a Central Bank'.

If as a Central Bank the R[eserve] B[ank of] I[ndia] is to discharge its main functions of management of money, development and regulation of banking and credit policies, and administration of exchange control, it should not be bothered with ... developmental and promotional functions,

the working group recommended.

It is worth noting that even this body saw the 'development ... of banking' as a key responsibility of the Reserve Bank. Although some of its recommendations were carried out in subsequent years, the reform (if such it was) was piecemeal, and few contemporaries ventured even as far as the working group in delimiting the Bank's functions. Speaking in Parliament on the Banking Laws (Miscellaneous Provisions) Bill in December 1965, Minoo R. Masani drew the government's attention to the dangers for the quality of its 'supervision and leadership' of enlarging the Bank's responsibility for managing the operations of commercial banks. But his views had little impact at the time.

In July 1957, the Governor, H.V.R. Iengar, commissioned studies by the Bank's officials of relations between central banks and governments in other countries. Iengar's immediate object was to seek a review of the 1955 arrangement on ad hoc treasury bills, which was discussed at some length in chapter 2, and on which more is said below. Understandably, while the Bank's studies examined the nature of relations between central banks and governments in several countries, they focused on the former's role in financing governments' ways and means. A few weeks earlier at the end of May 1957, Finance Minister T.T. Krishnamachari had announced in Parliament his intention to divest the Bank of its role as the apex lending agency for cooperative credit institutions and land mortgage banks. This led to some discussion of the scope of the Bank's responsibilities outside the narrow field of monetary policy. But it is significant that though taking place at the same time and initiated within the Bank by the Governor himself, the two exercises did not intersect at any point.

In the mid-1950s, the Reserve Bank was disposed to acquire ownership of a few banks associated with the former princely states, which the All-India Rural Credit Survey recommended in 1954, should be taken over by the State. Though unusual, it was not unknown for a central bank to participate in commercial banking operations either directly or through one of its subsidiaries, and many banking authorities in fact recommended such a course for countries with poorly developed banking systems. Although the Hyderabad State Bank passed initially into the Reserve Bank's hands when it was nationalized in 1956, state-associated banks were in the end taken over and reconstituted as subsidiaries of the State Bank of India. The Bank became the majority owner of the State Bank when it was formed out of the Imperial Bank of India, but exercised little operational control over it.

Officials at Mint Road drew a line at exercising administrative control over the stock exchanges. In April 1957, TTK suggested to Iengar that the government should yield to the Bank the powers vested in it under the Securities Contracts (Regulation) Act, 1956 to manage these

institutions. This Act gave the government powers to recognize stock exchanges, make or approve rules, make or amend bye-laws, supersede their governing bodies, and suspend their business. The Bank was, in the Finance Minister's view, in the 'best possible position to exercise control' over stock exchanges because it was not subject to 'administrative and political pressures such as are daily sought to be exercised on [the] government'. Control over stock exchanges, TTK also appears to have felt, 'dovetailed' neatly into the 'area of general monetary control'.

The Bank acknowledged that since stock exchanges played a 'vital part' in providing the market for both government securities and stocks and shares, it was essential for it to have a 'close and intimate knowledge of their functioning'. It was therefore willing in principle to allow its officers to be nominated as directors of recognized stock exchanges, maintain close contact with the office set up by the government to administer the Securities Contracts Act, and give it every assistance. Iengar was also in favour of a 'convention' whereby the government was always guided by the Bank in its actions under the legislation, so that 'it would be the Bank which would be administering the Act and not [the] Government'. But it was not 'desirable' for the government to give up statutory responsibility for overseeing stock exchanges or place it on the Reserve Bank. Iengar's personal experience of the functioning of stock exchanges taught him that no matter how the authorities acted in a crisis, controversy was impossible to avoid; while the Bank's experience of the bullion exchange was that the position of its directors turned 'most unpleasant' whenever a controversy developed. The government, Iengar informed TTK in April 1957,

can never escape the odium of taking decisions and sticking by them. This is what Government have to do every day and, in a democratic set-up, they are well accustomed to being shot at by every group which is disgruntled. But I think it would be a mistake to bring the Reserve Bank into such fields of controversy. The Bank has a high reputation because it is known to be engaged, in an atmosphere of detachment, in carrying out the responsibilities laid on it by Statute. Once the Bank gets mixed up in the controversies of the stock exchanges—and controversies in these organizations are liable to be particularly heated—the reputation which the Bank has is liable to suffer

That, Iengar added, would not be 'in the national interest'.

It is somewhat ironic, against this background, that Iengar should have himself been in the eye of the storm raised by the Mundhra affair. The latter

is discussed in appendix D. But following the controversy, the Bank decided to review some of its wider commitments, including those it was willing to shoulder in April 1957, in order to 'minimize the scope for possible misunderstanding of its position in the interest of upholding the highest public confidence in the monetary management of the country'. This review, which resulted in a Central Board memorandum on the subject, concluded that the Bank's 'functions should not be so diffused as to jeopardize its ability to carry out its primary responsibility as the monetary authority of the country'. At the same time, the memorandum counselled against the Bank withdrawing into an 'ivory tower'. As Iengar later explained the purport of the Central Board's resolution to the government, while the Bank should continue as in the past to 'function on a liberal rather than a narrow interpretation of its ... responsibilities' and not shirk its duties towards agriculture and small industry, it should disengage itself from bodies such as stock exchanges and commodity exchanges. Nor, according to Iengar, should the Governor or Deputy Governor be associated with the proposed investment board of the Life Insurance Corporation.

The Mundhra affair merely made the Bank pause for breath and did not fundamentally alter the course of its subsequent development. As discussed in chapter 9, TTK did not carry out his threat of May 1957. Although it was, in C.D. Deshmukh's words, a 'last minute inspiration', the Reserve Bank of India Act, 1934 already envisaged an important role for the Bank in the sphere of rural credit which it began to discharge in earnest from 1950 and endeavoured to enlarge during the next decade and a half. Its expanding involvement during these years in promoting term-lending to industry and the financing of exports and small industries was largely an outgrowth of contemporary ideas about its role which already commanded wide acceptance and legitimacy, and which were currently in the process of being realized in the sphere of rural credit. As such, this role too was initiated and expanded with little debate or controversy.

After the second world war, the Bank began acquiring powers to regulate the working of commercial banks. The latter were understandably not enthusiastic about regulation, in particular the regime of detailed inspections prescribed by the Banking Companies Act, 1949 which had few parallels at the time. But in keeping with contemporary views about the role of central banks, the Reserve Bank was also entrusted with the task of overseeing the functioning of these institutions. While the Bank's powers of supervision over commercial banks were strengthened during the 1950s and 1960s, they were also expanded towards the middle of the latter decade to cover cooperative banks and the deposit activities of non-bank financial companies. Few were

disposed to question even at this time the advantages of extending the Bank's control to the latter set of institutions or indeed of those of giving it power to effectively regulate only a part of their activities. On the other hand, the rise in non-bank institutions' public deposits was a result of the growth of direct controls over banks' deposit and lending activities, and the latter could hardly have been sustained without some regulation over the former. The debates and disagreements that occurred over the Bank's role in relation to cooperative banks too, merely highlighted the constitutional and practical aspects of endowing a central institution with powers to regulate the functioning of institutions which were subject in other matters to the jurisdiction of their state governments.

The Bank's role in financing state governments evoked some discussion in 1950–51. The preference of the two Deputy Governors, N. Sundaresan and Ram Nath, was to steer clear of state government loans while continuing to manage the issues of states willing to entrust this responsibility to the Reserve Bank. But the Bank decided at the instance of the Governor, B. Rama Rau, to support these loans to a limited extent. The context for this decision was clearly political. Schemes were under way to promote a modicum of integration in the financial sphere of the states and regions of the country which were coming together in the political sphere. The extension of banking treasury and currency chest arrangements was considered an important aspect of the process of financial integration, and the Reserve Bank's role in this regard—in particular its appointment as banker to individual state governments—was therefore judged to be crucial. A limited contribution towards their loans was thus felt to be a small price to pay for earning the goodwill of state governments proposing to enter the market, and for encouraging others to appoint the Reserve Bank as their bankers. Hoping to further promote the same objective, the Bank also agreed in the early 1950s to increase its ways and means advances to state governments. Although the implications for monetary stability of the Bank helping to finance state governments directly were not lost on officials, the view at the highest level of the Bank focused on the overwhelming political and economic advantages of promoting the financial integration of the Union. Fears that the price paid for financial integration might endanger monetary stability surfaced in the mid-1950s, as state governments ran up substantial overdrafts. Yet it was not until a decade later that in desperation, the Bank considered relinquishing its role as bankers to state governments which were 'chronically' overdrawn. Not only was this idea not implemented, neither the Bank nor the central government could thereafter summon the will to adopt the less radical step of stopping payments of state governments having large and persistent overdrafts.

It would be fair to argue therefore that, except in the context of the financing of state governments' deficits and to a lesser degree in the wake of the Mundhra affair, contemporaries did not generally perceive the likelihood of the Bank's other roles eroding or weakening its commitment to monetary stability. If anything, as became clear when Krishnamachari initiated his manoeuvres in the summer of 1957 to divest the Bank of its responsibilities in the sphere of rural credit, its commitment to monetary stability became a further justification in the Bank's own eyes for undertaking promotional and developmental responsibilities, since the central bank alone could discharge the latter without prejudice to the former. On the other hand, the fear in the Planning Commission and the agriculture ministry was precisely that the Bank would subordinate its rural lending activities to conservative monetary policy considerations or to those of institutional stability. Hence these departments sought to erect lines of credit and rules of financing that did not involve the Bank directly, and which appeared to it to endanger the integrity of the cooperative movement and carry, more widely, the potential to endanger the stability of the country's financial system.

The Bank may have been willing, in the last resort, to forsake its developmental responsibilities and nail its colours solely to the mast of monetary stability. But Mint Road's own preference, both in this instance and subsequently, was to defend its claim to the former. There was considerable justification for doing so since, though as yet unstated, the Bank tended to view these responsibilities as part of the 'institutional dimension' of its monetary policies. Besides, the Reserve Bank was better equipped than other agencies during these years to promote the reach and development of the country's financial system. However, in making this choice, the Bank was drawn ineluctably into expanding the size and scope of its developmental responsibilities. Widening its areas of activity and influence never became an end in itself during our years. Nevertheless, it also remains moot how far officials in the 1960s continued to view the Bank's less traditional pursuits in the manner their predecessors had done a decade earlier, as part of an effort to moderate populism rather than bow and bend to its every whim. Equally perhaps, on the other hand, the Bank had left itself few options on this score. Having ceded to the Government of India in the mid-1950s the power to draw on its credit virtually without limit, there was little the Reserve Bank could do to rein in a government disposed to adopt populist measures, except through greater institutional engagement with its different agencies. Not surprisingly, while these engagements may have increased the Bank's influence, they did so at the cost of its institutional autonomy.

Once the Bank began to shoulder and finance wider developmental responsibilities, its ability thereafter to reconcile them with the demands of monetary stability turned increasingly on the alliances it built within the government machinery. Paradoxical as it may seem to those disposed to locate the conflict between the central bank and the government in the narrow domain populated by monetary and fiscal policies and their respective objectives and institutions, the Finance Ministry emerged as the Bank's natural ally in the interdepartmental manoeuvring into which the latter was drawn during these years. While its close relations with the Finance Ministry enhanced the effectiveness of the Bank's intervention on a number of matters having important financial or monetary implications, particularly when these were handled primarily by other departments, they perhaps lulled the Bank into a sense of complacency vis-a-vis the Finance Ministry itself, and weakened its hand in dealings with that institution.

Thus, already by the mid-fifties, an unwary Bank appears to have perceived a closer consolidation between its views and those of the Finance Ministry than was warranted by circumstances or justified by experience. The best example of this is its almost casual acceptance of North Block's suggestion to keep the government in funds by crediting its account, whenever balances fell below Rs 50 crores at the end of each week, with money created against the issue of ad hoc treasury bills. Let alone a careful consideration of its likely consequences, no need was felt at the time even to explain or justify an arrangement which was viewed purely as an accounting convenience. No thought was given until over two years later to the possibility that the central government might be tempted to abuse the facility. Nor were other aspects of the arrangement—such as its impact on the Finance Ministry's ability to restrain the spending departments or that of the Bank to check state governments' overdrafts—considered at all at the time. So much so, in 1955 the Deputy Governor, K.G. Ambegaokar, made bold to counsel the central government against floating a second tranche of its loans on the ground that the government could place itself in funds more cheaply by creating ad hoc treasury bills! The 1955 arrangement also had the effect in due course of encouraging the Bank to increase its subscriptions to central government loans. As matters turned out, easy recourse to central bank credit not only eroded fiscal prudence at the centre, but more relevantly for our period, it also helped state governments to run overdrafts since a substantial part of these was subsequently taken over by the centre against fresh loans from the Reserve Bank. It is also far from clear that by agreeing to expand credit to the government, the Bank actually performed a service to the Finance Ministry. A less permissive regime may have strengthened

this department's civil servants, if not necessarily their political masters, in negotiations with state governments and the spending departments of the central government. As it happened, with this single indiscretion the Reserve Bank surrendered to the government a vital element of monetary control. The liberal availability of central bank credit greatly strengthened the Finance Ministry in relation to the Bank, and although the erosion of the latter's standing vis-a-vis the former may not have been palpable until nearly two decades later, its origins may be traced, at least in part, to the arrangement of 1955.

V

Since passing into public ownership in 1949, the Reserve Bank of India is an institution which is owned by the Government of India. Its capital is fully subscribed by the central government which also receives the surplus profits of the Bank. As discussed in another chapter, the Bank's discharge of governmental banking responsibilities is largely governed by sections 20, 21, and 21A of the Reserve Bank of India Act. The wider public responsibilities of the Bank are reflected generally in the provisions of section 17 of the Act which contains numerous subsections, clauses, and subclauses. Sections 7 to 13 of the Act deal with the management and the general superintendence of the Bank.

The overall superintendence and direction of the affairs of the Bank rest, under the Act, with the Central Board of Directors. The latter comprises the Governor and up to four Deputy Governors, all 'appointed by the Central Government'. The Directors of the Central Board are all nominees of the central government, one each from the four Local Boards of the Bank, and eleven other Directors of whom one, usually the Finance Secretary to the Government of India, is a non-voting government official. In addition, the central government also appoints five members to each of the four Local Boards of the Bank.

The central government's powers to nominate Directors had not always been so extensive. The Reserve Bank of India Act as passed in 1934 and worked until the Bank's nationalization in 1949 provided for Directors and members of Local Boards elected by shareholders. This arrangement gave way to nomination when the Bank passed into public ownership. The effects of this change were obscured for a number of years by the continuity of its composition, with Directors such as Purshotamdas Thakurdas, B.M. Birla, Shri Ram, and C.R. Srinivasan remaining on the Central Board for many years after the Bank's nationalization. Even

thereafter for the most part, Directors nominated by the central government brought an independent outlook to bear on the deliberations of the Board.

The central government also has the power to appoint or reappoint the Governor and Deputy Governors for terms of up to five years. Governors and Deputy Governors are not appointees of the Bank but of the Government of India, and officials of the Bank elevated to these executive positions resign their former appointments to join the service of the central government. The central government also has the power to 'remove from office' the Governor, the Deputy Governor, or any other Director or member of a Local Board. Finally, the government can, in the event of the Bank failing to carry out its obligations under the Reserve Bank of India Act, supersede the Central Board, and vest the general superintendence and direction of the Bank in any agency of its choice. While these provisions, other than those relating to the nomination of Central and Local Board members, have been in the statute book since the original Act was passed, section 7(1) of the Bank Act was amended at the time of nationalization in 1949 along the lines of section 4 of the Bank of England Act, to empower the central government to give 'from time to time ... such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest'. The Bank sought a more elaborate provision requiring the government to formally 'accept responsibility' for the action resulting from its directions, but yielded to the latter's preference for the English precedent.

Inevitably, in addition to these formal statutes and regulations, relations between the Bank and the government—in particular the Treasury–Bank relationship—are also subject to a number of institutional and interpersonal factors. No reckoning of the latter can afford to ignore the large number of career civil servants inducted into the Bank as Governors, Deputy Governors, and Executive Directors of the Bank.

The first Governor of the Bank—Osborne A. Smith—was a commercial banker who was hand-picked for the position by Montagu Norman. Osborne Smith's tenure was a short one, and his successor, James B. Taylor, was a member of the Indian Civil Service until he resigned from the cadre to become Osborne Smith's deputy. Taylor's precedent has not always been followed by other civil servants appointed to executive positions in the Bank, despite the Central Board's repeated efforts during the 1950s to underline this principle to the central government. Taylor was succeeded by C.D. Deshmukh who also belonged to the ICS. So indeed did three of the four Governors—B. Rama Rau, H.V.R. Iengar, and L.K. Jha—who held office during the years

covered by this volume.¹ Alone among the Governors of our period, P.C. Bhattacharyya (1962–67) did not belong to this exclusive club. But he too was a career civil servant belonging to the Indian Audit and Accounts Service.

In addition, the Bank saw a steady migration of civil servants from the government, either as Executive Directors or as Deputy Governors. B. Venkatappiah, ICS, who was earlier Finance Secretary in the Bombay government, entered the Bank as Executive Director and rose to become a Deputy Governor before taking over as Chairman of the State Bank of India in whose creation and transformation he had played a major role. K.G. Ambegaokar was Secretary for many years in the central government before he came to the Bank as Deputy Governor. Others who served in the Finance Ministry in senior positions before coming to the Bank as Deputy Governors or Executive Directors during the 1950s and 1960s included N. Sundaresan, M.V. Rangachari, R.K. Seshadri, J.J. Anjaria, B.N. Adarkar, and A. Baksi.² In addition, other civil servants such as M.R. Bhide moved from the Agriculture Ministry of the central government to join the Bank in senior executive positions. Indeed, of the thirteen Deputy Governors appointed during 1951–67, only five, J.V. Joshi (who held office for four months), Ram Nath, C.S. Divekar, B.K. Madan, and D.G. Karve, did not come from any wing of the government. Of these five, only the first four came from within the Bank, where the steady flow of government servants into senior positions was viewed with mixed feelings, the delay especially in Madan's well-deserved elevation to the post of Deputy Governor appearing to have caused some resentment. Karve was a distinguished academic and cooperator.

Despite the long tradition of appointing ICS officers in particular as Governors, the practice continued to raise eyebrows as late as 1967 when parliamentarians such as Madhu Limaye raised the issue with the government. However, civil servants need not necessarily submit the Bank to the tutelage of the Finance Ministry or more widely to that of the central government. N. Sundaresan, who was a Deputy Governor in the early 1950s, had earlier served in the Indian Audit and Accounts Service, but he reconstructed himself so comprehensively in the image of the orthodox central banker that one is easily liable to overlook his past. Besides, neither Rama Rau nor Iengar had served in the Finance Ministry.

¹ K.G. Ambegaokar, who was Governor for a few weeks between Rama Rau's exit and Iengar's coming to the Bank, also belonged to the Indian Civil Service. So did N.R. Pillai, who was appointed to succeed Rama Rau, but did not take up the office.

² Anjaria was formally an officer of the Bank on deputation to the Government of India. He however saw little active service at Mint Road before returning as Deputy Governor in 1967.

L.K. Jha was earlier in the Finance Ministry. He confessed in a newspaper interview in April 1984 to having held a 'basic reservation about conservative monetary policy'. Jha regarded 'development to be a more important goal of economic policy in ... India than [the] stability for which central banks normally strive'. 'Monetary constraints', he argued, produced 'stagnation, not stability', and this view determined his 'basic approach' as Governor of the Bank. Jha himself attributed his view to the 'Keynesian influence' (he read economics at Cambridge) and 'assignments ... in government'. But it is difficult to tell where the former's influence ended and the latter's began, or how far their 'assignments in government' predisposed officials in the Finance Ministry to take a particular corporate view of economic policy.

Jha did not hold office for very long where this volume of the Bank's history is concerned. Of the Governors who served a full term in office during our years, only Bhattacharyya had worked in the Finance Ministry before moving to head the State Bank of India where he succeeded Iengar upon the latter's elevation as Governor of the Bank. So that to the extent a common manning pool (this term is hardly inappropriate since no woman held office even as Executive Director during these years) may have assisted in this outcome, the close relations existing during our period between the Finance Ministry and the Bank were forged more at the level of Executive Directors and Deputy Governors than at the highest level.

Even in retrospect it is hard to determine the extent to which the presence of civil servants in senior positions compromised the independence of the Bank. Nor is it possible to separate their influence from that of the intellectual and ideological climate of the day. But it is entirely likely that with one or two exceptions, the induction of former civil servants directly at the top encouraged the Bank to venture into areas which more traditional central bankers with less public experience may have wished to steer clear of. That the Bank tended to take a narrower and more insular view of its responsibilities in the late 1940s than became its wont in the subsequent decades is undeniable. As late as 1951–52, the two Deputy Governors, Ram Nath and Sundaresan, took a dim view of diluting the Bank's core central banking functions.

Whether this insular outlook would have survived the climate and challenges of the 1950s regardless of who ran the Bank, is a question that can never be satisfactorily answered. But it is sobering to recall that the world over in the 1950s, central bank autonomy was thought to be a relic of the past. In an age dominated by government, many central banks were content to be relevant and grateful for influence. Lest we overburden the past with our present-day preoccupations, it is also worth remarking that the Reserve Bank of India's international stature appears at this time to have been considerable. It was

often invoked as a model for other central banks in the developing world, and at least until 1955, it possibly wielded a greater influence over the government than the central banks of several other countries including the Bank of England.

It was left to Rama Rau, who as well as being an experienced civil servant maintained close links with business and industry, to bring some fresh air into the corridors of the Bank in the early 1950s. With Venkatappiah's arrival at Mint Road soon afterwards, the whiff turned into a gust as he led the Bank, with not a little support from the Governor, into paths which no central bank had ventured into before. Rama Rau's later years in office were ones of relative quiet, or of consolidation if one is disposed to take a more generous view, and he was a tired man by the time T.T. Krishnamachari forced him out of office in January 1957.

Though a former civil servant, Iengar, who succeeded Rama Rau, was elevated as Governor after having successfully initiated the task of orienting the former Imperial Bank towards non-traditional banking goals. So that he came to the Bank with something of a crusader's spirit. The Bank steadily expanded its commitments and widened the scope of its engagement with a variety of agencies during the Iengar years. The latter part of Iengar's tenure was once again marked by a desire to consolidate rather than expand.

This continued to be a feature of Bhattacharyya's early months in office. Self-effacing by temperament but firm when it mattered, Bhattacharyya's tenure coincided with the pursuit of a more active monetary policy. He shared a good working relationship with the three Finance Ministers—Morarji Desai, T.T. Krishnamachari, and Sachindra Chaudhuri—who held office during these difficult years. Bhattacharyya's relations with TTK, in particular, were very close. He was at the State Bank during TTK's earlier stint as Finance Minister when the two men together weathered the Mundhra storm. Krishnamachari's return to the Finance Ministry in August 1963 accelerated the pace of institutional development with startling suddenness, and the Bank under Bhattacharyya's leadership effectively complemented TTK's initiative to set up institutions such as the IDBI and the Unit Trust.

Thanks to the complementary roles they played in guiding institutional and developmental initiatives and financing programmes to fruition during these years, the Bank and the Finance Ministry managed to establish a close working relationship. It is clear from the Bank's records that the Governor and the Deputy Governors regularly advised the government on a variety of issues, including some in which the Bank could have little interest in any capacity. The Bank also substituted for the government on more than one occasion. The Rural Credit Survey, whose Report became its gospel in this sphere for the next decade, was entrusted to the Bank because the government

preferred to have the subject studied first at a technical level and possibly wished to diminish public expectations about the likely scope of reform. For similar reasons, the Shroff Committee on financing the private sector was again constituted by the Bank rather than by the central government.

On the other hand, the Government of India failed even to consult the Bank, let alone give it a fair hearing, on some very fundamental issues with significant monetary policy implications. For example, the Bank's views were not sought either on the first plan or, more startlingly given its size and the financing problems involved, on the second plan until after these were finalized. The Finance Ministry too, according to T.T. Krishnamachari's letter to Jawaharlal Nehru written in the wake of the foreign exchange crisis of 1957-58, was kept in the dark about the financing aspects of the second plan.

VI

Under the Reserve Bank of India Act, the Bank is subject to the control of the central government. The government's control sat lightly upon the Bank in the early years of our period. So wide indeed was the latitude allowed to the Bank and the Governor at this time, that the financial press thought nothing of speculating about the prospects of the Finance Minister, C.D. Deshmukh, returning to Mint Road in 1954, or of the former Finance Minister, John Matthai (who was later appointed the first Chairman of the State Bank of India), becoming Governor when Rama Rau's term in office ended. But events in 1956-57 underlined with startling clarity that it was possible for a powerful Finance Minister to transform levers of influence that had largely lain dormant for many years into instruments with which to subordinate the will of the Bank to his own. These events culminated in Rama Rau's resignation as Governor directly as a result of disagreements with Finance Minister T.T. Krishnamachari, which erupted into barely concealed conflict late in 1956, and Prime Minister Jawaharlal Nehru's refusal to distance himself from TTK's efforts to undermine the independence of the Bank. The Rama Rau resignation episode was a defining moment in the Bank's history during our period. It also sheds light more widely on relations between governments and public institutions in India. Therefore, it is instructive to dwell upon this episode at some length.³

³ The papers bearing on this episode, including the letters exchanged between Jawaharlal Nehru and Rama Rau, are reproduced in the selected documents at the end of this book.

Differences between Rama Rau and Krishnamachari appear to have gone back a long way. While there is no dearth of speculation as to the origins of these differences, it is sufficient for the present to note that the new Finance Minister had for some years held an unflattering opinion of Rama Rau.

As a backbencher, the future Finance Minister campaigned for the nationalization of the Imperial Bank of India. Even as Minister for Industry and Commerce in the Union Cabinet, he took a close interest in the subject. Writing to the Finance Minister, C.D. Deshmukh, in September 1952 to press for greater control over the Imperial Bank, Krishnamachari confessed that he was 'prejudiced against Rama Rau and [had] criticized his appointment as Governor in the past'. Although his views of the man had 'undergone a change in his favour' subsequently, TTK maintained that Rama Rau was not a 'sound guide' on matters related to the Imperial Bank. Krishnamachari also appeared to imply in this letter that Rama Rau opposed taking the Imperial Bank into public ownership, among other reasons because an alleged 'stooge' whom Roderick Chisholm, the Managing Director of that institution, was 'grooming' as his successor was a close relative of the Governor. Rama Rau's path crossed Krishnamachari's at other times as well. For instance, in 1954 the Governor circulated a note arguing for a scheme of time-bound support for the handloom sector administered through institutional financing agencies to replace the existing cess fund scheme. Krishnamachari, who favoured the latter, took violent exception to this note, and in particular to its quoting—and purportedly misrepresenting—his remarks to the Cabinet on the issue.

Relations between Deshmukh and Rama Rau were cordial to begin with and correct at all times. Though as Finance Minister, Deshmukh could sometimes be sensitive to criticism by the Reserve Bank, he was determined for the most part to respect the Bank's autonomy and stature and enjoyed the confidence of the Bank, and of Rama Rau in particular. Relations between Deshmukh and Rama Rau may have been strained towards the end of the former's term in office. Deshmukh, for example, was clearly puzzled by the intensity of Rama Rau's opposition to the takeover of all the so-called state-associated banks. For reasons that are not altogether clear but which may have had their origins in the internal politics of the Congress party and the government, Deshmukh (who in 1955–56 also yielded to pressures to nationalize life insurance business in India) was eager to implement the Rural Credit Survey's blueprint for these institutions. Rama Rau favoured nationalizing only three state banks in the first instance, and there is some evidence that Deshmukh perceived the Governor's attitude towards the issue as being obstructive rather than helpful. Rama Rau too, appears by this time to have tired of his prolonged stint as Governor. In office since 1949, it was

with some difficulty that he was persuaded by the Prime Minister and the Finance Minister, both of whom wanted him to see the Rural Credit Survey's recommendations through to fruition, to continue for two more years when his extended term expired in March 1955. It was probably clear to Rama Rau by now that there was little he could look forward to in public service, and he may have also seen the writing on the wall for the Bank's influence in the new policy dispensation which was beginning to coalesce around the Planning Commission at this time. Whatever their differences, however, Deshmukh and Rama Rau formed a close and cordial, if not always a cohesive team, with each person respecting the other and giving him and his institution adequate space and autonomy.

Deshmukh's resignation in July 1956 over the report of the States Reorganization Commission and Krishnamachari's appointment soon afterwards to the vacant Cabinet position could not have greatly increased Rama Rau's enthusiasm for his job. TTK too, for his part, appears to have done little to make the Governor feel at ease or to reassure him. On the contrary, according to Rama Rau's letters to Nehru and TTK, the latter behaved towards him with 'personal rudeness', used 'very rude language', passed 'rude remarks', and indulged in 'rude behaviour'. Rama Rau protested at this attitude 'more than once' and would have, but for the Prime Minister's intervention, handed in his papers earlier. Precisely when these instances of rude behaviour commenced is impossible to establish. But it is clear that within weeks of assuming office as Finance Minister in August 1956, Krishnamachari began making his differences with Rama Rau over the busy season credit policy public, even going to the extent of announcing, pointedly in the Governor's presence, a monetary policy stance which was at variance with that signalled or preferred by the Bank.

Relations between Rama Rau and the new Finance Minister were thus never cordial. But the provocation for the series of public and private incidents culminating in the Governor's resignation sprang from differences between the Bank and the Finance Minister over one of the supplementary taxation proposals the latter tabled in Parliament at the end of November 1956. The controversial proposal envisaged an increase in the stamp duty on bills from 2 annas per Rs 1,000, at which rate it had remained since 1940, to a maximum of 160 annas or Rs 10 per Rs 1,000, and immediately to 80 annas or Rs 5 per Rs 1,000. So steep an increase in the stamp duty had immediate implications for the viability of the Reserve Bank's bill market scheme.⁴

⁴ The bill market scheme is described in chapter 3.

The Next Hold-up

Mr. Krishnamachari has been speaking of further measures to raise funds for the Plan.

— *Shankar's Weekly*, 30 Dec. 1956

It is possible that soon after taking over as Finance Minister, Krishnamachari had decided to force a confrontation with Rama Rau. His decision to raise the stamp duty on bills is otherwise inexplicable. The stamp duty proposal may appear little different at first sight from an interest tax such as has traditionally divided governments and central banks. TTK believed in mobilizing larger tax resources in every possible way and was undoubtedly something of an innovator in the fiscal sphere. He also favoured levying an explicit interest tax in 1965 during his second stint as Finance Minister, but was dissuaded by Bhattacharyya from doing so. But the analogy between the stamp duty increase TTK effected and the interest tax is an inexact one. So wide was the range over which the Finance Minister sought powers to vary the stamp duty by executive order, that it had the potential to translate into a hike in the effective lending rate under the bill market scheme of one percentage point, or an implicit 'tax' on the interest paid on accommodation against bills of nearly 29 per cent at the prevailing Bank rate of 3.5 per cent. Even the duty TTK proposed immediately to levy—of half of one per cent—meant a 'tax' of about 14.5 per cent on the interest charged or paid by banks on advances involving bills, at a time when the minister himself was in favour of easing financial stringency. Besides, revenues from stamp duties were collected by the centre for distribution to the states and

though not trivial, the benefit to the latter's resources of the hike was unlikely to have been substantial. The Finance Minister refused to divulge to Parliament any estimate of additional revenue from the higher stamp duties on the plea that the latter were not intended to raise resources. But to judge from aggregate bill market drawings in 1956 of Rs 436 crores, it is unlikely that the total stamp duty collections on usance bills at the proposed new rate would have greatly exceeded Rs 2 crores.

Nor was Krishnamachari's defence of the hike in Parliament and elsewhere convincing. His argument that the move was intended to promote the use of bills is almost perverse. The Finance Minister also justified the increase as a credit control measure falling short of a generalized increase in the Bank rate which he preferred to avoid both to preserve easy money conditions in the market and to reduce the possibility of banks profiteering from it. Taken separately or together, the two explanations defy understanding. Aggregate bill market drawings by scheduled banks were nearly as large or larger than their drawings against other securities between 1955 and 1957. Consequently, a rise in the effective bill market rate would not have left banks' general lending rates unaffected. This method of raising lending rates, moreover, left greater discretion in the hands of banks than a public and transparent increase in the Bank rate. Finally, it is difficult satisfactorily to explain the speed with which differences between the Finance Ministry and the Bank over a monetary policy-related issue degenerated into a public war by the Finance Minister against the Reserve Bank and its Governor otherwise than as an effort to force the latter out of office.

If Krishnamachari wanted a confrontation with Rama Rau and the Reserve Bank, he could not have chosen a better issue from his own point of view. The Governor took a close—perhaps too close—interest and considerable pride in the working of the bill market scheme which he regarded as his principal achievement at the Bank. The bill market scheme had only recently freed itself from the crutches of stamp duty and interest rate subsidies. But TTK's latest proposal threatened to end it altogether, since the effective rate of borrowing under it would now exceed 4 per cent when most banks could continue to avail of accommodation against government securities at the prevailing Bank rate. Further, not only had the Bank not been consulted about this proposal—its views had merely been sought on whether the new rates should be forty times the prevailing rate or eighty—the Finance Minister added insult to injury by declaring in Parliament that the proposed hike was a 'fiscal measure with monetary intent'. Indeed, as a memorandum which Rama Rau submitted to the Central Board of the Bank in December 1956 pointed out, the Finance Minister's move now meant that there would be

two authorities who would operate the Bank rate—the Reserve Bank in the usual manner under Section 49 of the Act, and the Government by variation of the stamp duty by executive order of the Finance Ministry.

The ‘consequences of this dual control of the Bank rate’, Rama Rau added, ‘need hardly be emphasized’.

Krishnamachari’s proposal evoked opposition from other quarters as well. As described elsewhere, there was a clamour from banks and businesses for easier credit in the 1956–57 busy season and for more liberal access to the bill market scheme. Far from liberalizing credit or access to the scheme, the new measure would discourage the use of bills and force banks which had them to sell or borrow against government securities. As H.V.R. Iengar, who was at this time the Chairman of the State Bank, explained to Rama Rau early in December 1956 and to TTK a month later, his institution could no longer borrow under the bill market scheme except at a loss to itself so long as it continued to peg its lending rate at four per cent.

Remonstrations to the Finance Minister against his stamp duty proposals were unavailing, even perhaps counter-productive. As protests multiplied and banks reduced their bill market limits with the Reserve Bank, Krishnamachari began to nurture dark suspicions that they were ‘boycotting’ bills deliberately to create a credit squeeze and force him into a retreat. Suspecting the State Bank’s role in this alleged campaign, he made a series of public comments against banks in general and the State Bank in particular.

Rama Rau’s efforts to persuade the Finance Minister to moderate his stance were—in the background of worsening relations between the two men—perhaps doomed to failure. Even if the minister did not initiate the stamp duty hike in order to force a confrontation with Rama Rau, the latter’s protests appear to have strengthened his resolve to elevate the issue to one on whose resolution would turn the future of the central government’s relations with the Reserve Bank. TTK, according to the Governor, responded with ‘personal discourtesy’ to his objections to the higher duties. This may have been an understatement. According to B.K. Nehru’s recollection of the episode, the Reserve Bank’s case went up to the Prime Minister who put it to the Cabinet at an informal meeting to which Rama Rau was also invited.⁵ TTK, according to this account, was angry with the Governor for forgetting that ‘he had been asked to attend ... only to answer specific questions’, and for his ‘temerity’ in speaking

⁵ B.K. Nehru, *Nice Guys Finish Second: Memoirs* (New Delhi, 1997), pp. 272–73.

at the meeting in defence of the Bank's views. When next they met, according to B.K. Nehru, the Finance Minister 'let fly in no uncertain terms and in the loudest of voices, at the Governor of the Reserve Bank of India'.

Not yet the chronicler he later became, B.K. Nehru retreated from the scene of this 'undignified brawl between the two highest ranking officials of the financial establishment'. There was, it appears, not much of a brawl since even according to Nehru's account, 'Rama Rau, the mildest of men, did not know how to handle ... [TTK's] unmeasured onslaught'. Unfortunately, though perhaps in the circumstances not surprisingly, the Governor too has left no complete account of this incident. But according to the few references Rama Rau made to this or to another meeting with the Finance Minister, the latter spoke derogatorily to him of the Reserve Bank as a 'department' or 'section' of the Finance Ministry.

Rama Rau's immediate reaction to these provocations was to resign his position as Governor. While he himself felt TTK's attitude made it impossible for him to continue in office, his trusted advisers were also of the view that the Governor could not stay on 'with any self-respect' or without further damaging the 'status' of the Bank or the 'status and dignity' of his office. But following long meetings with Jawaharlal Nehru and the Home Minister, Gobind Ballabh Pant, Rama Rau decided to hold his hand.

Matters did not, however, end there. Under the Reserve Bank Act, the general superintendence and direction of the affairs of the Bank are vested in the Central Board. Feeling it his 'statutory duty' to take the Board into confidence about the implications of TTK's proposal and the manner in which the decision to increase the stamp duty was taken, Rama Rau convened a special meeting of the Central Board on 12 December 1956 at which he circulated a memorandum entitled 'Implications of certain provisions of the Finance Bill, 1956'.

This memorandum too is reproduced at the end of this volume along with other papers bearing on this episode. Briefly, after explaining the Finance Minister's proposal, it pointed out that the decision was taken without consultation with the Governor or the Board 'on whom rests the statutory responsibility for altering the Bank rate'.

The decision of the Government was announced to the Governor and senior officers of the Bank six days before the introduction of the Bill, but it was made quite clear that it was a definite decision of Government on which the views of the Bank were not invited. The Bank's opinion was asked for only on the question of whether the immediate increase be Rs 5 per Rs 1,000 or Rs 10 per Rs 1,000.

The Governor then went on to describe his efforts to represent the Bank's view to the Finance Minister.

A few days after the introduction of the Bill, I attempted to discuss the implications of this measure with the Finance Minister, but he stated that he took full responsibility for the Government decision, that the Bank was a 'section' of the Finance Ministry of the Government of India and that we would have to accept the decision whether we liked it or not.

The memorandum also discussed at some length the implications of Krishnamachari's proposal for the Bank's independence. The latter had until then been preserved in India as in most other democratic countries, and although the government had powers under section 7 of the Bank Act to give 'directions ... after consultation with the Governor of the Bank ... in the public interest', no occasion had arisen since its nationalization in 1949 to necessitate the use of these powers. While the Bank and the Government of India had cooperated closely and 'harmoniously' during this entire period, Rama Rau pointed out, treating the Bank 'as a department of the Government of India' portended grave 'consequences' for its ability to exercise statutory responsibility for 'monetary policies and other matters'. After drawing attention to the dangers of 'dual control' over the Bank rate and of the increase in the cost of credit to industry emanating directly from the Finance Minister's proposal, the Governor moved the Central Board to 'explain to the Government the full implications of this proposal and request them to reconsider it'.

Thereupon the Central Board resolved that while the stamp duty might be regarded as a 'fiscal matter' its steep increase had, by the Finance Minister's own admission, 'monetary implications' which could not be 'ignored'. The stamp duty 'added substantially to the Bank Rate' which it was the 'statutory responsibility of the Reserve Bank to fix every week'. The latter's view, the Central Board felt, 'should, therefore, have been sought on the subject'. The resolution ended with a 'request' to the government 'to consult the Reserve Bank in advance on all matters which significantly affect[ed] ... monetary structure and policy'.

Helped along not a little by an angry Finance Minister, matters spun out of control from this point onwards. Jawaharlal Nehru received a copy of the memorandum from the Ministry and immediately wrote to Rama Rau expressing his 'great surprise' at its contents. The memorandum, Nehru told Rama Rau, was 'improper' and 'agitational'. 'To address your Directors in this way seems to me extraordinary.' The Prime Minister also took the Governor to task for disclosing in the memorandum details of a 'private talk'

between him and the Finance Minister. He also suggested, curiously and without offering any elaboration, that the Reserve Bank's policies were 'contrary to those of the Central Government'.

The Central Government ... is directing its policy to attain certain objectives laid down in the Five Year Plan. It would be completely absurd if the Reserve Bank followed a different policy because it did not agree with those objectives or with the methods of achieving them.

In a letter he wrote to the well-known cooperator, Vaikunth Lal Mehta, a fortnight later, Nehru acknowledged that the government may have handled the matter badly and that the Governor of the Reserve Bank should have been consulted before the Cabinet decided to raise the stamp duty. But to Rama Rau himself, Nehru yielded little ground.

You have laid stress on the autonomy of the Reserve Bank. Certainly it is autonomous, but it is also subject to the Central Government's directions. The question of fixing the bank rate is a matter for the Reserve Bank to consider. The stamp duty proposed by the Central Government is not the same thing as varying the bank rate, although it has certain effects upon it. That decision in regard to [the] stamp duty was taken by the Cabinet after full consideration and I cannot accept any plea that the Cabinet should not do so until the Reserve Bank approved.

While it was 'certainly desirable' to seek the Bank's views, Nehru pointed out in defence of his Finance Minister that the latter had 'mentioned' the matter to Rama Rau 'six days before the Bill was introduced in Parliament'. Finally, the Prime Minister expressed surprise that the Reserve Bank should 'encourage and indirectly participate' in the criticism of the government by 'some sections of the business community' who disapproved of the government's 'basic policies'. The Bank's memorandum, Nehru also told Mehta, was 'practically an indictment of Government's policy'

Jawaharlal Nehru's letter caught Rama Rau by surprise. Their meeting the previous week may have encouraged the Governor to conclude that the Prime Minister was not insensitive to the Bank's wider concerns. But his latest letter conveyed the opposite. With Nehru having, however, left on a prolonged overseas tour shortly afterwards, there was little Rama Rau could do immediately. Possibly emboldened by the Prime Minister's letter, which he may have even had a hand in writing since Nehru sometimes relied on his ministers to prepare preliminary draft letters for him in their areas of

competence, Krishnamachari chose to utilize Nehru's absence to intensify pressure on the Bank. He had accused the Reserve Bank in Parliament earlier of being 'reserved' and of being incapable of 'doing any thinking'. In a series of comments he made to the press in the south and in his address to the South India Chamber of Commerce in Madras towards the close of 1956, the Finance Minister carried his attacks on Indian banks and on the Reserve Bank, in particular, to the public. He once again accused the latter of betraying a 'clerical mentality' and suggested that it believed in a policy of 'stay put' and had turned moribund. He also attacked the State Bank and other banks in similar vein.

Krishnamachari's attacks on the State Bank invited a spirited reply from the head of that institution. Its Chairman, Iengar, wrote to the Finance Minister to convey his 'distress' at the latter preferring to carry out a 'public attack' on the bank to a 'private talk' with him. Since such attacks reflected adversely on his leadership of the State Bank and had created uncertainty in the minds of his staff, Iengar asked to know whether the government wished to replace him. As Vice-Chairman of the State Bank and the person instrumental in bringing Iengar to head it, V.L. Mehta 'deplored' TTK's criticism of the State Bank and the Reserve Bank and offered in a letter to Nehru to relinquish his position in the former since he had not 'outgrown' either the 'clerical mentality or an Imperialist outlook'. While TTK had little trouble in placating Iengar, Nehru managed to pacify Mehta. It should however be mentioned for the sake of completeness that TTK was less forgiving of Mehta than Nehru, as he pointedly ignored the cooperator's advice about Iengar's successor at the State Bank.

Matters with Rama Rau had gone too far, however, and there was now no pulling back. Rama Rau responded to Nehru's letter with a long, eleven-page reply in which he confessed to being 'puzzled' and 'pained' by its tone and contents. Explaining his conduct and rejecting the criticism that he had adopted an 'agitational approach', Rama Rau contrasted his own discretion with the Finance Minister's tendency to make public and private attacks on the Bank. Rama Rau pointed out that he had no choice but to take the Central Board into confidence about Krishnamachari's intentions, since his refusal to consult the Bank about a decision which directly affected its statutory responsibilities was not 'due to ... oversight but to his definite view that as a mere department of the Finance Ministry, the Reserve Bank was not entitled to be consulted'. The 'definite intention' of the Reserve Bank of India Act was to set up an autonomous body and this intention was restated in 1949 when the Bank was nationalized, but the Finance Minister seemed to have other ideas. The Governor also objected to the Prime Minister's suggestion that the Bank challenged the government's wider policies. Rejecting such allegations and defending the Bank's record both with respect to monetary stability and in

supporting the government's policies for development, Rama Rau however informed Nehru that he could no longer continue in office because of the Finance Minister's attitude, and sought his permission to resign.

I assured you that I would not go against your wishes in regard to my resignation, but the public attacks of the Finance Minister on the Reserve Bank have created a new situation in which it will be absolutely impossible for me to continue in office. I hope you will appreciate my position and allow me to submit my formal resignation

Nehru was perhaps reconciled to losing Rama Rau, since he refused even now to yield any ground. Maintaining that the Central Board memorandum was 'improperly worded', he advised Rama Rau to view the Finance Minister's remarks about the Bank in a 'larger context'. The Bank, he said, was

obviously ... a part of the various activities of the Government. Obviously also it has a high status and responsibility. It has to advise the Government, but it has also to keep in line with Government.

In the letter he wrote to Mehta around the same time, Nehru also defended Krishnamachari's public outbursts against the Bank as being in the nature of 'general remarks' made in reaction to the Board memorandum.

Rama Rau vacated office on 14 January 1957. In his resignation letter written a week earlier to the Finance Minister, Rama Rau protested TTK's 'unwarranted and insulting remarks' against the Reserve Bank. Such attacks by a Finance Minister on a central bank were 'absolutely unprecedented'. They were also unfair, given the Bank's substantial record of achievements. Recalling the cordial relations the Bank had enjoyed in the past with the Finance Ministry, Rama Rau stressed that it had always striven to maintain its independence even while cooperating fully with the government in implementing national policies. The Governor also pointed out to Krishnamachari that he had

more than once protested against your personal rudeness in the past, but I was prevailed upon to overlook it. Since, however, you have now thought it necessary to make public attacks on the Reserve Bank, it is not possible for any self-respecting Governor to offer that wholehearted cooperation with the Finance Ministry, which is absolutely necessary in the interests of the country during the critical times ahead of us.

In a letter he wrote to Nehru at the same time, Rama Rau conveyed his decision not to 'issue any public statement' even after relinquishing office unless there was some 'fresh provocation', since 'any public controversy between the Reserve Bank and the Finance Ministry might have repercussions in this country and abroad'. The events leading to Rama Rau's departure from office also provoked Purshotamdas Thakurdas, who had served without interruption as Director since the Bank's founding in 1935, to sever his connection with the Central Board when his current term expired.

The happenings in the last couple of weeks in the relation between the Board of the Reserve Bank and the Central Finance Ministry are so extraordinary, one-sided and unprovoked that I feel that it is not to the interest of the country that any non-official should avoidably keep up his connection with the Reserve Bank,

Thakurdas wrote to Rama Rau whilst requesting him to 'do the needful' to ensure that he was not 'renominated' to the Board.

Rama Rau's resignation brought the curtain down in more ways than one on an important period of the Bank's history. His was the longest spell in office for any Governor of the Reserve Bank since its founding, and Rama Rau's years as Governor coincided with an eventful period in the country's financial history. The Bank also saw a steady rise in its public and policy profile during these years, which Rama Rau was keen to promote and protect. It was in some ways entirely appropriate that Rama Rau should have sacrificed his office in defence of the Bank's independence since he, along with Deshmukh, had played a major role in safeguarding this feature of the institution's functioning since its nationalization in 1949.

Until 1956, according to B.K. Nehru, the Reserve Bank was 'one of the few financial institutions that had still retained some measure of autonomy'. But from the day the Prime Minister chose to back TTK against the Bank, it lost 'even such autonomy as it till then exercised and started becoming another subordinate office of the Government of India, taking orders even more than before from the Ministry of Finance'.⁶ The latter view may be somewhat exaggerated even where the remaining years of our own period are concerned. The Bank's freedom of policy, or its absence, depended on a number of other factors too, during these years, and as we point out

⁶ Nehru, *Nice Guys Finish Second*, p. 272.

below, it was restored briefly in the mid-1960s as the economy came face to face with a daunting set of domestic and external challenges. Nevertheless, Rama Rau's resignation proved that no Governor could hope any longer to defend the autonomy of the Bank by unfurling banners announcing its independence. 'Independence of the central bank' as the Bank, responding in August 1958 to the Radcliffe Committee questionnaire, acknowledged in words that evoked Nehru's remarks to Rama Rau on the subject, did not 'in any case mean independence of Government, but independence within the structure of Government'. Differences with the government would persist and these would have to be resolved continuously, but the business of protecting the Bank's independence would henceforth have to be carried out privately and without a great deal of fuss. The consequent lack of transparency provided a further source of power to the central government vis-a-vis the Bank and portended serious consequences for the latter's ability to hold its own in future conflicts with the former. As matters turned out, while the Bank and the government continued to differ over a number of matters, including those relating to monetary policy, relations between the two did not plummet again to quite the same levels during the remainder of the period covered by this volume; nor, whatever the immediate consequences of the 1956-57 conflict, were the Bank's status and standing challenged in the same direct or overt way.

A few months after Rama Rau's resignation, Krishnamachari, in a move which revealed the extraordinary imagination and talents of the man, favoured strengthening the Bank's ability to conduct an independent monetary policy by divesting it of responsibilities in the sphere of rural credit. Krishnamachari's move was regarded at the time as another attempt to cut the Bank down to size. That it almost certainly was. But thanks to the misgivings with which his suggestions were often viewed, few within the Bank or the government paid any attention at the time to the very real conflict, which was in fact already becoming apparent, between the Bank's monetary policy goals and its wider commitments. But by the time he returned to head the Finance Ministry once more in 1963, TTK himself began identifying the Bank's independence with 'bigness' and the diversity of its responsibilities. Speaking in April 1964 on the debate over the bill to promote the Industrial Development Bank of India as a subsidiary of the Reserve Bank, Krishnamachari defended the Bank against left-wing critics demanding dissociation of the proposed institution from the central bank. The Reserve Bank, he told the Lok Sabha, with uncharacteristic generosity and possibly unconscious irony,

is in the picture for everything today, and I am very happy that successive Governors of the Reserve Bank have been able to shoulder this increasing responsibility that is being cast on them, are ... able to take an independent view and not completely subordinate their views to those of the party in power including the Minister. I have been very grateful during my two spells as Finance Minister for the independence shown by the Reserve Bank, and I want it to have that independence.

VII

H.V.R. Iengar, who succeeded Rama Rau as Governor, was Krishnamachari's personal choice for the position. In Iengar's favour was the fact that he had worked closely with the Finance Minister when the latter was in Commerce and Industry. The Finance Minister's capacity for 'inspiration, grasp, and drive' was believed to have the effect of producing in his officials a 'blind sense of loyalty'. Whether blind or not, Krishnamachari did not suspect Iengar's 'loyalty'. There was an impression afoot when his name was put forward, that though 'not a creature of Krishnamachari' it would be 'expecting a lot to think he would take an independent line at the Reserve Bank'. Iengar was familiar too with TTK's foibles and susceptibilities, and not entirely averse to indulging them. At the State Bank, for example, he was quick to investigate Krishnamachari's complaints about his institution denying accommodation to a south Indian company specializing in the hire-financing of trucks. However, soon after taking over as Governor, Iengar displayed considerable firmness in rejecting TTK's insinuation that the Bank's inspectors had acted unfairly in pulling up a south Indian bank for having made advances to a prominent newspaper group against the pledge of its immovable property. TTK also urged Iengar in June 1957 not to 'leave ... out' of bipartite consultations, the 'small Union affiliated to the INTUC in Delhi', only to be told in rather blunt terms of the Governor's own preference to 'leave matters as they are' Industrial relations at the Bank had been a 'little delicate' of late, and calling an unrepresentative union for talks might 'seriously disturb ... [the Bank's] relations with the bulk of ... [its] employees'. Whatever the outcome of TTK's intervention in these two instances, it is worth noting that he ventured his views to Iengar on relatively routine aspects of the Bank's functioning in a manner he may not have done with his predecessor.

Iengar was, by every account, a man of enormous charm and intelligence who brought a keen intellect and abundant energy to bear on his endeavours.

A good listener, he was affable, accessible, and encouraged debate within the organization. Iengar was also effective and vigorous as Governor. Yet it is impossible not to detect a certain change in the tone of the Bank's relationship with the government after he took over as Governor. In the speech he made to the annual general meeting of the Indian Banks' Association in March 1958, its chairman, C.H. Bhabha, spoke of the 'impression ... prevailing ... despite all official and Ministerial assurances' to the contrary of a 'certain amount of subservience of the Reserve Bank to the Finance Ministry of the Government of India'. Declaring that all knowledgeable people 'longed' for this 'key institution' to maintain a 'sturdy independence', Bhabha called for changes in the way the Bank's Central Board was constituted and a 're-enunciation of its autonomy'. He also proposed that the Bank should revive the tradition of 'effectual and highly critical review of economic conditions' and policies for which it was known before it became a 'State-owned organization'.

While Bhabha's call for 'sturdy independence' would no doubt have touched a chord, few even within the Bank would have sought it in order to make a 'highly critical review' of the government's policies. The Bank's views about central bank independence conveyed to the Radcliffe Committee and quoted above may have evoked Nehru's remarks, but did not for that reason fail to reflect contemporary sentiments at Mint Road. The means Iengar adopted to enhance the Bank's effectiveness were in the ultimate analysis derived from such sentiments. More dynamic and energetic than Rama Rau was in his later years in office and keener than him to mark a presence on a wider stage—Iengar had felt his 'horizon [was] ... somewhat restricted' in the State Bank—he stayed in regular contact not only with the Finance Minister, but also with other members of the Union Cabinet and the Prime Minister. Iengar's excellent interpersonal relations with ministers and officials were to prove useful to the Bank on more than one occasion. But it will remain moot whether in trying thus to break the Bank's seeming aloofness, he may not have unwittingly helped weaken its institutional autonomy, especially since his initiatives to widen the Bank's points of contact coincided with the growing disposition of the country's political class to assert itself in relation to its public institutions.

On the other hand, institutional autonomy might often be a euphemism for irrelevance, and a major concern of Iengar's was to transform the Bank into an institution which strove continually to be relevant to the economic challenges facing the country. Rama Rau had left the Bank suspended midway between the lofty heights of traditional central banking and the noisy parlours in which political and economic decisions were increasingly being made in contemporary India. At the moment of his exit, Rama Rau may even have wished to reverse the descent he and Deshmukh before him had commenced. Iengar, in contrast,

appears to have judged that the additional influence and leverage the Bank gained thereby justified its descent into the real arenas of economic decision-making.

Besides having to reckon with a more assertive political class, in other respects too, the circumstances in which Iengar took office were less propitious for the Bank's independence, if not its influence, than those which had attended the larger part of his predecessor's term. In 1949 when Rama Rau became Governor, the Bank held a virtual monopoly of economic and technical expertise anywhere in the government or outside it. The Bank alone at this time could boast a full-fledged economic analysis and research department in India. Although departments of government such as commerce and industry and finance had their own economic advisers even in the 1940s, the latter were either seconded from the Bank or worked closely with it. The government drew frequently upon the Bank's research expertise, even if it did not always accept the views and policy advice Mint Road pressed upon it, so that the latter, to use TTK's expression, was 'in the picture' on most major economic policy decisions of the period.

By the time Iengar became Governor, however, the analysis and policy landscape had been greatly transformed. Although according to the Bank's replies to the Radcliffe Committee questionnaire, its 'lead ... in relation to [the] Government in the systematic study of economic questions ... [remained] a factor of some advantage to the Bank', and its economists continued to produce pioneering work in such fields as savings, income distribution, and poverty, the Planning Commission set up in 1950 had meanwhile grown enormously in stature and influence. Its Perspective Planning Division and the body of researchers P.C. Mahalanobis assembled at the Commission and at the Indian Statistical Institute were beginning at this time to emerge into their own. Not only was this 'think-tank' closer to the corridors of economic and political decision-making in Delhi, the gospel of planned development brooked no rivals in the hearing and adherence it commanded from a political class led by the Prime Minister himself. Apart from the Planning Commission, ministries such as those of agriculture, community development, and cooperation too had now a body of specialized expertise differing in emphasis, if not in substance, from that available with the Bank. These ministries also tended often to make common cause with the Planning Commission against the Bank and the Finance Ministry, and at least during the early years of Iengar's stewardship of the Bank, the Planning Commission-led alliance appears to have had the ears of key decision-makers in Delhi, including the Prime Minister.

The Reserve Bank, it must be said, also underwent an intellectual conversion

during these years which lasted for some decades thereafter. This conversion distanced the Bank from the staple discourse of traditional central bankers, and steered its perspective closer to that of governmental bodies in Delhi. Signs of the new perspective were already evident during Rama Rau's final years in office. Consider, for example, his spirited defence of the policy of deficit financing in the speech he made to the Fund-[World]Bank meeting in September 1955, extracts from which are reproduced below. Although the Bank's faith in the policy of deficit financing and in the government's ability to conduct it successfully weakened in the late fifties, its departure in other respects from the traditional canons of central banking intensified. Thus the Bank began moving during these years towards a 'structuralist' understanding of the relationship between money supply and inflation. The 'structuralist' grip over the Bank's thinking withstood the inflation of the 1960s and the vicissitudes of the next decade.

It may be argued, with the benefit of hindsight, that the Bank would have been better off in the longer run had it chosen to offer to the government a brand of economic advice which was distinct from that available, say, from the Planning Commission. Contemporaries would probably have laughed such suggestions away. Not only did the Bank not have an 'objective function' distinct from that of the government, the remorselessly Darwinian and modernist intellectual climate of the day also meant that few economists regarded monetarist ideas and the classical axioms upon which they were based as anything other than the relics of a disgraced past.

Keynes's was the dominant economic influence at the time. Nor was his work without influence on the early structuralist writers. Whatever the intellectual influences upon Iengar, the latter part of his tenure at the Bank coincided with some dispersal of B.K. Madan's interests and influence within it. Madan's later writings are unmistakably influenced by Keynesian and structuralist ideas. But he, unlike several Bank and government economists of the time, had never been to Cambridge. And though not immune to more contemporary influences, Madan came closest at this time to being a traditional central bank economist. In the early 1960s, Madan's was still a major influence helping to form the Reserve Bank's views on commercial banks' capital adequacy and liquidity norms. But as Executive Director and later as Deputy Governor, Madan's energies were increasingly diverted to issues relating to the financing of industry. The 1960s therefore saw a steady rise within the Bank of economists who, whatever their training, were brought up to regard classical ideas with scepticism and were wont to take a more positive view of the type of State intervention in vogue at the time. The younger economists were more disposed than their predecessors to harness the financial sector

securely to development goals and priorities. The Bank thus began moving with little evident distaste towards regulating interest rates, and soon thereafter into forms of direct intervention which fell little short of physical allocation of bank credit. Though never absent from the Bank's concerns even earlier, its focus on the 'institutional dimension of monetary policy' within the context of the planning process also became more pronounced and articulate during the mid-sixties. Thus when he came to the Bank as Governor towards the middle of 1967, L.K. Jha felt immediately at home, his new colleagues at Mint Road, 'particularly the Deputy Governors' agreeing with his view that

in a planned economy, overall credit control by itself made no sense and sectoral priorities had to be established. Through selective credit controls [including directed credit], keeping in view the accepted priorities, we could pursue the twin goals of development and stability.

To some extent, its recent intellectual journeys too, made the Bank more complaisant with regard to the government. To quote L.K. Jha once again, the Reserve Bank was 'bound to finance the budgetary deficit of the Government'.

What needs emphasizing is not the independence of the Reserve Bank but the importance of a basic accord to ensure that monetary and fiscal policies work in harmony and pull in the same direction.

Differences between the Bank and the government over economic policies were not altogether absent. For example, the Bank never approved of the substitution of financial planning by a kind of 'physical planning'. Once it awoke to the consequences of physical targeting during the course of the second plan, the Bank strove to trim the size of subsequent plans to match visible resources. But its general attitude of complaisance meant that harmony was achieved and areas of potential conflict minimized because, to extend Jha's metaphor, where the government pulled, the Reserve Bank generally followed.

VIII

A major area of discord between the Bank and the government in the late 1950s related to the financing of cooperatives and the pattern of organization of primary lending agencies. This controversy was marked by the consolidation of the views of several departments of the government, including the Planning Commission and the Agriculture Ministry, against those of the Bank and by

interventions by Jawaharlal Nehru and the National Development Council in defence of the position staked out by these departments.

The principal recommendations of the Rural Credit Survey, the progress made in implementing them until 1957, and the controversies that engulfed them thereafter have already been discussed. Here we may merely note that when successive initiatives of the Planning Commission and the Ministry for Community Development and Cooperation threatened to destroy what in its opinion was an important plank of the Rural Credit Survey recommendations, viz. the viability and integrity of primary cooperative credit institutions, the Bank felt moved to resist their efforts. This battle was however one which the Bank had to wage on its own, since its views evoked little support from successive Finance Ministers. While TTK believed cooperation was some form of 'collectivism', his successor Morarji Desai had little sympathy for the Bank's preference for large, viable primary credit societies. In November 1958, the National Development Council passed a resolution which advocated a new cooperative policy based on small, multi-purpose village societies and financing farmers freely and, in Mint Road's view, without regard to prudent cooperative or banking principles. For a brief moment, a gloomy Bank contemplated responding to these setbacks by withdrawing into itself. Although there was 'no question of withdrawing cooperation' to the government, the Bank's executives felt that they could not now help formulate annual plans for the cooperative sector without being implicated for the new policy. But in the end, as pointed out in chapter 8, Iengar and Venkatappiah decided to engage central government departments, state government officials, and well-known cooperators in a series of discussions on the subject. These efforts were not altogether unsuccessful, and appear to have educated the Bank in an important aspect of contemporary realpolitik: with the widening of its arena of domestic responsibilities and the proliferation of institutions dealing with each of these, the Bank would now have to fight its battles not so much through the exchange of carefully drafted memoranda between North Block and Mint Road, but in the back-rooms of conferences and meetings.

Iengar was nothing if not a cultivated back-room negotiator who possessed a great capacity for persuasion. His interests were wide-ranging, and he commissioned the Bank's officials to write, frequently for his own education, studies and notes on a variety of subjects. But because the sites of decision-making were now shifting increasingly to more or less informal meetings, the paper trails Iengar initiated often dry up abruptly.

As Governor, Iengar pursued with vigour his efforts to increase the Bank's influence as the means to promote its ability to preserve monetary stability. It was also during Iengar's tenure as Governor that the Bank's influence came

increasingly to be exercised through the Finance Ministry rather than directly. Thus, while growing popular expectations from the government may have motivated the Bank to use active policy intervention alternately as sword and shield, the resulting closeness of its engagement with government departments perhaps also forced the Bank to look to the Finance Ministry as a buffer against the pressures of populism.

The paradox in the Bank's reasoning was not as great at the time as it might seem in retrospect. The impact of deficit financing on monetary conditions and policy had by now become a major source of concern at the Bank. As Finance Minister for the first few months of Iengar's term in office TTK, unlike Deshmukh before him, opposed deficit financing because it put 'more pressure on an economy where strains have already developed'. Morarji Desai, who succeeded TTK and remained Finance Minister during the remainder of Iengar's term as Governor, was also averse to large deficits. Thus, whatever the eventual outcome of his efforts, Iengar's vision of an alliance between Mint Road and North Block was not altogether unrealistic. But problems arose because Iengar took the Bank deeper into the alliance than even he may have perhaps wanted.

Morarji Desai had served as Iengar's junior official in the Bombay government and the two men tended, especially in the background of the Mundhra affair, to be somewhat guarded in their relations. These appear also to have worsened during the latter part of the Governor's term in office. But Iengar and TTK, as we noted above, managed in the course of the early months of 1957 to establish a close, if somewhat unequal, working relationship. TTK's other key adviser during these months was H.M. Patel, the Principal Secretary in the Finance Ministry. Although their relations were not without tension, the three are believed to have formed a cohesive and close-knit team which managed the country's domestic financial affairs during these crucial months. Thanks to this cohesion, Iengar succeeded in defending an important Bank interest as it was perceived at the time, namely its role as the apex lending institution for rural credit, from erosion. He also managed during these months to initiate the process of expanding the activities of the State Bank of India in ways that complemented the Bank's own perceived strengths rather than competed with them, and of taking over the state-associated banks. Monetary policy too, it appears, was formulated with little overt tension. The long-delayed increase in the Bank rate was effected in May 1957, significantly before the central government entered the market with its loans. At the same time, the stamp duty on usance bills which had caused so much grief earlier, was reduced to a fifth of one per cent.

This state of affairs was too good to last. TTK's team was rudely broken

up as a result of the so-called Mundhra affair. TTK himself resigned as Finance Minister in February 1958. Patel fell a victim to the informal processes of decision-making the Finance Minister favoured at this time, and though no charge of wrongdoing was brought against him in the end, was scarred for life by the affair. Iengar managed to keep his job, though not without some damage to his reputation. Whether he came under an undeserved cloud or was fortunate to escape the worse fate that befell his supposed collaborators depends really on the view one takes of Iengar's role in the decision to invest LIC funds in the Mundhra companies. But the Mundhra affair seems to have brought home to Iengar, as it did to his successor, the dangers of associating the Reserve Bank too closely with the government as a means of influencing its policy. Indeed, as a fallout of the Mundhra affair, Iengar went into some kind of isolation—'boycott' is the term he himself used to describe his social life in Bombay after the event—while the Bank drew back from its involvement in overseeing the stock, commodities, and bullion markets.

Relations between the Bank and the Finance Ministry were for some time thereafter, correct rather than close. The Bank now began dealing with the Finance Ministry more at the level of its civil servants than at the political level, and with some interruptions this trend continued for the remainder of the years covered by this volume. This meant, in the beginning, a certain diminution in the Bank's standing and influence, and a significant reduction in its access to the corridors of political power. The denouement TTK had so assiduously sought in 1956 thus came about more than two years later, in circumstances the former Finance Minister could not have greatly relished. The lowering of the Bank's representative profile also meant a greater formalization of its links with the Finance Ministry and perhaps, to some extent, their insulation from political and other storms brewing in Delhi. This accorded with Bhattacharyya's own preferences. Though he shared a good personal rapport with both Morarji Desai and Krishnamachari and played a major role in piloting the country's external economic diplomacy during his last two years in office, Bhattacharyya unlike Iengar appears to have been content for the most part to deal with delegated officials of the Finance Ministry, while addressing the political leadership directly about the most important issues.

On the other hand, thanks to the pervading sense of crisis in the mid-sixties, civil servants in government were in a better position than in the past and relative to their political masters, to influence economic policy. This led briefly to a striking ascendancy in the Bank's influence over economic policy, which was exerted to some extent directly through the newly created Prime Minister's Secretariat headed by L.K. Jha. As Governor,

Bhattacharyya was instrumental, along with Jha and one or two other officials, in formulating economic policies during these critical years and in negotiating assistance from the international agencies. Although the Bank itself was scarcely involved, the Governor also played a central role in the discussions leading up to the devaluation of the rupee in June 1966. His correspondence files for this period contain copies of three letters drafted at the Bank. These letters, which Bhattacharyya handed over to the Prime Minister sometime in June 1965, were intended to be sent over the latter's signature. The first of these letters requested chief ministers to reduce their states' overdrafts. The second urged the Union Commerce Minister to closely regulate the issue of import licences. Most clearly illustrative of the Bank's new authority was the third letter. This was addressed to the Union Finance Minister, T.T. Krishnamachari, and dwelt at length on the need to reduce expenditure in the face of falling revenues in order to ensure that there was no recourse to deficit financing during the year! Sachindra Chaudhuri, who succeeded TTK as Finance Minister after the latter's resignation in December 1965, is also said by some to have been the Governor's nominee for the crucial cabinet position.

Bhattacharyya did attempt to translate the Bank's new influence into a measure of autonomy. Its interest rate policy, for example, came rather more into its own during these years. The Bank rate which had remained quiescent since May 1957 was put up first in January 1963, and twice during the 1964-65 busy season, on the latter occasion in February 1965 by a full percentage point. But its ascendancy notwithstanding, these years did not lead to any enduring changes in the Bank's relations with the government, and it retreated to the sidelines with the restoration of more normal economic conditions and Bhattacharyya's departure from Mint Road at the end of his term.

IX

Superfluous to say, the autonomy of a central bank is, in the ultimate analysis, reflected in the autonomy of its monetary policies. In general, the autonomy of a central bank may come under challenge from two quarters: first as traditionally and at present understood, from a government which disregards, say, price stability or exchange rate stability while pursuing an expansionary fiscal course which the central bank is forced to accommodate or whose monetary consequences it may have inadequate powers to regulate. Secondly, as many economists would argue, the ability of a central bank in a small, open economy to conduct autonomous monetary policies is constantly

under challenge from the pressures emanating from larger markets and economies.

These two aspects of central bank autonomy are not entirely unconnected. They in fact mirror each other in some respects. Given its relative lack of autonomy, the central bank of a small, open economy has often little choice but to follow policies initiated by the bigger central banks. On the other hand, the former is more likely to be independent of its government since it is generally responsible for preserving domestic price or external stability. Conversely, when external transactions are strictly controlled, there are fewer structural and institutional constraints on the degree to which a government can force the central bank to submit to its dictates.

India was essentially a closed economy during the years covered by this volume. Economic policy-making could thus afford to be largely indifferent to the direct impact of policy on the capital account of the balance of payments, or since the economy was not in a state of 'fundamental disequilibrium' during much of this period, on the exchange rate. Nor did external imbalances obtrude persistently on the minds of Indian policy-makers so long as external reserves were large or the aid environment appeared favourable. Sluggish export behaviour, rising export subsidies, hidden capital outflows, the rapid increase in gold smuggling, and declining current account receipts emphasized the need for preserving or restoring external balance, but did not fundamentally determine it until the mid-1960s.

In this environment, monetary policies were geared fundamentally towards helping to finance public expenditure. As pointed out above, the Bank's uncritical acceptance of the need for large plans financed to a considerable extent through deficit financing owed partly to the prevailing ideological climate. Most sections of society supported the objectives and strategy of central planning, and so great was the grip which the planning process exercised over the imaginations of policy-makers and the Indian elite that for agencies such as the Bank, commitment to contemporary planning exercises was partly a precondition for establishing and sustaining their own relevance. As Rama Rau (whose views were clearly not those of the Congress party as reflected in the Nagpur and Avadi resolutions) saw it, rapid development was the key to the survival of the 'democratic system'.

We must, therefore, be prepared to face a certain measure of inflation and must devise appropriate monetary, fiscal, and possibly administrative measures to ensure that the inflationary situation does not get out of control.

Rapid planned development, Rama Rau also informed the Fund-[World]Bank meeting in September 1955,

was imperative [for India] ... from the economic as well as the political point of view. We have established a democratic system based on adult suffrage. The masses, the vast majority of whom are ill-fed and ill-clothed, have become politically conscious. The 'pathetic contentment' of the masses, which a British statesman described many years ago as characteristic of rural India has disappeared, and there is evident a new outlook on life and a demand for a higher standard of life. We have to demonstrate that within a democratic structure we can develop at a pace comparable to the totalitarian countries. An increase of 25% in the gross national product [which the second plan envisaged] is about the minimum that political conditions demand in India. We are determined to make a supreme effort to reach the target by democratic processes. With five years of peace and a reasonable measure of foreign assistance, I have no doubt that we shall succeed.

Events did not bear out Rama Rau's hopes. The earlier consensus about the role of the State in the development process too, began slowly to crumble towards the concluding years of the second plan. Within a few years wider western support for the broad strategy of planning also grew more qualified. But the domestic consensus proved sufficiently durable until the mid-1960s, so that while the Bank's attitude towards several aspects of the planning process turned more critical, it remained fundamentally supportive throughout these years.

To a large extent, therefore, monetary policies (and indeed the central bank itself) were regarded as instruments to help the country achieve certain national goals. As well as the tremendous optimism and hope with which the planning process was received, there was implicit popular faith that the policy-makers in government would do nothing, fundamentally, to upset economic stability. Many contemporaries voiced misgivings about the validity of some assumptions on which the plans—particularly the second plan—were based. Ambitious plans were also derided as a gamble which depended for its outcome on factors outside the control of Indian policy-makers. But not only were such doubts swamped by the wider measure of support for the idea of planning and the feasibility of the planning exercise, their existence underlined the important role that responsible public agencies, including the Reserve Bank, had to play in ensuring the success of the planning process.

The impact on Bank officials of the dominant economic doctrines of the day was strengthened by the actual behaviour of prices during the first plan years. After the inflation of 1950–51 was spiked, prices tended generally to be stable or head downwards despite deficit financing having accounted for nearly a seventh of the first plan outlay. Cereal production too, was above the plan target, while there was a small net accretion to foreign exchange reserves during these years. Buoyed no doubt by these trends, the Reserve Bank, as already pointed out, actually loosened the purse-strings of the central government early in January 1955.

Speaking in 1960 more than three years after he was forced out of office, Rama Rau regretted the Bank's lack of control over the central government's deficit financing operations which were determined 'solely' at the latter's discretion. Although Rama Rau's successor felt anxious about the effects of this abdication on fiscal discipline even in 1957, these were not felt until much later. Neither the realized size of the second plan nor the quantum of deficit financing, which were both below target, tells the story of a spendthrift government bankrolled by an indulgent central bank. The real act of abdication, to the extent it took place in connection with the second plan, was committed when the Finance Ministry allowed its loose resources arithmetic to go through into the final plan document. As such, the Bank's willingness to loosen the central government's purse-strings is cited here only to illustrate the spirit in which the two institutions worked during these crucial years. An assumption within the Bank, which the government made explicit more than once during these years, was that plan targets, resource mobilization exercises, and deficit financing projections had legislative sanction which was renewed each year when Parliament considered and passed the budget. It did not occur to the Bank at least until the middle of the second plan, and that too more in the context of the problems state governments faced in raising resources for their plans than in relation to central finances, that the political and institutional dynamics of the planning process could subvert considerations of fiscal prudence; and that once a plan had been passed without serious consideration being given to its financing aspects, the Bank and the Finance Ministry would be driven by the resulting political momentum to ensure that inflows into the government's coffers matched expected outflows.

Midway through the second plan, the Bank (as pointed out in chapter 2) tried to prevail upon the government to reduce the size of the plan. While the latter was pared down to some extent, its experience during these years contributed to the Bank's resolve to be consulted about the resources aspects of subsequent plans. Such consultations inevitably drew the Bank more deeply into the planning process. This meant closer coordination with the Finance

Ministry, since the two institutions shared several perceptions in common and were both keen to ensure that the Planning Commission did not once more 'bump up the size of the plan' or set unrealistic resource targets which they would have to help meet through higher taxes, larger market loans, and high levels of deficit financing.

Deservingly or otherwise, the Bank's reputation in Delhi was that of a conservative institution which was not attuned to the challenges of planning. Besides, given its distance from the corridors of political power, the Bank often relied on the Finance Ministry to weigh in on its side in disputes with the Planning Commission and other government departments. It would be surprising indeed, if this had also not led to some dilution of the Bank's independence vis-a-vis the Finance Ministry. Secondly, thanks now to its closer association with the planning process, the Bank was implicated more deeply with the responsibility for helping to fulfil its targets. As a result of these factors, though led by independent-minded Governors who faced little effective challenge to their personal standing for the most part of their terms, the Bank had willy-nilly to trim the sails of its policies to the economic winds blowing from Delhi. In effect and over the longer period, this meant supporting the financial needs of the government, including by keeping interest rates artificially low to facilitate government borrowing, and offsetting the expansionary impact of public expenditure by squeezing the private sector's demand for credit from the banking system and curtailing the availability of bank credit to this sector through a panoply of direct instruments of control.

X

The Bank's willingness to accommodate the central government not only threatened its ability to conduct independent monetary policies, it also greatly complicated its relations with state governments. As pointed out in chapters 5 and 6, there was an important difference between the Bank's relations with the central government and those with the states. While the Bank was obliged to discharge banking and other functions on behalf of the central government, statutory provisions about state governments' banking arrangements were permissive rather than mandatory. However, with one solitary exception, state governments entered into agreements appointing the Bank as their banker.

As well as performing routine agency and banking functions, the Reserve Bank helped float state governments' loans, made advances to them, and tolerated to a great extent their propensity to draw unauthorized overdrafts. The first and third of these were enduring sources of friction for the Bank's relations with state governments.

Both issues arose prominently against the backdrop of differences in the Bank's roles with respect to central government and state governments' finances. For example, while the Bank was authorized to hold the rupee securities of the Government of India in its Issue Department, it could not accord similar treatment to securities issued by state governments. The Bank might hold the latter on its own account. But there were limits to the quantities of such paper it could hold in this manner, and consequently on its ability to intervene, even should it so desire, in the market for state government securities. Such differences in the treatment the Bank accorded to different categories of gilt-edged stock remained a sore point with state governments, particularly after the mid-1950s when the size of their loan issues expanded to finance larger plan outlays. The pressure to float large loans led some state governments to force them upon unwilling subscribers. As such subscribers took the first opportunity thereafter to unload these assets, the latter often went into discount soon after their issues closed. This led, inevitably, to a clamour from many states for Bank intervention to stabilize their loans, especially as these were floated to fulfil targets set by the Planning Commission. This the Bank could not do without further assisting the erosion of fiscal discipline in the states.

The Bank took various measures to promote the market for state government loans. From the early 1950s it began buying limited quantities of such stock at the time of issue. The Bank attempted regularly, but with limited success, to reduce the size of states' loans. It also attempted to even out the market for state government paper since the loans of some state governments were better regarded than others. But in general the Bank was wont to insist upon state governments financing its intervention to stabilize the prices of their securities.

The more important bone of contention between the Bank and state governments was not unrelated to the conditions the latter faced in the market for their loans. As described in chapter 6, the Bank made ways and means advances to state governments which, unlike in the case of loans to the central government against ad hoc treasury bills, were limited to a multiple of the minimum balances they held with the Bank. This limit was frequently violated in practice by some governments running large overdrafts for prolonged periods. Particularly in the early 1950s, when the Madras government led the way, many overdrawn states sought accommodation facilities from the Bank similar to those extended by it to the central government. For understandable reasons, the Bank and the central government refused to entertain such suggestions. Neither carrots—in the form of larger authorized ways and means advances—nor threats—in the form of a decision by the Union Cabinet to allow the Bank to dishonour cheques issued by the offending states—proved effective. Despite

the Cabinet approval, the latter recourse was not judged by the Bank to be in the realm of practical politics; nor was the Bank inclined to withdraw, as Bhattacharyya proposed in the mid-1960s, from its role as banker to the offending states.

In 1957, the Bank's auditors objected to state governments' overdrafts being carried over from one year to the next in its books. The Bank therefore attempted to persuade state governments to eliminate their excess drawings by the end of June each year. This was however not possible without the central government taking over each June the unauthorized debts state governments owed to the Bank. Although in principle such payments were to be adjusted against resource transfers from the central government to the states, in practice the latter managed to postpone that day of reckoning in one way or another. With the result, not infrequently and to a not insignificant extent, unauthorized overdrafts of state governments were replaced by loans from the Bank to the central government against ad hoc treasury bills. The monetization of state governments' overdrafts, which the Bank was determined mostly to resist, thus began to take place now in an indirect fashion.

XI

Speaking in February 1962 towards the end of his tenure as Governor, Iengar identified four areas of potential conflict between the Bank and the central government. These were interest rate policy, deficit financing, cooperative credit policies, and the management of substandard banks.

Governments and central banks rarely see eye to eye on interest rates. The Government of India was, given the large size of its borrowings, perhaps even more averse than other governments to high interest rates. Keen to support the government's budgetary operations in every way, not least because it hoped thereby to minimize recourse to deficit financing, the Bank had a realistic appreciation of the problems of 'dear money'. Its faith in the impact of interest rates on the demand for bank credit also lacked conviction. Therefore it postponed interest rate increases as much as possible, particularly until the 1960s, and generally deferred to the government on interest rate policy. But Bank-government differences over the issue were not altogether absent. In 1956-57 the Bank sought tighter policies from the onset of the busy season, but did not raise the rate until May 1957. The Bank's preference for an interest rate increase in March 1960 appears to have yielded to the government's preference for other measures. Hence the decision by the Bank to raise reserve requirements, which too led, incidentally, to a slump in the market for gilt-edged stock. The Bank did not abandon hopes of putting up interest rates in

the summer of 1960 and again towards the end of the year. But unable to overcome the government's resistance, it was forced to adopt a variety of other devices to restrict credit without directly forcing a higher borrowing rate upon the government. The stalemate continued through the latter half of Iengar's tenure as Governor, and it was not until January 1963 that the Bank rate was put up from 4 to 4.5 per cent.

Even the crisis years of the mid-1960s were not without challenge to the Bank's standing as the principal monetary policy authority. Old-timers at the Bank recall the efforts T.T. Krishnamachari made in 1964-65 to claim for the government, on grounds of privilege whenever Parliament was in session, the prerogative to announce Bank rate changes. Traditionally in India, unlike in some other countries, the Reserve Bank announces Bank rate changes which the government then conveys to Parliament should it be in session at the time, and Bhattacharyya saw in TTK's suggestion an effort to usurp an important responsibility of the Reserve Bank. Iengar feared in the beginning that Bhattacharyya would not be able to 'keep his end up vis-a-vis ministers in Delhi'. But made of sterner material and refusing doggedly to yield to the minister on this issue, Bhattacharyya is reported to have insisted on retaining the Bank's right of precedence in announcing the Bank rate. In retrospect the Governor's action might be viewed as a merely symbolic assertion by the Bank of one of its few remaining privileges. Symbols are not unimportant, and its inability to build on its 'symbolic capital' after the mid-1950s may be regarded as one of the Bank's failings in later years. But Bhattacharyya's stand also had an immediate significance since the Bank's interest rate policy was now showing more promise than at any time in the recent past of coming into its own, and the freedom to make Bank rate changes would have meant little in the absence of that to announce them.

Differences between the Bank and the government over deficit financing and cooperative credit policies have been discussed at other places. Suffice it to note here that although Iengar cited 'indiscriminate expansion of rural credit schemes' (and 'special measures to finance small-scale industries') as being at the heart of his 'steadily more difficult relations' with Finance Minister Morarji Desai and others in Delhi, contrary to his fears, differences over such matters narrowed somewhat in subsequent years, thanks largely to the fact that the cooperative credit movement never realized its potential sufficiently as to lend much practical meaning or significance to them.

The reorganization of sub-standard banks is discussed in chapter 12. It is worth recalling here that the Bank was committed, at least initially, to a programme of consolidation, but the pace at which it sought to consolidate weak banks soon became unacceptable to the government. The latter's

preference for a more cautious policy was motivated partly by the fear that consolidation would promote concentration in the banking industry and the elimination of smaller, more local banks. Once again it did not prove impossible to balance the Bank's considerations with those of the government, though the outcome reflected the government's position more than it did the Bank's preferences. To some extent, of course, this had now become something of a norm. But in this particular case, the consensus also reflected the Bank's continuing sensitivity towards the need to expand banking facilities throughout the country. The conflict between the safety of depositors' funds and the rapid expansion of banking also became easier to reconcile with the institution of deposit insurance, an intricate system of regulated interest rates, and more effective supervision over banks.

XII

An important justification for writing a retrospective account of the functioning of a public institution is founded on the principle of accountability. The latter, however, should not be understood narrowly, or merely in the sense of submitting the decisions and activities of an institution in one period to the judgement of the next. Rather, the certainty of historical scrutiny represents a stringent form of accountability for a public institution because, by promoting transparency, it might enhance the spirit of public purpose motivating its actions.

The preceding pages speak for themselves, and it is not necessary to dwell at any further length upon the extent to which the Reserve Bank's activities during our years were informed by a high sense of public purpose. Nor were they bereft of significant achievement. To take but one example, in the early 1950s the Bank was heir to an immense 'moral prestige', to use the first plan document's expression, and a poorly developed financial system in which the majority of the banks bordered on a state of crisis and disorganization, and whose reach did not extend beyond the major towns and cities. There was also no adequate mechanism to channelize capital for the needs of agricultural and industrial development. Its prestige the Bank translated into a series of positive initiatives to promote institutions purveying a variety of credit both to agriculture and industry. The Reserve Bank was also instrumental in transforming the banking system and placing it on secure foundations. The resulting financial deepening and widening of the Indian economy was perhaps the Bank's most lasting accomplishment during our period. In 1950, assets of financial institutions amounted to about a third of the gross national product. Seventeen years later this proportion had gone up to over half. The ownership

of these assets also grew more diversified, with the Reserve Bank's own share of the assets of financial institutions falling from about half at the beginning of our period to just over a quarter at the end, and from 16 per cent of the national income to nearly 14 per cent.

The Reserve Bank regarded financial deepening (and widening) as the 'institutional dimension' of its monetary policies. India's relatively modest rates of inflation until the mid-sixties suggests that the Bank was not unsuccessful even in its pursuit of the more traditional goal of monetary policy. But the price of this success was a credit policy regime which relied increasingly on an elaborate set of direct and discretionary controls and sectoral direction of credit to support the financial needs of the government, while closely regulating or restraining the flow of credit to commerce and industry.

These years also saw the Bank progressively surrender its autonomy to an expanding—some may say rampant—central government apparatus. On the other hand, the institutional independence of the central bank is considered desirable for its own sake today partly because of our experience of its lack during the last four decades and more. Few, say in 1955, would have sympathized with the suggestion that the central bank should, rather in the manner of the judiciary, exert itself as a form of an independent check or balance even on the excesses of executive authority in government, let alone on budgetary or plan programmes voted by the Parliament of the day. Other central banks too were guilty of self-effacement during these years. With one or two possible exceptions, these institutions saw their role as one of assisting governments to maintain full employment, rather than merely mind the rate of inflation. The relatively closed nature of national economies even in the industrialized world, many among whom retained capital account controls in some form or the other until the 1980s, afforded central banks the luxury of yielding their judgement to that of officials in government, and more generally of departing from the principles they traditionally preached.

As well as being guided by prevailing central banking philosophies and trends in other parts of the world, the Reserve Bank of India had also to exercise its responsibilities with an abiding sense of relevance. Practical ideas command acceptance only because they are judged to be relevant to the needs of contemporary society; and institutions are often less able than individuals to forsake relevance for the splendour of isolation. Institutions too, can rarely survive on dogma alone, especially when it is widely believed to have been superseded by recent experience. It is therefore hardly to be wondered at that both on intellectual grounds and the practical, the Reserve Bank felt the need during these years to identify itself closely with the needs of the government. Undeniably, however, in

some respects, the embrace was uncomfortably close. The Bank also gave up, without much thought, important institutional means of checking fiscal profligacy, and undermined thereby the independence and effectiveness of its own monetary policies in the longer run.

The history of the Reserve Bank of India during the 1950s and 1960s thus holds important and abiding lessons not only for our own present and the future, but also more widely for other central banks and the financial sectors of developing economies. Each generation has its own yardsticks with which to measure success; while their legacies in the present provide a basis using which to evaluate the failures of the past. Therefore, while helping to sum up the pasts they describe, these pages must inevitably reflect our preoccupations in the present. Yet, the process of learning also requires us to be sensitive to the needs and attitudes of the past, and the relatives against which we would like posterity to weigh our own interventions in the present. Thus, where the Bank's history is concerned for its own sake, it is useful to bear in mind that it was the climate of the times which determined its attitudes and actions, and it is by the standards of those times that these should be judged.

Unpublished Sources

Apart from the material used in the other chapters and appendixes, the following sources have been used.

BD.Sp7.05 Central Bank's Relations with Government
HC/RR/1 Resignation of B. Rama Rau

Memoranda to the Central Board and Committee of Central Board

APPENDIXES

- A. *Currency: Changes and Challenges*
- B. *P.L.480 Arrangements*
- C. *The Palai Central Bank*
- D. *The Bank and the Mundhra Affair*
- E. *Administering Exchange Controls*
- F. *Quota Increases at the Fund*
- G. *Bilateral Rupee Payment Agreements*

APPENDIX A

Currency: Changes and Challenges

Under the Reserve Bank of India Act (section 22), the Bank has the 'sole right' to issue currency notes in India. Bank notes in circulation and those held by the Banking Department constitute the liabilities of the Issue Department of the Reserve Bank, and are backed by assets specified in section 33 of the Bank Act. These include gold coin and bullion, foreign securities, rupee coins which constitute the liability of the Government of India, the latter's rupee securities, and other eligible bills of exchange and promissory notes payable in India. Currency formed two-thirds or more of money supply throughout our period, and currency in circulation rose steeply from Rs 1,230 crores in July 1951 to Rs 3,052 crores at the end of June 1967. In addition, these years witnessed a significant change in the composition of the assets of the Issue Department. In July 1951, gold coin and bullion and foreign securities made up 54 per cent and Government of India rupee securities another 42 per cent of the assets of the Issue Department. By June 1967, the former proportion had come down to less than 10 per cent, while the latter had risen to 88 per cent. The circumstances attending this change and the considerations and compulsions necessitating the amendments made to section 33 of the Bank Act in 1956 and 1957 have already been discussed.

This appendix will therefore be concerned mainly with some aspects of the Bank's currency issue and management operations during our period. The triumph of fiat money meant that the internal management of currency became merely a logistical question from being an economic one. However, a well-managed currency system remains an integral part of a smoothly functioning economy. It was particularly crucial during our period because of the existence of a large non-monetized sector. The promotion of monetization depended on public confidence in the currency, and although this was fundamentally influenced by economic factors, the Bank could not afford to ignore considerations of popular psychology in managing the logistics of currency. Currency management has therefore remained a major preoccupation of the

central bank, a large proportion of whose staff was, and continues to remain, deployed in this activity. The latter also involves an elaborate system of distribution of notes through thousands of currency chests in all parts of the country. As noted earlier, currency chests also provided the basis for the spread of remittance facilities throughout the country.

DESIGNING CURRENCY NOTES

Designing currency notes is a continuous process, and it formed a major part of the Bank's currency responsibilities during our period as well. Safeguarding against forgeries and the exchange for gain of notes mutilated in particular ways were among the important considerations influencing the design of currency notes. But equally during these years, the changing design of Bank notes reflected a variety of other factors.

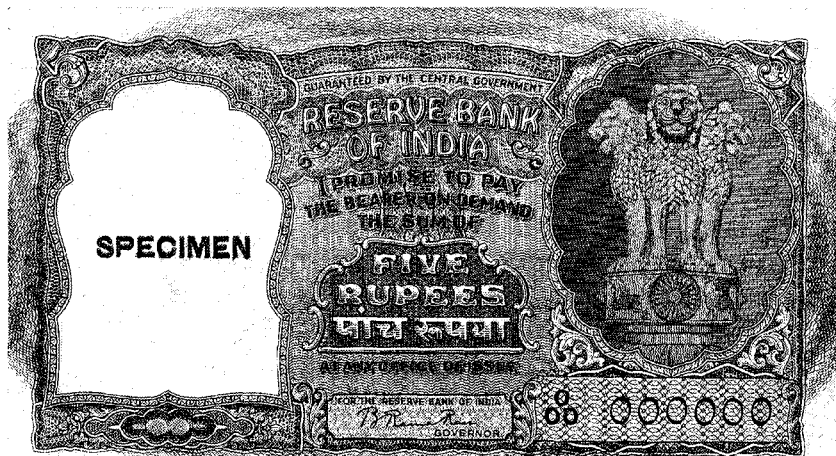
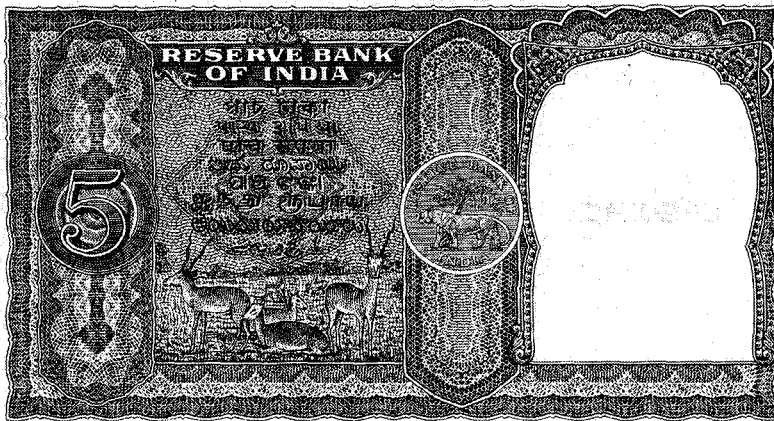
The inauguration of the Republic on 26 January 1950 and the vesting of sovereignty in its citizens was reflected in the replacement of the head of the king-emperor in new Bank (and one-rupee government) notes by the Ashoka Pillar emblem. The political and constitutional changes of the preceding decade led to a growing demand from the early fifties for currency notes to carry their value in different languages. Since 1935, the value of Bank notes was expressed besides English, in Urdu, Hindi, Bengali, Telugu, Tamil, Kannada (Canarese in the records), Gujarati, and Burmese. The demand to include Oriya in Bank notes became irresistible even in the 1940s and the opportunity presented by the separation of India's monetary arrangements from those of Burma was taken to substitute Burmese with Oriya on Bank notes printed after 1948. Not long afterwards, the omission of other languages included in the Eighth schedule to the Indian Constitution, viz. Assamese, Kashmiri, Malayalam, Marathi, Punjabi, and Sanskrit, came in for public comment and criticism.

Space was a constraint. But within a few years the Bank came round to the view that there were advantages to printing values in these languages. Finally in 1958, the Finance Minister and the Governor decided that new Bank notes would carry their values in all the fourteen languages included in the Eighth schedule in the order in which they were listed there. This decision was first implemented on 100-rupee notes in December 1960 after state governments authenticated the renderings of notes' values in their respective languages. This was an important precaution. The rendering on the Bank's notes of the Hindi number 'five' had been faulted in the past, and earlier notes also referred to the Hindi plural expression for rupees as *rupiah* rather than as *rupaiye*.

The security paper used for printing Bank notes was imported, and efforts commenced in the early-sixties to reduce the size of currency notes as a means of saving paper and foreign exchange. But the smaller designs took

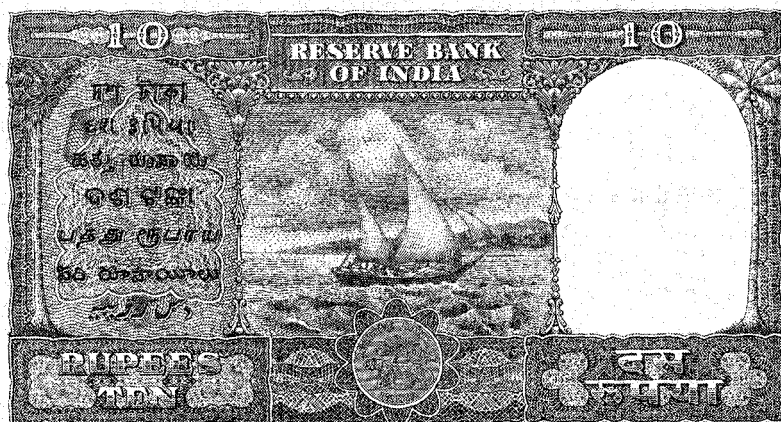
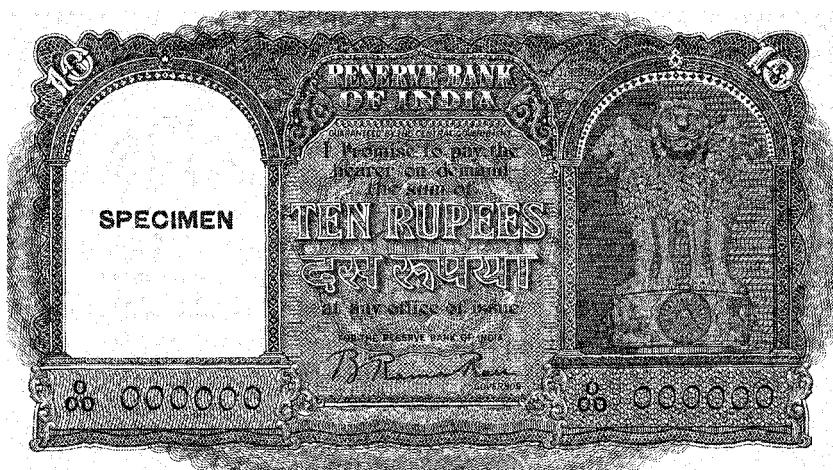
nearly five years to finalize, with even the Union Cabinet at one stage making detailed suggestions to the Bank on the size of the new notes. As part of this reform the Bank considered introducing 50-rupee notes to reduce the demand for its ten-rupee notes, but the Union Cabinet did not accept the suggestion because it was felt to be inconsistent with the objective of economizing on security paper.

The smaller notes were put into circulation in April 1967. At one stage in the mid-sixties, the Bank estimated the annual savings arising from them at 17 per



Five-rupee note issued in 1950 with value in Hindi (*panch rupaiah*) wrongly spelt;
size: 73 x 127 mm; green and brown with Ashoka pillar emblem

cent of the paper cost, or a princely sum of Rs 44 lakhs. The one-time cost of the exercise to reduce notes' sizes was never computed. The smaller notes were quickly felt to present a cluttered appearance. There was some text printed on currency notes which the passage of time had rendered superfluous. Initially the Bank proposed removing the words 'guaranteed by the Central Government', but the suggestion was not implemented for fear of adverse public reaction. The expressions 'for the Reserve Bank of India' below the Governor's signature and 'at any office of issue' were dropped. The Bank also proposed deleting the 'promise to pay' clause. Not only had the expression lost its meaning with the



Ten-rupee note issued in 1950 with value in Hindi expressed as *rupaiyah*;
size: 83 x 146 mm; violet and brown with Ashoka pillar emblem

abandonment of any kind of domestic convertibility, it did not, as the Bombay High Court confirmed, have any legal meaning. Besides, Bank notes in several countries did not carry such a clause. But it was feared this change too, would give rise to public confusion, and in the end only the expression 'on demand' in the 'promise to pay' clause was dropped. The Bank's liabilities were thus in form still at variance from what they were in fact. That an opportunity to eliminate the anachronism was missed illustrates the misgivings officials at the Bank and in the government harboured during these years about a largely unlettered public's faith in the country's currency.

DEALING WITH HIGH DENOMINATION NOTES

A major feature of currency management during these years was the reintroduction in 1954 of notes in denominations of Rs 1,000, Rs 5,000, and Rs 10,000. High denomination notes were de-monetized by an ordinance in 1946, but the idea of reissuing them commended itself to the Bank when the Rural Banking Enquiry Committee (1950) remarked on the need to provide adequate facilities for converting and exchanging notes and coins throughout the country. The Bank felt that while the problem could be tackled partly through ensuring that the Imperial Bank and state governments augmented the handling and storage capacities of their branches and treasury offices respectively, the reintroduction of high denomination notes would help reduce the physical quantity of notes in circulation. The bill to promote the reissue of high denomination notes was passed by Parliament in December 1953 amidst fears of members that they would encourage 'black-marketeers'. The Bank commenced the issue of Rs 1,000, Rs 5,000, and Rs 10,000 notes from April 1954. These notes were completely different in their design, watermark, and colour scheme from the pre-1946 notes. The new 1,000-rupee proved the most popular of the three, its circulation by the end of the year amounting to Rs 32 crores, compared with Rs 5 crores for the 5,000-rupee note and Rs one crore for the 10,000-rupee note. With the introduction of the new high denomination notes, there was some decline in the proportion of 10-rupee and 100-rupee notes in circulation.

Until 1956, it was the practice for notes of denominations of Rs 100 and above in circulation to be 'registered' in the books of the Issue Department. Under the Bank's note refund rules, a mutilated currency note in the 'registered' category could be exchanged only if its number was visible on the presented portion or, where such notes were lost or destroyed, the claimants were in a position to declare the number. In order to meet such claims without any loss to itself, special registration sections in the Bank's Issue Offices maintained a record of all 'registered' notes issued and cancelled.

'Registered' notes were still in vogue in several countries, but they made up a negligible proportion of the total circulation. In India, however, 100-rupee notes made up nearly two-fifths of the total circulation. The introduction of high denomination notes in 1954 was expected to reduce the demand for 100-rupee notes and ease the work of the registration section. But thanks perhaps to public fears of demonetization of the new notes, this expectation was not fully realized, with the circulation of 100-rupee notes falling merely from Rs 620 crores in 1952 to Rs 550 crores at the end of 1955. With the increase in their use, the public did not find it practicable to keep a record of the 100-rupee notes in their possession. In any event, work in the registration sections of the Bank had expanded so greatly and fallen into arrears to such an extent that 'registration' no longer facilitated the settlement of claims.

The Bank's managers and currency officers favoured getting rid of the cumbrous system. The issue came to the fore in 1953 when the Kanpur office of the Bank asked for more 'registration' staff and a strongroom for cancelled notes, and the Bombay office wanted to replace old punching machines used for cancelling numbers on 100-rupee notes. Officials at the Bank were convinced that registration had outlived its usefulness and that it should be abandoned. As for the danger of forgeries, more complex design and better quality paper were felt to be better safeguards than registration.

The Bank's executives did not wish to rock the boat. Registration arrears continued to pile up, and by the end of 1954 they amounted to 1,65,000 working days. With necessity staring it in the face the Bank finally abandoned registration from July 1956.

Within a year, however, the Finance Secretary proposed reintroducing note registration and tightening note refund rules as a safeguard against forgeries. The Bank felt a security thread was the safer precaution, but was moved to reopen the subject in 1959 following the increased circulation of counterfeit 100-rupee notes printed reportedly in Pakistan, the Middle East, and South Africa. The basic design of the 100-rupee note had remained almost unchanged since 1950, and the Master of the note press himself thought a change was overdue. Reviving registration too, was considered but never pursued seriously both because of the enormous work it involved, and the problems that would be posed by the notes issued or exchanged during the 'dark' period, in Ambegaokar's words, of over two years during which registrations had been discontinued. Registration now made sense only if its introduction coincided with that of newly designed 100-rupee notes, and all the old notes were demonetized forthwith. Since this too would have created enormous organizational problems, not to talk of avoidable panic and unrest, the Bank advised the government against resorting to so drastic a measure.

THE ISSUE OF ONE-RUPEE NOTES

One-rupee notes are issued by the Government of India. Unlike the Bank's notes which constitute the liabilities of its Issue Department, one-rupee notes and coins are included among the latter's assets. One-rupee notes were a response to the wartime shortage of silver for coinage in India. They were first issued in India in 1917, following perhaps the precedent set by the introduction in Britain of the so-called 'Bradbury' treasury notes three years earlier. These notes were convertible into silver rupees, though in fact, the shortage of silver during the war came in the way of the government carrying out this obligation. One-rupee notes were issued again during the second world war to overcome the shortage of rupee currency, but these were not convertible into silver rupees.

The Bank advised the government in 1956 to demonetize currency notes which had the former king-emperor's head as part of their design, and to use the opportunity to demonetize similar one-rupee notes. There was however a hurdle which stood in the way of adopting the latter suggestion, since the 1940 ordinance authorizing the issue of one-rupee notes did not provide for their demonetization. The law ministry held that the absence of a suitable provision in an emergency ordinance did not stand in the way of the Bank taking over the issue of one-rupee notes by suitably amending its Act and thereafter, if necessary, demonetizing them. The alternative was to amend section 15A of the Indian Coinage Act, 1906 which dealt with the demonetization of metallic coins, to secure the powers to demonetize one-rupee notes as well.

The Bank examined the proposal to take over one-rupee notes in 1940, but the idea had to be dropped at that time since it violated the Burma Monetary Arrangements Order, 1937 and would have been inapplicable there. Thereafter, and until the end of the war, this proposal lay in abeyance since one-rupee notes were regarded as a temporary arrangement, but was revived after 1945 when their issue did not cease. The Bank had no objection in principle to issuing one-rupee notes, but there was a practical difficulty in that nickel and quaternary rupee coins too, were in circulation and the reform would lead to the anomaly of two agencies issuing legal tender of similar denomination. Further, if the Bank took over the notes, rupee coins would also have to be excluded from the assets of the Issue Department and treated as small coins. In considering this proposal, the Bank estimated that the proposed reform would create a shortfall of nearly Rs 117 crores in the Issue Department, out of which about Rs 14 crores were in the form of quaternary and nickel rupees. In addition, eligible assets would have to be found against the 75 crore one-rupee notes in circulation.

The question was therefore deferred until the Bank's gold reserves were revalued. But when this was done in August 1956, the profits from revaluation were used at the Bank's insistence to strengthen its reserves. The only alternative now was to make good the shortfall by issuing ad hoc treasury bills or special rupee securities, and the Bank now took the view that ensuring conformity between the actual and juridical separation of the functions of the Bank and the government was not a sufficient argument for the reform. The Bank had already started withdrawing one-rupee notes with the king's head from circulation, and their demonetization no longer posed the same legal problems as before. Ambegaokar's own inclination was to 'let sleeping dogs lie'. Besides, he pointed out, metal prices could rise again in the event of war and necessitate the issue of one-rupee notes. The Bank's economists also pointed out that India was not alone in issuing small denomination notes and that many countries adopted this practice in various degrees and forms. Besides, in several countries the authority to issue notes vested in both the central bank and the government. But the economists, unlike Ambegaokar, preferred 'centralizing' the note issue at the Bank to the 'present hybrid system' since it was more in accord with 'modern trends' and made currency management easier. According to S.L.N. Simha, even the practice of the government issuing one-rupee coins to the Bank to the tune of Rs 5 crores each year was anomalous. Besides amounting to deficit financing by the 'back door', the Bank now held hoards of one-rupee coins for which there was no public demand. In the end, however, the Bank chose not to pursue proposals to take over the issue of one-rupee notes and to hold in abeyance the demonetization of the older king's head notes.

INTRODUCING DECIMAL COINAGE

Decimal coinage was first mooted in 1870 when the Indian Weights and Measures Act was passed into law. In 1944 a Mint Masters' conference made the same suggestion as part of a post-war coinage programme, but the proposal failed to overcome the resistance of the Bombay and United Provinces governments and of trade and industry associations. Despite this, a bill to amend the Indian Coinage Act to provide for decimal coinage was introduced in the Legislative Assembly in February 1946, but this bill soon lapsed. A special committee of the Indian Standards Institution constituted in 1949 to study the introduction of the metric system of weights and measures also recommended this reform, but to little immediate avail. Meanwhile, coinage in Burma where internal conditions were no less unsettled than those in India went decimal in July 1952, prompting the Indian Banks' Association to request the Bank to take up the overdue reform with the government. The Bank

merely forwarded the association's suggestion to the government without itself expressing an opinion.

In 1953, a private member's bill on decimal coinage was introduced in the Council of States. The government opposed the bill because its subject was already being considered by an inter-ministerial committee. With the Bank too, not wishing to pursue a stance independent of the government, decimal coinage was relegated to the background until April 1955 when the Union Cabinet decided in principle to introduce it along with the metric system of weights and measures. Since adequate time had to be given to the mints to build up sufficient stocks of the new coins, it was proposed to implement the reform from April 1956.

The Indian Coinage (Amendment) Bill, 1955 was introduced in the Lok Sabha early in May 1955, but was passed only in September 1956. The original proposal was to divide the rupee into 100 *cents* instead of 192 pies. But with members objecting to the former term, the government was moved to change it to *naye paise*. The implementation of the new Act was put off to 1 April 1957, when a new series of seven units (namely one *naya paisa*, 2, 5, 10, 25, 50, and 100 *naye paise*, the last amounting to one rupee) were issued. There were no exact equivalents in the new series for the old pice and pie and for quarter, half, one, and two annas. The transition to the new system was remarkably smooth for a country the majority of whose population was unlettered, and was a tribute to the intensive educational and propaganda campaigns which preceded and accompanied it. The older coins already in circulation were allowed to be legal tender for about three years after the new coinage was introduced and were thereafter gradually withdrawn from circulation. The prefixes *naya* and *naye* were discontinued in 1963.

INDENT, ISSUE, AND MANUFACTURE OF NOTES

The memorandum of procedure on the printing and distribution of notes by the currency note press at Nasik Road stipulated that the Bank would send to the government twice every year, indents showing the number of pieces of notes of different denominations required for each currency circle. The first period, which was referred to as Period A, ran from April to September, and indents for this period were sent in the middle of January each year. Period B ran from October through March, and indents for this were sent in the middle of July. Each indent reflected forecasts of the probable demand for notes of each denomination during the next three periods based on detailed monthly statements of note consumption submitted by the Bank's currency officers. The Bank's issue offices were also normally expected to hold three months' stock of Government of India one-rupee notes and six months' stock of notes of other

denominations. But for a variety of reasons, the Nasik press could not meet the Bank's indent in full from the 1950s. Consequently, the latter had to make do with notes in quantities which fell far short of requirements and in denominations which were not in demand, very low stocks, and old and 'reissuable' notes.

The rising demand for currency notes from the mid-fifties first tested the capacity of the note press. With capacity expansion lagging behind the growth in demand, the Bank was moved to maximize the salvage of 'reissuable' notes returning from circulation. Salvage operations proceeded rather slowly, and in order to speed things up the Bank persuaded commercial banks in 1955 to follow the international practice of accepting against their own requirements, reissuable notes lodged by them under guarantee with the Bank. The long-term solution lay in expanding note-printing capacity in India, but even as this was substantially achieved by the early sixties, a fresh bottleneck cropped up in the form of shortfalls, thanks to foreign exchange and capacity problems, in the import and availability of note paper. A short-term palliative was to match the denomination mix of its indents with the denomination mix of the note paper in stock at the Nasik press. This focused the shortage on two-rupee (and 100-rupee) notes and led to a relative excess supply of five and ten-rupee notes.

The question of manufacturing currency note paper in India to ensure its uninterrupted supply had engaged the attention of the Bank and the government since the 1930s. It was pursued in earnest during the second world war. But difficulties of locating a suitable place with perennial freshwater supply in the vicinity of the Nasik Printing Press and of procuring and shipping the necessary machinery under wartime conditions halted further progress.

The idea was revived in 1949 when the Bank's legal competence to set up a security paper mill either by itself or in association with other investors was explored. Section 17(15) of its Act allowed the Bank to manufacture and issue Bank notes. Section 19(1) prohibited it from engaging in any trade, commerce, or manufacture, while section 19(2) barred the Bank from purchasing shares in any company. But the Bank's section 17 activities being precluded from the application of section 19, it was opined that manufacturing security paper for printing Bank notes was incidental to the latter activity, and there could be no objection to the Bank setting up a security paper mill either by itself, in partnership with another investor, or by acquiring a stake in a company floated for that purpose. But by the same argument, legal experts maintained, the output of the mill would have to be consumed entirely in printing the Bank's notes and could not be used to manufacture one-rupee notes, government securities, or stamp paper.

In May 1950 Portals, a British firm which for over 100 years had supplied note paper to India, offered to set up a small pilot security paper plant if the

government met its cost. The government advised the firm to conduct the experiments at its own cost. With the gradual monetization of the Indian economy and the rising demand for currency in India, the Bank's total annual indent in 1951 of 1,300 million pieces was expected to nearly double by 1966. Proposals to set up a security paper mill received a fillip in 1956, with the Finance Minister, C.D. Deshmukh, directing that they should be pursued in right earnest. But the mill became a casualty of the foreign exchange crisis which broke out the following year. The Estimates Committee of Parliament (39th Report, 1958-59) regretted the project's lack of progress and suggested that annual foreign exchange savings of Rs 1.25 crores would have soon compensated for the one-time expected outgo of twice that amount.

Plans to set up a security paper mill thus revived in the early sixties as a means of saving foreign exchange. With the Union Cabinet approving the project, a contract was awarded to Portals in March 1962 to erect a mill in Hoshangabad with three machines at a cost of nearly Rs 6 crores. This mill, which for reasons discussed below opened with two machines, was commissioned in June 1967.

With the shortage of note paper intensifying in the meantime, in 1964 the Governor, P.C. Bhattacharyya, impressed upon Finance Minister T.T. Krishnamachari the urgent need to release foreign exchange for importing sufficient paper to produce at least 3,300 million note pieces annually. Some currency offices were functioning with less than a month's stock of notes against the normal practice of holding six months' stock, and Bhattacharyya warned TTK that while it was important to conserve foreign exchange, economy in this particular area could have serious consequences. But it soon turned out that Portals too, experienced difficulties in stepping up their supply of note paper. Bhattacharyya's intercession, this time directly with the British firm, led to a solution by which it offered to increase monthly shipment from 6,800 reams to 10,000 reams if the Bank agreed to divert some of the machinery intended for the Hoshangabad mill to its own works. This was not expected to delay the commissioning of the Hoshangabad mill since the replacement equipment would arrive in India within ten months. Bhattacharyya consented to the arrangement on the condition that it would involve no further delay or any cost escalation. The government, for its part, released additional foreign exchange for Rs 90 lakhs to import paper, while the Bank intensified its efforts to recycle reissuable notes, scrutinize indents received from the chests more closely, supply to them the minimum possible quantity of notes, arrange salvages wherever possible at the chests themselves, and effect inter-chest diversions of notes.

Until 1923 India had obtained her supplies of printed postage stamps and currency notes from either Thomas de la Rue, an English firm, or the Bank of

England. The Inchcape Committee (1922) departed from its retrenchment brief to recommend setting up a government printing establishment to meet the demand for security documents. Since experts in intaglio printing were not easily available, India decided at that time to adopt the surface printing method (lithography). Repeated efforts by the representatives of the English firm to persuade India to adopt the intaglio method failed to make any headway in the 1930s and 1940s. Lithography along with the 'security thread' was considered by the press Masters to provide adequate safeguard against forgery, while the higher cost of the intaglio technology was a powerful argument against its adoption. However, in 1949 the Finance Minister, John Matthai, formed a committee with the Secretary, K.G. Ambegaokar, as its chairman. The Deputy Governor, N. Sundaresan, represented the Bank on this committee which also included, oddly enough, a representative of Thomas de la Rue. The latter was naturally committed to his company's technology, and it was clear from the beginning that he would not sign any report which condemned its proposal outright. After some effort, Sundaresan managed to produce a draft report which was acceptable both to the English company and to the Bank and the government, neither of whom were enthusiastic about the intaglio method. As Ambegaokar remarked in a note to the Finance Minister in May 1950, though the report was framed in a 'spirit of compromise', its unmistakable conclusion was that there was 'no justification for a change at present'. The English company continued to pursue its objective with an intensity which won it few friends in India immediately, with Deputy Governor Ambegaokar, for example, suspecting in November 1955 that an article in a trade magazine critical of the Bank's notes was 'part of the offensive that de la Rue were carrying out to induce the Government to give them the work of printing our note'.

In 1960, the Governor, H.V.R. Iengar, visited the printing works of the Bank of England and the Portals factory. He also met a representative of de la Rue who was earlier a senior official in the Finance Department of the colonial Indian government. Iengar learnt from these meetings that authorities in Britain and the USA no longer attached much importance to the watermark alone but depended more on a type of printing similar to intaglio. His unease about the security aspects of the Indian note issue was underlined by the detection of a sophisticated operation to forge currency notes in Coimbatore the same year. The government was more inclined now to consider other note-printing technologies, but cited foreign exchange difficulties to rule out any new projects.

Thomas de la Rue, meanwhile, remained unremitting in their efforts to take India along the intaglio path. In November 1964, representatives of the firm met Bhattacharyya, officials of the government, and the Master of the

Nasik press to discuss doubling the latter's capacity to meet the estimated note demand (worked out by the Bank's economists) of 7,000 million pieces by 1974–75. The company's representatives proposed setting up a new press to print notes using the direct plate impression (intaglio) method in combination with an offset lithographic press. The quality of notes, they also argued, should be improved to embody the benefits of recent developments in the field. Irrked by the patronizing tone of the company's presentation, the Master of the Nasik press maintained that barring intaglio printing (which India could not yet afford) the quality of notes printed at his press by the wet offset method was comparable to that produced anywhere else in the world. Moreover, he retorted, the five-colour offset press promoted by de la Rue was identical to the dry offset press manufactured by Giori, a Swiss firm. The Bank thereupon decided to examine what Giori could offer, only to learn three months later from the firm's Indian representatives that it had meanwhile merged with Thomas de la Rue. The latest turn of events only intensified officials' misgivings about de la Rue. 'I am afraid this does not speak well of the dealings of the firm', N.D. Nangia, the Chief Accountant, remarked. 'We must [now] take particular care to see that they would be offering to us their new and latest machines and not passing on to us ... obsolescen[t ones].'

While matters were thus poised, the Bank received proposals from some American firms. Two proposals were considered at this stage. The first was to set up a press at or near Hoshangabad where the security paper mill would soon go into production, while the second involved adding to the capacity of the Nasik press. The American equipment for the new press was found to be too expensive, nor was there any certainty in December 1965 of the US government extending the necessary financial assistance. With the government not in favour of expanding note-printing capacity at Nasik, the scales began once again to tilt in favour of de la Rue-Giori.

A decision was soon taken in principle to offer the contract to this company. But the government was gripped by second thoughts almost immediately, as it grew attracted to the idea of introducing a new and lighter one-rupee coin in preference to that of setting up a new press. Although the latter was intended to print notes in all denominations, one-rupee notes accounted for more than 40 per cent of the total quantity of notes printed, and a new mint would therefore help relieve the capacity constraint at the Nasik press.

According to the government's estimates, the foreign exchange cost of establishing a new printing press would amount to over Rs 5.6 crores. In addition, expanding the paper mill was expected to involve a net foreign exchange outgo of Rs 4.7 crores, while paper imports needed until the country's paper manufacturing capacity was raised sufficiently, would cost another Rs 10.5

crores. In addition to the foreign exchange cost of Rs 20.8 crores, the cost of printing notes was put at Rs 12 crores. Against this, the foreign exchange cost of switching over to rupee coins was estimated at Rs 18 crores until 1974–75. The rupee cost of increasing the production of one-rupee coins was negligible because a second shift at the Calcutta and Bombay Mints would suffice for the purpose. It cost Rs 344 to mint one thousand pieces of one-rupee coin in pure nickel, each of which had a life of 40 years. The average life of notes was about six months, and their circulation was judged to be 3.7 times costlier than that of coins. In addition, the value of metal used in coinage was fully recoverable. The country's total dependence on imported nickel was an argument against embarking on the project, but the strategic danger of this was felt to be negligible since Canada was the principal source of supply.

For reasons that are not clear, the idea of replacing one-rupee notes with coins of the same denomination was not pursued despite its advantages. In the end, therefore, the Finance Ministry's rethinking only delayed the plan to set up a new press and did not cause its abandonment. The proposal for a new press was revived in 1969. In January 1970, de la Rue's several decades of effort finally paid off, and the firm was awarded the contract to set up an intaglio press at Dewas in Madhya Pradesh.

Unpublished Sources

- Cy.16(2) Decimal Coinage—Introduction of
- Cy.24(3)D Note Designs
- Cy.28(1) Currency Notes—Indents
- Cy.24(3)D.Spl. Notes, Sets, Sizes, etc.
- Cy.30(1)C One Rupee Notes—Proposal about the Bank taking over the issue of
- Cy.39 Proposal to abolish Registration of Rs 100 Notes
- Cy.44(6) Manufacture of Currency Note Paper in India—Hoshangabad
- Cy.44(6)A Question of using Thomas de la Rue's Plant for Printing Currency Notes
- Cy.44(7) Printing of Note Forms—Planning and Estimates
- MS.39 Currency—General
- SB.92(A)(4) Facilities for Conversion and Exchange of Notes and Coins
- SB.104 Elimination of Pies from Banking Transactions—Decimalization of
- Cy.140(1) Exchange and Issue of Notes
- HC/CM/I Currency Management—Miscellaneous

Memoranda to the Central Board and Committee of Central Board

APPENDIX B

P.L.480 Arrangements

As is well known, India experienced persistent shortages of foodgrains and other agricultural commodities such as cotton in the 1950s and 1960s. Even in years of normal monsoon and despite low per capita levels of cereal consumption, India was barely self-sufficient in food during these decades. With inadequate food stocks, especially with the government, a poor monsoon or a drought could mean widespread starvation in the absence of imports. The latter were constrained by foreign exchange shortages from 1956–57, so that thereafter India depended on imports of food financed by grants or soft loans.

The United States was the largest source of food assistance to India. In 1951, it exported 2 million tonnes of wheat financed by a loan of about \$190 million (Rs 90.3 crores) repayable in dollars. Thereafter, almost the entire US food assistance to India took the form of loans repayable in rupees.

Between 1955 and 1957, India imported wheat (and cotton) worth nearly \$68 million under the US Public Law (or P.L.) 665, whose sale proceeds, deposited in rupees with the State Bank of India, were used to finance projects such as the Rihand dam. The bulk of the American food aid to India was, however, extended under P.L.480 whose stated objectives were to use that country's food surpluses to 'combat hunger and malnutrition' and 'promote, in other ways, the foreign policy of the United States'.

India was the largest beneficiary of the P.L.480 programme. In the seventeen years from July 1954, total shipments under P.L.480 to all countries amounted to \$23,392 million. Of this, India (which did not begin receiving P.L.480 assistance until 1956–57) accounted for \$5,611 million, or nearly a quarter of the total. Besides foodgrains, particularly wheat (or wheat flour), rice, and jowar, India imported cotton, tobacco, soyabean oil, milk powder, and some other dairy products. Though the private sector too, imported commodities such as cotton under the agreement, P.L.480 imports were principally made on the government account.

Four 'titles' were listed under P.L.480. Until such sales were wound down from 1966, Title I allowed the US to export its agricultural surpluses against payment in the currency of the importing country. Nearly 90 per cent of the P.L.480 assistance to India came under Title I. The Indian government received credits from the US government, either in the form of dollar funds made available to the India Supply Mission in Washington to buy imports covered by the agreement, or less commonly in the form of direct commodity assistance. Rupee proceeds from the sale of commodities imported under the agreement were banked in India, and used to finance agreed projects and activities and meet the expenses of the US embassy in India.

Cumulative imports under P.L.480 amounted to over \$4,131 million by the end of December 1967. The bulk of this comprised wheat (\$2,807 million), followed by cotton (\$375 million), and rice (\$208 million). Of the counterpart amount, \$2,495 million (60.4 per cent) and \$818 million (19.8 per cent) were given to the Government of India as loans and grants respectively. Loans to private enterprises totalled \$272 million (6.6 per cent), while \$546 million were used to finance the expenses of the US government in India.

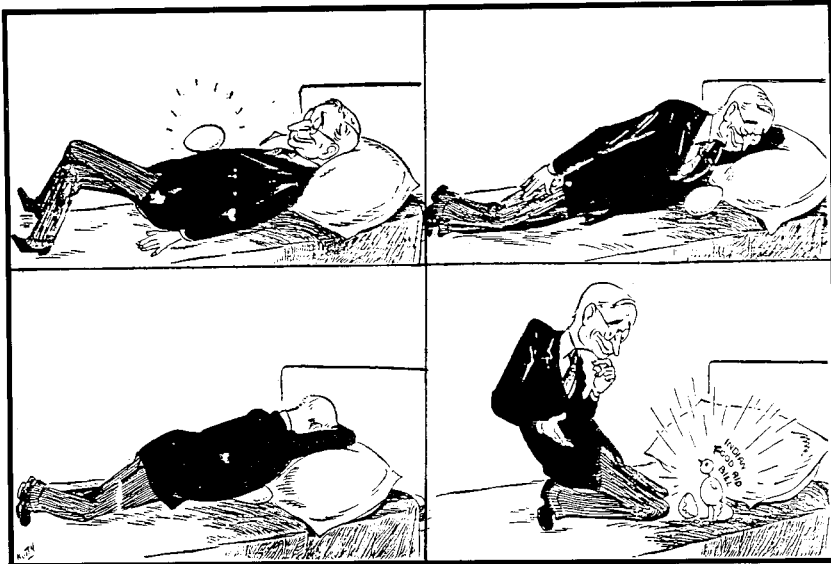
P.L.480 CONTROVERSIES

P.L.480 imports aroused intense controversy and debate in India. The wider debates reflected, partly, the difficulties of reconciling the immediate objective of ensuring adequate supplies of cheap food through imports, and the longer-term objective of stepping up food production, among other means, by improving incentives for farmers. Some macroeconomic effects of P.L.480 imports were also debated. Odd as it might appear, much of this debate related to the 'inflationary' consequences of P.L.480 financial arrangements, and it is with the latter that the remainder of this appendix is mainly concerned.

The primary disinflationary impact of P.L.480 imports, especially of foodgrains such as wheat, could hardly have been doubted. According to some estimates, total net imports of wheat amounted in some years to 60 per cent or more of domestic output. They also exceeded the estimated marketable surplus of the crop in ten of the seventeen years between 1951 and 1967, sometimes by more than 100 per cent. Imports under P.L.480 (Title I) alone accounted for more than three-quarters of total wheat imports by India during 1957-67.

On the other hand, P.L.480 imports did not, unlike normally financed imports, lead to a transfer of funds abroad, but to their accumulation as banking funds in India. In the first agreement between the Indian and US governments under this legislation, almost the entire rupee counterpart funds of P.L.480 sales were deposited with the State Bank of India. By prior agreement, these were invested predominantly in Government of India

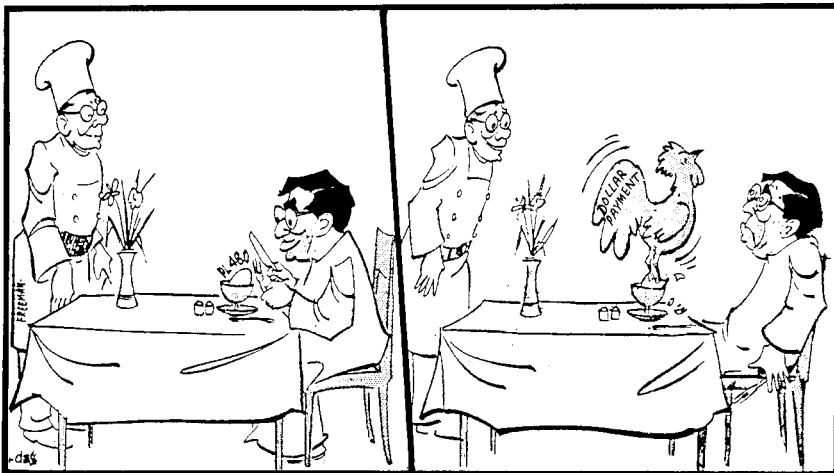
Truman's Triumph



The bill to supply 2 million tons of food grains to India has been finally approved by the U.S. Congress: (A man created a sensation by personally hatching an egg. — News item).

— Shankar's Weekly, 17 June 1951

Between the cup and the lip



Under the "food for freedom" programme, the U.S.A. will ask to be paid in dollars for its food exports.

— Shankar's Weekly, 24 July 1951

securities. About 80 per cent of the programme funds were given as loans or grants to the Government of India for developmental purposes. Some 5 per cent was earmarked for loans by the Exim Bank in Washington to American firms and their collaborators, and the remaining money was placed at the disposal of the US government. However, owing to delays in concluding agreements for utilizing them, funds to the credit of the US Government rose substantially to amount to a little over Rs 250 crores by the end of May 1959.

Though the State Bank did not profit greatly from the P.L.480 banking arrangement, this was widely seen as a form of discrimination in favour of that institution. More serious, in the Reserve Bank's view, was the fact that besides distorting figures of bank deposits, P.L.480 balances with the State Bank artificially inflated subscriptions to government loans. The Governor, H.V.R. Iengar, warned the government in July 1959:

This lends an air of unreality to our loan operations and it is desirable that we should, as soon as possible, rid ourselves of the complacency that inevitably arises from the shadowy nature of these subscriptions

The Bank's advice to the government was to deposit these funds with it. Following discussions with American officials, it was decided that up to a fifth of P.L.480 funds would be deposited with the State Bank, leading Indian private-sector banks, and American banks such as the First National City Bank of New York and the American Express Banking Corporation. The larger part of these balances was deposited in an account with the Reserve Bank's Delhi office, and operated by the US disbursement officer. Since the Reserve Bank was precluded under section 17 of its Act from paying interest on deposits, P.L.480 balances were invested in multiples of Rs one lakh in special non-negotiable securities issued by the Government of India. These securities carried an interest rate of 1.5 per cent per annum and were 'payable on demand'. Balances below Rs one lakh were kept in the account and did not earn any interest. Whenever it became necessary to utilize P.L.480 rupee counterpart funds, the special securities were redeemed to the required extent, and the corresponding amount placed at the disposal of the US disbursement officer. The latter then transferred the funds either to the government as loans and grants—almost 80 per cent of P.L.480 funds were utilized in this way—or to other agencies such as the US embassy.

P.L.480 AND DEFICIT FINANCING

It was argued, notably by B.R. Shenoy, who became Professor of Economics at Gujarat University after a long stint at the Bank, that P.L.480 financing and

disbursement arrangements constituted an addition to deficit financing. The sum and substance of Shenoy's arguments was that the government redeemed special securities not out of its own revenue receipts or by borrowing from the public, but by creating ad hoc treasury bills.

Shenoy's arguments evoked a well-reasoned response from V.V. Bhatt and D.R. Khatkhate, both economists at the Bank, which was published in its *Bulletin*.¹ This study argued that the potential net impact on bank credit to government and money supply of (a) payments to the US embassy, (b) their investment in special government securities, (c) sale to the public of commodities imported under P.L.480 and P.L.665 agreements, and (d) the expenditure of rupee counterpart funds, was neutral. While ad hoc treasury bills issued originally by the government to finance (a) would be retired with the proceeds of (b), the rise in the government's cash balances as a result of (c) would be offset by the redemption of special securities required to finance (d). A similar effect would obtain on private-sector balances where the latter sold commodities imported under these agreements. However, should the government utilize these imports to build larger stocks or subsidize their sales, net bank credit to the government as a result of these transactions would rise to the extent (a) or (d) (assumed here to be equal) exceeded the proceeds of (c). Likewise, net bank credit to the private sector would expand to the extent the latter used imports to build their inventories. These results were valid regardless of whether P.L.480 funds were deposited with the Reserve Bank or the State Bank.

Bhatt and Khatkhate also pointed out that the *actual*, as distinct from the *potential*, monetary impact of the government's imports under P.L.480 and P.L.665 was likely to have been contractionary. This was because while imports aggregated Rs 633.5 crores between 1956–57 and 1961–62, disbursements (or expenditures) of rupee balances amounted only to Rs 243.5 crores. Therefore, on the assumption that there was no increase in the government's stocks and that its sales were not subsidized, the net contractionary impact of these transactions would have amounted to about Rs 390 crores.

The government, too, was generally content to argue that these operations did not exert an impact over and above that caused overall by its budgetary intervention, since all P.L.480-related transactions were reflected in the budget. This was no doubt true in the strict accounting sense, and many were content to adhere to this truth rather than venture an investigation or judgement of the net impact of these budgetary receipts and disbursements in relation to a

¹ 'Effects of the United States Commodity Assistance to India on Money Supply', *Reserve Bank of India Bulletin*, January 1963.

carefully chosen set of counterfactuals sensitive to a variety of real and monetary sector possibilities.

The manner in which the government financed its redemption of special securities posed a relatively more limited and simpler set of alternative possibilities, and therefore its impact remained at the centre of attention where Shenoy had placed it. This issue, mainly, was debated at a special conference in November 1967. The significance of this conference lay in the list of its participants. Though organized by Shenoy's Economics Research Centre which was a private body, it was inaugurated by the Deputy Prime Minister and Finance Minister, Morarji Desai, and its three sessions were chaired by L.K. Jha, Governor of the Reserve Bank of India, John Lewis, Minister and Director, USAID in New Delhi, and D.R. Gadgil, Deputy Chairman of the Planning Commission. Those presenting papers at the conference included officials of the Bank (notably the two authors of the *Bulletin* article who reiterated its principal conclusions) and of the Ministry of Finance, B.R. Shenoy himself, and the US disbursement officer in New Delhi.

Finance Ministry officials maintained that since all P.L.480 transactions passed through the budget, their net effect formed an integral part of that of the budget as a whole, and that 'no further adjustment' was called for on their account in the budget deficit. Other papers pointed out that the actual monetary impact of P.L.480 expenditures depended on whether the government redeemed special securities out of current budgetary receipts, borrowings out of genuine private savings, or through borrowings from the Reserve Bank. The US disbursement officer conceded that the net additional 'cash outlay' necessitated by the redemption of special securities accounted for a small part of the central government's budget, while Shenoy himself maintained that the government financed P.L.480 expenditures, in the ultimate analysis, by creating ad hoc treasury bills and borrowing from the Reserve Bank.

The controversy over the inflationary implications of P.L.480 financial arrangements was prolonged for some more years, with parliamentary and expert committees pronouncing their views upon the subject. The controversy was, in the final analysis, perhaps irresolvable so long as P.L.480 funds existed in some identifiable form.

Redeeming P.L.480 special securities did sometimes pose financial problems for the government. Its cash balance turned negative on one occasion. On another occasion, the resulting increase in the Bank's net credit to the government led to a breach in the net domestic assets ceiling agreed between India and the IMF as part of the March 1965 standby arrangement. But even if the government redeemed special P.L.480 securities entirely through resources raised against ad hoc treasury bills, it did not follow that this

represented an addition to the 'planned' budgetary deficit. Equally, on the other hand, those holding the contrary view might argue that the 'planned' deficit was higher than it would have been had P.L.480 receipts not been available to the government. Thus, in essence, the P.L.480 monetary controversy revisited the familiar debate over whether the availability of any form of lending or assistance *encouraged* a government to run deficits or merely financed deficits determined *ex ante*. This debate, over whether or not deficits arose before the resources to finance them, has taken place in a variety of contexts, including most recently that of the Latin American debt crisis. Discussions in the west, too, about aid to India in the 1950s and 1960s focused on whether such aid plugged or widened resource gaps.

Unpublished Sources

- F 103 Accounting Procedure under P.L.480
- CF(B)16 Foreign Aid Loan Agreements with USA—P.L.480

APPENDIX C

The Palai Central Bank

The Palai Central Bank was incorporated as a public limited company in 1927 in the former state of Travancore. As other similar banks were at the time, this bank too, was included in the second schedule to the Reserve Bank of India Act in 1937 merely on the strength of its share capital and without a prior inspection or verification of its books. By all indications, it enjoyed rapid growth after becoming a scheduled bank, its deposits increasing more than tenfold from Rs 37 lakhs in 1936 to about Rs 382 lakhs twelve years later.

The affairs of the Palai Central Bank first came to the Reserve Bank's notice in 1948. But its powers of inspection were limited by the restrictive provisions of the Banking Companies (Inspection) Ordinance, 1946, which did not extend to the princely states, and all the Bank's officers could do at this time was to 'study the balance sheets' of the Palai Bank. Their study showed that while the bank had not 'indulged in any undesirable race ... to open ... branches', it did not 'conform to orthodox methods in regard to the investment of its funds'; nor had it made an attempt to 'strengthen its liquid position' to match the growth in deposits. Nearly two-thirds of its advances appeared to be unsafe or illiquid. The bank followed a generous policy on dividends, despite which its shares continued to be quoted below par, and had failed to build up sufficient reserves. Consequently, it was not in a position to 'meet losses arising out of its commitments, particularly the high level of its unsecured advances'. Verbal assurances the bank gave to the Madras office of the Reserve Bank and to the Chairman of the Madras Local Board had not been kept, and its actions subsequently did little to 'inspire confidence' in its 'ability and preparedness to eliminate ... undesirable features and conform to recognized practices in the conduct of ... business'.

The Palai Central Bank was, according to a Reserve Bank report, also poorly managed. Its management had remained in the hands of K. Joseph Augusti, about whose suitability and qualifications little was known, since 1932. The bank's resources had grown some eighty-fold during the intervening

years, and it was moot whether Augusti had the skills needed to lead an institution of the size to which the Palai Central had grown.

The dividend policy so far followed by the bank ... in combination with the poor level of its reserves and the high percentage of ... unsecured advances casts doubts whether the Managing Director is really alive to his duties and responsibilities and is capable of guiding the affairs of the bank along the right lines

The report noted that while it would be in the interests of its depositors to 'undertake a close examination' of the Palai Central Bank's affairs, this was not possible under the existing laws. On the other hand, since Palai Central's clean advances aggregated nearly four times its paid-up capital and reserves, the Reserve Bank should consider inspecting the bank 'after obtaining its consent' to determine whether it continued to be 'eligible for retention in the Second Schedule' of the Bank Act. In the meantime, the report proposed, the Reserve Bank of India should ascertain from the bank its liabilities and assets outstanding at branches situated in the former British India to gain some idea of the

extent to which its Indian Union branches have contributed to its deposits and secondly, whether a fair proportion of resources so obtained has been invested within the Indian Union for the benefit of depositors coming within the latter jurisdiction.

ATTEMPTING REFORM ...

No action appears to have been taken on the strength of this study. The first formal inspection of the bank under section 35 of the Banking Companies Act took place nearly three years later, in October–December 1951. The inspection report listed several major defects in the working of the Palai Central Bank. The bank's board of directors did not adequately oversee its working, and the Managing Director appeared to 'wield unrestricted powers of management'. He had sanctioned large clean advances to his relations, and to other directors and their concerns. The head office of the bank exercised poor control over the working of its branches many of whose advances were 'sticky and doubtful of recovery'. Advances 'showing undesirable features' constituted nearly 47 per cent of the total while unsecured advances alone amounted to nearly 40 per cent. The bank's directors, their relations, and firms in which they were interested accounted for about 13 per cent of its advances, and loans to them amounting to Rs 32 lakhs (or nearly 10 per cent of the total advances of the bank) had become sticky. Seven of the bank's twenty-four branches were

operating at a loss, three of these for the last fifteen years. The bank inflated its profits by adding to its income interest on accounts under litigation and sticky advances. It also offered high rates of interest on deposits and advertised aggressively to obtain them. As a result of 'unsound policies and methods of operation', the inspection report warned, the Palai Central Bank 'appear[s] to have lost not only its entire paid-up capital and reserves but also its deposits to the tune of Rs 3.95 lakhs'.

This report was considered by the Committee of the Central Board in October 1952. As the memorandum to the Committee recognized, the bank was liable on the basis of the inspection report to be excluded from the second schedule. But at the inspecting officer's instance, the Bank decided to invite the views of the Palai Central Bank on his findings and to defer a decision to exclude it from the schedule if its management appeared to be earnest about improving the bank's working. Although the Palai management agreed to follow the Bank's advice, there was little discernible progress on the ground. One year after the inspection, the liquidity ratio of the Palai Central Bank continued to fall, advances having 'undesirable features' had increased, and the bank continued to give large clean advances. Nor was there any change in the working of loss-making branches. The bank's overall earning capacity also appears to have suffered during these months.

The Bank however decided against 'drastic action'. According to a memorandum to the Committee of the Central Board, only a 'small portion of the deposits' was affected so far and exclusion from the second schedule may 'apart from creating a run on it, have serious repercussions on other banks in the Travancore-Cochin state' where the Palai Central occupied an 'important position'. Besides, there was no evidence of the bank's management having 'acted fraudulently' and it also appeared more willing now than in the past to 'act upon ... [the Bank's] advice or guidance'. These considerations and the relatively large size of the Palai Central—the 'fact [is that] that the depositors' stake in the institution ... [is] considerably high'—encouraged officials at Mint Road in October 1952 to put off for six months, a decision about the bank's exclusion from the second schedule should it agree to follow the Bank's directions. This course of action, the memorandum to the Committee argued, gave the Palai Central Bank 'a reasonable opportunity to improve its methods of operation', while by maintaining a close watch the Bank would be able to step in, if necessary, to prevent their 'further ... deterioration'.

The conditions the Bank imposed on the Palai Central Bank included appointing a Banking Adviser in informal consultation with the Bank. The Adviser would not be subordinate to Joseph Augusti, whose powers as Managing Director the Bank sought thereby to restrict, and would report to the board of

directors of the bank to whom he would furnish advice in writing 'on all important matters of policy'. The bank was also asked to desist from granting advances to its directors, their relations, or firms in which they held an interest, ensure that its books of accounts were maintained properly, bring down clean advances to a 'reasonable proportion of its total advances', and report to the Bank at monthly intervals its progress in implementing these reforms. Finally, the Reserve Bank reserved the right to demand any information about the bank and to depute its officers to verify the information supplied to it and watch over the bank's progress in implementing these conditions.

While the Palai Central Bank maintained that these conditions were either unnecessary or not in the interests of its constituents, it took violent exception to the last condition, viz. the appointment of an observer, two directors of the bank even calling at the Bank's office in Madras to voice their protest. They and the bank argued that Palai was 'practically a village with one street', and a visitor would 'naturally catch the public eye and become the subject for gossip'. Daily visits by the observer to the bank's head office could 'cause the talk to gain momentum'. The Palai Central Bank had grown in a small place such as Palai 'as no bank in a similar place in India had done'. This was entirely due to the confidence the public had in the bank's directors, and any suspicion that the affairs of the bank were under close scrutiny by the Reserve Bank would have 'unwholesome repercussions'.

Officials at the Bank thought these apprehensions unfounded. But they decided to meet the Palai Central Bank's objections halfway by stationing the observer at Kottayam, a town some seventeen miles from Palai, and leaving it to him to determine the frequency of his visits to the latter centre. But two of the bank's directors then called on the Deputy Governor, Ram Nath, to press for a reconsideration on the plea that they had already engaged a former officer of the Imperial Bank as an adviser. Following this, the Bank decided towards the end of January 1953 to postpone appointing an observer until July, and to rely in the meantime on monthly reports from the bank.

In July the Bank undertook a rapid scrutiny of the bank's accounts which revealed little improvement in its affairs. But the scrutiny also seems to have convinced the Bank that reforming Palai Central was going to be a long haul. Hence, while deciding to impose another condition, viz. that its directors, with the exception of the Managing Director, would not hold any office of profit in the bank, the Reserve Bank gave Palai Central until the end of 1954 to improve. The question of appointing an observer was also deferred till December 1953. In November 1953 the Palai Central Bank resumed its campaign against an observer. J.A. Frost, the aforementioned adviser, arguing that the move would have 'serious repercussions'. The Palai Central Bank's

deposits had grown steadily until his appointment. Thereafter, its rivals 'promptly made capital', quoting his arrival as evidence that all was not well with the institution. As a result, Palai Central had lost deposits of nearly Rs 40 lakhs since the middle of 1953, of which the Ernakulam branch, where his own office was situated, alone accounted for Rs 2 lakhs. Frost thought there was no justification for sending an observer. He himself attended all meetings of the bank's board. The bank had stopped practically all advances 'except against gold ornaments and ... deposits', and advances exceeding Rs 10,000 were now sanctioned only by the board. Directors of the bank had also begun to repay their loans, and the bank had filed nearly 150 suits to recover advances. He was currently preparing a manual which provided for tight head office control over the branches. The bank had a superintendent of advances and an inspector of branches, and hoped soon to appoint a retired official of the Imperial Bank as its chief accountant. Far from 'helping matters', the appointment of an observer Frost argued, would have 'extremely unfortunate repercussions'.

Officials at the Bank felt Frost's fears were exaggerated. But once again the Bank chose in the end not to test them, and decided in January 1954 to postpone a decision until July. In the meantime, the bank was allowed to open a branch at Madurai.

Predictably, the Palai Central Bank resumed its campaign in July 1954. Apart from its earlier arguments, the bank now pointed to the growth of its deposits and its lower credit-deposit ratio. It had cash on hand and with banks of Rs one crore against deposits of Rs 5.65 crores, and its investment in government securities totalled about Rs 1.14 crores. The bank also claimed to have made progress in recovering outstanding advances. Officials at the Reserve Bank conceded that the overall financial position of the Palai Central Bank was now 'slightly improved' and that it had begun to satisfy some of the conditions imposed earlier. The Bank therefore decided that the question of sending an observer 'no longer possessed the same urgency as it did before', and the expiry in December 1954 of the time granted to the Palai bank to remedy its functioning offered a suitable opportunity to review the situation.

This review, which took the form of a 'rapid scrutiny of the affairs' of the Palai Central Bank early in 1955 by O.R. Srinivasan, the Trivandrum-based Deputy Chief Officer of the Bank's Department of Banking Operations, revealed that although the bank had rectified most of the procedural defects noted in the earlier inspection report and restricted fresh advances, its financial position was now actually worse than in 1951. Even 'on the basis of a very liberal assessment of the real value of its assets', it was apparent that deposits to the extent of Rs 51.51 lakhs were at risk now as against

Rs 4 lakhs in 1951. Many advances which were unsecured and outstanding in 1951 had now reached a 'stage of complete stagnation' and been 'inflated in their book value to an alarming extent due to periodical applications of interest that is being booked to income' Advances amounting to Rs 89 lakhs out of total advances of Rs 343 lakhs were 'unrecoverable'. The bank also kept its records in a manner which did not easily reveal the true financial position of the borrowers, and 'in its desperate attempts to maintain the confidence of the public and collect more deposits without which it cannot survive', it showed 'unreal profits out of which dividend and taxes are paid and reserves ... built up'. The bank's board of directors refused to view the situation with the seriousness it deserved, and directors who were indebted to the bank appeared to 'find it embarrassing to sit in judgement over the debts of ... other borrowers'. Consequently, the board of the bank had not made 'earnest attempts' to evolve a 'planned programme' of recovering advances. The scrutiny report concluded by pointing out that 'however honest the intentions of the management', it had proved incapable of recovering or reducing frozen advances. 'A further deterioration in the solvency of the bank' was almost certain if its present management was allowed to continue or was given more time to implement the Bank's conditions. The scrutiny officer therefore recommended a 'detailed re-inspection' to better establish the bank's true state of affairs and determine the future course of action.

At first blush the Bank thought Srinivasan's report made a strong case to 'warrant' the bank's exclusion from the second schedule. But this step was not taken because it was likely to have 'far-reaching effects in the Travancore-Cochin State' where the Palai bank was the largest of five scheduled banks, two others among which were already in a 'vulnerable' position. Besides, the bank had not been entirely idle and had taken some steps to improve its affairs. Though incompetent, neither had its management done anything to 'jeopardize the depositors' interests further'. Hence the Bank decided in April 1955, 'as a special case', to grant the Palai Central Bank another year to remedy its affairs, and in the meantime to direct it to appoint a chief executive in place of the adviser (who it appears wanted to quit), desist from offering more than 4 per cent on any class of deposits, refrain from booking as profits unrealized interest on frozen and doubtful advances, and recover at least a quarter of the bad debts and half the doubtful debts classified by the scrutiny officer. It was also decided to invite Joseph Augusti for an interview with Ram Nath.

These conditions invited spirited opposition from the departing Frost. Summarizing the progress the bank had made since he was appointed to his present position, Frost told T.V. Datar, Chief Officer of the Department of

Banking Operations, in June 1955 that the affairs of the bank had actually improved since its inspection in 1951. The advances which the Bank's scrutiny officer identified as having 'undesirable features' were granted before 1948, and the bank's working had improved steadily since the new executive took office in 1949. Frost argued that the bank's immediate requirements were 'cheaper funds, larger deposits to provide high earnings without undesirably increasing the ratio of advances to deposits, and ... time to recover outstandings'. The latter was, however, best achieved through negotiating rebates in return for regular instalments, rather than 'summary legal action'. Such recoveries, Frost said, must 'necessarily ... be slow'.

The additional conditions the Bank wanted to impose on the Palai Central Bank, Frost maintained, were largely inspired by his letters to Joseph Augusti. But while he had advocated 'the surgeon's knife, the scrutinizing officer apparently preferred the hatchet', and it would be impossible for the bank to fulfil these conditions without eroding public confidence and bringing on a banking crisis. Instead of despatching an observer, Frost proposed, the Bank should undertake more frequent scrutinies of the Palai Central Bank. The latter should also be allowed to reduce the cost of its funds in a less obtrusive way than by lowering the maximum interest rates it offered on deposits. If the bank was prevented from booking interest on doubtful advances to income, it would be forced to show a loss. 'No possible advantage can result from this change.' Doubtful advances, moreover, were not always irrecoverable. Expressing himself satisfied with the present head office executive and its decision to engage two retired officers of the Imperial Bank, Frost claimed the set-up proposed by the bank was superior to the Bank's proposal to replace the chief executive.

If in addition to the recent reduction in dividend, the appointment of a Reserve Bank observer, the lowering of deposit rates, and the declaration of a loss in the bank's working, a stranger, however well qualified, replaced a man of Mr. Augusti's standing in the small centres where the bank is established, the result would be disastrous. Nothing can be lost, and much gained by giving my suggestions a fair trial.

The Managing Director of the Palai Central Bank also represented to the Bank in similar vein. Some directors of the bank called on Ram Nath late in June 1955 to protest against the plan to depute an observer as it would encourage the 'communist plan ... of fanning the flame of evil rumours' about the stability of the bank. At this meeting Ram Nath suggested 'amalgamating the bank with some other banking institution'. The directors rejected the

suggestion and sought more time to set their affairs in order. They promised gradually to reduce the interest the bank offered on deposits and pointed out in defence that a government-supported bank in the region and the Mysore government both offered 4.5 per cent on longer-term funds. The bank also argued against hastily classifying any of its debts as doubtful and showing 'imaginary losses' in its accounts. Then followed an exchange of letters between Mint Road and Palai after which the Bank decided in October 1955 to re-inspect Palai Central early in 1956 and in the meantime to relax many of the conditions the latter had taken objection to. The Bank retained the option to send an observer but did not, in the event, do so. The Bank also decided not to press for Augusti's replacement which, officials now agreed, might 'jeopardize the confidence of its constituents as he was a founder of the bank and had nursed it since ... inception'.

... AND ENCOUNTERING RESISTANCE

The Palai Central Bank was inspected in February and May 1956 with reference to its position at the end of 1955. This inspection revealed that most of the major defects noticed earlier 'remained unrectified' or had worsened. The Managing Director, six of whose cousins held responsible posts in the bank, was incapable of taking energetic steps to improve its working. Many of the advances granted by the Manager of the bank's Madras branch, who also happened to be one of its directors, had turned sticky. He and his wife owed the bank nearly Rs 13.5 lakhs in the form of clean advances, and although he repeatedly flouted the head office's directions, it was unable to 'exercise effective control over him in view of his dual capacity'

Despite being in business for nearly three decades, the bank had meagre reserves. Its reserve for bad or doubtful debts was small even by normal standards. Nearly a third of the bank's deposits carried high interest rates of 4.5-5 per cent, and over 60 per cent of its advances were unsecured. There was a high 'concentration of risk' in the bank's advances, as nineteen borrowers, including some of its directors, accounted for nearly 44 per cent of the total. Nearly half the advances of Rs 34 lakhs owed by the bank's directors had been outstanding for over twenty-five years. Sticky and disputed advances and those having 'undesirable features' amounted to nearly Rs 270 lakhs, or more than three-quarters of all advances. The 'bank's income', the inspection report warned, was 'mainly derived from unrealized interest charged by it on sticky advances'. The estimated realizable value of the bank's assets amounted to about Rs 520 lakhs as against its total outside liabilities of Rs 659 lakhs, indicating that not only were its paid-up capital and reserves wiped out, its deposits also had been affected to the tune of Rs 139 lakhs.

There was, the report concluded, 'sufficient material' to suggest that the bank was 'conducting its affairs in a manner detrimental to the interests of its depositors'. It did not, besides, comply with sections 11 and 22(3)(a) of the Banking Companies Act and section 42(6)(a)(i) of the Reserve Bank of India Act. A note written in August 1956 and enclosed with the inspection report also detailed the bank's resort to 'objectionable methods of manipulation of accounts, creating fictitious assets which did not exist, and inflating incomes which did not really accrue'. These practices had been going on for several years, but after 1952 the bank was 'faced with the ... awkward problem of wiping out a huge intangible asset aggregating to Rs 16.96 lakhs' which was a 'legacy of past manipulations'. These 'assets' could 'no longer pass without notice', nor could the bank adjust them out of its 'normal earnings' since its income from advances, much of which was frozen, was declining. Hence, the note added, the bank had adopted the 'ingenious method of "creating" income for the above purpose out of certain "dead advances"' Despite the management of Palai Central refusing to cooperate with their investigations, the Bank's inspectors felt they had unearthed enough evidence to establish deliberate manipulation of the bank's books and to pin responsibility for it on individual officials.

The note ended with a strong indictment of the manipulations by the bank of its books which, it said, could not

by any standard be regarded as in the nature of a normal window-dressing permitted at times by convention. The *intention* behind these manipulations has clearly been to create false income and assets ... for the definite purpose of presenting a better and more satisfactory picture ... of the bank than would otherwise be warranted by *actual* results of its working known as such to the management. The elements necessary to prove guilt are intention, knowledge, and motive, and it has been amply borne out ... that in passing false entries for the purpose of its annual accounts and balance sheets, these have been present in this case. All these facts lead to the inference that the Board of the Bank on the whole has not been straightforward and has pursued policies which, by no accepted standards, ... satisfy the requirements of honest management. [Emphases in the original.]

Suggesting that these manipulations explained why the bank opposed the appointment of an observer, the note concluded that the Bank should not allow these 'highly objectionable manipulations' to 'pass ... without taking serious notice' of them.

For reasons that have been suggested in the main chapter and are referred to below, events thereafter appear to have moved rather slowly. A copy of the inspection report was sent to Palai early in January 1957. The bank's response came at the end of April 1957 in the form of a thirteen-page letter from Augusti. It is not clear whether Augusti was emboldened by the results of the recently concluded elections in the state to adopt a combative tone, but his letter questioned the judgement of the Bank's inspector who, he alleged, came from a region having 'little in common with the differing problems and features' of the Travancore-Cochin region, spent too little time in Palai to assess his bank's working in the 'proper perspective', and whose 'knowledge of practical problems that face a private joint-stock banker in day-to-day working' was 'meagre'.

He could not realize the difficulties and obstacles that have to be surmounted in piloting an institution through good times and bad, through war and peace, through periods of rise and fall of prices, through legal labyrinths, state enactments and political upheaval. He does not seem to have viewed the complexities of the problems involved in adapting and shaping an institution to suit standards and procedure which became applicable to it a generation after it was founded.

Alleging that the picture of the bank painted by the inspector was 'incorrect, contrary to facts, and ... absolutely misleading', Augusti said he had disposed of the members of the board in a 'slipshod way'. The report's assessment of every feature of the Palai bank was 'coloured and clouded'. The bank had made rapid progress since 1951 despite the 'restrictions, the difficulties and the vexations that arose from continued inspections'. Its deposits had grown from Rs 4.75 crores to nearly Rs 6.5 crores at a time when other banks in Kerala, including those enjoying government patronage, were losing deposits, the state was rocked by 'unrest and political instability' and 'continued onslaughts against capital and financial institutions', and Mint Road had refused to allow Palai Central—whose requests to do so had purportedly received 'assurances of sympathy from some of the highest quarters in the Reserve Bank and in the Ministry of Finance'—to open new branches. His bank, Augusti argued, could have shown better profits and paid out larger dividends if it had not been forced by the Reserve Bank to reduce its ratio of advances to deposits from 65 per cent to 54 per cent.

The letter ended by remarking on the 'widespread feeling throughout ... Kerala' that the 'peculiar economic conditions of the state' and the 'banking problems' arising from them were not

assessed in a proper light by the Reserve Bank of India authorities. One of the complaints heard during the recent elections was that the small banks in the state were being sacrificed. ... the cry of the small banks is a voice in the wilderness. ... unemployment and unrest are increasing due to the impediments put in the way of banking development and the consequent decline in business activities. The people here affirm that by discouraging small banks, the only means of obtaining rural credit are being withdrawn.

The Bank read Augusti's letter as a sign that the management of the Palai bank did not 'even now realize the gravity of the situation'. There was no argument in the letter that warranted a fresh or 'favourable consideration of the bank's case'. However, since any 'penal action against it at the present time might bring in its trail serious repercussions on the banking structure in Kerala' where the Palai Central Bank occupied a 'prominent position', the Bank decided at the end of June 1957, to give it 'one more year's time to improve its position', and in the meantime 'continue keeping its affairs under ... surveillance by imposing a fresh set of conditions'. It was also decided to summon one of the directors of the bank to impress upon him the need to reorganize the bank on 'sound lines', rectify its defects, 'explore the possibility of amalgamating it with some other banking company', and put right the bank's 'questionable transactions'.

The conditions imposed on the bank at this stage included better head office and board supervision of its branches, immediate appointment of a qualified and experienced chief executive officer, removal of the Madras manager, K. George Joseph, stopping all fresh advances to the bank's directors, their relatives, and their concerns, bringing down unsecured advances to a fifth of total advances, creating a 'specific reserve' equivalent to the unrealized interest on bad or doubtful debts credited to the profit and loss account, and taking steps to improve earnings and strengthen reserves. Finally, apart from securing monthly statements from the Palai Central Bank, the Bank reserved the right to call for any statement or information it required and to depute its officers to attend meetings of the bank's board and scrutinize its books. The Bank also warned that if any of these conditions were violated or the bank was found to persist with policies that were detrimental to the depositors' interests, it would pass 'without any further notice', orders under section 42(6)(b) of the Reserve Bank of India Act on the strength of the inspection report of December 1956.

These conditions, and the Bank's decision to defer action for twelve months if it accepted them, were communicated to the Palai bank in July 1957.

Predictably once again, the Palai Central Bank protested these conditions, in particular the one calling for Augusti's removal, as it would 'spread mistrust' about the bank and weaken its ability to improve its affairs. In letters to the Bank in October and December 1957, the Palai Central Bank argued that the appointment of an observer was also the 'surest way to undermine the credit of a bank', particularly one located at a small centre. The creation of a specific reserve to balance the unrealized interest on advances credited to income, the bank also said, would create an 'imaginary loss' and 'unwanted panic and trouble' for the institution. Pleading for a waiver of the proposed conditions, the bank said the Reserve Bank's 'sympathy and farsightedness' had already enabled it to rectify some of the features pointed out in the inspection report and strengthen its position. Its liquidity was also now being maintained at a very high level, but all these efforts to 'improve the working of the bank would be in vain if public confidence ... [was] ... shaken in the least'.

The Palai Central Bank's latest response clearly tested the patience of officials at the Bank. None of its arguments was new. They were, in fact, 'stereotyped and ... common to most of the banks in Kerala who often take shelter by laying ... emphasis on ... peculiar local conditions'. The bank refused to accept the conditions imposed upon it and was intent on pursuing 'dilatatory tactics'. Nor had the bank recently sent a director to meet Ram Nath or replied to the reminders sent to it in this connection. The tactics adopted by the management of Palai Central to evade the Bank's conditions and the recent 'upward trend noticed in its deposits', officials at Mint Road felt, indicated the need for 'some sterner action ... in the interests of ... depositors'.

The 'sterner action' the Bank now proposed was to take advantage of the amendments to the Banking Companies Act that came into effect in January 1957 to issue directions (section 35A), depute an observer (section 36) to the Palai Central Bank, and back the former up with the threat of refusing it a banking licence. These directions were issued at the end of January 1958 and the bank asked to comply with 'each of the directions' failing which it would attract a 'notice informing that a licence cannot be granted to it'. The Bank also deputed one of its officers, C.N. Sivabhushanam, to attend meetings of the board of directors of the bank and of the committees constituted by it, and to keep a close watch over the bank's affairs. Although the bank had no option now but to accept these directions and implement them, it continued to plead with the Bank to be allowed to retain Augusti as Managing Director and to appoint the Superintendent of Advances, K.M. George, as its chief executive. Officials in Bombay saw little merit in the suggestion which they felt promised no departure from the bank's 'old business policies'. But they had little choice in the matter. The banking situation in Kerala—in particular

the Travancore-Cochin region and the recommendations of the recent expert committee which dealt with the subject—constrained its options. The best hope in the circumstances lay in recovering as large a proportion of Palai Central's doubtful and sticky advances as possible, and officials at Mint Road were persuaded by a plea from the Trivandrum office that George's appointment might help achieve that objective.

Seeking also to keep the affairs of the Palai Central Bank under constant review, the Bank undertook another inspection of the institution in March–May 1958, with reference to its position at the end of February the same year. This inspection revealed that the bank's deposits had been affected to the extent of Rs 177.24 lakhs, as against Rs 139.13 lakhs at the time of the last inspection barely two years earlier, and that it was not in a position to pay its depositors in full as their claims accrued. Deposits and advances had also grown substantially during this period, the former mainly due to aggressive publicity campaigns and the bank's success in enlisting the support of some religious institutions. However, the bank had failed to implement most of the important directions and even violated some. Despite the directive against making advances to directors, their relatives, or their concerns, the bank had purchased cheques and drafts from concerns in which a director held a substantial interest. It had also continued to make fresh unsecured advances, which now amounted to nearly three-quarters of total advances as against about 60 per cent at the time of the last inspection. Most of the other major defects still remained to be rectified. Head office control and supervision over the branches was weak and ineffective, the bank's books of accounts continued to be in an unsatisfactory state, and its reserve remained 'small'. Twenty borrowers accounted for advances aggregating Rs 179.98 lakhs (or 42.7 per cent of the total). Advances having undesirable features and those in respect of which suits had been filed amounted to over three-quarters of all advances, and in the inspecting officer's judgement, Rs 208 lakhs (or nearly half the bank's advances) were irrecoverable. A 'major portion' of the bank's income was derived from 'unrealized interest on advances, a sizeable portion of which had become sticky'. It had been charging higher interest on certain decreed debts than those stipulated in the relative decrees, and was charging interest on certain advances in respect of which it had no legal remedy. Yet, the report pointed out, the bank continued to pay dividends.

The inspection report forced the Department of Banking Operations at last to acknowledge in September 1958 that there were good reasons to deny the Palai Central Bank a licence under the Banking Companies Act. But not knowing how deep the waters were, it refused to take the plunge. 'Drastic action', the department explained, was 'fraught with many risks' including 'adverse

repercussions on the entire banking structure of Kerala'. That was not the end of the Bank's dilemmas. Even a change in the bank's management, the department argued, might create problems. Although it had mismanaged the bank's affairs, the present board comprised 'influential persons', and removing them would 'lead to undesirable rumours'. Nor was it possible, because of the 'large depreciation' its assets had suffered, to amalgamate the Palai Central Bank with some other institution. On the other hand the Bank's regulators could not wish away the formidable challenge which the Palai Central Bank posed, and they decided to issue a fresh set of directions in the hope of bringing home to its management the seriousness of the situation, and achieving a 'speedy improvement' in its affairs. These directions included prohibiting the bank from declaring dividends until a reduction had been achieved in the size of its bad and doubtful debts and asking it to appoint four additional directors in consultation with the Bank; the latter largely so that the bank's board could no longer argue that it was prevented by its composition—all the directors were in debt to the bank—from reviewing the dues of its members!

By this stage the Governor, H.V.R. Iengar, was also in the picture. He remarked that the 'state of affairs' disclosed by the inspection report was a 'very sorry one'. But the action the Department of Banking Operations now contemplated

seven years after we first knew the bank is being mismanaged is likely to be criticized as being weak and ineffective and not in accordance with the interests of the depositors, in particular *new* depositors likely to be attracted by the advertisements of the bank.

The Governor conceded that in the end the Bank might be 'driven' to take the mild action suggested by the Department of Banking Operations, but he wondered whether 'as an opening gambit', a notice should not be issued to the Palai Central Bank asking it to show cause 'why a licence should not be refused' to it.

The Department of Banking Operations knocked back the Governor's proposal. It had been decided 'on grounds of policy, not to refuse licences to banks ... operating in Kerala'. Besides, the show-cause notice 'might leak out to the depositors and cause a scare among them', thereby ruining any hope of improving the bank's position or of 'reconstructing it on the basis of a scheme of arrangement'. Instead, the department proposed deferring a decision about what action to take against the bank until its directors had been sent for and acquainted with the findings of the Bank's inspectors. The Governor acknowledged the strength of Banking Operations' argument, but maintained that the Reserve Bank should tell the Palai bank when its directors

called at Mint Road that there was a case for 'descheduling the bank ... (and) ... refusing it a licence', and ask them to explain why this action should not be taken.

The directors of the Palai Central Bank called on Ram Nath two months later on 20 November 1958. In the meantime, the Bank directed the Palai bank not to declare a dividend until it managed to bring its bad and doubtful debts down to a reasonable level. Ram Nath pointed out to the directors that nearly a quarter of the deposits of their bank had been wiped out and wondered aloud why it should not be descheduled or refused a licence. The Palai Central Bank, the Deputy Governor declared, 'had the distinction of being the worst-managed scheduled bank in the whole of India'. In response, the directors alleged that 'some enemies of the bank' had conveyed 'false reports' about it to the Reserve Bank. The Palai bank, they contended, had progressed rapidly since the Bank first inspected it. It had not made any fresh mistakes, and the high proportion of bad advances was a legacy of the past. While the bank could not carry on business if it was denied a licence, even de-scheduling would force its closure. The latter 'will mean not only a serious setback to banking in Kerala but might even involve an economic crisis in South India'. In the end, the Bank told the directors of the Palai Central Bank to study the inspection report and to explain within a month why action should not be taken against their institution.

The Palai Central Bank came back with a prompt but partial response. While it acknowledged the defects pointed out by the Bank's inspectors, it was silent on why it should not be descheduled. But the Bank decided once again against any 'drastic action' because of its likely effects on the other Kerala banks. The Committee of the Central Board, the Department of Banking Operations also observed, had decided to 'go slow' in refusing licences to Kerala banks for another year. However, since the necessity remained in the meantime of alerting shareholders and the public to the 'seriousness of the situation, which the Board of Directors is not prepared to admit or appreciate', it should be prevented from declaring dividends.

The stoppage of dividend which it has been paying all along would have the effect of putting the public on guard that all is not well with the bank and this step is likely to bring about a check on the inflow of deposits to some extent, the department argued.

This direction was issued in November 1958.

Meanwhile, thanks to the earlier growth in its deposits the Palai Central Bank graduated from the 'C' class of banks to the 'B' class. The new

classification had little banking implication, intended as it merely was to determine the salaries payable to a bank's employees. Though the reclassification portended fresh trouble for the bank in the form of a higher wage bill, Palai's directors preferred to see it as a fresh affirmation of the strength of their institution. Consequently, the bank responded to the Reserve Bank's latest direction in February 1959 with a fourteen-page letter from Augusti which recalled its origins in a small village, its ability to withstand a succession of crises including the depression and the banking panic of 1937-38 in the region, and its growth to the status of one of the top twenty banks in the country and the largest bank in Kerala despite the presence of government-supported local banks in the state. Earlier restrictions imposed by the Bank, Augusti claimed, had only helped undermine the health of the institution and placed 'serious handicaps' in the way of its growth. Despite this, its deposits had grown rapidly. The Reserve Bank, according to Augusti, was also to blame for the large proportion of Palai's bad or doubtful advances. Left to itself the bank would have recovered these advances. But Reserve Bank intervention had had the effect of giving borrowers the impression that if they repaid their loans, 'no fresh advances would be allowed and their business and honour would be imperilled'. Besides, the bank was not

allowed to open any branches during the last nine years except one. We were continuously expanding over the 21 years prior to the [first] inspection. If we had only been allowed we would ... have grown to thrice the size of what we are. Our means of earning profits would have been enlarged. The old debts could have been considerably recovered and fresh advances on sound basis could have been granted.

Alleging that the Bank's licensing decisions were arbitrary, the letter cited instances of banks refused licences because of the way their affairs were conducted, 'repaying their deposit liabilities in full within weeks of the refusal of licences'. The liquid assets of the Palai Central Bank, the letter maintained, amounted to 47.6 per cent and 'all easily realizable assets' to 80 or 85 per cent of its deposits.

Augusti also objected to the restriction on dividends. The resulting saving of Rs 1.25 lakhs (at a rate of 5 per cent which was the dividend the bank paid out since 1955) would not improve the reserves significantly. Besides, it would take eight years by this method to make the bank's reserves equal its paid-up capital. The faster way to 'increase ... reserves, ... wipe off ... losses and to strengthen our position' was to 'increase ... earnings'. It was

important consequently to ensure that the bank's 'integrity' was 'left unimpaired' and it was allowed to increase the ratio of advances to deposits from the present level of about 53 per cent to 60 per cent or more. This 'cannot safely be done if there is a stoppage of dividend and consequent loss of prestige'. The letter ended with a plea for 'understanding and wisdom' from the Reserve Bank and a thinly-veiled reference to the political circumstances of the state.

The State of Kerala even now has vexatious problems which defy solution and are baffling to the supreme authorities in the country. We fervently hope that the Reserve Bank will ... help us in every way so that the discontent among the people of the State may not be aggravated [and] ... the integrity of the country ... [may be] consolidated.

Augusti's letter was followed a month later in March 1959, by one from George Thomas Kottukapally, the Member of Parliament from Muvattupuzha and a director of the Palai Central Bank, to the Governor. This letter was largely on the same lines as the longer one from Augusti, and pleaded in particular for relaxing the ban on dividends. Thomas also referred to the contemporary political situation in Kerala in rather more direct terms.

Conditions in Kerala ... are difficult and different from the rest of India. Under existing conditions we live in severe strain under a regime ideologically opposed to everything that we stand for. I fervently hope, as the supreme head of our entire banking system, you would view the position in all its implications and all its varied and comprehensive aspects and extend your support which a subsidiary institution deserves especially at a time such as we pass through in Kerala.

Referring to the 1938 banking crisis, Thomas remarked that it was

a sad thought for the historians of the time, that if the Central Banking Institution had moved during the TNQ Crisis the economic conditions of Kerala would have been different, and its political developments would not have taken the tragic turn [they have] taken today.¹

¹ The abbreviation TNQ here refers to the Travancore National and Quilon Bank. The collapse of this bank is discussed on pp. 183-90 of the earlier volume of the Bank's *History*.

Soon after this letter towards the middle of April, the Governor gave George Thomas an interview in the course of which he refused to reconsider the Bank's decision on dividend payments by Palai Central. As an office note written in April 1959 explained the decision of six months earlier, the Palai Central Bank was

systematically giving publicity through advertisements about the services rendered by it to the public, and this may also be one of the main reasons for the steady growth of its deposits. The ... directive is therefore intended to safeguard the interests of its existing and future depositors.

A NEW APPROACH?

There matters largely rested during the remainder of the summer, though the Bank used this period to urge the Palai Central Bank to create a reserve against specific advances and to add four new members to its board. Three months after Iengar's meeting with Thomas, the Palai Central Bank decided in July 1959 to introduce a 'Cumulative Savings Scheme' differing little from similar schemes introduced by other banks.

On past form, the Reserve Bank might have been expected to stop the scheme. Apart from leaning on the Palai bank to improve its affairs, the Bank's efforts had earlier been to protect the interests of the wider public by discouraging its members from placing fresh funds with this institution. There were limits to the extent to which new depositors could be discouraged without encouraging existing depositors to flight. Consequently, the Bank never formally asked Palai Central not to take fresh deposits. However it attempted to make it more difficult for the sick bank to attract new deposits by not allowing the latter to open new branches, advertise widely for deposits, offer high interest rates, and most recently, pay out dividends. During these years, the Palai bank had applied to the Bank several times to be allowed to take the new deposits route to rehabilitation, but always in vain. As recently as March 1959, when George Thomas made a similar request, the Bank had thought his argument 'strange!'

In August 1959, however, the Bank, for reasons that remain a mystery, turned its back on the earlier approach and supported the Palai Central Bank's plea to be allowed to attract deposits under its new scheme. Remarking on the request, an official pointed out that the bank's earning capacity was 'already low', and a 'substantial portion' of its existing advances were difficult to recover.

Hence, the chances of its retrieving its position will be slim if it cannot successfully augment its earning capacity and build up adequate surplus as to be in a position to write off, in due course, the bad debts. As a significant portion of its existing resources is practically locked up in sub-standard or irrecoverable advances, the bank cannot but make efforts to increase its resources as a necessary prelude Thus, although there is an inherent danger of permitting it to introduce schemes intended to attract further deposits, this is an unavoidable step if the bank is to rehabilitate itself.

The note went on to remark that the Reserve Bank so closely oversaw the working of the Palai Central Bank that the 'scope for any further abuse of funds or frittering away of resources by the bank' was 'limited'.

In the circumstances and as it is not our intention to de-schedule the bank or refuse a licence to it before giving it the maximum opportunity to rehabilitate itself, it does not appear desirable for us to object to the bank's proposal

Somewhat contradictorily, the note also argued that the

sudden non-declaration of dividend on shares by the bank for 1958, pursuant to the direction issued by us, would have already put the public on guard to some extent in regard to the real financial position of the bank. Consequently, it is doubtful whether, in practice, any significant response to the new scheme of deposits will be forthcoming.²

The course of action proposed in the office note was hotly debated within the Bank, the Executive Director, C.S. Divekar, observing that he was not convinced by the 'reasoning' behind it. The Palai bank, he said, was

on the brink and for some time to come it should not go in for additional commitments but concentrate on setting its house in order. The R[eserve] B[ank] would be perfectly justified in descheduling them but having decided not to precipitate a crisis, let us not be parties to ... unwary depositors being trapped by them.

² In the event, despite the ban on dividends, the bank's deposits increased from Rs 855.56 lakhs at the end of December 1958 to Rs 968.77 lakhs at the end of December 1959. This, according to a memorandum to the Bank's Central Board in February 1960, belied the Palai Central Bank's contention that the 'stoppage of dividend ... will jeopardize its reputation'.

But a meeting with the Chief Officer of the Department of Banking Operations appears to have set Divekar's reservations at rest, for the Bank decided to allow the Palai bank to introduce the new deposit scheme while keeping a 'watch over the amount of deposits' collected under it.

Whether and how far the Reserve Bank allowed extraneous considerations, such as the surcharged social and political situation in Kerala, to affect its judgement on this question must remain a matter for conjecture. But it is evident from reports in the local press that the Palai Central Bank was not above the contemporary political fray in Kerala. We have already noted that a Congress member of Parliament from Kerala was a director of the Palai bank which also orchestrated protests by the region's banks against the state government's agricultural debt relief legislation. These protests culminated in a decision taken in May 1959 at a meeting of bankers hosted by the Palai Central Bank, to boycott the state government's loan programme that year, and force its abandonment. There were reports in the state's political press that the bank held the deposits of the state Congress party, bankrolled the 'liberation struggle' against the United Front government, and that its resources had been eroded in consequence.³ Such charges cannot be verified. But we may note in passing for what it is worth, that the Bank's decision to relax its long-standing policy of preventing the Palai Central Bank from actively seeking fresh deposits coincided with a period of heightened social and political strife in Kerala.

Whatever the other pressures and motivations, there were limits to how far the Reserve Bank could backtrack on the course it had pursued for the past many years. It will be recalled that in January 1958 the Bank directed the Palai bank to create a specific reserve or make a provision equivalent to the interest charged to accounts considered by the Reserve Bank to be bad or doubtful of recovery. The bank then set up an 'Interest Deferred Account' which accumulated Rs 4.05 lakhs during 1958. But rather than show a loss (of some Rs 37,000) in 1958, the directors of the Palai bank preferred to violate the Bank's direction and transfer the amount in the 'Interest Deferred Account' to its profit and loss account. This enabled the bank to show a profit of Rs 3.78 lakhs for 1958, but also necessitated a provision of Rs 2 lakhs towards taxes. Asked by the Bank to explain its conduct, the management of the Palai bank argued that if it was prevented from taking credit in the profit and loss account for interest on all the debts the Reserve Bank's inspectors considered bad or doubtful, the balance sheet for 1959 would end up showing

³ A malicious report even claimed that forged currency notes detected in circulation in the Coimbatore region were kept in safe custody at one of the bank's branches.

a loss of Rs 16 lakhs. This 'disclosure all of a sudden' it argued, 'might cause a panic among its depositors and result in a crisis'. But it was not only the Palai bank which was caught in the cleft-stick. So was the Reserve Bank, which sympathized with the fears voiced by the management of the Palai Central Bank. But it could not relax the directive relating to special reserve provisions without seeming to 'acquiesce in the manipulation resorted to by the [Palai Central] bank'. Since 'either course was fraught with embarrassing consequences' the Bank decided to take the matter to the Southern Local Board and also hold a new round of discussions with representatives of the Palai Central Bank.

THE FINAL WEEKS

It was a chastened group of directors who came to Madras in December 1959 to discuss the crisis facing their institution. Willing at long last to concede the enormity of the crisis facing the Palai bank and to take urgent steps to restore the position, they were however anxious that the 'implementation of the directions issued by the Reserve Bank should not directly or indirectly result in its closure'. But the management's reformed attitude had come too late to make any appreciable difference to the future of the Palai Central Bank or the fortunes of its depositors. After a careful review of the latest discussions and the bank's position, the Southern Local Board concluded that 'the bulk of the bank's income consisted ... of interest on its unrealizable advances', and that it would not be able to show any profit 'for several years to come'. Hence there was 'no question of any relaxation of the direction prohibiting the payment of dividend'. The Local Board also decided that the bank's accounts should be inspected 'immediately' to 'arrive at the exact figure of unrealizable advances'. More fatefully, the Palai Central Bank was asked to retain the interest accruing on such advances in an 'Interest Deferred Account' and show the resultant loss in its balance sheet for 1959. In addition, the Local Board insisted that the bank should quickly carry out the directive to appoint four additional directors, appoint an 'independent and suitable' chief executive, stop paying Joseph Augusti (who had earlier been divested of all his powers) a monthly salary, and cut down its administrative costs by retrenching the senior management of the bank, closing down unremunerative branches with 'meagre deposits', reducing deposit rates in stages, and slashing expenditure on advertisements.

The scrutiny which followed in January 1960 revealed that out of total advances of Rs 528 lakhs, advances to the tune of Rs 221 lakhs would have to be considered 'definitely as irrecoverable'. Of the remainder, Rs 4.73 lakhs were 'doubtful of recovery', and advances aggregating



Panicky depositors at the Delhi branch of the Palai Central Bank

Rs 121.08 lakhs were 'either frozen or sticky'. According to the inspecting officer, this meant that the Palai Central Bank would have to show a loss of at least Rs 13.73 lakhs, and possibly of Rs 15.07 lakhs for 1959. The condition of the Palai Central Bank was brought to the notice of the Bank's Central Board in March 1960, following which the earlier directions were reissued. While the bank dallied in appointing independent directors, it was not until April 1960 that it agreed to appoint an independent chief executive officer. This appointment came about in July 1960, when

T.R. Sivaraman, the agent of the Cochin branch of the State Bank of India, took over as the General Manager of the Palai Central Bank. On 21 July, the Bank sent Palai bank a report on the scrutiny of its advances, and gave it a month's time for explanations and a year's time to remedy its many defects. But the final denouement involving the Palai Central Bank had begun to unfold, and neither these measures nor the Bank's intentions could do much to arrest or deflect the course of events already under way.

From all accounts, the Palai Central Bank began suffering a run on its deposits at least from 24 June 1960. The proximate cause of the run was the publication the previous day of the annual accounts of the bank for 1959 showing a loss of some Rs 14.5 lakhs. The run on the Palai Central Bank was also accompanied by a smaller run on the South Indian Bank, but this appears to have been largely because other smaller banks in the region anticipated a rush for withdrawals and drew down their deposits in this institution to cope with it. According to Finance Minister Morarji Desai's statement in Parliament some days after the collapse of the bank, withdrawals increased steadily from Rs 12 lakhs during the week ending 1 July 1960 to Rs 17 lakhs a week later, Rs 20 lakhs during the week ending 15 July, and Rs 23 lakhs, Rs 29 lakhs, and Rs 35 lakhs during the weeks ending 22 July, 29 July, and 5 August 1960 respectively. The Palai Central Bank's deposits fell by nearly a sixth between 24 June and 8 August 1960.

The board of the Palai Central Bank met on 30 July 1960 to consider fire-fighting measures, and decided to send Sivaraman to Bombay to apprise the Reserve Bank of recent developments and request to be allowed to open a branch or two as a confidence-building measure. In May 1960, when the Bank first learnt of Sivaraman's impending appointment, it had hoped to invite him for an interview soon after he took up his new position to discuss the shape in which to consolidate the various directions issued to the Palai Central Bank over the years, and the reorganization of the working of the bank. This meeting now came about in circumstances of crisis, and in discussions with the Governor and senior officials of the Bank in the first week of August, a grim Sivaraman acknowledged that the Palai Central Bank was beyond redemption and that it was best taken into liquidation as soon as possible. The bank, Sivaraman disclosed, was left with a cash balance of Rs. 50 lakhs and reserve borrowing of Rs 100 lakhs against government securities.

LIQUIDATING THE PALAI BANK

Following Sivaraman's report, the Bank came to the conclusion that the Palai Central Bank was not in a position to pay its depositors in full and that its

continuance would be prejudicial to their interests, and on 8 August 1960 moved an application in exercise of its powers under section 38 of the Banking Companies Act before a judge of the Kerala High Court at Ernakulam seeking the winding up of the bank. After the High Court admitted the application and passed an interim order appointing a provisional liquidator, the General Manager of the bank called a meeting of its board the same afternoon to apprise it of these developments. (According to some press reports critical of Sivaraman's role, he had called a meeting of the board to coincide with the anticipated receipt of word from Ernakulam about the admission of the Bank's application.)

The Bank's action in seeking the liquidation of the Palai Central Bank predictably raised something of an outcry in the press and in Parliament. The front pages and editorial columns of Kerala's newspapers appear to have had space for little else for a few days in August. Some newspapers attacked the Reserve Bank for having waited too long before acting, others attacked it for acting without sufficient cause, while those steering a middle course held the Bank guilty of having done too little for too long and then wielding the hatchet without warning. Articles by the distinguished economist, K.N. Raj who was no stranger to the Bank, and A.D. Gorwala, Chairman of the Committee of Direction of the All-India Rural Credit Survey, also criticized the Bank for allowing the Kerala bank to beguile new depositors. If the Bank's handling of the Palai Central Bank typified its policy with respect to other banks, Gorwala thundered,

there cannot but be grave doubt about the state of the whole banking system. Much may need to be done, much set right, and the first step towards correction must be a thorough and impartial investigation into the affairs of the Palai Bank and the Reserve Bank's part in them.

The events of 8 August also reverberated through Parliament which was in session at the time. The Parliament discussed the bank failure more than once during the next few weeks. Though not all members who participated in these discussions were critical of the Bank, it once again faced the charge of allowing matters to drift until only extreme measures were possible. In public and in Parliament, the Finance Minister whom Iengar had 'informed' by telephone before taking action against the Palai Central Bank, defended the Reserve Bank forcefully.

If action had been taken earlier, it might have been open to the criticism that sufficient time and opportunity had not been provided

for those controlling the bank to set their house in order. If it had been deferred, there was every chance of preferred creditors and those with demand liabilities getting away with what was readily available, leaving the other creditors to face a dead loss. One has to balance nicely the various conflicting considerations and with full knowledge of all the factors involved, I have little doubt that the action taken by the Bank and the timing were appropriate,

the Finance Minister told the House. He was also fulsome in the Bank's praise, and spoke of the 'admirable manner' in which it was 'doing its work'.

Privately, however, the Finance Minister conveyed to the Bank his reservations about its handling of the Palai affair. Writing to the Governor two days after the bank closed its doors, Morarji Desai invited Iengar's attention to the criticism the government faced in Parliament and asked to know why the Bank had allowed the affairs of the Laxmi Bank and the Palai Central Bank to drift before deciding eventually to wind them up. Exhorting the Bank to ensure against such failures in the future, the Finance Minister wondered

whether some more positive steps cannot be taken, on the basis of inspection reports, as soon as there is an indication that the banks concerned have not been functioning properly. The Reserve Bank has now a wide range of powers under the Banking Companies Act, including power to give directions relating to a number of matters. Perhaps those powers might be more freely used.

While defending the Reserve Bank as 'one of the best central banks in the world' maintaining a 'high level of efficiency', the Prime Minister, Jawaharlal Nehru, was reported to have acknowledged that it may have made a 'mistake' in closing down the Palai Central Bank.

Defending the Bank's action, the Governor recalled the representations received from the Kerala Bankers' Association and the Travancore-Cochin Banking Inquiry Commission to 'go slow' on refusing licences to banks in Kerala and pointed out that if the Bank had taken the action it had now taken in any of the previous three years, it would have been subject to even greater criticism. 'This has been the considered judgement of my colleagues and myself in the Bank.' However, Iengar conceded, 'someone else could have exercised his judgement differently'.

The Bank issued a press statement on 9 August 1960 explaining the reasons for its action against the Palai Central Bank. Thereafter, however, the Bank had said nothing in public on its own behalf. While the onus of defending it in Parliament fell, naturally enough, on the government of the day, the Bank's case threatened to go unrepresented in the press. Besides, public reaction to the August

events was intense and widespread and so little appreciation existed of the Bank's point of view, that the Governor chose to devote his Presidential address to the annual general meeting of the Indian Institute of Bankers to placing in perspective the relative roles and responsibilities of the Bank and of banks' managements in ensuring the soundness of their institutions and of the banking system.

The Reserve Bank has been given pretty wide powers to inspect, give advice, and issue directives. All this, however, is no substitute for operational responsibility I do not suppose any one suggests that the Reserve Bank should carry out these responsibilities over nearly 4,000 branches in the country; apart from the sheer physical difficulty, that would be taking over a direct and continuous administrative responsibility which rests on commercial banks. *The Reserve Bank's powers are not ... a substitute for the efficiency and integrity of the managements themselves* In the final resort, if a management does not listen to advice and chooses to be recalcitrant and it is felt that continued pressure would be useless, the Reserve Bank would have no option but to close down [the bank] in the interests of the depositors. But this decision involves a delicate balancing of several factors, some of them operational, some psychological [Emphasis as in the original draft of the speech.]

It was 'easy enough to be drastic'. But greater wisdom lay in 'nursing' a bank to bring it to a 'healthy state' if there was 'any reasonable hope of doing so'. Pointing out that this had in fact happened in a number of cases, and that nursing a sick bank back to health was a 'time-consuming process', the Governor averred that 'persuasion and pressure applied persistently over some years' had resulted in many a bank 'reforming its ways and putting its house in order'. But such reform took 'patience and time'

The next stage of the Palai Central Bank episode unfolded in the law courts. Citing two grounds, namely that it was mala fide and that section 38(3)(b)(iii) of the Banking Companies Act offended Articles 14 and 19 of the Constitution, sixty-six creditors of the Palai Central Bank opposed the Bank's application to wind up the institution. The plea of mala fide was soon withdrawn by the petitioners, and in December 1960 Justice Raman Nayar of the Kerala High Court upheld the constitutional validity of section 38 and allowed the Bank's application to wind up the Palai Central Bank. Joseph Kuruvilla Vellukunnel, a former director of the Palai Central Bank and a contributory, appealed against the judgement in the Supreme Court where he was joined by another contributory and depositor who filed a separate writ under Article 32 of the Constitution. By a majority judgement delivered in

March 1962 by the Chief Justice, B.P. Sinha, and Justices M. Hidayatullah and J.R. Mudholkar, the appeal and writ petitions were dismissed, the Court holding that sections 38(1) and (3)(b)(iii) of the Banking Companies Act were neither discriminatory nor unreasonable and violative of Articles 14 and 19 of the Constitution. Nor were these provisions, since they were manifestly in the public interest and protected by Article 302, *ultra vires* of Article 301 of the Constitution. In their minority judgement, Justices J.L. Kapur and J.C. Shah felt the High Court order should be set aside as section 38 imposed unreasonable restrictions on the right of a bank to carry on business without making adequate provision for subjecting executive actions under it to judicial review.

Back in the High Court, the liquidator moved a plea in August 1961 for publicly examining the directors and the auditor of the Palai Central Bank under section 45(G) of the Banking Companies Act on the ground that their actions and omissions had led to the bank and its depositors losing money. After the court allowed the appeal, the liquidator initiated malfeasance proceedings against the bank's directors and auditor and to recover Rs 288 lakhs from them. The directors denied personal liability. The Court exonerated some directors of the bank and directed the others and the auditor to pay Rs 288 lakhs. But the liquidator failed to recover any part of this amount. The main proceedings to liquidate the Palai Central Bank also dragged on for nearly three decades, the High Court's final orders dissolving the bank coming only in December 1987, i.e. twenty-seven years and four months after the Bank moved its application. The real losers, both due to the bank failure and the prolonged liquidation proceedings, were the unfortunate depositors of the Palai Central Bank who managed in all to recover some two-thirds of their 1960 deposits. In real terms, of course, depositors' losses were much greater.

Additional Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
DBO.81(A)	Palai Central Bank Ltd. (in liquidation)
Liq.4(163)	Palai Central Bank Ltd. (in liquidation)
C.73(D)	Palai Central Bank Ltd.
B.2.3030	Palai Central Bank (Appeal and Writ Petition Filed in Supreme Court)
Ins.22(B)	Supreme Court Judgement in Palai Bank Case
Ins.22(B)(4)	Palai Central Bank Ltd.—News Items

Memoranda to the Central Board and Committee of Central Board

APPENDIX D

The Bank and the Mundhra Affair

More than its actual dimensions, the fact that it was the first major financial scandal involving the government in post-independence India has helped secure a unique place for the Mundhra affair in the appendixes of the country's financial history. The scandal and Haridas Mundhra's indictment by the Chagla Commission set up to enquire into the affair also led to the exit from office of the Finance Minister, T.T. Krishnamachari, while the reputations and careers of H.M. Patel, the Finance Secretary, and G.R. Kamat and L.S. Vaidyanathan, Chairman and Managing Director respectively of the Life Insurance Corporation (hereafter LIC), too, came under a cloud. The Governor, H.V.R. Iengar, whose name figured prominently in the controversy and in the two inquiries which followed, was more fortunate. But the affair cast a shadow over his reputation, and to some extent over his effectiveness thereafter as Governor, and led to a re-evaluation by the Bank of some of its wider responsibilities. Some old-timers at the Bank, such as K.S. Krishnaswamy who retired as Deputy Governor in 1981, have even traced the diminution of the Bank's stature in subsequent years to this episode.

THE BACKGROUND

As we point out below, there are many dimensions to the Mundhra affair. The one which caught the political and public eye at the time and with which it continues to be identified today relates to the investment by the LIC, as later events showed at considerable loss to itself, of policyholders' funds to the tune of over Rs 1.25 crores in the shares of Mundhra's concerns through the purchase of these securities directly from the man himself. But to quote the Chagla Commission, Haridas Mundhra was a 'financial adventurer', and convincing the powers that be to use public funds to bail him out was only his most spectacular escapade. He had also in the meantime built through takeovers, a large industrial empire financed to a substantial extent by loans from Indian and exchange banks secured against his companies' overpriced stock, and

apparently against forged, duplicate, triplicate and in one alleged instance, quadruplicate shares.

The latter aspects of Mundhra's activities have largely been obscured in recent years. But they are important not only for their own sake. Rumours of a funds-starved Mundhra seeking to liquidate his stocks and of fake share certificates, and news of brokers and banks to whom Mundhra owed money wishing to sell shares of his companies were reported to be among the factors depressing Lyons Range during the early part of 1957. The taxation proposals passed in the May 1957 budget, including the short-lived expenditure tax, were also believed to have added to the depression the government purportedly wished to relieve by using LIC funds to steady Mundhra's shares.

Why the government should have been so disposed in the summer of 1957 is at first glance harder to understand, since inflation was already nudging upwards, external reserves were under strain, and public investment—to finance which it would soon come into the market with large loans—was rising sharply. Besides, the Calcutta stock exchange had been heading downwards since August 1956, there was no noticeable intensification of the crisis in the summer, and Mundhra's shares had been a drag on the market since some time in 1955. According to accounts of the period, the unexpectedly severe reaction of stock prices to the expenditure tax proposed in the 1957–58 budget motivated the Finance Minister to do something to revive the market. But as we note at the end of this appendix, it was also reported that Mundhra had donated Rs 2.5 lakhs to the Congress party and agreed to defer the closure of the Kanpur Cotton Mills to avoid throwing a large number of workers off work. According to rather more productive mills, the LIC bail-out was Mundhra's reward for these gestures. Rumours such as these are impossible to verify. Let us merely note here that Mundhra had a degree of access to officials holding high public office such as cannot be explained solely by the crisis in his finances or its effect on the market. Secondly, as M.C. Chagla argued convincingly in his report and the departmental disciplinary inquiry board which was set up in its wake agreed, the LIC's investment appears to have been intended less to influence prices in the Calcutta market and more to relieve Mundhra's difficulties. 'In other words, the object [of the transaction] was to finance Mundhra to the extent of a crore and a quarter [rupees] by the purchase of his shares.'

THE RISE OF HARIDAS MUNDHRA

Starting from scratch and with virtually no education, Mundhra built a formidable industrial empire within a matter of years in the 1950s. He began with the acquisition of F.&C. Osler (India) Ltd. which was the Indian subsidiary

of a well-known British lamp-manufacturing concern, and soon bought controlling stakes in Richardson and Cruddas Ltd. and Jessop and Co. Ltd., both of which were reputed engineering concerns under European management in Calcutta. After his attempts to take over some tea companies met with mixed results, Mundhra acquired a controlling interest in the British India Corporation, a well-known managing agency, in 1955. Soon thereafter he turned his attention to Turner Morrison and Co. Ltd., another large firm of managing agents owned by a Singapore-based investment company which in turn was owned by the Turner brothers in the UK. The British India Corporation acquired a 49 per cent interest in Turner Morrison and a reported assurance of a 51 per cent stake within five years.

Mundhra's takeover technique involved the snowballing of controlling interests in cash-rich firms and managing agencies which at this time were particularly vulnerable to predatory raids. He also drew on bank finance for his operations, covering margin requirements largely through manipulating the share prices of his companies. Thus, according to a secret report written in February 1956 by the Deputy Governor, Ram Nath, and sent to the central government, Mundhra bought his controlling interest in the British India Corporation by paying its former owners Rs 10-12 per share. Subsequently he drove the price of these shares up to nearly Rs 14 per share. He then obtained accommodation from banks of up to Rs 11 per share, thereby managing to finance the takeover almost entirely with borrowed funds.

It was clear by the end of 1956 that Mundhra had overreached himself. Large borrowings from banks and falling share prices were together narrowing his room for manoeuvre. Mundhra began buying his own shares back from the market to steady them but with only limited success. Nor could he, for want of the necessary resources, take delivery of shares from brokers who largely financed their operations on Mundhra's behalf with loans from banks. As the prices of his shares continued to slide, brokers began demanding additional margins from their principal. It is not clear when Mundhra began raising bank finance against bogus shares, but by spring 1957 his affairs were in a state of crisis and were said to be a major cause of the gloom hanging over the Calcutta stock market.

Mundhra's financial adventures had done little to endear him to other business families in Calcutta. A large business house in that city was believed to be ill-disposed towards him and it was often alleged at the time—frequently by Mundhra himself—that this business house played a big role in bringing about his downfall.

Nor was his wealth of much assistance yet in improving his somewhat shadowy reputation. Company law administrators and the government had

been seized of Mundhra's operations since 1954. In the same year, Mundhra was also pulled up for offences and 'irregular' exchange transactions under the Foreign Exchange Regulation Act. Ironically, in the light of subsequent developments, T.T. Krishnamachari was among the first in government to take any notice of Mundhra. Writing to the Finance Minister in August 1955 from his perch in Commerce and Industry, TTK warned Deshmukh about Mundhra's doings 'right at our very nose', and wondered whether the Companies Act should not be strengthened to deal with them. The Finance Ministry suspected even in December 1955 that Mundhra had defrauded Osler's shareholders to the tune of about Rs 6 lakhs, while in dismissing a petition he had filed against one Chimanram Motilal, a judge of the Bombay High Court remarked on Mundhra's 'thoroughly dishonest attitude ... [and] conduct'. Ram Nath's assessment of Mundhra's methods too was far from positive: he did not, in the Deputy Governor's view, 'possess either the experience or the background' to run an industrial empire; while in a letter to H.M. Patel written a fortnight after Ram Nath's report, the Governor, B. Rama Rau, confessed to being 'disturbed' by Mundhra's activities. As Jawaharlal Nehru noted on a file in September 1957 well before the scandal broke, 'the reputation of this gentleman [was] not good'. It is instructive to note that rather than following it, Mundhra's poor reputation preceded the collapse of his industrial empire.

BANKING ON MUNDHRA

From the mid-1950s, the Bank began to receive disturbing reports of Mundhra's activities from a variety of sources, and decided in December 1955 to investigate the entrepreneur's use of banks' funds. Preliminary inquiries revealed that nine banks had made substantial loans to Mundhra or his companies. These included the State Bank of India, whose advances were however fully secured against raw materials and goods in process belonging to Jessops and British India. Four banks, of whom all but one were exchange banks, had lent Rs 3.3 crores to Mundhra, which were largely secured against the pledge of his companies' shares.

The Reserve Bank's inspection of the accounts of the three exchange banks in March 1956 revealed many irregularities, some bordering on the farcical. The Calcutta managers of two of these banks, it transpired, had exceeded their powers to finance Mundhra's acquisition spree and managed successfully to conceal this from their head offices in London by having his loan account regularized for a day or two at the end of each month. When Mundhra failed to make the necessary credits to the account of one of these banks at the end of November 1955, the head office was told that the client

had been prevented from undertaking a balancing transaction by the traffic congestion arising from the visit to Calcutta of Nikolai Bulganin and Nikita Khrushchev, and that he had deposited cash and shares at the home of the manager. The Reserve Bank inspection revealed that all three banks had also committed a number of other irregularities, including overvaluing his shares, in lending money to Mundhra. The reports of the Bank's inspectors led to the resignation of the Calcutta managers of these banks. The prosecution which the Bank sought of one of them proved impossible as he had fled meanwhile to Pakistan en route to Britain.

From 1956, the Bank also began carrying out half-yearly reviews of bank lending to Mundhra and his concerns. These reviews showed that banks' loans to these borrowers had risen from Rs 3.3 crores at the beginning of 1956 to Rs 14.5 crores by the end of the year and further to Rs 15.6 crores in May 1957. Meanwhile, reacting to reports received from the government in December 1956 of Mundhra using finance from banks to corner shares of some Calcutta-based companies, the Bank initiated inquiries which showed that six banks, including one exchange bank, had sanctioned advances to share-brokers against the shares of these companies. Following this, the Bank issued instructions to all banks in April 1957 to desist from financing takeovers and speculation in shares.

By May 1957 there were serious fears that Mundhra's financial difficulties would prevent banks from realizing their debts without unloading his shares on the market. Apprehensive that unregulated selling would lead to a collapse of the stock market besides eroding the realizable value of the banks' securities, the Bank mooted the possibility of Mundhra's creditors forming a consortium to coordinate the recovery of their advances to him. The banks refused to heed the suggestion following legal advice that they would be liable to civil action by Mundhra should he suffer any loss or adversity as a consequence of their action. Some creditor banks suggested instead that the Bank should itself convene a meeting for the purpose. But this suggestion too, was not pursued since it was felt to do little to improve the legal position.

The Bank's and the government's knowledge about Mundhra's market activities originated to a great extent from the regular letters A. Raman, Research Officer at the Bank's office in Calcutta, wrote to his superiors in Bombay. Raman's reports, which the Bank shared with the Finance Ministry and which were later quoted extensively in the report of the Chagla Commission, spoke at length about Mundhra's methods of operation, his manipulation of stock prices, the use he made of bank funds, and the drag his shares exercised on stock prices in Calcutta. Raman also faithfully reported to his employers rumours, which in the event were not without basis, of imminent

LIC intervention to aid Mundhra, and the market's assessment of it. By September 1957 his letters were warning of the chronic nature of Mundhra's troubles, the transient impact of the LIC's support, and of the effects on the market of British India withholding dividend payments and of Jessop's inability to finalize its annual accounts. The very least the market felt the government should do, he reported early in September 1957, was to order an inquiry into the affairs of Mundhra's concerns. Raman's reports went up in the ordinary course to the Finance Minister, T.T. Krishnamachari, who noted gloomily on the last of his letters that it did not 'make good reading'.

By the autumn of 1957, other reports about Mundhra's activities painted a grim story of an adventurer who had descended to fraud to build an empire and extricate himself from financial difficulties. Rumours abounded of shares in circulation of Richardson and Cruddas being in excess of the company's share capital. These rumours were confirmed in November 1957 when two banks reported to the Bank that they were in possession of duplicate shares of this company and of British India. Mundhra, one of these banks also discovered to its discomfiture, had pledged two sets of shares bearing the same serial numbers, neither of which was authentic, with two of its branches! The study the Bank conducted thereafter of banks' holdings of Mundhra shares showed that he and three of his concerns had pledged as security to banks, shares amounting from 3.5 to 92 per cent of their paid-up capital. In five cases the shares pledged exceeded half of the respective firm's paid-up capital and in three cases, 75 per cent. The Bank's investigation also revealed the large-scale duplication, triplication, and in one case even quadruplication of his companies' shares.

From autumn 1957, Governor Iengar began with increasing frequency to alert the government to what was soon to become a major public scandal. The 'business of Haridas Mundhra is getting worse and worse', he warned the Finance Minister in November. While advising the government to take a comprehensive view of the group's activities, the Bank itself began taking steps to initiate legal proceedings against Mundhra. One of the banks in possession of bogus shares was advised to lodge them with the State Bank of India, while following meetings with the chairmen of the latter institution and the Life Insurance Corporation, and Secretaries in the Finance Ministry, it was decided that the State Bank and the LIC should move the courts under the Companies Act to appoint suitable persons to manage Richardson & Cruddas and British India. At Iengar's instance, it was also decided to order, in the public interest, an investigation into the affairs of Mundhra's companies. Finally upon the Bank's insistence, one of the banks in possession of bogus shares pledged by Mundhra agreed, though somewhat reluctantly, to lodge a complaint to that effect with the police in Delhi. Not long afterwards, the

‘denouement’ Iengar had been warning about for some weeks came about in circumstances which not only exploded Mundhra’s flimsy industrial and financial empire, but also damaged the reputations and careers of a number of officials and public servants.

THE LIC STEPS IN

It is in the event something of an irony that Iengar too should have been singed by the flames of the Mundhra affair. The collapse of his industrial empire and the many civil and criminal cases lodged against him arose because of the dubious methods Mundhra adopted to raise money for his activities. But public and parliamentary concern, if not necessarily interest since the judicial fate of this unsuccessful adventurer continued to feature regularly in the newspapers for the next few years, was mainly evoked by the efforts of the government and the life insurance monopoly owned by it to rescue Mundhra, and the financial losses that the LIC sustained as a result. H.M. Patel, the Finance Secretary, whom the Chagla Commission held was principally responsible for the LIC’s decision, insisted that TTK, Iengar, and P.C. Bhattacharyya who at this time was Chairman of the State Bank of India, shared equal responsibility. While TTK’s strenuous denials failed to convince Chagla, Patel failed in his efforts to implicate the other two men. But Iengar’s reputation never completely recovered from the fact that Mundhra’s movements during those crucial days in June 1957 shadowed his, that Mundhra called on him in Bombay to discuss his proposals, and that he sent the Governor a copy of the proposal upon which the LIC decision was based. The Governor made some remarks on the letter which some felt were incriminating, and which Patel claimed supported his contention that Iengar was, along with TTK, a party to the decision to invest LIC funds in Mundhra’s shares.

It is necessary at this stage to quickly summarize the chain of events and decisions leading to the fateful decision of 22–25 June 1957 to deploy LIC funds to rescue Mundhra. On 18 June, T.T. Krishnamachari, accompanied by Iengar, Patel, and Bhattacharyya addressed a meeting of businessmen and financiers in Calcutta. The prolonged slump in Lyons Range and the Mundhra effect on it also figured in these and subsequent discussions. Mundhra does not appear to have met any of these persons in Calcutta. But Iengar and Patel interviewed B.N. Chaturvedi, the president of the local stock exchange and a member of the investment committee of the LIC, who accompanied Mundhra when he followed Patel to Bombay on 21 June and played a notable role in the discussions which followed.

Mundhra met Patel on 21 June at the Bank. The same day he wrote to Patel at his invitation about his problems and conveying a ‘few suggestions

which would go a long way' in solving them. Mundhra proposed to Patel that the LIC should buy shares worth Rs 80 lakhs from him and pick up another Rs 30–40 lakhs from the market to stabilize it. In addition he sought a loan of Rs one crore from the LIC and undertook to give it business to the same extent. The corporation, he also suggested, should buy fresh issues of preference shares of British India and Jessops to the extent of Rs 1.25 crores, and offered as a sweetener, fire insurance business worth Rs 15 lakhs. Attached to this letter was a list of his total liabilities amounting to about Rs 5.25 crores of which Rs 3.93 crores were owed to banks, and unencumbered assets of Rs 1.55 crores. The following day, Mundhra sent a copy of these proposals to Iengar who remarked three days later that the LIC was 'looking into this in consultation with the Principal Secretary'.

Patel discussed these proposals with Kamat who was willing only to buy Mundhra's shares. On the same day according to Patel's account of these events, he and TTK discussed Mundhra's proposals at the Bank in Iengar's and Bhattacharyya's presence, and took the fateful decision. According to B.K. Nehru's recollection of the episode, TTK 'simply ordered' Kamat to buy certain shares which included those of the Mundhra concerns.¹ On 23 June, which happened to be a Sunday, Patel, Kamat, and Bhattacharyya met Mundhra. At this meeting Mundhra was invited to come up with definite proposals which were presented and discussed the following day in a meeting attended besides the others present at the Sunday meeting, by Vaidyanathan. On 25 June the Life Insurance Corporation wrote to Mundhra communicating its willingness to buy from him an agreed list of shares of his companies at prices prevailing at close of trading the previous day. Not only were the various participants at the meetings clear about the prices the LIC would pay for the Mundhra shares, the manner in which they were finalized allowed ample scope for the markets to be manipulated when they opened on Monday.

The deal finalized by the LIC on 25 June was not the first investment by the corporation in shares of Mundhra's companies. In March and April 1957, in the course of three transactions of which the last two were conducted directly with Mundhra himself, the LIC bought substantial lots of his companies' shares. Nor was it the last, the LIC entering into four more purchase transactions in September 1957 through a firm of brokers. But the deal of 25 June 1957 was the biggest by far of any single investment the LIC had undertaken until then. Significantly, this transaction was conducted without any reference to the investment committee of the corporation.

¹ *Nice Guys Finish Second: Memoirs* (New Delhi, 1997), p. 275.

THE CHAGLA COMMISSION AND AFTER

The LIC's attempt to rescue Mundhra first caught parliamentary attention in September 1957 and became a subject of intense scrutiny and debate later the same year. Bowing to pressures in Parliament and outside, the government appointed Justice M.C. Chagla as a one-man commission of inquiry into the affair. After a public inquiry which lasted some weeks and evoked great public interest, Chagla came to the conclusion that the object of the impugned deal was to relieve Mundhra rather than satisfy any public interest, and that it had been undertaken at Patel's instance. Kamat and Vaidyanathan were both 'overborne' by him and failed to 'exercise ... responsibility'. Chagla also held that the Finance Minister had, as Patel maintained, acquiesced in the transaction and even otherwise could not avoid responsibility for the decision.

The Governor, H.V.R. Iengar, appeared before the commission as a witness. More than his own involvement in the decision, his evidence was expected to resolve the differing accounts TTK and Patel gave of their conversation of 22 June. Mundhra's letter to Iengar and his unsuccessful attempt the next day to meet the Governor, who apparently 'threw him out' out of his house, also figured prominently in the questioning. Iengar disclaimed all knowledge of the conversation between Patel and TTK. Justice Chagla accepted Iengar's evidence but the Attorney-General, M.C. Setalvad, cast reflections on it and suggested that the Governor knew more than he was prepared to admit. It appears from B.K. Nehru's recollections of the event that Iengar's statement was not 'generally believed'. Nehru reports that TTK sent him to meet Iengar, Patel, and Bhattacharyya in Bombay to ensure that the three officials did not try to 'save their own skins' by telling 'stories which differed from each other' and from TTK's. There was, according to Nehru, no need to 'make up' any story since there were no disagreements about it between the three men, all of whom resolved to defend the transaction on its merits and expected the Finance Minister to do the same. But once in the witness box, TTK, acting reportedly on G.B. Pant's advice, went back on the agreement he had deputed Nehru to Bombay to secure, and disclaimed all knowledge of the LIC's decision. An angry Patel reacted by placing the blame on the Finance Minister. Nor was Patel amused, it seems, by Iengar's claim of not having heard his conversation with the Finance Minister. While Setalvad drew pointed attention to it, Iengar's 'temporary loss of hearing' was, according to Nehru, an act of dissimulation which contributed to diminishing the 'prestige of the office of the Governor of the Reserve Bank of India'.² The Bank's initiative to form a

² *Nice Guys Finish Second*, pp. 276–79.

consortium of bankers to promote an orderly recovery of Mundhra's dues, Setalvad also suggested, was another reflection of its solicitude for the adventurer's interests. The Bank sought leave at this point to intervene in the proceedings, only to be told by the commission that neither the Bank's conduct nor that of its Governor was under scrutiny.

TTK resigned as Finance Minister on 18 February 1958 following his indictment by the Chagla Commission. In the parliamentary debate on the report, some members pointed accusing fingers at Iengar (and Bhattacharyya), while one member even charged the Prime Minister with protecting the Governor because he had earlier been his principal private secretary. Rejecting the allegation and defending Iengar, Nehru pointed out that there was 'nothing involving him at all' in the commission's recommendations, and it was 'unfortunate ... [and] not quite fair' that his name should have been 'brought in simply without any reason'.

The Prime Minister's stout defence of Iengar did little to sway the Justice Vivian Bose board of inquiry set up to initiate follow-up proceedings against Patel and Kamat, both of whom belonged to the ICS and were employees of the Government of India, and because the charges against him related to the same transaction, also against Vaidyanathan. While the Chagla Commission's conclusions and its fallout are public knowledge, little is known yet publicly about the Bose inquiry and the government's response to its recommendations.

The inquiry, which was set up under the All-India Services (Discipline and Appeal) Rules, 1955, recommended Patel's removal from service and compulsorily retiring Kamat. Both recommendations were overturned by the Union Public Service Commission (UPSC) which considered the report of the Bose inquiry. The UPSC concluded (with one member, J. Sivashanmugham Pillai, dissenting) that no blame attached to Patel and decided to exonerate him. It held Kamat responsible for not exercising 'due care and caution' in fixing the prices of Mundhra's shares and for entering into an 'unbusiness-like' transaction, and recommended his censure. The government accepted the UPSC's recommendations.

Not being accused persons, neither Iengar nor Bhattacharyya appeared before the board. But the latter thought it fit, nevertheless, to make 'adverse observations' against the two bankers without giving them an opportunity to be heard. This, the government concluded, was 'unfortunate'.

The Vivian Bose inquiry endorsed the Chagla Commission's view that the object of the impugned transaction was to benefit Mundhra rather than the public interest. But it also went much beyond the Chagla Commission in suggesting that the only possible motive for the transaction was 'a quid pro quo for the donations given by Mr Mundhra to the Congress Funds and an

attempt to fulfil promises made to him about the Kanpur Mills'. The UPSC rejected this charge which it felt had been made without proper inquiry. Neither had Patel cited it in his defence nor had the inquiry board put the proposition to the witnesses appearing before it. 'In the circumstances', the UPSC concluded, there was

no ground for the inferences that either Shri Mundhra's donations amounting to Rs 2½ lakhs, or his agreement to defer the closure of the Kanpur Cotton Mills placed the Government under any obligation—express or implied—to enter into a transaction with him of the order of over a crore of rupees.

The government too, endorsed this view and felt that there was no evidence in support of the motive put forward by the board. There the matter has rested ever since.

THE RESERVE BANK'S ROLE

Arguably, as Setalvad implied, the Bank may have followed the LIC transaction closely. There was no lack of reason for such interest. Banks had lent large sums to Mundhra, and a collapse of his business empire would have affected these institutions and possibly their depositors and other borrowers adversely. The Reserve Bank also kept a close watch over stock market trends. But it was powerless to persuade the LIC or the government to step in to save the situation, and appears to have made no attempt to do so. Nor, once the latter agencies decided to act, was the Bank qualified to comment on matters of propriety involving an autonomous corporation. Proposals were on the anvil at that stage for the Governor of the Bank to be made the chairman of the proposed investment board of the LIC, but there was no reason until such proposals materialized for the Bank to evince any interest in the investment policy of the corporation.

Whether or not the Mundhra affair dimmed the lustre of the Bank is a matter of opinion. It did bring the Bank and its chief executive some harsh and unwelcome publicity. The decision to undertake the transaction in question was made on the Bank's premises, while Mundhra visited the Bank more than once to call on Patel who, like other Finance Secretaries before and since, was provided an office at Mint Road whenever in Bombay. Iengar was aware of the crisis in Mundhra's finances and the banks' exposure to him and his concerns. But few would deny that lack of knowledge in this important regard would have been the greater failure. It will always remain moot when and how much Iengar knew about the LIC decision. On the other hand, it is also difficult in matters such as these to judge where the limits of subjective

knowledge yielded to those of liability. But it must be added in all fairness to those involved, that Iengar's reputation came under a cloud not so much because he was believed to have been responsible for the LIC decision, but because he did not divulge to the Chagla Commission the truth of which he was believed to be in possession.

The Mundhra affair certainly dimmed Iengar's lustre which was not enhanced by the remarks Setalvad and the Vivian Bose board of inquiry passed about his reliability as a witness. As we have also pointed out elsewhere, Iengar went into a state of isolation after these events. Writing in August 1958 to TTK who had meanwhile taken up residence in the southern resort of Kodaikanal, Iengar remarked:

You have asked about the boycott in Bombay. Quite frankly, I have ceased to be interested in it and I have ordered my life in such a way that I could not possibly care less. I do not think I have accepted a single invitation from any business magnate since January and it seems to be generally known that I am averse to accepting such invitations. I feel much happier because I am getting a great deal more time which I devote partly to reading economic literature and partly with my family; the latter is a pleasure which I have unfortunately denied myself for many many years.

Although the Bank did not follow Iengar into a shell, the outcome of the Mundhra affair did motivate it to consider shedding responsibilities that were liable to be misunderstood in a manner as to undermine 'the highest public confidence in the monetary management of the country'. The initiative to 'disengage' himself and the Bank from activities which did not 'directly and statutorily' form a part of the latter's responsibilities came from Iengar himself. Expressing his 'dismay' early in February 1958 at the manner in which the Attorney-General 'twisted' his evidence and the Bank's interest in Mundhra's financial affairs, Iengar drew TTK's attention to the presence of D.D. Pai, the Calcutta manager of the Bank on a committee set up to consider a case involving the Jessops. Alarmed by the possibility that 'at some future date the Attorney-General or other lawyers may draw wholly false conclusions about the attitude of the Reserve Bank in regard to the Mundhra concerns', Iengar asked Pai 'not to attend meetings of the Calcutta Stock Exchange' until he was instructed otherwise. TTK believed stock exchanges could not 'normally [be] dissociated from the activities of the Reserve Bank'. In any case, he added in a letter to Iengar early in February 1958, the 'abnormal incident which happened

in connection with the LIC enquiry' would not be repeated 'in the case of any decision by a Stock Exchange Board'. Besides, it was 'unwise' to dissociate the Bank's officers from such activities.

The position of the Reserve Bank is such that it is impossible for it to dissociate itself from the economic activities of the country; and this will be on the increase in the future rather than on the decrease. The objectivity of the actions of the Reserve Bank should not be questioned and I think it will not be in the future. We should not be unduly obsessed with what happened recently.

Iengar followed TTK's advice to 'take his time' and consult the Central Board before coming to any decision. Proposals to the Board were formulated by the Deputy Governors who recommended that while the Bank should not abandon institutions on which its representation was statutory, arose from contractual obligations, or fulfilled a vital national interest without great cost to the institution or its effectiveness, the disadvantages of associating its officers with the working of stock, bullion, and commodity exchanges 'outweigh[ed] the advantages'. Although associations such as these were not without benefit to the Bank, they were not free of friction. There could also be instances in which the 'Bank's name would be drawn into controversy' or the stance its officer took as a nominee of the government (for example on the boards of stock exchanges) conflicted with the Bank's own policies. Therefore, the Bank took the view, which the government in the event accepted, that the latter should nominate its own officers to the stock, bullion, and commodity exchanges rather than those of the Bank.

As pointed out above, an amendment bill was on the anvil at this time to constitute an investment board of the Life Insurance Corporation with the Governor of the Reserve Bank as its chairman. This proposal, the Bank now felt in the changed circumstances, would 'divest the Life Insurance Corporation of responsibility for investment of its funds'. Associating the Governor as chairman was also felt to present other difficulties.

The Board would presumably be responsible for investment of the funds of the Corporation primarily in the interest of policyholders The Bank and its Governor, on the other hand, are charged 'generally to operate the currency and credit system of the country to its advantage', viz. to the advantage of the whole economy and 'to secure stability'.

This arrangement, the Bank argued, would create a 'dichotomy of responsibility' of the Governor in his two capacities and lead to complications. Nominating a Deputy Governor to the investment board was also open to the same objection. Reluctantly, after some delay, and also rather mysteriously and impenetrably, the government accepted the Bank's suggestion 'without prejudice to the general question of the relations of the Reserve Bank with the Government of India and the State Governments and their executive organizations' However, proposals to associate the Reserve Bank with the investment board of the LIC or officers of the Bank as directors of stock and bullion exchanges did not entirely fade away, and were revived from the 1960s.

Unpublished Sources

- | | |
|------------|--|
| G.8 | Governor's Correspondence with Government of India,
Ministry of Finance |
| C.124(M) | Papers regarding Shri Haridas Mundhra |
| C.124L(1)4 | Shri Haridas Mundhra Group |
| C.124L(1) | LIC Enquiry Commission |
| MS.95 | Representation of the Reserve Bank on Statutory and Other
Organizations |

APPENDIX E

Administering Exchange Controls

by C.J. Batliwalla

This appendix details the involvement of the Reserve Bank as the primary agent of the government in the design and implementation of exchange control policy during 1951–1967. The growth of the control system, brought about by the inconvertibility of the pound sterling in the post-war period and the changes necessitated in the control measures following the return to sterling convertibility forms one aspect of this story. But the other and more important aspect is the adaptation of the control regime to the stresses and strains imposed by the development process on the country's foreign exchange reserves and earnings.

Exchange control was first introduced in India at the outbreak of the second world war in September 1939 and its pattern was set by the Defence of India Rules and a regular stream of addenda and amendments to them. At first, many, including officials at the Finance Department of the Government of India, hoped that it would be possible to dispense with the system of controls when the war ended. Reality proved otherwise. On the termination of hostilities, it was found that the pent-up demand for imported goods precipitated a deficit in India's external payments. While India had large accumulated sterling balances with which to finance the deficit, the UK regulated withdrawals closely because of the sterling area's own tenuous balance of payments position. Thus in March 1947, legislation in the form of the Foreign Exchange Regulation Act (FERA) was passed to put exchange control regulations on a statutory footing, and brought into force the same month. Initially valid for five years, the Act was extended for another five years in 1952, and put on a permanent footing under rather different circumstances in 1957. Thereafter as the development process gained momentum, the scope and intensity of exchange controls, which by then came to be regarded as an essential instrument of national economic policy, widened. By the middle of the second five-year plan, sterling balances had reached a level which left virtually no cushion for development purposes. With India's limited foreign

exchange resources having to be husbanded carefully to finance essential imports and service the growing volume of external debt, a special responsibility devolved on the Exchange Control Department (ECD). Initially, the department was headed directly by the Governor (who was the ex-officio Controller). P.J. Jeejeebhoy became the Deputy Controller in 1949. Jeejeebhoy was assisted by D.N. Maluste who became the Controller when that position was formally separated.

The ultimate controlling authority in India was the Finance Ministry, which was also responsible for policy. But the day-to-day administration of exchange control was in the hands of the Reserve Bank. Unlike the UK, where the central bank operated on delegated authority, in the Indian case the Reserve Bank was vested with statutory authority to administer FERA and had powers to act on its own. The government had the overriding power to formulate policy. But as its adviser, the Bank was also closely involved in making policy.

Both in size and importance, the Exchange Control Department was a striking presence at the Reserve Bank. In the fifties, the number of persons employed solely for exchange control work was around 160. The Reserve Bank delegates a large measure of authority to commercial banks, both Indian and foreign, and the bulk of foreign exchange transactions are routed through these 'authorized dealers', who in 1967 numbered forty. Despite this, in the sixties, the strength of the ECD had grown to around 300.

The Foreign Exchange Regulation Act lays down that foreign exchange transactions should not be based on exchange rates for the rupee other than those authorized by the Reserve Bank. Under the prevailing IMF system, a member country was required to express the par value of its currency in terms of gold or the US dollar, and was required to maintain the exchange rate of its currency within a narrow band of not more than one per cent on either side of its par value. The par value of the rupee originally conveyed to the IMF by India was 4.145 grains of fine gold per rupee. Being a part of the sterling area, India decided to follow the sterling when the latter was devalued in September 1949. Consequently, while the rupee-sterling parity remained unchanged (at Rs 13.33 to the pound sterling), the new par value was fixed at 2.880 grains of fine gold (or 21 cents) per rupee. The Bank supported the rupee-sterling rate by buying spot sterling from authorized dealers at 18 pence per rupee and selling sterling at the rate of $17\frac{63}{64}$ pence. The rate for forward sterling was lower by another $\frac{1}{64}$ pence per rupee. Until the British currency went decimal, there were 20 shillings to the pound. A shilling equalled 12 pence. The rates at which sterling was bought and sold to the public were fixed by authorized dealers in line with the Bank's general policies. To facilitate

coordination and better supervision of foreign exchange transactions, the Bank recognized the Foreign Exchange Dealers' Association of India (FEDAI), which comprised the authorized dealers, as the banking system's representative body in all discussions with it. Authorized dealers were required to abide by the rate schedule for the sterling published by the FEDAI, but were permitted to quote their own rates for all other currencies. When the London market reopened, they were allowed to carry out spot and forward transactions in other permitted currencies in that market. The Reserve Bank also permitted authorized dealers to make payments in US and Canadian dollars for imports from those countries and cover their transactions in these currencies. These and other changes mentioned above were among the first steps towards developing a foreign exchange market in this country.

STERLING AREA CONTROL

India was, along with other countries of the commonwealth, a member of the sterling area. In general, there were few restrictions on capital flows within the area. However, each member of the area was autonomous, and the Indian control, for instance, was at liberty to impose its own regulations. This it did when, after the war, it slapped exchange control on certain remittances from the so-called Scheduled Territories. Remittances from Pakistan were initially excluded from this restriction, but they too came under this regulatory net in February 1951. The effect of this measure was that fresh investments in India from other countries in the group were now regulated. Another departure came in the form of powers taken by the Indian authorities to control, when necessary, the export of capital. However, conversion of various sterling area currencies within the group continued unrestricted.

There were many changes in the geographical composition of the sterling area over the seventeen years covered by this volume. A key feature of sterling area membership was that member countries pooled their resources of foreign exchange, kept their foreign exchange reserves in sterling, and maintained exchange rate stability with each other. The rate of exchange was, however, determined by each member country. India had no independent dollar reserves and relied, as many other adherents to sterling area arrangements, on London for dollars. Nor was leaving the sterling area a realistic option since it would result in greater immobilization of balances in the 'blocked' No. 2 account. Therefore, though it had many features India would have preferred to see amended, it never actively pursued alternatives to sterling area arrangements.

Although the 1947 experiment at sterling convertibility failed, it did not result in the demise of transferable accounts which remained central to the

sterling area exchange control system. Following the brush with convertibility, transfers between these accounts were permitted, but not transfers of sterling in these accounts into US dollars. This system continued in existence for the greater part of the fifties but was widened over time. As a member of the sterling area, India was required to keep in step with changes in the domain of transferable accounts which, with minor exceptions, it replicated.

Throughout the fifties, efforts were on to unify and free all non-resident sterling outside the dollar area and to have a single transferable area for the entire non-dollar world. As a first step towards general simplification of non-resident sterling and following the changes effected by Britain, Indian regulations were amended in March 1954 to widen transferability and usability of sterling held by non-residents and the transferable account area itself to include all countries, except those in the American account area, viz. Turkey, Iran, and Hungary. The latter countries were brought into the fold later. Balances in these accounts could be transferred freely for any purpose—current or capital—within the area.

In February 1955, Britain began allowing intervention in transferable sterling to check the tendency for the latter to go to a heavy discount. Taking advantage of this development and assisted by the favourable foreign exchange position, four months later in June, the Reserve Bank decided to allow Authorized Dealers (ADs) to deal in foreign currencies other than US and Canadian dollars, the pound sterling and the Pakistan rupee, at market related rates, provided the rates for spot transactions were at or between the official buying and selling rates of the Bank of England. (From September 1956, this facility was extended to cover the US and Canadian dollars.) ADs were also permitted to deal in forward contracts. This move marked the beginning of a foreign exchange market in India. In June 1956, arbitrage facilities in certain European currencies were extended to Indian banks. This relaxation enabled authorized banks in India to conclude spot and forward transactions, for periods up to six months.

In December 1958, the British authorities decided to merge transferable and official sterling. India too, followed suit by merging American Accounts with Transferable Accounts and designating the new group as Convertible Accounts. There were now three categories of external accounts: convertible, bilateral and 'scheduled territories', and the term 'transferable account' disappeared from the Indian exchange control vocabulary.

ADMINISTERING EXPORT CONTROLS

While the government framed the country's trade policy, often in close consultation with the Bank, it fell to the latter to implement the prescribed

methods of payment for imports and oversee the repatriation of proceeds of exports. Exchange control was made applicable to all exports, whether or not the items exported belonged to restricted categories. The role of the Reserve Bank was principally to ensure that the foreign exchange proceeds of exports were repatriated in full within the period specified by the Bank and through an approved method.

The customs authorities had the task of scrutinizing the validity and genuineness of export shipments. The formality to be completed by the exporter included the completion of the GR and other forms in quadruplicate (later triplicate).¹ The original form was submitted to the customs authorities, and its duplicate and triplicate copies to the bank handling the export documents. These forms enabled the Bank to keep a watch on the repatriation of export proceeds by 'marrying' the duplicate forms with the triplicates to arrive at an estimate of outstanding export receipts. Exporters and authorized dealers preferred looser regulations, particularly regarding methods of finance and GR formalities for low value export transactions. When such suggestions were made in 1957, the Bank felt that waiving the GR formality for low value exports would diminish its powers of surveillance over foreign exchange transactions. Much better, the Bank felt, to abolish quantitative restrictions on exports, if the object was to boost India's export earnings. Quantitative restrictions on exports, the Bank's economists argued, did little to offset inflationary pressures in the economy while they cost the country vitally required earnings of foreign exchange. Following the Bank's advice, quantitative controls on several exports were lifted during 1957–58.

With the deterioration in India's external accounts in the mid-1960s, the Bank took steps to secure speedier realization of export proceeds. From 1965, a stricter watch was instituted to see that proceeds of non-credit exports were repatriated within six months. The Bank generally refused to extend this period, or allowed extensions only reluctantly. In a few cases, exporters were even advised to reimport their exports or dispose of them at the best available

¹ The following forms were prescribed for declaring exports: GR1—for declaring shipments generally; GR2—for declaring shipments to countries outside the sterling area financed under guarantee by the UK agents of the exporters; GR3—for shipments, proceeds of which were permitted to be retained abroad for specified uses; GRX—for shipments to countries, exports to which were permitted only against advance payment or an irrevocable letter of credit; EP and EP1—adaptations of GR1 and GR3 forms, respectively, for declaring shipments to Pakistan and Afghanistan in respect of which a period of three months was prescribed for realization of proceeds; PP—for declaring exports by Post Parcel generally; VP/COD—for declaring exports by Post, where parcels were sent on 'Value Payable' and 'Cash on Delivery' basis, respectively.

price. The vigilance machinery was also tightened, and authorized dealers were instructed to report overdue cases to the Bank.

Proceeds of exports made on deferred payment basis were allowed to be repatriated in five years subject to prior approval by the Bank. But such exports carried exchange risks. The problem of providing cover against such risks was raised repeatedly during our period, and the Bank was asked by the government to work out a suitable scheme early in 1967. Both then and subsequently, there was a clash of viewpoints at Mint Road. The Exchange Control Department opposed the idea of the Reserve Bank arranging or participating in forward cover and cited the worldwide practice of deferred credits being extended in the currency of the exporting country; the economists, in particular V.G. Pendharkar, were in favour of a more active role by the Bank. The Bank's resistance yielded to consistent pressures from the government and from within. However, because of turbulence in the international currency markets, a detailed plan for covering deferred credits which it prepared in 1971 could not be implemented until May 1974. The Bank administered the scheme in the initial stages before it was taken over by the Export Credit and Guarantee Corporation (ECGC).

ADMINISTERING IMPORT CONTROLS

For the greater part of the period covered by this volume, India's import policy was highly restrictive, and licensing and controls embraced all import activity. Intending importers were first required to obtain a licence from the Chief Controller of Imports and Exports. Licences were issued in duplicate, one copy of which served as an authority for making remittance in foreign exchange in payment for the import. No letter of credit could be opened or remittance of payment effected without producing the exchange control copy of the relative licence. Remittance for imports on Open General Licence (OGL) for which no specific licence was given, was made on production of documentary evidence of import. The Bank's role in this area was to ensure that exchange was utilized for the authorized purpose and that there were no disguised exports of capital. Payments had generally to be made in the currency of the country from which the imports originated or were to be credited to a non-resident rupee account in India held by a bank resident in that country. While exercising no detailed supervision, the Bank kept a general watch over payments through a variety of forms completed by remitters, which authorized dealers submitted to it.

With the growth of bilateral and multilateral external assistance, the Bank also became engrossed in devising payments procedures for goods imported against World Bank/IDA loans, and country assistance. Beginning in the

early 1960s, the Bank was equally involved in devising the accounting and payments procedures for goods imported under rupee payment arrangements. To avoid the accumulation of short-term foreign exchange liabilities, the Bank also endeavoured to ensure that capital goods were imported against long-term deferred credits.

As import and exchange controls grew more stringent and increasing reliance was placed on bilateral and deferred payment approaches, strains and frictions became apparent in the administration of the control apparatus. For example, in the late 1950s, there was an impression in London that licences were more easily available to import goods to India against payment in rupees. This impression, which was created by the existence of rupee accounts of countries with whom India had bilateral clearing arrangements and was fostered by some Indian importers, led to suggestions that India operated a system of blocked rupees, and that exporters abroad could get rid of these rupees by selling them at a discount. Several British banks, it appears, approached Pendharkar, the London Manager of the Reserve Bank, and the Indian High Commissioner inviting their attention to such alleged practices, and seeking clarifications. Despite official denials, reports about the possibility of doing import transactions via the system of blocked rupees persisted. Such reports brought home to the Indian authorities that the mechanism of blocked rupee accounts of non-residents was open to abuse. By early 1962, international traffic in the blocked rupees of bilateral clearing arrangement countries appeared to have reached serious proportions, and officials in London invited Pendharkar's attention to the flood of enquiries which suggested both a widening of the range of commodities under negotiation and a steep rise in the amount that could apparently be handled. The apparent *modus operandi* for such transactions was that rupees paid into one of the east European clearing accounts were offered to potential buyers in third countries at discounts ranging from 5 to 25 per cent.

As evidence of abuse of rupee payment arrangements continued to flow in, the Exchange Control Department suggested that the Finance Ministry issue a suitable clarificatory press note clearing the misconceptions and explaining that all payments to foreigners, whether in Indian rupees in India or foreign currencies abroad, were payments in foreign exchange. While there was some debate over whether the government or the Bank should issue such a statement, it soon became clear that no press note or notification would help to bring a problem of this kind under control without perversely adding to restrictions on the use to which bilateral rupees could be put. Besides, the source of the abuse lay in the inability of the east European countries to meet licensed import orders from India from their own sources. A possible solution lay in

paying greater attention, when agreements were finalized, to the actual availability of imports from these countries out of their own production, and enforcing rigorous scrutiny of larger imports from them. A fresh circular was therefore issued by the Finance Ministry outlining the procedure for entering into contracts for the import of goods and services against payment in blocked rupees.

From the early sixties, the Bank began to improve its techniques for monitoring the payments situation and refining its forecasting tools and techniques. Arrangements were made for compiling special tabulations giving licence-wise data for imports. A separate section (the Foreign Aid Forecasting Section) was created which, in collaboration with ECD, was made responsible for preparing regular forecasts and estimates of India's balance of payments. These estimates provided the input for the government's foreign exchange budget, and became an important policy tool both for the Reserve Bank and the government. These arrangements also gave the Bank something of an early warning capability about likely reserve outflows during years when India's foreign exchange reserves stood barely above the minimum statutory level.

The necessity for the Bank to develop such techniques was reinforced when it was asked by the Finance Ministry in 1964 to assist in 'mechanizing' import licence statistics. What, on the face of it, appeared to be a routine request for organizational assistance, quickly became a major source of embarrassment to the Bank. Its examination revealed a number of irregularities in the maintenance of licence-wise records, in particular that licences were issued to the private sector much in excess of the availability of foreign exchange. This discovery rendered the foreign exchange budget exercise entirely suspect. Its examination also revealed that there were no proper records of licences issued, utilized, and outstanding, nor were details available of infructuous, cancelled, or revalidated licences. The Bank saw this as the major source of discrepancy in its balance of payments estimates and forecasts. Overhauling the import policy system was, however, a long-drawn-out affair. The first step was to provide a format based on which the data could be maintained and mechanized to arrive at the quantum of outstanding licences. This the Bank soon did.

FOREIGN EXCHANGE FOR TRAVEL ABROAD

The 1960s saw a gradual but persistent tightening of foreign exchange regulations pertaining to foreign travel by Indian residents to the point where the administration of the regulations became somewhat arbitrary. Foreign travel was undertaken for a variety of purposes, and all categories of travel required prior approval. The Bank was the focal point through which all

applications were cleared on an individual basis, and approvals were granted on the principle of essentiality.

Travel for Pleasure

Until 1956, pleasure travel by Indian residents was administered through a basic quota which, at first, was released once in three years. Later it was enhanced and relaxed to once in two years. No exchange was, however, released for visits to hard currency areas. With the deterioration in the foreign exchange situation after 1956, the Bank was forced to review its policy, and in January 1957 it took the draconian decision to ban all pleasure travel by withdrawing the basic quota of foreign exchange for such travel. The denial of the travel quota, coupled with the gradual tightening of release of foreign exchange for other types of travel, drove some residents to finance their travels through illegal channels, including compensatory payment arrangements. This led to diversion of normal foreign exchange earnings by way of export proceeds and private remittances, and deflected tourist traffic to foreign carriers.

The adverse movement in invisible earnings from 1961-62 led the Division of International Finance of the Economic Department to estimate that the leakage of foreign exchange into unauthorized channels ran annually into about Rs 50 crores. The Division's study put the problem down to excess demand for gold and consumer goods, and restrictions on the availability of exchange for foreign travel. While little could be done about the former, further regulation of foreign travel was resorted to in June 1962.

The Bank's view at this time was that the freedom to book a passage without any release of foreign exchange contributed to a major part of the leakage of foreign exchange. In fact, according to the Governor, P.C. Bhattacharyya, 'exchange control had broken down in this field altogether'. It was the Bank's assessment that nearly 60 per cent of Indian nationals travelling overseas did so without obtaining any exchange from the Bank. Secondly, there were cases where exchange was released for travel and the official allotment was supplemented through illegal sources. Thirdly, the 'guest scheme' was a source of abuse as it allowed persons to proceed to the US with nominal amounts of legally procured foreign exchange. The existence of such lacunae rendered the control instrument ineffective and made a mockery of controls. The Bank's suggestion was to abolish the 'guest scheme' and ban all travel without exchange authorization, if exchange controls were really to serve their intended purpose.

The Bank's proposals were accepted in June 1962 and announced by the Finance Minister in Parliament later the same month. The notorious 'P' form was the principal outcome of the Bank's recommendation. To mitigate hardship

You Said It

By LAXMAN



How I got my 'P' form?—Well, I was lucky—My husband who's abroad has fallen seriously ill!

— *ToI*, 16 July 1963

to workers moving to neighbouring countries, deck passengers alone were exempt from 'P' form formalities.

The object of the 'P' form was to screen overseas hospitality and ensure that it did not result in compensating payment transactions. By weeding out obvious cases of infringement, the 'P' form became a convenient tool to curb a good deal of 'undesirable' travel. The immediate reaction to the restriction was a rush to advance travel plans. In a bid to outwit the government, operators in Calcutta were reported to have expedited foreign exchange deals, and there was apparently considerable selling of foreign currencies at 'fantastic rates'. But this was a shortlived phenomenon.

The records of the Reserve Bank of India reveal that a number of organizations and individuals approached the Government to seek a waiver of the new formalities. Nor was there any dearth of human ingenuity to circumvent them. But exchange control officials exercised great care in verifying the

genuineness of invitations before issuing their clearances. The stringent scrutiny of 'P' form applications no doubt caused hardship to travellers. In 1967, L.K. Jha, who succeeded Bhattacharyya as Governor, apprehended that the validity of the 'P' form was open to challenge in a court of law. In particular, he wondered whether the Bank could refuse permission to travel abroad when the journey involved no foreign exchange or when an air ticket was paid for by a host abroad. He also feared that the stricter policy for granting permission to women travelling in their own right as business executives and the stipulation that they could not use blanket permits of exchange without prior approval of the Bank, could be challenged on the ground of discrimination.

As a result of the examination which followed Jha's note, several ad hoc decisions were taken after 1967 to soften the procedure and make it less irksome and rigid. The 'P' form lingered on for several years thereafter, but by enlarging the list of approved relatives, introducing the Foreign Travel Scheme in 1970, and recognizing the hospitality of friends, the regulation was watered down. Finally, in 1978 'P' form control was abolished.

Business Travel

The Bank remained the focal point for the clearance of all business travel. Overall, the policy of release of exchange was tight, and although a reasonable degree of flexibility characterized the exchange control operations of the Reserve Bank, its task was a difficult one. There were constant demands for reconsidering rejection or for additional releases of foreign exchange. Often, the government too backed such demands. In 1953, there were complaints that Indian businesses suffered from the denial of dollar exchange for travel to the USA and Canada. The Finance Minister asked the Bank to adopt a more liberal attitude, while the Finance Ministry asked it to send a monthly report on rejected cases. It also queried the embargo on wives of businessmen accompanying their husbands, and wanted the daily allowance of \$40 per day for the USA raised. Finally, the government asked to be consulted on all doubtful cases. Piqued by the communication, the Bank undertook a survey of applications for dollar exchange in the past three years and concluded that out of 380 applications, only 47 cases were rejected either because the particulars supplied were inadequate, or because the proposed trips were only exploratory and existing rules did not permit them. It also maintained that the Indian daily allowance of \$40 per day, which compared favourably with that allowed by the United Kingdom, was adequate. As regards wives accompanying their husbands to the US, the government was reminded that no such facilities needed to be given under the general regulations obtaining within the sterling area. The Bank also rejected the government's demand for

You Said It

By LAXMAN



You've twenty years' experience in a travel agency? So sorry, we can't offer you a job. You must understand our chief business is banking!

— *Tol*, 7 July 1962

monthly reports. While the government could prescribe the conditions for releasing exchange, the Bank could not function as the administrative authority unless it had the discretion to approve or reject applications. If, however, the government wished to review the Bank's decisions, it could itself take over the administration of exchange control. The government did not press its suggestions in the face of Mint Road's resistance to them. However, while exchange controllers at the Bank opposed the submission of monthly reports, the Governor offered to provide data on a quarterly basis to the government.

In the early sixties, the scheme to issue blanket permits for release of exchange was instituted to enable businessmen to undertake trips for export promotion without having to apply to the Reserve Bank for exchange for each such tour. At first, the facility was confined to recognized export houses wishing to explore new markets for non-traditional commodities and to large

exporters of non-traditional goods. In July 1963 it was extended to cover large export houses engaged in traditional commodities.

Medical Treatment Abroad

Specific permission of the Bank was required to travel abroad for medical treatment. Such permission was rarely denied. The Bank knew that it was not competent to decide on the nature of the ailment or the type of treatment required, and generally relied on the recommendation and certification of the Presidency Surgeon or the Chief Medical Officer of the state.

Training and Higher Studies Abroad

Policy on the release of exchange for higher education abroad was determined by the Ministry of Finance, in consultation with the Ministry of Education, but its implementation was assigned to the Reserve Bank. The courses qualifying for release of exchange were laid down by the government. Prior to June 1957, exchange for education was liberally granted. Thereafter in consultation with the Bank, the government decided to take immediate action to curtail foreign expenditure on studies abroad. The new guideline was to release exchange to students taking up university education or higher technical courses abroad, and who had secured at least 50 per cent



Interviewing applicants for foreign exchange, February 1958

marks. No exchange was released for children going to schools abroad or to those wishing to take up the Bar examination, secretarial courses, languages, domestic sciences, music, tailoring, and drawing. In practice, the 50 per cent marks rule was rigidly followed. However, several students who had secured a higher percentage in their chosen area of specialization failed to meet this overall requirement. Recognizing the absurdity of applying the rule rigidly when several courses of study were not available in India, the Bank approached the Finance Ministry to be allowed some discretion in the matter. In June 1957, the government appointed an expert committee to review the educational remittances policy, based on which it was decided to release exchange for all degree courses except in medicine and diploma courses in subjects such as languages, accountancy, apprenticeship training, and factory training. Seven subjects—bar-at-law, secretarial training, domestic science, tailoring, fashion designing, photography, and ballet dancing—continued to be on the banned list.

The Bank was not comfortable administering the new policy, since it was not very clear-cut and gave rise to a number of ambiguities. It was also forced to make too many references to the government for clarification, and found conflicting decisions emerging from New Delhi. Following discussions with the government, a more coherent policy for the release of exchange for studies was evolved, whose thrust was to weed out mediocre talent and ensure that exchange was released only for courses that would enhance the availability of technical skills required for a developing economy.

Pilgrimage

The large number of Haj and Ziarat pilgrims from India necessitated evolving an appropriate payments mechanism as part of the restrictive foreign travel policy. Government policy was to allow religious travel on the basis of foreign exchange released to pilgrims at scales fixed in consultation with the Reserve Bank. Earlier, there were no restrictions on the number of pilgrims who went on Haj, but with the withdrawal of the basic travel quota from January 1957, only a limited number of persons were allowed each year to proceed on these pilgrimages. Prior to 1959, banks in Saudi Arabia accepted Indian currency notes from Haj pilgrims, and these were subsequently redeemed by the Bank. But abuse of this facility led to the introduction of special Haj notes in May 1959. After the Gulf countries introduced their own currencies, the rationale for the special Haj notes disappeared and these were withdrawn. From 1964, a revised arrangement was worked out by the Reserve Bank with the State

Bank who made available to pilgrims, through their correspondents at Jeddah, Saudi riyals equivalent of the rupees surrendered by them at the time of departure.

Emigration Facilities

Under exchange control regulations in force in 1947, Indian nationals wishing to take up permanent residence in sterling area countries were allowed to transfer their assets, in full, at the time of emigration. There were however limits set by UK on the transfer of assets by those who wanted to migrate to the non-sterling and dollar areas. Initially, the annual outgo on account of migration, of Rs 1.25 crores to Rs 1.50 crores, was regarded as sustainable. But in 1957, as the weakness in the balance of payments became a prominent feature of the economic landscape, the Governor, H.V.R. Iengar, felt something had to be done to restrict unwarranted outflow on this account, and recommended restricting the facility to a maximum of Rs 2 lakhs per family. This proposal was implemented from July 1957. But a further tightening of the limits for capital transfer facilities soon became inevitable. By March 1960, a uniform limit of Rs 50,000 was fixed per family, irrespective of the country of emigration. In June 1962, even the lower remittance limit was at first suspended, and later withdrawn. The Bank favoured a complete ban on transfer of assets by Indian nationals, but the government remained sceptical about singling out capital remittances for the axe while doing nothing about current remittances. Jha, for instance, argued that a poor man taking out his entire capital might place much less of a burden on the reserves than a rich man taking only his income out annually. Asking the Bank to consider both aspects of remittances by migrants, he urged it to undertake a study of the pattern of remittances by types of emigrants to find out whether a more liberal policy on remittances would prove more onerous. Devising a policy based on making judgements about the motives for migration did not appeal to the Bank, since it would create more problems than it solved, more so as policy on migration was made by the Ministry of External Affairs. As a pure balance of payments operation, the Bank preferred to stick to a common yardstick or rule for all types of migrants.

The difficult foreign exchange situation also necessitated a further cut in the ceiling imposed on capital repatriation by foreign nationals from Rs 1,25,000 to Rs 75,000 per migrant in June 1962. The Bank's guidelines in this area of control were specific and there was little ambiguity in their interpretation or application except in one or two odd instances, where pressure was exerted by the government on the Bank to revise its decision. But the Bank stood its ground.

CONTROL OF INVESTMENT ABROAD

Establishing Subsidiaries Abroad

At the time of the enactment of the Foreign Exchange Regulation Act in 1947, the main focus of section 13 was to regulate the export of securities rather than control investments abroad by residents. This was in keeping with the prevailing corporate situation in which companies operating in India but incorporated in the UK maintained dual registers, one in each country. However, by 1950, instances came to light of persons and firms resident in India acquiring business interests in foreign countries or forming subsidiaries abroad through clandestine means. The absence of any restrictions on the purchase of shares in foreign companies or on the formation of subsidiaries abroad by residents provided a convenient loophole, with the result the Bank was unable to exercise control over their activities. To plug this loophole, in March 1950, the Reserve Bank suggested to the government that the scope of section 13 of FERA be enlarged through an amendment to cover acquisition and dealings in foreign securities by residents and to make its prior approval mandatory for such transactions. Despite the lacuna in the regulation, the Bank allowed resident firms and companies to open branches abroad, but turned down requests for opening subsidiaries abroad. The Bank's reluctance stemmed from the fact that subsidiaries were governed by the laws of the country in which they operated and so were outside the jurisdiction of the Indian authorities. An overseas branch of an Indian company, on the other hand, was amenable to Reserve Bank control. However, in August 1950 the government gave up this hard line and displayed a new willingness to entertain requests for establishing subsidiaries abroad. Such requests were confined to large business houses in India. An initial release of exchange up to £5,000 was allowed, but further releases were made subject to the business house furnishing to the Bank an account of its financial operations and an undertaking to repatriate profits. The Bank was aware that UK provisions in this regard were more liberal but the Bank felt that before India could afford to be as liberal as the UK, the government should arm itself with powers to control the operations of overseas subsidiaries in order to ensure that their operations did not become 'free zones' in the exchange control system.

After several informal meetings between officials of the government and the Reserve Bank, a memorandum proposing the relevant amendments was placed before the Committee of the Central Board of the Reserve Bank in November 1950. Although a formal proposal for amending FERA was sent to

the government in December, the bill could not be introduced in the Lok Sabha for almost a year owing to a heavy legislative agenda. In the circumstances, the expedient of an Ordinance was resorted to, to bring activities of subsidiaries established abroad by Indian residents into the exchange control net. This was subsequently replaced by the Foreign Exchange Regulation (Amendment) Act, 1952 which was passed by the Lok Sabha in February 1952 and received Presidential assent the same month.

Foreign Bank Accounts and Portfolio Investments

Prior to July 1947, Indian residents were allowed to maintain and operate sterling and sterling area currency accounts without restriction. Restrictions were, however, applicable to the acquisition and holding of dollar balances. But with the implementation of five-year plans and the growing need to husband foreign exchange resources, direct controls were introduced to regulate such capital outflows.

FERA placed an embargo on all capital remittances outside India. The Bank, in turn, issued a notification in July 1947 cancelling the general permission given earlier for transactions in sterling and sterling area currencies, while authorizing the maintenance of existing accounts in those currencies by persons domiciled and resident in India. This meant that maintenance and operation of foreign currency balance by individuals, resident and domiciled in India, was restricted except in the case of accounts opened prior to July 1947 (referred to as pre-zero accounts). Even in the latter case, through a clarification put out by the Bank in September 1953, only payments could be made without prior approval, and fresh credits required its permission. Later in the decade there was a further tightening of these regulations. It was decided to mop up foreign currency balances held by residents, and the Government of India put out a notification in September 1958 requiring all foreign currency balances except balances held in pre-zero accounts to be surrendered within one month. There was some confusion and misunderstanding about permitted operations on the pre-zero accounts, so that in April 1960, the Bank clarified that persons holding pre-zero accounts in sterling and sterling area currencies could utilize their balances without its prior approval and that surrender requirements were not applicable to them or to those who opened accounts after July 1947 with its permission. These clarifications were of little avail, and the Bank suspected that a number of foreign currency accounts were in existence without its approval—some wilfully and others out of ignorance. Through a press note an attempt was made by the Bank to collect information on holdings of foreign currency balances, based on which in April 1962, it was decided to allow holders of

pre-zero accounts to utilize the balances. Holders of accounts opened after the September 1961 notification were advised to close them and repatriate the balance, or face penal action.

Yet another aspect of the control structure related to foreign portfolio investments by residents. In the late 1940s, the policy on portfolio investment abroad in shares and securities by residents was a liberal one. But in June 1957, the Bank withdrew the permission earlier accorded to residents to acquire sterling shares in the London market of companies exclusively operating in India and maintaining dual share registers. Three months later in September, by an amendment to section 13(1) of FERA, the Bank's permission was made compulsory for acquiring, holding, and disposing of foreign securities. Shares of sterling companies held on Indian registers by Indian residents were not covered by the amendment. By December 1962, the permission earlier available to invest earnings abroad was withdrawn and it was made obligatory for Indians with foreign portfolio investment to repatriate their earnings and the maturity proceeds when such investments were liquidated. In October 1963, a limited facility to switch investment to longer-dated securities with improved yields was crafted, but eligibility to reinvest sale proceeds was confined to shares and securities with maturities extending beyond ten years. Proceeds of sales of securities of shorter maturities were required to be repatriated.

REGULATING FOREIGN INVESTMENT

Before Independence, foreign capital in India was almost entirely of British origin, and was concentrated in tea plantations, jute, mining, and services, or was associated with the development of railways and utilities. In the years following Independence, there was a gradual shift in the pattern, nature, and fields of investment. To illustrate, earlier investments were in branches or wholly-owned subsidiaries, whereas after 1955, joint ventures with Indian participation increased. Another feature of the later period was the preference for participation by residents in companies in which the foreign stake was the major one. An important change of policy towards foreign investment came with the Industrial Policy Resolution of April 1948 whereby pre-Independence investments were assured fair treatment and no restrictions were imposed affecting their activities, but entry for new companies was granted on a selective basis and on an evaluation of their likely contribution to the Indian economy. Proposals were viewed more favourably if the foreign corporation made provision for local equity participation and its investment was in accordance with the priorities and pattern of development envisaged under the plans. However, there were no

rigid predetermined spheres yet for foreign investment and no rigid rules as to the extent of foreign participation. Each investment was screened and evaluated on its own merits.

Attracting foreign business investment on such criteria influenced the style of regulation of the Bank. The latter also reflected the Finance Ministry's interventionist approach, and its extreme sensitivity to the threat of external investors invading captive and protected consumer markets or key sectors. In principle, the entry of foreign investment was encouraged in the field of manufacturing and in industries for which adequate capacity did not already exist in the country. Ordinarily, foreign investment was not permitted in trading, financial, or commercial concerns. The usefulness of a foreign investment proposal was judged on criteria such as its likely contribution to import substitution or export promotion, promotion of industries where domestic capital was inadequate or reluctant in coming forth, or where domestic technical know-how was not available or not of a high order. Provision for training Indian personnel for technical and administrative posts in enterprises established with foreign capital participation was made a precondition for approval. Subject to these considerations, foreign capital, once admitted, enjoyed equality of treatment in regard to rights and obligations. Remittance of profits, dividend, and interest earned by foreign investors was allowed freely. Repatriation of existing foreign investment was permitted, except for older investments from countries outside the sterling area, but even here, projects approved after January 1950 were entitled to free repatriation facilities. Compensation on fair and equitable terms was assured for enterprises acquired by the State.

Although repatriation policy guidelines were quite explicit, by the late 1960s the Bank began to harbour doubts about the justification for them. For instance, a number of dollar investors wanted to sell their business interests and repatriate the proceeds. Being American companies, investments in which were made before 1947, the Bank was not obliged to allow sale proceeds to be repatriated. But Governor Jha felt that in the conditions prevailing in 1968, it would be difficult to justify a discriminatory policy. The policy for old sterling companies was made when there was justifiable ground for treating the dollar as a hard currency in comparison with sterling. It was also an outcome of agreements over sterling balances, under which capital repatriation within the sterling area was free and was debited to the No. 2 account. But much had happened since then, and Jha was uneasy about continuing a discriminatory policy in the changed conditions. He was also aware that a simple extension of sterling area treatment to dollar investors could mean loss of foreign exchange and suggested to the government

the via media of allowing old investments, whether dollar or sterling, to be repatriated in instalments spread over five years.

Operationally, requests for repatriation were cleared by the government while remittances on account of profits and dividends were approved by the Reserve Bank. In September 1957, the Government of India entered into a convertibility guarantee agreement with the US government under which the latter offered against a small premium, guaranteed payment in dollars of profits and capital which the investors wished to transfer home but were prevented from doing by exchange restrictions in the host country. This agreement was intended to clear the way for a larger flow of foreign investment from the dollar area.

Although policy on foreign direct investment was fairly explicit, in practice it posed numerous irritants for investors. The Industrial Policy Resolution envisaged entry and exchange barriers administered through a meaningful screening process. The latter soon became a formidable obstacle for investors, who were required to secure clearances from various ministries and departments. Formal authorization under FERA was then handled by the Reserve Bank. In addition, those bringing capital in had also to seek permission from the Controller of Capital Issues if the total issued capital was Rs 10 lakhs or more. This was later raised to Rs 25 lakhs or more. Such procedures caused considerable frustration to investors, so that foreign investment in business enterprises during our period was, at best, modest.

The extent of foreign control of Indian assets and the magnitude of the country's external liabilities were aspects of considerable importance from the point of view of exchange control arrangements. Information on inflows, portfolio investment overseas, and foreign ownership was made available by the Bank through periodic surveys of foreign assets and liabilities. The first such comprehensive census involving an analysis of over 30,000 returns was undertaken as at the end of June 1948, and subsequent surveys gave a picture of the country's international investment position as at the end of December 1953, 1955, 1961, and 1968. But the system of periodical surveys involved considerable labour for the public and effort to the Bank, and their results became available only after an appreciable time-lag. Hence, in addition to the survey from 1956, the Economic Department of the Bank undertook annual assessments based on some limited information furnished by foreign-controlled companies. These annual exercises were useful in assessing changes in liabilities arising from direct investments and provided continuity to the results derived from infrequent surveys. The surveys and assessments helped shed light on the financing of industry, the size of the assets, earnings and distribution of profits, and the pattern of foreign participation. Not only did the survey

results become important tools for decision-making in operating the restrictive system, they helped fill gaps in the capital account of the balance of payments relating to investments through goods and services, and retained earnings, thereby helping the Bank to refine its payments data as well.

By the mid-1960s, there was intense public discussion about the policy aspects of foreign collaboration. In 1965, the Bank planned its first survey on 'Foreign Collaboration'. As the foreword to the publication indicated, 'it was not directed to an elucidation of the pros and cons of possible policy adjustments'. The data were intended to assist a factual and objective assessment of financial and technical collaboration agreements in force. The Bank did not wish to be seen to be spearheading a debate over whether or not foreign collaboration was beneficial to the country. It realized that any such assessment required a proper examination of progress made in production, employment, exports, and technology in general, and of import substitution in particular. Therefore, the survey concentrated on contributing towards a better understanding of the issues involved and strove to heighten public awareness by providing authentic data on the key features of foreign collaboration agreements.

The Reserve Bank played a limited role in regulating foreign investment. Clearance of collaboration proposals required the prior approval of the government. Each proposal was considered on its merits, having regard to plan priorities, existing capacity in the country, and future requirements. Inflow control was achieved by the most direct means available, by restricting foreign collaboration to those cases which brought into the country technical know-how not adequately available indigenously, for developing new lines of production, or where domestic capital was inadequate or not forthcoming, or where a collaboration project assisted in reducing pressure on the balance of payments. The cost of imported capital equipment set the minimum amount financed through foreign equity participation or loans. On the other hand, majority control was generally expected to remain in Indian hands. Apart from the above considerations, the terms for technical collaboration were also vetted by the government. Royalty payments were usually limited to 5 per cent of net sales, subject to tax, and the duration of royalty agreements was not allowed to exceed ten years.

These elaborate rules on foreign investment and their administration by the central government on a case-by-case basis led a study team set up by the Administrative Reforms Commission (1967), to conclude that too many obstacles and restrictions were being placed in the way of securing foreign collaboration. The government sought the views of the Governor on these

findings. Bhattacharyya advised against any change in the existing policy on royalties and argued in favour of the existing method under which payment of royalty was not encouraged where the foreign investor had a share in equity investment. Jha, who soon succeeded him, agreed generally with Bhattacharyya, but also suggested that the government should be more liberal in approving the payment of a certain percentage of the value of the product as royalty, since this would be much cheaper than importing the entire article. Much of the idle capacity in the engineering industry, he argued, could be harnessed to the task of import substitution, if the requisite designs, drawings, and know-how were imported.

Between 1948 and 1958, foreign collaboration approvals averaged fifty each year. But as the manufacturing sector made inroads into technologically intensive areas, recourse to foreign collaboration increased. The attractions of a protected market led a number of foreign companies to seek entry for setting up manufacturing capacities in the country, and the number of approvals climbed to over 300 per year between 1959 and 1965. In all, 2,200 foreign collaboration agreements were cleared between January 1948 and March 1964. On the remittance front, outflows on dividends increased from Rs 7.1 crores in 1956–57 to Rs 28.8 crores in 1966–67, while remittances of royalties grew from Rs 1.2 crores to over Rs 5 crores. Remittances of technical fees went up from Rs 3.6 crores in 1964–65 to over Rs 10 crores in 1966–67.

NON-RESIDENTS' INVESTMENT IN INDIA

Throughout the period 1955–1967, official policy was to encourage the inflow of remittances from Indians residing abroad. Even though limited facilities were offered to attract inflows, reconversion of such funds into free foreign exchange was severely restricted. To facilitate inflows, in June 1958, a few procedural changes were made, but with little success. Apprehensive that unscrupulous elements would exploit them, the Bank tightened procedures for telegraphic transfers and demand drafts. In the upshot, non-residents, who operated via rupee drafts, opted for sterling drafts, thereby reducing the inflow of funds. The new rules were abandoned within eight months.

Around 1960, political instability in East Africa triggered requests from Indians resident there to open different types of bank accounts in India. The Reserve Bank reacted to the requests positively, and in October 1960 accorded general permission for such bank accounts. In November 1964, to popularize and encourage investments by non-residents in units and in shares of limited companies, permission was given to export units and shares, provided they were bought with funds remitted from abroad.

In the years that followed, the extent of control by non-residents of their Indian assets was frequently discussed within the Bank and with the government. In August 1967, the Finance Ministry had in hand a comprehensive review of investments by non-residents of Indian origin in private limited companies. For the first time, guidelines with greater precision were spelt out and made public. The policy provided for ownership and control of such enterprises by non-residents of Indian origin, by allowing investment of over 51 per cent in industrial concerns with minimum paid-up capital of Rs 10 lakhs provided no repatriation of capital, dividend, or profits was proposed. Such investments were not, however, allowed in trading or service ventures. Different rules were applied to public limited companies where ownership and control were allowed even on a repatriation basis.

The Bank also helped to design and administer the National Defence Remittance Scheme which was unveiled in October 1965. The scheme was partly an adaptation of proposals the Bank had been discussing with the Fund for some weeks prior to the outbreak of hostilities with Pakistan in September 1965. Introduced in the wake of these hostilities which led to the suspension of external assistance to India, the scheme fetched Rs 70 crores of foreign exchange until June 1966 when it was discontinued following the devaluation of the rupee, and helped pull the country back from the brink of defaulting on its external obligations during these critical months.

REGULATING AUTHORIZED DEALERS

In terms of the powers conferred upon it by FERA, the Reserve Bank licensed several foreign and Indian banks, including Thomas Cook & Co. (a travel agency with a long history of providing exchange services) to deal in foreign exchange. As authorized dealers, these banks could deal in foreign currencies, open and maintain accounts in such currencies, approve applications from residents for purchase of foreign currencies, and maintain rupee accounts in the names of non-residents. In 1960, to facilitate proper reporting, the Exchange Control Department designed, in consultation with the Economic Department, the 'R' returns which besides simplifying the procedure, provided for the transparency of key figures needed for policy formulation.

Prior to July 1958 there were two exchange dealers' associations—one each representing exchange banks and Indian banks. But as the latter's operations in foreign exchange expanded, the Bank felt that it would be desirable to form a single association uniting all authorized dealers. A new association called the Foreign Exchange Dealers' Association of India (FEDAI) came into being in August 1958 with the explicit objective of bringing about

uniformity in the rates offered by different authorized dealers thereby avoiding unhealthy competition amongst them, and ensuring uniform service to clients.

The 1960s were marked by some relaxations in the inward flow of remittances and tighter controls on outward payments. Prior to 1964, authorized dealers were permitted to freely avail of loans and overdrafts from branches and correspondents in the sterling area without prior clearance from the Reserve Bank. In the absence of suitable regulation, it was found that there was a tendency for larger recourse by authorized dealers to such borrowing and that this tended to dilute the Bank's control over credit. So from December 1964, the general approval to bring in funds from abroad was modified and authorized dealers were required to obtain the Reserve Bank's approval for availing of loans and overdrafts from overseas branches and correspondents in excess of Rs 20 lakhs. From here on, all requests for bringing in funds were treated on merit, and some flexibility was employed to ensure that genuine productive activities financed by them did not go unmet. This measure, which originated in the tight monetary policy of the period, represented the first instance in which monetary and exchange control policies operated in tandem.

In September 1965 the requirement for prior approval was withdrawn, provided the loan or overdraft was taken to purchase rupees from the Reserve Bank for financing normal business operations in India. In addition, repayment of such borrowing was permitted if (1) the authorized dealer had no outstanding borrowing either from the Bank or other banks in India, and (2) the local inter-bank call money rate was less than the Treasury Bill rate of the week. Foreign banks operating in India were perturbed by these restrictions and conditions. In a letter to Bhattacharyya, the Chairman of the Calcutta Exchange Banks' Association suggested that the new restrictions could force exchange banks to refuse new business and lead to a fall in exports. But the Bank was in no mood to yield, with the Economic Adviser, Pendharkar, commenting that exchange banks were overextended anyway and could do well to curtail some business. The argument of the exchange banks that since they had limited local resources and were unable to mobilize increased deposits, they could not maintain their current level of advances except through borrowings from their offices abroad, was countered by the Reserve Bank advising them that they could turn to it for accommodation in the busy season. Nor was the Bank convinced that recourse to external funds took place only in exceptional circumstances. In the Bank's perception, short-term flows of this nature created strains on the country's slender reserves. The Bank's senior officials set their faces against conceding the demand of the exchange banks and allowing them to bring in funds or take them out without restriction. Bhattacharyya endorsed the official thinking but, while

agreeing not to waive the first conditionality, suggested waiving the second condition or making it an alternative to the first. The Deputy Governor, B.N. Adarkar, in his search for a way of doing this, came up with the suggestion of replacing the second condition by another (as an additional, not alternative, condition), viz. that the exchange bank should repay the overdraft out of the proceeds of the export bills negotiated. The advantage of instituting such a requirement was that it would not cause a net draft on the reserves. In the end, however, only the first requirement was retained, and the second one regarding inter-bank call money rate being lower than the treasury bill rate was withdrawn from November 1965. However, the September 1965 measure (A.D. 26) endured for several decades as the basis for regulating banking capital flows to and from India.

ENFORCING FERA

As originally enacted, the Foreign Exchange Regulation Act had not envisaged the creation of an independent agency to enforce its penal provisions and bring offenders to book. Overall powers in this regard were vested in the government, while the Reserve Bank administered the legislation. Through another administrative arrangement, a small cell located in the Exchange Control Department was assigned, in collaboration with the government and the police, to look after the work relating to enforcement, including the responsibility for initiating action against those violating FERA. But as violations grew in scope and magnitude and the number of cases increased phenomenally, the need for a specialized agency with independent identity and armed with wider powers became apparent. The Bank was relieved of this responsibility, when in April 1956 the Government set up an independent Enforcement Unit in the Economic Affairs Department of the Finance Ministry. However, the anomalous position continued, in which the Reserve Bank or the Directorate of Enforcement acted as both prosecutor and judge simultaneously.

Based on the difficulties experienced in the operation and enforcement of FERA, in March 1950 the Bank suggested amending sections 4, 9, 19, and 23 of the Act. Amendments to sections 4 and 9 were intended to put the onus on the persons acquiring foreign exchange to prove that they had not contravened FERA, whereas the amendment to section 23 was intended to give discretionary powers to the court trying contravention cases to confiscate other assets held by the accused, in addition to any sentence of imprisonment or fine. The amendment to section 19 sought to strengthen the existing provision by widening the powers of the government and the Bank to compel the accused to make available all documentary evidence.

In its informal meetings and correspondence with the government, the Bank canvassed the need for these amendments, but the former was reluctant to accept amendments to sections 4 and 9 in principle, as they sought to put the burden of proof on the accused. The Reserve Bank's proposals had the effect of admitting, as evidence against a defendant, written statements of third parties in foreign countries who could not be called to give evidence before a court of law. The Law Ministry was not in favour of stretching the principle contained in the Indian Evidence Act to enable courts and the prosecution to accept a statement by such third parties without giving the accused an opportunity to cross-examine them. The Bank's legal advisers too, expressed some doubts about the acceptance of a rule which made the court a mere instrument to punish a person found guilty by the Bank. But the Deputy Controller of Exchange, P.J. Jeejeebhoy, argued that the proof of any unauthorized acquisition or retention of foreign exchange was normally contained in an admission by the party or a bank statement or other documents such as personal diaries or memoranda, and these sufficed to confirm the existence of unauthorized funds outside India. The Bank, in certain cases, had been successful in unearthing such evidence but had not been able to make use of it due to the limitations imposed by the Evidence Act. Unless something was done to enable courts to 'admit, as proved, documentary evidence secured directly by the Bank from the defendant', there was no point in it undertaking investigation to uncover evidence. The government remained sceptical about using such evidence, but following consultations with the Law Ministry, it was proposed that there should be no objection, legal or otherwise, to a special rule of evidence for the purpose of FERA, by which a court might presume the authenticity of documents seized or produced by the accused himself. Encouraged by this response, the Bank, in consultation with its legal advisers, sent the necessary amendments to the Ministry of Finance.

The bill containing the amendments was cleared by the Committee of the Central Board of the Bank in November 1950, but owing to a heavy legislative agenda there was little prospect of its introduction in the Lok Sabha till December 1951. Recourse was therefore taken to a Presidential Ordinance entitled 'the Foreign Exchange Regulation (Amendment) Ordinance, 1951' which, with slight reordering of the sections as originally proposed by the Bank, was promulgated on 27 December 1951. The Lok Sabha passed the amendment bill in February 1952 after a brief discussion and it received the President's assent the same month. The opportunity was also taken to extend FERA's validity up to December 1957.

While the Bank favoured legislative amendments to bring the guilty more effectively to book, the Ministry of Finance had other ideas, including a

provision for compounding offences and settling them out of court. Ministry officials had some notion that such a provision would induce persons to readily hand over incriminating documents. The Law Ministry, to whom the matter was referred, felt compounding offences under FERA would not be in the public interest, for the object of the legislation was not to collect revenue. A revenue law like the Income Tax Act could appropriately provide for compounding of offences in suitable cases, but not so FERA where prohibitions and penalties were aimed at controlling the import, export and acquisition of foreign exchange. According to section 345 of the Code of Criminal Procedure, compoundable offences were really those offences which were against an individual rather than against the State. FERA offences were against the State and compounding them would dilute the deterrent effect of the Act's penal provisions.

The Bank too resisted the proposal to compound FERA offences, as it felt that the mere imposition of penalty was not a sufficient deterrent; contravention of FERA was a criminal offence and guilty persons should be prosecuted and suffer the penalties prescribed under it. In its view, enforcement provisions could not be subordinated to considerations which dominated the collection of revenues. The very essence of the legislation, which was to bring under control all available holdings of foreign exchange, would be lost if the entire holding was not brought under control. The Bank also questioned the status of the foreign exchange that would be left to the share of the illegal holder and warned that it would amount to an 'approved holding' liable to be treated thereafter as such. Subsequent holders of this exchange would also have to be exempted and such holdings could, in course of time, become a shelter for economic offenders. In the face of such strong arguments against compounding, the Finance Ministry decided in 1952 not to pursue the suggestion any further.

This, however, was not the end of the story. In April 1957 the Ministry of Finance sent the Reserve Bank a list of proposed amendments to FERA. Most of the amendments were of a technical nature and were suggested by the Reserve Bank. Others suggested by the government did not raise major issues, except a new clause under which the government proposed to acquire powers to compound exchange violations. Despite the Bank's objections and a resolution of the Committee of the Central Board which expressed reservations, the government introduced the bill with the compounding provision in the Lok Sabha in August 1957. There was some parliamentary opposition to the clause, but the bill was passed without much difficulty on the very day it was introduced and received the assent of the President in September 1957. The vesting of powers for compounding exchange control cases in the hands of the Enforcement Directorate was seen by the Bank as a step away from

bringing the guilty to book. However, citing difficulties encountered in enforcing FERA provisions, the Enforcement Directorate came up with further proposals to amend the Act in 1961. These proposals, which were further modified in 1964, strengthened the powers of the directorate to deal with FERA offenders.

CONCLUSION

Post-Independence exchange control policies were shaped by the Bank and the Finance Ministry. Consequently, the role of the Bank, which was mainly responsible for administering these policies, expanded in size and scope. Exchange control policies grew more restrictive and detailed over the period covered by this volume. The astonishingly rapid growth of controls had, by the mid-1960s, led to a situation where the public knocked at the Bank's doors with questions of bewildering complexity, which might relate often to trivial sums of foreign exchange. By the end of the decade, the need to restructure and reorganize the exchange control mechanism had become amply clear, but it was equally evident that controls were there to stay in the foreseeable future.

Additional Unpublished Sources

ECS.1	Policy—General
ECS.1.A(i)	Remittances outside India—Travel Policy
ECS.4	Import Control Policy
ECS.21	Securities—Restriction on Sale of
ECS.21.A	Purchases of Sterling Shares by Indian Nationals
ECS.21.B	Investment of Overseas Indians in Indian Securities—Report of Shri Adarkar
ECS.21.C	National Defence Remittance Scheme
ECS.47	Indian Exchange Act—FERA
P&C.47	'P' Form Statutory Rules
P&C.76	Forward Exchange Cover to Exports on D.P. Basis
ECS.79	Sterling Area Dollar Pool

APPENDIX F

Quota Increases at the Fund

with C.J. Batliwalla

This appendix deals with the negotiation and implementation by India of quota increases at the International Monetary Fund. Quotas represent subscriptions by member countries of the IMF. Payable partly in gold and dollars and partly in the currency of each member, quotas constitute the largest source of the institution's financial resources. They determine a member's voting power at the Fund and the amounts it can draw in need. In the 1960s and 1970s, quotas provided a basis for distributing multilaterally created international liquidity such as special drawing rights (SDRs). However, this appendix is not concerned with international liquidity issues, nor with the terms of access to Fund drawings.

Quotas are determined on the basis of indices such as a country's national income and its share of world trade. Political considerations and alliances also play a significant role. The Fund's Articles require it to carry out five-yearly reviews of the quota structure. A four-fifths majority of voting power is required to effect a change in quotas, and no country's quota can be changed without its consent.

Despite the reservations of its delegates who sought a larger quota, India's quota was fixed at \$400 million in 1945. Its was the sixth largest quota after those of USA, Britain, USSR, China, and France. The 'big five' had a right to appoint their own Executive Directors, whereas other Executive Directors at the Fund were elected by country groupings, which tended, for a variety of reasons, to be in a state of some flux. India became one of the 'big five' when the USSR did not join the Fund. But its position in this exclusive club soon came under challenge from West Germany and Japan (whose political rehabilitation in the western alliance complemented their rapid economic growth), and Canada. But thanks to the reluctance of these countries to rock the boat other than gently, widespread recognition of the incongruity of Taiwan (Formosa) exercising the privileges conferred by the large quota unified China was allotted in 1945, and its own efforts, India

managed to retain a 'permanent' seat on the Executive Board of the IMF throughout our period.

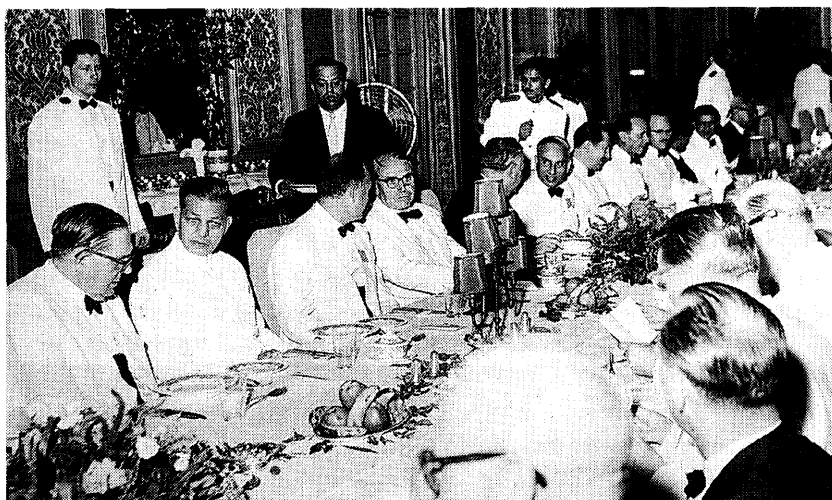
REVIEWING QUOTAS

Far from distributing obligations and powers in any enduring way, the Bretton Woods quota formula quickly became a reference point for revisions. The first exercise to revise quotas was initiated in December 1949 and proved abortive because of the prevailing economic and political uncertainty. The US, which commanded an effective veto because its individual voting strength exceeded the 20 per cent required to block change, was opposed to quota increases in 1951 and 1953, so that it was not until 1955 that an exercise to revise quotas got seriously under way.

Even now there was not much support for a general revision of quotas, nor any great desire to upset existing equations on the Board. The United States and Britain were not willing to add to their quotas, and neither supported West Germany's case for a quota increase which might see it replace India as one of the 'big five'. The US was keener to enhance the position of some Latin American countries and this, principally, led to a suggestion for arranging members into five groups based on their quotas, and increasing quotas such that the smaller quota-holders secured a proportionately larger increase. This proposal gained some support—the quotas of USA, Britain, and China were not to be increased—and for India it had the advantage of blocking a German advance. But consensus proved elusive, and it was resolved in January 1956 that while there would be no general increase, the Board would look favourably upon requests for increases by members with small quotas.

India's seat on the Board being far from secure, several manoeuvres were considered or carried out to safeguard it. One such related to China's position on the Board. The Fund's Managing Director, Ivar Rooth, and several executive directors questioned the appropriateness of allowing Taiwan to sit on the Board and exercise China's large voting power. Aware of Indian anxieties, in 1956 Rooth raised with the Indian Executive Director, P.S. Narayan Prasad, the probability of Germany seeking an increase in its quota, and sought his view on the possibility of India using the China issue as a second line of defence of its position at the Fund. Though this suggestion accorded with India's overall views on China's representation in international bodies, the issue faded into the background for the time being after it became clear that the anticipated German request would not materialize.

Quota revision exercises also carried other risks. One such risk was that they might reinforce the relative under-representation of south-east Asia and west Asia which had, between them, four directors. Europe was over-



Per Jacobsson (extreme left) in conversation with host H.V.R. Iengar, at a banquet for delegates of the Fund-[World]Bank meeting, Delhi, October 1958

represented on the Board since the basic quotas were fixed in 1945 when several countries were still colonies of European powers. Besides, there were anomalies in the constitution of country groupings, some of which also reflected the vestiges of European domination. Indonesia, for example, was represented by Italy, while South Korea was represented by Belgium. The Philippines formed part of the west Asian constellation.

Nor were recent additions to quotas and votes reflected in the Board's composition. Between 1946 and 1956, European votes increased by 8,455 while their elected representation went up by three. Asia's total votes went up over the same period by 8,765, but it had to be satisfied with having only one additional member on the Board. Thanks to a variety of historical and arbitrary arrangements, Europe had annexed seven of the sixteen seats on the Fund's Board. While it was important to increase the Asian representation, it was also necessary to ensure that the new Asian member on the Board would articulate the concerns of underdeveloped countries. These two objectives were not always easily reconcilable. The general policy India followed whenever any Asian or African country wanted to break away from a European-dominated grouping was to assist the formation of more cohesive groups of developing countries which could together send a representative to the Board. Thanks to India's discreet and timely initiatives, in 1958 a new electoral group coalesced around Indonesia after it broke away from its former European group.

The Suez crisis, the wave of speculation against European currencies in the summer of 1957, recession in the US economy, and the sharp fall in prices of primary commodities together increased the demands placed on the Fund's resources, so that by the time the annual Fund-[World]Bank meeting took place in New Delhi in October 1958, there was widespread recognition of the need to revise quotas. With the formal decision to initiate the exercise taken at the meeting, the Executive Board of the Fund met to consider a memorandum suggesting (a) a general increase of 50 per cent in the quotas of all members, with some countries being allowed larger increases, and (b) payment of a quarter of the increased quotas in gold. The latter was judged to be necessary, among other things, to secure US support for enhanced quotas.

These proposals had a special bearing on India's position at the Fund. While a general increase in quotas was welcome, there was the risk that changes in relative quotas might redistribute voting power at the Fund in favour of the industrialized countries, displace India from its fifth position, and cost it the right to appoint an Executive Director. The gold payment obligation would also impose some hardship on India. But the official brief prepared by B.N. Adarkar, the Indian Executive Director at the Fund, and I.G. Patel, his Alternate, to enable the government and the Bank to formulate its views, argued that it was 'unwise' and contrary to India's 'general acceptance of an international approach' to appear to oppose a large increase in the German quota merely in order to safeguard its permanent seat on the Board. An increase in the German, Japanese, and Italian quotas by more than 50 per cent would benefit all countries needing Fund resources, including India. But the present arrangements involved a serious anomaly in that China, which had a quota of \$550 million, was represented by Taiwan. If the revision exercise did not lead to an increase in the Chinese quota, India could still be one of the 'big five'. According to the rumour mills, the Americans would probably accept this compromise. Should the latter not be possible, the brief argued, India should strive for an increase in the number of permanent members on the Board from five to six. As it happened, the US was keen to see India retain its permanent seat on the Board, and prevailed on Taiwan not to seek any increase in its overall quota.

Nor would much be gained, the Adarkar-Patel brief argued, by opposing the gold quota. While the need to keep India's gold contribution to the minimum was real and urgent, there were distinct advantages to making it. Besides adding to the Fund's liquidity, India could draw the gold automatically in the event of need. Finally, it was inappropriate to give the impression that all but a few members sought and obtained special exemptions from the responsibilities which went with membership. Recommending a flexible attitude

on this question as well, the brief suggested that India could use its sterling balances to buy gold for the contribution.

Along with Egypt, India opposed the gold quota when the Board met several times in November to debate the quota revision. Though various means of easing the burden on developing countries were advanced, it soon became evident that there was no prospect of the gold quota being relaxed. Therefore, Adarkar urged the Governor, H.V.R. Iengar, that India would be acting with 'grace' in accepting 'responsibilities which go with privileges especially when so many other countries not entitled to these privileges had declared their readiness to make the full contribution'. Britain, Adarkar added, was agreeable to India using its sterling balances to buy the gold. Iengar saw the merit in Adarkar's reasoning and concurred in the payment of India's full contribution in gold.

PAYING IN GOLD

The revision, which was shortly approved, meant that India's quota at the Fund would go up from \$400 million to \$600 million. A quarter of the increase (\$50 million or Rs 23.75 crores) had to be paid for in gold, and attention at the Bank turned towards the means of executing this transaction. The Bank advised, and the government agreed, that the 7.9 lakh tolas of gold with the mint and the Reserve Bank (comprising 3.6 lakh tolas of newly mined gold and 4.3 lakh tolas of confiscated gold) valued at \$10 million should be used to make a part of the contribution. The cheapest method of making the remaining contribution of Rs 19 crores was to dip into India's official holdings of the metal. But doing so would reduce them below the statutory currency cover minimum of Rs 115 crores and necessitate an amendment to section 33 of the Reserve Bank of India Act. This was quickly ruled out in favour of using India's sterling balances to buy the metal in the world market.

Thanks largely to India being a member of the sterling area, the Reserve Bank of India had little exposure to the working of the international gold market and no expertise for dealing in it. The Bank therefore decided to act through the Bank of England, which hoped to buy the metal, depending on exchange rates, in London, New York, or Zurich, at a price lower than the US assay price of \$35.08³/₄ per oz., if it was given some flexibility and discretion in choosing the place of delivery. The Reserve Bank was represented in these transactions by its London manager, V.G. Pendharkar, but to judge from the by-product of 61 cables and 153 letters, they were closely monitored from Bombay.

Transporting the metal too, posed some knotty problems. The Reserve Bank was an authorized depository of the Fund's gold, and there was

naturally some preference, subject to cost, for bringing the gold to India. The original proposal was to ship the metal to India on Scindia's boats. But soon fierce competition broke out, and with Air-India offering attractive prices, the contract was split between the two companies. Air-India offered to lift its share of the cargo, ex-London, in nine flights beginning mid-September, while Scindia promised to do so in three bottoms fitted with strongrooms, the first boat leaving in the first week of September. Harrowing tales of train journeys through jungles led the Deputy Governor, K.G. Ambegaokar, to favour lifting the gold from Bombay to Nagpur by air.

The purchase and transport operations did not go off without hitches. The unavailability of wooden containers of a specific type required for packing the gold led to some delays and to the first Scindia boat being missed. Meanwhile, the sterling came under pressure during the last week of August and the first week of September. Anticipating this eventuality, Pendharkar had advised officials in Bombay to buy spot dollars in the summer. But little came of his suggestion, and now in September, Pendharkar advised the Bank of England to defer the gold purchases until the exchanges turned more favourable.

The logistics of transport too, were not easy to work out. The risk of unloading gold in Nagpur after sundown meant the metal having to be held overnight at the Bombay airport. Flights from London to Bombay departed early on some days of the week, and the risks, likewise, of transporting gold through London in the small hours led to the agreed schedule being altered. Purchases recommenced towards the middle of September. Shipments by air began on 29 September 1959 and were completed a month later. Arrangements were also concluded to bring gold worth Rs 9 crores by sea on Scindia's 6,370 ton freighter, M.V. *Marilu*—which though a single screw vessel had a triple-A rating—sailing from the Surrey docks. Every precaution was taken to maintain the secrecy of these arrangements. Despite this, news of gold being loaded for India on the *Marilu* was splashed the same day in the *Evening News* whose report also carried the precise value of the consignment on board the vessel. By 30 October 1959, all the consignments, aggregating 14,28,617 fine ounces, had found their way safely to Nagpur.

REVISING QUOTAS AGAIN

From India's standpoint, the outcome of the 1958–59 review of quotas was quite satisfactory. Although the relative quotas of Canada, Germany, and Japan were also raised, India had managed to retain its fifth position at the Fund. The next quinquennial review fell due in 1965. There was general

support for a revision when the subject was raised in 1964. Gold subscriptions were now an accepted part of quota revision arrangements, but apart from the nervousness of developing countries about finding the gold with which to subscribe to their new quotas, the 1964–65 exercise was carried out in the shadow of the deteriorating gold position of the key currency centres. While discussions were simultaneously initiated on multilateral liquidity creation which culminated in the Special Drawing Rights (or SDRs), the more immediate fear of the key currency countries was that higher quotas would lead to the metal being diverted to the Fund from London and New York. The latter problem was resolved, over France's objection, by allowing the Fund's enhanced gold holdings to be held in deposit. The fears of developing countries were sought to be addressed by allowing them to finance their gold subscriptions using special drawings (not to be confused with SDRs, which came into existence in 1969) from the Washington institution.

Preliminary studies at the Fund recommended a general quota increase of 50 per cent along with some selective increases. The general increase was whittled down, despite Britain's and Canada's preference for larger quotas, to 25 per cent by the Group of Ten (G-10) industrialized countries. This now formed the basis for the Fund's studies of quota revisions. Several methods of mitigating the immediate impact of quota increases on the liquidity position of the developing countries were aired in discussions and memoranda. The Fund's articles of agreement [III(4)(a)] allowed the institution to reduce the gold contributions of members with low reserves, and this was India's own preferred method of dealing with the problem. The Bank advised the government to press for a 'complete waiver of gold subscription' for countries with low reserves, but announce at the same time India's willingness to pay its gold quota in full. 'Our argument for a complete waiver of gold subscription can then be made to appear ... disinterested and objective ...', Bhattacharyya counselled the Finance Ministry. 'Outright payment of gold' by India, the Governor also told officials in Delhi, would strengthen its position as a member of the 'First Five', and help the 'tranche position'. 'This would be of considerable help to us in the immediate future if we have to undertake next year an operation of the 1961 type to fulfil our current repurchase obligations.' Finally, by strengthening India's advocacy of Art. III(4)(a), it might prove to be of some help 'on the next occasion of a quota increase'.

Mitigation proposals did not make much headway in the face of opposition from a majority of the industrialized countries. Eventually, a compromise was hammered out which avoided recourse to Art. III(4)(a) and offered relief through the technique of special drawings with some relaxation of repurchase requirements. Countries pleading hardship were to be given the

facility of an additional special drawing, which would not take borrowers into a higher credit tranche. These were to be repaid in five years. With the G-10 endorsing this compromise approach, the rest of the journey was quite smooth, and the Governors of the Fund approved two resolutions to sanction a 25 per cent general increase in quotas and special increases for sixteen countries.

India managed to hold on to its fifth position, and thus the right to nominate its own Executive Director, by the proverbial whisker. Substantial special increases were clearly indicated for France, Canada, Germany, and Japan, but the last three countries, in particular, were restrained in pressing for quota increases to the full extent warranted by technical calculations. Addressing the Board of Governors of the Fund in Tokyo in 1964, the Finance Minister, T.T. Krishnamachari, pointed out that not all the considerations determining the quota structure could be expressed or compressed in statistical formulas. TTK's advice was reflected in the final outcome, which was made possible by Canada and Japan, both of whom would have secured larger quotas had technical calculations been the sole basis of the quota revision, settling for \$740 million and \$725 million respectively, against the Indian quota of \$750 million. India was, however, put on notice that it could not expect similar consideration when the next round of quota increases was undertaken.

The increase in the Indian quota amounted to \$150 million. Of this \$37.5 million had to be found in the form of gold in the immediate future. The Bank's advice to the government was to consent to the increase and accept the quota in full, rather than in instalments as some proposed, meet the gold obligation by making a special IMF drawing, and deposit it immediately to secure the full benefit of the quota increase. According to Bhattacharyya, India should not allow Canada or Japan to outstrip its quota even temporarily. India, he also argued, should declare its intention to repurchase the drawing in three to five years, as this would postpone the first repurchase obligation to 1968 when repurchases on other drawings would be out of the way.

Various options of buying the gold were considered, including directly from the Bank of England and the Federal Reserve Bank of New York, rather than from the London or New York market. There were also some misgivings that the arrangements the Fund envisaged for the special drawing to purchase gold might necessitate paying a premium on the metal and bearing a higher cost of transporting it, should the government so decide, to Nagpur. An easier option was to transfer \$37.5 million (approximately Rs 17.8 crores) worth of gold from the Reserve Bank's holdings to the Fund's account in India. Apart from enabling India to take advantage of the higher quota immediately, it would also save the expense of transporting gold to its final depository.

It was pointed out in chapter 17 that the Issue Department's gold assets were augmented by about Rs 16 crores early in 1965 by taking over stocks of confiscated and indigenously produced gold. The object of this manoeuvre was to enable foreign exchange to be released to finance imports and debt repayments while keeping the Issue Department's total stock of gold and foreign securities above the section 33 minimum of Rs 200 crores. The IMF special drawing would, in principle, now enable the opposite substitution to be made in the overall composition of the Issue Department's reserves of gold and foreign exchange. But the withdrawal of nearly Rs 18 crores of gold would bring its gold holdings down from Rs 133.76 crores to Rs 115.89 crores, or only Rs 0.89 crore above the statutory minimum for this particular component of the currency cover. In addition, some doubts existed over the permissibility of using the special drawing to restore reserves rather than buy gold.

The idea of selling silver, whose price was quite high at this time in the international market, as a substitute for the special drawing was considered briefly. It was abandoned after the Bank cautioned the government that refining and assaying silver to international standards would take far too long for India to be able to meet the IMF obligation with the proceeds of its sales. Besides, Indian sales of the metal could depress international prices and draw unwelcome attention to a hidden source of foreign exchange. Fresh tidings from Washington also indicated that India had until the end of December to make its payment to the IMF and that the special drawing could be used to replenish reserves. This clinched the issue in the Bank's mind, and Bhattacharyya informed the government of its view that there was no special advantage to avoiding the special drawing which would not affect India's other drawing powers at that institution in any way. J.J. Anjaria, the Indian Executive Director at the Fund, who had earlier backed the plan to sell silver and conserve the special drawing for another rainy day, also came round to Bhattacharyya's view that 'the decision on silver need not be rushed'. So that finally, the obligation to pay \$37.5 million to the IMF in gold was met by drawing down gold holdings in the Reserve Bank's Issue Department, and using the proceeds of the special drawing to replenish the latter's foreign exchange assets. The payment was completed on 28 February 1966.

Additional Unpublished Sources

BF-19A	Increase in Resources of IMF and IBRD
BF-29B-1965	Increase in Resources of the Fund and the Bank
301(A)	Purchase of Gold

APPENDIX G

Bilateral Rupee Payment Agreements

with C.J. Batliwalla

One of the more striking features of India's external economic relationships of the fifties and the sixties was the forging of trade, investment, and financial links between India and the centrally planned economies of eastern Europe. No narrative of developments in the country's external sector during these years can be complete without a brief survey of this relationship.

Until 1952 trade contact with east Europe was confined to agreements with Poland, Yugoslavia, Hungary, and Czechoslovakia. Commercial contacts with the Soviet Union and the other countries of eastern Europe were established in the 1950s. Thereafter, trade with the region increased rapidly, from \$9.2 million in 1952–53 to \$658 million in 1965–66, and from a mere 0.3 per cent to 14.2 per cent of India's foreign trade. These bilateral agreements were important because they were believed to give India access to new markets, and enabled it to import vitally required capital and defence goods, often on easy rupee payment terms.

India's policy on trade and financial relations with this region was determined largely on political grounds. Their rapid expansion under the impetus of bilateral rupee payment agreements evoked a certain amount of concern, notably over the contribution of such arrangements to enhancing India's access to capital goods. It was argued that rather than offering new and expanded markets, these agreements led directly or indirectly to a reduction in India's hard currency export receipts. Reports of switch trade or shunting—i.e. the diversion by socialist countries to world markets of imports from India paid for in rupees—also abounded. Alarmed by what appeared to him as a headlong push towards bilateral trading arrangements and the limited benefits to India therefrom, Iengar wrote to Jawaharlal Nehru alerting him to the dangers of such agreements. But Nehru brushed aside Iengar's reservations. In a two-page handwritten note, he instructed the Finance Ministry to ignore the Governor's views and declared that 'political compulsions far outweigh[ed] economic considerations in this relationship'.

Thereafter, the Prime Minister did not discuss the matter with the Governor, and the Bank was largely excluded from the arena of policy-making in this particular area. Nor did it take part in the negotiations except to advise the government about certain operational aspects of bilateral trade. But it fell to the Reserve Bank to administer the settlement of transactions under these agreements and maintain the accounts of India's trade with the region.

MECHANISM OF TRADE AND PAYMENT AGREEMENTS

Bilateral trade agreements with Yugoslavia, Czechoslovakia, Hungary, and Poland went back to 1948–49. The early agreements did not embody any special payment arrangements, and surpluses and deficits were settled in sterling. Agreements concluded between 1953 and 1958 accepted the rupee as the unit of account, but while every effort was to be made to balance trade, imbalances were expected to be settled in sterling or a convertible currency. These agreements were more an expression of intent than a means immediately to promote trade, but they also helped familiarize each country with the trading potential of the other. Though trade was bilateral, payment arrangements were not, and as the Reserve Bank of India noted in its *Report on Currency and Finance* for 1955–56, these agreements were 'essentially multilateral in character' in that outstanding balances were settled in sterling 'at the end of the agreement period or on demand'

India's experience with these early agreements was far from encouraging. Centrally planned economies did not display the same enthusiasm for importing from India as for exporting to it, and saw bilateral trade as a means of earning sterling for expenditure elsewhere. In 1958–59 a radical change was effected in payment arrangements. From now on payments for all transactions were to be effected in inconvertible rupees, and contracting countries agreed not to demand balancing payments in convertible currency and instead to hold rupee balances. Protocols were appended to earlier agreements deferring the convertibility of rupee balances and enabling central banks of partner countries to hold accounts with the Reserve Bank and some commercial banks. For its part, India agreed to provide overdrafts (called technical credits) on the partner country's rupee account to smoothen short-term imbalances. The object of these amendments was to ensure a balance in India's bilateral trade with the socialist countries, conserve foreign exchange, and enlarge its export markets. The value of the rupee was fixed in terms of gold for the purpose of these agreements, intergroup transfers of balances were generally disallowed, and no distinction was made between trade and transactions financed from aid.

East European countries maintained their accounts with the Reserve Bank. As part of this responsibility, the Bank administered these accounts and monitored the balancing aspects of the various accounts each country maintained with it. This work was handled in the then Chief Accountant's office and the Economic Department, with the latter entrusted with responsibility for compiling, collating, and presenting material for the Governor and the other departments dealing with banking relations of this group, and analysis and reviews for use by the government. The Economic Department was also the principal source of data for India's balance of payments with east Europe and undertook reviews at regular intervals of trade and financing arrangements with each bilateral partner. Over time, the intricacies of these arrangements increased with the growth of trade, aid, and the exchange of technical know-how. Besides, the Bank also tried to assess the impact of these arrangements on the Indian economy, and supplied data and material to help resolve disputes between contracting parties, notably over the interpretation of the 'gold clause' after the rupee devaluation of 1966. But the Bank itself was rarely involved directly in the negotiations.

It is necessary before getting any deeper into the working of these agreements to understand how trade transactions with rupee payment countries were operated and accounted. Each such country maintained four accounts with banks in India: a central clearing account, a special account in which were deposited credits extended as assistance to India, another similar account to which were credited debt repayments by India, and a current account. While the first three accounts were maintained with the Reserve Bank, the fourth was held with one or more commercial banks. India paid for normal imports by depositing inconvertible rupees in the first central account and for aid-financed imports by withdrawals from the second. Its trading partners financed their imports by making payments through their current accounts. Credits in the third account could be transferred to the current account through the central clearing account. Funds could be moved freely between these four accounts, but while transactions financed by technical credits were routed through the central clearing account, trade transactions were put through current accounts. Having to maintain this complex set of accounts, the Bank was obliged to engage in continuous liaison with its holders (especially the central banks of India's socialist trading partners) and with the Finance and Commerce Ministries. Information was often sketchier than the Bank wished and establishing the precise nature of a transaction was not always easy.

Temporary 'swing credits' were extended to a country which ran out of its rupee balances on the understanding that they would be repaid as soon as possible. On the other hand, should any country accumulate a large rupee

surplus, India imposed licensing restrictions on imports from that country to redress the imbalance. Originally, technical credits were a temporary form of trade credit extended by the Indian government to its rupee payment partners to boost exports in 1959 when there was a recession in the western demand for them. Though conceived as a 'once for all operation', it was converted in due course into a revolving credit or a semi-permanent overdraft facility for the duration of each agreement, on the reasoning that with trade financed in inconvertible rupees, exports to the socialist countries would otherwise be constrained by the size of India's imports from them. Upper limits were fixed separately for each individual country, except the USSR, credits to which had no upper limit, while withdrawals up to Rs one crore were free of any interest charges.

This credit facility was not invulnerable to abuse. In 1961 D.N. Maluste, Deputy Exchange Controller, drew the Finance Ministry's attention to one bilateral trading partner availing of technical credits to the hilt despite having large current account balances, possibly with a view to earning some additional return. On this occasion, the central bank of the concerned country represented that current account balances were intended to support the letters of credit opened by the bank against exports from India. Following this the Bank advised the government to ensure that no country used technical credits as a means of increasing its interest earnings. But little came of this suggestion as the Ministry of Commerce and Industry felt excessive credits were not the problem. The real problem, according to this ministry, was the opposite one of inadequate credits hampering bilateral trade. The Bank's more extensive review carried out in 1964 confirmed its earlier assessment. India's exports to eastern Europe did not suffer for want of funds or credit. Several countries continued to draw on interest-free technical credit to deposit in interest-earning commercial bank accounts. The review proposed more intensive scrutiny of outstanding credits, efforts to persuade debtor countries to repay their borrowing whenever they had sufficient balances in their current accounts, and in the meantime to charge higher rates of interest on technical credit. But to little immediate avail.

Thanks to its role in operating these arrangements, the Bank was privy to very detailed data on trade with the socialist countries and the manner in which it was balanced or financed. However, largely for strategic reasons, these data were never put out in a comprehensive or transparent form. Generally too, the working of these agreements have been shrouded in mystery. According to the summary position for four years (1960-61 to 1963-64) worked out by officials at the Bank, India ran substantial merchandise trade deficits with the Soviet bloc countries, which rose from Rs 13.1 crores in 1960-61 to Rs 45.5

crores in 1963–64. Invisible transactions were relatively small except in the first year, and these figures are also generally reflective of the position on the current account. Capital receipts registered a steady and perceptible increase from Rs 4.6 crores to Rs 42.5 crores during these years. Although these loans were made on concessional terms at nominal interest rates and carried longer amortization periods, east European credits were of much smaller magnitude than those extended by the west. The real significance of these flows lay not in their size but in the competition they injected between donor groups, and their success in forcing the major western countries to re-evaluate their aid programmes.

Combined current and capital account transactions with bilateral payment countries reflected nominal surpluses of Rs 1.4 crores in 1960–61 and Rs 1.5 crores in 1962–63. Against these may be set net drawings of technical credits of Rs 2.7 crores and Rs 3.4 crores respectively during these two years. In 1961–62, India ran a deficit of Rs 9.4 crores, which the socialist countries used partly to repay technical credits (Rs 5.6 crores) and partly to augment balances in their central and commercial accounts (Rs 3.8 crores). The 1963–64 payments outcome vindicated the Reserve Bank's suspicions: despite a deficit of Rs 11 crores in that year, net technical credits extended by India exceeded Rs 4 crores when repayment would have been the proper course. As a result, socialist countries' rupee balances in their commercial bank and Reserve Bank accounts improved by Rs 15 crores.

Merchandise imports under bilateral agreements increased faster than exports in the first half of the sixties. But this trend was interrupted in 1965–66, when the growth in imports levelled off and gave way to an export surplus. Thereafter, India's trade relations with the socialist countries suffered some uncertainty due to the 'gold clause' controversy arising from the devaluation of the rupee in June 1966. This controversy is discussed below. Although imports in 1968–69 and 1969–70 were again higher, from 1970–71 they stabilized at a lower level. To an extent, this reversal reflected the repayment and servicing of assistance drawn to finance the import surplus of the earlier period. But also, India was committed under the agreement to liquidate its export earnings from an individual country on imports of goods and services from it. In the early sixties, over half of India's imports from socialist countries comprised machinery or turnkey projects tied to aid. But by the beginning of the next decade, as the Bank informed the government, thanks to the difficulty of finding suitable products, licences issued for capital goods imports from the socialist bloc remained unutilized. In other cases, there were long delays between orders and shipment. The resulting imbalance often forced India to enhance technical credit limits to several socialist countries.

A major issue of contention arising from bilateral rupee trade agreements concerned the diversion of Indian exports from hard currency markets to the socialist countries and the reported re-export by them of their imports from India. With outlook in Delhi dominated by the country's balance of payments problems, the advantage of paying for capital goods imports in inconvertible rupees was thought to outweigh such losses. There was some concern voiced at the Bank, notably by the Division of Trade, about trade diversion when supplies of exportable goods were inelastic. But more detailed commodity studies suggested that there was no large reduction in India's exports to the rest of the world due to higher exports to the socialist world. If anything, there was some trade creation, particularly in the case of exports such as cashew nuts, tobacco, and iron and manganese ore, and some improvement as a result in India's terms of trade.

Raw hides and skins were believed to be an exception. While world demand was buoyant and Indian suppliers were constrained by a variety of factors from meeting it, some east European countries began pre-empting supplies by offering much higher prices. This benefited one section of the trade, but value addition and employment in the downstream activities suffered as many tanneries could not secure adequate supplies of raw hides and skins and were forced to close. Exports to hard currency markets too, suffered a setback.

Re-exports by the socialist countries of imports from India presented another aspect of the diversion problem. Sometimes, however, the evidence for shunting—as in the case of India's exports of oilcakes, the Soviet bloc's shares of which rose significantly through the 1960s despite shortfalls in domestic availability—was suggestive rather than conclusive. Apart from oilcakes, there were several complaints in the 1960s of re-exports of coffee, tea, spices, and hides and skins, and the Estimates Committee of Parliament too, examined the problem without coming to any definite conclusion. On a visit to Europe, V.G. Pendharkar, Manager of the Bank's office in London, came across Indian tea and cashew nuts consigned to Russia and Poland being offloaded at Hamburg and Bremen for re-consignment to US ports. The Indian government was aware of such practices, but little could be done about them in the absence of reliable quantitative information. In the meantime it preferred to turn a blind eye to shunting on the assumption that it did not account for any significant proportion of India's exports to the socialist bloc. Besides, many officials argued, India was not in a position to strike hard bargains in international markets to which its exports were not indispensable. India also depended on eastern Europe for essential supplies and, overall, trade with the region had been of benefit to it.

But elsewhere, particularly in the west, there was mounting scepticism about such arrangements. Western criticism of rupee trade was not entirely disinterested, and Britain, in particular, was concerned about the effects of such arrangements for its trade with India. Some of the concern was no doubt motivated by ideological and political considerations. There was also some fear that British suppliers eager to retain markets in India would be willing to accept inconvertible (or deferred convertible) rupees, and the London manager of the Reserve Bank was asked more than once about reports of such deals. The annual Art. XIV consultations with the Fund became occasions for some close questioning of India's motives and intentions about rupee settlements. The host country generally responded to the Fund's probing by emphasizing its preference for multilateral trade, and pointing out that in practically all bilateral agreements India had retained and exercised its right to buy from the cheapest market. India also urged the Fund to look more closely at the commercial policies of the stronger creditor nations to understand India's recourse to bilateral trading relations. As officials at the Bank also began to stress by the mid-sixties, while aid from both the west and from eastern Europe came in a tied form, repayments to the former took the form of free foreign exchange. In contrast, repayments to India's east European creditors were 'tied' to its exports to them. In that sense, loan and repayments arrangements with eastern Europe were marked by a greater symmetry than those with the west.

Our account of India's rupee trading arrangements in the 1950s and 1960s ends on a note of irony. As India's external debt servicing and repayment obligations began to appear onerous in the mid-1960s, officials in London and Germany considered accepting part of its repayment in inconvertible rupees to be used for expenditure within India. Similar suggestions had been mooted (in payment for exports of military hardware and capital equipment) after the Chinese aggression, but the Bank of England would not hear of them. To canvass the advantages of rupee payment arrangements but insist that they be kept within modest dimensions, one official argued in March 1963, was to admit like the 'barmaid, that the child is illegitimate but will not be a nuisance because it is tiny'. Though the new proposals were closer to P.L.480-type arrangements than to India's rupee trading agreements with eastern Europe, it is worth noting that many more officials, at least in London, were willing to countenance rupee payment to deal with the anticipated crisis in Indian external finances in 1965-66 than they were two years earlier.

Nothing ultimately came of such suggestions. But it is useful in concluding this appendix to draw attention to an innovative method aired in London of weaving together the two strands of India's external financial diplomacy

since the 1950s. Responding to fears that the western insistence on India repaying its debts might strengthen Soviet propaganda about the 'usurious terms' on which such loans were extended, some senior officials at the Bank of England reflected that the time had perhaps come to draw the USSR into Indian aid negotiations. The west, according to this view, had never been certain whether it gave aid to the developing world because of any 'moral imperative' or to give the 'Bolsheviks a black eye'. India may become a further cause of tensions between the west and Russia should the latter step in to fill the breach caused by a pause in the former's aid commitments. On the other hand, if aid commitments continued as before to India and the west gave similar assistance to the rest of the developing world, there was the risk of the resulting debt burden causing an 'almighty balance of payments freeze-up' between the 'north' and the 'south'. This would almost certainly give the Soviet Union a great propaganda and strategic advantage. Therefore, some officials suggested, 'careful thought' should be given to the possibility of using the Indian situation to

talk to the Russians about the subject of 'competitive aid', which is doing neither team of donors any good and ... is a rod in the pickle for the so-called beneficiaries. If this could lead to the opening up of perspectives, at the end of which ... Soviet bloc membership of the international institutions could be thought of as a real possibility, ... [that would] be one of the most significant steps forward in international economic relations since the war.

In the event, western concern over extending to India relief on its debt to consortium members when its repayment obligations to the socialist world were left untouched, extended beyond the Bank of England. Approached by Bhattacharyya in February 1966 to negotiate a postponement or refinancing of debt repayments to the original members of the consortium, the World Bank sought from India an explanation of 'why any relief thus secured without a corresponding relief from the Soviet Union and other east European countries would not work to the detriment of consortium members'.

DEVALUATION AND THE GOLD CLAUSE

The rupee was the unit of account in India's payment agreements with eastern Europe. Under the so-called gold clause found in many of these agreements, the exchange value of the rupee was fixed in terms of its gold content, thus effectively protecting holders of rupees governed by such agreements from devaluation. The Reserve Bank was not in the picture at the time these agreements were made, when little thought appears to have been given to the

You Said It

By LAXMAN



Don't sign the agreement on a rupee payment basis, Sir. We don't have any rupees either!

—*ToI*, 5 May 1961

significance of this clause. The devaluation of 1966 turned the spotlight on the gold clause. Not only did India discover now that it was on a sticky legal wicket, with the Soviet Union determined to dig in its heels and insist on the application of this clause to contracts between the two countries and the other countries waiting to see how this test case would be resolved, rupee trade between India and east Europe came to a virtual standstill immediately after the devaluation. This caused great concern in India because at the time of the devaluation, only a quarter of the trade planned for the 1966 calendar year had moved.

Under the gold clause, the agreed value of the rupee was defined in terms of gold, so that in the event of a devaluation of the rupee, adjustment would take the form of an additional payment in rupees. As exercises undertaken in the wake of the Russian demand for compensation revealed, the gold clause

worked to the detriment of the Indian exporter: while it was applicable to Russian exports to India, no similar protection was available to an Indian exporter exporting to Russia, since price contracts did not allow for domestic price increases arising from devaluation. Russian officials justified the asymmetry on the ground that contracts were expressed in a currency controlled by the Indian government. Had the arrangement been in roubles, they argued, the USSR would have stood ready to extend protection to India against a rouble devaluation. The Poles argued along similar lines or wanted to switch over to a third currency, while Bulgaria and Czechoslovakia proposed a form of double accounting.

Several rounds of negotiations were held between Indian officials and representatives of the socialist bloc over the latter half of 1966. The first priority in these talks was to revive or sustain trade flows, and understandings were reached to maintain pre-devaluation unit prices for all traditional items for the duration of the existing agreements. Further Indian shippers were permitted to mark up the rupee value of the 'unimplemented portion' of their contracts by 57.5 per cent in the case of all other countries and 47.5 per cent in the case of the Soviet Union. India also agreed to revise the value of imports from these countries by the full extent of the revaluation.

This agreement was not easy to implement in the case of goods already in the pipeline, with differences breaking out over the meaning of the term 'unimplemented'. Besides, the agreement related to current trade flows, and was silent on the revaluation of the various balances which the Soviet Union and the east European countries held in rupees. Discussions on the latter subject dragged on for several more years and merged with those over the extension or modification of rupee payment agreements with these countries.

The 1966 devaluation experience reinforced India's determination to incorporate a symmetric gold clause in future rupee payment agreements. This was easier said than done, with the Soviet Union and Poland, in particular, opposing any move to protect the receipts of Indian exporters in the event of another rupee devaluation. Disputes about the manner in which to overcome the problem continued for several more months and tended to take some of the gloss off bilateral payment agreements. The devaluation of sterling in 1967 added more confusion and uncertainty, but also highlighted the dangers of basing bilateral trade on third country currencies over whose parities neither of the contracting countries had any control. While this led India and the former Yugoslavia in the direction of settling imbalances in convertible currencies generally, the Soviet Union advanced solutions—such as double accounting or accounting for trade in roubles—which Indian negotiators found unacceptable. The former involved, in the Bank's view, an unworkable clearing

arrangement necessitating its acquiring a foreign exchange liability without the advantage of a forward cover or guarantee. As it happened, the negotiations over compensation in the immediate aftermath of the 1966 rupee devaluation and the failure of India and the Soviet Union to agree on symmetric ways to protect the interests of both countries foreshadowed future problems of fixing exchange parities in a world of relatively greater instability between the values of the rupee and of currencies such as the rouble whose exchange rates were administered rather than market-determined.

Additional Unpublished Sources

- F-116.00 Trade Agreements between Government of India and the USSR—Important Correspondence
- 32.05.01 Trade Agreements with Bulgaria
- 32.05.03 Trade Agreements with the German Democratic Republic
- 32.05.04 Trade Agreements with Hungary
- 32.05.08 Trade Agreements with Yugoslavia
- F-117.01 Protocol to the Trade and Payments Agreement between Government of India and the Hungarian government—15.6.1959—Important Correspondence
- CY(T)17 Review of Balance of Payments with East European Countries
- FE(N)4 Balance of Payments Forecasts—Papers in Connection with External Finance for Five-Year Plans
- BP.Com(N)1 Notes Prepared in Balance of Payments Section

SELECTED DOCUMENTS

This part contains a selection of documents from the Bank's records. To enable the reader to relate these documents to the narrative, they are arranged in sections and subsections corresponding broadly to the sequence of chapters in the text, and chronologically within each subsection.

I.	MONETARY POLICY	859
A.	Ad hocs: The 1955 Arrangement	859
B.	Other Selected Documents	863
II.	FINANCING GOVERNMENTS	899
A.	State Loans	899
B.	Funding of Ad hocs	922
C.	Overdrafts of State Governments	925
III.	RURAL CREDIT	950
A.	All-India Rural Credit Survey	950
B.	Controversies over Co-operation	968
IV.	STATE BANKING	1009
A.	State Bank of India	1009
B.	State-associated Banks and Subsidiaries of SBI	1021
V.	BANKING	1042
A.	Prudential Norms	1042
B.	Regulating Co-operative Banks	1046
C.	Non-scheduled Banks in West Bengal	1051
D.	Consolidation and Licensing of Banks	1060
E.	Banking Situation in Kerala	1073
F.	Deposit Insurance	1101
VI.	EXTERNAL SECTOR	1121
VII.	THE BANK AND GOVERNMENTS	1150
A.	Resignation of B. Rama Rau	1150
B.	Aftermath of the Mundhra Affair	1166

I. MONETARY POLICY

A. AD HOCS: THE 1955 ARRANGEMENT

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
January 8, 1955

D.O.No.[...]

My dear Bala,

We notice that our cash balance has gone down below Rs 40 crores. As the working minimum balance, which we have been assuming, is about Rs 50 crores, we will be glad if you will kindly arrange to have ad hocs issued to the extent of Rs 10 crores and let us know the date on which you do this.

Yours sincerely,
H. S. NEGI

Shri G. Balasubramanian
Secretary
Reserve Bank of India
Central Office
Bombay

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
January 10/11, 1955

D.O.No.[...]

My dear Balasubramanian,

I send you herewith the usual ways and means forecast for the months of January and February 1955. In order to maintain a minimum working balance of the Central Government with the Reserve Bank of India in the neighbourhood of Rs 50 crores at the end of every month it indicates creation of new special ad hocs by about Rs 30 crores in January 1955 and Rs 20 crores in February 1955. 'A'

I would in this connection also invite your attention to my D.O. No.[...], dated the 8th January 1955.

Yours sincerely,
H. S. NEGI

For information with reference to 'A' above.

Payments to States during January and February 1955 have been estimated at Rs 61.07 crores.

(GB) 13/1/55

Secretary

DG (Ram Nath) 13/1/55

Governor 17/1/55

RESERVE BANK OF INDIA
BOMBAY
January 12, 1955

D.O.No.[...]

My dear Negi,

Will you please refer to your D.O. letter No.[...] dated the 8th January 1955? As per our telephonic conversation, ad hoc treasury bills for Rs 10 crores were created by us on the 7th idem, the proceeds of which have been credited to Government Account. As a result the Central Government's cash balance on Friday amounted to Rs 50.53 crores.

2. In future we will create ad hoc treasury bills in suitable blocks to the extent necessary in order to maintain Central Government's cash balance roundabout Rs 50 crores on Fridays.

Yours sincerely,
G. BALASUBRAMANIAN

CONFIDENTIAL

No.[...] of date

Copy forwarded for information to :

Shri D.D.Pai, Manager, Reserve Bank of India, Calcutta. If the balance of the Central Government on any Friday is less than Rs 50 crores he may please make a reference to the Secretary by IMPORTANT telegram or telephone before closing the books for the day.

An acknowledgement is requested.

The Chief Accountant, Reserve Bank of India, Central Office, Bombay.

SECRETARY

CONFIDENTIAL

RESERVE BANK OF INDIA
BOMBAY
May 21, 1955

D.O.No.[...]

My dear Negi,

Will you please refer to your D.O. letter No.[...] dated the 14th May 1955 forwarding the ways and means forecast for the months of May and June 1955? It is observed that the closing balance for the month of June has been shown as Rs 43.75 crores as against the minimum working balance of Rs 50 crores which Government wish should be maintained with the Bank. As no credit has been assumed on account of the creation of new 'ad hocs', we shall be glad to know whether Government would prefer their balance to remain unadjusted even though it falls below Rs 50 crores.

Yours sincerely,
G. BALASUBRAMANIAN

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
May 27, 1955

D.O.No.[...]

My dear Bala,

Will you please refer to your D.O.No.[...] dated the 21st May 1955 regarding the maintenance of our minimum working balance with the Reserve Bank?

2. We thought that it would be better to show in the ways and means forecast the overall deficit in Government transactions without allowing for ad hocs. The drop in the balance following the overall deficit was thus not intended to modify the arrangements settled last January, namely to maintain the balance at about Rs 50 crores on Fridays and to create the necessary ad hocs in lots of Rs 5 crores for that purpose. The Reserve Bank may, therefore, continue to create ad hocs so as to provide for a Central working balance of Rs 50 crores at the Bank.

Yours sincerely,
H. S. NEGI

For information

Secretary	28/5
DG(A)	30/5
Governor	30/5

SECRET

RESERVE BANK OF INDIA
BOMBAY
July 5, 1957

D.O.No.[...]

Dear Shri Krishnamachari,

Ever since I came to the Reserve Bank, I have been exercised over the fact that under the arrangements in force for the last 5 years or thereabouts, currency is expanded against the creation of ad hoc Treasury Bills as a merely mechanical process depending on the weekly closing balance of the Central Government. There is no check against the volume of currency that could be so expanded. If Government want to go on increasing their expenditure without regard to the available resources, there would be nothing to stop them, so far as ways and means are concerned; the currency would be provided automatically. The process is in fact so mechanical that it is operated by my Calcutta Manager and I hear about this action subsequently.

I have, of course, no need to worry about the problem so long as you are Finance Minister, for I know that you are as concerned as anyone could possibly be about the stability of the currency. The reason I am exercised in my mind is that the present arrangement, as a standing arrangement, is defective. If there is a weak or careless Finance Minister in Delhi, which could conceivably happen after some years, the situation could easily get out of hand. It is, therefore, essential that proper conventions and safeguards are set up at the earliest possible stage.

The Reserve Bank, under the Statute, is charged with the responsibility of regulating "the issue of bank notes and the keeping of reserves with a view to securing monetary

stability in India." (Please see the preamble to the Act.) As matters now stand, with an automatic expansion of currency at the will of Government, the Bank in my judgement, is not really in a position to discharge its responsibility.

I have initiated a study of possible methods by which, on the one hand, the Government of the day is not hampered in its activities by an obstreperous Bank and, on the other, the Bank has the opportunity of considering and advising, in conscious exercise of its prerogative and duty, on the degree to which currency could be expanded from time to time without damage to monetary stability. As you know, different countries have different arrangements. A somewhat striking arrangement is the one followed in France. The Bank of France, a nationalised institution, recently refused to grant a loan to the French Government except on certain conditions regarding raising the level of taxation. This it was entitled to do under established convention. I am not for a moment suggesting that we should follow the French example. I am mentioning it merely as an extreme example of the checks and balances which other countries have found it necessary to maintain in order to make it difficult for Governments to damage currency under the pressure of short term political difficulties.

When I have completed my study of the problem and have some concrete proposals to put forward, I shall write to you again. Meanwhile, I thought I ought to inform you of the fact that I am turning the problem over in my mind.

Yours sincerely,
H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister
New Delhi

FINANCE MINISTER
INDIA

SECRET
D.O.No.[...]

NEW DELHI
July 27, 1957

My dear Iengar,

Please refer to your letter of the 5th of July on the subject of the creation of ad hoc Treasury Bills. While I appreciate your concern in this matter, I feel that it would be a mistake to lay down any rigid procedure such as is followed in France. That does not appear to have helped France in keeping away from difficulties. What to my mind is necessary is to ensure that Government policy is formulated in this respect after very full discussion with the Reserve Bank and that the latter is kept informed from time to time of any changes that Government feel called upon to make before they are made. Thus, it would be the duty of the Finance Ministry to formulate their proposals for borrowing as also for deficit financing in consultation with the Reserve Bank. These programmes of borrowing and deficit financing are incorporated in the Budget and placed before the Parliament for its approval. The subsequent creation of ad hoc Treasury Bills when the Government's cash balances fall below a certain level is done within the limits thus prescribed. If in the course of the year it is found that these limits are likely to be exceeded, revised arrangements may become necessary

and these would certainly also be formulated in consultation with the Reserve Bank. The Reserve Bank thus would have every opportunity of discharging its responsibility of regulating the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India.

I believe Patel had discussed this matter with you and it seemed to him that generally you would be quite satisfied so long as such discussions took place in good time to enable the Reserve Bank to tender its advice for the consideration of the Government.

I look forward to any further suggestions or concrete proposals that you may wish to put forward though I hope that you would find working along lines indicated above to be sufficient for your purpose.

Yours sincerely,
T.T. KRISHNAMACHARI

B. OTHER SELECTED DOCUMENTS

SECRET

[1-9-1955]

STATUTORY RESERVE AGAINST NOTE ISSUE

Given the likelihood that the volume of note circulation will increase considerably as the development programme proceeds and, at the same time, our holdings of foreign securities will decline, a change in Section 33(2) of the Reserve Bank of India Act, 1934¹ may be necessary. The question, then, is, if a change in this Section has to be made, which of the alternatives available would be most suitable. The three broad alternatives available are as given in Shri [B.K.] Nehru's letter, viz., (1) to reduce the percentage of the statutory backing, (2) to adopt the system of a fiduciary issue and (3) to delete the sub-section altogether and have no statutory requirement for a currency reserve. As the Appendix to this note shows, the trend has latterly been towards the third alternative. This question has, however, to be considered primarily in the light of our own conditions, though with due regard to practices adopted by other central banks.

2. If an amendment has to be made in this Section, there appears to be a balance of considerations in favour of dropping this Section altogether. A consideration of the rationale of the statutory currency reserve and the altered conception of its essential function as well as the limited place which this requirement occupies in the overall obligation and responsibility of the Government and the Central Bank to ensure general economic and monetary stability point to this conclusion.

¹ The Section reads as follows:

33. Assets of the Issue Department—

(2) Of the total amount of the assets, not less than two-fifths shall consist of gold coin, gold bullion or foreign securities:

Provided that the amount of gold coin and gold bullion shall not at any time be less than forty crores of rupees in value.

3. The function of foreign reserve is to be viewed not in terms of a backing for the note issue but as a reserve against the possibility of adverse movements in the balance of payments. The reserve has, therefore, little relation to public confidence in the currency which will be maintained or impaired by the overall fiscal and monetary policies of Government and the Reserve Bank. Given policies which ensure reasonable stability the absence of a statutory requirement in respect of the reserve will do no harm; in the absence of such policies, the statutory requirement could not stem a continuing decline in the value of money (or rise in prices). The fact that the statutory requirement may have to be modified periodically with substantial additions to the note issue only reinforces this point. With this altered conception of the function of a foreign reserve, it does not appear necessary or useful—once we depart from the present Section—to retain a lower ratio of statutory backing for the currency. On the other hand, too, if the fiduciary system were to be adopted, either the stages at which recourse to Parliamentary sanction will be required would be infrequent or frequent. If the former, Parliamentary sanction for exceeding the limit every time may, in effect, in the public eye, be little different from changing the proportion under the present Section; if frequent, Parliament and the public may get so used to it that, in effect, they will recognise that this provision is of small consequence for ensuring general economic and monetary stability.

4. It is this last point that is of particular importance in considering the question of an alternative to the present provision. After all, compliance with the requirements of a statutory provision in this regard does not safeguard against the possibility of a substantial inflationary movement or detract from the responsibility of Government or the Reserve Bank to ensure reasonable monetary stability. The fact that a provision—and now an altered provision—is being respected could not diminish the general responsibility or ensure its automatic fulfilment. This general responsibility requires more than fulfilling the requirement in respect of maintaining the backing against currency. It is currency and bank deposits together that constitutes money supply and with an altering relationship between currency and bank deposits, an inflationary movement could take place through an exceptionally large increase in deposits without corresponding increase in note circulation. In the making of adequate policies for fiscal and monetary control, the policies of interest rate, debt management, capital issues control, trade control, investment incentives and effective policies for economic development and increase in production, all play their part. Government has the overall responsibility and obligation to pursue policies in all these and related spheres, which make for the maximum rate of development consistent with stability. On the other hand, too, if Government decide that even reasonable stability is to be sacrificed and risks taken in the interest of a rapid rate of development, that issue will have to be resolved on overall general considerations of the precise combination of economic development and monetary stability that is supposed to serve the best interests of the economy and the country. In this context, the statutory ratio of the currency reserve has a small place; there is no risk that the absence of this ratio will lead Government to expand its expenditure programmes, because note circulation can be expanded without coming up against this particular wall; nor would it be a reasonable hope that Government will restrain the pace of expenditure when this limit is too near; it would

not do so because whatever new limit, whether in terms of a proportion (as in the proportional system) or in terms of absolute amount (as in the fiduciary system), is prescribed, there will be no clear rationale underlying any particular limit in either form (viz. as a ratio or an absolute amount). Since, logically, there is only a thin line of division between the proportional and the fiduciary systems, each being based upon an arbitrary level of limitation, it appears best to adopt the third alternative.

5. The levels of limitation would be regarded as arbitrary, because, given an adequate increase in general production in the economy, the level of note circulation may well go up substantially without necessarily resulting in serious inflation and, therefore, without need of a restraint on the increase in note circulation which, however, the statutory ratio may impose. For, if the national income expands at a greater rate than the volume of our international trade, the requirement of the foreign reserve, for what constitutes its proper purpose, may not increase, though in terms of an expanding monetary circulation internally a statutory ratio would continue to require an increase in the level of reserves. This points to the essential defect of the foreign reserve being related to the internal note circulation liability rather than to the possible magnitude of a foreign deficit. The fiduciary system would not be subject to this particular logical snag of establishing a relationship between the reserve and internal circulation, but does come up against the other difficulty that the volume of note circulation, by and of itself is, by no means, a satisfactory index of the discharge by the monetary authorities of their general responsibility to maintain monetary and economic stability in the country.

6. For the discharge of this general responsibility Government (and the Reserve Bank) are answerable to Parliament and the country. There is, therefore, no derogation from the authority of Parliament either, which is best exercised in terms of enforcing adequate discharge of the general responsibility of Government rather than only formal fulfilment of the provisions of a Section, the essential rationale of which has been greatly modified, as explained above.

7. There is, besides, the illogicality in the present provision that under the traditional and somewhat artificial division of the Bank into the Issue and Banking Departments—artificial at least from the point of view of a total picture of assets and liabilities of the institution—the statutory reserve provision applies only to the Issue Department, while the expansion of the free reserves of banks (viz. their deposits with the Reserve Bank) are an equally potent source of inflation. A proper proportional reserve system should include deposit liabilities as well as note liabilities. This question would arise, if a revised proportion were to be considered. It should arise even in terms of the logic of a fiduciary system, which applies equally to the base of credit expansion by banks, viz., their deposits with the Reserve Bank. In fact, it may become necessary for the Reserve Bank to explore and perfect other techniques of monetary and credit control, including maintenance of statutory reserve requirements by banks with the Reserve Bank, as part of its overall apparatus of monetary control. This only emphasises, however, the subordinate role of the present form of Section 33(2) in the whole mechanism of control.

8. A closer look at the fiduciary system as it is today in the U.K. reinforces the conclusion of the above paragraphs. An increase in the limit of fiduciary issue under the

system as at present is authorised by an Order of the Treasury. The Order, however, is subject to annulment on a resolution of either House of Parliament. Under the system as it worked before the War, Parliamentary approval was necessary if the excess over the statutory limit was continuously maintained for a period of two years. That was the fiduciary system as it is commonly known and understood. At present, Parliamentary approval is not necessary for the Treasury Order, though Parliament may pass a resolution annulling the Order, which is different. In practice, then, subject to the overriding right of Parliament to cancel the Treasury Order, the limit is left to be regulated by the Treasury in the light of the need for expansion of note issue from time to time. This is the only statutory limitation on the authority of the Bank of England.

9. Whether the fiduciary system operates in terms of specific Parliamentary approval, or in terms of the specified right of Parliament to annul a Treasury Order, the fiduciary system does not appear to offer a satisfactory alternative to the deletion of the cover provision, if a change has to be made now, for the following additional reason. Under the fiduciary system a limit of note issue is specified in absolute terms. We have at present a reserve equal to Rs 40 crores in gold, and Rs 622 crores in foreign securities (held in the Issue Department), exclusive of Rs 95 crores of balances held abroad in the Banking Department. Assuming that a certain amount of balances in the Banking Department would normally need to be held there, though they could be reduced, the foreign securities available for cover against note issue may, in round figures, be placed at Rs 660 crores, which with the available amount of gold would give Rs 700 crores, against which, under the present ratio, notes to the amount of Rs 1,750 crores can be issued. If gold were revalued, as is suggested in a later paragraph, an additional cover of Rs 78 crores would become available, enabling a further expansion to the tune of Rs 195 crores, say, to a total amount of Rs 1,950 crores. Under the fiduciary system, specific authority should presumably be required for note issue in excess of that for which gold cover is available: it follows that gold should be revalued to provide the maximum cover that is possible in terms of gold before the necessary limit of fiduciary issue is determined. The absolute limit of the capacity of the Bank to issue notes in terms of the present statutory cover provisions is of the order of Rs 2,075 crores (if all foreign balances were included and gold were revalued). If a shift to a fiduciary system were to be effected now, it would not be reasonable to ask for a lower limit than, say Rs 2,100 crores, in round figures, as compared to the actual circulation of Rs 1,300 crores. If this were to be done, it would confound public opinion more, and give a greater shock to confidence than the removal of the cover provision. In fact, it would be opposed to the rationale of the fiduciary issue system to ask for a limit of issue which is so much in excess of the current circulation. If the fiduciary issue system were preferred, it would be more in accord with its logic to make a shift *when the need arises*, and at that time give due explanations as to why the need arises.

10. The above description of the U.K. system indicates that under it the formal authority of Parliament is recognised, but in practice the system is little different from leaving the note issue to be determined (by the Treasury) without reference to any reserve in gold or foreign securities. In fact, there is no cover for the note issue in U.K. in terms of gold or foreign securities, these being kept in the Exchange

Equalisation Account. In U.K. the present system derives from the century-old history of the system during which it has been rendered progressively more elastic till it is completely elastic to-day. There is, therefore, no system of uniform stringency or elasticity which is identifiable under a name like the fiduciary issue. Under a system equivalent to the U.K.'s for specifying a limit of note issue we should probably require a limit only in respect of note issue in excess of the gold cover, though we *could* stipulate that specific authority would be required and the limit of issue would apply only for note issue in excess of gold *and foreign securities*, as in Finland (vide Appendix). Since, however, foreign securities will be declining, the rate at which the limit of issue will have to be raised will be greater than the rate of increase of note issue, to allow also for part of the existing note issue which will be deprived of foreign securities cover. It would, therefore, be better to leave the foreign securities out of account. On the other hand, it would be true that the foreign securities, together with gold, will provide a foreign reserve which might be normally adequate for our requirements in relation to the balance of payments situation. In the circumstances, it is possible that the publication from time to time of a limit of note issue in excess of gold cover—viz., under the fiduciary system—will mislead the (lay) public into believing that the amount of note issue without gold cover thus publicised from time to time is really without cover. From the psychological point of view, therefore, with ignorance in elementary financial matters to reckon with, the less public attention is directed to figures of statutory limits, the better. Deletion of the provision would cut the Gordian knot once and for all and subsequent assessment of the economic and monetary situation would be facilitated in terms of the total picture rather than of a figure the significance of which might be magnified out of proportion to its relevance.

11. The point might be made that the question should not be viewed from the short-term angle of the present Government in power, but should be viewed—in respect of a fundamental provision like this which concerns the basis of currency—from the long-term angle, and against the possibility of other Governments coming into power which might conceivably be less regardful of their general responsibility to maintain the stability of the economy. For one thing, as the above paragraphs indicate, the argument has hinged on the limited efficacy of the provision itself, rather than on the complexion of Government. For another thing, the point regarding the complexion of Government has only to be stated to appreciate that there is no ultimate safeguard against a Government unmindful of its responsibilities to the country and, in any case, a formal restraint of limited efficacy will not be of any use in the circumstances.

12. The above reasons indicate that if the provision has to be modified, it would be as well to delete it. The logic of the above argument would suggest the scrapping of the proviso to the sub-section, which provides for a minimum gold cover, together with the substantive part of the sub-section which relates to a 40 per cent cover in gold and foreign securities. *It is for separate consideration* whether it would be advisable to go to the logical conclusion and remove the statutory requirement in respect of a small amount of gold backing also. *We could retain the proviso*, by transferring it to sub-section (1), with the amount of gold marked up in value as is suggested in a subsequent paragraph. If we did so, however, the contrast between treatment of gold and of

foreign securities would be obvious. It would be pointedly clear that we are removing foreign securities because we expect to find difficulty in complying with that requirement indefinitely, but we are retaining the provision regarding gold, because we do not anticipate any similar difficulty there. The validity of the reasoning in the above paragraphs applies equally both to gold and foreign securities and there would be no system or rationale about differentiation between gold and foreign securities. The gold backing should, therefore, remain as much a matter of actual fact rather than of formal provision, as foreign securities. It would be a more easily defensible position to treat both equally in form. In Australia and Canada, for example—countries which could easily fulfil a requirement—regarding gold cover, no such cover is prescribed. 13. The other changes in the Act will be as follows: Sub-Section (3) of Section 33 which will be renumbered as (2) will only describe the types of rupee securities, like Sub-Section (6) does in respect of foreign securities.

In Sub-Section (4) the basis of valuation of gold will be altered. Sub-Section (5) would stand as it is. The fact that it does will afford some assurance that the deletion of Sub-Section (2) is only a formal alteration which will make no change in fact so far as gold is concerned. Section 37 would also be deleted.

14. When would it be necessary to delete or amend Section 33(2)? If the balances in the Banking Department are assumed not to be available, and if the foreign securities in the Issue Department have to be drawn down at the rate of Rs 40 crores a year, and if gold has been revalued, the reserves will be able to provide cover for a note issue of Rs 1,850 crores now, Rs 1,750 crores a year hence, Rs 1,650 crores two years hence, and Rs 1,550 crores three years hence. The present note issue may be put at Rs 1,350 crores (peak issue), though it is in fact lower. Note circulation has expanded by about Rs 140 crores in the course of the last year. The limit—excluding Banking Department balances—may conceivably be reached in two years, taking the drawing down of balances into account. Without revaluation and without taking account of the Banking Department balances and with a draft on balances at Rs 40 crores a year—which are the most reasonable assumptions, since revaluation cannot be assumed unless it could be justified separately, in advance—these figures will be Rs 1,650 crores now, Rs 1,550 crores a year hence and Rs 1,450 crores two years hence. On this basis, there is not much more than a year, before some change in the cover provision should become obligatory.

15. Coincidentally with the deletion or amendment of Section 33(2), gold may be revalued at the I.M.F. par of 2.88 grains of fine gold per rupee. The weekly statements of the Reserve Bank will continue to show (from week to week) the amount of gold holding together with the volume of foreign securities *in fact* available as part of our foreign reserves; the amount of ad hoc rupee securities will be reduced corresponding to the increase in the value of gold. We have another proposal under examination seeking to vest in the Reserve Bank power to vary statutory reserve requirements of banks. If this could be simultaneously put through, the deletion of the cover provision could, with some justification, be presented as the elimination of a somewhat outmoded provision in the context of the overall technique of monetary control. This other proposal about reserve requirements is being considered as part of the objective of perfecting the machinery of credit policy to deal with the problems of the Second Plan.

16. When deleting the sub-section, it appears important that Government should explain carefully the reasons as to why this provision is being deleted; at the same time Government may take the opportunity to reaffirm their awareness of the general responsibility to ensure economic and monetary stability consistent with development. It seems important to do this as the markets might interpret the step (viz., deletion of the provision) as the precursor of large-scale deficit financing and it is possible that an unhealthy boom in the stock exchange may be initiated by the announcement. This should, however, prove short-lived if the measure is presented in the right perspective, and if the public realise accordingly that the removal of the legal requirements makes no difference to the essential strength of the currency which depends on other fundamental factors. The fact that gold will be revalued simultaneously would serve to focus part of the public attention on what could rightly be represented as a change in the direction of more accurate presentation of the statement of affairs of the Bank. On the whole, to the inevitable criticism of such a step, there appears no better answer possible than that the action which is being taken is for the purpose of bringing the position in this respect in India in line with the latest thinking, which also conforms with the requirements of our economy, emphasising as it does the integral character of the general responsibility of Government and the Reserve Bank rather than place reliance on formal compliance with a provision of limited and partial efficacy.

B.K. MADAN
1-9-1955

TOP SECRET

No.[...]

Memorandum to the Committee of the Central Board

RAISING THE BANK RATE

In a memorandum which I placed before the Central Board, at the meeting on 10th April 1957, on "The Financial Stringency in India", I expressed the view that it is the duty of the Reserve Bank and Government to see that monetary expansion does not take place at a much faster rate than the capacity of the community to mobilise real resources for development. The economy had already been severely strained in the first year of the Second Plan and if adequate precautions were not taken the strain would go progressively worse. A policy of monetary ease, or general relief of financial stringency, by stimulating expansion of investment as well as consumption would run directly contrary to the necessity of restraint in the present situation. I accordingly suggested that in order to safeguard against more serious inflationary pressures, general restraint and discipline combined with selective response to specific financial needs of essential productive sectors was the best line of approach. The Board generally approved of these views; and this is the context in which the Committee has been considering, at its weekly meetings, the question of revising the Bank rate.

2. I consider that in view of the continuing strain on the economy caused by the inability of the savings in the community to keep pace with mounting expenditure, in both the public and private sectors, the time has come to make a special review of our Bank rate. Perhaps it would be appropriate if I prefaced my proposal with some brief general observations.

3. In the highly developed economies of the West the weapon of the Bank rate has been actively used during the last 6–7 years. It has been used, however, in conjunction with other instruments of fiscal and monetary policy, general as well as selective. Consequently, it is difficult to isolate the effectiveness of changes in the Bank rate alone in correcting external and domestic disequilibrium in these countries. The general view appears to be that while the Bank rate is an effective instrument for correcting balance of payments difficulties, especially through changes in the flow of foreign short-term funds, its role in restraining domestic inflationary pressures is less direct and powerful than was previously supposed. Within limits the Bank rate weapon can be of assistance in restraining inflationary forces. It has also been generally recognised that the indirect or what may be termed the psychological effects of changes in Bank rate are nearly as significant as the direct effects in terms of the cost of credit.

4. While, in the context of inflationary conditions, a rise in the Bank rate will prove beneficial, too sharp a rise or too frequent changes could ultimately defeat themselves insofar as they produce serious disturbances in the money and securities markets, raise the cost of Government borrowings and servicing the large and growing national debt, not to mention the enhanced strain to balance of payments of higher interest payments abroad on invested foreign funds. Further, in the present day general economic setting, with increasing public investment (which is by and large unresponsive to interest rate changes) increased share of Government in the total economy, high taxation and growing rigidities in the economic system, the effectiveness of the Bank rate weapon is even less potent than it was before the War.

5. These limitations of the Bank rate weapon are probably even more true in the case of under-developed economies with a significant non-monetised sector, narrow money markets as well as a low rate of investment activity, and with the public sector assuming a predominant role. Moreover, in India we have, under the Banking Companies Act, considerable powers of selective credit control, and we can directly regulate the volume of credit extended by the banking system. The Government has also wide powers under such statutes as the Capital Issues Control Act and the Industries (Regulation and Development) Act, to regulate directly investment in the private sector. These considerations, however, only indicate that the scope for wielding the interest rate weapon is comparatively limited; they do not by any means signify that the Bank rate weapon, operated in a flexible manner, has no place at all in our anti-inflationary arsenal.

6. On a review of the general economic situation in our country, I have come to the conclusion that a small increase in the Bank rate would be beneficial. It is scarcely necessary to add that in making this recommendation I am assuming that we shall effectively use, whenever we consider it appropriate to do so, all other means of monetary control that we possess.

7. I suggest that the Bank rate be revised forthwith from $3\frac{1}{2}$ to 4 per cent. To a very large extent it may be stated that in doing so we shall only be giving formal recognition to a situation that has existed *de facto* for several weeks. The Committee will recall that the rate on advances under the Bill Market Scheme was raised last November to $3\frac{1}{2}$ per cent and from February this year the stamp duty on usance bills was raised to $\frac{1}{2}$ per cent making the effective rate of advances against Bills 4 per cent. Simultaneously the rate on advances against Government securities was also raised to 4 per cent. The markets have had time to adjust themselves to this rate and no dislocation need be feared by rationalising the lending rate structure of the Bank by raising the Bank rate itself. There would on the other hand, be certain advantages in doing so. In the first place, our lending rate to borrowers like State Governments and the Industrial Finance Corporation of India is the Bank rate itself. The impact of any policy to harden the interest rate structure should, by and large, apply to all borrowers. If this is not done, the borrowers would be disinclined to go to the market and pay the appropriate rates for raising funds; they would rather be inclined to lean more heavily on the Reserve Bank. Secondly, as regards the scheduled banks, our not raising the Bank rate *de jure* is stated to have led to some inconvenience to them in raising their lending rates which are customarily tied to Bank rate. The banks, of course, can raise their lending rate by giving special notice to their customers (and in fact they seem to have already done so). It would perhaps be more convenient to them if any change in the effective lending rate of the Reserve Bank could be so brought about as to facilitate an automatic increase in their own lending rates. The maintenance of Bank rate at $3\frac{1}{2}$ per cent has also brought forth a grievance from one of the major industries, namely, the Electricity industry, which under the Electricity (Supply) Amendment Act of 1956 is allowed a standard rate of return of 2 per cent above Bank rate. The electricity industry considers that the maintenance of the Bank rate at $3\frac{1}{2}$ per cent in the context of a rise in the general pattern of yields has the effect of denying the industry a legitimate return. There appears to be some force in this plea and the realignment of our Bank rate with the other rates would help to remove this grievance, although this is not by any means a major consideration in our policy decision.

8. If the Bank rate is raised to 4 per cent the cost of raising money under the Bill Market Scheme will be $4\frac{1}{2}$ per cent (ignoring for the present the further cost arising out of the fact that banks do not draw fully against Bills lodged by them). I consider this is too high. I recommend that we propose to Government that the stamp duty be reduced from Re.1.25 to 0.50 naye paise per Rs 1,000, which means a reduction from $\frac{1}{2}$ per cent to $\frac{1}{5}$ per cent per annum.

9. If the Committee approves of the proposals, the following resolution may be passed :-

RESOLVED

That (a) the Bank rate be raised to 4 per cent (b) Government be moved to reduce the stamp duty on usance bills from Re 1.25 per Rs 1,000/- to 0.50 naye paise per Rs 1,000/-.

H.V.R. IENGAR
Governor

Reserve Bank of India
Central Office
Bombay
Dated May 15, 1957

SECRET

December 9, 1960

[My dear L.K.,]

Thank you very much for your letter No.D.O.[...] dated the 7th December. As desired by you, I will have a note sent to you before the 13th on the question of bank amalgamations and I will also send, as soon as possible, a note on the lines you have suggested regarding the balance of payments position.

2. I am particularly grateful to you for having given me an account of what transpired at the meeting of the Consultative Committee. I was absolutely certain that the leakages in the press were unauthorised and inaccurate; nevertheless, I am afraid a certain amount of misunderstanding has been caused because the press has built up, sometimes with banner headlines, the story that the Minister has decided that there shall be no increase in the Bank rate at present. Mr. Murphy, the leader of the I.M.F. Mission, when he had a meeting with me two days ago, referred to these press reports and seemed clearly disturbed by them. I explained to him that the reports were unauthorised and that the position continues to be as it always has been, namely, that the authority for deciding changes in the Bank rate is the Reserve Bank and that the Bank, as a matter of policy, keeps in the closest touch with Government and would not make any changes except after consultation with them. I do not know whether Mr. Murphy will raise this point again in Delhi. It would be disturbing if international bodies like the I.M.F. felt that there was any conflict and confusion in India in regard to Bank rate policy.

Yours sincerely,

[H.V.R. IENGAR]

Shri L.K. Jha, I.C.S.

SECRET

SECRETARY
ECONOMIC AFFAIRS
MINISTRY OF FINANCE
NEW DELHI
December 19, 1960

D.O.No.[...]

My dear Iengar,

I am extremely sorry that at the last minute I had to cancel my trip to Calcutta to attend the Board meeting. I learnt on Saturday morning that there would be a general hartal in Calcutta on the 20th and knowing Calcutta as I do, I did not feel confident about being able to take the return flight for which I was booked. I tried in vain to have it changed to the 19th evening and as the World Bank team would be here from the 21st and I could not risk being delayed in Calcutta, I came to the conclusion that I had better postpone my journey to a later date.

2. In coming to this conclusion, I was encouraged by Rangachari who was also not proceeding to Calcutta and as there were a number of points of common interest to be discussed outside the Board room with you and Bhattacharyya, it would be perhaps best for me to come down for one of the Central Committee meetings—say, on the 4th

January if it suits all concerned. In fact, I tried to contact you over the phone on Saturday, but apparently you were not available at your house when I tried to get you.

3. I had two sessions with the I.M.F. team. The first one was when I was giving them a forecast of our balance of payments trends and explaining the statements which we had handed over to them. The second meeting was on Saturday when Murphy made a statement, giving an outline of the conclusions which he had reached to which I had to reply.

4. In his statement, he expressed considerable satisfaction about the improvements in our industrial and agricultural production and the progress reflected thereby. He expressed anxiety, however, on account of the fact that we were starting the Third Plan with a deficit arising on account of past commitments for repayment of credits and loans. He also expressed the view that inflationary forces were more in evidence and urged the importance of suitable monetary and fiscal policies to check them. In replying to him I dealt with the other points directly, but said that so far as monetary policy was concerned, the authoritative view on that matter would have been given to the Mission by the Governor of the Reserve Bank. I said that the policies being followed by the Reserve Bank were, of course, known to me, particularly as I was a Director of the Bank. I was prepared to philosophise on those policies, though not to expound them. I said that on a philosophic view of the situation, what you seemed to have really done is to raise lending rates to trade and industry without a technical change in the bank rate and, therefore, without raising the borrowing rate for Government. I also endorsed the thought you had expressed in Madras that it is wrong to think that monetary policy does not affect the Indian economy because of the preponderance and impact of deficit financing. Different sectors of the economy reacted to different forms of control and monetary policy had been particularly successful in certain selective fields where bank finance played an important role. Indeed, some of the pointers, e.g., the Stock Exchange, showed that the policy had been effective. A very much tougher fiscal policy was also clearly necessary to raise resources for the Plan and to divert goods from domestic consumption to export markets. At the same time, it should not be forgotten that a good sector of the Indian economy is not very responsive either to monetary or to fiscal policies and is, in the main, susceptible to supply and demand factors, affecting individual commodities.

5. Another point which the team raised with me, which I gather had been raised with Madan and then with you, was about the possibility of touching our gold reserves. The answer I gave was that we do not contemplate touching our gold reserves not because they are gold, but because such contingency would imply that our sterling balances had been fully exhausted. It was our firm policy not to treat the present level of sterling balances as available for further drawals as a long-term or permanent measure as distinct from short-term drawals. It was not, therefore, the sanctity of gold but the level of our total foreign exchange reserves which would cause grave anxiety if the Reserve Bank had to reduce its gold reserves.

Yours sincerely,
[L.K. JHA]

Shri H.V.R. Iengar
Governor
Reserve Bank of India
8, Council House Street
Calcutta

NEW DELHI

April 27, 1964

My dear Bhatta[charyya],

I hope to see you here on the 30th. In the meantime I am very uneasy with regard to our policy towards bank credit. It is no doubt true that any control of bank credit by itself does not touch even a moiety of the monetary problem.

2. While there is a great deal of justification for restricting credit for foodgrains, which we have done spasmodically and piecemeal, it does not seem such restriction has been confined to foodgrains only and has not extended to the legitimate demands of industry. At the same time one is not quite sure how much of the scheduled bank lending is directly to industry as such and how much of it goes to rediscounting of Multani hundies. If we could only get separate data from the scheduled banks as to how much of their advances are for rediscounting hundies, then the size of the problem and the needs of the industry will be somewhat clear. Can you get these details as quickly as possible?

3. There are many other matters which we might discuss. I am very uneasy how some of our big financial institutions, the State Bank, the Life Insurance Corporation, the I[industrial]F[inance]C[orporation] and so on seem to sway with personalities. We might discuss these when we meet.

Yours sincerely,
T.T. KRISHNAMACHARI

CONFIDENTIAL

D.O.No.[...]

Dear Shastriji,

BOMBAY

June 18, 1964

As desired, I enclose herewith "A Note on the Present Economic Situation". I trust that you will find it useful.

With regards,

Yours sincerely,
P.C. BHATTACHARYYA

Shri Lal Bahadur Shastri
Prime Minister
Government of India
New Delhi

CONFIDENTIAL

A NOTE ON THE PRESENT ECONOMIC SITUATION

I

The domestic economic situation demands urgent attention at this time in view of the slow progress of the Plan, the slow increase in the national income, and in particular the large and continuing rise in prices.

The most distinctive feature of the current economic situation and one that is cause for serious concern is the deterioration of the price situation. Wholesale prices in India are now at the highest level ever reached, and we are entering the difficult lean season when prices normally rise further. The general index at 144.5 on May 30, 1964 is 8.6 per cent above the level a year ago. Prices of foodgrains and other agricultural commodities in particular have risen sharply in the past year. Cereal prices have increased by 16.5 per cent and those of food articles by 13 per cent.

During the last year or more the rise in prices, particularly of foodgrains, has been the largest of all years since the beginning of planned development. The present rise has come on top of a continued increase in prices ever since the beginning of the Second Plan, the total increase in the last eight years being over 50 per cent.

The rise in prices imposes extreme hardship and inequity on large sections of the people and has serious implications for the steady progress of economic development. The upward pressure on prices, if it continues, is likely to build up higher wage demands all over the system, to affect industrial production by work stoppages and to jeopardise the investment programme itself through serious inflationary strain. The effects of inflation in raising costs of production would soon extend to the vital sector of exports and thus hamper the financing of development.

The basic element in the price situation is the failure on the supply side. Two successive harvests, those of 1961-62 and 1962-63, saw hardly any rise in availability of agricultural supplies. Though the 1963-64 harvest is believed to be better, the higher level of production has not been reflected in market arrivals. It is likely to have gone toward replenishing the depleted pipelines of supply, viz., the stocks with traders and producers. To some extent, in these conditions, the farmer and trader are likely to continue to withhold supplies from the market in the hope of realising better prices later on. A lot depends upon the course of the monsoon and good and well-distributed rains could yet change the outlook for the better. But the price trends so far have been rather ominous and it would not be prudent to bank on an improvement in the situation in the ordinary course.

The policy with regard to prices has to be considered both in its immediate short-term aspect and in terms of its longer-term strategy. The short-term measures should be so designed that they could be meshed into a long-term strategy. It would also be well to remember that any solutions should not be mechanistic and deal only with the symptoms of inflationary pressures such as hoarding, profiteering etc. but should seek to eliminate or at least to reduce the impact of the causes behind the price increase.

In the short-term, any real relief to the situation from the supply side can only come through quicker imports of the balance of quantities to be imported under P.L.480 and through arrangement of additional imports as far as possible immediately and as part of a programme over the next few years. We have clearly not reached the stage of self-sufficiency. This has to be worked for through a consistent and carefully drawn up programme rather than be attained through a snap decision. In the meanwhile, even an announcement of arrangement of substantial imports both for supplementary consumption and buffer stocks should have a salutary effect on the price situation.

Measures such as the extension of State trading into the sphere of retail distribution should be decided on only after assessment of the magnitude of commitments that this

would entail and after arrangement has been made to provide for such extra commitments. The stocks with Government both at the Central and State level—are lower than last year and much lower than are necessary for undertaking any immediate obligations for large-scale retail distribution. The introduction of State trading for internal procurement has to be ruled out at this stage as this is bound to give a further push to prices.

The fixation of maximum prices may be of some help in the short-term although the relief that can be expected from such a measure would be no more than marginal. The fixation of maximum prices should however follow—and not precede—adequate arrangements to augment supply by import and for distribution of a minimum quantum of supplies through fair price shops organised in urban areas. The enforcement of any prescribed maximum prices would depend upon the capacity to make a minimum quantum of supplies available at the prices notified. In the absence of this, there is bound to be widespread evasion and the law will be brought into disrepute.

II

Any long-term solution would be the building up of buffer stocks through (1) the stepping up of procurement internally and through (2) conserving part of imported grains for building up such buffer stocks. But these methods of building up a buffer can be used effectively only during a good agricultural year. The experience hitherto, however, has been that when the crop is good and supply is adequate the urgency of the problem is not apparent and the opportunity has not been availed of for building up the buffer stocks. When, on the other hand, the crop is not good, and the need for a buffer stock is urgent, it is not feasible to build up such a buffer. Attempts to build up a stock under such conditions through internal procurement has led only to a further increase in prices in the past. The dilemma can be resolved only if a consistent long-term policy is pursued which is adapted to the agricultural cycle so that in good years the procurement both internally and by import is intensified and the stock built up and in bad years stocks are released. In our precarious food situation, the scope for open market sales is limited and release through fair price shops may be the main method of supplementing private stocks.

III

Apart from the supply side, namely, the failure of output to match rising demand, we have to recognise the factors making for an unusual increase in the level of aggregate demand which has been a major source of pressure and rise in prices. An index of the aggregate demand pressures in the economy is the expansion of money supply. Money supply expanded by nearly one-third in the first three years of the Third Plan as against a very small rise in real output. During the last twelve months money supply has risen by over Rs 450 crores as against Rs 300 crores last year. A part of this has transformed itself into unaccounted money and is exercising undue pressure on commodity prices.

The main impetus to monetary expansion in recent years has come from government budgetary operations. Deficit financing has been heavy and recently on the increase. The very considerable increase in the defence expenditure has been a source of additional pressure; also new rehabilitation demands have, to some extent, further intensified the burden on the economy. Defence and rehabilitation, however, have a certain priority, which throws the onus of adjustment on other sectors. At a time when

inflation threatens the basis of economic progress, a very strict scrutiny of Government expenditure with a view to drastic pruning down of non-essential expenditure and utmost economy in expenditure generally are necessary. It is essential that deficit financing is eliminated for the time being or at least, reduced considerably even if it means the slowing down of certain activities or developmental projects which are not of a basic character. The alternative would be a real deflation later—a course which would have very bad repercussions.

Ways and means of tightening the reins of credit extension without affecting the financing of expansion of production have also to be thought of in the private sector. Credit policy for the long-term has to be attuned to adequate financing of planned development, but the unusual pressure of development and other demands calls for the most effective mobilisation of genuine savings, failing which, here again, demands will have to remain unfulfilled.

The increased statutory requirement for investment in Government securities by banks would ease to some extent the problem of Governmental financing and limit availability of bank credit for private sector expansion. This would, in itself, act as a disinflationary source to some extent, if Government expenditure can be restrained. But if the latter does not happen, the restraint in the private sector expansion would be incapable of achievement as the two sectors are complementary to each other. If the private sector is restrained unilaterally, the result would be a lopsided development, apart from the fact that inflation would still continue.

When the need is to emphasise restraint in Government expenditure, it would not be wise to commit ourselves at this stage to figures of an unduly large Fourth Plan with all their implications of an expansionary—and inflationary—psychology. In the light of our current experience, our ability to finance a much larger investment effort has to be carefully appraised. Finalisation of the Fourth Plan should therefore wait for some time.

IV

A word about unaccounted money. This is one aspect of the problem of corruption at various levels in the economy. An approach to this latter problem cannot leave out of account an analysis of the sources, forms and extent of proliferation of unaccounted money throughout the system: it manifests itself in real estate, in bullion, in shares and other assets. By its very nature, however, this phenomenon is an elusive one and one which does not admit of any short or easy remedies.

Unaccounted money is symptomatic of the extreme pressure on the economy, for the most important source of unaccounted money is inflation which inflates most of all the unearned incomes and profits; the existence of various controls in the economy—fiscal controls such as high tax rates or import or investment controls—accentuates the problem. A policy aimed at correcting the basic inflationary situation would help in reducing the impact of this large volume of unaccounted money in the economy. This, again, points to the necessity, in our conditions, of trying to ensure the most effective utilisation of our limited real and financial resources, of the enhancement of production, of avoiding increases in expenditure which do not help in increased production and generally in limiting deficit financing.

CONFIDENTIAL

[31-8-1964]

CREDIT POLICY FOR THE ENSUING BUSY SEASON

The objective of credit policy for the ensuing busy season must clearly continue to be one of restraining credit expansion to levels warranted by the productive requirements of the economy. This is necessary in view of the current imbalance between aggregate monetary demand and overall supply as reflected in the continuing pressure on prices. Even if, as is likely, the onset of the harvest season (and the improvement in supplies) brings some relief to the price situation the need for continuing monetary restraint will not be the less.

2. Scheduled bank credit in the slack season so far has contracted (upto August 21) by Rs 125 crores which is in absolute amounts of about the same order as that of last year upto this point (Rs 122 crores). The inadequacy of the contraction is, however, evident in relation to the previous seasonal expansion. If the pattern of earlier years is to be repeated, it would seem that the major part of the credit contraction has already occurred. At most we might expect a further contraction of about Rs 90 crores by the end of the slack season. Consequently, the banking system would be starting the next busy season on a substantially larger credit base than last year. Aggregate deposit liabilities (excluding P.L.480 funds) have risen so far in the current slack season by Rs 160 crores. Though this pace of deposit accretion has been significantly higher than in the last slack season, this still would not leave much room for manoeuvre by banks for meeting seasonal credit demands from October onwards, in the light of the enhanced liquidity requirements that will be coming into force next month. Despite an addition of Rs 160 crores in the current slack season the investment/deposit ratio (excluding P.L.480 funds) is, at 30.7 per cent, still below the level of a year ago while the credit/deposit ratio at 69.6 per cent is 2.8 percentage points above the corresponding level of last year. On the assumption that credit contraction in the slack season would amount to Rs 180 crores and that deposits in the same period rise by about Rs 220 crores (both of them somewhat optimistic assumptions) the credit/deposit ratio at the commencement of the next busy season would be 66.3%; this is not much below that at the beginning of the last busy season (67.5%) though the enhanced liquidity requirements that would be needed would have suggested a lower level.

3. The higher credit base and the enhanced liquidity requirements in effect constitute built-in limits to the amount of credit expansion banks will be able to finance out of their own resources next season. The reliance on central bank credit to finance the seasonal needs would correspondingly be greater and perhaps be felt sooner than last year. The background to the operation of credit control will thus have to take into account the change in the frame-work of regulation reflected in the higher liquidity requirements.¹ Banks would be feathering their holdings of government securities so as to not impair their liquidity ratios and would borrow in larger measure against bills under the Bill Market Scheme. In other words, banks would make use of central bank credit to sustain their liquidity ratios in a very direct sense. In fact, this was what

¹ The assumption here is that these higher liquidity requirements would be enforced and that neither a deferment nor an exemption [is] contemplated.

happened even in the last busy season when some banks ran up their credit/deposit ratios to not much less than 100 per cent while maintaining comfortable liquid assets ratio in terms of our legal definition largely by not encumbering their government security holdings but by borrowing from the Reserve Bank against bills, largely manufactured bills—under our Bill Market Scheme.

4. Our present mechanism of general credit control is through the operation of rediscount ceilings under the (in effect) three-tier system in terms of which borrowings by scheduled banks upto one half of their statutory reserves are available at the Bank rate at $4\frac{1}{2}$ per cent, borrowings between 51–100 per cent of their statutory reserves are available at 6% and borrowings above their level of statutory reserves are charged a higher rate of $6\frac{1}{2}$ % and come under special accommodation. Special limits are granted taking into account the general conduct of its business by a bank, its pattern of assets and liabilities and in the light of needs of special sectors (such as defence production, exports etc.). This system which combines the principle of both a quantitative ceiling on central bank credit and a differential interest rate system irrespective of the type of eligible securities offered as collateral has been instrumental in regulating access to the Reserve Bank during a period of intense pressure in the market and has worked reasonably well in limiting the overall credit totals. In operating the system, the special needs of the export sector and of the small industries/co-operative sector and the collieries have been taken into account. Advances against rupee export bills are being made at the Bank rate by the fixation of an additional quota. Such an additional quota for lending at the Bank rate has also been provided for advances to small industries/co-operative sector. Also, advances under the Coal Industry Guarantee Scheme have been exempted from the ceiling. The total value of rupee export bills thus exempted did not amount to a very large figure last year (being Rs 7 crores at the peak) mainly because the scheme itself came into operation only in March 1963. Similarly, not much use has been made of the exemption with respect to Coal Industry Guarantee Scheme. In the case of small industries/co-operative advances, the total value of the additional quota amounted to about Rs 11 crores. In other words, with statutory reserves being roughly Rs 75 crores, the total of advances available from the Reserve Bank of India to the scheduled banks at Bank rate would (notionally) have amounted to Rs 55 crores; as against this, the actual level of advances obtained by the banks at Bank rate went up to as high a figure as Rs 60 crores at the peak of seasonal borrowings from the Reserve Bank of India.²

5. The tier system has come in for criticism as being somewhat cumbersome in operation; it has also been suggested that under the system bond rates are comparatively insulated and that the private sector alone has been subjected to the discipline of higher rates. Nor does the system make any distinction between a bank whose credit totals are high in relation to its liabilities and one which is not so over-extended. Further, though in principle the tier system is designed to make credit not only dearer but also tighter, in actual operation credit has been made dearer and not particularly tighter as through the instrument of special accommodation the volume of central

² The aggregate figure of statutory reserves on the one hand and the actual borrowings are not strictly comparable as there would be quite a number of banks borrowing well above their 'normal' quota and equally banks borrowing well below it.

bank credit has not been unduly restricted.³ This is not mentioned here as a criticism; in fact the actual manner in which the policy operated was perhaps more suited to the situation. What is suggested is that if the objective was only to make credit dearer, the apparatus of a ceiling control was perhaps redundant. Simplification of the system would be desirable but this objective should be combined with ensuring continued central banking control on the overall level of credit expansion. Action on bank reserves does not appear appropriate during the busy season when the objective is not so much to reduce the quantum of credit but limit its expansion; further the attainment and subsequent maintenance by banks of the enhanced liquidity requirements will pose difficulties for many units in the system and raising reserve ratios would make their problem more difficult. Credit control should, therefore, seek to operate as it has done in the last 2 or 3 years on the access rights of the banks to the Reserve Bank. Whether this should take the form of fixation of rediscount ceiling or bringing about a limitation to the credit expansion by working primarily on the cost dimension would be a matter for decision. A stiff increase in the Bank rate of $1\frac{1}{2}$ to 2 per cent would have a salutary effect by enforcing the discipline of higher rates on the entire market structure. For various reasons however—chiefly on grounds of budgetary interest cost considerations and because of the link of the Bank rate with other public sector and local authority operating rates—a certain rigidity has been imparted to the Bank rate as an instrument of monetary policy and such action might not be feasible. We have, therefore, to work within the confines of a policy which while effectively raising the rate structure (in effect for the private sector) would lead to only a slight upward adjustment in bond yields.

6. A variant of the present tier system which would emphasise the cost aspect is to adopt a system wherein no quotas as such would be set but differential interest rates would be prescribed to cover central bank lending against different types of eligible securities. Thus, we could think of one rate, namely, the basic Bank rate to cover central bank lending to commercial banks against the following securities, namely, (a) government securities, (b) export bills, (c) genuine (internal) bills of exchange including bills drawn by small industries/traders and a higher rate say $\frac{1}{2}\%$ or 1% above the Bank rate to accommodate all other lending in effect against bills under the Bill Market Scheme. In view of the rather restricted volume of 'free' government securities (i.e. unencumbered government securities, above the level required for liquidity purposes), commercial bank borrowings would, as mentioned earlier, be increasingly against bills for most banks. The inclusion of export bills would continue the preferred sector treatment which we now accord to this class of bills. Similarly, by encouraging the use of 'genuine' bills as distinct from created bills we would be making sure that the transactions being financed were self-liquidating in character. The above change would not involve any necessity for legal amendments and would be covered within the four corners of the present statutes. However, such a classification

³ An interesting corroboration of this is that after the March 11, 1964 directive cutting the basic quotas back to 100% (instead of 150%) of statutory reserves, the Reserve Bank of India in nearly every case restored the original quotas through special accommodation. Also, in April and May 1964 the volume of fresh central bank credit exceeded Rs 100 crores in each month, which was not much less than during the relatively liberal phase upto March 11, 1964.

and the inclusion of government securities in a group of assets entitled to a lower rediscount rate is open in even stronger degree than at present to the charge that government securities are being shown undue preference. (Even if as proposed later the basic Bank rate were raised from its present level, the gravamen of this charge would remain.) Further, it would be possible for borrowers to adopt the bill as an instrument of finance to the extent necessary; borrowings from the Reserve Bank do not represent at the peak more than 7–8 per cent of credit extended by banks and a conversion of this part of credit into ‘genuine’ bills might be less convenient but no less possible than ‘creating’ bills as now. Thus the system would not ensure sufficient quantitative control of credit; again, even at the higher rediscount rate there is no absolute limit on the quantum of central bank assistance against ‘created’ bills as there is now.

7. Another alternative to the present tier system would be to operate a rediscount rate related to the actual level of credit extended by the commercial banks. In effect, if the intention is to limit credit expansion by a bank, the classical method of doing so is to operate via its liquidity base. The minimum statutory liquidity ratio in India is basically a measure of safety leverage rather than an instrument of credit control. There is, however, no reason why it should not serve the purpose of credit control not in the sense of constituting the base for credit expansion but by serving as a regulator for the cost of central bank rediscounting operations. This could be done by fixing a norm for the liquidity ratio and charging progressively higher rates as the proportion of the liquid assets falls below the norm.

8. In deciding on the norm an outside limit is set by the minimum liquid assets ratio of 28 per cent. No bank can go below this ratio without violating the statute. However, at present, in the calculation of the liquid assets ratio, borrowings from the Reserve Bank and/or State Bank of India are not taken into account in calculating the total of aggregate liabilities. Part of the justification for this is that to the extent that such borrowings are against government securities, the owned government securities of a bank become encumbered and hence do not qualify for inclusion in the total of liquid assets. However, as pointed out earlier in this note, it is conceivable and in fact it has even been our experience that some banks might be borrowing from the Reserve Bank but not against government securities. Thus while the denominator (i.e. the aggregate liabilities) is not increased, the numerator (i.e. legal assets total) also does not get reduced and these banks are able to extend credit without impairing their liquid assets position as defined by the law though in terms of banking criteria (as measured by the advances/deposits ratio) their credit levels might be high. It could, therefore, be suggested that while for purposes of Section 24, the ratio of 28 per cent will continue to be the minimum, for the purpose of credit control a norm of 28% may be fixed in respect of the net liquid assets position defined as the liquid assets in terms of Section 24 less borrowing from the Reserve Bank of India against bills.⁴ To the extent to which the net liquid assets ratio is 28% or above, the rate of lending could be at the Bank rate and for every one per cent drop in this ratio, the rate of lending ought to go up by say $\frac{1}{2}$ or 1 per cent. Thus a bank with a ratio of 30% for gross liquid assets (i.e. as defined in Section 24) but with a net

⁴ Borrowing against government securities, in any case, will reduce the liquid assets position for Section 24 purposes.

liquid assets position of say 25% (as defined above) would have to pay 1½ or 3 per cent as the case may be above the basic Bank rate for the amount of Reserve Bank credit outstanding against its name for as long a period and to the extent to which the net liquid ratio is below 28%.

9. The implications of this proposal may briefly be considered. To the extent that a bank has liquid assets (as defined by the statute) above the level of 28% it makes no difference to it whether it borrows against government securities or bills as long as the total of such borrowings is equal to or below the excess over 28 per cent. Such borrowings would be at Bank rate. A bank might as well liquidate its holdings of government securities to the extent possible instead of approaching the Reserve Bank. This possibility is equally open under the present system. The difference arises only where a bank's liquidity ratio (for Section 24 purposes) is near or at the waterline of 28 per cent, for then its borrowing would bring its net liquid assets below 28 per cent. As at this point banks cannot impair their government security holdings, such borrowings would have to be against bills. Thus, while a preferential rate is not charged for borrowing against government securities as such, it has to be recognised that a preference is shown for a bank whose holdings of government securities are in excess of the statutory requirements—a position that prevails even now in a sense. The defence for this is that to the extent that a bank has such an excess it is comparatively underlent in any case and its large holdings of government securities implies a certain sacrifice of earnings power, which merits some compensation.⁵ Should the increase in its credit totals be more than seasonal or sharp (in the season) it implies that the bank's excess of holdings of liquid assets is diminished and possibly wiped out and this would naturally contract the volume of its borrowing at the Bank rate subsequently.

10. On the other hand, it will have to be admitted that relating it to the concept of liquid assets will not make this less cumbersome in operation than the present system. The calculation of the ratio and, in particular, arriving at the figure of 'encumbered' securities, will have to be done weekly and on a somewhat arbitrary basis viz. by adding 10 per cent to the figure of borrowing from the Reserve Bank and the State Bank of India (to take into account the maintenance of the margin against such borrowings). To make it less cumbersome, we could operate the system in such manner that when a bank approaches the Reserve Bank, a scrutiny is then made of its net liquid assets position and the corresponding rate charged for the actual amount of credit taken. This of course would mean that banks would not be in a position to ask for limits in advance but treat each borrowing from us as a separate transaction. The same effect could be more simply and more directly obtained by making the credit/deposit ratio the basis for regulation. Deposit liabilities, in any event, constitute the overwhelming proportion (roughly 90 per cent) of aggregate demand and time liabilities as defined for purpose of Section 24, the only additional items included in the latter being inter-bank deposits, inter-bank borrowings and other miscellaneous items. The credit/deposit ratio is thus effectively, though not exactly, the obverse of the liquidity ratio and constitutes as rational a basis for regulation as the latter, and has the further

⁵ The same argument could in fact be adduced in support of the previous alternative viz. a preferential rate for borrowing against government securities.

advantage of simplicity. It is true, of course, that in our legislation whether it be for purposes of statutory reserves or for liquidity ratios, we have used the concept of aggregate demand and time liabilities but this by itself need not preclude using deposit liabilities as the basis for regulation for credit control purposes. For the latter we could adopt whatever basis happens to be convenient, even though no specific reference to it is made in the Statute; an example of this is our present practice of fixation of rediscount quotas on the basis of statutory reserves. The eligibility criteria to govern lending by central banks in general lay down the type of securities and occasionally the purpose but the form or method by which such lending is undertaken is a matter for discretionary judgement based on institutional and structural aspects of the banking system. Further, relating credit to deposit liabilities indicates the emphasis on banks' efforts to increase their deposits and would also discourage banks obtaining funds through interbank borrowings to increase credit more than would be the case if credit to aggregate liabilities were taken as the guiding principle.

11. It could, therefore, be suggested that a norm be fixed for the advance deposit ratio of the commercial banks and that the basic Bank rate be charged for credit to a bank whose advances/deposits ratio is at or below this norm. This norm may be fixed at 70 per cent of deposits. The choice of this norm is suggested by the prescription of 28% as the minimum of liquid assets against aggregate liabilities excluding borrowing from the Reserve Bank and taking into account the difference in the base. For every 10 percentage point increase in the advance deposit ratio, the rate of lending would go up by 1 per cent. Thus a bank with an advance deposit ratio of 75 per cent would pay a rate equal to Bank rate plus $\frac{1}{2}\%$ and a bank with an advance deposit ratio of 80 per cent would pay Bank rate plus 1% and one with an advance deposit ratio of 100% pay Bank rate plus 3% and so on. It may even be possible to think of further penal provisions for banks whose advances deposit ratio has exceeded 100 per cent. (Statement 2 shows the ratios for the leading banks).

12. The operation of this system of a 'floating' or 'sliding scale' rediscount rate has the advantage of directly and without much complication linking the cost of central bank lending to the aggregate expansion of credit by a bank. It would also meet the objections of those who see in the present system or in the variants proposed earlier an attempt at extending either overtly or indirectly preference for borrowings against government securities. This system would not lead to showing any more preference for banks' investments in gilt-edged than is implicit in the present liquidity ratio prescription.

13. An implication of this is that if a bank should be permitted to bring in funds from abroad for meeting seasonal needs this would put up its credit/deposit ratio and penalise it when it comes to the Reserve Bank of India for borrowing.⁶

14. This approach is consistent with the objective of limiting central bank credit by and large to the productive requirements of the economy; there need be no quantitative ceiling as such but by increasing progressively the cost of credit to the commercial banks, we would be inducing an economy in the use of rediscount facilities and, by implication, efficiency in resource use while the greater reliance on borrowing against

⁶ Even if it should bring in funds from abroad subsequent to borrowing from the Reserve Bank of India, the higher rates will nonetheless apply.

bills would permit a degree of qualitative control. The emphasis is thus on dearer rather than on tighter credit, especially as emphasising the latter could lead (and has led) to some extent, to diversion to non-bank finance which is not merely a costlier source of finance (indicating incidentally the willingness of the borrower to pay higher rates) but weakens the area of effective central banking control.

15. The above discussion of the mechanism of control is independent of the level of the Bank rate. Any change in the apparatus of control should ensure that the average cost of borrowing from the Reserve Bank is at least as high as it is now, taking the banking system as a whole.⁷ In fact, consistent with our policy of a gradual hardening of rates the Bank rate may be put up for the present by $\frac{1}{2}$ per cent to 5 per cent and place the main reliance (may be placed) on the higher effective cost of Reserve Bank credit to banks to limit credit totals. An increase in the Bank rate would also be consistent with the proposals regarding deposit rates made later in this note.⁸ To ensure the maximum effectiveness of the differential interest rate instrument, it is also suggested that the Reserve Bank in terms of Section 21 prescribe maximum interest rates for advances at 9 per cent. It is believed that the present marginal rate is 8–8½ per cent for the bigger banks though smaller banks charge more though even they would not find this maximum prescription unduly inhibiting as they would increase the rates in the intermediate levels of their lending. An increase of $\frac{1}{2}\%$ is consistent with the proposed increase in the Bank rate. This would mean that banks cannot afford to

⁷As the emphasis is on raising the cost of Reserve Bank credit rather than on restricting its volume, it would be interesting to compare (on the basis of the present Bank rate of $4\frac{1}{2}\%$) the effect of the adoption of these alternative systems. Taking the highest level of the ratio reached in the 1963–64 as the basis for comparison, the average rate of lending under the credit/deposits ratio system of 1% increase for every 10% rise in the ratio, the rate of lending works out to 5.61% (including the State Bank of India) and 5.95% (excluding the State Bank of India). For this purpose, the higher rate is calculated for the whole of the borrowing outstanding at the time and is not a weighted average which is more appropriate to a slab system. The calculations of the cost of borrowing from the Reserve Bank on the basis of net liquid assets is somewhat more complicated. If one were to apply the net liquid assets ratio last year (at the point the ratios were at the lowest) the rate of borrowing on the basis of a $\frac{1}{2}\%$ increase for every drop of 1% in the net liquid assets ratio from a figure 28% works out to 5.70 for all banks including the State Bank and to 6.90% if the increase in the rate were 1% above the Bank rate for every one per cent drop from the level of 28%. This method, however, might not be quite appropriate as last year there was no requirement for 28% liquidity ratio and consequently the net liquid assets position could go down to 25.6% for all banks including the State Bank and 21.6% for all banks excluding the State Bank. Viewed at the difference between the gross ratio and net ratio, for all banks including the State Bank it was 1.7% of aggregate liabilities and for all banks excluding the State Bank 2.2%. If one were to assume banks would maintain the 28% liquidity ratio this time and treat only this gap as leading to their additional interest charge, the rates would be 6.2% including the State Bank and 6.7% excluding the State Bank on the basis of 1% increase for every 1% drop in the ratio. If the increase were only $\frac{1}{2}\%$, the rate would be 5.3% and 5.6% respectively. As against this the weighted average rate under the present tier system touched a high point of 5.62%.

⁸By implication the rate charged to the co-operative sector will also be stepped up by $\frac{1}{2}$ per cent while maintaining the present differential.

increase their marginal borrowing cost to above 8 per cent at the most (in other words would not allow their advances/deposits ratio to exceed 100 per cent or net liquid ratio to fall below 25% if the marginal borrowing rate is not to be penal in the full sense of the term).

16. The problem remains of dealing with the preferred sectors, namely, exports, small industries and collieries. The rationale for additions to the borrowing quota at a time when we are operating a system of quantitative ceilings on central bank credit is apparent but it would not be so when ceiling limits as such are not prescribed. To take the case of small industry, the problem here is one of availability of credit rather than its cost; the existence of this additional quota at the Bank rate has perhaps helped to make a larger volume of credit available to the small sector but not necessarily to lower its cost.⁹ The availability of finance for working capital purposes need not be impaired by the termination of the scheme as the problem before banks would be not the shortage of funds as such but the need for a quicker turnover of the credit they extend. This and the prescription of maximum rates for advances would meet the psychological objection that a concession now in force is being withdrawn.¹⁰ The case of exports under the Rupee Export Bill Scheme is somewhat different.

17. In this case, the cost of credit is a major consideration and the grant of concessional finance is linked with a ceiling on the discount rate charged by the Bank. The evidence of a self-liquidating transaction ensures that the funds made available by the Reserve Bank do in fact go to the exporter. Hence a continuance of this concession may be considered by excluding the finance made by the bank against Rupee Export Bills in computing net liquid assets position and/or the credit/deposits ratio as the case may be. With the expected full utilisation of the IBRD's loan to the coal industry and on the basis of the limited use made of this concession so far, there is no reason to continue the preferred sector treatment to coal industry guaranteed advances. At the time of its inception itself, it was recognised that this was a temporary measure and its termination could now be considered.

18. The above proposals, as observed earlier, lay emphasis on the necessity for banks to augment their deposits with a view to meeting both the statutory liquidity requirements and the need for credit expansion. In this connection, the Reserve Bank has through its directive dated March 11, 1964 and in subsequent meetings with the representatives of banks indicated the need for stepping up term deposit rates. At present, the term structure of deposit rates does not provide for a wide enough spread between the short end and the long end of rates. At one extreme 3% is being paid for three day money i.e. call deposits and it is suspected that many current accounts are being classified as call deposits to earn this rate of interest. The Inter-Bank Interest Rate agreement does not permit the member banks to pay any interest on current accounts; the existence of 3% call deposits rate constitutes a circumvention of the spirit if not of the letter of the Agreement and it is something which one would expect

⁹ While this increase in credit refers to absolute amounts, in terms of proportion to total scheduled bank credit, the increase is from 3.3 in December 1961 to 3.7 in December 1963.

¹⁰ The present scheme, incidentally, is operated on the basis of the banks' return to us and there are no ways (except through inspection) of verifying the accuracy of the data.

the banking community itself might wish to rectify. The attempts at reducing this rate (for example the recommendations of the Bhabha Committee) have not succeeded. The Reserve Bank has also an interest in this from the point of view of ensuring that the rate structure for short-term money is in alignment with the other market rates, including, in particular, the discount rate on treasury bills. From this point of view, it might be regarded that 3% for 31 days distorts the pattern of other short rates. On the one hand, the jump from 0 to 3% between the current account and the three day deposit is steep and on the other the spread between this rate and the other short-term rates is unnaturally narrow. Thus, two months deposits fetch only $3\frac{1}{4}\%$ and deposits upto 90 days fetch only $3\frac{1}{2}\%$. The narrowness of the spread tends to discourage the genuine saver and has possibly been a factor behind the growth in the placement of deposits with non-bank financial intermediaries and other companies. The payment of 3% on three day deposits had also tended to inflate the interest cost of banks and has limited their ability to offer more attractive rates on longer-term money. In the absence of agreement amongst the banks themselves to bring about the rationalisation of rates—the lukewarm response to even the marginal character of the Bhabha Committee recommendations is evidence of this—it may be necessary for the Reserve Bank to step in and in terms of Section 35(a) of the Banking Companies Act prescribe ceiling rates on short-term deposits. It is accordingly proposed that:

- (1) deposits upto 14 days be treated as on par with current accounts,
- (2) deposits between 15 days to 45 days be allowed a rate not more than 1.25% and
- (3) deposits between 45 days and 90 days be allowed a rate not more than 2.5%

At the same time, to provide for a reasonable spread and an upward revision of other short-term rates, we might also set a minimum of 4% for deposits of 91 days and over. The structure of deposits for terms above 91 days would be set through the State Bank of India setting a pattern of rates for varying terms. Though the State Bank is not a signatory to the Inter-Bank Agreement, its rates were, until the most recent change in Inter-Bank Agreement rates, in conformity with the latter. Announcement by the State Bank of a pattern of rates somewhat higher (by implication) for the longer-term deposits than what they are now will induce other banks to step up their rates to this level. The instrumentality of the deposit rate agreement need not be precluded; only the Agreement rates would then tend to follow the State Bank's rates.

19. In any discussion of deposit rates, the relation between those rates and other money market rates will also have to be considered. The relationship between deposit rates and bank advances rates has always been close. Hitherto, banks have invariably followed an increase in the deposit rates by putting up lending rates on the ground that they have to maintain the spread between the cost at which they borrow funds and that at which they lend funds. Our experience has, however, shown that the reverse does not always occur. Thus, following the Bank rate increase in January 1963, though the banks put up their advances rate, there was no adjustment of their deposit rates despite the fact that the increase in Bank rate made only a marginal difference to the total cost at which banks raised funds (including in this not only the raising of funds from depositors but from the Reserve Bank as well). With the proposed increase in the Bank rate and the institution of higher interest rate application system

instead of only three tiers, the average cost of borrowing from the Reserve Bank and (by implication) the average cost of raising funds would be followed by an increase by banks in their minimum lending rates as well as in rates to the intermediate class of borrowers. The prescription of a maximum advance interest rate, however, will not affect the marginal borrower—generally the small industrialist/trader unduly.

20. The relationship of the deposit rate pattern with the Treasury bill rate is yet another aspect to be considered. The Treasury bill rate generally rules close to the deposit rate offered by banks for equivalent maturities. At present the Treasury bill rate is quoted at 2.4 per cent reflecting the seasonal easing of pressure on the banking system and the increase in demand from banks in view of the proximate increase in their liquidity requirements. It is in respect of non-bank demand for Treasury bills that the deposit rates offered by banks have significance and the fact that until recently the Treasury bill rate was quoted at 3% was partly because of the ability of depositors of 'house money' to obtain 3% from banks for three day deposits. With the return flow of funds into the banking system, though banks continue to pay 3% to their house money customers, they are able to obtain only 2.4% against Treasury bills.¹¹ The prescription of ceiling rates for short-term deposits might in one sense add to the attractiveness of the Treasury bill as a short-term investment outlet both for banks and non-bank customers but such a ceiling prescription is to be regarded only as part of a larger package of measures, the other constituents of which such as the increase in the Bank rate and the stepping up of other term deposit rates would not fail to have repercussions on long-term bond yields and on the rates offered on small savings. The rise in such yields would be consistent with our policy of a gradual but definite hardening of the interest rate structure all along the line.

[Statements not reproduced]

[M. NARASIMHAM]
31.8.1964

TOP SECRET
PERSONAL

ECONOMIC SECRETARY
MINISTRY OF FINANCE
NEW DELHI
April 20, 1965

D.O.No.[...]

My dear Bhatta[charyya],

The upward trend of domestic assets of the Reserve Bank is so disquieting that we have decided today to draw another \$25 million from the I.M.F. immediately. You will remember that our original decision to draw in the first week of May rather than in the last week of April was due to a desire to demonstrate that we were ourselves anxious to draw as little and as late as possible. There is now a considerable risk that before the 1st of May the domestic assets of the Reserve Bank may exceed the agreed ceiling of [Rs] 3044 crores. If this happens, we cannot draw at all without further consultation. Our foreign exchange position does not allow us to take this risk of a

¹¹ The Treasury bill rate is Rs 2.5% and on the assumption that a holder rediscounts the bill after a week, his earning on a 7 day investment works out to 2.23% as against 3% for 'house money'.

few weeks' delay in further drawing. That is why I have sent a telegram today to Anjaria (copy enclosed [not reproduced]) asking him to ensure that the money is effectively transferred to the Reserve Bank on or before the 25th. I hope that by the 25th at least the ceiling of [Rs]3044[crores] will not have been burst. Anyway as a measure of precaution in this regard, and also to ensure that we shall be able to draw again a month later, I have asked Dehejia to reduce his indebtedness to the Reserve Bank by about [Rs]30 crores before the end of this month. I would however suggest, for reasons which you can guess, that our decision to go to the Fund immediately may be kept to yourself only for the time being.

Yours sincerely,
S. BHOOHALINGAM

FINANCE MINISTER
TOP SECRET

NEW DELHI
September 24, 1965

My dear Bhatta[charyya],

Our monetary policies have been partly framed with an eye to the promises that we gave to the I.M.F. The stringency of the market as such has been further accentuated by the withdrawal of unaccounted money which used to be inducted into business by bogus hundis. How much of unaccounted money has been taken out this way is very difficult to say, but one may say it is somewhere between [Rs]200 and 400 crores. The difference between the busy season and the slack season is narrowing down mainly because of the reason that the expansion of credit for agricultural purposes has not been of the same order as before because of the holding power of agriculturists. Nevertheless, increase in sugar production accounts for roughly a [Rs]100 crores of increased credit during the sugar crushing season which happens to coincide with the busy season. The beneficiary effect of monetary policies on prices is very very faint largely because there is a very large volume of unaccounted money still in operation and we have not been able to touch private credit; but the mal-effects of the credit squeeze are apparent: it has certainly stifled business to some extent, made money more costly which has the effect of dampening an already slack share market, increased the cost of deposits to banks causing thereby a general increase in interest rates. Conventional methods of monetary policy would not seem to apply with the same force in an economy such as ours and some measure of improvisation is necessary in order to achieve the ends we have in view.

May be, to a certain extent we have to maintain these policies because of the undertakings given to the I.M.F., but I think we should ask them to relax this stringency and allow us to adopt other means to make borrowing more costly which would otherwise not affect either the deposit rates or the interest rates to the same extent as the present monetary policies have done. I think from next year onwards we should have a tax on borrowings of at least 1.2 per cent per annum. This by itself would give us about [Rs]25 crores and more and at the same time enable us to reduce the bank rate by $\frac{1}{2}$ per cent, decrease the cost of deposits to banks and also help us to borrow

money in the market at slightly lower rates, while to a person who does not have to borrow on shares, the possession of shares would perhaps give him a better return vis-a-vis the bank rate. I would like the Governor to have this matter examined so that next year we might make a change on the lines indicated above.

Yours sincerely,
T.T. KRISHNAMACHARI

TOP SECRET

D.O.No.[...]

Camp: CALCUTTA

December 23, 1965

Dear Shri Krishnamachari,

I must indeed apologise for not replying to your letter No.[...] dated September 24, 1965 earlier. I have been pondering over the points in your letter all this time as these require a very careful consideration from both the short- as well as the long-term point of view.

2. It seems to me that the present stringency in the market arises mainly from the fact that demand for bank credit from all quarters has been accelerating at such a pace that despite a substantially high rate of increase of bank deposits witnessed in the last two years, banks are finding it increasingly difficult to meet the demand on their own. In a developing economy where the production base goes on widening year after year an increasing trend for bank credit is only to be expected. This apart, a part of the increase in the demand for credit is, as you say, due to withdrawal of bogus hundis. But the main reasons for the present persistent high demand for bank credit seem to be three. Firstly, the continuing strong upward price trend experienced over the last two years. Secondly, because of the depression in the capital market, bank finance has had to fill in the gap caused by absence of equity capital from genuine investors. Thirdly, the level of stocks of sugar, foodgrains and textiles financed by bank credit lately was somewhat higher than last year. In the case of sugar and foodgrains, this is due to Government's policy of releases and building up buffer stocks. As regards cotton textiles, as you know the whole position, I need not discuss it any further except to say that fortunately the position seems to be easing somewhat now.

3. To the extent bank finance replaces the resources of the unorganised money market, it is no doubt a useful development. Similarly, one has to accept that the policy of building up of buffer stocks of sugar and foodgrains with bank finance under Government control is inescapable in the present circumstances. But the trouble is that the money released thereby from trade and industry finds its way into other channels and does not come to the banking system.

4. The position has thus been reached where the banking system, if it has to meet all demands to the satisfaction of all its clients, has to be fed continually throughout the year by the Reserve Bank. This is an unhealthy development both from the point of view of the economy as a whole, as well as the banking system. The banking system, to be healthy, should provide all non-seasonal finance out of their own resources only, the Reserve Bank helping them to meet the pressure of seasonal funds when more money is needed to finance agricultural movements as well as increased trade

movements during the winter. If the banking system were to be fed by Reserve Bank funds throughout the year, it would only add to the monetary pressure on the economy which is already suffering from the ill-effects of the heavy deficits incurred by the Government.

5. In view of the foregoing, I feel that it is necessary to continue with measures which, on the one hand, will increase deposit resources of the banking system and, on the other, ensure their economic utilisation. As regards the former objective, I agree of course that it is not necessary for banks to raise interest rates all along the line. What I have been trying to do is to hold rates on short-term deposits down and ask banks to pay higher rates on longer-term and savings deposits. You will recall that till directives were issued in this behalf banks were paying unreasonably high rates on short-term deposits and practically neglecting long-term ones. The cost of deposits to the banking system has increased somewhat. But it is not too onerous compared to the increase that is taking place in staff expenses owing to automatic increase in dearness allowance. A study of the volume of deposits at various rates of interest shows that on an average the cost of deposits to major banks has moved by less than 1 percentage point from about 2.4 per cent to $3\frac{1}{4}$ per cent. Perhaps some further reduction of rates on short-term deposits is called for. A substantial proportion of these deposits are for business purposes and have a fast turnover. There is no reason to require banks to pay high interest rates on these deposits. A reduction of the rates on these deposits should effect some economy from the point of view of the banks. I am considering this as well as the question of standardisation of the terms and conditions on which savings deposits are collected by the banks so that they represent genuine savings accounts and do not contain money that should go appropriately to current accounts. But I do not think reduction would be advisable at this stage for longer-term deposits. These deposits would represent savings of individuals and just as it is necessary that the banking system attracts as much of them as possible, it is also necessary to ensure that the public gets a feeling that they are having a reasonable return on their savings deposited with the banks. A reduction of interest rates paid by the banks at this point of time on genuine savings would merely drive them to the non-banking sector where extremely high rates are paid but where the depositor hardly gets any protection that is available when he puts his money in a bank. I do not think such a move would be in the long-term interest of the banking system or of the economy.

6. As regards the use of the resources of the banking system, as you know, we are trying to control this through both selective and overall controls. It is, however, a well-known fact that selective controls by themselves are not of much use if at the same time there is no control over the total volume of credit creation by the banking system. Further, there is the added complication of the non-banking sector in our economy. Here of course, we try to vary our strategy according to the requirements of the seasons. For, despite a popular feeling to the contrary, there is even now a very marked difference between the busy season and the slack season. This is so because besides agriculture there are certain important industries like textiles, sugar, coal etc. which experience seasonal fluctuations and the Government's budgeting operations

also exert seasonal pressures on the banking system in the same direction as the pressures exerted by the rest of the economy.

7. In the present busy season, therefore, what I have done is (a) to ensure that banks do not expand credit for non-seasonal financing unreasonably beyond their own resources, (b) to ensure that if as a result of a bank's past commitments it has to meet a large demand it gets the necessary resources temporarily from us but has an incentive in returning them as quickly as possible and (c) banks do not charge too high a rate to their borrowers. Thus, in the busy season Reserve Bank resources are not denied to the banking system; but they are available at a cost which increases if they are used disproportionately to the banks' own resources so that their use is strictly temporary.

8. It is quite true that the beneficiary effect of the monetary policy on prices is very faint. The reasons, as you say, lie elsewhere. But I do not think this would justify either a cheapening of credit by reducing the Bank rate or by making other changes which would encourage banks to borrow freely from the Reserve Bank money which they will not be in a position to return in the slack season. The share market has adjusted itself to a yield pattern comparable to the returns from other types of investments but even if the return on bank deposits were reduced, I do not think the share market would be the beneficiary of the same.

9. I fully share your view that conventional methods of monetary policy do not apply with the same force in our economy as in the western ones and that some measure of improvisation is needed all the time in order to achieve the ends we have in view. It is for this reason that we have let it be publicly known that our policy is flexible and that we shall not allow production to suffer because of lack of finance. But I would strongly urge on you that this is not the time when credit should either be cheapened or made more freely available generally. We have to wait to see that the economy is geared to a condition where increased production possibilities are apparent before we make any change in the monetary policy.

10. Now, to turn to the proposed device like a tax on bank borrowings, I am doubtful if this can fit into the present situation in an appropriate manner. In the first place it is not desirable to use fiscal instruments in the monetary field. A fiscal instrument has a certain amount of rigidity and cannot be changed as flexibly as a monetary instrument. Thus when the time comes for a substantial change in interest rate policy it may be found that because of the revenue implications, the tax on borrowing cannot be changed so easily. Secondly, whereas an important objective of our policy is to penalise only those banks which expand credit out of proportion to their resources, the tax would not be able to discriminate in such a manner. Thirdly, a tax if it has to be followed by Bank rate reduction would reduce the profits of banks which follow a reasonable credit policy much more than that of the others. On the other hand, if it is not followed by a Bank rate reduction or any other change in policy, the burden on the customers would have to increase correspondingly. Fourthly, the effects of the tax would generally be regressive. Its impact would be higher on those paying low rates of interest. Finally, if a tax is to be levied on the borrowing from the organised sector, it has to be accompanied by a tax on all borrowings and taxing borrowing from the unorganised sector would raise great administrative problems. On the other hand, if this is not done, it would strengthen the tendency of companies to rely more and more

on the unorganised sector for its finance whereas our objective should be the precise opposite. In all the circumstances, I would very strongly urge on you that it would be inopportune to introduce such a tax even if it is to be levied on all borrowings. The situation would be much worse if it is to be levied only on bank borrowings.

With regards,

Yours sincerely,
P.C. BHATTACHARYYA

SECRET

D.O.No.[...]

BOMBAY

May 21, 1966

Dear Finance Minister,

In the busy season that has just ended the expansion of money supply was as high as Rs 496 crores—as much as nearly Rs 100 crores more than in the preceding busy season. This occurred despite the fact that bank credit expansion in the same period at Rs 306 crores was little over Rs 100 crores less than in the earlier period. The divergent movement in almost equal measure of money supply and bank credit was entirely due to the growth in net bank credit to the government sector which increased in the 1965–66 busy season by as much Rs 387 crores as against Rs 160 crores in the 1964–65 season. This large expansion in the money supply, occurring as it has in a period marked by a severe shortfall of supply both domestic and imported has, not unnaturally, led to the building up of a considerable amount of liquidity in the economy. 2. As we enter the slack season which also is the lean season for agricultural supplies, this liquidity would in itself add to the seasonal pressure on prices. But on top of this liquidity that is already built in to the system, there is likely to be, as is usual, further addition to liquidity in the near future from the side of fiscal operations. I am aware that in the coming months there would be substantial sales of P.L.480 foodgrains. Despite this, on past experience and recent indications, the impact of fiscal operations on the money supply in the coming months is likely to be expansionary. One cannot view with equanimity such a situation. We estimate that the consequence of the expansionary impact of fiscal operations past and present would be to increase the deposit resources of the banks substantially. Our estimate of the order of deposit expansion in the lean season, based on the probable increase in net bank credit to Government and the impact of currency contraction, is that it is likely to be around Rs 200 crores. This expansion would obviously enable banks to create additional credit. Further, in the last busy season, credit against seasonal commodities rose by about Rs 170 crores. In view of the special circumstances relating to foodgrains and sugar advances, on a tentative assessment, it is considered that the contraction, in the slack season, of advances against seasonal commodities should be somewhere around Rs 135–150 crores as against which credit against non-seasonal items might ordinarily rise by anywhere between Rs 50–60 crores suggesting that the overall contraction in bank credit in the slack season should be within the range of Rs 75–100 crores. This money will also be available to banks for creation of additional credit if banks were left completely free to deploy their accruing resources during the lean season.

3. I am, therefore, convinced that, placed as we are, some restrictive action on the monetary side is called for to be operative during the lean season only. This will, however, affect only the private sector and poses for us a very difficult problem of public relations. You are aware that the Reserve Bank has been, off and on, criticised on the ground that its monetary action seeks to control expenditures in the private sector at a time when fiscal operations which are the main element in the monetary imbalance remain uncontrolled. It is also stated that such a situation leads to excessive restrictions inhibiting production in the private sector. We have, of course, on several occasions answered such criticism by making a reference to the emergence of private expenditures as a positive element in the monetary expansion and by stating that this makes it necessary to pursue an active monetary policy to regulate the operations of the private sector. None the less, you will agree that there is considerable force in the argument. It has to be admitted that if Government (and here I include the State Governments) were in a position to so order their affairs the recourse to deficit financing had been substantially smaller, the severity of action on the monetary side could, to that extent, be moderated.

4. A possible view may, therefore, be to let things go on without any intervention on our part. But if we were to take this view, we would be failing in our primary duty as the central banking authority. We have necessarily to take an overall view of credit operations and if Governmental operations continue to add to liquidity in the economy, we have to try to counteract the effect of this by restricting expansion in the private sector to the maximum extent possible, if we are to be true to our charter. As our measures are general in nature, it is not possible to guarantee that no productive efforts in the private sector will be hurt under such circumstances even when we take all possible precautions. If therefore we take action on the lines proposed later in this letter, I am afraid our action will be severely criticised by the private sector of business and industry and we shall need all the support that Government may give us.

5. I would add that our proposals have been framed with a view to limiting the secondary impact of the primary expansion of money as a result of fiscal operations, especially against the background of squeeze on supplies. I am aware of the possibility of augmentation of supply through larger availability of external assistance, especially maintenance imports. But on a realistic basis, I would presume that any such substantial supply is unlikely to flow before September or so whereas the problem of monetary imbalance would be at its most acute in the months before that. In fact, to be able to meet the need for credit when it is required (with more imports) action now to conserve bank resources for this eventuality would appear to be indicated.

6. The total resources that would accrue to the banking system may be set at Rs 300 crores made up, as indicated earlier, of about Rs 200 crores of deposits and Rs 100 crores or so of return flow of credit. Of this Rs 30 crores would be absorbed in the repayment by banks of their borrowings from the Reserve Bank while another Rs 60 crores would be preempted by the need to maintain statutory liquidity ratios.

7. The problem, as it seems to me, is therefore to attempt an immobilisation of Rs 200 crores or so which you will observe is also our tentative estimate of the likely volume of deposit expansion. Immobilisation of resources to this extent could be done through impounding of reserves and it is our proposal that this should be done. To take into

account the differential deposit outturn and portfolio behaviour of different banks, I propose the use of the instrument of incremental reserve requirements and call up the full 100% of increment to deposits in May. This is the maximum percentage of incremental reserves that can be called up under the law. The call up of reserves for June could be decided later in the light of Government's borrowing programme and other relevant factors. What we hope for is that the action that we propose to take for the May deposits will place the banking system on the alert. We would pay interest on such impounded reserves as permitted by the law and assure the banking system that the additional reserves would be released with the onset of the busy season or as and when the situation so demands including for instance banks' desire to subscribe to government loan issues.

8. I have also given thought to the question as to how the essential needs of additional credit during the lean season could be safeguarded along with the adoption of the restrictive measure outlined above. To achieve this, I propose to continue the refinance facilities which we now have in respect of food procurement, exports and defence supply bills even beyond June 30, 1966 when our usual Bill Market facilities are withdrawn. Further, it has been represented to us by banks in Eastern India that the requirements of those banks which purvey tea finance increase during the lean season as the requirements from the tea gardens are heavy during this period. There is some point in this. I therefore intend to keep the Bill Market facilities available in respect of tea garden financing also during the lean season in addition to the three refinancing schemes mentioned above. I propose, however, to limit this facility to the increase in banks advances to the tea industry over the level of June 30, 1966.

9. The advent of the lean season also justifies a review of the deposit rates structure, which we have helped to build in the banking system. For some time we have been thinking that in the case of deposits of less than 3 months which, in any event are largely institutional deposits, the maximum rates now prescribed could be lowered without any fear of this leading to a diversion of deposits or having adverse effects on savings which our intervention in the deposit rate structure was intended to promote. The present money market conditions would also justify such a move. Accordingly I propose to lower the maxima for rates on short-term deposits from 1.50% for 15 to 45 days to 1.25% and for 46 to 90 days from 3% to 2.50% per annum. This would also permit a lowering of our present 'administered' Treasury Bill rates to 3.00% which will be done. At the same time, I propose to modify our minimum rates directive somewhat. The banking system has by now got used to the new rate structure and the continuance of a minimum rate prescription does not seem to me to be necessary. I propose, therefore, to rescind our minimum rates directive insofar as it applies to three months' and six months' deposits and savings bank deposits. I do not expect that the abolition of minimum rates here will in fact be followed by a lowering of rates. But if it is done marginally, it will not be unwelcome to us. As a measure of abundant caution against any substantial reversal policy, I propose to leave the prescribed minimum rate for one year deposit undisturbed so that our objective for which the deposit rate intervention was resorted to, namely, widening of yield differential, still remains clearly apparent. I also propose to prescribe later on certain rules regarding savings bank deposits to emphasise the savings character of these deposits. Action,

however, in this regard will have to be co-ordinated with the rules in regard to Post Office Savings Bank and it is for this that I do not intend to take any immediate action.

10. I shall be glad to know if you have any other views in the matter. I would request an immediate reply as the proposed directives if they have to be issued, should be issued before the end of the month.

11. I have separately sent a copy of this letter to I.G. [Patel.]

Yours sincerely,
[P.C. BHATTACHARYYA]

Shri Sachindra Chaudhuri
Finance Minister
Government of India
New Delhi

SECRET

Camp: NEW DELHI
June 21, 1966

My dear L.K.,

Various opinions are being given expression to in the Press and elsewhere regarding the proper credit policy to be followed after devaluation. This matter has now been studied in the Reserve Bank and I enclose herewith a copy of a note recorded on the subject. You will notice that the conclusion arrived at is that measures should be taken so as to conserve resources with the private banking sector for less essential purposes during the slack season so as to be available for meeting the larger and more essential demands from the private sector for the proximate future when non-project assistance starts flowing in.

I shall be grateful if this note is put up to the Prime Minister for her information. I am arranging to have these measures discussed in the Devaluation Committee of the Cabinet this morning.

Yours sincerely,
P.C. BHATTACHARYYA

Shri L.K. Jha, I.C.S.
Secretary to the Prime Minister
New Delhi

DEVALUATION AND MONETARY POLICY

Devaluation is primarily a corrective measure taken to meet a situation where internal prices have risen ahead of international prices. When internal prices rise faster than prices abroad, it leads to a situation of imbalance in external payments. This arises because on the one hand exports become uncompetitive while on the other strong demand is generated for imports. With a system of strict import control, this import demand tends to be satisfied through illegal channels. Though the external payments gap in our conditions is structural in character and related to the plan level of investment, we must, at the same time, keep the objective in view of

moving towards a position of balance in external payments so that our dependence on external aid is reduced. Devaluation helps to achieve this objective by making it attractive for the local producer to export his produce while at the same time it tends to discourage imports. It provides valuable time for the needed adjustments in the internal economy.

A situation where internal prices rise faster than world prices is a result of internal inflation. It is this inflation which is at the root of the problem. The immediate impact effect of Devaluation is, however, to raise prices of imports and consequently of articles with import content. There is also the possibility of prices of export commodities rising in view of some diversion from internal consumption. While this diversion is indeed one of the objectives of Devaluation, in a scarcity economy such as ours, this might have the effect of aggravating local shortages. In our situation, the import content of articles entering into the cost of living is low. Also, Government has decided not to raise the issue prices of foodgrains and other items of mass consumption such as kerosene. Further, the adjustments of import duties on the one hand and the fact that there was already a difference between landed cost and market prices in respect of a large range of imports would suggest that import prices need not rise to the full extent of Devaluation. Yet, some price rise must be regarded as inevitable. The measures now being contemplated such as the enlargement of the fair price shop network over a wider range of commodities and a wider area of operations, the various administrative measures to check prices etc. are necessary steps to correct the immediate price increase following Devaluation but it must also be noted that these form no more than a temporary holding operation.

The obvious and lasting solution to the problem is to tackle the inflation at the source. This calls for a sizeable increase in output of real goods and services on the one hand and the scaling down of expenditures both in the public and in the private sectors on the other.

The growth in aggregate output in our conditions is largely a resultant of the crop outturn. Given normal weather and with the emphasis on intensive farming in selected areas it is reasonable to expect that agricultural production in 1966-67 will more than recover to the levels of 1964-65. This should not only provide the needed relief to the food situation but also enlarge output in important agro-based industries such as cotton, jute, sugar, vegetable oils etc. These industries account for much the greater part of industrial production and some of them are also important from the point of view of exports. As regards other industries, the availability of substantial non-project assistance and the consequent fuller utilisation of capacity should lead to a perceptible increase in internal output. Even here, the major beneficiaries would be the engineering and chemical industries whose importance in the total industrial picture is still small but which are strategic for growth and which could generate a cumulative expansion over a wide range of industry. The outlook on the side of supply availability is thus reasonably hopeful but this cannot be expected to be realised before the end of 1966, whereas the problem of inflationary pressures following Devaluation would be at its most acute in the months immediately ahead. These months also coincide with the lean season for agricultural supplies and the pressure on prices would thus be aggravated. Immediately, therefore, the problem of inflation should be tackled from

the side of limiting expenditure in the public and private sectors. The growth of public expenditures ahead of an increase in resources had led to extensive recourse to credit from the banking system and particularly from the Reserve Bank. Deficit financing has been a major factor behind the present imbalance in the economy and the attendant economic strain and social tensions. Last year, for instance, the level of deficit financing was at a very high level and, against the background of a poor agricultural outturn, contributed significantly to the emergence of the present inflationary conditions in economy which have ultimately necessitated the drastic corrective measure of Devaluation. It is essential to keep deficit financing to the barest minimum if it is not possible to eliminate it over the year. Taking the Government sector as a whole, including both the Centre and the States, the objective should be to have a balanced budget. In concrete terms the Centre should aim at a surplus budget, while the States should once again be asked to review their financial position with a view to avoiding all postponable expenditure and limiting all non-development expenditures. In the private sector also expenditures have recently tended to run ahead of resources and the aim of credit policy has been to limit the recourse of the private sector via the commercial banks to the Reserve Bank and thus avoid deficit financing in this sector. Devaluation is not expected to add immediately to the strain on the liquidity in this sector. Rather, the banking system should acquire higher liquidity in the short run. Though the cost of financing imports would go up, so would export receipts. The private sector generally has a surplus in its external transactions and, to the extent that this is so, the rupee value of the surplus would be enhanced as a result of Devaluation. Further, a considerable amount of seasonal advances provided in the last busy season should return to the commercial banks in the immediately coming months. The problem will, however, arise for the private sector with regard to finding the rupee resources necessary for making use of the non-project assistance that is likely to become available in the country say, from October onwards. But if the private sector is to be financed in respect of this additional amount, in effect, by the Reserve Bank, it would be a case of deficit financing by the private sector which would be inflationary. It should be remembered that the rupee equivalent of this assistance would already have been taken credit for by Government to whom the loan is initially made. Obviously, rupee resources cannot be generated twice over in respect of a single addition to real resources without generating inflation.

The objective of monetary policy in the immediate future must therefore be to ensure that the present excess liquidity of the banking system is not used to finance non-essential expenditures in the private sector in the slack season. This is called for both from the point of view of reducing demand pressure now and to provide finance for the additional imports in the next busy season without aggravating inflationary pressures. Measures should accordingly be taken so as to conserve the resources of the banking sector from being used for less essential purposes for meeting the larger and more essential demand from the private sector in the proximate future when non-project assistance becomes available. Any measure to bring about a containment in private sector expenditures however justifiable on economic grounds is likely to be criticised by trade and industry merely on general considerations. It would be argued that it runs counter to the move towards allowing the private sector greater freedom

from controls. On the other hand, precisely because administrative controls are in the process of being liberalised, a restraint on the growth of demand in the economy has to be obtained through fiscal and monetary measures. Monetary controls are preeminently 'market' instruments of control. Another argument would be that when the private sector hopes to utilise larger non-project assistance, a reduction in the credit available to it will nullify the benefit of such assistance being made available. The answer to this line of reasoning is that such assistance may reasonably be expected to become available only from October, whereas the measures of control are intended to operate in the months before then so as to relieve the pressure on scarce supplies. The funds conserved are intended to finance essential seasonal and non-seasonal requirements after October. The proposed measures should however provide that if supplementary funds are needed for lending to industry even during the slack season, this would be made available by the Reserve Bank.

II. FINANCING GOVERNMENTS

A. STATE LOANS

SECRET

GOVERNMENT OF MADRAS
FINANCE (WAYS AND MEANS)
DEPARTMENT
FORT ST. GEORGE
MADRAS
August 9, 1951

D.O.No.[...]

My dear Balasubramanian,

Please refer to your D.O.No.[...] dated the 2nd August 1951.

The Madras Government have considered the matter carefully in the light of the results of their previous issues, most of which were under-subscribed by the public and the underwriters had to take up a portion. They would prefer their entire loan upto about Rs 5 crores in the current year being underwritten in full. But, in case the Reserve Bank finds it impossible, in spite of its best efforts, to secure underwriting arrangements for State loans this year, the Madras Government will have no other alternative than the issue of a straight loan in the open market on terms that will attract investors adequately.

Yours sincerely,
T.A. VARGHESE

Shri G. Balasubramanian
Secretary
Reserve Bank of India
Central Office
Bombay

CONFIDENTIAL

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
August 18, 1951

D.O.No.[...]

My dear Varghese,

Will you kindly refer to your D.O.No.[...] dated the 9th August 1951 regarding the projected Madras loan for the current year?

2. We fully appreciate your preference for the entire loan of about Rs 5 crores being underwritten in full, but so far as we can see, none of the underwriters in Bombay are prepared to accept such a risk. I do not know if you have considered the feasibility of the Hon'ble Finance Minister in Madras using his political influence to get sufficient support in Madras and the Governor would much like this possibility to be canvassed. In the absence of the loan being underwritten, you will have no other alternative than issue a straight loan in the open market but the Reserve Bank presume that by the expression "the terms should be such as would attract investors adequately", the

Madras Government do not mean a rate of yield as might prejudice the pattern of other loans including the Government of India loans. We consider that 3½ per cent at par for 11 year money is a sufficiently attractive rate. We are pursuing further the possibility of underwriting your loan and will advise you of the final result in the course of the next ten days.

Yours sincerely,
G. BALASUBRAMANIAN

Shri T.A. Varghese, I.C.S.
Secretary to the Government
of Madras
Finance Department
Madras

CONFIDENTIAL

RESERVE BANK OF INDIA
BOMBAY
August 21, 1951

D.O.No.[...]

My dear Reddi,

Please refer to D.O.No.[...] dated August 18th 1951 to Varghese from Balasubramanian regarding the Madras loan for the current year, which I have seen after my return from Delhi yesterday.

2. I am afraid the expression "political influence" might be misunderstood, and I would like to explain that it was never my intention to suggest that you should exercise any illegitimate political pressure in order to get subscriptions to the loan. What I had in view was that you should make an appeal to local patriotism, especially as the loan is for development purposes. I had been to Calcutta last week in connection with the Bengal loan. The Chief Minister, Dr. B.C. Roy and the Finance Minister, Mr. N. R. Sarkar, appealed to the banks and insurance companies to support the loan and the entire loan has been subscribed by these institutions. It will not, therefore, be necessary to underwrite the Bengal loan, which will be on the same terms as the Madras loan. You might consider whether you should not make an oral appeal to the heads of the local banks and insurance companies to subscribe adequately to the provincial loan. As Balasubramanian has stated, we are also considering further the possibility of underwriting your loan.

3. I should be grateful if you could let me know, as early as possible, what the response of the Madras banks and insurance companies is to your appeal.

Yours sincerely,
B. RAMA RAU

The Hon. Mr. B. Gopala Reddi
Finance Minister
Fort St. George
Madras

SRI B. GOPALA REDDI
FINANCE MINISTER

FORT ST. GEORGE
MADRAS

D.O.No.[...]

August 22, 1951

My dear Rama Rau,

Many thanks for your letter No.[...] dated 21st. I am under no misapprehension about the nature of the appeal to be made to the financing agencies regarding the Madras loan. In fact, even last year, quite apart from the Manimuthar effort, I had informal talks with the agents of selected banks and insurance companies and there was indeed a satisfactory response. I had intended to do it again this year and shall let you know shortly the reactions. But, you would appreciate that as the head offices of the more substantial institutions are either in Bombay or Calcutta, my efforts might be effective, only to the extent local agents could influence their head offices. I am sure that you would also do your best at your end and let us hope that we can somehow pull through.

Yours sincerely,
GOPALA REDDI

Shri B. Rama Rau
Governor
Reserve Bank of India
Bombay

SECRET

RESERVE BANK OF INDIA
BOMBAY

D.O.No.[...]

August 24, 1951

My dear Reddi,

Will you please refer to the correspondence resting with your D.O.No.[...] dated August 22nd, 1951 regarding your new loan?

2. I had informal discussions with the local underwriters yesterday afternoon and the general consensus of feeling was that in spite of their best efforts banks and brokers may not be able to canvass subscriptions for more than a crore of rupees for all the State Governments put together as against our estimated proposals of Rs 11 crores in the aggregate. The estimate may be unduly cautious, but it is evident all the same that the market is not favourably circumstanced to lend good support to a loan. In the circumstances, it is inevitable that we should abandon the idea of adopting the underwriting scheme for the State Governments' loans and the only course will be for your Government to issue a straight loan in the market for the minimum possible amount, which in the case of your Government will be Rs 3 crores. To aim too high and achieve too low may jeopardise your credit, which it is important to maintain for the sake of future borrowings. For your confidential information we may add that the undernoted State Governments will be issuing loans to the extent indicated against each.

Bombay

...

Rs 3 crores

Uttar Pradesh	...	Rs 2 crores
West Bengal	...	Rs 2 crores
Madhya Pradesh	...	Rs 1 crore

3. In the light of the present trend of yields on Government loans and consistent with the general pattern of interest rates, I recommend that the loan should have a currency of 11 years, i.e. repayable in September 1962, carrying an interest of 3½% per annum, the interest being payable half yearly on the 17th March and 17th September. The issue price may be fixed at par or a little below par which can be decided when you send the notification for our approval. Brokerage will be paid at the usual rate of ⅛th per cent.

4. If the above proposal is agreeable to your Government, I suggest that the following programme may be followed subject to there being no untoward developments either in the domestic or international situation. Should such a situation arise, it may be necessary to abandon the idea of a loan.

State Government to communicate acceptance of the amount and terms of the loan and forward a draft notification with the number and date of issue inserted so as to reach us not later than

.. 1st September 1951

Statement showing the financial position of the State Government to reach us not later than

.. 4th September 1951

Loan notification to be issued on

.. 10th September 1951

Lists will be opened and closed on

.. 17th September 1951

5. In view of the present uncertain conditions we have tried to keep the date of issue of the loan as near as possible and the date 17th September has been chosen as it would enable the public to utilise the proceeds of the Government of India 3% Loan 1951-54 which will be repaid on the 15th September 1951 to invest in your loan.

6. Subscriptions will be received at the Reserve Bank of India offices at Bombay, Calcutta, Delhi and Madras and at the branches of the Imperial Bank of India and at District Treasuries within your State.

7. As all the loans will be issued simultaneously, our office will arrange for publication of a joint advertisement of the loans in newspapers and financial journals at Bombay, Calcutta, Delhi and Madras. You will, doubtless, make suitable arrangements for publicity of your Government's loan within the State. The cost of joint advertisement by our offices will be distributed equally among the Governments concerned. A sum of Rs 3,000 may be provisionally allowed for this purpose.

8. Please let me know your views early to enable us to advise our offices.

Yours sincerely,
B. RAMA RAU

CONFIDENTIAL

RESERVE BANK OF INDIA
BOMBAY

D.O.No.[...]

September 11, 1951

My dear Ambegaokar,

I have seen the two extracts sent with your confidential D.O. of the 10th September 1951 regarding State loans.

2. Before commenting on them, it would be advisable to give you some background information so that you may appreciate the position better. The so-called 'busy season' ends somewhere in June or July as the experience of recent years has shown. The Central Government has the first claim for borrowing on an easy money market as on its credit depends a good deal of public finance. So the Central Government naturally draws off the top cream. We allow some 3-4 weeks for the markets to adjust themselves after a Central Government loan before the States have a chance to dip into the market. By then, the money investible in Government loans has practically been absorbed. State Governments loans appeal to a limited clientele which concentrates on higher yield rather than on quick liquidity and State Governments bring some kind of pressure on small banks and insurance companies to help making a success of their loans. Till this year, these loans were underwritten, the underwriters parting with their six anna commission to their clientele. States loans are not popular with the big banks and the market for such loans is limited. The Reserve Bank has no portfolio of States loans and as you know any purchases of States loans by the Reserve Bank is like other purchases, inflationary. Such purchases tend to give a false impression regarding the popularity of States loans. Before the flotation of the Central Government's loans, it is possible to prepare the market for the kind of loan it is proposed to be issued because of the wider field for the investment of Government of India securities. In the case of States loans, the field is limited and the interval between the flotation of Central and States loans is even more limited, not to forget the fact that the so called slack season is hardly three months in a year. Again the credit of each State Government is rated differently by the market as evidenced by the quotations and their popularity also varies. There is a lack of appreciation of relevant factors when one talks of nursing the market for States loans. What happens is that no sooner than the lists of States loans are closed, there begins a selling pressure from those who took the loans and as the field is limited and the amounts offered at times bear a larger proportion to the recent debt incurred, the result of a drop in quotations is naturally exaggerated.

3. From the foregoing, you will observe that the statement that the Reserve Bank does not "support" States loans in the open market is correct. The reason is obvious. In the first place, we do not hold, as I said above, a portfolio of States loans because of the composition of our reserves, though in exceptional times as in the difficult days of summer of 1947 we do buy in moderation such loans; and in the second place the loss resulting from open market operations will eventually have to be borne by the Bank, which will be passed on to the central revenues by a reduction of profits. I can take a safe bet, that once we start supporting States loans by buying them, the Reserve Bank will soon become an asylum for such securities and we shall be kidding ourselves by a lot of created money. Any limit we may impose on such purchases would hardly avail in these days of financial stringency. If sales of States' Governments

securities are not indulged in, we should have no hesitation in accepting pledges of such securities for advances. So far my experience has been that no such proposal for pledging has been made. The "*Commerce*" apparently got some misinformation from some irresponsible broker which it put out in its issue of September 1. In the nature of things States loans have not that liquidity which the Central Government loans have and unless we formulate some scheme by which the States Governments would bear the losses resulting in the open market operations in their loans, nothing can be done further in the matter, unless the Centre is prepared to subsidise.

4. As regards Sri Vaikunth L. Mehta's observations, I do not see how the Reserve Bank can in the existing state of affairs 'nurse' States issues beyond so timing the loans as to derive benefit from the payment of 1951-54 loan and by refraining from sucking the market of funds by sales of Government of India securities or the issue of treasury bills. Nursing of Central Government loans is done by buying or refraining from sales of appropriate securities and, as you know, what we do is really to go off the market in selling securities before we float a Central Government loan so as to create an attractive appetite for the new loan. This we cannot do for the States for reasons explained above. I have come to the conclusion that borrowing by multiple Governments is not on the whole conducive to orderly borrowing on any appreciable scale. Moreover, as things are at present, we cannot have different dates for borrowing by various States nor can we have different maturities without causing discrimination.

5. As I shall be in Delhi in the course of the next two days, we shall have an opportunity of discussing this matter.

Yours sincerely,
N. SUNDARESAN

Shri K.G. Ambegaokar, I.C.S.

CONFIDENTIAL
CHIEF MINISTER OF MADRAS

FORT ST. GEORGE
MADRAS
July 11, 1952

[My dear Rama Rau,]

You are no doubt aware of the difficult political situation that is obtaining in this State. The taxation proposals which are embodied in the budget are meeting with much resistance, as indeed, was to be expected, but I am not without hopes of retrieving the bulk of them. At this juncture, it is very desirable that Madras should face the money market boldly and could demonstrate that she commanded the confidence of the investing public all over the country. In this Government's letter No.[...] dated 9-7-52, the Bank has been requested to assist this State to raise a loan of Rs 5 crores, including a conversion operation of the sum of Rs 219 lakhs, due for repayment this year. If you time the new loan suitably and offer reasonably attractive terms, it should be possible to do the conversion without hitch. In that case, the amount of fresh money that has to be tapped is less than Rs 3 crores, which is about the sum raised by this State during each of the last 2 years. I believe it

will have a very useful heartening effect on the morale of the country if we could announce that Madras has successfully raised a loan of Rs 5 crores in the open market. In sheer self-interest, if not on nobler impulses, some of the money bags should hasten to strengthen my hands. You may kindly advise me in time on this matter and also indicate the method of any special approach, if you recommended such a course. I hope you will help.

Kind regards,

Yours sincerely
[C. RAJAGOPALACHARI]

SECRET

RESERVE BANK OF INDIA
BOMBAY
July 14, 1952

D.O.No.[...]

My dear Rajaji,

Your letter of July 11th, which I have just received, has crossed my letter dated July 12th to Shri Subramaniam. I fully appreciate the very difficult circumstances under which you have to carry on the administration and I need hardly repeat the assurance I gave you personally in Madras that I will do my utmost to help you in your financial difficulties, which I know have repercussions on the political situation, though the Reserve Bank is not directly concerned with the political aspect.

2. This year I have introduced an important change in the loan procedure that we hitherto followed. As you know, the Government of India invariably issued their loans first and the States were obliged to go into the market later. There were good reasons for this procedure, which I need not go into now. I have, however, persuaded the Finance Minister to allow the States Governments this year to issue their loans first, and you will observe from my letter to Shri Subramaniam that I have suggested a rate of 4% for a 12 year loan, to be issued at a slight discount. This happens to be the rate which you mentioned in the course of the interview I had with you.

3. The other departure I have made is in regard to the amount of the loan to be issued. We have in the past given the States an estimate of what, in our opinion, the money markets were likely to take. This estimate was based on the money available in the market, the attitude of banks, insurance companies and other institutions, our own open market operations etc. I am sure the Madras Government will recognise that our estimates in the last two years were not pessimistic. The figures for Madras are as follows:

	Original proposal	Bank's recommendations	Public subscriptions
1950: 3%	13/14	3 crores	311 lakhs
Madras	crores	+ 1 crore by Tirunelveli	128 lakhs
1960		ryots	taken by Government

1951: 3½%	5 crores	3 crores	Public	189 lakhs
Madras			I.B.I.	10 lakhs
1962			Reserve	
issued			Bank	50 lakhs
at 99/12			State	
			Govt.	52 lakhs
				<hr/> Rs 301 lakhs

This year I am not asking the States to adhere to our estimates (the States were never under an obligation to accept our figures) and I am leaving it to the State Governments to determine what amounts they feel they can raise. In regard to development projects, there is a good reason for the States making their own decisions, for appeals to local patriotism and propaganda have a considerable influence on subscribers in the areas affected by the development schemes. You are in a far better position than we are to assess the results of an intensive campaign in the areas concerned. Even capitalists and other investors not directly concerned would undoubtedly be influenced by the possible political repercussions, if the loan should fail. If you feel that by your personal exertions, which I know will have a profound effect, you can raise Rs 5 crores, I will have no objection. You will, of course, appreciate that the Reserve Bank will have to be impartial in regard to their own subscriptions, if any, and it would not be possible to give any undue preference to any one State.

4. I may add for your information that when circumstances were not propitious for a successful loan last year in West Bengal, Dr. Bidhan Roy was able by private arrangements with insurance companies, banks and other big investors to get the entire amount subscribed before the date of issue. You will no doubt consider whether you should not make a similar attempt to raise at least a portion of the loan in Madras. In any case, an intensive campaign will be necessary to mobilise public opinion in favour of the loan.

With kind regards,

Yours sincerely,
B. RAMA RAU

RESERVE BANK OF INDIA
BOMBAY
August 8, 1952

D.O.No.[...]

My dear Rajaji,

Your telegram regarding the Madras loan. I have asked Sundaresan to explain the position to Varghese on the telephone. So I have not sent you a reply by telegram. When I made the suggestion about sale of Madras Government securities in lieu of cash payment, I was under the impression that you could sell the securities in your Cash Balance Investment Account. Varghese has just told us on the phone that these securities have been earmarked for some Fund. In the circumstances, the suggestion is not feasible.

2. We have explored all possibilities in regard to your suggestion that you should be allowed to retain the excess for ways and means purposes, but we cannot think of any expedient by which this can be done. As you know, with your approval, I issued a statement yesterday that applicants who had subscribed more than a lakh would receive partial allotment. Even if the suggestion was otherwise feasible, we cannot now say that no partial allotment will be made. It is well known that the loan has been heavily oversubscribed, and many of the applicants may insist on the return of the balance, especially as the new loan is now quoted at a discount.

3. I may also point out that according to the Madras loan notification, the proceeds of the loan will be utilised only for capital expenditure on electricity schemes and productive irrigation works. It would hardly be proper to use it for any other purpose, although there would, in practice, be no means of discovering how the loan has been utilised. I am very sorry that I cannot help you in regard to this matter, but you will appreciate that any departure from the authorised terms of the loan notification would provoke criticism and tend to destroy public confidence.

With kind regards,

Yours sincerely,
B. RAMA RAU

The Hon. Shri C. Rajagopalachari
Chief Minister
Madras

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
December 12, 1952

D.O.No.[...]

My dear Bala,

I enclose a copy of the West Bengal Government's letter No. [...] dated the 4th December, 1952 [not reproduced], in which they have asked for sanction to their raising a further loan of Rs 2 crores for financing their schemes for the development of salt production and for the Calcutta Sewage Gas. We are consulting the Planning Commission about the desirability of West Bengal launching the schemes which are outside the Plan and which, because of the limited financial resources which are likely to become available during the period of the Plan, may well jeopardise the schemes in the Plan. Meanwhile, on the question of the loan itself our line will presumably be that, if the West Bengal Government are reasonably certain that they can get this additional money, we need not raise any objection to a further issue of this year's loan on the lines of the arrangements which have recently been accepted in the case of the U.P. Government. We will, however, be grateful for your comments both on the proposal and also the prospects of its success.

Yours sincerely,
H. S. NEGI

[For information: There could be no public issues of a loan. If the West Bengal Government are able to privately negotiate with any institution(s) for taking up a further sum of Rs 2 crores of their last loan a fresh issue may be created as in the case of U.P. Govt. It is, however, doubtful if the schemes, especially the development of salt production could be considered as so urgent as to be taken on Govt. Account and whether they will be able to find the balances of nearly Rs 5 crores in the next year or so in addition to the finance they will be requiring for the schemes already approved under the 5-year plan. If approved, we may reply on the above lines.]

G.B. 13/12/1952

CONFIDENTIAL

RESERVE BANK OF INDIA

Camp: CALCUTTA

December 19, 1952

D.O.No.[...]

My dear Negi,

Will you please refer to your D.O. letter No.[...] dated the 12th December 1952 regarding the proposal of the West Bengal Government for raising a further loan of Rs 2 crores for financing their schemes for the development of salt production and for the Calcutta Sewage Gas?

2. In our opinion, the tendency of State Governments to pursue their own paths would run contrary to the idea underlying the appointment of the Planning Commission. The object behind the setting up of the Commission is that all schemes should be approved or formulated by a central authority which should be able to decide upon the relative priorities and the allocation of resources. These objects cannot be achieved if State Governments are allowed to formulate their own schemes and use their influence with banks and insurance companies or other investors to raise the initial finance required for embarking upon these projects. Any funds that the State Governments may be able to raise by bringing pressure to bear upon insurance companies or other investors will necessarily entrench upon the resources available for the schemes approved under the Five Year Plan as the total of investible funds in the hands of institutions and others is limited.

3. It is doubtful if the schemes proposed by the West Bengal Government could be considered so urgent as to be taken upon Government account and whether the Government would be able to find the balance of nearly Rs 5 crores in the next year or so in addition to the finance that they would be requiring for the schemes already approved under the Five Year Plan.

4. One possible way out of the difficulty would be to lay down a requirement that if a State Government desires to embark upon a scheme, it may do so with its own resources, but if it wishes to raise funds from the market, whether by the issue of a public loan or by negotiation with private investors, it must obtain the approval of the Planning Commission for the project. This will ensure that only schemes which are considered desirable in an all-India perspective and in accordance with an approved order of priorities, are embarked upon and that resources are not frittered away in carrying out schemes, which may appear important to an individual State but may not be so having regard to the overall requirements of the economy. This proposal would

still leave the States free to pursue their own projects even though these may not be of sufficient importance to justify the expenditure of scarce resources. It would, however, tend to minimise the danger of uncoordinated planning and overlapping, which is inherent in the present position.

Yours sincerely,
G. BALASUBRAMANIAN

Shri H.S. Negi
Deputy Secretary to the
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

SECRET

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
NEW DELHI
June 30, 1953

D.O.No.[...]

My dear Subramaniam,

Will you kindly refer to para 2 of my D.O. letter No.[...] dated the 29th May, 1953, in which I had mentioned that I shall be writing to you after consulting the Reserve Bank, on certain points raised by you regarding the current year's loan and the State agreement with the Reserve Bank? This has since been done and the position is as follows:

(a) On examination it does not seem to be a practicable proposition for the present Government to raise a loan from the market before the partition on the basis that subscriptions in the respective areas will be spent on works in that area. Under the constitution, the proceeds of any loan raised by the present Government will be credited to the Consolidated Fund of the State and will merge in its balances. Under the proposed legislation for the setting up of the Andhra State the balances of the present State on the date of the partition will be divided in a certain proportion between Madras, Andhra and Mysore. There is no means of securing that the sum raised by the market loan will, in fact, be available in the cash balances of the Government on the date of the partition. This is most unlikely in view of the fact that between now and the 1st October, 1953, the present Government will be in continuous deficit. Even if the amount were so available the proportion in which the cash balance, including this amount, will be divided may not reflect the subscriptions realised in the respective areas. It has also to be remembered that if the subscriptions are so earmarked there will be no money for repaying the maturing loan on the 15th September 1953, the burden of which will fall on the present State. In view of all these complications, I feel that the most prudent course is to float a loan in the ordinary course, without earmarking the proceeds for any specific area and use them for repaying the maturing loan and meeting the current capital requirements thereby reducing the overall ways and means accommodation from the Centre. The Reserve Bank are also of the same view.

(b) The Reserve Bank have to adopt a uniform policy in regard to accommodation given by them to the States and they are reluctant to agree to give ways and means advances in excess of the amount under their agreement without security. If a State Government do not have securities to pledge they will have to arrange for raising money by treasury bills or take loans from the Centre.

I trust that this makes the position clear.

Yours sincerely,
C.D. DESHMUKH

Shri C. Subramaniam
Finance Minister
Government of Madras
Madras

CHIEF MINISTER OF MADRAS

FORT ST. GEORGE
MADRAS
July 20, 1953

D.O.No.[...]

[My dear Rama Rau,]

The enclosed copy of the letter to Deshmukh will speak for itself. Please help.

Yours sincerely,
[C. RAJAGOPALACHARI]

[It seems sad to give back money which subscribers definitely want to give us for our ways and means. C.R.]

Copy of D.O. dated 20th July 1953 from the Chief Minister, the Government of Madras to Shri C.D. Deshmukh, Minister for Finance, Government of India, New Delhi.

1. Our loan was oversubscribed by Saturday to the extent of Rs 125 lakhs. As in last year, I am glad that agriculturists and other non-institutional investors supported us in large numbers. Banks and other institutional subscribers are holding out till the notified closing date. I have called off the drive in the districts of the Residuary State. The Andhra target of Rs 2 crores may be reached in two days and I shall call off the drive in those districts also.
2. Under the terms of the notification, the loan has to be kept open till the 31st of July. Since interest is payable in any case from 15-7-1953, a few institutional investors are holding back to the last notified date. The loan may therefore be very substantially oversubscribed by the closing date.
3. In making allotments, subscriptions of Rs 1 lakh and less have to be accepted in full and this will cover the agriculturists and small investors. Refunds will therefore be mostly to institutional investors. The terms of our loan are favourable and investors are by no means anxious to take refunds. Besides, they will lose interest from the 15th of July on the sums becoming due for refund. This may be an important consideration with many of them and they will be all the more anxious to get acceptance in full. You are well aware of our financial difficulties and the necessity for the two

new States to start with a fair opening cash balance. I hope it will be possible for you to find a way by which we can retain the full subscriptions, even if it may sound a bit unorthodox. The Reserve Bank may even now consult the larger investors, whose number may not be many, whether they would like full allotment or whether they would insist on partial allotment, as per the terms of the notification. Chances are that the large bulk of them may agree to full allotment and it may be possible that legal difficulty can be got over that way. Perhaps the Reserve Bank may be able to suggest an easier way of achieving the same result.

4. When our ways and means position is as difficult as it has been and will continue to be, it appears to me we must find some way of retaining money voluntarily offered by subscribers for this loan if we can at all do it properly and legally.

5. I am sending a copy of this letter to the Governor of the Reserve Bank in the hope that he will find a way out.

CONFIDENTIAL

RESERVE BANK OF INDIA

BOMBAY

D.O.No.[...]

July 21, 1953

My dear Deshmukh,

Rajaji has sent me a copy of his D.O. letter dated July 20, 1953, regarding the Madras loan, which as you know, has been heavily oversubscribed. The figures for Andhra and Residuary Madras last evening were as follows:-

Andhra	..	Rs 163 lakhs (includes Rs 63 lakhs conversion)
Residuary Madras	..	Rs 596 lakhs (includes Rs 74 lakhs conversion)
Total	..	<u>Rs 759 lakhs</u>

2. Under the terms of the loan notification, the Madras Government are entitled to retain Rs 5 crores plus 10%, i.e., Rs 5½ crores. Subscribers of Rs 1 lakh and less have to be given full allotment, while those who have subscribed more than Rs 1 lakh will get partial allotment. Rajaji observes in his covering letter to me that "it seems sad to give back money which subscribers definitely want to give us". There is considerable force in this statement, especially as Madras is badly in need of money. I would, therefore, suggest that persons and institutions who have subscribed more than Rs 1 lakh be given the option of receiving partial or full allotment. I enclose a draft notification, which could be issued by the Madras Government. Our legal officer states that this procedure would be quite legal, and subscribers can have no grievance, since they are given the option of receiving partial allotment.

3. I should be grateful if you would convey your approval on the phone tomorrow morning. West Bengal made a similar request, but we had already issued orders regarding partial allotment. If we allow Madras to keep the surplus, West Bengal will also have to be allowed to do so. I have asked our Calcutta branch not to make any partial allotment until further instructions.

Yours sincerely,

B. RAMA RAU

Shri Chintaman D. Deshmukh
Finance Minister, India
New Delhi

DRAFT NOTIFICATION

It is notified for the information of the subscribers to the 4% Madras Loan 1963 that the said loan has been heavily oversubscribed. Although paragraph 7 of the Madras Government Finance Department Notification [...] dated the 11th July 1953 provides for partial allotment to subscribers in cash for sums of over Rs 1 lakh, Government consider that applicants who desire to have the full amount of their applications should be permitted to do so. Applicants who, however, wish to have the excess amount refunded to them are requested to make an application in writing before the 31st of July 1953 to the office at which the original application was made. In the absence of any such application for refund, full allotment will be made on the assumption that no refund on partial allotment is claimed.

GOVERNMENT OF MADRAS
FORT ST. GEORGE
MADRAS
September 27, 1956

D.O.No.[...]

My dear Ambegaokar,

You will recollect my representation on the phone immediately after the closure of the Madras Loan for the year that we had done intensive canvassing in the districts and this would result in some selling pressure till the securities found their way to more permanent resting places. You must have noticed from your office returns that there were over 25,000 subscribers to this year's Madras Loan. Even granting that investment in Government bonds is becoming popular in the agricultural sector, not all the 25,000 could have been genuine investors. Whatever be the orthodox views on this form of salesmanship, we have to recognise the fact that the method has proved effective for hard-pressed States and will therefore be repeated. It is therefore prudent that we devise correctives to ensure that the bonds do not slump immediately after issue and thereby prevent avoidable loss to fugitive investors. The market quotation of

the Madras and Andhra issues are roundabout Rs 99-4-0 today and this is entirely due to the selling pressure by such of the agriculturists as had merely obliged district officials. I am sure the position will improve in a few months but you can expedite that process by some little concealed buying in the open market in Madras, Coimbatore, Madurai and Bezwada in Andhra. The amount you have to invest to make an impression on the market, may not be more than about Rs 50 lakhs and this is only a fraction of the sum you were willing to invest in case we had not reached our targets. The very fact that there is a buying enquiry in important centres, will immediately stabilise the position and the movement of the bonds from the unwilling investor to the willing one will be smooth and unnoticed. You may even be able to sell these bonds again after a time and make a small profit in the bargain. Perhaps it is not usual for the Reserve Bank to buy up State securities, but when the States do operate in the money market on as large a scale as at present, it is only prudent that the Bank gives them a measure of timely support in this way. We are ourselves buying in the local market to stabilise the price but the funds at our disposal are limited. Besides, we should normally go in for Central Bonds which alone would provide us cover for ways and means advances.

With regards,

Yours sincerely,
T.A. VARGHESE

SECRET

RESERVE BANK OF INDIA
BOMBAY
October 1, 1956

D.O.No.[...]

My dear Varghese,

Will you please refer to your letter D.O.No.[...] dated 27th September 1956 suggesting that the Reserve Bank should make some purchases of your new loan which is quoting at a discount of 8 annas at Rs 99/4/-? I remember that when you spoke to me on the phone about the closing of your loan you had mentioned the possibility of some support being required and pleaded that it should be given. We have been carefully studying the results of this year's State loan flotations and feel that it would be inadvisable for the Reserve Bank to buy any of these loans from the market for the following reasons.

2. What you have said about fugitive investors is not only true of Madras but of most of the States. Further it applies not only to individual investors but also institutional ones including banks. Your estimate that we may have to invest not more than Rs 50 lakhs is bound, therefore, to be considerably exceeded even for the Madras loan. The issues of other States, particularly Andhra, U.P. and Orissa, are also in the same position and they would also expect the same assistance from us so that if we agree in the case of Madras we shall have to be prepared to invest a very large sum indeed in the State loans. The floating stocks of all the State loans on the market are estimated at as high a figure as Rs 15 crores.
3. You have argued that we had agreed to take upto 10 per cent of your issues to enable the subscription list to be closed and that since we did not have to subscribe

anything initially we should now be prepared to use a portion of that money in making purchases from the market. I am afraid, the two situations are very different and not at all comparable. It is one thing for the Reserve Bank to agree to make a contribution for the purpose of insuring against the failure of the loan, particularly as the State Governments wanted to fix as large a target as possible and at the same time did not wish to risk a failure. To undertake to support the loan after it is issued in order that the investors may not suffer a loss is quite a different proposition. Such an undertaking would involve unlimited commitments and cannot be justified. It is not as if a few purchases by us would stop the selling pressure. What we are afraid of is that as the price goes up there will be more sales and if the price comes anywhere near the issue price even other investors like banks, who are holding back at present in order to avoid booking heavy losses, will start unloading. As it is, we seem to have financed a considerable portion of the loan subscriptions through our loans and advances to scheduled banks, which show an increase of Rs 36.7 crores during the three weeks ended September 21, 1956, the period during which the impact of the State loans was reflected in the financial position of the banks. Of this at least Rs 17 crores would seem to have been taken by banks against their purchases of the State loans. If we were now to start buying the loan, what was a temporary accommodation will become a long-term investment by us. You think that we should be able to sell out after a short while at a profit, but we cannot be so sure of this. Our experience of holding the 3½ per cent National Plan Loan of 1964 which was shared by the Central Government with the States shows that it is very difficult for the Reserve Bank to get rid of loans which have been forced on the market. In any case, it does not seem to us right that the Reserve Bank should be expected to take up loans for which it is claimed that they have helped to mop up surplus money from the mofussil. The whole object of the drive to secure the money from the countryside would be defeated if ultimately the loans are to come to rest with the Reserve Bank. In that event far from helping to keep down inflation they would be directly inflationary. It would also serve to conceal the real position and thus encourage the States to issue even larger loans in future without having to face the consequences of such action.

4. There must of course always be an element of fugitive investors, but their place must be taken by genuine investors and not the Reserve Bank. As other States also have adopted the Madras technique, the weight of the State loans on the market appears to have become too heavy to be supported by small purchases by the Reserve Bank. If you say that the Madras Government have to go in for Central bonds which alone provide cover for ways and means advances it is even more true that the Reserve Bank has to hold Central loans as a cover for the note issue. As you know, we cannot expand currency against State Government securities. Actually I find that against the maximum limit for grant of special ways and means advances of Rs 2 crores you already hold Rs 8.57 crores of Government of India securities so that it would seem that you have considerable scope for investing your funds in your loans. There is no reason why you should not invest the sinking fund contributions, prescribed for the loans issued by you from time to time, in your own issues. This is the advice we have recently given to Andhra and U.P. who have now agreed to put a part of their availabilities on this account in their new loans. Besides yourself the institution which

can make long-term investments is the Life Insurance Corporation and I understand that they have been making some purchases in the market. Provident Funds might also prefer the higher yield of State loans to those given by Central loans. I would suggest your canvassing help from these quarters instead of depending on the Reserve Bank to come to your rescue. It is not that we do not wish to help the State Governments, but we feel that purchases by the Reserve Bank will not be the correct course. I hope, therefore, you will appreciate our inability to comply with your request.

Yours sincerely,
K.G. AMBEGAOKAR

SECRET

CHIEF MINISTER
GOVERNMENT OF WEST BENGAL
CALCUTTA
March 20, 1957

D.O.No.[...]

My dear Iengar,

In September last we raised a loan of Rs 7 crores through and with the support of the Reserve Bank. The Finance Minister approved of such support. In November last the Bank advised that in view of great selling pressure in State loans we should place Rs 50 lakhs at the disposal of the Bank to purchase our own loans in the open market. We accordingly placed a sum of Rs 50 lakhs at the disposal of the Bank. In December the Bank again requested us to place a further sum of Rs 50 lakhs at the disposal of the Bank for the same purpose.

You will appreciate that the loan was raised for financing certain definite schemes in the Plan and it was the Planning Commission which insisted on our raising a loan of Rs 7 crores per year during the Plan period. We presumed that before making the estimate of the loans to be raised by this and other State Governments the Planning Commission consulted the Reserve Bank. In any case, if after raising the loan and starting implementing the schemes we have to buy back our own loans to the extent of Rs 150 lakhs in course of a few months, the position becomes really difficult. We are, however, authorising the Reserve Bank to make further purchases to the extent of Rs 50 lakhs as advised by the Bank; but it would not be possible for us to make any further allotment for this purpose. I hope if any further support is necessary this year or in future years, it will be possible for the Reserve Bank to give the support. In fact we are hoping that the Reserve Bank will be able to restore good conditions in the market so that it would be possible for it to sell back securities at good prices.

I am sending a copy of this letter to Sri T.T. Krishnamachari and also to Sri V.T. Krishnamachari.

Yours sincerely,
B.C. Roy

SECRET

RESERVE BANK OF INDIA

BOMBAY

March 29, 1957

D.O.No.[...]

My dear Dr. Roy,

I am writing with reference to your D.O. letter No.[...] dated the 20th instant regarding the West Bengal loan of Rs 7 crores floated last year. As it appears that all the facts are not before you and there is also some misapprehension regarding the role of the Planning Commission in the matter of these loan issues, I am setting out the position of the Bank at some length.

2. I find from the papers that at the time of the flotation of the State loans last year, the Bank had emphasised in its communications, as well as in the discussions which Ambegaokar had with the representatives of the State Governments, that it would not be safe for the State Governments to base their expectation on the amount to be raised from the market on the basis of the experience during the previous year. The Bank had, on more than one occasion, drawn pointed attention to the monetary stringency and the fact that the capacity of the market to absorb the State loans had diminished considerably, as contributions from banks and insurance companies, who had all along been the principal supporters of the State loans, would be smaller than in the past. I would refer in this connection to Rama Rau's D.O. letter No.[...] dated 29th June 1956 and Ambegaokar's D.O. letter No.[...] dated 21st July 1956. In spite, however, of the advice given by the Bank, your Government decided not to make any reduction and adhered to the figure of Rs 7 crores. As was anticipated by the Bank, there was not sufficient response from the market in spite, we understand, of your own personal efforts and even after the Government had subscribed Rs 123 lakhs themselves, the Bank had to put in a tender on its own behalf for Rs 140 lakhs in order to close the loan and save the Government from an embarrassing situation. Although it was made clear in the Bank's letter dated 21st July 1956 that the maximum contribution by it, in the event of shortfall, would be limited to 10% of the subscriptions from the market, which in the case of your loan would have been about Rs 58 lakhs, the amount taken up was more than double this amount.

3. According to information available to us, several State Governments in their anxiety last year to make their issues a success, resorted to pressure on investors, both individual and institutional. It is, of course, perfectly proper to canvass for subscriptions and indeed not to do so would be a negligence. But in some of the States pressure was exercised to a point at which institutions and individuals subscribed to State loans far in excess of their available resources. Soon after, these unwilling holders started selling off; and it was mainly as a result of such sales that there was unusually heavy selling pressure in State loans with the onset of the busy season in October last. This pressure still persists even though large purchases have been made by the Bank on behalf of the State Governments and Administrators' funds. The recent debacle in prices of States loans, which led to a sympathetic fall even in the case of Central loans, was largely due to the fact that the State Governments had fixed their loan targets for 1956 too high and had borrowed amounts far in excess of the capacity of the market. While the Reserve Bank is at all times willing to assist the State Governments in their loan operations, we have always hoped that on their part the

State Governments would heed the advice of the Bank. If the State Governments do not accept the advice of the Bank, it seems only fair that they should be prepared to accept full responsibility for the consequences. Moreover, the assistance which the Bank can render to State Governments can only be for temporary periods and when the Bank buys State loans either out of the new issue or from the market there must be a reasonable prospect of the Bank being able to dispose of the purchases to the market in the near future, else it would amount to the Bank financing capital and development projects of State Governments with created money. This year for instance, such large amounts have been offered for sale that had the Bank purchased them on its own account, it would have been quite impossible for it to unload the purchases for a long time to come. It was, in these circumstances, that we had to advise the State Governments to make available their own funds to support the loans. In the case of your loan, having already taken as much as Rs 1.40 crores at the time of issue which it would not be possible for the Reserve Bank to dispose of for a long time, it would clearly not be desirable for us to lock up further funds in it. On the other hand, repurchase by the State Government would amount to recognition of the fact that you have not been actually able to raise the full amount of Rs 7 crores and it would seem better to adopt this course than to take the risk of depreciation which may create difficulties for future borrowing.

I entirely agree with you that every effort should be made to restore health to the securities market and as you must have noticed, this is exactly what we have been endeavouring to do. The steadiness of the gilt-edged market when the share market has collapsed and there is an acute stringency of money, is a testimony of our efforts. You have referred to the role of the Planning Commission in the matter of the loan issue of Rs 7 crores. It has never been the practice of the Commission to consult the Bank regarding public loans to be raised by State Governments. Indeed, it is not within their province to advise on the amounts which can be raised by State Governments in the market in any particular year. The competent authority in this matter is the Reserve Bank which is in close and intimate touch with the market.

Yours sincerely,
H.V.R. IENGAR

Dr. B.C. Roy
Chief Minister
Government of West Bengal
Calcutta

SECRET

RESERVE BANK OF INDIA
Camp: MADRAS
May 29, 1957

Dear Shri Krishnamachari,

You may remember that, after discussion with you, we wrote to the State Governments advising them not to float any loans in the market this year and adding that if in spite of our advice, they decided to do so, they must be quite clear in their

minds that they would not get any support from the Reserve Bank. In reply to this circular we have received letters from various State Governments to the effect that they do propose to float loans, totalling in all Rs 37 crores, the significant exception being West Bengal which has agreed to keep off the market.

2. I decided to discuss the subject with the Finance Ministers of Madras and of Mysore during my present tour in South India. The Mysore case is rather a special one as they have to repay a loan floated previously. The Madras case is very similar to that of other States in that it has a heavy development programme involving capital expenditure which it would be difficult for them to stop or slow down.

3. I do not like to burden this letter with a detailed exposition of all the arguments which were raised in the course of my discussions. Briefly, I pointed out that the securities market for State Government loans had got demoralised, more particularly because of the tremendous amount of official pressure that had been used last year in certain States, for example Madras, in collecting loan subscriptions. The bulk of the money supposed to have been subscribed by individuals in fact came from the banks; the individuals in many cases lost the money which they advanced from their own resources, usually 5 per cent. On their part, the banks have suffered on account of depreciation of the securities. The Madras 4½% 1968 has now dropped to Rs 96.40 and, even at that price, it is very difficult to sell. There are brokers who have told me that they find it difficult to sell even small amounts of Rs 10,000. I expressed the fear that if the Madras and Mysore Governments wanted to float loans this year, they could not possibly do so at less than 4½%. Even so, a great deal of official pressure would be required and a good part of the loan would rebound on the market and the prices would be depressed. There would be two consequences, both equally serious. If it was known that the State Government was coming on the market—and the market now realised that the State Governments could not do so at less than 4½% — the Central Government loan, if we wanted to issue it at possibly 4%, would become a flop. Secondly, the exercise of a great deal of pressure would result, as happened last year, in demoralisation of the market for State Government securities and that would result in a general aversion to Government paper, which would have serious consequences for the future. I explained that this was really the reason why we had advised the State Governments to keep off the market this year.

4. In both Mysore and Madras this point is appreciated but is met by the counter argument that they must have the money which they have budgeted for either directly through a loan operation conducted by themselves or through a further loan granted by the Central Government. In the case of Mysore, the loan required is about Rs 5 crores and in the case of Madras about Rs 10 crores. The Madras Finance Minister stated that, while small savings here and there may be possible, the schemes included in the Madras Plan were such that it would not be possible to stop them at this stage or slow them down without serious economic consequences. He said he could not possibly contemplate this. He was agreeable to one combined loan for both the Centre and the States being floated by the Central Government and the proceeds distributed on some rational basis. In other words, he was agreeable to the arrangement that we actually used in the year 1954. The Mysore Government put forward the same suggestion on their own.

5. In the course of discussion, we did contemplate the possibility that even a single issue may not result in getting from the market Rs 100 crores which is in the Central Budget *plus* Rs 57 crores which, I understand, is the figure of loan requirements of all the State Governments. In that event, the Plan may have to be cut down; but as that would be very difficult and contrary to the express intentions of the Government of India, the consequence would be that deficit financing would have to be increased in magnitude. That is likely to have serious inflationary consequences. The Madras Finance Minister told me quite frankly that as between facing a general disruption of the economy by increased deficit financing and getting a State loan through the use of pressure by the entire apparatus of the State Government, he would much rather prefer the latter. At worst, he said, this would have the same effect as a tax by the State Government. It might make the State Government unpopular but he would much rather have this than a general upward swing of inflationary forces in the country which might be the result of increased deficit financing.

6. These points obviously require further consideration. I think it would be very difficult to take the line that we advise the State Governments to keep off but if they do insist on coming into the market we wash our hands off them and they take the consequences. The trouble is that there will be serious consequences for the Central Government themselves because their own loan operations would be affected by the knowledge in the market that State Governments are also going to float loans. Moreover, as the local Finance Secretary, Varghese, pointed out to me, the Central Government cannot really wash their hands off this matter. If it comes to the worst, the State Governments will raid currency chests as has happened before and as is happening at present. We have now reached the situation in which the States and the Centre must take concerted action in the matter of raising loan resources.

7. After turning this matter over in my mind, I have come to the conclusion that the whole matter requires a little further consideration. I think it would be best if you could hold a conference with a few selected Finance Ministers and the Reserve Bank so that the matter could be thrashed out further. Apparently the National Development Council is not the right forum for this purpose, for few of the Chief Ministers who would be present, are also Finance Ministers of their States.

8. I am myself greatly concerned that the loan operations of the Central Government this year should be a success in the sense that we get all the money that we have planned for at as reduced rates as possible. I am also concerned that the demoralisation that has set in the securities market in the sense both of a depreciation of securities values as well as the difficulty of selling even small lots should be set right. On the other hand, the State Governments are oppressed by the problem that they must get on with the Plan and must find the resources for it, without adding to the inflationary pressure in the economy. I commend to you the proposal that a conference on the lines suggested above be held at the earliest possible opportunity. It could be held in Delhi; but if you would prefer to hold it in Bombay, I would, of course, be delighted to give all the required facilities in the Reserve Bank.

Yours sincerely,
H.V.R. IENGAR

BOMBAY

February 9, 1959

D.O.No.[...]

My dear Shri Reddi,

Will you please refer to the correspondence resting with my D.O. letter No.[...] dated 16th July 1958? A recent analysis of subscriptions to the State Government loans issued in 1958 prepared by our Department of Research and Statistics has revealed that among all the State Loans, the Andhra Loan alone had a disproportionately high contribution by individuals and the percentage of subscriptions from non-institutional investors in its case was as high as 45% followed by 16% for the Uttar Pradesh Loan, 15% for Rajasthan and much lower for other States. Though on the face of it, it may seem gratifying that there should have been such an outstanding response in Andhra by individuals, the information obtained by one of our senior officials who visited the districts indicates that severe official pressure was used in collecting subscriptions to the Andhra Loan in spite of the instructions issued by you to the Collectors as a result of my D.O. letter No.[...] 11th July 1958. It appears that each district was allotted a set target and the Revenue, Registration and Sales Tax officials who were called upon to complete the allotted quotas passed on the burden in turn to the lower officers of the Departments and considerable pressure was brought to bear on individuals to subscribe to the loan. In certain cases, the individuals who were not inclined to, or could not take, the allotted amount, were given the alternative of paying 10% of the amount without any return whatsoever. The amount so collected was used to induce well-to-do persons to purchase these bonds at a special discount of 10%. Certain revenue officials put pressure on tax-payers to purchase bonds equivalent to the land revenue or to pay 10% of it gratis. We need hardly reiterate that such pressure tactics would seriously affect the future borrowing operations of the State Government and would thus be self-defeating. What is, however, even more disquieting is that the same technique is being followed for the sale of National Plan Savings Certificates and you may be interested to read the following extract from a note recorded by one of our officers:

“Some of the capitalists who purchased the certificates paying only Rs 90/- for the certificates of face value of Rs 100/- wanted to cash them forgoing interest for the year but the petty officials are raising objections, being afraid of the reactions of their superiors on the large-scale repayments. Here the reputation of the Government is involved. Further the public specially those who are paying 10% gratis are exasperated at these demands year after year.”

It is also reported that in some villages the collection of land revenue is at a standstill as the parties refuse to pay the extra 10% and the officials refuse to take land revenue unless National Savings Certificates of an equal amount are purchased or the 10% fee is paid. If your district officials are adopting these methods, they would make the National Savings Certificates extremely unpopular among the masses and nullify the constructive efforts that are being made by the various official and non-official bodies to increase the sales of Small Savings Certificates in order to reach the higher targets aimed at for raising resources for the Plan from this sector.

I have taken the liberty of bringing these reports to your notice, as we have no doubt that your Government will feel equally concerned about ensuring that misplaced

zeal and misdirected efforts should not jeopardise the success of loan flotations and collection from Small Savings and would want to take precautionary measures against such methods.

Yours sincerely,
K.G. AMBEGAOKAR

Shri K. Brahmananda Reddi
Finance Minister
Andhra Pradesh
Hyderabad (Dn.)

No.[...] of date.

Copy forwarded for information to Shri H.S. Negi, Government of India, Ministry of Finance, Department of Economic Affairs, New Delhi.

CONFIDENTIAL

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
July 31, 1959

D.O.No.[...]

My dear Rangachari,

Mehta tells me that he had a telephone call from Shiv Naubh Singh regarding the publication of the details about the State loans in the "City Notes" column of the *Times of India* of the 28th instant, i.e. a day before the official announcement was made. I myself was surprised at this scoop and after the loans were publicly announced I made enquiries from one or two brokers as to how the *Times* could have obtained the information earlier. Their view was that the Press correspondents have a way of ferreting out such information and may have got at one of the several State Governments. I have no doubt that the information did not leak out from the Reserve Bank.

I have also made an attempt to get the truth out of the horse's mouth by sending for Hariharan, the Financial Editor of the *Times*. He would naturally not disclose the source of his information, but said that he had actually all the details much earlier and had purposely misquoted some of the States' figures to create the impression that he did not really have the exact information. According to him the various States had started canvassing long before the announcement by sending for the local Agents of banks who had sent on the particulars to their head offices. It was not, therefore, difficult to get the details of all the loans from one of these institutions. Some States had also sent instructions to their Collectors which also got known. His point was that newspapers were naturally anxious to publish such information for its news value as early as possible and he had in fact waited till a day before the formal official publication. He was quite unrepentant and even made the point that it was good for the States to get this kind of publicity for their loans.

As you know, we have to deal with several States and in order to enable them to decide the various issues put to them we have to give them particulars of the proposals of not only their own loan but also those of others. Under these circumstances it seems almost an impossible task to secure the same degree of secrecy for the State loans as we are able to achieve in the case of Central loan. At the most, we can make a further effort to secure the cooperation of the State Governments by pointing out to them that since we now allow three weeks between the date of announcement and the opening of subscription lists, this period is sufficient for them to do the canvassing and that they should, therefore, refrain from starting negotiations with banks and others for subscribing to their loans until the announcement is made. I doubt, however, whether this would have any effect. When I made this appeal recently to Dr. B.C. Roy in Calcutta, his reply was that in a previous year when he had waited in this manner, he found when he approached the banks that they had already made commitments to other State Governments, who had got at them earlier. Unless there is a gentleman's agreement in this matter among all the States, it will be difficult to ensure secrecy. I am also inclined to think that since there is no speculation in the case of State loan issues little harm is done by premature leakage since nobody can make any big profits on the basis of this information. We on our part would, of course, continue to take all possible precautions.

Yours sincerely,
K. G. AMBEGAOKAR

Shri M.V. Rangachari
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

B. FUNDING OF AD HOCs

SECRET

RESERVE BANK OF INDIA
BOMBAY

D.O.No.[...]

March 18, 1958

My dear Rangachari,

As we explained to you personally, the creation of ad hoc Treasury Bills in large quantities for the purpose of replenishing the Central Government balance is creating some difficulties for us, especially in regard to their accounting. Hitherto, it has been our practice to show all ad hocs under the head "Government of India Rupee Securities" in the Issue Department Statement and to issue notes thereagainst, if currency was required to replenish our cash balance; while if no expansion was necessary, dated Government of India securities of an equivalent value held in the Issue Department were transferred to the Banking Department under the head "Investments", in order to equalise the assets of the Issue Department with the total note liability. Recently, however, due to the fact that Government balance was required to be replenished on a much higher scale than the demand for additional currency, we had to have recourse

largely to the second alternative of transferring dated securities from the Issue to the Banking Department, with the result that the balance of such securities in the former Department has been greatly depleted. Any further ad hocs created will, therefore, have to be taken directly in the Banking Department or set off against a corresponding transfer of Sterling securities to the Banking Department. The question of showing such ad hocs in the Banking Department was, on a previous occasion, discussed with our Auditors who considered that, since there was a separate head, viz., "Treasury Bills Purchased and Discounted Account" in the Banking Department Statement, such bills should appropriately be taken under that head. They, however, at the same time expressed a doubt whether it could be done so in view of the fact that, although the ad hocs were theoretically to be repaid in three months, it was very likely that they would be renewed from time to time and thus represented some sort of long-term investments, which should more properly find a place under the head "Investments". The position, in their opinion, was, therefore, anomalous. As for Sterling securities, there was hitherto the restriction that interest on Sterling securities held in the Banking Department was not exempt from British income-tax and, although this limitation is now proposed to be removed according to a recent communication received from the Bank of England, it does not seem proper that a disproportionately large amount of Sterling should be held on the Banking side leaving almost the entire note issue to be shown against ad hocs except, of course, to the minimum extent represented by other forms of assets as laid down by the Act. It has, therefore, become necessary that a portion of the ad hocs should be converted into securities so that the Bank may be able to make their transfers from Issue to Banking Department without any difficulty and without infringing the provisions either of our Act or General Regulations.

2. We were at one time inclined to suggest to Government that the funding should be made into existing loans of various maturities; but on reconsideration we felt that additions to dated loans would not only make repayments in the respective years difficult, but would also have psychologically a depressing effect on gilt-edged prices. We also considered the alternative of issuing a special long-term loan with a specific date of maturity carrying the same rate of interest as obtainable on the Treasury Bills, but this proposal was also found not feasible for the reason that such a loan would not obviously be quoted on the market, a condition which will make the security ineligible for being held in the Issue Department [vide Section 33(4) of the Reserve Bank of India Act]. The obvious course open would, therefore, appear to be to create a further tranche of an existing loan quoted on the market but not repayable on any stated date of maturity.

3. We now hold about Rs 875 crores of ad hoc created for replenishing Government balance and it would seem sufficient if we converted for the present about one-third of this amount, viz., Rs 300 crores into the 3 per cent non-terminable loan 1986-97. The issue price may be at Rs 71 per cent which is almost the same as the current market rate of this security. This will, of course, result in the Bank getting a higher return on the funded portion of the Treasury Bills as compared to that on the unfunded balance, but in our opinion, this is a minor point, since any increase in the Bank's profits resulting from this or any other cause would automatically accrue to Government. We have also to take into account the fact that the Bank has lost a

good deal of its income in the shape of higher yield on British Treasury Bills as a result of heavy depletion of its Sterling balances. In order that the creation and issue to the Bank of a large block of non-terminable paper may not have any untoward effect on the market, we should simultaneously with the funding operation make it known by means of a Press Note that the issue has been made purely to meet a special purpose and that an undertaking has been obtained from the Reserve Bank that no portion of it will be put on the market at any time. If this is done, there is no reason to fear that the funding of the ad hocs into an existing loan would have any harmful effect on security prices in general. On the other hand, the conversion of a part of the ad hocs held by the Reserve Bank, which are 3 months Treasury Bills, into a long-term loan will be a recognition of the realities of the situation, since it represents in fact a permanent debt of the Government which would not be repaid ordinarily.

4. The balance of dated securities held in the Issue Department now amounts to Rs 5 crores and we shall be glad if Government will take the necessary action as early as possible.

Yours sincerely,
K. G. AMBEGAOKAR

SECRET
SPECIAL SECRETARY

MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]

March 27, 1958

My dear Ambegaokar,

Will you kindly refer to your secret D.O. letter No.[...] dated the 18th instant about the replacement of a part of the ad hocs by the issue of a further tranche of the 3% non-terminable loan 1986-97? Ever since you mentioned this proposal when you were here for the last meeting of the Central Board I have been thinking over the consequences of implementing it and I think that the matter requires some further consideration. If we replace Rs 300 crores of ad hocs with you by the 3% loan 1986-97 at Rs 71 we shall have to create securities of the nominal value of Rs 422 crores and keep the difference in our books as a discount on this issue. Ordinarily, as you know, such a discount has to be written back to revenue over a period and I do not know if it will be possible to hold it unredeemed indefinitely in the debt section. In any case the creation of a block of Rs 422 crores will exaggerate the public debt. It will also involve an addition of Rs 5½ crores to the interest bill (the difference between 2½% on Rs 300 crores and 3% on Rs 422 crores) and while it is true that the bulk of it will come back to Government as surplus profits, I do not think that one can always bank on this, particularly if, as in the last few years the practice of agreeing the amount of surplus profits paid to Government from time to time in informal consultation between Government and the Bank continues. In view of all this I am wondering whether the idea with which both of us initially approached this problem, namely, the creation of a special issue at the rate of interest now paid on the ad hocs is not the really feasible one even if it involves some amendment to the Act. I feel we

should talk this over once again before we make up our minds. I am planning to be there on the 7th April in connection with the Committee on interest rates, if the date is convenient to you and Madan. L.K. is going off to Europe and will not be available but I think we could cover some ground in his absence and conclude the discussions on his return in May. Unless I hear to the contrary from you I shall assume that the date is suitable.

Yours sincerely,
M. V. RANGACHARI

C. OVERDRAFTS OF STATE GOVERNMENTS

I would like to see the papers regarding the "raiding" of the currency chests by the Madras Government and (more recently) by the Andhra Government. Are there any other sinners?

H.V.R. IENGAR
13/3

D. G. (A) K. G. Ambegaokar

Secy.

Please see note below.

As desired by the Governor, letters addressed by the Bank to the *Madras Government* and the Government of India in connection with the overdrafts of the Madras Government have been flagged[...]. Replies received from the State Government and important notings have also been put up. The account of the Madras Government was overdrawn from April 1951 to July 1953 except for brief periods when they were able to maintain a credit balance, very often as a result of purchases of securities made by us or by the Central Government, financial assistance granted by the Central Government or the proceeds of open market loans. The maximum overdraft was Rs 22.10 crores, with outstanding ways and means advances of Rs 80 lakhs, as on 21st March 1953. In recent years, the Madras Government have been maintaining a fairly satisfactory cash balance with us.

2. The *Andhra Pradesh Government* have been running an overdraft with us off and on since January 1955 and the highest debit balance was *debit* Rs 4.52 crores with normal ways and means advances of Rs 60 lakhs and special advances against Government of India securities for Rs 2 crores as on 18th January 1957. Their latest available balance (as on 15th inst.) is *debit* Rs 2.04 crores with ways and means advances of Rs 260 lakhs. We had called upon the State Government to repay in full the overdraft, as well as the ways and means advances, before the end of February 1957 in view of the provisions contained in the Agreement between the State Government and the Bank which requires a State Government to clear the ways and means advances not later than three months from the date of the initial advances in the series of outstanding advances. The Andhra Pradesh Government have not,

however, been able to square up their account. We have written to them on the 13th instant conveying Government of India's offer to take over Government of India securities out of the State Government's holdings to enable them to repay the borrowings from us and to maintain a reasonable working balance to meet normal disbursements.

3. The *Government of Orissa* have been defaulting in the maintenance of the balance since April 1956, their account being overdrawn on several occasions and for fairly long periods. The maximum overdraft was on the 18th May 1956 when their balance was *debit* Rs 2.28 crores with ways and means advances of Rs 99 lakhs inclusive of special advances for Rs 79 lakhs being maximum advance that could be made to them against their holdings of Government of India securities. Their balance on the 15th instant was *debit* Rs 1.35 crores with outstanding advances of Rs 98 lakhs. In terms of the Agreement with the Bank, the Orissa Government should have repaid the outstanding advances in full before the 28th February 1957. We had asked the State Government to repay their debt to us before that date and had also requested the Government of India to grant sufficient financial assistance to enable the Orissa Government to do so. The Orissa Government have failed to clear the overdraft and the advances and the Central Government have not so far advised us as to whether they propose to make any advances to the State Government.

4. The other State which has overdrawn its account very often during recent times is the *Government of Bihar*. They had to repay ways and means advances for Rs 240 lakhs before the 15th February 1957. It has not been possible for them to liquidate the advances and their balance has, in fact, become *minus* since 18th instant (*Debit* Rs 11 lakhs with ways and means advances of Rs 210 lakhs). We have sent a telegram on the 20th instant asking them to replenish their account urgently.

5. Governor may like to see in this connection the circular letter which was addressed by the Government of India to all States in February 1956 on the subject of overdrafts with the Reserve Bank [...] and the procedure which will be followed if a decision is taken by the Bank (with the prior concurrence of the Central Government) to stop payments of the State Governments [...]. The note at [...] of the same file describes the manner in which the Madras Government had overdrawn their account during 1951-1953.

M. K. VIJAYAKAR

22/3/57

I would like to be kept in touch, from time to time, with the major developments of this case.

I expect that D.G.(V) has seen these papers some time or other. In any case I would like him to see them again and then discuss one aspect with me. I had hitherto been under the impression that these "raids" on the currency chests were facilitated by the fact that many of them are under the control of the State Government Officers. I see now that that is not primarily the point. The "raids" take place because State Governments live beyond their known means, even after taking account of the ways and means advances made by the Bank and *exploiting the natural*

reluctance of the Bank to dishonour State cheques. I see this stated explicitly in one of the notes on Madras.

The point I would like to discuss with D.G.(V) is whether we have not in our discussions on State-associated banks and on the necessity of taking them over as subsidiaries of the State Bank of India, made excessive use of the argument that such taking over is essential in order to prevent the misuse of currency chests.

H.V.R. IENGAR
28/3

D.G.(A)

I think the point we had in mind was slightly different from this kind of "raiding" that has so far taken place; we presumably want to avoid giving possession of currency chests which contain unused money, which might be put into circulation without our knowledge.

D.G.(V)

I have had a brief talk about this with the Governor and, insofar as State Governments on the one hand and State-associated banks on the other come into the picture, mentioned the following points. I should like D.B.D. to elaborate a little some of these points (e.g. by mentioning facts and figures or citing reasons given or views expressed by previous committees) for submission to the Governor:

1. There are sound reasons for banks, rather than treasury offices, managing the operations of currency chests. The more important of these grounds are connected, not with apprehensions concerning "misuse" by the State Government through its treasury staff, but with the ability of the custodian *bank*—as distinguished from the custodian *treasury office*—to offer larger remittance and allied facilities to other banks and to the general public, as also to Government itself, through the custody and operation of the currency chest.

2. Not all banks can be chosen as custodians of currency chests (which, incidentally, together hold an enormous volume of cash). There is ground for maintaining that, barring the State Bank, there is hardly any satisfactory agent bank available. Even the one or two State-associated banks so appointed have been required to obtain a guarantee from the State Government; further they have had to be brought under some form of control with which the Central Government and the Reserve Bank are associated. Even so, it has been thought proper that they should only be cautiously and gradually entrusted with currency chests. In many areas there is no "agent bank" at all. This has retarded what in many ways is an essential reform. Hence, for a very positive reason, the need to take over State-associated banks as subsidiaries of the State Bank. There is also (as mentioned above) a similar positive reason for transferring currency chests from treasury offices to "agent" banks, whether there be the State Bank or re-constituted State-associated banks.

3. The negative considerations connected with possible misuse by State Governments of their custody of currency chests can be seen in their proper perspective only if recognised as supplementing the positive grounds mentioned above. Apart from that, the relevant points here seem to be briefly these:

- (a) Vis-a-vis State Governments, the currency chest system is in effect a form of decentralisation which permits practically unlimited *local* overdrafts, in cash, subject to the limits of the overall account with the Reserve Bank. The danger arises when the local overdrafts persistently add up to more than is permissible under the overall arrangement.
 - (b) The local overdrafts can legitimately occur whether the custodian is a bank or a treasury office.
 - (c) The distinction *may* turn out to be of real importance if and when the Reserve Bank, with the Central Government's sanction behind it, chooses to instruct the custodian that no overdraft at all, or no overdraft beyond a specific limit, shall be given to a particular State Government from one or more currency chests or from any currency chest. An agent bank will find it easier to carry out such instructions than a State official who is subordinate to the State Government. (The real difficulty, however, will of course lie in taking the decision to deny an overdraft i.e. in the Central Government deciding beforehand to issue instructions for the contingent dishonouring of a pay order emanating from a State Government).
 - (d) Lastly, and perhaps only theoretically, there is the remote possibility of a State Government not merely "overdrawing" in a persistent fashion, but also ignoring all canons and rules in the use it makes of the currency chest. Entrustment of all chests to an agent bank, as distinguished from a treasury office, would of course be a complete safeguard against such a contingency.
4. It may be repeated that, so far as the proposal to reconstitute State-associated banks as subsidiaries of the State Bank is concerned, the considerations which have weighed are those set out in para 2 above rather than those mentioned in para 3.

B. VENKATAPPIAH
29-3-1957

O.S.D., D.B.D.

This has been discussed in the past with Governor. His note on [...] and mine on [...] may be seen. The further noting elaborates some of the points.

B. VENKATAPPIAH
31/7

Governor

No further action on these papers.

H.V.R. JENGAR
5/8

I am attending the Finance Ministers' Conference in Delhi on the 18th of this month. The Finance Minister has asked me to utilise the opportunity to speak to the Ministers on the undesirability of their raiding the currency chests.

I shall be glad if a self-contained note is prepared for my use before I leave for the Conference. The note should be historical beginning with the trouble we had with the Madras Government when C.R. was the Chief Minister. I remember to have read various letters of the Madras Government at that time to the effect that they had no option but to raid the currency chests because they had to incur development expenditure. This, of course, completely gives the case away and useful extracts from those letters may be included in the note.

H.V.R. IENGAR
11/11/1957

D.G.(A) Notes have already been prepared on the subject. This was dealt with by DCA(W) but he is away. C.A. should get a consolidated note prepared.

KGA
11/11/1957

C.A. As instructed, a note is placed below.

14/11

D.G.(A) Please see the separate note which I have placed below.

KGA
15/11

Governor

Thank you. I have detached the notes for taking to Delhi.

HVR
15/11

OVERDRAFTS OF STATE GOVERNMENTS

Section 17(5) of the Reserve Bank of India Act authorises the Bank to make to States Governments "advances repayable in each case not later than three months from the date of the making of the advance". This provision in the Act for advances to States Governments has been embodied in the Agreement (Clause 6) the Bank has entered into with States Governments and is reproduced below:

- "6. The Bank shall make ways and means advances to the Government if so required at such rate of interest not exceeding bank rate as may be fixed by the Bank from time to time, provided that the total

of such advances outstanding at any one time shall not exceed twice the amount of the minimum balance prescribed under Clause 5 and any subsidiary agreement provided under the Clause and provided further that the advances outstanding shall be fully paid off at intervals not exceeding three months, from the date of the initial advance."

As will be seen, the Clause provides for grant of ways and means advances by the Bank to States Governments upto twice the amount of the minimum balance prescribed for the concerned State Government. The accommodation made available by the Reserve Bank to State Governments in terms of section 17(5) of the Reserve Bank of India Act, read with clause 6 of the Agreement, is intended to be of a short-term nature, the advances granted being for meeting temporary deficits on revenue account.

In connection with a reference made in 1942 by the Secretary of the State regarding the renewal of ways and means advances granted to the Government of Burma for a period beyond three months, the Legislative Department of the Government of India had examined the legal position and had expressed the view that "all what section 17(5) requires is that at the time of the making of the advance, there should be no stipulation for its repayment after more than three months". There was in their opinion no objection to such advances being renewed by the Bank on the expiry of the three months period. Although from a strictly legal point of view the opinion of the Legislative Department is correct, the view taken by the Bank has been that it will not permit such renewals and the State Governments must repay the advances in full within three months. The original sub-clause (5) of Section 17 of the Reserve Bank of India Bill, 1933, read as follows:

"the making of advances to the Governor General in Council repayable in each case not later than three months after the close of the financial year in respect of which the advance has been made."

The Joint Select Committee had made the following observations on the above Clause:

"We consider that the provision in its original form might lead to undue latitude. In an extreme case it would be permissible for Government to borrow in this way for a period of fifteen months. We consider that such advances should normally, as soon as possible be converted into treasury bills which should be offered on the open market even though the Reserve Bank may take them up. We have therefore limited the period to three months. We have enlarged the scope of this clause so as to include advances to such Local Governments as may have the custody and management of their own provincial revenues."

The above views of the Joint Select Committee have been taken by the Bank as a clear directive as to the policy to be followed and we have been insisting upon all States Governments to clear off the ways and means advances after three months as expressly provided in clause 6 of the Agreement.

The minimum balances for the former Provinces were fixed in 1937 on the basis of distribution amongst the Central and Provincial Governments of the aggregate minimum balance prescribed for the pre-Provincial autonomy Central Government,

the balance for each Provincial Government being determined on the basis of the ratio the revenue of that Government bore to the total revenue and expenditure of the Government of India. When we took over subsequently the banking functions on behalf of Part 'B' States, the minimum balances were determined having regard to the minimum balances which were applicable in the case of Part 'A' States with comparable figures of revenue and expenditure. These minimum balances are intended to compensate the Bank for the out-of-pocket expenses incurred in connection with Government work. In October 1952, we wrote to the States Governments and pointed out that the minimum balances which had been fixed as early as 1937 were no longer appropriate and there was a case for an upward revision of the balances on the basis of the considerable increase in the turnover of Government transactions at the Reserve Bank and its agencies and the rise in the figures of their revenue and expenditure. The revised balances were made operative early in 1953. The minimum balance prescribed for an individual State also represented the extent upto which that State Government would be entitled to avail itself of ways and means advances from the Bank. With the increase in the minimum balance, we also agreed to grant to State Governments financial accommodation on a more liberal scale and the limit for advances was fixed at twice the amount of the minimum balance. A provision was also made for the grant of advances against cover of Government of India securities at the discretion of the Bank upto a uniform figure of Rs 2 crores, over and above the normal ways and means advances which were granted on a 'clean basis'. Whereas the interest charged on the normal ways and means advances has, except for a short period from 1st October '39 to 31st March '40, been one per cent below the Bank rate, the rate for such advances against Government of India securities varies according to the quantum of accommodation as under:

- 1) For advances upto Rs 50 lakhs (in excess of normal ways and means advances) — $\frac{3}{4}\%$ below the Bank rate.
- 2) For advances upto Rs 125 lakhs (in excess of normal ways and means advances) — $\frac{1}{2}\%$ below the Bank rate.
- 3) For advances over Rs 125 lakhs (in excess of normal ways and means advances) — Bank rate.

It may be mentioned here that in Clause 6 of the Agreement, the Bank has agreed to make advances to States Governments at rates of interest fixed from time to time but not exceeding the Bank rate. Although we had in the past refused requests from States Governments for accommodation in excess of Rs 2 crores, against Government of India securities, we have relaxed the limit recently at the instance of the Union Finance Minister. In the case of the Government of Andhra Pradesh, for instance, we have sanctioned special advances upto Rs 9.90 crores. The limit for Bihar is Rs $3\frac{1}{2}$ crores while that for Governments of Kerala, Madhya Pradesh and Madras is Rs 3 crores each.

Till 1948, the States Governments had been able to repay the outstanding ways and means advances within three months as provided in the Agreement, but thereafter there have been several instances where the States Governments were unable to repay the advances in time in spite of our having called upon them to do so. At present also

there are as many as 5 States against whom advances are outstanding for periods exceeding three months.

Overdrafts by States Governments have become more common and frequent since October 1950 and while in the beginning the main offenders in this respect were the Governments of Madras, Bihar and Orissa, a number of other States (Andhra, Madhya Pradesh and Kerala) are now running large overdrafts with us. During the period April '51 to July '53, the account of the Government of Madras was overdrawn almost continuously, the overdrafts being of a substantial order. For instance, the balance of the Government of Madras on the 21st March '53 was debit Rs 22.10 crores with ways and means advances of Rs 80 lakhs. To the innumerable communications sent by us on the subject of their chronic indebtedness to us, the usual reply given by the Madras Government was that the overdrafts were due to the large expenditure which was being incurred by them on development and irrigation projects which had been approved by the Planning Commission. It was further pointed out that the schemes had reached an advanced stage and if they were to be slowed down or abandoned altogether the considerable amounts which had already been spent on them would be wasted. (Extracts from some replies received by the Bank are reproduced [not printed]). The Government of Orissa have also adduced the same explanation for their present unsatisfactory ways and means position and a copy of their recent communication is also attached (Enclosure II [not printed]). There is no provision in the Reserve Bank of India Act for allowing such overdrafts but we have no alternative than to acquiesce in them. Under the present procedure, State Governments can draw upon us, the State Bank of India branches and treasuries, etc. without any limit and we or our agents cannot dishonour the cheques drawn by the States Governments. The receipts and payments made on account of the State Governments at our offices, the branches of the State Bank and other agency banks and the treasuries and sub-treasuries are adjusted at our Central Accounts Section, Calcutta who maintain the principal accounts for the various States and arrive at the day-to-day balance of individual States after taking into account all the advices received by them. An overdraft occurs if the total payments made on behalf of a State Government on any day are more than the receipts and the balance in their account. It is not possible for any of our offices or the agencies to know if a particular payment being made by them will result in an overdraft; this will be known only after the balance is struck at our Central Accounts Section, Calcutta. The balance of a State Government may also become overdrawn as a result of inter-Government debits. As has been pointed out by D.G.(A) in his note dated 13th July 1955, the relevant extract from which is appended, the overdrafts are due mainly to payments at the State Bank of India and Reserve Bank offices and not so much to drawings from the treasuries. It is not that the States are consciously or wilfully utilising the balances in currency chests but rather that the States are spending more than their resources. As compared to the Government disbursements at the branches of the State Bank of India (or the agency banks), withdrawals at currency chests for Government disbursements in the treasuries and sub-treasuries are insignificant. Some time ago, figures had been collected about the debits to the account of the Madras Government during the nine months ended 30th September 1952 and it was found that the net debits for Rs 12.32 crores

were due to payments at State Bank of India branches for Rs 25.69 crores and debits for Rs 9.29 crores representing inter-Government adjustments.

Extracts from D.G.(A)'s note dated 13th July 1955:

“Governor wanted to know how exactly the Madras Government had overdrawn large amounts during 1951–1953. As the above notes will show, the reasons for the excess spending were

- (i) capital expenditure on irrigation works which had reached an advanced stage and could not, therefore, be prevented;
- (ii) large expenditure for famine relief, and
- (iii) big amounts locked up in food grains.

The *mechanism* by which the Madras Government obtained the money was by getting the payments made through their accounts in the usual course. *It will be seen that the excess debits were mainly at the Imperial Bank of India branches so that it cannot be said that the Madras Government misused the currency chests under its own Treasury Officers.* Actually, the procedure followed by the Government was perfectly legal and it was not as if they had helped themselves to the monies kept in their custody in the form of currency chests. At the Imperial Bank of India offices the Agents of the Bank are not, at any given moment, in a position to make out whether there has been an excess of drawings by the Government. For the purpose of drawing cash from the currency chests the Agents take into account their total requirements which include

- (i) the payments to be made on account of the State Government;
- (ii) the requirements for the Bank's own purposes, and
- (iii) amounts required for remittance on account of the public.

It will be clear from this that the mere restriction of operations on currency chests at Treasuries other than those at District headquarters will not help to stop overdrawals by State Governments. The only effective way by which the State Governments can be made to restrict their expenditure within their own resources is to have limits prescribed at each Treasury. Since the resources available to the State will depend not merely on the rate of its expenditure, but the realisation of its estimates in regard to revenue, it will be necessary to evolve an elaborate procedure in order to make sure that the functioning of the Government is not brought to a standstill by any mechanical application of the limits. This is the problem on which the Finance Ministry and the Comptroller & Auditor General are engaged at present and until the separation of audit and accounts is effected it will not be possible to introduce any new procedure.

As regards the apprehensions felt by the Finance Minister about the misuse of currency chests by State Governments, Shri Rangachari pointed out that except for the Madras experience in 1951/53 there has been no instance of State Governments resorting to excessive deficits and even in the case of Madras the position was well known to the Government of India, who could not at that time, in view of the political circumstances, order the Madras Government to stop the development projects....

Recently and more particularly after the reorganisation of States in November 1956, the number of States which overdraw their accounts with us has increased and as on the 11th November 1957, 7 out of 13 States were in debit, the total overdraft being a little over Rs 22 crores. These Governments have been running overdrafts in spite of our having granted them normal ways and means advances (i.e. on a clean

basis) to the maximum extent permissible in their cases and special advances (against Government of India securities) for Rs 23.31 crores.

FINANCE MINISTER
INDIA
NEW DELHI
June 3, 1957

D.O.No.[...]

My dear Iengar,

Thanks for your letter of the 29th May in regard to State loans particularly as it pertains to Madras and Mysore. The matter will come up today in the National Development Council meeting.

I have spoken to Subramaniam about this and told him that Varghese was not a very reliable guide in this matter but that if he wants to insist upon floating a loan of Rs 5 crores, it should be for ten years bearing 4¼% interest, though the issue price might be Rs 98, and that in no case would I permit a loan to be floated bearing 4½% interest by the States.

I think some time you must explain this matter as also the question of State overdrafts to the Cabinet. I am going to ask the Prime Minister if he would like you to come and meet the Cabinet at one of its informal meetings and tell them about it.

With kind regards,

Yours sincerely,
T.T. KRISHNAMACHARI

[15-11-1957]

On reading over again my note of 13th July 1955 which has been quoted in the office note, I feel that the essential point has perhaps not been clearly brought out in it. I would, therefore, like to restate the position as I understand it.

There is no doubt that the prevailing impression that the States manage to run up their overdraft against the Reserve Bank by raiding the currency chests in charge of their Treasurers is not correct. It is true that they can make use of the currency chests under their charge for the purpose of incurring their expenditure and pass on the debit to the Reserve Bank, but in actual practice the large overdrafts that occur are mainly due to cheques issued by them on the offices of the Reserve Bank and the State Bank. To the extent that these cheques are met by us or by withdrawing money from the currency chests in charge of the State Bank Agents, it is we who help them to get the money. Thus it is quite clear that what is essential is to stop the power of the State Governments to get money whether from us, the State Bank or the non-banking currency chests.

This does not mean that a State Government which has decided to defy the authority of the Central Government may not appropriate to itself all the money—and these amounts are very large—lying in the currency chests under their control. This, however, is a remote contingency and if and when it occurs it would mean almost a state of war. In such an eventuality even the treasury under the control of the Reserve

Bank or the State Bank will not be safe. Before, however, such a serious situation develops, the Central Government may be expected to take military or other measures that may be necessary. All the same it may also be conceded that currency chests which are not directly in charge of the State Government officers might be safer. The effort to establish more branches of the State Bank which would take over the currency chests in the area, which is being made for the purpose of improving banking facilities, will automatically help in this direction though, as pointed out in the previous notes, it will take a long time before all the chests are taken over in this manner.

I was at one time under the impression that the overdrafts by the State Governments occur because of the way in which the Central and the State accounts are mixed up and also because the Agents of the State Bank withdrew money from the currency chests whenever their cash balance was insufficient to meet not only the requirements of the State Governments, but also those of the Central Government and of the State Bank itself. While this may be true in the case of a casual overdraft, it is quite clear that when the overdraft continues for a considerable time and is, in fact, being added to from week to week, there can be no doubt that the State Government has no balances with the Reserve Bank. It is not, therefore, a question of prescribing limits up to which a State Government can draw on particular treasuries, as I was inclined to think at one time, but of preventing a State Government from making any withdrawal whatsoever from the Reserve Bank when it is clearly established that the State Government has no funds left. It was for this reason that the procedure to give warnings to State Governments and then to put a complete ban on further payments was evolved. Though the Central Government had bravely issued a circular to all State Governments, they find they are unable to implement the threat when the actual contingency arises as is happening at present.

The real problem is not the raiding of the currency chests by the State Governments, but the way in which State Governments are living beyond their means without worrying the least bit about it because they have the facility of getting the funds from the Reserve Bank. Stopping that facility may seem at first sight to be the proper remedy, but in actual practice it cannot be applied for political reasons. But even if that is so, there is no reason why the Reserve Bank should be compelled in this manner to continue to finance the deficits of the State Governments without limit. The rules about the ways and means advances to be given by the Reserve Bank to the State Governments were laid down for the purpose of ensuring that they did not get credit for disproportionate amounts or for long periods. Not only are those rules being set at naught, but the States are even going further by helping themselves to overdrafts which are not even sanctioned. Since the Central Government will not allow the Reserve Bank to stop payments to the State Governments, it is for the Central Government to provide the necessary funds to the State Governments or compel the State Governments to reduce their expenditure. In my opinion, the real trouble arises because of the reluctance on the part of Central Government to force the State Governments to cut down their development plans for which the State Governments themselves are not making adequate efforts even to find resources which are available to them.

At the forthcoming conference of the State Finance Ministers we should take care not to be allowed to be diverted by the red herring of the State Governments' raiding

the currency chests, but concentrate on getting the Central Government to bring every possible pressure on the State Governments to cut down their development outlays. We must also make it clear to the Central Government that if they cannot induce the State Governments to live within their means, the Central Government must undertake to provide the finance and not let the State Governments continue the forcible overdrafts. The way in which we are at present showing these overdrafts as advances to Governments, because we cannot show a debit balance for the State Governments, is extremely improper. In fact, if any bank under our control was indulging in such a practice we would have called it to account. Our auditors would be perfectly justified in making a special mention of this irregularity in the audit report. We must, therefore, make every possible effort to get the position rectified.

K.G. AMBEGAOKAR
15.11.1957

Governor

This matter was discussed in the Finance Ministers' Conference at Delhi. The Prime Minister and the Home Minister as well as the Finance Minister impressed on the State Governments the imperative need of avoiding the overdrafts. I also spoke, pointing out that the continued recklessness of State Governments might affect the credit of the Indian Government.

The State Ministers nodded agreement but to what extent they will improve is an open question. The new grants that State Governments will get as a result of the Finance Commission's recommendations will affect only their Revenue Budgets. The overdrafts are probably due largely to capital expenditure.

H.V.R. IENGAR
20.11.1957

22-1-58

I would like to see the letters we have written to the Government of India in the last, say 12 months, on the subject of these unauthorised overdrafts by State Governments.

H.V.R. 22.1

As desired by the Governor, the undermentioned letters addressed to the Government of India, Ministry of Finance are flagged below:

- 1) No.[...] dated 25th July 1957; and
 - 2) Cy.No.[...] dated 9th October 1957.
2. The Governor may also like to see in this connection the note dated 18th July 1957 in which a reference has *inter alia* been made to the conversation the Secretary (Shri K.N. Mehta) had with Shri H.S. Negi in the course of which the latter indicated that for political considerations the Central Government would not agree to the Reserve

Bank stopping payments on account of State Governments who overdraw their account. It will be recalled that overdrafts of the State Governments have already been brought to the notice of the Cabinet by the Governor at an informal meeting in September last (Please see Governor's remarks on Office Note dated 30th August 1957).

3. The note on overdrafts of the State Governments which was prepared for the Governor at the time of the Finance Ministers' Conference held in Delhi in November 1957 is at pages 342 to 352.

23/1/58

(A) We have also been writing to Govt. of India drawing their attention to any specific statements made by State Governments that timely and adequate help is not forthcoming from the Central Government.

(B) Further, whenever a State Government's account is overdrawn we call upon them to set right their account and forward a copy of our communication to the Government of India.

23/1

D.G.(A) Apart from the letters, I have also talked recently on two occasions with the Special Secretary at Delhi. He has undertaken to clear the overdrafts by 31st March. The Government of India have accepted the principle that States should not take such forced loans from us but do not want us to stop payments for political reasons.

K.G.A.

23/1

Governor

The Government of India may be informed that at the last meeting of the Committee, the Directors once again expressed serious concern at the continued unauthorised overdrafts by the State Governments and desired that the Govt. of India should be requested to examine whether the time had not come to take more drastic steps than hitherto even if politically unpalatable.

Please let me have a draft D.O.

H.V.R.

24/1

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
February 1, 1958

D.O.No.[...]

My dear Rangachari,

I expect you have seen the several communications which the Bank has addressed to Government regarding the heavy and continuous overdrafts of some of the State

Governments. I explained the gravity of the situation to several Ministers of the Cabinet at an informal meeting held in September 1957 in the Finance Minister's house. The Prime Minister himself took the trouble to speak about this in his address to the Finance Ministers when they met to consider the Finance Commission's report. Nevertheless, the situation shows no improvement, the latest figure of unauthorised overdrafts being Rs 10 crores. I do not have to tell you that this is a serious matter; apart from other consequences, a particular embarrassment to us arises from the fact that we have given an undertaking to our Auditors when we agreed in October 1957 to show the debit balance of State Governments in a particular manner, that the overdrafts were purely temporary and would be soon adjusted. It does not look as if we will be able to carry out this undertaking to our Auditors.

2. At two recent meetings of the Committee of the Central Board, the directors expressed serious concern at the continued unauthorised overdrafts by State Governments and desired that the Government of India should be requested to examine whether the time had not come to take more drastic steps than hitherto. The only step that I can think of, although this would be politically unpalatable, would be to put in force the procedure already evolved in consultation with the Finance Ministry for stopping payments on account of the States if they fail to clear their overdrafts after sufficient notice has been given by the Bank.

Yours sincerely,
H.V.R. IENGAR

Shri M.V. Rangachari

SPECIAL SECRETARY
MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]

February 16, 1958

My dear Iengar,

Will you kindly refer to your D.O.No.[...] dated the 1st February 1958 about the overdrafts of State Governments with the Reserve Bank? We have had the matter under continuous consideration and we hope it will be possible to clear the matter up satisfactorily before the end of the current financial year and make reasonable arrangements for the future. A large sum is still due to State Governments on account of grants and loans for development and will be paid to them in the course of this month and early next month. This should clear the outstandings of most.

Yours sincerely,
M.V. RANGACHARI

[Submitted as an informal item to the Central Board Committee at meeting held on 19.2.1958.]

CONFIDENTIAL

RESERVE BANK OF INDIA

BOMBAY

D.O.No.[...]

May 8, 1958

My dear Rangachari,

Will you please refer to your D.O. letter No.[...] dated the 16th February 1958? Although no overdrafts were outstanding as at the end of the financial year, several States started overdrawing their account almost immediately. As you must have seen from the daily position advices sent by our Central Accounts Section and the communications addressed by the Bank to States Governments, copies of which are endorsed to the Ministry of Finance, as many as five States are now in *debit* and the amount of the overdraft has also been steadily rising. According to the latest advice received from our Central Accounts Section, the total of the debit balances as on the 3rd instant was over Rs 22 crores in spite of our having granted ways and means advances for about Rs 25 crores. In your letter of the 16th February, you had mentioned that arrangements were being made to avoid the recurrence of overdrafts in future and we were hopeful that occasions on which States Governments would overdraw their accounts during the current financial year would, if at all, be rare; in any case, we had not anticipated that the overdrafts would be of the present magnitude. We shall be glad if you will kindly look into the matter and advise us as early as possible as to what action was being taken by Government.

2. The question of adjusting the debit balances is also of some urgency in view of the Bank's annual closing of accounts. Our Auditors have approved of our showing the overdrafts under "Loans and Advances to Governments" only as a temporary expedient and it is imperative that the overdrafts are repaid in full before the 29th of the next month.

Yours sincerely,

K.G. AMBEGAOKAR

SPECIAL SECRETARY

MINISTRY OF FINANCE

NEW DELHI

D.O.No.[...]

July 16, 1958

My dear Ambegaokar,

Will you kindly refer to your D.O. No.[...] dated the 9th July 1958, about State overdrafts? I am marking the reply private and personal because not all of it is for the consumption of your Board.

2. As you know this problem is one of some years standing and you may recall grappling with it in the case of Madras some years ago. It has become wider and more intractable. I have been struggling with it ever since I came back last October. It is not easy to control the ways and means of fourteen States from the Centre but we have been doing the best we can to keep the State finance on an even keel.

3. The States' difficulties largely stem from the fact that their plan outlay is not wholly covered by their resources plus the Central assistance promised to them. Some of them also have large commitments in respect of food grains and scarcity. We have been trying to clear each of these separately.

4. At our instance the Planning Commission are engaged in a reassessment of the States' resources for the current year and may ask the States to readjust their plans on that basis. We are now releasing the Central assistance promised to the States in monthly instalments so as to keep pace with the State expenditure. Similarly, we are paying them their shares of revenue and grants either in advance or in monthly instalments. We are also considering whether the dislocation caused by a shortfall of their resources vis-a-vis the plan upto 31st March 1958 and reflected in their current balance position should be made good to them. The question of making separate arrangements for large food stocks is also under consideration. All this is bound to help and has helped but obviously one can never guarantee that the States may not once in a way find themselves in the red. Two things are clear to me. First, most of them have no adequate machinery for watching their ways and means and take no interest in it. Second, considering the magnitude of the transactions all of them would have to increase their minimum balances with the Bank. Something must be done to place both these matters on a satisfactory basis. A satisfactory long-term solution will take some time and I am sure you and your Board will appreciate this.

5. Today only two States are in the red, Bihar for a nominal amount and Madhya Pradesh for a substantial sum. I am writing to them offering a further ways and means accommodation to clear their overdrafts and keep an even balance with the Bank.

Yours sincerely,
M.V. RANGACHARI

[This is a very helpful reply and I would like to thank Mr. Rangachari for it. Governor may like to mention it first to the Committee.]

K.G. Ambegaokar 18.7.58

Governor 18.7.58

[29-4-1959]

Our Directors have been expressing deep concern from time to time at the manner in which some State Governments continue to have large unauthorised overdrafts. This was again voiced strongly at today's Committee meeting. It was urged that we must not allow this state of affairs to continue. One way which was suggested was that there must be an arrangement by which any overdraft is cleared within a week by the Central Government making the necessary funds available to the State Government. Some of us pointed out that this would mean that the Central Government has to acquiesce in any expenditure incurred by the State Government and would result in the disappearance of all control and restraint on the State Governments. Failing any other remedy the Committee was of the view that we should at least not allow the State Governments to have such forced loans without paying any interest. We have in the past not been inclined to levy interest charges for fear that this would only mean regularising the unauthorised overdrafts and our policy has been not to give any countenance to such overdrafts. However, since there does not seem to be any other

way of checking this malpractice, the suggestion seems worth exploring, and I would like it to be examined so that I can discuss it with Government of India. We could have an increasing scale of penal interest, like what is prescribed in the case of Scheduled Bank's balances and make it so steep for longer periods as to force the State Governments to take early action to regularise the position.

Rates of interest on overdrafts against State Governments

D.G.(A) has indicated that he would discuss this matter with the Ministry of Finance. If they agree, the penal rates may be made effective from 1st July 1959.

DG(A)

I have discussed with Mr. Rangachari today the question of continuing overdrafts of some of the State Governments. He said he had arranged to have the M.P. overdraft cleared—the M.P. Government having been given Rs 5 crores. Bihar also will be settled shortly.

As regards the proposal for a penal interest rate, he said this would be for the Bank to decide and he would not like to interfere with the Bank's discretion being exercised in accordance with banking principles. He pointed out however that the imposition of a penal rate would not have the intended effect of making the States avoid incurring overdrafts. The fact was that the plan expenditure made the position of the States so tight that they had no manoeuvrability left and with the smallest trouble in utilising their estimates of revenue, due to scarcity etc., they were bound to be in deficit. Some more fundamental remedy was needed to remedy this situation. Charging higher rates of interest would only make their position worse.

I shall discuss this further with FM tomorrow.

23/5/59

Discussed with FM and Mr. Rangachari yesterday. They both stated that all the overdrafts would be cleared by the six-monthly closing. We may also again write to all the States concerned that the overdrafts must be fully cleared by 30th June as we cannot show any minus balances.

As regards the penal rate of interest, FM also expressed the view that the States were helpless in view of their development programmes and because they had no such means of meeting deficits as the Central Government had. They both thought that charging higher interest would only increase the State Governments' burden. As some kind of check, however, they had no objection to our introducing a slightly higher rate after the 30th June when the present overdrafts are cleared. I shall mention this to the Committee at the next meeting.

25/5/59

Secretary

Submitted as an informal item to the Central Board Committee at the meeting held on 27th May 1959.

DG(A) 28.5.59

The Committee's reaction to the proposal for a penal rate was not very favourable.

One Director in particular was of the view that this would make no difference to the spending of the States. We may keep this matter pending till the Governor's return.

Confidential

The folder containing notings in connection with the overdrafts against State Governments is resubmitted as directed by D.G.(A). The latest position of the State Governments who are having overdrafts with us is indicated below:

As on 6-6-1959 [Rs]

		Ways & Means advances
Bihar	69,14,000 (Dr.)	3,90 lakhs
Rajasthan	1,14,97,000 (Dr.)	14 lakhs
Kerala	3,31,38,000 (Dr.)	3,30 lakhs

Government of Bihar: A credit of Rs 5 crores was received by them from the Central Government on 5-6-1959 which brought down the overdraft to Rs 34 lakhs (with ways and means advances of Rs 390 lakhs). The debit balance has again gone upto Rs 69 lakhs. Government of India have indicated that further assistance for Rs 2.26 crores will be given to the Bihar Government this month for Plan Schemes and the account of the State Government should be in credit on the 29th June although they will not be able to repay the ways and means advances in full.

Government of Rajasthan: The Rajasthan Government have advised us vide their letter dated 4th June 1959 that efforts will be made to keep their account in credit as on 29th June 1959. It may be mentioned that we have recently agreed to an increase in their cash credit arrangement with the State Bank of India from Rs 10.75 crores to Rs 11.30 crores against cover of securities and to an additional limit of Rs 3.75 crores against cover of stocks of foodgrains.

Government of Kerala: According to the reply dated 4-6-1959 of the State Government they have applied to Government of India for ways and means advance to clear the overdraft.

In view of the closing of the Bank's annual accounts, we have already addressed the State Governments concerned on 1st June 1959 to take immediate steps to repay the outstanding overdrafts and to ensure that the balance of the Governments with the Bank is in credit as on 29th June 1959 (30th being a holiday). A copy of the letter has been endorsed to Government of India requesting them to grant sufficient financial accommodation to State Governments.

9/6/59

Secretary 9.6

CA 9.6

DG(A) 9.6

I think we may drop for the present the idea of charging a penal rate of interest on overdrafts. The suggestion originated from Mr. Tata at one of the meetings, but at a subsequent meeting, when he was not present, it was not favoured by Mr. Kasturbhai,

who thought it would make no difference to the behaviour of the States. We may consider it again if overdrafts start again after the 1st July.

Governor 9/6

Memorandum by the Reserve Bank of India regarding
unauthorised overdrafts of State Governments

The increasing extent to which State Governments are running unauthorised overdrafts with the Reserve Bank year after year is causing considerable concern. It is absolutely essential, if the economy is to remain stable, that deficit financing in the Public Sector is regulated.

2. Normally any deficit financing that can be reasonably incurred in the Public Sector is provided for through the Central Government's annual budget. The Reserve Bank is constantly in touch with the budgeting operations of the Central Government and the extent of deficit financing provided in the Central Budget is an agreed figure which is considered as capable of being absorbed by the economy without any deleterious effect. Due to the unauthorised overdrafts created in the past years by the State Governments which had to be taken over by the Centre each year, the extent of deficit financing incurred by the Centre in these years had, however, exceeded considerably the safe limits of deficit financing each year and this has had extremely adverse effects on the economy of the country.

3. Apart from this overall consideration, any State Government running an unauthorised overdraft with the Reserve Bank does so in breach of the agreement under which the Reserve Bank has agreed to act as the banker to the State Government. This makes the position of the Reserve Bank untenable under the Act setting up the Bank and the Bank has been advised that it may be dragged into a court of law on this account.

4. The Bank has therefore no other option but to insist that a definite procedure must now be devised and given effect to immediately to ensure that the drawings of a State Government from the Bank in any year are limited to the amount of resources definitely expected to be credited to the account of the State during the year, leaving no scope for unauthorised overdrafts to appear.

5. At the same time, it is appreciated that the problem can only be tackled in stages. The first step proposed therefore is to control the flow of expenditure out of the Consolidated Fund so that this by itself does not lead to overdrafts. The following suggestions are made for securing this control.

6. As soon as the budget for the year is passed, the State Finance Department, in consultation with the Reserve Bank, will distribute the budgeted provisions among various drawing officers. This will be done for the year as a whole but in the first three months of the year the drawing officer will operate without any limit. For the purpose of these allocations, payments like loan repayments, interest payments, pension payments, charged expenditure, supplies received through Central Purchase Organisations like India Supply Mission, London and Washington, D.G.S.&D., Food, etc., book adjustments in respect of transactions originating in other States and payments

to gazetted officers, which are authorised by the Accountant-General, will be excluded. The allocations for each drawing officer would be intimated to them by the State Government under advice to the Treasury Officer and Sub-Treasury Officer with whom he is in account. The Reserve Bank of India will separately intimate the allocations to the branches of the State Bank of India and its subsidiaries conducting Treasury business with instructions that payments should be limited to the amounts intimated unless changes are subsequently notified by the Reserve Bank. In respect of payments in non-banking treasuries and sub-treasuries, the allocations settled in consultation with the Reserve Bank will be intimated to the Treasury Officer and Sub-Treasury Officer by the State Government with similar instructions. For the purpose of watching that the prescribed limits are not exceeded, it will be necessary for the branches of the State Bank of India and its subsidiaries to keep separate ledgers for each drawing officer for whom the limit has been prescribed. In the case of non-banking treasuries and sub-treasuries similar ledgers will have to be kept by the treasuries or sub-treasuries, as the case may be.

7. The allocation made in accordance with paragraph 6 above will deal only with expenditure met out of the Consolidated Fund.

8. If the State Government's budget, taking into account only the Consolidated Fund heads, provides for a deficit over the year, the initial allocations will be restricted to expenditure omitting the deficit which will be distributed over the heads and additional allocations will be made as and when ways and means have been found to cover the deficit. But if the budget as a whole is balanced i.e. any deficit in the Consolidated Fund is covered by a surplus in the Public Account, no adjustment will be made in the figures of expenditure in making the allocations. In determining the resources available to cover the expenditure to be authorised, resources which seem only reasonably certain would be taken into account.

9. The limits intimated to the drawing officers and treasuries and sub-treasuries, both banking or non-banking, will not be altered without prior consultation with the Reserve Bank. Alterations will be made only to the extent that additional resources appear to be definitely available during the course of the year.

10. Payments in one State on behalf of other States at banking treasuries and sub-treasuries will be taken against the balance of the State concerned and will not affect the balance of the State in which the payments are made. Payments on Central account in non-banking treasuries and sub-treasuries in a State and payment in such treasuries and sub-treasuries on behalf of other States will be cleared daily with the Accountant-General who will pass on the debit to the Accountant-General concerned.

11. States which have payments to make in other States should, as far as possible, *arrange for payments by the issue of demand drafts.*

12. If during the course of the year owing to a shortfall in resources or other reasons, the movement of balances indicates the likelihood of an overdraft, steps should be taken immediately by the State Government to arrange for accommodation to tide over the shortfall.

13. For the efficient working of the system the Reserve Bank will post in each State capital, one of its officers to work in close association with the State's Finance Department. It will also arrange for a telegraphic instruction being sent to the States

of its daily balances by the Central Accounts Office. Efforts will be made to start the new system in the current year itself although it may not be possible to give effect to it till the 1st September i.e. the initial period during which the drawing officers will be acting without any limit will for this year be extended from 3 months to 5 months.

14. The normal ways and means of a State Government are frequently strained by large transactions on food purchases and procurement. Arrangements should be made that these are separately financed through Commercial Banks in all cases so that such purchases do not lead to overdrafts on the Reserve Bank.

15. The existing limits for ordinary ways and means advances under the various agreements of the State Governments have proved inadequate in the context of the large increases in the volume of the State transactions. Reserve Bank of India will take steps to examine this problem in consultation with the State Governments and fix adequate limits, not necessarily a multiple of the minimum balances as under the existing agreements, to meet the seasonal requirements of individual States with reference to the overall transactions in the last two or three years.

16. It is desirable that commencing with 1967-68 the local bodies, State Electricity Boards, State Transport Corporations and similar bodies which now bank with Government, should be allowed to bank with the State Bank of India and its subsidiaries or with any other scheduled bank which may be approved by Government. At present the balances of all such bodies, which represent banking liabilities, are used for financing expenditure of the States and the States may not be in a position to meet the demands from the various bodies when they arise, as few of them have comfortable cash balances or liquid assets. Once this system is started, the accumulated balances at the end of the current year at the credit of these bodies could be handed over to them in a phased manner over a period.

[Submitted to the Government of India in June 1966]

Governor, RBI

[16-7-1966]

This draft was discussed—It will be seen that Finance Ministry is not likely to press for the adoption of the Scheme sponsored by us. They would rather proceed on the old lines and tell CMs that once the normal ways and means limits are re-fixed any overdraft in excess of such revised limits will automatically result in stoppage of payment.

I am not sure how far they will succeed in this approach. The only amendments to the paper that I have suggested and are being adopted are as follows :

(1) Once the ways and means advance limits are revised, we will not give any notice to the State to clear the overdraft. We will only intimate on the Friday in question by telegram that the States' operations have resulted in an unauthorised overdraft.

(2) We will then wait to see in the next week's account whether the overdraft has been cleared. If it has not been cleared but the amount of overdraft has increased, we will immediately issue orders to stop further payments.

(3) If, on the other hand, the overdraft is reduced or remains stationary, we will wait for another week to see if it is being cleared completely. If not cleared by then, we will issue orders to stop further payments.

(4) There should be definitely understood arrangements between the Central Government and the States and we should not be asked to hold our hand in any case of deviation in the same.

The draft is being revised and will be submitted to Cabinet. Let us await developments.

[P.C.B.]

[22-7-66]

In the recent discussions in Delhi on the subject of overdrafts created by the State Governments the consensus of opinion was that the limits for normal ways and means advances permitted to State Governments needed a review. These limits were fixed last in 1953 and since then the size of the State Governments' budgets has increased considerably.

The Government of India also took the view that rather than pursue the adoption by the States of the procedure suggested by us for detailed control of their drawings, it would be better to refix the limits of normal ways and means advances on a realistic basis and thereafter advise each State Government that if after that any State were to so conduct its operations as to result in the normal limit of overdraft being exceeded, the Reserve Bank of India will automatically issue instructions to stop all further payments on behalf of such State Government. I believe this position has been put to the Chief Ministers of the States and, as is to be expected, has provoked mixed feelings amongst them.

Pending a communication from the Government of India, I would like this question of limit of normal ways and means advances to State Governments being reviewed without any delay. I have spoken to the Economic Adviser about it. Secretary will please associate himself with the study that will be conducted in the Economic Division and I should like to have the considered views of all of them submitted to me at the earliest possible date.

P.C. BHATTACHARYYA

(Points made by me [P.C. Bhattacharyya] in the CMs/FMs Conference on
11-4-67)

A.

1. Grateful to have the opportunity to offer some explanation on behalf of the Reserve Bank pertaining to some of the points discussed round the table.
2. The two points on which I would like to offer remarks are (a) Deficit financing in its overall aspect (b) unauthorised overdrafts of State Governments.
3. So far as (a) is concerned, the necessity for eschewing it has arisen out of the present price situation. The latter is the result of imbalances between demand and supply. The former is a function of money supply. The latter is a function of supply of real resources.
4. Deficit financing increases money supply. While when production is going up, a

regulated dose of deficit financing is required to keep money supplied for additional production, any further increase in money supply when production has gone down is bound to raise prices further.

5. What is therefore desired [is] that for some time deficit financing should be discontinued. Otherwise we will get into a stage of runaway inflation. The annual rate of price increase is all time high.
6. Once price situation is stabilised, and production is again on the increase, a second look at the situation could be justified.

B.

1. So far as unauthorised overdrafts are concerned, the Centre has so far taken over these every year. But this has resulted in the planned deficit in the Central budget being converted into an unplanned deficit. If deficit is incurred through various points in an unregulated manner, it is not possible to secure monetary stability. It, in fact, amounts to each State and the Centre itself having a printing press of its own.
2. It is in this context, that the procedure of the notice by the R.B. has been devised. The R.B. is the creation of a Statute. Its authority is what the Governments have conferred on it. It is the moral responsibility of the Governments to adopt their financial operation in such a way that the Reserve Bank can discharge the statutory responsibility placed on it.
3. The procedure has been devised because the unauthorised overdrafts have become a means of financing the plan, whereas the law contemplates that the R.B. should only give overdrafts to meet temporary ways and means difficulties. The law prohibits the grant of overdrafts for more than 90 days at a time.
4. It is necessary that if there is shortage of plan finance, the resources for that should be secured by raising fresh resources. If the states are unable to raise the resources it is for the Central Government to consider whether they can raise it and pass it on to the States. The recourse of the State Governments should therefore be to the Central Government and not in creating unauthorised overdrafts on the R.B. If resources cannot be raised, the plan has to be cut.
5. The procedure provides for a notice of three weeks, to make it possible for the State Governments to have discussions with the Centre and clear up the overdraft with their assistance, if possible.
6. If on the other hand, it cannot be so cleared the Reserve Bank cannot continue to carry in its books an operation which is illegal under the Statute. Any tax payer can sue the R.B. for this neglect of duty. In such circumstances, therefore, there is no alternative to the R.B. taking steps that unauthorised overdraft is not allowed to increase. This can only be secured by stopping further drawals.
7. So far as temporary difficulties are concerned, if it is genuine, a special arrangement can be made with the Reserve Bank. Of course, the essential condition is that the Reserve Bank must satisfy itself that such a temporary arrangement will not last more than 90 days. A balanced state budget is an essential pre-condition for the Reserve Bank to agree to give a special line of credit.

[P.C. BHATTACHARYYA]

Governor

[13-10-67]

I had a discussion with the Deputy Prime Minister yesterday regarding overdrafts of State Governments. He was quite clear that we must take firm action even if it ultimately meant stoppage of payments of cheques issued by the defaulting Governments.

2. In a subsequent meeting this morning in the Ministry with Shri Jagannathan and Shri Govindan Nair, it transpired that while the overdrafts had developed as a result of the States having paid their dues to the Centre in the beginning of October, they were going to receive payments from the Centre on account of their share of income tax as well as by way of Plan assistance in the middle of October and again in the beginning of November. It was further noted that two or three States had not received anything from the Centre when their overdrafts were made good by Central assistance at the end of the last financial year. The Ministry of Finance will be looking into these cases and I have left a copy of our note with them. Meanwhile, it was agreed that having regard to the special circumstances, it would be appropriate for us to call upon the defaulting States to clear their overdrafts by the end of November with the warning that otherwise we might have to stop the payment of their cheques.

3. E.D.(S) may now proceed to take action accordingly keeping the Ministry informed.

L.K. JHA

RESERVE BANK OF INDIA
Camp: NEW DELHI
November 11, 1967

My dear Morarjibhai,

I mentioned to you as well as the Deputy Chairman, Planning Commission, the fact that once again State overdrafts have begun to worry us, the total amount overdrawn on 3rd November 1967 being over Rs 65 crores. This deterioration took place immediately after the beginning of October when most States had to make heavy payments to the Centre against their loans as some payments from the Centre to the States are due for disbursement in October–November each year, some improvement in the position can be expected. In fact, West Bengal and Punjab, which were originally overdrawn, are now, for the time being at least, in the clear. As regards Madras, Andhra Pradesh, Bihar, Madhya Pradesh, Rajasthan and Mysore, their accounts, even with this month's payments, continue to be overdrawn. Their combined overdrafts as on 7th November were of the order of Rs 39 crores.

2. I think I can say that the firm tone which you adopted in dealing with this problem has had its effect on the States. Most of them are making efforts to avoid an overdraft. At the same time, we must also recognise that many of them have genuine difficulties. Their debt burden is heavy. The fact that repayment has to be made in one large lump makes the problem more difficult. Subscription to their loans has not been too satisfactory. There has been deterioration on other counts also for which they are not entirely to be blamed. In addition, political pressures and election pledges are having the effect of eroding their resources one way or another.

3. In this kind of a situation a simple three weeks' notice of stoppage of payments will not, I feel, achieve the result. Even with the best efforts and will most of these States will not be able to muster enough resources within three weeks to clear their overdrafts. The stoppage of payments on their failure to do so will also have serious repercussions, some of a political nature but even more of the already dangerous law and order situation because if policemen do not get their salary, we cannot expect them to be on the side of law and order.

4. In these circumstances I feel that what is needed is a joint consideration of the States' financial situation between representatives of the State Governments, the Finance Ministry and the Planning Commission. They may have to cut their plans. They may also have to agree to other cuts in expenditure or measures to mobilise additional resources and there may be a case for the Centre to give some relief to States whose difficulties are genuine either by staggering their debt payment liabilities or by additional loans or grants. I know that the resource position of the Centre is no better. However, a deficit at the State level is economically as bad as a deficit at the Centre and there are some advantages in not letting the States incur deficits in addition to what might be incurred at the Centre.

5. If after such a review a State does prove to be recalcitrant and if there is no other remedy left, the stoppage of payments may have to be a last resort remedy. However, to take this extreme step at this juncture on three weeks' notice may not be the best method of dealing with the situation.

6. In order to pave the ground for such a meeting I have arranged for telegrams to be sent to the Finance Secretaries of all States concerned asking that they should take immediate steps to clear their overdrafts before the end of November 1967 and that they should send their representatives to the Reserve Bank to explain to us the action which they propose to take. It is possible that the States will refer to certain problems and difficulties which they have. We propose, in the light of these discussions, to send to Government an analysis of the problem as we see it. This would be helpful in the kind of tripartite discussions which I have suggested above.

7. I trust that what I have said above will have your approval. Further, since I gather that the N.D.C. is due to meet shortly, you might wish to call the State Finance Ministers a few days in advance so that when the N.D.C. meets, each State will be able to give a more realistic account of its own resource position, and both the Central Government and the Planning Commission will have a better picture of the kind of effort for resource mobilisation that the individual States are likely to put forth.

Yours sincerely,

L.K. JHA

Shri Morarji R. Desai
Deputy Prime Minister
Government of India
New Delhi

III. RURAL CREDIT

A. ALL-INDIA RURAL CREDIT SURVEY

SECRET

BOMBAY

D.O.No.[...]

December 10, 1954

My dear Deshmukh,

Would you kindly refer to your D.O. letter No.[...] dated 15th September 1954, in which you said that you presumed that the Government of India would be consulted before the actual publication of the Report on the Rural Credit Survey (Volume II, i.e. the "General Report")? In that letter, as well as in our subsequent talks, you indicated your anxiety that early decisions should be taken on the main recommendations of the Report and that the decisions themselves should be followed by prompt action, legislative and other, to implement them. The proposals of the Committee are far-reaching and important and, as you know, I fully share your anxiety that there should be no avoidable delay in formulating and pursuing the further steps now necessary. In order that you may be put in early possession of the views of the Bank on these recommendations, I propose to convene a special meeting of the Central Board towards the end of January. The final printing of the Report is in progress and, by about the 21st of this month, it should be possible to have a sufficient number of copies for supply to the members of the Board as well as for general publication. For reasons I shall presently mention, it will not only facilitate publication but also greatly assist the Board in its deliberations, if, at the same time as the release of the Report to the public, the Government of India could announce and reaffirm their decision in general terms on one issue to which, from time to time they have already given consideration in the past. The particular issue I have in mind is connected on the one hand with the Imperial Bank of India in the different contexts in which its future has been considered by Government, and on the other hand (in the new context provided by the Report), with the establishment of a State Bank of India proposed by the Committee on the Rural Credit Survey.

2. I summarise below the various ministerial pronouncements on this question as well as my own views expressed at different stages to the Board of the Reserve Bank and to the Finance Ministry.

(a) On February 4th 1948, in reply to a short notice question in Parliament, the Finance Minister (Shri Shanmukham Chetty) stated as follows:

"Government accept the policy of nationalising the Imperial Bank of India but as the Bank has branches outside India, Government propose to examine carefully the various technical questions that would arise in connection with the nationalisation of the Bank before the policy is implemented."

On the basis on which compensation would have to be paid, he stated as follows:

"As regards the Reserve Bank, Government's intention is to acquire its share at the average of the monthly market value of the shares during the period March 1947 to February 1948 taking the opening quotations for each

month and to issue in lieu thereof to the shareholders 3% long dated stock of equivalent value of appropriate maturity. *In regard to the Imperial Bank of India, Government propose to adopt a similar basis for the acquisition of its share capital.* The period for which the average of the market value of the shares is to be taken will be determined at the time of nationalising the Bank."

- (b) Subsequently on the 1st of February 1949, in answer to a question the Finance Minister Dr. John Matthai said that in the light of the examination of the technical questions referred to and in view also of the possible repercussions on the investment market and of the existing unsettled economic conditions in the country, Government considered that it was not feasible to proceed at the time with the nationalisation of the Imperial Bank of India.
- (c) In connection with the debate on the Reserve Bank of India (Amendment) Bill 1950 on the 22nd November 1950, you, as Finance Minister, quoted the reply given by Dr. John Matthai on 1st of February 1949 and said "I may add that I am in complete agreement with this view and I am convinced that it is not in the best economic interests of the country to attempt any such measure."

3. The Rural Banking Enquiry Committee which reported in 1950 recommended, among other measures, that the appointment of the Managing Director and the Deputy Managing Director of the Imperial Bank should be made subject to the approval of the Central Government or in the alternative the constitution of the bank should be changed and the general superintendence of the bank placed in charge of a Chairman whose appointment would be subject to the approval of the Central Government, the day-to-day internal working of the bank being entrusted to a General Manager.

In my memorandum to the Board of the Reserve Bank on this proposal, I described the fairly comprehensive powers of control which the Government and the Reserve Bank exercised over the Imperial Bank under the Banking Companies Act and the Imperial Bank Act, and stated that the Imperial Bank was definitely a State-controlled institution at present and that unless and until it was proved by experience that our powers were ineffective and that the Imperial Bank's active co-operation in the planned development of industry and agriculture was not forthcoming, I would deprecate strongly any drastic changes in the constitution of the Bank. Nevertheless, I pointed out certain special features peculiar to this institution:

"It has to be recognised that the Imperial Bank has, partly on account of its long association with the Government and the special privileges it has enjoyed, attained a pre-eminent, if not dominant, position in the banking structure of the country. With a network of branches spread all over the country, it is still functioning as banker to Government at places where the Reserve Bank has no branches. It maintains currency chests and small coin depots and operates the remittance facilities scheme. It acts as a bankers' bank by keeping their surplus cash and by granting them advances. It manages the clearing houses in many places. It is obvious that the Government cannot be disinterested in the working of a Bank, which has acquired such a dominant position in the credit structure of the country and is at present the biggest banking institution in Asia. It is immaterial from the point of view of national interests whether close association with the Government or sound management is the more important factor

which has contributed to this development. A Bank which has reached this position cannot justifiably claim to be treated like an ordinary commercial bank.”

4. When the question of the appointment of the Managing Director and the Deputy Managing Director was raised again in August 1952, I observed in my letter to the Finance Ministry [...] dated August 26th, 1952 as follows:

“The time has arrived when we should consider the question of nationalisation or radical changes in the constitution of the Bank from the point of view of the planned development of the country. As you know, I suggested nearly three years ago, the transfer of all treasury work to the Imperial Bank, who would be required to extend their branches to all places where treasuries are functioning at present. The idea behind this was the planned integration of the banking structure. Commercial banking would be taken up to the taluk headquarters and as the Purshotamdas Committee have recommended, beyond this stage co-operative credit banks and other institutions would carry credit facilities to the rural areas. At present, considerations of possible losses arising from the rapid expansion of branches to semi-urban areas deter the bank from any such expansion on the lines suggested. This outlook influenced by the profit motive, is inevitable so long as the Directors and the Executive Officers, are responsible to the shareholders for the management of the Bank. If a partial nationalisation is to be undertaken for a rapid expansion of credit facilities, the proposal for the appointment of the Managing Director and the Deputy Managing Director by Government would not achieve the object, for these officers would still be responsible wholly or partly to the shareholders. Indeed, their position would become impossible if they have divided responsibilities to the Government and the shareholders. If control by Government is to be effective, the Government must hold, at any rate, a majority of the shares, if not all the shares.”

5. The Rural Credit Survey Committee’s main recommendations in regard to the Imperial Bank are briefly these:

- (i) the amalgamation of the Imperial Bank of India with ten specified “State-associated” banks; (Bank of Mysore, Bank of Hyderabad, Bank of Baroda and others);
- (ii) the expansion of the share capital of the amalgamated institution, in order that, among other things, it may initiate a large programme of branch expansion;
- (iii) the allotment of this additional share capital (in the form of non-transferable and dividend-limited shares) exclusively to the Government of India and the Reserve Bank;
- (iv) the assumption of major State control over the resultant institution (in which less than half the paid-up share capital would be private and more than half that of the State);
- (v) the reconstitution of the Central and Local Boards of the Bank;
 - (a) the nomination of the majority of Directors on the Central Board by the Government and the Reserve Bank. The first Board would be wholly nominated by the Government for two years;
 - (b) appointment of the Chairman by the Government after consultation with the Board;
 - (c) the appointment of the Managing Director and Deputy Managing Director to be made by the Board with the approval of the Government.

- (vi) subsidy from the State for that part of the branch expansion which is unremunerative but which, at the same time, is undertaken at the instance of the State for the benefit of the rural areas;
- (vii) designation of the institution as the State Bank of India; and
- (viii) provision for the State Bank later amalgamating with itself, as and where suitable, small banking units which happen to be complementary to its area of operations.

In general terms, the Committee describes the object of the recommendation as “the creation of one strong, integrated, State-sponsored, State-partnered commercial banking institution with an effective machinery of branches spread over the whole country, which, by further expansion (including further, but minor, amalgamation where necessary), can be put in a position to take over cash work from non-banking treasuries and sub-treasuries, provide vastly extended remittance facilities for co-operative and other banks, thus stimulating the further establishment of such banks, and, generally in their loan operations, insofar as they have a bearing on rural credit, follow a policy which, while not deviating from the canons of sound business, will be in effective consonance with national policies as expressed through the Central Government and the Reserve Bank”.

6. The position has thus changed in important respects since the Ministerial pronouncements referred to in paragraph 2.

- (a) In the first place, one of the important “technical questions” referred to in Shri Shanmukham Chetty’s statement in 1948 arose from the fact that the Imperial Bank was then doing Government treasury work in Pakistan. The National Bank of Pakistan has since been established, and all the Government work done by the Imperial Bank of India in Pakistan has been taken over by the new institution. At present the Imperial Bank of India does not function as Government banker to any foreign Government outside India. The question of nationalisation of the Imperial Bank can now be considered on the merits.
- (b) In the second place, the strongest objection raised by the Board of the Imperial Bank to the proposal that the appointments of the Managing Director and the Deputy Managing Director should be subject to the approval of the Government was that there was no justification for this discriminatory treatment, since the appointments of the higher executives of other scheduled banks would not be subject to such approval.

As a result of an amendment introduced in 1951 to the Indian Companies Act (Section 86J) the appointment of a Managing Director or the appointment of a Director not liable to retire by rotation is void, unless approved by the Central Government. Their approval is also required in respect of any increase in the remuneration of a Managing Director. This section is applicable to all banking companies except the Imperial Bank, which is governed by a separate Act. The position has thus been reversed. If the Central Government’s approval is required in the case of the appointment of the Managing Director of other banks, *a fortiori*, the appointment of the Managing Director or the Deputy Managing Director of a semi-public bank like the Imperial Bank is fully justified.

- (c) In the third place, for the implementation of the far-reaching recommendations of the Committee on Rural Credit Survey, it is imperative that there should be

effective control over the policy and working of the Imperial Bank with a view to ensuring that the policy of the Imperial Bank, insofar as it has a bearing on rural credit, will be in consonance with the national policies as expressed through the Central Government and the Reserve Bank.

The difficulty of implementing this comprehensive scheme, which is of vital importance to the development of agriculture and small-scale industries, without a reconstitution of the Imperial Bank is strikingly illustrated by a very recent incident. The Shroff Committee, of which a senior executive of the Imperial Bank was a member, recommended that the Imperial Bank should aim at providing free remittance facilities to banks on all working days instead of on only one day in a week as at present; and that, as a first step, it should make provision for such remittances on two days of the week. The proposal was an extremely moderate one in that it obviously did not involve any large additional expense or trouble to the institution. Even so, it has been twice rejected by the Imperial Bank. This, of course, is merely one small instance cited as an illustration of the need for greater control over a commercial bank of such importance, which has grown up in association with the State, and on which the Reserve Bank has to depend for the translation into practice of many matters of policy.

7. I have no doubt whatever as to the essential soundness of the main recommendation of the Committee on the Rural Credit Survey regarding the Imperial Bank. For many valid reasons pertinent to the planned economic development of agricultural and industrial India—and such development will constitute the major aspect of governmental effort for many years and quinquennia to come—it is to my mind essential that, as an instrument of national policy, the nationalised Reserve Bank should be supplemented by a powerful commercial banking structure, which is under the effective control of the State and is positively aligned to its aims and objectives. This can and should be done without any lowering of the commercial banking standards of the State-associated bank which will thus come into being.

To the extent that such an idea may be applied to the Part 'A' and Part 'C' States, and therefore to the Imperial Bank which constitutes both the foundation and the framework of such a structure in those areas, it may be said that the essence of the suggestion has already found acceptance with Government, not now after the Committee has incorporated it in its recommendations, but for the last several years when the question of the future of the Imperial Bank came to be considered by Government from time to time.

I do not imply, of course, that Government are unequivocally committed to full nationalisation; indeed, as will be seen from some of the extracts, Government may be said to have been thinking of something which falls short of full nationalisation; however that be, what I am concerned with pointing out is that underlying all the pronouncements is the anxiety of Government that effective control should be assumed over the Imperial Bank.

Effective State control cannot be secured unless -

- (a) the Government hold at least a majority of the shares;
- (b) the majority of the Directors are appointed by Government; and
- (c) the appointments of the Chairman and the two Chief Executives (the Managing

Director and the Deputy Managing Director) are subject to the approval of the Government.

The solution of the Committee is more or less on these lines. It is based on the vesting of a majority of the shares in Government and the Reserve Bank; the shares in question will largely consist of additional share capital, since, for one thing, it is postulated that existing shares are not to be disturbed; hence, while State control will be ensured, what will come into being is not a fully "nationalised", but a "State-partnered", banking institution in which there will be a mixed pattern of shareholding, private and State, with the State as the major partner.

8. As I have said, the reasons for State control over this important sector of commercial banking are of a fundamental nature in the present context of economic planning. Insofar as such reasons arise in connection with rural credit, certain considerations which are dealt with at length in the Report may here be very briefly indicated:

- (i) Private credit, i.e. that of the moneylender, is most extortionate and the interest rates highest in those large tracts of the country which are subsistence food crop areas or which at any rate do not grow enough cash crops to come under the description of commercialised and monetised areas. This happens because there is no effective alternative to the moneylender. The alternative we want to see established here, as well as elsewhere is the co-operative society financed by the co-operative bank. But among the many difficulties in the way of establishing co-operative banks in these areas, one of the most important is the absence of facilities for the cheap and ready remittance of cash. Only the Imperial Bank (through the currency chests it gets from the Reserve Bank) can offer such facilities. By and large, however, neither the Imperial Bank nor of course other commercial banks are interested in relatively undeveloped areas including subsistence areas. The Imperial Bank must be made to expand to such areas on a much larger scale than at present and if necessary subsidised for the purpose. This cannot be done unless major ownership, and along with it effective control, are assumed in respect of the institution.
- (ii) In Part 'A' and Part 'C' States alone, there are more than 90 district headquarter places to which the Imperial Bank has not yet extended and where the cash work of treasuries (along with the currency chests) is still managed by the State Governments. In addition, there are the "subdivisional" treasuries which continue to be managed by State Governments, because of the absence of a branch of the Imperial Bank; these are of course much larger in number; on the figures given by the Committee they number about 210 for Part 'A' and Part 'C' States. For many reasons, connected not only with the extension of commercial and co-operative banking to rural areas but also with the efficacy of the management of the Reserve Bank's currency chests, it is a matter of great importance that these non-banking treasuries should be converted into banking treasuries over not too long a period. This, in turn, presumes a much more rapid expansion of the Imperial Bank than can be expected to be undertaken by an institution which belongs almost exclusively to private shareholders. Major State-ownership and control are again indicated.

(iii) The Committee has propounded an integrated scheme in which, *inter alia*, the development of co-operative credit and the development of co-operative economic activity (processing, marketing etc.) are proposed to be undertaken on a countrywide scale through State-partnered co-operative institutions, i.e., through co-operative banks, marketing societies, etc., to which finance in the form of share capital, and other assistance in the form of trained technical personnel etc., will be provided in the fullest measure necessary by the State Governments. The State Governments, for their part, will be helped by the Reserve Bank (in the context of credit societies and banks) and by a Statutory Board under the Agriculture Ministry (in the context of processing societies, marketing societies, etc.). This extremely important scheme for the co-ordinated development of co-operative credit and co-operative economic activity is in turn dependent (as already indicated) on extended rural banking facilities such as can basically be provided by the Imperial Bank alone in association with the Reserve Bank and its currency chests. But that is not all. The Committee also envisages that if the Imperial Bank (along with the other specified banks) could be converted into a State bank responsive to national policies such a bank could also help in the following directions:

- (a) The establishment of branches of apex and central co-operative banks in many of the relatively undeveloped States could take place in close co-ordination with the branch expansion of the State Bank itself; for one thing, the latter can provide accommodation and certain banking services to the branch of the co-operative bank, thus reducing the expenses of the co-operative institution as well as its requirements of trained personnel.
- (b) Short-term loans to credit societies would be provided by the Reserve Bank through the apex and central levels of the co-operative credit structure; but there is the whole sector of co-operation represented by marketing and processing societies, or societies engaged in some similar economic activity, to which a State bank aligned to State policies could be expected, wherever possible, to lend the requisite monies without any diminution of its own business standards. This is extremely important from the point of view of a programme which depends for its success on the effective and co-ordinated development of both marketing and credit.
- (c) The Committee further points out that much the same problems as confront agricultural credit are also involved for small-scale and cottage industries in the context of the credit which they require. A responsive, but not unbusinesslike, State Bank of India would, the Committee indicates, make a great deal of difference to the proper and adequate financing of this important sector of planned industrial development.

9. The remarks I have so far made are with special reference to the Imperial Bank vis-a-vis Part 'A' and Part 'C' States. Without entering into details and without committing myself to particular items such as the list of the individual "State-associated" banks specified by the Committee in connection with Part 'B' States (and certain merged areas of Part 'A' States), I would endorse the Committee's contention that all the considerations mentioned above are equally valid in their application to

these other banks vis-a-vis the particular areas of former princely States in which the banks had been established as State-associated institutions of commercial credit. In other words, here also there is a need for a banking institution over which Government has control through major ownership of shares. It takes but one more step in this reasoning to arrive at the broad conclusion that an integrated State-controlled banking structure for the whole country—covering Part 'A', Part 'B' and Part 'C' States—should be the eventual aim of policy. In regard to the ultimate objective of integration, therefore, as distinguished from the detailed timing or manner of its achievement, as also from the detailed examination of the components which are to integrate, I find myself in substantial agreement with the Committee. The method, the time schedule etc. require much further consideration and I propose to advise Government on these matters after I have had an opportunity to consult the Central Board. The principle of eventual integration should apply not only to the Imperial Bank and suitable State-associated banks, but (as pointed out by the Committee) also at subsequent stages of the process of amalgamation to *small* banking units complementary to the area of operations of the State Bank.

10. At the same time, even as regards the method of integration, one thing seems to me clear, viz., that the integration of the Imperial Bank and the various State-associated banks cannot take place in one quick and comprehensive operation as the Committee appears to have envisaged. If only for practical reasons, it is necessary that the largest of these institutions, viz., the Imperial Bank, should first be taken up and major State ownership and control assumed in respect of it as soon as possible. Similar operations can then be undertaken with regard to such of the State-associated banks as may be selected for amalgamation with the State Bank of India which will thus have already come into existence through the transformation of the Imperial Bank into an institution over which the State has effective control. For this reason, it seems to me that, when examined from the practical angle, the Committee's recommendations, like the background of previous consideration I have set out in earlier paragraphs lead to a common conclusion—one, moreover, to which Government may already be said to be committed—viz. that the next step to be taken is to assume effective control over the Imperial Bank of India, and that a minimum requirement, for the control to be effective, is the ownership by the State of not less than half of the paid-up share capital of the institution.

11. I would now reiterate certain considerations which I indicated at the outset:

- (i) It is desirable that decisions should be taken and implementation commenced as early as possible. So far as the broad issues are concerned, it appears to me that Government is in a position to take immediate decisions since those issues are not materially different from questions which have received Government's attention in the recent past. In particular, Government is already seized of the question of assumption of control over the Imperial Bank. A final enunciation of policy on this important question—which will in fact amount to a reaffirmation of the essence of previous decisions on this subject—will not only help to facilitate the speedy disposal of the detailed issues, but also be of considerable help to the Central Board of the Reserve Bank when they meet to consider some of these issues. Such decision or re-affirmation would of course

confine itself to broad principle; and its main aspects would consist in the following statements of intention which may form part of a communication to the Reserve Bank:

- (a) Government proposes to assume effective control over the Imperial Bank;
- (b) in doing so, it intends that the private shareholder should, if possible, be left in undisturbed possession of his existing shares or their equivalent; and
- (c) as part of the scheme of control and through the allotment of additional shares made necessary by a large-scale programme of branch extension to rural areas or otherwise Government intends that not less than half the expanded share capital shall vest in the State (Central Government and/or the Reserve Bank).

The communication may add that Government has an open mind as to how these intentions may be embodied in concrete measures and that it will await the Reserve Bank's advice on this matter.

- (ii) It is at the same time necessary to reaffirm the decision already taken by the Government of India regarding the broad lines on which compensation will be fixed for acquisition of Imperial Bank shares, should such acquisition become necessary at all. A suitable announcement at the time the Report is published will go far to allay the possible apprehensions of private shareholders. I would strongly urge, as a vital part of my suggestions, that the lines of compensation should be the same as those announced in the past by Shri Shanmukham Chetty. Similar considerations will apply where, instead of acquisition, there is exchange of Imperial Bank shares for State Bank shares.

12. Since the Government are committed as regards the basis on which the compensation for shares acquired by them will be calculated, it is hardly necessary to justify the Government decision. The following figures regarding the distribution of shares and the yield on the basis of the market value may, however, be of interest.

The total paid-up capital of the Bank amounting to Rs 5.26 crores was held on December 31st, 1953 by 10,472 shareholders in all. Out of these, as many as 7,256 shareholders constituting about 69% of the total number, held upto 10 shares only. The number of shareholders who held more than 100 shares was only 338 constituting, that is about 3% of the total number. More than half the share capital is thus held in the form of small- or medium-sized holdings. My information is that a fair proportion of the shareholders are persons of relatively small means, who have acquired these shares because of their steady yield. In the case of these shareholders income from their investment in the shares of the Imperial Bank is very important, and payment of compensation to them at anything less than the full market value will not only involve them in serious capital loss but would also result in a reduction in their current incomes.

I have also certain figures collected at your request some time ago of shares held continuously since 1921 and those acquired thereafter. Of the 75,000 fully paid-up shares of the Imperial Bank of India, only 2,991 shares have been continuously held by the respective shareholders, while 72,009 shares, or 96 per cent of the total, changed hands since 1921. Similarly, out of 1,50,000 partly paid-

up shares, only 3,979 shares were continuously held, while 1,46,021 shares, or 97.3 per cent of the total number, changed hands during the same period. The bulk of the holdings are thus at present held by persons who must have acquired the shares at a value higher than their face value. In a majority of these shareholders, therefore, there could not be a very large element of capital appreciation that could justify payment of compensation at anything less than the market value. Recently, at the request of Rajadhyaksha we worked out certain figures of yield on the shares of certain selected banks, and we found that on the basis of the current market values, the Imperial Bank shares gave during the years 1949–54 an average yield of 4.32%. In the last 7–8 years, the price of fully paid-up shares of the Imperial Bank of India has varied between Rs 1,700 and Rs 3,300, whereas the paid-up capital is only Rs 500. This means that against a nominal rate of 14–16 per cent dividend, the *effective* yield on market value has varied from a little over 2 per cent to slightly under 5 per cent. The fully paid-up shares of the Imperial Bank of India are now hovering around Rs 1707.

I, therefore, feel strongly that, apart from the definite commitment of 1948, there is no justification on the merits for any departure from the undertaking in regard to the payment of compensation. Apart from being a breach of faith to the investor, such a course would have serious adverse repercussions on the general investment market.

13. The decisions on some of the points I have mentioned above could be announced through a statement by you in the Lok Sabha simultaneously with the publication of General Report of the All-India Rural Credit Survey. I enclose a draft statement. As I have already indicated, the publication of the note as well as the Report could be timed to take place about the 21st of this month. I need hardly add that this implies that Government will reach very early decisions on the broad issues mentioned in this letter.

Yours sincerely,
B. RAMA RAU

Sir Chintaman D. Deshmukh
Finance Minister
Government of India

All-India Rural Credit Survey:
Report of the Committee of Direction

The Officer on Special Duty wished to have the remarks of the Agricultural Credit Department on the recommendations of the Committee of Direction of the All-India Rural Credit Survey. I have selected 5 major points and set down my views on them. They are matters of fundamental importance. They may be perused by E.D.(V[enkatappiah]). The points on which my views are submitted are:

- (i) State Partnership in Co-operatives,
- (ii) Partnership of Co-operative Financing Banks in Borrowing Institutions,
- (iii) The Agricultural Credit (Stabilisation) Fund,
- (iv) Open Membership in Agricultural Credit Societies, and

(v) Large-sized Primary Co-operative Credit Societies.

O.S.D. wishes to have a copy of my notes today. May I send him an advance copy?

[J.C.R(YAN)]

29.12.1954

E.D.(V[enkatappiah])

I. STATE PARTNERSHIP IN CO-OPERATIVES

(Recommendations: 34, 54, 91, 113, 136, 140)

The central recommendation of the Committee of Direction of the All-India Rural Credit Survey concerning co-operatives is that the State should enter into partnership with co-operative institutions not only in administrative and technical matters but also by subscribing to their share capital. The principle that the State might take shares in co-operatives has already been recognised by statute. Thus, Section 31 of the Madras Co-operative Societies Act and Section 33A of the Bombay Co-operative Societies Act permit the State to become shareholders in co-operatives. In practice, several States, including Bombay, are already shareholders in co-operative institutions. While, therefore, there is no objection to the State subscribing to the shares of co-operatives, the point for consideration is at what levels it may do so. The Committee has recommended that the State might take shares in the apex co-operative bank (State level), in the central co-operative bank (district level) and in the primary society (level of the village or the town), albeit indirectly in the last two cases.

There can be no objection to the State taking shares in financing institutions (state co-operative banks and central co-operative banks). This will enable them to command adequate funds so as to make them available in the form of rural credit. But it is open to question whether it would be proper for the State to take shares in the primary co-operative societies to enable them to borrow funds from the financing bank. The Committee are of the opinion that the "State's participation in Co-operation cannot stop at an intermediary stage but must be taken to its logical conclusion which is that of providing for a cultivator a strong and suitable superstructure." The word "superstructure" would appear to restrict State partnership to the higher organisation of the co-operative structure but actually the recommendation made by the Committee is that the State should take shares even in the base of the co-operative structure, namely, the primary co-operative societies.

Firstly, is there a need for it? Share capital is needed to measure the borrowing power of the borrowing institution and is usually determined as a multiple of its owned capital. In the case of rural credit societies, most of which are based on unlimited liability, the borrowing power is not fixed at so many times the share capital. It is fixed with reference to the total net assets of the members of the society or with reference to the general solvency of the society. Thus, in Madras and some other States, the borrowing power is fixed at $\frac{1}{8}$ th of the total net assets of the members of the society. In some States it is fixed at so many times the land revenue paid by the members of the society. In Madras, a society having Rs 1,000 share

capital is allowed a credit limit of say even Rs 25,000 reckoned on the net assets of its members whereas it will not be entitled to a credit limit of Rs 8,000 if the borrowing power is measured in terms of owned capital. This will show that increased share capital in primary society is not necessary for enhancing its borrowing limits. Nor is it necessary for attracting rural deposits. Rural savings do not flow into institutions on account of the size of their owned capital. They are to be hunted out and seized before they are spent away.

It might be contended that though there may not be so much need for large share capital in an unlimited liability credit society there would be such a need in a limited liability credit society. At present, the latter variety of societies is situated only in towns; but there is a tendency in some parts of the country to replace unlimited liability by limited liability even in villages. On account of this, it might be pressed that the State should subscribe to the shares of the least limited liability credit societies, the reason advanced being that the primary credit unit should be strong and that strength can only be imparted by adding to its owned capital. This argument would stand very well in the case of a joint stock banking institution which is a "union of capital". It will not fit in with a co-operative institution which is a "union of individuals".

The former is an association of lenders who lend chiefly to non-members; the latter is an association of borrowers who lend only to themselves. The former need capital to make it fructify, the latter need character to help themselves with the credit they need. The co-operative credit society claims to "capitalise honesty" and borrow on that security. Capital itself is of minor importance to it. It raises funds on the basis of thrift, namely, its members' ability to save. It raises them on their ability to avoid improvident expenditure and utilise the credit obtained only for provident purposes. One of the most essential distinctions between co-operative banking and joint stock banking lies in this, viz., that the former is educative in character. It stresses the point that if one seeks a loan he should merit it. If facilities for borrowing are provided by increasing the share capital of primary societies with State subscriptions this educative character will gradually disappear. There will be less desire to save and rely on one-self and an increasing tendency to depend on the State. While, it is certainly necessary to extend rural credit, it is more important that the agricultural-borrower should be educated in self-help and thrift. We should endeavour to increase the number of agriculturists who rely on their own strength for the credit they need and who will put their savings in their society.

I, therefore, plead that, while we should facilitate the provision of rural credit by asking the State to be a shareholder in financing institutions, we should not allow rural credit to become *facile credit* by asking the State to take shares in primary credit societies as well.

It may be asked whether a distinction cannot be made in the case of a co-operative marketing society and whether the States may not be advised to take shares in it. Here again, the question is whether there is a need to do so. A marketing society with Rs 1,000 share capital does not have maximum borrowing power limited to Rs 8,000. It is allowed to borrow upto Rs 1 lakh provided what is borrowed in excess of Rs 8,000 is covered by the security of the agricultural produce of the members of

the marketing society kept under the safe custody of that society. Marketing societies have, therefore not complained of inadequate credit. Their problem lies in securing agricultural produce on the security of which loans could be given to their members. When marketing societies assist their members to sell their produce, they do so only on agency basis and for a commission. Few societies purchase their members' produce on their own account and dispose of them on their own account. The latter variety of business is risky. It is, therefore, restricted to about twice or thrice the owned capital of the marketing society. If the State is to be advised to take shares in a marketing society to help in the outright purchase and sale business, an important question arises, viz., whether the State could take to trading business on a partnership basis. Considering the risks in trade it is natural to expect the State to embark on it without any partner. A third variety of business undertaken by marketing societies is storage and processing. The suggestion that the State should take shares in marketing societies to help them to erect warehouses or processing plants will not secure the end in view. A warehouse does not pay. Witness after witness who appeared before the Rural Banking Enquiry Committee asserted this, so that, that Committee considered that warehouses could be promoted only by giving a State grant to the extent of 25 per cent of the value of the warehouse and a State loan to the extent of another 25 per cent at a reduced rate of interest. To add to the share capital of the marketing society from the coffers of the State for this purpose is, therefore, an unsound business. Likewise, to provide additional shares from Government for erecting processing plants will not ensure the speedy execution of the object in view. What the society needs in this case (as also in the case of building warehouses) is facilities to acquire lands, to import machinery, and to erect them. When a grant and a loan are given by the State for erecting a processing plant, they can be given at the appropriate time and the execution of the work can be speeded up. The subscription of share capital by the State would be a wasteful investment. In the case of co-operative industrial enterprises, however, the State's participation in primary societies is desirable. A co-operative spinning mill, or a co-operative sugar factory, or a co-operative handloom factory is an institution in which the State should take shares if such an enterprise is to be developed. The shares taken will be utilised for erecting the equipment necessary to start the factory, which is the first function of the society. Without State help in the form of shares the factories may not, in many cases, be established at all. But where the co-operative industrial enterprise is not conducted in a factory but is conducted in the homes of its members, as for instance, in the case of a handloom weavers society, the State need not take shares in the society because the yarn provided to the members is given to them as loans in kind just as in rural credit society loans are given in cash. Hence, in this case the member should merit the loan.

II. PARTNERSHIP OF CO-OPERATIVE FINANCING

BANKS IN BORROWING INSTITUTIONS

(Recommendations: 68, 74, 102, 120, 136)

The Committee of Direction of the All-India Rural Credit Survey has advocated that the apex co-operative bank should take shares in the central co-operative bank

and that the latter should also take shares in the primary co-operative societies. Likewise, the Committee has recommended that the central land mortgage banks should take shares in the primary land mortgage banks. This recommendation has probably arisen from the fact that, in Bombay, the apex co-operative bank has taken shares in the central co-operative bank (albeit with State funds) and, in Madras central co-operative banks have taken shares in co-operative wholesale stores.

I am not sure that this procedure of the creditor becoming a partner in the affairs of the borrower is correct. Possibly, this point was not examined in Bombay. In Madras, central co-operative banks became shareholders in wholesale stores in a hurry as a matter of expediency to enable co-operative wholesale stores to undertake procurement business on behalf of Government. The procedure is now considered to be unhealthy there and steps are afoot to retrace the step taken. When a financing bank takes shares in an institution which is its borrower it amounts to saying this: "You hold a share capital of Rs 10,000; you can borrow only Rs 80,000; but you need a lakh and sixty thousand rupees; you should increase your owned capital to entitle you to a lakh and sixty thousand rupees; you are unable to do so; I shall give you a share capital of Rs 10,000; then you can have Rs 20,000 x 8 namely, a lakh and sixty thousand." Looking at this line of thought critically we should say that it nullifies the principle that the borrowed capital of an institution should be related to its owned capital. When the State provides the extra Rs 10,000 as share capital instead of the creditor, the creditor has the shares of Government and those of the other Members of the institutions as its margin of security; but when the creditor himself takes the shares, the creditor has himself for his security. If he is anxious to lend the institution a lakh and sixty thousand rupees, the proper course for him would be to say that the borrower's credit limit might be fixed not at 8 times the owned capital but at 16 times that. But the creditor knows that to lend upto 16 times the borrower's owned capital is not sound banking. Yet he is anxious to lend. Therefore, he says: "I shall lend only 8 times your owned capital, but I shall contribute Rs 10,000 to your share capital." Apart from the fact that this course is not a straightforward course, should the borrowing institution fail, the financing bank will lose not only a part of the money it has lent to the borrowing institution but it will lose the entire share capital it has invested in it. Hence, correct banking standards would require that a financing institution should not be a part-owner in the institution which borrows from it.

Applying the above canon, an apex co-operative bank need not be a shareholder of the central bank and the central bank need not be a shareholder in the primary credit society. In the case of a central land mortgage bank and a primary land mortgage bank the need for the former being a shareholder of the latter does not arise at all. Loans are given by the central land mortgage bank to the primary land mortgage bank on the security of immovable property mortgaged by the member. Where the immovable property is adequate each loan is sanctioned and disbursed to the member by the centre. If a restriction is placed that the loan should not exceed 20 times the share capital of the borrowing institution, the share capital is intended to strengthen the shares of the central land mortgage bank. The fact is that unlike the short-term banking structure, the land mortgage banking structure is a centralised structure in which money is raised by the centre and passed on to the units and the units have no

responsibility for raising funds. Debentures are issued by the centre and not by the units. The units, therefore, do not require large share capital. What they have, they pass on to the central land mortgage bank. Hence, the State's subscription to the share capital of the central land mortgage bank alone will suffice for strengthening land mortgage banking.

III. THE AGRICULTURAL CREDIT (STABILISATION) FUND

(Recommendations: 8, 63)

The Committee of Direction of the All-India Rural Credit Survey has recommended that the Reserve Bank should establish a National Agricultural Credit (Stabilisation) Fund and that each State Co-operative Bank and central co-operative bank should have an Agricultural Credit (Stabilisation) Fund. "The Stabilisation Fund in the hands of the Reserve Bank should be utilised for the purpose of granting medium-term loans to State Co-operative Banks etc. in circumstances in which it is satisfied that short-term loans of which repayment to it has become due by the State Co-operative Banks etc. cannot, without serious dislocation to the credit structure of the State's co-operative system, be repaid in due time on account of famine, drought, etc. and consequently that repayment of such loans or part thereof, may justifiably be allowed to be deferred. In such a case, a book adjustment will be made between the Stabilisation Fund and the Banking Department of the Reserve Bank; the short-term loan will be technically treated as repaid to the Banking Department, but in effect converted into a medium-term loan from the Reserve Bank's Stabilisation Fund. The Reserve Bank may make this facility conditional on the State Co-operative Bank concerned maintaining a similar Agricultural Credit Stabilisation Fund, the same applying to central co-operative banks, and where feasible, to the larger-sized primary societies; the Reserve Bank, in such cases, may further insist that part of the overdue liability should be met from such Stabilisation Funds kept within the co-operative credit structure itself." Co-operative financing institutions are already having the system of granting extension of time for the repayment of loans which fall overdue owing to circumstances beyond the borrower's control. But the extent to which such extensions are given is confined to the resources of the financing bank at the time and by ordinary business prudence. The present recommendation of the Survey Committee takes the matter a little beyond the pale of pure business; but what will be the consequences?

In Madras, the Government constituted a Revolving Fund of Rs 5 lakhs and placed it at the disposal of the Madras Central Land Mortgage Bank in order to relieve borrowers from the distress caused by famine. The primary land mortgage banks which were affected by famine were selected and borrowers who could not pay off the annual instalment due from them were told that the demand against them would be met from the Revolving Fund and that the amount so provided would be treated as a five-year loan payable by them on the expiry of the period of the original loan. About Rs 65,000 were disbursed out of the Revolving Fund according to this scheme. Thereafter investigations were made as to how the Revolving Fund was utilised with a view to making it a permanent feature. These investigations revealed

that although there were a few cases in which borrowers genuinely in distress had benefited, in a large number of cases borrowers who were not actually in need had been helped with the Revolving Fund. It was not that the scrutiny before the sanction of the loan was inadequate but it was a case of feigned distress in many cases which misled the loan sanctioning authorities. In some cases, evil advisers induced even borrowers who could pay their dues not to pay them but to avail themselves of the Revolving Fund. Ultimately, the Government of Madras scrapped the idea of the Revolving Fund and took back the undisbursed balance out of the Rs 5 lakhs.

The above experience reveals that the presence of a Stabilisation Fund makes the borrower less responsible than he should be. But such a Fund could make even the lender become less responsible. It is not unusual that the existence of a bad debt fund often encourages the managements of co-operative banks to write off loans against that fund even before every effort necessary to recover the loan is exhausted. The bad debt fund has also led the managements of some banks to sanction loans with greater ease relying upon that fund in the event of losses; when a Stabilisation Fund is established, worse results may follow. It cannot be ignored that the managements of co-operative central banks are entrusted in increasing measure in the hands of borrowers' representatives. It would be difficult for them to exercise their judgement in a judicial and independent manner, when help is sought for out of this Stabilisation Fund. Therefore, the proper thing to do is to entrust the Stabilisation Fund to an independent agency unconnected with the co-operative movement; for example, the Judiciary or the Revenue Department, or a Credit Stabilisation Board set up by the State under a special statute. Borrowers in distress may approach such a tribunal who may examine the merits of each application, grant extension of time to pay off the loan overdue and transfer equivalent funds out of the Stabilisation Fund to the creditor concerned. The removal of the Stabilisation Fund from the hands of the banks to an outside agency, which is not even the co-operative department will leave the banks intact as business institutions and avoid producing the impression that they are also agencies for relieving distress. So far as the Reserve Bank is concerned, the Stabilisation Fund with it may be administered by it. As no applications for help from the Stabilisation Fund will come to the Reserve Bank until and unless the tribunal set up in the districts approves help from the Stabilisation Fund to the central bank concerned, recourse to the Reserve Bank may be taken to be genuine in most cases. The administration of its part of the Stabilisation Fund by the Reserve Bank will serve as a check over the tribunal in the districts for each case will be examined on its merits a second time.

IV. OPEN MEMBERSHIP IN AGRICULTURAL CREDIT SOCIETIES

(Recommendations: 118, 55) .

The Committee of Direction of the All-India Rural Credit Survey has recommended: "Membership of agricultural credit societies in general, larger-sized or small should be open to all persons residing in the areas of their operations. Further, as already mentioned a person who is refused admission to the society should have the right to appeal to the Registrar of Co-operative Societies."

This recommendation has emanated from a desire to provide rural credit to every credit-worthy borrower in the village; but it treats the agricultural credit society as a public body and takes away its autonomy as well. An agricultural co-operative credit society is not a public institution like a village panchayat or a municipality, where residence for a prescribed period within the limits of the local body, entitles one to vote. It is a private body like the Cricket Club or the Cosmopolitan Club. It has not come into being by an order of the Statute but has been brought into existence by a group of individuals getting together on a voluntary basis and having themselves registered as a co-operative society. These individuals have a right to say which of their fellow villagers can be permitted to associate with them and which should be kept out, in the same way as the Cosmopolitan Club can blackball any applicant for membership without assigning any reason. Indeed, the right to do so would be more justifiable in the case of the agricultural credit society than in the case of the Cosmopolitan Club; for, the members in the society have assumed unlimited liability and pledged all their worldly belongings as security for the loans taken by the society. If the society fails on account of a few bad members not paying off their loans, the rest of the members will have to make good the deficiency. It is, therefore, an inalienable right of those who assumed unlimited liability to say who can be admitted into their company and who cannot. There can and ought to be no appeal to any outside body like the Registrar on this matter; for, if unlimited liability happens to be enforced on account of the Registrar having forced the admission of an undesirable member into the society, the Registrar cannot prevent unlimited liability being enforced against the rest. Even if the agricultural credit societies are based on limited liability the danger is there, though it will be limited to the extent of the share capital of the members or a multiple thereof.

V. LARGE-SIZED PRIMARY CO-OPERATIVE CREDIT SOCIETIES

(Recommendation: 116)

The Committee of Direction of the All-India Rural Credit Survey has recommended that "The future line of development of co-operative credit at the level of the village should be unhesitatingly in the direction of bigger societies covering larger areas. Primary agricultural credit societies should hereafter be established, or wherever necessary, existing ones reorganised, so as to cover, according to local conditions, groups of villages with reasonably large membership and reasonably adequate share capital."

The same suggestion was made before the Fifteenth Conference of the Registrars of Co-operative Societies held at Madras in 1947. It was sponsored by the then Registrar of Co-operative Societies, Madras, Mr. N.S. Arunachalam, I.C.S. He advocated the constitution of rural banks on limited liability basis, covering a wide area. It was claimed that such a large bank could command large business, could maintain an office of its own, could appoint competent paid staff and could even undertake such lines of business as the supply of provisions as well as the sale of agricultural produce. The suggestion was opposed by the late Mr. T.A. Ramalingam Chettiar who believed in "one village one society", but he had no objection to

experiment with one or two rural banks in each district. The Chairman of the Conference, Sir Phiroz Kharegat, observed as follows:

"If I may take you back for one moment to our early days of co-operation, you will find that we started with the very idea that is now adumbrated by those who want a society for a group of villages. In 1904, all the societies that were started were not for each village but for a group of neighbouring villages. Every one of them was a failure, and had to be liquidated. Then, we experimented with the other idea, and that was to try and take all the people of one community of neighbouring villages and constitute them into one society. These were equally a failure although we expected that the caste feeling would be so strong as to supply a common bond of unity. It was after experimenting with all these types that our predecessors came to the conclusion that the ideal to be aimed at is one village one society. What I would suggest for the consideration of the Conference is that we might say that the area of operations of a primary multi-purpose society should ordinarily be the village. But the area of operation of the mandi trading society should cover all the villages from which produce is brought to the mandi. However, in tracts where villages are very small, or for other adequate reasons, there may be one primary society for more than one village. That would be a sort of general thing which would cover all conditions."

The suggestion of the Chairman was accepted and the following resolution was adopted by the Conference:

"This Conference considered the note submitted by the Government of Madras regarding the reorganisation of the primary credit unit as "Rural Bank" on limited liability basis and recommends (a) that the area of operations of a primary multi-purpose society should ordinarily be the village, (b) that in tracts where villages are very small there may be one primary society for more than one village, and (c) that the area of operations of a mandi trading society should cover all the villages from which produce is brought to the mandi."

The All-India Rural Credit Survey Report recommends large-sized credit societies for groups of villages. But these large-sized agricultural credit societies are open to the following objections:

- (i) The present tendency of planners is to develop each village as a unit. A large-sized credit society will operate against this objective.
- (ii) The anxiety of the Rural Credit Survey Report is that rural credit should be conveyed to as many agriculturists as possible. This can be done only if rural credit is not confined to propertied individuals but extended also to those who cannot provide movable or immovable properties as security for the loans taken. In the latter case, loans will have to be given to a member on the strength of his character assured by a surety of equally good character. Assessment of character over a large area would be difficult. A society with about 20 villages will, therefore, tend to confine itself to loans on the pledge of properties—immovable or movable and defeat the very object of the Rural Credit Survey Report. In this connection, it may be mentioned that the view of Sir Frederick Nicholson, the father of co-operation in India are worth considering. He writes in his Report as follows:

“That which is required jointly by both lender and borrower may be summed up in the word “proximity”. The great lesson of European credit is that without absolute proximity there is no such thing as credit on any reasonable terms for the small folk; hardly indeed is there credit at all. Until of late, only one form of credit satisfied this postulate, viz., that of the private moneylender; his credit satisfied the postulate of proximity, but not necessarily any other postulate.” Hence, the idea of large-sized agricultural credit societies need not be stressed.

[J.C.R(YAN)]

23.12.54

B. CONTROVERSIES OVER CO-OPERATION

D.G.(V) has recently shown concern at the information that he has obtained that the Planning Commission is thinking of making a radical departure from the policy regarding co-operative credit which has been set out in the Agricultural Ministry's letter of the 17th January 1957 addressed to State Governments. His concern is based partly on the ground that the policy itself, which has been adopted by the Government of India with the agreement of the State Governments and the Reserve Bank, is right and should not be amended, at any rate till we have given it a fair chance, and partly that, in any event, a ‘chop and change’ in matters like this at frequent intervals is ruinous to progress.

2. I was not able in Delhi to see the Deputy Chairman of the Planning Commission as he was away on tour, but I did speak to the Finance Minister. At first he said that he was in agreement with the Deputy Chairman. I got the impression, however, that he had not really appreciated the point of view of the Reserve Bank and I explained to him what was the experience of Bombay State in the matter of integrated rural credit and how the proposals which have now been accepted are merely an extension to the whole country of what has already been attempted successfully in Bombay. He seemed greatly interested. Apparently somebody has been talking to him about the dangers of so-called “collectivism”. I told him that the success of the integrated credit experiment in Bombay has been due to “co-operative” effort; and it is resulting in the elimination of the middleman. The Minister agreed that whether this is called co-operation or collectivism, it seemed to be a pretty good thing deserving of encouragement.

3. I also got a chance to explain to the Prime Minister how much I had been impressed by the smooth transition that has been taking place in some areas, for example, Broach District, where an integrated co-operative effort is bringing benefits to the cultivators without destroying the smoothness of the processing or distributive mechanism. He asked me whether we had any statistics about the movement for integrated co-operative credit.

4. I would be grateful if D.G.(V) would let me have a brief note explaining precisely what has been achieved and is being attempted in certain selected areas. I would like to send that note to the Prime Minister.

H.V.R. IENGAR

18.3.1957

D.G.(V) I have mentioned this to C.O., A.C.D. 18.3.1957

C.O., A.C.D.

Mr. Rao, we might send the note you are getting ready.

J.C. RYAN

18.3.1957

Camp: MADRAS

29th May, 1957

[Dear Shri Krishnamachari,]

I notice from the papers that at the meeting of the Lok Sabha a couple of days ago, you announced your intention to promote legislation at the next session of Parliament for divesting the Reserve Bank of certain functions in connection with the handling of agricultural credit. According to the newspapers, you mentioned this point in the context of your enunciation of the future role of the Reserve Bank. We are all most grateful to you for having stated in such explicit terms the place you propose to attach to the Reserve Bank. I personally am particularly grateful that this statement should have been made by you after I became Governor. At the same time, I write to express the hope for the reasons stated below that you have not made up your mind finally with regard to the precise role of the Reserve Bank and the State Bank in the matter of agricultural credit.

2. In the first place, it seems to me necessary that the Boards of the two Banks should be consulted, more particularly as your proposal would involve an amendment of the Reserve Bank of India Act and the State Bank of India Act. It would be necessary to inform them in reasonably precise terms what exactly are the changes proposed and why, so that they can have an opportunity of expressing their views.

3. In the second place, it would seem to be necessary that leading co-operative institutions in the country should be consulted about the proposed changes. From the point of view of good public relations of the Central Government, I should consider such consultations obligatory. At the moment, they are completely at sea, having only vague reports in the press before them. As you are aware, some of these institutions are run by people who have dedicated themselves to the cause of co-operation and whose views it would be improper to bypass before a final decision is taken by Government.

4. In the meanwhile, also, as you are aware, there is an Ad Hoc Committee in the Reserve Bank consisting of Bhattacharyya, Prof. Gadgil and myself to examine this subject. We have already had a couple of meetings and are proposing to have another one early in June. I myself have, as you may have heard, been going round personally investigating this subject and during the course of my present trip, I have arranged a number of meetings with leading co-operative institutions. I am meeting, for instance, the directors of some co-operative land mortgage banks this afternoon and the directors of the State Co-operative Bank of Madras tomorrow. I am also arranging for some similar meetings in Bombay before the meeting of the Ad Hoc Committee. While

these consultations are useful from the point of view of the Ad Hoc Committee, they could not replace the more formal consultations with the co-operative movement which I have suggested above because of the status of the Committee, which is a purely Ad Hoc domestic committee of the Reserve Bank and the State Bank. Moreover, I am not able at this stage to tell the people I meet precisely what is the plan that the Government have in mind beyond that the State Bank should step into the shoes of the Reserve Bank. But this leaves certain questions in the air, such as, for instance, the precise role in the future set-up of the central co-operative banks and the State co-operative banks.

5. I had asked Dr. Madan, while he was in Australia, to study the practice of their Commonwealth Bank. As you are aware, there has been a great deal of discussion in Australia, most of it quite heated, about the role of the Commonwealth Bank in the matter of commercial and agricultural credit, and certain decisions have recently been taken as a result of which, while commercial banking is kept outside the purview of the Commonwealth Bank, agricultural credit will continue to be handled by the Bank. I have asked Dr. Madan to give me a note about this. What may be a correct decision in Australian conditions may not necessarily be appropriate for India, but it would be useful nevertheless to study the Australian debates before we reach a final decision.

6. After the next meeting of our Committee, when we have drafted our provisional conclusions, it might be useful if the Committee could meet you and have a personal discussion on the basis of our draft report. I hope you would agree to this.

Yours sincerely,
H.V.R. IENGAR

FINANCE MINISTER
INDIA

NEW DELHI
June 3, 1957

D.O. No.[...]

My dear Iengar,

Please refer to your letter of the 29th May, written from Madras, in connection with the statement that I made in Parliament on the subject of agricultural credit.

I have no intention of hustling you, but we have to get a move on. The ideas we have of agricultural credit itself is rather narrow and has to be expanded.

The position of bank advances against paddy and rice is not very happy. As you would have seen, twenty scheduled banks by themselves are holding as pledge about eight lakh tons of rice. We do not know what other scheduled and non-scheduled banks are doing. The increase in the advances to co-operative societies *plus* their own increased resources must account for a fair stock of rice pledged with them. An integrated credit policy is therefore necessary.

Besides, it seems reasonably certain that the National Warehousing Corporation has failed and a reorientation of our ideas in this connection must be thought of. The agency of the State Bank might be utilised in this connection as well. The pressure of circumstances now prevailing is so great that we have to move quickly. As I have said at the outset, I am quite prepared to wait until you have made up your mind in

this matter. But in the meantime I am increasingly of the view that the hasty implementation of the perfunctorily conceived recommendations contained in the Rural Credit Survey Report has done us a lot of harm.

With kind regards,

Yours sincerely,
T.T. KRISHNAMACHARI

Organisation of large-sized agricultural credit societies
and expansion of the Agricultural Credit Department

The following papers relating to the question of organising large-sized agricultural credit societies are placed below for perusal, in connection with Governor's forthcoming visit to New Delhi.

- i) Copy of Governor's letter to Shri A.P. Jain, Union Minister for Food and Agriculture dated 3 September 1958, together with a copy of the enclosed note.
- ii) Copy of Governor's letter to Shri A.P. Jain dated 20 September 1958 (together with copy of circular letter).
- iii) Copy of the D.O. of Chief Officer, A.C.D., dated 28 April 1958 to Shri A. Baksi, Joint Secretary to the Government of India, Ministry of Finance, together with a copy of the detailed note enclosed thereto, which had been prepared earlier in the A.C.D.
- iv) Copy of D.G.(V)'s D.O. dated 10 June 1958 to Shri A. Baksi.
- v) Copy of Shri Vaikunth L. Mehta's pamphlet on "Some aspects of Rural Credit Organisation".
- vi) D.O. addressed to D.G.(V) by Shri G. Jagathpathi, Registrar of Co-operative Societies, Madhya Pradesh, together with the enclosures.
- vii) A table showing the frequency distribution of villages with a population of less than 5,000, classified according to different population sizes, for 15 districts, selected on the basis of the criterion of the percentage area under irrigation out of the districts in which the All-India Rural Credit Survey was conducted.

[C.G.R.(AMASUBBU)]

27/9

A.C.O.(Das) - K.M.D. 29/9

D.G.(V) - B.V. 30/9

Governor—I have discussed this with the Finance Minister.

2. I am afraid he is wholly unsympathetic to our views. He is quite prepared for us to stop further expansion of Reserve Bank credit for agricultural production till what he calls the basic objective is achieved viz. of setting up co-operatives which can move on their own (people's) momentum, without official support or patronage. He thinks that the decisions taken on the basis of the Rural Credit Survey Committee Report were completely misconceived and that the sooner they are reversed the better. All he is prepared to do is *not* to break up large-sized societies that have (unfortunately) already been set up.

In view of Finance Minister's attitude we must assume that Cabinet will approve of Planning Commission's views. I think we must now reconsider the entire problem of R.B.'s policy and administrative arrangements.

H.V.R. IENGAR

6/10

D.G.(V) - C.O. wanted this (copy) to be put up for D.G.(V)'s orders on the last para.

K.M.D.

22/10

DCO(R) - I.S. Rao 22/10 - DG(R) wanted this to be raised.

The following points may be mentioned in connection with the reconsideration of the entire problem of the Reserve Bank's policy and administrative arrangements in the sphere of rural credit and co-operation with special reference to the activities of the Agricultural Credit Department and the proposals for this expansion :

(1) The controversy with regard to the reorganisation of the co-operative credit structure is only in respect of the primary level, viz., that concerning large-sized societies. There is no difference of approach whatsoever with regard to the reorganisation at the higher levels of the credit structure, viz., central banks and State co-operative banks. There is unanimity of view that these higher levels need considerable reorganisation by State partnership, etc.

(2) A good part of the activities of the Agricultural Credit Department relate to the reorganisation at the higher levels of the co-operative credit structure. Thus, we inspect apex banks and central banks and central land mortgage banks. A large amount of work has yet to be done to ensure that the higher co-operative financing structure functions on sound lines. A good part of the expanded programme of activities of the Agricultural Credit Department in fact cover activities intended to reorganise the higher levels of the co-operative credit structure.

(3) Even as regards the basic level, the question is still an open one, and according to recent proposals, it is surmised that a high level committee would be set up to consider the various issues involved in the question of small vs. large-sized societies. Present indications, however, are that several of the Registrars are strongly of the view that the programme for organisation of large-sized societies should continue vigorously, at any rate, till the end of the Second Five Year Plan, according to the targets fixed in that Plan. They feel that the plans for the strengthening of the co-operative credit structure will receive a severe jolt if the instructions contained in the Government of India's latest circular on large-sized societies are implemented. This applies both to Registrars in States where the movement is developed and also to the Registrars in States where the movement is undeveloped. At any rate, there are about 5,000 large-sized societies functioning in the country now and they will need considerable attention in the co-operative development plans. There is, besides, the enormous problem of existing small societies (many of which are not strong) through which the bulk of the Reserve Bank's finance is now channelled to the co-operative credit structure. About 1,700 more large-sized societies are expected to be organised in 1958-9.

(4) The need for close liaison with the States, careful watching of credit development plans, giving technical assistance to State Governments and co-operative institutions,

remains in the same manner as before. Although the rate of expansion of credit may be slowed down a little, there will be no fundamental change in the scope and variety of our activities. It would thus appear that the general direction of our policy and administrative arrangements will remain largely unaffected.

I.S. Rao
23/10

The volume of loans drawn from the Reserve Bank by the co-operative movement as short-term agricultural credit, has risen from Rs 12.11 crores in 1951-2 to Rs 61.38 crores in 1957-8. It is not only likely that the increased volume of drawals will continue in the coming years but there is a prospect of that volume increasing further as the co-operative banking structure becomes stronger and stronger. The same is the position in regard to medium-term loans of which a sum of Rs 0.27 crore only was drawn from us in 1954-5 but which has risen to Rs 2.80 crores in 1957-8. The Reserve Bank is also making investments in debentures of central land mortgage banks, which stand at over Rs 1 crore today.

2. The supervision of the application of the loans taken from us for the purposes for which they are given and their recoveries on due dates, is becoming more and more important. There were defaults to us of a few days in Punjab and of nearly a month in West Bengal and the Agricultural Credit Department had to take suitable measures for recovering the overdues as well as for ensuring that similar defaults did not recur. Our responsibility for supervision over the State Co-operative Banks is bound to increase in the future and the need for tightening of supervision by the State Co-operative Banks over the central co-operative banks and the central co-operative banks over the primaries is looming large. Our advice and efforts to get the co-operative credit structure to recover its dues and discharge the duty of supervision satisfactorily, are likely to increase in the future.

3. Apart from this, the Agricultural Credit Department is entering the field of financing cottage and small-scale industries. Already the financing of the handloom industry has been taken up, and, during the year 1957-8 a sum of Rs 1.80 crores was sanctioned to State Co-operative Banks for the purpose. An increasing volume of credit will have to be given for this purpose in the present and coming years. Further, other cottage industries will also have to be taken up for financing. Already, the leather industry, the coir industry and the fisheries industry have been taken up for study and 6 more have been marked for investigation.

4. The inspection of State Co-operative Banks is to be done by the Agricultural Credit Department once a year, and the inspection of central co-operative banks has to be done once in two years. The inspection of central co-operative banks is in arrears for lack of adequate staff.

5. Apart from the above, the requests from State Governments for advice not only by correspondence but also by personal discussions, have increased and the Agricultural Credit Department has to keep in constant touch with the State Governments, the Registrars of Co-operative Societies and the non-official co-operators in every State.

6. Thus, it will be observed that even if the worst should take place and the organisation of the large-sized credit societies is ruled out altogether from 1st April

1959, the need for the expansion of the Agricultural Credit Department and the establishment of 4 more regional offices this year, will continue. May I, therefore, have orders :

- (i) to continue the recruitment of the staff which has been sanctioned, and
- (ii) to go ahead with the arrangements that have been initiated for providing the regional offices with office accommodation at Indore, Bangalore, Patna and Lucknow.

[J.C.R(YAN)]

23.10.58

D.G.(V)

I have assumed that the point raised by Governor concerns the future expansion of co-operative agricultural credit and R.B.I.'s part therein, and that accordingly we should review future administrative and other schemes of the R.B.I. from this point of view. We may discuss this after Governor's return from tour.

As regards sanction already given I have told C.O. that, since these are related to the level of expansion already reviewed, we can proceed on the assumption that the proposed review does not affect these.

[B. V(ENKATAPPIAH)]

25/10

[D.G. A(mbegaokar)]

27/10

Please take action accordingly and put up again after Governor's return from tour.

[B.V.]

27/10

C.A. (for information) : On tour

C.O., A.C.D. Seen.

The papers are submitted for Governor's perusal. 8/11/58

D.C.O.(R) I.S. Rao 8/11/58

Governor: I should like to discuss these papers with DG(V) and C.O. in the light of the decisions...taken at the meetings of the NDC in Delhi.

[H.V.R.]

DG(V)

D.G.(V) and I discussed the matter with the Governor this afternoon. The Governor drew attention to the decisions reached a few days ago by the National Development Council and inquired how this would affect the co-operative movement and the A.C.D. In particular, he desired to know (i) what effect this decision would have on the increasing credit given by the Reserve Bank to the co-operative movement and (ii) on the scheme of co-operative training looked after by the A.C.D.

2. I submitted that the National Development Council decision only affected the co-operative credit societies at the primary level. The effect would be that we might not have any more large-sized societies than the 5,000 societies which had so far been registered. The small-sized societies would continue to exist and more small-sized societies would be registered. The increase in our sanction of credits might not be so

much as in the past but there would still be an increase. The Governor drew attention to the letter he had written to the Agriculture Minister saying that if 5,000 large-sized credit societies were not registered increased credit to the tune of Rs 40 crores would not be available for agricultural production, and enquired whether the N.D.C.'s decision did not mean that the volume of credit supplied by us would be cut down. I indicated that Rs 40 crores would not indeed be given through large-sized credit societies but there would still be an increase in credit sanctioned in small-sized primary societies and the large-sized credit societies already organised. In effect, the rate of increase in future would be small but nevertheless there would be an increase.

3. I indicated that our programme for marketing societies, namely, 1,900 societies by the end of Second Five Year Plan remained unaffected by the N.D.C.'s resolution. Similarly, our plan for linking credit with marketing also remained undisturbed.

4. The Governor enquired whether State partnership in central co-operative banks and state co-operative banks would not be interfered with. I indicated that nothing was said on the subject in the N.D.C.'s resolution and added that so far there was no such proposal. State partnership at the primary level had been disputed by the Planning Commission, but it had acquiesced in state partnership at the central bank level and the state co-operative bank level. They were aware that without state partnership in co-operative financing banks, the volume of credit that might be supplied by the Reserve Bank would be cut down and were not likely to disturb that principle at the level of the financing banks.

5. As regards the training schemes, I represented that we were running five regional co-operative training centres at Poona, Madras, Indore, Ranchi and Meerut as also one Senior Officers' Training Course at Poona. All other training centres (block level and junior officers) were financed by the Government. The junior schools might lose for training the staff intended for 5,000 large-sized credit societies which were cut out from the Plan; but the requirements of higher staff for other societies and departments remained intact. The 5 training centres with which we are concerned require 250 candidates per year of the intermediate and the 6th centre requires about 90 candidates of the superior grade per year. These candidates would be forthcoming in the rest of the period of the Second Five Year Plan and even thereafter. The normal recruitment of additional staff against casualties and leave vacancies would itself provide an adequate number of students for being trained. D.G.(V) agreed that there was need for the continuance of these training centres and added that the arrangements for permanent abodes for Madras, Poona and Agra might be continued; but permanent abodes for the rest might be deferred.

6. The Governor considered that it would be useful to call an informal meeting of leading co-operators namely Prof. Gadgil, Prof. Karve and Shri V.L. Mehta, place before them the N.D.C.'s resolution, and discuss with them the consequences thereof and the steps that would have to be taken in the future regarding the relations of the Reserve Bank with the co-operative movement.

7. D.G.(V) drew the attention of the Governor to the observations of the N.D.C.'s resolution to the effect that agriculturists should be financed more freely even disregarding the usual banking principles. He felt that this would be dangerous if implemented; for the agriculturists who could not repay their loans could not be

provided with credit. The Governor observed that we had gone so far as providing credit for landless agriculturists who could repay out of their produce but could scarcely go beyond that.

8. D.G.(V) raised the question of our participating in the annual plans regarding Co-operation. He felt that invitations received from the Agriculture Ministry which were of a routine character need not be accepted. Those of an important nature might be responded to. But discussions initiated for the Plan by the Planning Commission might be avoided, if possible. This would save us from embarrassment resulting from participating in serious changes of policies. The Governor agreed with D.G.(V) though he felt that it would be difficult to avoid participating in the meetings; we could not refuse co-operation.

J.C. RYAN

13.11.58

D.G.(V) 14/11

A.C.D. 14/11

DG(V) desired that a letter may be addressed to Prof. Gadgil inviting him to the proposed informal discussion on the 24th. If approved, we may also send a similar letter to the other invitees, though they are at present away from Bombay. A draft letter of invitation is placed below for approval.

15/11

D.G.(V) has approved the draft.

A draft note for the informal meeting on the 24th is placed below for approval. We may send two copies of it to Delhi for D.C.O.(R)'s use.

ACO(TSK) 17/11

DG(V) has returned the draft note, as approved by him. As desired by D.G.(V), this and the other material indicated have been sent to Prof. Gadgil, Shri Saraiya and Shri V.L. Mehta last night. A set of the notes will be handed over to P.A. to Prof. Karve to-day. He will hand them over to Shri Karve on his arrival.

2. It is presumed that the meeting will take place in the Board Room. D.G.(V) may indicate whether, apart from D.C.O.(R), A.C.O.(TSK) and R.C.O.(Shri Ramasubbu) who have been dealing with this subject should be present at the meeting.

3. Since it is an informal meeting no seating arrangements need be made.

4. A set of the notes is placed below for retention by D.G.(V). Another set has been sent to Governor.

DG(V) The meeting was held today. 24/11

Note by the Agricultural Credit Department

[November 1958]

Scope of the future activities of the Agricultural Credit Department
in the light of recent decisions on Co-operative Policy

This note seeks to analyse, from the point of view of the Reserve Bank, some of the implications of two recent developments pertaining to official policy in regard to the supply of agricultural credit through co-operatives. The first of these

developments is the issue of a directive by the Ministry of Food and Agriculture, Government of India, to the State Governments (vide its circular No.[...] dated 1 September 1958) to the effect that no large-sized agricultural credit societies should be registered after the end of the year 1958–9, except in States where ten per cent of the villages have not been covered by that date and, even in such cases, that these societies should be organised mainly in backward and scarcity areas. The more important and recent development is the adoption of a resolution on co-operative policy by the National Development Council at its two-day session which concluded on 9 November 1958. This resolution lays down, *inter alia*, (i) that service co-operatives should be organised on the basis of the village community as the primary unit and should serve, as a rule, an area identical to that of a village panchayat, (ii) that suitable arrangements should be worked out in consultation with the Reserve Bank for meeting the credit requirements of the new agricultural programme, which are estimated to be larger than the sum of Rs 225 crores envisaged in the Second Five Year Plan, and (iii) that, in the provision of credit, special attention should be paid to facilities for the grant of crop loans and for assistance to those who could not hitherto obtain credit under the ordinary banking principles. The object of this note is to examine whether these decisions are such as to call for any major changes in the scope and level of the activities of the Agricultural Credit Department of the Reserve Bank of India.

2. The most direct consequence of these decisions relates to the provision of loans by the Reserve Bank to the State Governments, from the National Agricultural Credit (Long-term Operations) Fund, for contribution to the share capital of large-sized agricultural credit societies. It may be mentioned here that the provision of these funds by the Reserve Bank for this purpose figured in the estimates of co-operative development plans, though not specifically included in the outlay of the Central and State Governments, and that in pursuance of a decision of the Standing Advisory Committee, our practice has been to sanction a lump sum of Rs 10,000 as loan for contribution to the share capital of a large-sized society without going into the details of its lending programme, expected share capital contribution of members, etc. The decisions reflected in the circular of the Government of India and the resolution of the National Development Council virtually rule out the organisation of any large-sized societies beyond 1958–9 and, therefore, the sanction of any further loans for contribution to the share capital of large-sized societies, as part of the Plan programme, on the lines indicated above, will have to be treated as closed. At the same time, loans for State contribution to the share capital of primary credit societies need not perhaps be totally ruled out. Firstly, the future requirements of additional share capital contribution by Government in the case of *large-sized societies already established* and to be established before 1958–9 may be considered by us and met where justified. If on the other hand, it is decided to break up existing large-sized societies into smaller units, it may be necessary to withdraw the State contribution already made, and the State Governments may be permitted, if necessary, to use these funds for contributing to the share capital of the concerned central or State co-operative banks. Secondly, we may consider the sanction of loans to State Governments for share capital contribution to small-sized primary

agricultural credit societies, on merits, provided they satisfy certain conditions such as the following : (i) the society should be based on limited liability, (ii) the society should not be engaged in activities such as trading, farming, construction of public works etc. in a manner which may jeopardise its financial condition, (iii) the society is in a position to employ a paid secretary on its own, without a Government subsidy of the type provided so far to the large-sized society, (iv) the society satisfies certain criteria of viability, e.g., pertaining to volume of loan business, etc., which will have to be determined on the basis of a careful examination. These considerations, however, will not arise if all the State Governments decide not to make any share capital contribution whatsoever to co-operative institutions at the primary level.

3. As far as State contribution to share capital at other levels is concerned, it may be mentioned here that no objection has so far been taken to the principle of State partnership in the case of the district central co-operative banks and State co-operative banks. Loans from the National Agricultural Credit (Long-term Operations) Fund for this purpose will, therefore, have to continue to be given, on merits, though, here again, the provision made in the Plan estimates need not be taken into account by us in future as was done in the past, in view of the change in overall co-operative policy. One probable result of the proposed changes at the primary level is that the central co-operative banks may not be able to derive the share capital contribution which might have been expected earlier from the primary large-sized societies and the volume of State contribution needed to be made to the share capital of central banks, therefore, may be larger than earlier anticipated. The alternatives will, therefore, be the curtailment of the credit programme to the size permitted by the relatively small owned funds of the borrowing institutions, or additional contribution to the share capital of central co-operative banks by the State. In any case, any relaxation of the accepted principles of financial soundness will have to be resisted in view of the adverse effects this is bound to have on the strength of the structure as a whole. For example, the restriction of borrowing power to a reasonable multiple of owned funds will have to be insisted upon. The shift in policy now proposed is likely to affect the soundness of the structure at the primary level and this, in turn, may affect, in some measure, the position of the State and central co-operative banks on the strength of whose signatures the Reserve Bank's funds are provided for agricultural purposes. The Reserve Bank will, therefore, have not only to insist on a strict adherence to banking principles in the matter of provision of credit to (and borrowings by) these institutions but, further, ensure that proper arrangements are made for audit and supervision at the primary level. The programme of inspections of these institutions by the Reserve Bank will be of added importance in this context and will have to include a careful study of the working of the structure at the primary level as well which may perhaps involve an intensive examination of the working of the primaries in a compact area i.e. a firka or sub-taluk. It is only in step with such watchfulness and careful inspection of the working of the structure, that the Reserve Bank can proceed to provide increased loans to State Governments for participation in the share capital of central and apex banks.

4. The decision in regard to the expansion of agricultural credit beyond the target of Rs 225 crores and the supply of credit to those who could not obtain it under ordinary "banking principles" (subsequently clarified to mean "commercial banking principles") have policy implications which call for careful examination. As those institutions at the primary level which were expected to command sizeable owned funds to provide a reasonable margin of security for the funds to be borrowed viz. large-size agricultural credit societies—are to be given up, as a rule, and at the same time the supply of credit is to be expanded, it may be suggested at some stage that the borrowing power of a co-operative need not be limited to a specified multiple of its owned funds. On this principle, the co-operative banks as well as the Reserve Bank will have to stand firm and uphold this prudent banking practice which compels the borrowings of institutions organised on a limited liability basis to bear a reasonable relationship to their owned funds. The owned funds form the margin of security for the lender and the banking system cannot work on sound lines and inspire public confidence if the volume of resources raised by institutions by way of borrowings is not carefully related to some stake of the borrowing institutions themselves and their members in their transactions. It will, therefore, be for those who are in favour of the small-sized societies, as a rule, to devise ways and means of enabling these institutions to acquire owned funds of sufficient magnitude to be able to provide credit of the order proposed. One possibility to be explored is that of State partnership at the primary level in those small-sized societies which satisfy certain criteria to be determined. Another line to be pursued will be that of obtaining a sizeable contribution of share capital from members whose ability to save is expected to be substantially promoted through village co-operatives. However, our experience of savings drives, promotion of thrift habits etc. has not been promising. Still another way of meeting the problem might be to provide loans to cultivators to enable them to take shares in co-operatives as has been done in the case of handloom weavers' co-operatives. In the case of handloom societies, the State Government advances loans to members from out of amounts obtained from the Cess Fund, to enable them to invest that money in the shares of societies. If this is adopted the State Government must find necessary funds for the purpose. It is doubtful whether in the midst of various other commitments related to the execution of the Plan they could find funds themselves. While the pros and cons of alternative or complementary methods of providing the primary co-operatives with a sufficiently strong capital base will require to be examined, the need to preserve a proper link between owned funds and borrowings is inescapable.

5. In determining the quantum of credit which the co-operative banks (and ultimately the Reserve Bank) can provide to primary co-operatives, the banks will naturally have to take into account the nature and functions of the primary co-operative unit proposed to be organised. It is important to ensure that the non-credit functions with which the primary village co-operative is to be saddled will not be such or so numerous as to jeopardise its financial soundness. Where any supply functions are to be taken up, they should be undertaken on an agency basis and based on the indents placed by members and not on any account undertaken on a proprietary basis. It is also not known as to precisely what part these co-operatives will be required to play in the context of the socialisation of the wholesale trade in foodgrains which may involve

widespread procurement and distribution, though the Prime Minister is reported to have stated at a meeting of the Congress Parliamentary Party that the socialised wholesale trade in foodgrains would be successful only if village co-operatives are developed. Then again, it is not also clear how exactly the village co-operative will be required to undertake various special functions connected with actual agricultural production, rural welfare and development which are referred to in elaborate detail in the third paragraph of the resolution of the National Development Council. While certain non-credit functions with suitable safeguards could be taken up by large-sized societies which were likely to have sufficient financial and organisational strength necessary for the purpose, it is doubtful if the weaker small-sized societies can handle such additional functions with their negligible resources and turnover which will not enable them to employ adequate paid staff to attend to day-to-day business. Suitable safeguards will, therefore, have to be devised to protect the financial soundness of these primaries through which the funds provided by the banking system will have to flow.

6. Thus, on the one hand, the emphasis on small-sized societies with a village as the area of operations and the discontinuance of the organisation of large-sized societies are both developments which are likely to weaken the institutions at the primary level, especially from the point of view of their ability to borrow from the banks or otherwise raise financial resources; on the other hand, the village co-operative is likely to be burdened with functions which may impair its financial soundness and is to be required to provide loans to those who cannot obtain them on banking principles; both of these are likely to affect adversely the willingness of banks to finance the primary agricultural credit societies. For all these reasons, the flow of funds from the banks to primary co-operatives may actually decline, but the proposal is that the volume of agricultural credit supplied should be expanded beyond the Second Five Year Plan target of Rs 225 crores. Besides, the additional functions of the primaries are likely to add to their credit requirements. In this context, if the primaries are to be enabled to borrow on the scale required and if, at the same time, the soundness of the co-operative banking system is to be protected, the provision of Government guarantee at various levels—those of the central and state co-operative banks and the Reserve Bank—may become necessary in a manner comparable to the practice now obtaining in regard to the financing of industrial co-operatives. (In States like West Bengal, Assam and Bihar where the co-operative movement is weak, Government guarantee is already being given in respect of Reserve Bank finance for agricultural operations.) The Government may have to be persuaded to accept this responsibility in view of the urgent need for expanded agricultural credit, their preference for relatively uneconomic units at the base and their emphasis on radical changes in procedures for the registration of societies, grant of loans and management of co-operatives.

7. The changes in policy now announced will take time to be spelt out in practical terms and to be implemented on any significant scale. The co-operative banks are themselves likely to be watchful in regard to their interests and the Reserve Bank may have to take a firm stand against unsound expansion only if the co-operative banks fail to put forward this point of view and get it accepted by the authorities. As regards the credit to be provided by the Reserve Bank, there is not likely to be any contraction

of the present volume as, even today, the bulk of our funds is reaching the cultivators through the small-sized societies. At the same time there will undoubtedly be a substantial decline in what would otherwise have been achieved, e.g. through fulfilment during the next two years of the target of 10,400 large-sized societies, with the additional share capital at the primary level (together with the corresponding borrowing power) which these would have involved. Of course, the existing large-sized societies and those likely to be established upto the end of 1958-9—about 6,200 in all—will have sizeable borrowing power and their further progress will be attended with an increase in the supply of agricultural credit. This increase may even be quite appreciable. Besides, State participation in share capital in the central and state co-operative banks will continue. All these factors suggest that the agricultural credit structure will continue to draw (though at a much slower pace than at present) an increasing volume of accommodation from the Reserve Bank, notwithstanding the cut in the number of large-sized societies. As for the slower pace, this should not, in view of all the implications of the changed policy, be a matter of regret. It will be all the more necessary hereafter for the Reserve Bank to improve the *quality* of the working of the co-operative credit system through appropriate regulation, inspections, co-ordination etc. The Bank will have to emphasise at each stage the safeguards necessary for ensuring that, alongside the expansion of agricultural credit, there is also a strengthening of the structure in financial and organisational terms, through increases in owned funds, satisfactory arrangements for audit and supervision, the evolution of suitable procedures in respect of non-credit functions and the provision of appropriate guarantees from the State in respect of risks which the system is required to undertake for reasons of State policy, viz., those connected with increased agricultural production.

8. The other important aspect of the resolution of the National Development Council which concerns the Agricultural Credit Department relates to facilities for the training of co-operative staff. The emphasis placed by the Council on the training of village leaders, young men in rural areas who can serve as secretaries of village institutions and staff of co-operative departments only underlines the need for the retention and expansion of training facilities now being provided under the direction of the Central Committee for Co-operative Training. An important factor to be taken into account is, however, that the number of trained secretaries required for primary agricultural credit societies is likely to be reduced, consequent on the cut in the number of large-sized societies. It may be mentioned here that notwithstanding the general accent on deofficialisation, the need for a large number of properly trained departmental staff has been generally accepted on all sides.

9. In conclusion, it may be recalled that the functions of the Reserve Bank of India in the field of agricultural credit in practice consists of (a) the provision of financial accommodation for various purposes, (b) inspection of co-operative banks, (c) planning and co-ordination and the provision of advice to State Governments and co-operative banks, and (d) provision of training facilities for co-operative personnel. Except for the provision of loans to the State Governments for enabling them to contribute to the share capital of large-sized rural credit societies, it does not seem that the part to be played by the Bank in this sphere will in any way be smaller in future than it is today. While undoubtedly the rate of expansion of the

volume of agricultural credit provided by the Bank will be reduced in comparison with the target, which otherwise would have been possible, the Bank will have its hands full in ensuring the development of the agricultural credit structure on sound lines. This will be a difficult task in the context of the decisions now taken regarding the type of co-operative credit institutions to be built up at the primary level and in the light of the present eagerness to expand the supply of agricultural credit beyond the Plan target. If, as the central bank of the country, the Reserve Bank should see that these decisions do not result, in practice, in an impairment of the financial soundness of co-operative credit system, it will have to make active efforts in this direction, on the one hand, through the system of inspections of co-operative banks and, on the other, through such participation in policy-making in this regard as may still be open to it at the Central and State levels.

[6-12-1958]

Informal meeting to consider the National Development Council's
Resolution on Co-operative Policy

Governor had convened an informal meeting on 24 November 1958 at 11 a.m. to consider the implications of the Resolution dated 9-11-1958 of the National Development Council on Co-operative Policy from the point of view of the Agricultural Credit Department of the Reserve Bank of India. The following were present :

1. Governor
2. Deputy Governor (Shri Venkatappiah)
3. Shri M.R. Bhide
4. Shri V.L. Mehta
5. Shri R.G. Saraiya
6. Prof. D.G. Karve

Prof. D.R. Gadgil could not attend.

2. Governor indicated that he was surprised at the manner in which the Resolution involving such large-scale monetary implications should have been passed so casually and without consulting the Reserve Bank of India. He said that the question of co-operative policy was not on the Agenda of the National Development Council and, therefore, even State Governments had not had the opportunity of studying the full implications of the new policy. He felt, however, that nothing would be gained by conveying the Bank's protest to the Government of India. He mentioned that the Government of India, Ministry of Food and Agriculture, had constituted a Working Group to consider the administrative and organisational arrangements required for implementing the Resolution on Co-operative Policy adopted by the National Development Council. Deputy Governor (Shri Venkatappiah) was a member of the Group which had so far met twice on 18 and 19 November and was expected to continue its deliberations. At these meetings Shri Venkatappiah had raised a number of points which would probably be taken into account before the Group came to any conclusions. He pointed out that although there was no estimate of the extent of agricultural credit which the Reserve Bank of India would be called upon to provide it

might be presumed that the Resolution envisaged a large volume of credit from the Bank for agricultural purposes. There were really two aspects of the question. One was whether the type of co-operative credit societies envisaged would be sound enough financially to command the necessary volume of credit, and secondly if that was the case, whether the Reserve Bank should agree to undertake provision of credit on a scale which would appreciably increase the supply of money in the country. The implications of both these aspects would have to be fully studied. He felt that since the Reserve Bank was already aware of the Resolution officially, an interim reply to the Government of India that the matter was receiving its attention should be sent immediately. He also proposed to refer the whole question to the next meeting of the Board of the Bank. He asked the invitees to indicate whether it would be advantageous to convene a conference of State co-operative banks in the country to discuss the matter.

3. Shri Bhide explained the circumstances under which the Resolution was passed. While discussing the food policy, the Prime Minister had felt that, in that context, the co-operative policy needed immediate change, and accordingly wanted a resolution on the subject to be drafted and passed in the meeting. The Planning Commission had not been happy about the experiment with large-sized credit societies, as in many States the area covered by such societies was too extensive. The controversy about large-sized credit societies was going on from January 1957 and certain decisions were reached from time to time culminating in the circular letter of September 1958 of the Government of India, directing State Governments to restrict the area of operations of a large-sized society to 4 or 5 villages, and to organise such societies in backward areas. Some members of the All-India Congress Committee, however, were not happy even with this formula and expressed their disapproval in the last meeting of the Committee. The Community Projects Administration, in the meanwhile, had not been able to create enough enthusiasm among people about agricultural production and co-operatives. The combined effect of these was the present Resolution of the National Development Council.

4. Prof. Karve said that the Reserve Bank could not be expected to lower its standards regarding the supply of agricultural credit. The omnibus character of the small credit society contemplated in the Resolution was not envisaged even for the large-sized credit society, which had better capital structure and better management. He felt that no useful purpose would be served by calling a meeting of State co-operative banks. Perhaps, the banks might take up the question with the Chief Ministers of their respective States who could take up the matter again before the National Development Council. Governor, however, did not expect any such move from the Chief Ministers in view of the strong feelings of the Prime Minister on the subject.

5. Shri Saraiya said that State co-operative banks would be prepared to undertake the programme, provided firstly that advances made by them to agricultural credit societies of the type envisaged were guaranteed by State Government and secondly that they were also provided with necessary financial resources. It was not enough to guarantee the advances made by the Reserve Bank to the State co-operative bank, because in that case, the money provided by the latter bank out of its own resources would not be adequately covered.

6. Shri Mehta also felt that a conference of State co-operative banks would not serve any useful purpose. He indicated that the type of society envisaged in the

Resolution was not to be found in any part of the world. Primary credit societies based on unlimited liability did not take up any functions other than the supply of credit and of certain commodities on an agency basis. Experience in the past was not encouraging about mutual knowledge and mutual co-operation which the Raiffeisen type of society was expected to promote. The Resolution of the Council seemed to ignore completely the experience of the past 4 decades of co-operation in this country. Partnership of the State gave status to institutions of small men and enabled them to expand their business. Government guarantee was not a substitute for State partnership. Emphasis should be on development of co-operative institutions as sound business organisations. The Council's Resolution would not enable the institutions to build themselves up on sound financial lines. He felt that it was necessary for the Reserve Bank to make the position in this regard clear to the Government of India.

7. It was, therefore, decided by Governor to write immediately to the Minister for Food and Agriculture and to endorse a copy of the letter to the Finance Ministry. It was also decided that as the Council's Resolution involved a fundamental change and had implications of a far-reaching nature, the matter should be placed before the next meeting of the Board of the Reserve Bank.

[C.D. D(ATEY)]

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
November 25, 1958

D.O.No. [...]

Dear Shri Jain,

I am writing with reference to the Resolution on co-operative policy adopted by the National Development Council at its meeting held on the 8th and 9th November 1958, a copy of which has been sent to me by Tarlok Singh. A representative of the Reserve Bank has since been invited to join the Working Group set up by your Ministry to consider the administrative and organisational arrangements required for implementing the Resolution. I imagine that, in due course, the Bank will be specifically consulted, as stated in the Resolution, on the arrangements for the expansion of agricultural credit.

2. It is these arrangements and more particularly the implications, in the field of credit policy, of the Resolution adopted by the National Development Council, that concerns the Reserve Bank. The changes proposed are far-reaching in character. The resolution contemplates a rapid multiplication of village co-operative societies which, though relatively small in size, will be expected to undertake a multiplicity of functions some of which involve substantial financial risks. The volume of credit to be provided to these societies will be of very large dimensions and may in fact, form, in size, much the largest part of the Bank's activities. The risk involved will be correspondingly very large. In view of these far-reaching implications, I propose to place the subject before our Board at their next meeting which will be held in

Calcutta on the 22nd of December 1958. I will thereafter communicate to you the considered views of the Bank insofar as the Resolution deals with the credit policy of the Bank.

With kind regards,

Yours sincerely,
H.V.R. IENGAR

Shri Ajit Prasad Jain
Minister for Food & Agriculture
Government of India

MINISTER FOR FOOD & AGRICULTURE
GOVERNMENT OF INDIA
NEW DELHI
December 3, 1958

D.O. No.[...]

My dear Iengar,

Please refer to your D.O.No.[...] dated the 25th November 1958. Originally it was intended that the Ministry of Food and Agriculture will set up a team for working out the scheme to implement the resolution on co-operative policy adopted by the National Development Council. Later on, however, at a meeting of the Planning Commission, it was decided that the team should be set up by the Planning Commission. My Ministry is fully associated with the team and is giving its full co-operation. I am sure that the Reserve Bank will be duly consulted in regard to the arrangements for expansion of agricultural credit.

It is true that the changes proposed are of far-reaching character. Naturally when big things are done, correspondingly large risks are involved. I can well appreciate that you are going to place this matter before the next meeting of the Board of Directors of the Reserve Bank. I shall await with interest the views of the Board.

When you come to Delhi next, please look me up. I would like to have a little chat with you.

Yours sincerely,
AJIT PRASAD JAIN

CO (JCR) 9/12

The following message was dictated over the trunk telephone by the Delhi Manager :

From Governor to Shri Venkatappiah—

“Prime Minister asked me whether some sort of federation of four or five Co-operative Societies could not be made to work. Last night the Home Minister developed the same idea at some length and hoped that some such scheme could be worked out which would meet both the basic conception of the N.D.C. and the Reserve Bank’s criticisms. There may be a meeting ground between this conception and your own suggestion to the working group.

Prime Minister has taken note of [my suggestion for] reinforcing the working group by inclusion of non-officials with real working knowledge of the Co-operative Movement.

Meantime whatever the final answer may be, we must give serious thought to the conception suggested by the Prime Minister and the Home Minister and see whether we can give it practical shape. I would like to discuss this with you tomorrow."

12.12.58

Secretary 12/12

D.G.(V) This has been discussed and notes are being prepared for informing Governor.

12/12

C.O., A.C.D. A draft note on the lines discussed is placed below for favour of approval. The note has been approved by DCO (R).

C.D.D.

15/12

D.G. (V) 15/12

Third Meeting of the Working Group on Co-operation (16.12.58)

CREDIT UNIONS

(Note by Shri B. Venkatappiah, Deputy
Governor, Reserve Bank of India)

At the last meeting of the Working Group held on 8 December 1958, I outlined a proposal by which village societies could federate into unions which would deal with the credit requirements of the people for agricultural and other purposes, while the village societies themselves, as individual units, would devote themselves to as many aspects as practicable of the economic development of the village community as a whole. The federations may be called Credit Unions. It seems to me that this kind of arrangement has considerable advantages and that it gives practical expression, in an important sphere, to the National Development Council's Resolution which states that "village societies should be federated through unions" while ensuring viability and strength of resources so important for providing adequate credit. In further elaboration of my tentative views I circulate this note in order to outline briefly (as I envisage them) the respective functions of the Unions and societies, their mutual relationship and the relationship between these and the institutions at the higher level of co-operative structure. I would emphasise that these views are personal and tentative.

2. Ordinarily, there will be a village society in each village. Where, however, the villages are too small, a society may be formed, with the consent of the people, for a group of villages, provided the total population covered by it does not exceed 1000. Every family in the village will be eligible for membership of the society through one or more of its adult members. Concerted effort will be made to bring all the families in the village or group of villages in the society. The general body of the society will

meet as often as necessary, but at least twice in a year, for the purpose of drawing up a production programme for the village community as a whole. Before the programme is placed before the general body, the managing committee will have gone into the production programmes of individual members, for it is on the basis of individual programmes that the programme for the entire village can be finally settled. The general body, after taking into account the various aspects of the question, will fix targets of production for the different varieties of crops grown in the village. Having fixed the targets for the village as a whole, the general body will first proceed to fix the responsibilities of individual members towards attainment of the targets.

3. Having thus decided upon the total and individual production programmes, it will be the responsibility of the village society to see that the resources and facilities required are mobilised in the village itself or from outside the village. There are certain programmes which can be carried out in the village itself without much outside help and the village society can easily promote them. One such is the multiplication of improved varieties of seed at the village level. The society can select a few enlightened cultivators from amongst its members and make them responsible for the maintenance of seed farms. The additional cost involved in this can easily be met out of the higher price the seed from this farm will fetch; and any technical assistance, advice, subsidy, etc. may be made available through the society by the agricultural department and other agencies. Popularising green manure preparation of compost and obtaining compost, fertilisers etc. can be done in a similar manner by the society. The society can further serve as a good medium for propagating amongst the cultivators knowledge of improved agricultural techniques.

4. There are, however, certain other programmes which cannot be implemented without substantial financial or technical assistance from an outside agency. These may fall into two broad categories, viz., programmes of individuals and programmes benefiting a group of individuals. In either case, financial assistance in the form of loans can come from the Credit Union and technical assistance can be provided by the concerned departments of the State Government. The manner in which the Credit Union will provide finance in the case of both individual and group programmes is indicated below.

5. It is stated in para 2 above that the village society will draw up production programmes for individual members; provision of credit will be based on this programme. Individual agriculturists will be advanced loans directly by the Credit Union on the strength of the recommendations made in this behalf by the village society. It follows, therefore, that individual agriculturists will be members of both the village society and the Credit Union. No loans will be advanced by the latter unless recommended by the village society. Nor will loans be given to anyone who is not a member of the village society. Ordinarily, a group of villages served by a village level worker may come within the jurisdiction of a Credit Union (although this may be flexible, and considered from the points of having an adequate turnover and ensuring accessibility to different parts of the area etc.), and all the societies organised in these villages should also be its members. Since loans will be made by the Union on the basis of a village society's recommendations, responsibility for supervising the proper utilisation of the amounts will to some extent devolve on the

village community as a whole, i.e., as organised in the co-operative society. Thus the benefits of mutual knowledge and mutual supervision will be fully ensured because of the vital position assigned to the village society in the whole system. On the other hand, the Credit Union, with loan business extending to a sizeable number of families residing in a group of villages, can hope to develop within a reasonable period into a viable business unit capable of commanding confidence among depositors and financing agencies at higher levels. The Union will be in a position to employ trained staff and provide efficient service to its members. It would be possible for the State Government to strengthen the Union, where necessary, by contributing to its share capital. The stronger capital base of the Union will enable it to borrow larger funds than will otherwise be possible. The share capital to be collected from members will at the same time be kept at a low enough level, so that the credit programme may be commensurate with the village and individual production programmes drawn up by the village societies. In certain respects, where the village societies find it necessary to have common arrangements—e. g. maintaining a godown for storage or keeping a stock of fertilisers at a point fairly near the village—the Credit Union can be used for such purposes.

6. As regards programmes which are of direct or special concern to a certain number of individuals, and not necessarily to the whole village, such as (in some cases) contour-bunding, soil conservation, construction and maintenance of irrigation works, irrigation channels, etc. the executive responsibility may be undertaken by the village society as a whole or by a special committee appointed for the purpose. The finance required for such activities can be made available by the Credit Union as loans to individuals interested in the activities, who can, thereafter, pool their funds and undertake those activities. The financial responsibility will thus devolve on those who are directly interested in the activities. Technical assistance required will come from Government who may also subsidise partially the expenses incurred.

7. The credit required by individual agriculturists will be partly cash and partly in kind in the form of seeds and fertilisers. The supply of seeds can be arranged in the village itself by the village society from the seed farms as suggested in para 3 above, or from seed obtained from outside, and any payment necessary for the same can be made from loans granted by the Credit Union. The supply of fertilisers also can be arranged in the village itself by the village society by obtaining the necessary quantities from the Credit Union which will serve as sub-stockist of the marketing society, or directly from the marketing society itself. In making the fertilisers available the Credit Union will do so against cash payment by raising the necessary debits in the loan accounts of the individuals receiving fertilisers. In this manner, the tasks intended for the village society in the National Development Council's Resolution, as per paragraph 3, can be performed by the village society in close co-operation with the Credit Union.

8. The village society will have to play yet another important function in recovering the loans advanced by the Credit Union. The managing committee of the society will see that the produce raised by its members is taken directly to the marketing society situated at the mandi centre where it will be sold. The Credit Union's dues will be first realised out of the sale proceeds. In the scheme of linking credit with marketing,

it is envisaged that the services of an agent (e. g. the marketing panchayatdar) would be utilised at the village level for assembling the produce of members and for taking it to the marketing society. The president or secretary of the village society can perform that function and thus officially associate the society with the work of recovery of loans of the Credit Union. If the Union has a godown, the produce can be assembled in that godown before it is transferred for sale to the marketing society. The extent to which the village society makes a success of the link between credit and marketing will determine the extent of credit becoming available from the Credit Union.

9. The Credit Union will be affiliated to the central financing agency at the district level. Since the credit requirements of individual agriculturists will be met by the Union, the village societies may or may not be affiliated to the central financing agencies.

10. Thus the idea of a Credit Union serving a group of villages and confining itself to the supply of credit and of production requirements, and of a village society organised in each village drawing up production programmes, making arrangements for supply of seeds, fertilisers, manures, implements, etc. and undertaking on behalf of its members, such functions as contour-bunding, soil conservation etc. or any other economic activity which may be appropriately taken up by it, including joint-farming, can meet the basic conceptions in the National Development Council's Resolution as well as the fundamental banking principle of separating from the purely credit function those other functions, such as trading and production, which involve appreciable financial risk as distinguished from the normal credit risk. It can, at the same time, ensure a free and adequate supply of credit, mobilise local resources and attract deposits, and ensure the full co-ordination of credit with village production programmes and marketing of produce, especially foodgrains. The centre of activity will thus be the village society and the Credit Union will be made to serve the needs of the village societies in its jurisdiction with the help of a nucleus of trained staff serving under its board of directors.

RESERVE BANK OF INDIA

BOMBAY

15.12.1958

[March 1959]

[Note by D.R. Gadgil]

It is difficult to comment on the report of the working group. This is because the reasons which led the National Development Council to adopt the particular resolution on co-operation are not clear to me. It does not appear that the reasons are clear to the members of the working group themselves. They are evidently doubtful regarding the proper and full meaning of the various parts of the resolution and also as to the definitive programme that is implied in the resolution. However, their attitude towards the resolution is that towards an oracular pronouncement which they diffidently try to interpret but whose possible inconsistencies, misdirection or ineffectiveness they dare not examine.

In the circumstances, I think it would be useful if, instead of commenting on the curious document produced by the working group, I offer brief, general observations upon what seems to be an impossible position into which policy relating to development of co-operation in India has got itself. In common with other matters of policy, attention is directed towards particular aspects of governmental socio-economic policy when difficulties are faced in implementation of existing policy or are created by any development of the situation. It is when problems and difficulties become acute and are identified that they are enquired into. An investigation or an analysis may suggest causes and explanation and also possible remedies. These remedies will usually be tentatively applied or tried on a small scale and when proved fruitful will be incorporated in principles and practices of general policy. None of these stages seem to have been gone through or even contemplated before the production of the N.D.C. resolution on co-operation.

The history of co-operative policy during the last 15 years may be said to begin with the appointment of two committees in 1944-5; one was the Co-operative Development Committee and the other, the Agricultural Finance Sub-Committee. Following the publication of the reports of these committees, steps were taken in many States in a variety of directions. The report of the Rural Credit Survey Committee, appointed by the Reserve Bank of India, contains a full account of most of these. That report, on the basis of one of the fullest factual enquiries ever undertaken in recent times in any country, embodies a generalised set of recommendations. These were considered by the Board of the Reserve Bank of India and submitted to Government. They were, in turn, the subject of many conferences, at official and non-official levels, in the States and at the Centre. As a result, a comprehensive policy relating to co-operation was formulated and has presumably been in operation throughout the country. It is expected of any policy however carefully thought out and implemented that it would, in practice, raise new difficulties and problems. Therefore, it was not unexpected that in subsequent years, complaints should be made and difficulties would arise. In these circumstances the proper procedure is to investigate the nature of difficulties and to ascertain whether they rose out of any defects of the policy itself or of its implementation or interpretation. This would have indicated directions in which modifications were required and not only would the proper remedies have suggested themselves, but also the reasons behind the changes would have been made clear to the public at large. Nothing of this sort appears to have been done, at least to my knowledge. The results of no enquiry, investigation, or analysis are available to the public in this behalf. If anything has happened, that has been in discussions at the Planning Commission or other closed circles and remains buried in official files. This development leads me to comment on another sinister aspect of recent developments.

Ever since the appointment of the MacLagan Commission, it was the practice of even the British government, in the sphere of co-operative policy, to appoint committees of enquiry which always had an important representation of non-official workers in co-operation. The Committees which shaped post-war policy were also appointed by the British Government and these consisted mainly of non-officials and had non-officials as Chairmen. On the State level, one may claim that in the Bombay State, for example, non-officials have participated even more than officials in co-operative

policy making in a history spreading over more than 20 years, say, from the Mehta-Bhansali Report to the Report of the Crop Evaluation Committee of the Bombay State Cooperative Bank published in 1958. The basic continuity, the analytical approach, the background of field experience and the importance attached to non-official workers and leadership, all are fully evident in this history. The working group, of which the report has been circulated, was, in contrast, a body consisting entirely of officials; and in discussions of co-operative policies subsequent to the formulation of policy on the Rural Credit Survey Report, no important representatives of non-official co-operators have been called in for consultation.

So much in relation to what appears to be the most alarming feature of the present situation; which is that co-operative policy is made not after rational, scientific study and full uninhibited participation of non-officials and officials in all States but by fits and starts through personal predilection or prejudice in Delhi. I may add some brief comments on what appear to be the main controversial points involved in the N.D.C. Resolution and the report of the working group. The first is a question of size, area and functions of the primary society. I cannot see how any dogmatic approach can cover the total situation in this regard. It appears clear to me, in the first instance, that co-operative societies must be looked at essentially as business organisations and must be primarily designed and constructed to carry out their particular businesses. They ought not to be confused with purely political or administrative organisations like Panchayats. It will happen, as often happens in all contexts, that the groups of people who lead the Panchayats and the co-operative organisations are the same; but this ought not to lead to confusion between legal and financial or other provisions under which a Panchayat acts and must act and the constitutional structure and business operations of a particular co-operative society. Secondly, even vaguely planning functions such as that of producing crop or production plans for the village, whatever that may mean in concrete terms, ought not to be confused with co-operative organisation. Here again, it may be good to have co-operative organisations represented on planning authorities at various levels; but this must not lead to mixing up the two organisations.

Coming to co-operative business proper, it is difficult to see how a single organisation can perform all functions or a rigid type of a single area organisation can satisfy all needs in every context. The co-operative business organisations have to carry out a large number of different functions. Co-operatives of producers have obviously to be formed in an entirely different way than the co-operatives for marketing or for credit. An artisan co-operative such as a co-operative for leather workers or weavers has to be composed of a number of artisans of the same type and may cover a number of contiguous villages or be confined to one, depending on the concentration of the workers. But if most of the lands in a village come within the fold of co-operative farming, it may be found desirable in the normal-sized village to form, say three or four co-operative farming societies rather than bringing all the lands into a single society. On the other hand, a processing society such as cotton pressing, ginning or rice milling must, to function efficiently, draw its supplies, from large enough areas to give it sufficient business throughout the year or the season. For the purpose, it must spread its membership over many

contiguous villages. In another context, a sales society can operate only where there is habitually a large congregation of traders. No doubt where there is an important element of assembling or grading and storing before transporting the produce to the market village, a village society may act as a useful subsidiary or supplement to the main sale society; but it could never function as the sale society in itself. Similar reasoning applies to purchases; purchases, say of fertilisers from Government cannot be made independently by a village society, but most of the larger village societies can act as distributive agents for an efficient purchasing organisation formed on the basis of a larger area. Credit, similarly, must be related to efficient handling of the credit business. This has two aspects; one is the processing and the scrutinising of applications, disbursement of funds or of materials in lieu of money, insistence on marketing through co-operative channels and recoveries. All this suggests an essentially local organisation in which knowledge of operations of individual operators assumes importance. At the same time, a certain turnover is essential before a primary credit society can operate efficiently. Therefore, unless there is going to be a perpetual subsidising of the secretaries of the societies, the size of a credit society must represent a certain minimum turnover.

All this again will not give a uniform answer regarding the area coverage required in each context. Where operations of agriculture are intense and heavy crops such as sugarcane predominate, even a hundred farmers may be able to sustain a credit society, i.e. in a small-sized village. On the other hand, where farming is largely insecure, non-monetised and subsistence farming the turnover per farmer would be very low. In extreme cases of this sort, no extension of area alone would serve the purpose and subsidisation may be necessary till considerable agricultural development takes place.

The whole question is further complicated by the possibility of combining a number of functions, at the village level. Credit operations may be combined with agency operations for sale societies and local distribution or consumer store business. With such combination, multi-purpose village societies may prove viable. It needs, however, to be remembered in this context that it is usually at a fair-sized village with a relatively central location that assumption of variety of functions becomes possible or profitable.

The upshot of all this is that it is impossible to lay down, it is in fact dangerous to lay down hard and fast rules. Large size is not an objective in itself but excepting in the poorest and most backward areas viability is or should be. The aim of combining everything in one society is impracticable. At the same time, at the primary level, a number of functions that can usefully be performed through one paid agency and one managing committee ought to be so combined. Therefore, policy should be defined in terms of broad objectives and desirable operations and the actual working out of details should be left to individual states being in fact adapted to the circumstances of agricultural business of each type of region.

Considerable controversy has also arisen in relation to government participation. The proper view in this regard is that government participation should be forthcoming where resources that can be raised by members of the societies themselves are inadequate in particular contexts. In a primary society, for example, the need may

arise in two different contexts. In a poor backward area people may be unable to raise funds initially required for even credit or multi-purpose societies in central villages. On the other hand, in developed areas the undertaking of important functions as that of processing or warehousing may require government subscription of share capital. At the same time, government participation by way of subscribing to the share capital of a society ought not to be confused with official domination of the movement. Even in British times the development in various provinces were not uniform in the latter regard. Today, there are a number of states where the resources of the credit movement are mainly derived from the Reserve Bank of India, where the distribution of funds by primary is largely through government or bank officials and where such development as appears to take place is through the pressure on community project or other administrative agencies. In many of such areas, there is no government participation but the movement is essentially officially guided and directed. On the other hand, in the Bombay State the entire co-operative banking structure has, during the last ten years, obtained large funds through subscription of share capital by government. The raising of the structure of sugarcane co-operative factories has also been possible only through government participation. However, in both these contexts, as I can vouch from personal experience, official dominance or interference is completely absent. Official assistance and technical help are always available but the main formulation of policy as well as the conduct of daily operations have been essentially in non-official hands.

It has been contended that the establishment of small village societies will lead to such a mobilisation of internal resources as will make external help unnecessary. This is an entirely illusory belief. In areas like South Gujarat, developments such as of co-operative cotton ginning and pressing have taken place gradually over decades without much external aid. These represent the exceptions. It is only where agriculture is secure and already well-developed and the grip of the moneylender-trader interest is relatively weak that external aid may not be required. Elsewhere rapid and planned development must be initiated with considerable external help. However, once development fructifies devices can be found to step up internal savings and dispense progressively with external aid. This has been the experience for example, of the older established co-operative sugar factories. To talk of depending on internal resources from the beginning is tantamount to condemning, as in the past, all the poorer and moneylender-dominated areas to permanent stagnation. Government participation is, thus, required for widening initially the owned resources base and to start developments. Whether this will lead to official domination or not, depends on the tradition and temper of local officialdom and the strength and quality of non-official workers. Where the latter is found inadequate, official dominance will exist even with little or no government assistance.

There is another vaguely formulated idea current, that a small all-purposes society will help stepping up agricultural production. Detailed analysis of the existing situation will show that this has no adequate basis. Agricultural production lags behind because of a number of reasons such as insecure tenure, unstable prices, an oppressive marketing and processing system, backward technique, failure of seed, fertilisers, etc., supply of inadequate resources which may mean inability to maintain irrigation sources,

implements and bullock power adequately and to purchase in time and sufficiently, needed materials or labour. All these and other defects have to be dealt with specifically and appropriately. An adequately articulated and integrated co-operative structure can alone provide for the total programme in this behalf. Atomistic, all-purposes village societies are not only no panaceas but will, in fact, prove a hindrance in the way of building up the proper remedial programme.

Conditions of underdevelopment, poverty, backwardness, all denote current inadequacy of resources both in finance and in personnel. That external assistance in both these respects, from those more fortunately situated, is urgently required by the underdeveloped is universal experience. The small-sized village in India represents inadequacy of resources in an extreme form and all programmes of its development must, therefore, seek to supply the needed assistance from outside and to integrate this weak unit meaningfully with the rest of the economy.

All this is not to deny that a large new programme of intensified co-operative activity is what the country needs most at this juncture. For the major part of the field of economic activity, co-operation must soon become the dominant form. In the context of this requirement existing developments are seen to be highly insufficient. But building up the new programme should not begin by throwing the baby out with the bath water. What is required is to utilise to the fullest what has been already achieved and what promises results and to think out clearly and step by step the variegated, multi-tiered and adjustable structure that alone can meet the needs of the situation. This is a task in which the participation of every co-operatively conscious element in the country, wherever located and in whatever position, must be invited and encouraged.

To sum up, as a result of a number of personal prejudices and preconceived notions, which have never been adequately discussed in public, co-operative policy in India finds itself in a sorry state. It is high time it was recognised (i) that future developments must take into account the achievements and experience of the past, (ii) that there is enormous variety in conditions and stages of development within the country; and that these rule out a rigid, uniform approach and call for regional adaptation and adjustment, and (iii) that no adequate policy can be formed, in any context in the absence of full public debate and of the co-operation of non-official workers.

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
March 31, 1959

D.O.No.[...]

My dear Bhide,

Please refer to your letter D.O.No.[...] dated the 23rd March 1959 in which you have invited the comments of the Reserve Bank of India on the Report of the Working Group on Co-operative Policy. This Report was considered by the Central Board of the Bank at its meeting held on 2nd March 1959 in New Delhi, and it is in the light of

the views expressed at this meeting that I communicate my comments. I hope Government will forgive me for being completely frank in my criticism of the Report of the Working Group. The matters at issue are so vital that not to do so would be an act of disservice to Government.

2. The criticisms which I have to make relate both to a vital matter of procedure as well as to substantive issues of policy but not, I would like to emphasise, to objectives. The Reserve Bank is in full agreement with the main objectives of the National Development Council's Resolution on Co-operative Policy. In other words, it shares the desire to ensure that as large a section as practicable of the rural economy and, in particular, activities such as credit, marketing, processing and storage, are organised on a cooperative basis. The Reserve Bank also agrees that the maximum possible scope for initiative and growth should be retained at the primary level, that there should be the fullest co-ordination between Co-operation and Community Development, and that the development envisaged should be for the rural community as a whole, including the artisan and the landless labourer. But while agreeing with Government in the objectives stated in that Resolution, the Bank fears that some of the decisions likely to flow from the Report of the Working Group may retard rather than promote progress.

3. *Procedure*: It may be recalled that the present programme of co-operative development was decided upon after the most detailed data had been collected and the fullest discussions held with leading non-official co-operators, State Governments and the Reserve Bank. It is, in my opinion, a matter of regret that a major change in co-operative policy should have been formulated without similar examination of all available facts and the fullest exchange of views with all those concerned, including non-official co-operators, among whom, as you are aware, are persons of great eminence and experience. From this point of view, moreover, it cannot but be regarded as unfortunate that the Working Group appointed should have been wholly official in its composition. It is a matter for further regret that the proposed Conference where both State Ministers for Co-operation and leading non-officials who have worked in the co-operative field would have been present had to be postponed. The first point I would make, therefore, is that even at this late stage, the same procedure might be adopted as in the past and, before decisions are reached, the fullest provision made for consultations and discussions among all those concerned.

4. *"One village, one society"*: None of the considerations set out in para 2 justifies the very small unit—one village as a rule but, if this is departed from, not more than 200 families—which the Resolution envisages as the right size for a co-operative society. Nor, as pointed out by the Working Group, is there justification for the conclusion that all interests and all activities should be concentrated in this one society. Indeed, as the Working Group has been at pains to emphasise, it is essential that the credit function, for example, should not be combined with activities which involve substantial financial risk or sizeable long-term investment. For such activities, therefore, it will be necessary to organise separate societies, and some of these may well cover an area larger than a village. Similarly, where special interests have to be catered for or special needs met, as in the case of handloom weavers or other

artisans, it is often advisable to organise a separate society, covering a suitable area, for this class of persons. Briefly, the size of a co-operative as well as the range of its functions must be allowed to be determined by the wholly pragmatic consideration as to whether or not it will work. There should be no dogma such as "one village, one society", or "one society, all functions". Nor is there any reason why the Panchayat and the co-operative should invariably be made to cover the same area. Moreover, while it is important that these two bodies should work together, it is equally important that their functions and responsibilities should be defined and demarcated. The basis of the distinction is that which the Working Group itself has broadly indicated in its Report.

5. *Large-sized credit societies:* The large-sized society was conceived of as large enough to be viable while compact enough to be co-operative. The "size" was with reference to neither area nor population but to the turnover of business. But if viability, in any particular case, could not be secured without the area being too large or the membership too big, it was also contemplated that it would be the viability that would be sacrificed and not the compactness of the society. In other words, neither area nor membership would be permitted to exceed certain optimum limits. These principles have in general been well understood by State Governments. Any significant deviations therefrom, largely traceable to the newness of the experiment, have been confined to one or two State Governments; and, even there, steps were being initiated to rectify the position in the relatively few cases where that course was necessary. It was in this context, and with little or no attempt to ascertain the facts concerning the working and record of large-sized societies, that criticism was levelled against this form of organisation and attempts made to reverse the momentum which the programme had already gained. It is my duty to point out that much of the criticism was ill-informed. It has been hinted, for example, that the large-sized society perpetuates bureaucracy, whereas the small-sized society helps retain the initiative at the village level and is relatively free of officialdom. In most States, if not all, this is the exact reverse of what actually happens. The viable society has appreciable resources of its own and, in addition, a competent executive as its paid servant. The small society, on the other hand—as Shri V.L. Mehta and other experienced co-operators have repeatedly pointed out—is usually almost wholly dependent on the central co-operative bank, or the co-operative department, or both, for even the preparation of its credit statements and maintenance of its records, and is therefore in effect run by either or both of these outside authorities. The domination of the small society by the supervisors of the central bank or the officials of the co-operative department is all the greater in States which are co-operatively backward. This is only one illustration of the many misconceptions which have been generated concerning the functioning of large-sized societies. It is not my purpose to deal with each of these misapprehensions. I would leave that to a fact-finding enquiry which I hope will in due course be conducted. Meanwhile, I would emphasise that it is unfortunate that, without any attempt to ascertain facts and discuss conclusions, attempts should have been made to stop or curtail even the strictly limited programme of large-sized societies embodied in the Second Five Year Plan. Some of the State Governments have made available to us data which are summarised in the Annexure to this letter. (Information is awaited

from certain others.) On the facts set out, it appears to me that the only conclusion possible, albeit tentative, is that, from the point of view of the provision of adequate credit, this form of organisation is the most promising yet experimented upon in Indian conditions. Indeed, many of the societies appear to have succeeded not only in effecting a large increase in the quantum of loans available for agricultural purposes, but also in attracting deposits, effecting prompt recoveries and, above all, inspiring confidence and enthusiasm in the people. The Reserve Bank notes that a very vigorous programme of cooperative development—including marketing, processing, farming and other activities—is contemplated with almost immediate effect by the National Development Council. This is most welcome; but it should at the same time be realised that an adequate credit organisation is one of the essential pre-requisites of any such programme of co-operative development. It would, from this point of view, be unfortunate if no more large-sized societies were to be organised during the remaining two years of the present Plan. The Reserve Bank is, therefore, firmly of the view that the programme of large-sized societies should be neither stopped nor curtailed but should be proceeded with as laid down in the current Plan. A fact-finding enquiry should at the same time be initiated so that adequate data on the working of the credit societies at the primary level may be available in time for the formulation of an appropriate programme for the Third Five Year Plan.

6. *Pattern No.1:* As already emphasised, compromise has to be effected between viability and compactness where both cannot be secured. To restrict the size to a rigid 1,000, i.e. to 200 families (of whom in all likelihood only 120 to 150 would be farmers), is to abandon altogether the consideration of viability for a degree of compactness which surely no principle of co-operation can be said to require. Thus, if a single village with a population of 3,000 can be served by one multi-purpose society without violating co-operative principles, is there any reason why three close-by villages with the same total population should not be similarly served? There should be no rigid insistence on 1,000, which in any case is far too small. I would urge that, consistently with the principles of compactness of area, accessibility to all members and, last but not least, viability, the actual area of operations should be left to be determined according to local conditions by the State Governments themselves.

7. *State contribution to share capital of village co-operatives:* It is observed that, though the National Development Council's Resolution is silent on the question of State partnership, the Working Group has ruled it out at the level of the primary village society, while providing for it at higher levels such as central and apex banks and marketing and processing societies. It is not clear why State partnership should be objectionable at the village level. In fact, as the examples of Andhra and Madras show, State partnership in the primary society has helped very appreciably in attracting deposits from the rural area. This is a phenomenon of great importance since it points a way of mobilising rural savings. I would suggest that wherever the State Government and the people themselves favour it, State partnership should be permissible in the village society.

8. *Pattern No.2:* This pattern has much to commend it in that it seeks to combine smallness and viability : i.e. the small single village society with the compact and viable credit union. If, for any reason, the choice has to be between pattern one and

pattern two, it is clear that only pattern two can bring about rehabilitation of the movement in many areas. This applies, for example, to large tracts in Bihar, Bengal and Mysore, where hundreds of villages have been burdened for years with an almost equal number of stagnant credit societies. But that is not all. From the point of view of larger agricultural production, which in turn implies adequate credit, it is clear that pattern two will be immeasurably more effective than pattern one in most parts of the country including areas which are co-operatively developed. The Working Group was, in my view, misguided in attempting to confine this pattern to sparsely populated tracts and economically and co-operatively backward areas. The State Governments and the people concerned should be at liberty to adopt pattern two wherever they want it. The idea that the Centre should dictate to the States on each occasion whether or not this pattern might be adopted appears to me to be both cumbersome and untenable.

9. As regards accommodation from the Reserve Bank, the Working Group have said, "We appreciate that the provision of larger funds by the Reserve Bank will depend a good deal, among other factors, on the strength of the co-operative credit structure, and the effectiveness with which credit and marketing are linked for ensuring prompt recovery of loans." I note that it is proposed to discuss this matter more fully with the Bank at a later stage.

10. Since your letter has reached me only a few days before the National Development Council is due to meet, I have confined my comments to a few of the major recommendations of the Working Group, especially those which deal with credit and the credit structure. These as well as other recommendations require further and careful examination and, above all, full and frank discussion with non-official co-operators, the State Governments, the Reserve Bank and others. I would, therefore, urge again that final decisions be deferred until there has been such an exchange of views.

Yours sincerely,
H.V.R. IENGAR

Shri M.R. Bhide, I.C.S.
Secretary to the Government of India
Ministry of Community Development and Co-operation
New Delhi

[7-4-1959]

I had a long talk in Delhi with the Minister for Co-operative Development, Shri S.K. Dey. I explained to him at some length the views of the Reserve Bank on the NDC Resolution and the Working Group's Report. I told him I was unhappy at the way the whole problem was being dealt with in the Government of India and, in particular, the manner in which decisions were being attempted to be rushed without a proper consideration either of the issues involved or of the actual functioning of different types of co-operative organisations. The Minister told me that he did not

think that any final decision would be taken at the meeting of the NDC and that it was his clear intention to have a meeting, which he hoped would take place in July, with the Ministers in charge of Co-operation and leading non-officials who have worked in the movement. He told me also that he would want particularly to discuss with the Reserve Bank all the issues arising out of the NDC Resolution and not merely the problem of credit.

My discussion with the Minister was on the day before the NDC meeting. Whether the Minister was right in thinking that no firm decision would be taken or whether, in fact, contrary to his desire, the Government of India representatives at the meeting did take a final decision would only be known when we get the minutes of the meeting.

I notice that, in any case, a further discussion would be held with the Reserve Bank on the problem of credit. I had a talk with the Finance Minister about this yesterday. I told him that I was feeling apprehensive about the statement in the paper submitted by the Planning Commission that the problem of credit would have to be dealt with in a fundamental manner. This, together with newspaper accounts of what happened at the meeting, suggest that what the Planning Commission have in mind is that the Reserve Bank should give credit on a large scale to the new societies on a wholly different basis to that hitherto adopted, namely, on the basis of mere needs and not of a multiple of the share capital and reserves. I told the Minister that it would be a complete disaster to the financial reputation of India which, at present is very high, if the Reserve Bank had to show in its books sums as overdues from co-operative institutions. The Bank would have to take up a firm position with regard to the grant of credit to institutions beyond the limits of creditworthiness as assessed by the Bank. If the issue was forced by Government and it was decided finally that sums should be advanced against the Bank's considered judgement of the appropriate credit limits, I felt that it would be more appropriate if the problem were handled not by the Reserve Bank but by a separate institution to be set up for the purpose of handling agricultural credit. It would be open to Government to give such loans to this corporation as they might consider appropriate. Eventually, of course, the money would be advanced by the Reserve Bank, but channelling the funds through a separate corporation was desirable, partly to avoid the risk of the Reserve Bank having to show bad debts in its books and partly to indicate more clearly the nature of the transaction. I said that this was only a preliminary view. Many things could be said against it, but it may have to be resorted to as a lesser of the two evils. The Minister said that he would like to discuss this idea further with me on my return from my overseas trip.

[H.V.R. IENGAR]

7.4.1959

D.G.(V) 7.4

D.G.(A) 8.4

C.O.ACD 8.4

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
April 7, 1959

My dear Bhide,

One of the papers circulated to the National Development Council contains a summary of the views of different people and of the State Governments on the Report of the Working Group. The views of the Reserve Bank, as conveyed in the Governor's D.O. letter of 31 March 1959, are also summarised. It is unfortunate that the summary does not bring out adequately the Reserve Bank's comments on issues of substantive policy as distinguished from those of procedure. It will now be some time before the Conference of Ministers for Co-operation is held. Since there is an adequate interval, may I suggest that, for such conference, the replies not only of the Reserve Bank, but of the State Governments and others, be circulated in full? This will enable more informed discussion at a stage when that will be very important from the point of view of implementation of policy.

Yours sincerely,
B. VENKATAPPIAH

Sub: Rural Credit—Revision of Policy
Letter to Deputy Chairman of the Planning Commission

I submit herewith a draft letter to Shri V.T. Krishnamachari on the lines advised by the Governor. I should like to make two observations:

- (1) I have refrained from making the suggestion that if a radical change in the co-operative structure is made, it may be that a separate central banking organisation will have to be established in the country. I am afraid that if this is said they may adopt the policy of establishing a separate central bank for financing the Co-operative Movement which may protect the Reserve Bank, but throw the Co-operative Movement as a whole in danger.
- (2) I have also extracted the Press interview of the Governor as reported in the *Hindu*. I have deliberately avoided quoting the official version because the Deputy Chairman should have what the public knows about the Governor's views.

[J.C.R.(YAN)]
13.4.1959

Governor (HVR) 13/4/1959

D.O.No.[...]

April 13, 1959

Dear Shri Krishnamachari,

Yesterday I met Shri Jivraj Mehta, the Bombay Finance Minister, and he told me that you are under the impression that I am not happy about the Reserve Bank financing the Co-operative Movement. I was very greatly surprised by this; and I do not know how you gathered this impression. Actually I have been extremely happy

over the progressive increase in the volume of credit provided by the Reserve Bank to the co-operative credit structure. The short-term funds provided by the Bank for seasonal agricultural operations and marketing of crops have been mounting up year after year; the sanctioned amount increased from Rs 16.32 crores during 1953-54 to Rs 48.24 crores during 1957-58. As these sanctions are in the nature of a recurring credit, during 1957-58 the Co-operative Movement drew from us Rs 61.38 crores. In a press interview which I gave at Bombay in September 1958, I drew the attention of the public to this fact and hoped that this progress would be steadily maintained with the result that the Agricultural Credit Department of the Reserve Bank would become one of its most important Departments. I extract below the Press report from the "*Hindu*" dated 5th September 1958.

"Mr. Iengar said that the activities of the Bank had been most striking in the sphere of rural finance, in the wake especially of the recommendations of the All-India Rural Credit Survey Committee. The Reserve Bank had done much to assist in the setting up of an integrated system of rural credit. The scale of financial assistance which the Bank had been providing to the rural sector, primarily through the agency of the State Co-operative Banks had been rising fast, the bulk of the advances being made at a concessional rate of two per cent below Bank Rate. The total of the outstanding advances of the Bank to the State Co-operative Banks, which was something like Rs 3 crores on the eve of the commencement of the First Plan now stood at a little below Rs 50 crores. By the end of the Second Five Year Plan it might go to Rs 100 crores. Besides, the Bank had made available a sum of about Rs 6 crores to State Governments to enable them to contribute to the share capital of co-operative institutions. Mr. Iengar visualised that the Rural Credit Department of the Bank would be one of the biggest institutions in the country in terms of money it handled. It might surpass some leading banking institutions in the country and that was only a 'peep' into the future, he added."

I feel that if the present progress of financing the rural sector is maintained, the Co-operative Movement will be able to reach the target fixed under the Second Five Year Plan viz., Rs 150 crores of short-term credit of which a very large part will be provided by the Reserve Bank.

2. My anxiety about co-operative credit does not relate to what is happening at present. It concerns the plan for the future, which involves a radical change in the basic structure of the Co-operative Movement, viz. the primary credit society. This anxiety has been shared by the Board of Directors of the Reserve Bank who considered at length the recommendations made in this behalf by the National Development Council in November 1958 and the Report of the Working Group on Co-operative Policy appointed to work out methods of implementing those recommendations. I communicated the Bank's views to the Co-operative Department at Delhi before the recent N.D.C. meeting, but it does not appear that they circulated a copy of my letter to anybody. I enclose a copy for your information in case you have not seen it. My real anxiety is that the Bank may be called upon in future to provide a large amount of credit to societies which are structurally weak and if that happened there may well be large unauthorised arrears. I consider that it would be wholly disastrous for the financial reputation of the country if the Reserve Bank had to show in its books a

volume of frozen advances. It is this I am worried about and not the current lending policy of the Bank.

Yours sincerely,
H.V.R. IENGAR

Shri V.T. Krishnamachari
Deputy Chairman
Planning Commission
Government of India

PLANNING COMMISSION
NEW DELHI
April 16, 1959

My dear Iengar,

Many thanks for your letter No.[...] dated 13th April, on financial credit to agricultural co-operatives. Shri Morarji Desai mentioned to me in a general way the point you make in your letter.

2. I had intended to discuss this subject with you. I understand, however, that you are leaving for the U.S.A. on the 19th. As soon as you return, we shall arrange a meeting.

3. Like you, we in the Planning Commission are most anxious that the Reserve Bank should not get involved in unsound financial credits to the movement.

4. In the Second Five Year Plan and a series of letters issued in connection with it, there are two patterns of rural co-operative development envisaged:

(i) The 'rural bank' or the large-sized society recommended by the All-India Rural Credit Survey Committee's Report:

The Plan set a target of about 10,000 societies covering approximately 50,000 villages. By the end of March, 1959, 6,300 societies have been formed covering 70,000 villages.

(ii) Revitalisation of village societies and forming new ones:

Targets for this have been indicated.

5. The National Development Council has laid down the policy to be followed in regard to the latter programme. The main point in this is the linking up of credit with an approved production programme of the village made up of family plans. The question to be considered now is how far the Reserve Bank should provide finance for this programme. Discussions on this are going to take place at official level with Venkatappiah and others. A final decision can be taken after you return and the Finance Minister and myself have discussed the whole question with you.

Yours sincerely,
V.T. KRISHNAMACHARI

June 20, 1959

Dear Shri Morarji Desai,

During the last week or two, I have been busy acquainting myself with some of the more important developments which have taken place while I was abroad. On one

of them I feel it my duty to write to you at once. It pertains to agricultural credit. I refer to the Rs 8 crore pilot scheme for establishing a "line of supplementary credit" from the Central Government to the cultivator through State Governments and co-operatives. The details are given in Circular Letter No.[...] of 16th May 1959 issued by the Ministry of Community Development and Co-operation. The connected papers show that the whole idea of a "supplementary credit line" has emanated from the Planning Commission.

If this had merely been a draft scheme for discussion, my comments would have been unnecessary. It is not. On the contrary, State Governments have been asked to take immediate action on it; and there has been no attempt to discuss beforehand either with them or the Reserve Bank certain features of the Scheme, and various assumptions on which they are based, which *prima facie* merited such a consultation. The point I am raising is not solely one of procedure, though even as a procedural matter it is one of considerable importance. For, firstly, the Reserve Bank is Government's statutory adviser on agricultural credit. Secondly, it operates the very credit scheme to which the present one is supposed to be "supplementary"; and thirdly, it is far and away the largest lender to co-operatives and, in that capacity, is directly interested in the effect of any such scheme on the co-operative credit structure.

My main objection to the scheme, however, is based on substantive and not merely procedural grounds. I shall be doing less than justice to the importance of the subject if I am not completely frank. It is my considered opinion that in its present form the scheme is immature and ill-advised. In justification of this comment I shall draw your attention to three or four of those features—many more can be cited—which are likely in my opinion to render the scheme harmful in certain respects and ineffective in others:

(1) One of the strongest objections to the scheme is the effect it is likely to have on the conduct of business by primary societies. According to the letter, "Central co-operative banks will be sanctioning loans to the primary societies in the normal course. A supplementary loan over and above the normal credit limits for additional finance required by the primary society to finance its members on the fuller scale envisaged above will be given by the central bank. For this purpose, special credit limits may have to be sanctioned by the appropriate authority to the primary society as well as the central co-operative bank". These additional limits will be derived from the supplementary line made available by Government and, obviously, will be specifically related to whatever is not "normal", i.e. (a) loans to new members who would not otherwise have been admitted, (b) loans to existing members who would not ordinarily have been lent anything, and (c) in respect of a member who is a 'normal' borrower, such part of the new loan as is above the 'normal' level. All this is fairly complicated since not only notionally, but in actual practice, societies will have to distinguish between what is "normal" and what is "supplementary". Moreover, the line between normal and supplementary is not static; it changes as the society grows in financial or organisational strength; it also changes if, for example, a good marketing society happens to be established in the area and a few more can be confidently given loans because there is a prospect of their being recovered through the marketing society. To introduce the idea of "normal" and "supplementary" in such circumstances,

with separate resources earmarked for the "supplementary", is in fact tantamount to inviting the society to adopt a double set of standards for its borrowers. Far from leading to progress, it is likely to result in confusion and retrogression. A conservative society will have every temptation to become even more conservative so far as its own risks are concerned, for it can readily relegate to the supplementary category all cases about which it has the slightest misgivings, including those which in normal circumstances it might well have considered favourably and lent from its own resources. There can be no better way of demoralising the co-operatives than to introduce double standards of this kind.

(2) It might be said, in answer to the foregoing objection, that the scheme does not in fact contemplate the bearing of any risk on the part of Government and that it is a basic assumption that all the [Rs] 8 crores together with the interest thereon will come back to the State Governments and through them to the Central Government. In the first place, the assumption is open to question. The supplementary money is Government money and even though it may be channelled through co-operatives every borrower will know it to be Government money; and if experience with tagai and "grow-more-food" loans is any guide, the prospects of full recovery cannot be said to be very bright. In fact the arrears are likely to be substantial. Secondly, if it is indeed true that Government has launched this scheme on the understanding that it will bear no part of the risk, it may be asked what there is in the project to impel central co-operative banks and primary societies to extend their lending programmes, and along with them their risks, so considerably.

(3) That brings me to the point that few, if any, State co-operative banks have exhausted the credit limits which the Reserve Bank has sanctioned them. The limits themselves are being increased from year to year, along with corresponding increases in the share capital etc. of the banks; and today, in 1958-59, the total of such limits sanctioned by the Reserve Bank, insofar as they are for the specific purpose of seasonal agricultural operations and the marketing of crops, amounts to as much as Rs 68.24 crores. (Incidentally, out of this only Rs 40.40 crores was outstanding on 22-5-1959, leaving a balance of Rs 27.84 crores which could still be drawn by the banks.) Indeed, the Ministry's own letter explicitly states: "Generally speaking, shortage of funds is at present not the main reason why central banks do not lend more to societies." It then goes on to propound a remedy of which the main feature is the putting of more funds at the disposal of central banks!

(4) The letter says, "The most effective way of increasing the borrowing capacity of the members is to link up credit with intensive production plans in which every family participates and also with the marketing of agricultural produce. *If this is effectively done* (emphasis mine), it will ensure not only prompt repayment of loans but also considerable increase in the share capital and reserves of the society. It will also attract local deposits and increase the membership". With this counsel of perfection there can be no dispute; nor even with the picture of all that will happen, once that counsel is translated into reality. But the Scheme is silent as to how all this will be "effectively done". There is no mention of more technical

staff for drawing up detailed production plans, nor of physical supplies (e.g. more fertiliser) for bringing about the production, nor of larger outlay on the establishment of marketing societies and godowns. In the absence of financial and other provision for simultaneous effort on all these fronts, the Scheme can have only one implication for the primary credit society, namely, that it alone among all the parties concerned is to act as if certain assumptions were true—e.g. that village production plans exist and marketing societies are effective—even though they are as yet (according to the letter itself) nowhere near reality. What is more, the society is to incur the financial risks involved in acting on these assumptions. Thus it may give a loan for production, but may find itself unable to recover it because effective marketing has not meanwhile been organised. It seems to me that, as a pilot scheme for production *cum* marketing *cum* credit, the project under discussion is wholly inadequate because it has no concrete proposals for either production or marketing.

(5) I am aware that officers of the Ministry, the Planning Commission and the Reserve Bank are engaged in further discussions on this Scheme both among themselves and with State Governments. In view of what I have pointed out, however, it appears to me very necessary that the Scheme be put in abeyance until such time as its harmful features are eliminated and suitable modifications introduced for making it more realistic and effective. I would, therefore, suggest that State Governments be informed that various points arising out of the circular are being considered by Government in consultation with the Reserve Bank and that, pending a further communication, no action should be taken by them on the Scheme previously communicated to them.

I am sending a copy of this letter to Shri S.K. Dey, Minister for Community Development and Co-operation.

Yours sincerely,

H.V.R. IENGAR

RESERVE BANK OF INDIA

CENTRAL OFFICE

BOMBAY

August 4, 1959

D.O.No.[...]

Dear Shri Morarji Desai,

You may recall that I wrote to you some time ago expressing serious apprehensions about the pilot project scheme recommended by the Ministry for Community Development & Co-operation to State Governments. It was subsequently decided that I should discuss the matter further during the Conference of State Ministers of Co-operation at Mysore. I attended this Conference at the invitation of the Minister and am very glad indeed that I did so. For the first time in some years, there was full and frank discussion in which, besides the framers of policy in Delhi, those directly concerned with policy and implementation also participated. In addition to the State Ministers, these included eminent non-official co-operators from different parts of the country. The Conference gave me the opportunity to have some exceedingly useful discussions with the Deputy Chairman of the Planning Commission and his colleagues

and with the Minister, Shri S.K. Dey. As a result, certain misunderstandings have been mitigated, if not cleared, different points of view better appreciated and a definite course of action suggested in regard to the formulation of future policy and procedure.

2. In the Conference itself I made two or three points which seemed to me of importance from the angle of the Reserve Bank. My object in writing this letter is to let you know the position in regard to these matters.

3. I emphasised that one of the primary duties of the Reserve Bank was to ensure the monetary stability of the country; that this was a task on which it had been engaged with some degree of success over the years; and that any unrealistic expansion of agricultural credit on its part would not only be inconsistent with its charter but also give rise to inflation and injure the economic interests of the country. Briefly, any loans given by the Bank to the co-operative credit structure would have to fulfil three requirements: (a) they would have to be related to productive purposes; (b) they should in fact be utilised for such purposes; and (c) they should be fully recovered and returned in time. If these conditions were fulfilled, there was no reason why the Bank should not make a large-scale expansion of its credit to co-operative institutions. It was common knowledge that the Reserve Bank, on its own initiative, had conducted a most elaborate survey and helped to formulate policies on the basis of the results of that survey. Not only had the Bank taken a positive and constructive attitude in this matter, but, in the translation of those policies into practice, had actually stepped up its accommodation to the co-operative credit institutions from a mere 6 lakhs in 1946-47 to nearly Rs 65 crores in 1958-59. Indeed the latest figure of drawings from the Reserve Bank for agricultural credit was very nearly Rs 80 crores which was more than two-thirds of the total of the agricultural loans given by primary co-operative credit societies. The primary task (which, incidentally, the Prime Minister himself emphasised in his message to the Conference) was to make a sustained effort so that the conditions mentioned above could be fulfilled. I pointed out, however, that the mere fact of production, still less the mere formulation of plans of production, would not mean that every cultivator could be given a loan by a primary society. The society ought certainly to reassess a cultivator's credit rating in the light of an effective production programme, but it would nevertheless happen that a certain number of marginal and sub-marginal cultivators would not stand the test of being able to repay. In other words, while a production programme might enhance individual income, and an effective marketing arrangement might enable the credit society to treat more people as 'creditworthy', there would still remain a number of farmers at the subsistence level or below for whom the real requirement would be not credit, but economic rehabilitation. Any pilot project meant to provide these with credit must perforce take into account the future solvency of the credit institution and therefore give adequate guarantees to the latter. In this connection, the position regarding amounts overdue to the primary societies was very pertinent. There was at least one State in which the percentage of overdue to outstandings was more than 50% and a few in which it was less than 20%. (In terms of percentage of overdues to demand, the picture would be even more alarming.) In the light of all this the Reserve Bank's own credit policy,

while as progressive as circumstances permitted, could not depart from certain fundamental criteria; and as a practical matter it did not appear that the co-operatives could possibly advance credit to every single cultivator in the villages.

4. There was considerable discussion on the above points and I believe there was general understanding and appreciation of the attitude taken by the Reserve Bank. Indeed, I was gratified to note that both in his Presidential Address and his later speeches the Deputy Chairman repeatedly underlined the point that neither the credit society nor the Reserve Bank should be called upon to make unsound loans. In the result, it was decided to modify the original pilot project very considerably and put forward an alternative which in effect dealt only with the production aspects of the programme. In particular, it was agreed to omit from the previous pilot project at least two of the features to which I had objected, viz. the provision of Government finance (which you will recollect was to be of the order of Rs 8 crores) and the establishment of a supplementary line of credit at the level of the primary society. This was, I think, a very satisfactory result. All the States seemed to think so too.

5. The second main item I should like to bring to your notice concerns the form of organisation of the primary credit society. There has been, as you are aware, an unfortunate controversy regarding the relative merits of the large-sized and the small-sized societies. It was clear to me that conditions differed so widely in different areas that no one formula could be regarded as holding good everywhere. Most of the non-officials and many of the Ministers present at the Conference were unhappy that they had not been given a full opportunity of expressing their views before important policy changes were made. However that be, the Deputy Chairman of the Planning Commission and the Minister for Community Development & Co-operation were both agreed at the end of the discussions that the fullest possible opportunity should be given for both large-sized societies (i.e. those which had already been established) and the small-sized societies to stabilise themselves and make the maximum possible progress in their respective spheres. In particular, any impression that Government looked upon large-sized societies with disfavour was to be removed and each State asked to give immediate attention to the consolidation of such of these societies as had been hitherto registered on the lines which the Reserve Bank had had in mind. There was to be no question of their being broken up, and this was to be made clear to the States. Evaluation of both types of societies was to be undertaken in due course before any further changes in policy were attempted. But it was important that such evaluation should not be hasty or premature. Apart from size, the other aspects of organisation which claimed the attention of the Conference were those which had a bearing on the adequacy of the borrowing power of the primary society vis-a-vis the co-operative central bank and, through it, the apex bank and the Reserve Bank. It was the general view of the Conference that a committee should be asked to go into this matter. The terms of reference, it was felt, should be specific and detailed. These were drawn up and accepted by the Conference. I believe the personnel of the committee will be shortly decided upon by Government.

6. I believe the Conference fully justified itself. Shri Dey's intention is to follow it up with closer consultations with the Reserve Bank and with non-official co-operative agencies. This, I think, is all to the good.

7. I am sending copies of this letter to Shri V.T. Krishnamachari and Shri S.K. Dey.

Yours sincerely,

H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
New Delhi

IV. STATE BANKING

A. STATE BANK OF INDIA

SECRET

BOMBAY

August 26, 1952

D.O.No.[...]

My dear Deshmukh,

This is with reference to your discussion with me on T.T. Krishnamachari's letter No.[...] dated August 3rd, 1952 regarding the nationalisation of the Imperial Bank of India.

2. As you know the demand for nationalisation of the Bank was based primarily on three grounds:

- (a) The higher personnel of the Bank was overwhelmingly British and Indians were excluded from the higher posts.
- (b) In regard to advances there was discrimination in favour of European companies and this was facilitated by a majority of European Directors in the Board.
- (c) The Bank derived unfair advantages in regard to facilities for transfer of funds to currency chests and remittance of notes through treasuries and branches of the Bank.

In regard to Indianisation, the Imperial Bank has given an assurance to the Government that all senior appointments in the Bank will be Indianised by 1955 and the Purshotamdas Committee, which examined this issue, has stated that this assurance should be regarded as satisfactory. The process of Indianisation is going on according to schedule. It may now be taken for granted that consistently with the requirements of efficiency, everything will be done to Indianise the personnel of the Officer class within the shortest possible time.

As you know, a representative of Government now attends the weekly meetings of the Bank at which all the advances are reviewed and the general policy discussed. A.D. Gorwala, the Government representative, whom I have consulted, has assured me that there was no discrimination whatever against Indian companies. Whatever may have been the policy when the British were in charge of Government, it is extremely unlikely that under present conditions any discrimination will be exercised in favour of European companies. Europeans are no longer in a majority on the Board.

The question of unfair competition was examined by the Purshotamdas Committee, who made recommendations that other scheduled banks should share as far as possible the remittance and other facilities enjoyed by the Imperial Bank. These recommendations have been given effect to.

3. In view of these developments, there is no case for nationalisation on the basis of the old allegations made before India attained independence. There are, however, other factors which have to be considered very carefully before we arrive at a definite decision. You know the history of this problem, for you dealt with it as Governor of the Reserve Bank. In February 1948, Sir Shanmukham Chetty announced in the Assembly that it was the intention of the Government to nationalise the Reserve Bank of India and the Imperial Bank. In regard to the Imperial Bank, Dr. Matthai stated in

1948 that "in the light of the examination of the technical question and in view also of possible repercussions on the investment market and of the existing unsettled economic conditions in the country Government considered that it was not feasible to proceed at that time with the nationalisation of the Imperial Bank of India". Expressing your entire agreement with this statement, you stated in Parliament on November 22nd, 1950, that you were quite convinced that it was not in the best economic interests of the country to attempt nationalisation of the Bank.

4. There have, however, been certain fundamental changes in regard to the Imperial Bank and other scheduled banks since Sir Shanmukham Chetty made his announcement on nationalisation in 1948.

Firstly, the Reserve Bank was nationalised in January 1949 and under Section 7 of the Act the Central Government has the power to give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest. The Directors of the Reserve Bank are now entirely nominated by the Government.

Secondly, under the Banking Companies Act, which was passed in 1949, the Reserve Bank has been invested with very wide and effective powers of supervision and control over all scheduled banks, including the Imperial Bank of India. The more important of these powers are as follows:

- (a) Section 21: Where the Reserve Bank is satisfied that action is necessary in the public interest, it may determine the policy in relation to advances to be followed by banking companies in general or any particular banking company. The Reserve Bank has also been empowered to give directions to banking companies, either generally or individually, as to the purposes for which advances may be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances.
 - (b) The Reserve Bank has also the power to inspect any banking company and its books and accounts. As you know we have now instituted a scheme of systematic inspection of all banks, including the Imperial Bank. Our expectation is that after next year every bank will be inspected at least once a year.
5. Apart from these general powers, which apply to all scheduled banks, the Imperial Bank Act contains provisions for the following additional powers of control and supervision by Government over this Bank.
- (a) The bye-laws of the Bank require the previous approval of the Government.
 - (b) The regulations of the Bank and all amendments thereto require the specific sanction of the Central Legislature.
 - (c) Under Regulation 59, the Government is authorised to appoint auditors to examine and report upon the accounts of the Bank.
 - (d) Under the Clause 3 of the agreement with the Reserve Bank, the Imperial Bank is required to carry out all the orders and directions of the Reserve Bank in carrying out Government business and for the maintenance of the relevant accounts.
 - (e) A Government representative now attends the weekly meetings of the Committee of the Central Board at which all advances are considered and decisions taken on questions of policy.

6. I have described these powers at length, since it is not generally recognised that wide and effective powers of control over the Imperial Bank of India are now vested in the Government of India and the Reserve Bank. As I stated in a memorandum to the Central Board of the Reserve Bank of India "it is definitely a State-controlled institution at present, and if the comprehensive statutory powers vested in the Government and the Reserve Bank are exercised when necessary, and certain minor organisational changes are made, the development of this Bank as a national institution can, in my opinion, be assured. In the next few years a vast extension of the credit machinery will be required to meet the requirements of the planned development of industry and agriculture. In this very difficult period, it is imperative that the Reserve Bank should have the willing co-operation of the largest banking institution in the country, which is functioning as its agent. Unless and until it is proved by experience that our powers are ineffective and the Imperial Bank's active co-operation is not forthcoming, I would deprecate strongly any drastic changes in the constitution of the Bank."

7. Nevertheless, (I am quoting again from my memorandum to the Board) "it has to be recognised that the Imperial Bank has, partly on account of its long association with the Government and the special privileges it has enjoyed, attained a pre-eminent, if not dominant, position in the banking structure of the country. With a network of branches spread all over the country, it is still functioning as banker to Government at places where the Reserve Bank has no branches. It maintains currency chests and small coin depots and operates the remittance facilities scheme. It acts as a banker's bank by keeping their surplus cash and by granting them advances. It manages the clearing houses in many places. It is obvious that the Government cannot be disinterested in the working of a Bank, which has acquired such a dominant position in the credit structure of the country and is at present the biggest banking institution in Asia. It is immaterial from the point of view of national interests whether close association with the Government or sound management is the more important factor which has contributed to this development. A Bank which has reached this position cannot justifiably claim to be treated like an ordinary commercial bank."

8. The time has arrived when we should consider the question of nationalisation or radical changes in the constitution of the Bank from the point of view of the planned development of the country. As you know, I suggested nearly three years ago, the transfer of all treasury work to the Imperial Bank, who would be required to extend their branches to all places where treasuries are functioning at present. The idea behind this was the planned integration of the banking structure. Commercial banking would be taken up to the taluk headquarters and as the Purshotamdas Committee have recommended, beyond this stage co-operative credit banks and other institutions would carry credit facilities to the rural areas. At present, considerations of possible losses arising from the rapid expansion of branches to semi-urban areas deter the banks from any such expansion on the lines suggested. This outlook, influenced by the profit motive, is inevitable so long as the Directors and the Executive Officers are responsible to shareholders for the management of the bank. If a partial nationalisation is to be undertaken for a rapid expansion of credit facilities, Krishnamachari's proposal for the appointment of the Managing Director and the Deputy Managing Director by Government would not achieve the object, for these officers would still be responsible

wholly or partly to the shareholders. Indeed, their position would become impossible if they have divided responsibilities to the Government and the shareholders. If control by Government is to be effective, the Government must hold, at any rate, a majority of the shares, if not all the shares.

9. With reference to our discussion last week in Bombay, I will re-examine the whole question afresh from the point of view of development of banking and credit facilities after I have had the report of the Rural Credit Survey, which, as you know, is considering the question of the lines on which credit facilities should be extended to rural areas.

Yours sincerely,

B. RAMA RAU

11-3-1955

State Bank of India—Vesting of shares in the Reserve

Bank of India—advantages

The Central Board of the Reserve Bank has strongly endorsed the Governor's proposal that the major ownership of the share capital of the State Bank should vest in the Reserve Bank and not partly in the Reserve Bank and partly in Government as suggested by the Committee of Direction, All-India Rural Credit Survey. An attempt is made in this note to state the advantages of the proposal approved by the Board. These advantages principally flow from the basic assumption made in this note that there is some virtue in preserving the commercial character of a banking institution after the transference of control to Government; also that when a fundamental change is brought about in the economic field, it is always expedient to usher in the change in a manner which does not immediately cause much dislocation in the process of changeover or gravely disturb the confidence of the classes whose co-operation in the evolution of a new pattern is a considerable source of strength.

(1) Need for retaining flexibility of working:

For the successful and efficient working of a commercial bank, flexibility in working is of great importance, and it is necessary that it should not be hampered by the rigidity of Government rules and procedures. Although the managerial autonomy and operational flexibility of the State Bank may be achieved by constituting it into a separate corporation distinct from Government, it is believed that the vesting of its capital in an institution such as the Reserve Bank rather than in the Central Government would provide it greater flexibility, and eliminate delays and red tape. In other words, the Reserve Bank's ownership of the capital of the State Bank will prevent the latter from turning, despite its separate corporate existence, into a Department of Government subject to its traditional and rigid restrictions.

(2) Greater public confidence:

Ownership by the Reserve Bank of the major share of the capital of the State Bank will inspire greater confidence in the public in its capacity to continue to provide quick, efficient and satisfactory banking service and to maintain its confidential relationship with the constituents. This would be viewed as earnest of the Government's desire to implement the assurance given to the public that the Government's association

with any bank will not result in impairing the credit and banking facilities generally enjoyed by commercial and other interests and the usual confidential relationship between the bank on one side and its clients and depositors on the other.

(3) Lesser political interference:

The Reserve Bank's ownership will be an assurance that, conversion of the Imperial Bank into the State Bank will not lead to interference by Government in the day-to-day working of the Bank. Direct holding of the capital by the State, it is feared by some, may lead to frequent interpolations in Parliament and political interference in the detailed working of the Bank, the effect of which would be injurious to the healthy development of the institution.

(4) Expert advice of the Reserve Bank:

The Reserve Bank is essentially an expert body in close touch with the working of commercial banks and fully alive to their needs and problems. It is, therefore, felt that the over-all supervision and control over the State Bank should be vested in that Bank. Such supervision and control will be more purposeful if the capital of the State Bank is vested in the Reserve Bank than in the Central Government.

(5) Freedom from Governmental Audit:

If the Government were to own the capital of the State Bank either in full or in part, the question of providing for audit by the Comptroller and Auditor-General would arise. (In this country, the extension of Government type of audit to institutions working on commercial lines is relatively a new phenomenon, and it is far from clear whether the enlargement of the sphere of such audit, intended largely to serve greater accountability of public funds to Parliament, so as to cover commercial banking institutions would necessarily advance public interest. In any case, it is desirable that the State Bank, at any rate in the early stages, should have freedom from the inhibitory effect and irksome restrictions of such an audit so as to retain for it its operational and financial initiative.)

(6) Consistency with the main purpose and objective:

The functions of the State Bank will include—

- (a) the taking over of cash work from non-banking treasuries and sub-treasuries with charge of the Reserve Bank's currency chest;
- (b) the provision of vastly extended and cheap remittance facilities;
- (c) the spreading of banking facilities to rural areas; and more particularly to assist in fostering the development of commercial, and particularly co-operative, banking throughout the country.

In all these the Reserve Bank is vitally interested, while in some of them, the State Bank will be functioning more or less as the agent of the Reserve Bank. It appears logical therefore that the Government's partnership in the capital of the State Bank should be through the Reserve Bank. It is considered that such a relationship will, if anything, be more in accord with the aim of the Committee of Direction, which was to evolve a mixed pattern of shareholding.

2. The object of the Government to assume control over the Imperial Bank is principally to regulate effectively its policies. Since the Reserve Bank is a fully nationalised institution there can be no doubt as to effectiveness of Government control over the policies of the State Bank by the proposed device. It appears

therefore that the vesting of the capital of the State Bank in the Reserve Bank would be a more desirable method of carrying out the reform the Government have in mind. There is a precedent in Australia for the course suggested where the ownership of the Government Trading Bank vests in the Commonwealth Bank and not in the Central Government.

[N.D. NANGIA]

[23-2-1955]

STATE BANK OF INDIA

The Department of Banking Operations have prepared a note containing their observations in regard to the recommendation of the Committee of Direction, All-India Rural Credit Survey, for the formation of a State Bank of India. The conclusion reached by them is that it might be preferable to wait and watch the experiment of nationalisation of the Imperial Bank before taking any steps either for the amalgamation of the 10 other State-associated banks with the Imperial Bank or even for their formation as subsidiaries for eventual amalgamation. Their suggestion is that a provision may be made in the State Bank Act for voluntary amalgamation and that this course may be pursued where the State Bank considers it desirable and the other banks also agree. Before dealing with the reasons given by the Department of Banking Operations for reaching this conclusion, it may be useful to describe the background against which the Committee of Direction have recommended the formation of the State Bank of India.

2. In July 1949, the Indian States Finances Enquiry Committee (under the Chairmanship of Shri V.T.Krishnamachari) in its report on the financial integration of the Princely States with the rest of India, emphasised the need for an early review of the question of bringing the banking and treasury arrangements in Part 'B' States into line with those obtaining in Part 'A' States as, in its opinion, the then existing arrangements in some of the States were far from satisfactory. Later, in November 1949, the Government of India appointed the Rural Banking Enquiry Committee which was asked, among other things, to consider the measures that could be immediately adopted for the extension of banking facilities in rural areas and also to make recommendations regarding banks which were handling treasury work in Part 'B' States. The Committee, after a detailed study of the subject, reached the following conclusions regarding Part 'B' States:

- (i) The Hyderabad State Bank, in view of its origin and history and the functions which it was already performing, should be appointed as agent of the Reserve Bank in the State;
- (ii) As regards the other States, the majority of the banks handling Government work in them were not qualified for being appointed as agents of the Reserve Bank. They had inadequate resources and were of insufficient standing. However, in order to avoid damaging their position by depriving them of Government work suddenly, the Committee recommended that they might continue to function on the lines they were doing for a period of five years, at the end of which period their position would have to be further reviewed.

3. The Committee's recommendations were examined by the Government of India in

consultation with the Reserve Bank. The Government of India decided that it would be a retrograde step to ask Part 'B' States to reverse the process and to assume treasury functions themselves. It was, therefore, decided to explore the possibility of appointing the State Banks as agents of the Reserve Bank and to entrust them with treasury work at appropriate centres subject to such safeguards as might be considered necessary in order to ensure the safety of Government monies, the balances of currency chests maintained by the Issue Department of the Reserve Bank, etc. In pursuance of this decision, the Hyderabad State Bank and the Bank of Mysore have been appointed as agents of the Reserve Bank in the respective States with effect from the 1st April 1953 and the 1st November 1953 respectively. It has also been announced that the Travancore Bank and the State Bank of Saurashtra will be considered for appointment as our agents. The safeguards taken are that the banks are required to accept the scheme of control in terms of which there is a nominee each of the Central Government and the Reserve Bank on the Boards of these banks. The Central Government have also power to issue instructions to the banks e.g. in circumstances involving contravention of the terms of the relative agreements between the State Banks and the Reserve Bank or in regard to the safety of balances in the currency chests. Over and above this, the State Government concerned is required to give a guarantee for losses occurring in the balances in the currency chests. It may be stated that these safeguards are of limited value. For instance, the scheme of control does not give an effective control to the Reserve Bank on the affairs of the banks. All important matters e.g. grant of advances, investments of the banks' funds, etc., are decided by the Boards of the respective banks and although our nominees may tender advice, they have no power to overrule the Boards. The Boards can thus disregard the advice tendered by our nominees. The scheme of control is, therefore, not effective and so long as the banks are owned by private shareholders, no effective control can be acquired over them. *The guarantee of the State Government, it may be mentioned, may be of no value in certain contingencies.* Utmost caution has, therefore, to be exercised in establishing currency chests at offices of the State Banks.

The upshot of the foregoing historical background is that the rate of progress in converting non-banking treasuries into banking treasuries in Part 'B' States through the medium of the State Banks will be extremely slow if these banks continue to function as separate units and the Government or the Reserve Bank do not acquire control over them. As separate units and owned largely by private shareholders (except, of course, in the case of the Bank of Patiala and the State Bank of Saurashtra and also the Hyderabad State Bank), it would be impossible to secure an alignment of policies of these banks in consonance with national objectives. Further, none of the State-associated banks in Part 'B' States approaches anywhere near the Imperial Bank's standards from the point of view of resources, experience and traditions, equipment and managerial efficiency. These are limitations which have to be recognised in the context of handing over currency chests to them and entrusting them with remittance and treasury functions on Reserve Bank's behalf. The Committee of Direction, All-India Rural Credit Survey, took into account these limitations and the whole background of the State-associated banks and reached the conclusion that, in national interests, the next logical step to take would be to amalgamate them with the Imperial Bank.

4. Coming to the note of the Department of Banking Operations, the main points made by them and our comments thereon are given below:

- (i) There will be an enormous rise in the establishment cost of the State Bank of India and its capacity to extend its activities by opening new branches will be severely curtailed. The argument "capacity to pay" will be difficult to sustain in the case of the State Bank of India.

The Department of Banking Operations have stated that the proposed nationalisation of the Imperial Bank and the 10 major State-associated banks has been hailed by the employees as a step in the right direction as they expect that their emoluments would considerably increase by such a step. The employees have perhaps supported the proposal because the control of the banks will pass from the respective managements to the Government or the Reserve Bank. This is perhaps because they think that they will receive a better treatment at the hands of the Government or the Reserve Bank than from the present managements. The answer to this point is that the employees of banks very well know that the employees in the commercial departments of Government such as Posts and Telegraphs Department, Railways, get much less emoluments than those prescribed in the award for banks. It is hardly likely that the employees would expect an increase in their emoluments as a result of nationalisation. As regards other State-associated banks, if, as stated in the Department of Banking Operations' note, they are run as subsidiaries of the State Bank of India, they will be treated as separate units for purposes of labour awards and continue to be placed in the respective classes as prescribed in the awards. In this context, it may be stated that the Grindlays Bank is a subsidiary of the National Bank of India and yet the two banks are treated as separate units for purposes of labour disputes. Similarly, the Allahabad Bank is an affiliate of the Chartered Bank of India, Australia and China and yet both these banks are considered as separate entities for purposes of labour disputes. It cannot, therefore, be stated that the conversion of the Imperial Bank of India into the State Bank of India or the taking over of the State-associated banks as subsidiaries would involve an enormous increase in establishment costs. Nor is there any ground for the assumption that "the capacity to pay" would cease to be a valid consideration because of State control. The Railways, for example, are not paying their employees without regard to earnings and capacity to pay. For that matter, the pay scales of clerical and subordinate staff in the service of the Central and State Governments are not higher than those of Class 'A' banks. In fact, they are very much lower in the case of certain Governments e.g. Mysore.

- (ii) The State Bank of India may have to undertake expansion of foreign exchange business. This will, however, depend partly upon the attitude adopted by the other countries towards the State Bank.

There are several State-owned banks engaged in commercial banking business which have branches outside the respective countries. Among Commonwealth countries, the Commonwealth Bank of Australia and the Bank of New Zealand are instances in point. Right in our midst in the city of Bombay, we have

branches of the Bank of China and Comptoir National D'Escompte de Paris, both of which mainly transact foreign exchange business. The first is a State-controlled bank (2/3rds of share capital vests in the Government of China) and the second is a fully nationalised institution.

It would not be incorrect to assume that a State-owned bank may even have greater prestige abroad than a bank which is owned by private shareholders.

- (iii) The advances granted by many of the State-associated or State-owned banks were, as a result of Reserve Bank inspection, found to be based on other than purely commercial banking practice and while some State-associated banks had gone into liquidation after the integration of the States, the financial position of many of the remaining banks is not quite satisfactory.

This applies to banks owned by private shareholders also. The inspections of private-owned banks conducted by the Department of Banking Operations have revealed that there are instances of advances being granted on other than purely commercial banking practice. The number of State-associated banks, which have gone into liquidation, so far as we are aware, is not very large, and in any case, only smaller-sized institutions had to be taken into liquidation. The real or exchangeable value of the paid-up capital and reserves of the 10 State-associated banks, as estimated by the Department of Banking Operations, *does not reveal that their financial position is not satisfactory*. All of them appear to be solvent institutions and their position is no worse than that of many private-owned commercial banks. In fact, the entire case for amalgamation rests on the weaknesses (to the extent these exist) of the individual State-associated banks. By bringing them together with the Imperial Bank, a strong, well-integrated bank would result. This is the only way for us to get a stable and reliable agent in Part 'B' States. Of course, the case is different if the propositions were that banks which are not financially solvent (i.e. capable of meeting their liabilities in full) should be amalgamated. The Department of Banking Operations' inspections of these banks have not, in the case of any of the 10 major banks, reached that conclusion. Amalgamation is merely the principle of achieving strength through unity. Indeed, certain provisions in the Banking Companies Act show that the Legislature has fully appreciated this position.

- (iv) With variations in paid-up capital and reserves, earning capacity and the rate of interest and market quotations for shares, it will be difficult, if not impossible, to find any basis for compensation which will not lead to dissatisfaction, not without foundation, among the shareholders of the bank concerned.

The question of devising a suitable basis for compensation may present some difficulties in certain cases. But it cannot be stated that the question is beyond solution. It should be possible to devise a machinery for ensuring that a fair basis of compensation is worked out in each case. In any case, this by itself, would not appear to be a reason for withholding the establishment of the State Bank of India.

- (v) The rates of interest on deposits allowed by the Imperial Bank are lower than those of the other State-associated banks. If the amalgamation takes place, it is not unlikely that a fair portion of the deposits held at present by the State-associated banks will be transferred elsewhere.

In this connection, it may be stated that it is the common practice among banks to pay different rates of interest on deposits at different centres. Thus, for example, the Imperial Bank offers 1½% on 6 months' deposits at Calcutta but the rate at Delhi is 2½%. The Bank of Baroda offers interest on Savings Bank deposits at various centres at rates varying from 1% in Ahmedabad and Bombay to 2% at Hyderabad and Madras. The State Bank of India could, therefore, pay slightly higher rates at centres in Part 'B' States, if necessary. In any case, if the State-associated banks are run as subsidiaries for some time, the question of lowering the rates of interest will not arise. There is nothing sacrosanct about rates of interest which are dictated purely by business considerations. There is no law which prescribes what the rates of interest given by banks on deposits (or those charged on advances) should be. Our assumption is that the State Bank of India should function as a business institution and at the same time, it should avoid the undesirable type of competition with other banks. It is a truism in banking that the bigger and stronger the bank, the lower is the rate it needs to pay to attract deposits. It may be that the State Bank of India would be able to retain the present level of deposits of the State-associated banks by offering lower rates. If, however, deposits show a tendency to get diverted to other banks in the area, the rates could be put up to the extent necessary to arrest such a process. A business concern knows best how to run; we may well leave this question to be tackled by the State Bank carefully and judiciously.

- (vi) The amalgamation of the 10 State-associated banks with the Imperial Bank will lead to a concentration of the offices of the State Bank in the western parts of the country, leaving the eastern sector such as the tracts of Madhya Pradesh, Bihar, Orissa, West Bengal, Assam, etc., with relatively fewer offices of the State Bank. The objective of the Committee will be better achieved if the State Bank opens offices in the relatively undeveloped parts instead of taking over the State-associated banks.

In this connection, it may be stated that very great emphasis has been laid in the expansion programme of the Imperial Bank for opening branches in undeveloped areas such as Madhya Pradesh, Bihar, Orissa, Assam, etc. It is after great pressure exercised by the Reserve Bank that the Imperial Bank has agreed to open branches in these areas. So long as the bank is private-owned, it is bound to look at every proposition for opening new branches from the angle of earning potentiality. It is for this very reason that the Committee has recommended acquisition of control over the Imperial Bank and other State-associated banks, as otherwise they do not extend their activities to undeveloped areas. There would, of course, be rationalisation of branches of the Imperial Bank and other State-associated banks at certain centres. This will release trained staff, etc. for opening branches in undeveloped areas. The amalgamation will thus assist the bank in opening branches in undeveloped areas rather than impeding progress. The map given in the Report shows that the respective State-associated banks e.g. Hyderabad State Bank, Bank of Patiala, State Bank of Saurashtra, Bank of Mysore, Bank of Rajasthan, etc., have a considerable number of branches in the respective States. This is the reason why the Committee has suggested that the

amalgamation of the banks would provide a network of branches throughout the country to undertake treasury work, give remittance facilities and generally carry on and extend their operations in conformity with national interests. The Committee was well aware of overlapping at certain centres. This will have to be dealt with suitably when the State Bank of India is formed. The Committee, because of the vast field which exists for expansion, has pointed out that there would be no need for the retrenchment of surplus staff. In the Committee's appraisal of the situation, the need may well be for the recruitment of further staff e.g. by re-employment of retired personnel.

- (vii) The offices of the State-associated banks are concentrated in a few districts. The institution of a currency chest at each of these centres would be an uneconomic proposition.

Currency chests will be established after careful investigation. At present, there are over 100 district centres and over 300 sub-divisional centres where currency chests do not exist.

Conclusion

The Government of India have already taken a decision on the conversion of the Imperial Bank of India into the State Bank of India. The question now for consideration is as to whether and if so in what manner the State-associated banks should be amalgamated with the Imperial Bank. If, as suggested, the State-associated banks are run as subsidiaries of the State Bank of India for some time, these banks will continue to be placed in the respective classes under the labour awards and there would not be any increase in establishment expenses. Such subsidiaries could also continue the rates of interest on deposits and advances according to local conditions and make adjustments gradually. Their administrative standards could also be improved during the interim period i.e. till they are integrated with the Imperial Bank. One of the essential conditions for extension of banking facilities in the country is the establishment of currency chests to facilitate the movement of cash from one centre to another. As already explained, a vigorous and co-ordinated programme for the establishment of currency chests cannot be carried out so long as these banks continue as separate, and relatively smaller units. So long as these banks continue to function as private-owned (except, of course, the Bank of Patiala and the State Bank of Saurashtra), these banks will be managed by the respective Boards and effective control over them cannot be exercised. In view of the smallness of their size, lack of premises and other arrangements comparable with those of the Imperial Bank and inadequately paid managerial staff, it would not be possible to entrust currency chests to them at many of the centres. Thus, remittance facilities cannot be provided until currency chests are established and currency chests on a large scale cannot be established so long as these banks continue to operate as smaller units. The guarantee of State Governments is not an effective safeguard, considering the changes in the political set-up which have taken place in certain States. It is true that the Banking Companies Act has conferred several powers on the Reserve Bank. It is also true that banks in Part 'B' States which are appointed our agents have to comply with our scheme of control. But, by the exercise of these powers, we cannot get over the limitations arising from the smallness

of size of these banks and the consequential lower standards of administration, particularly at branches, and generally of financial soundness and strength of these institutions as compared with the Imperial Bank. The presence of a Police force does not create good citizens. In the same way, weaker banks cannot be converted into stronger units by the exercise of certain powers. The case for integration of banks is the same as that on which the political and financial integration of Part 'B' States was based. The aim is to unify the banks and thus create the framework we want.

[T.K. RAMASUBRAMANIAM]

23.2.1955

17th July 1957

Dear Shri Krishnamachari,

I got the impression, from what you told me on the telephone the other day, that you felt that the report of the Ad Hoc Committee on the State Bank's role in agricultural credit had put you in difficulty vis-a-vis Parliament and the general public. I write this letter to elaborate the point I briefly made, viz., that, that impression would not be correct. While, of course, the Committee dealt with the proposals entirely on their merits, I was throughout conscious of the need of avoiding, as much as possible, any political or personal embarrassment so far as you are concerned; and, in the final analysis, the report, I think, has not been unsuccessful from this point of view.

2. According to the *'Times of India'* of the 28th May 1957, while speaking in the Lok Sabha on the two Bills to amend the Reserve Bank and the State Bank Acts, you stated that the State Bank "should be not only a commercial bank but should also have a non-commercial or developmental side, taking over from the Reserve Bank the function of lending to co-operative institutions, to agriculture and to small-scale industries". Referring to suggestions made by some members of Parliament, you observed that the "Reserve Bank must remain the topmost financial institution in the country controlling practically every movement in finance. But some of its present functions which were of a commercial nature, like affording agricultural co-operative credit, would be transferred to the State Bank."

3. The Ad Hoc Committee's recommendations fit in with this pronouncement. Let us first consider whether the State Bank would be taking on "a non-commercial or developmental side". Credit to agricultural marketing and processing societies, which, according to the Committee's recommendation, is to be the function of the State Bank in most of the States, is commercial in nature; at the same time, it is in furtherance of the co-operative movement at the primary level of villages and must be co-ordinated with the functioning of primary societies. It has, therefore, quite definitely a developmental aspect. No commercial bank would, in the ordinary course, give advances to such societies or be ever bothered with the tedious and unprofitable task of liaison with primary village societies; nor has the State Bank ever thought of doing so itself. In breaking this new ground, therefore, the State Bank will be taking on a commercial-cum-developmental activity to which the Second Five Year Plan attaches very great importance. As stated in the report, the quantum of assistance called for is immense and

I have, in fact, doubts in my mind as to whether the target can be reached.

May I add here that this proposed development in the activities of the State Bank must be assessed in the context of other similar activities, e.g. the experiments in the field of small-scale industries? When I was in Madras, I went into this in some detail and I was very greatly struck by the potentialities of this new line. If the initial momentum in this field is kept up, the State Bank will be taking on a very big responsibility indeed. The combination of credit to marketing and processing societies and to small-scale industries will constitute a totality of developmental activity of tremendous size.

4. We may now consider your proposal that the Reserve Bank should divest itself of "functions of a commercial nature, like affording agricultural co-operative credit". I would like to point out that the Reserve Bank does not provide funds to agriculturists direct, nor even to primary co-operative societies composed of agriculturists. It gives them to central co-operative banks for reimbursing the funds they have already lent to primary co-operative societies. This, as explained in the Committee's report, is a central and not a commercial banking function. You are possibly aware that the Reserve Bank lends on the rediscount of agricultural bills at 2 per cent below the Bank rate. Quite apart from the nature of the transaction itself, no commercial bank would ever dream of giving a subsidy of this size.

5. I see no reason, therefore, for your feeling unduly defensive in case you accepted the Committee's recommendation.

Yours sincerely,
H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister, India.

B. STATE-ASSOCIATED BANKS AND SUBSIDIARIES OF SBI

Summary of the views expressed at the meeting of the Central Board of the Reserve Bank on the 28th February, 1955, on item No. 8 of the agenda, viz. "Integration of the State-associated banks with the State Bank of India".

In his opening remarks, the *Governor* said that he would confine himself to some of the main points which would have to be borne in mind in the discussion of this subject. First of all, there would have to be certain criteria on which to decide whether or not it was desirable to amalgamate an individual "State-associated" bank with the State Bank of India. He suggested that there were two broad criteria, one relating to the utility of such amalgamation and the other to the degree of association with the State discernible in the present features of the bank. In other words, it would first have to be considered whether the amalgamation would serve one or more of the purposes intended, such as banking development generally and the provision of rural banking facilities in particular. Secondly, it would have to be examined whether, as of the present, the State Government concerned was intimately enough connected with the particular bank for the latter to be described as "State-associated". In this

context, it would have to be remembered that the State Government's relationship with the bank could take one or more different forms. One of these was the degree of control, if any, exercised through appointment of directors, approval of the appointment of the Managing Director, sanction of bye-laws, etc. Another was the nature of the Government business, if any, e.g. cash work at the treasuries, entrusted to the bank. The third was financial partnership in the bank through ownership, wholly or in part, of the share capital of the bank. Fourthly, yet another connection with the bank might take the form of financial and other assistance, e.g. by way of maintaining Government funds in deposit with the bank. Bearing in mind the two broad criteria—utility and degree of association—one would also have to examine the practical difficulties which might arise in the process of integrating the individual bank with the State Bank of India, whether the integration takes the form of complete amalgamation or of owning and managing the bank as a “subsidiary”. Thus, note would have to be taken of the fact that many of the State-associated banks pay much higher rates of interest on their deposits than does the Imperial Bank. The question of pay-scales (for officers, etc. as well as for staff governed by the Award), and the possibility of having to incur much larger cost through an upgrading of the pay-scales would be another point to be taken into consideration. The qualifications of the existing personnel, and the standards of work generally, differ for different banks; and this point too would need to be considered in the context of amalgamating particular banks with the State Bank of India. Another set of considerations arose in respect of the State Bank of Saurashtra, the Bank of Patiala and the Hyderabad State Bank. The State Governments were cent per cent owners of the Saurashtra and Patiala banks, while the major part of the share capital of the Hyderabad State Bank was held by the Hyderabad Government. From the constitutional point of view, the legality of this arrangement is itself open to question. In regard to these three banks, therefore, the case for their being taken over by the Central Government might be said to be on a different footing from that of the other banks. The Governor emphasised that he was merely analysing the considerations involved, and that it was for the members of the Board to express their views in order that the considered advice of the Central Board on this important matter might be duly conveyed to Government.

Prof. D.R. Gadgil stressed the following points:

The avowed object was the creation of a countrywide banking structure which would be effectively associated with the policies of the State and, for that purpose, also be effectively controlled by the State. It was a basic assumption that the existence and operation of this State-controlled banking institution in any particular area would confer certain important benefits on that area in the sphere of rural credit and other matters, whereas an ordinary commercial bank, which had all the time to look to its dividends, would not be able to confer such benefits. It followed that we could not think of such an institution in terms of Part ‘A’ States alone. The Imperial Bank was broadly confined to Part ‘A’ States. In Part ‘B’ States (and in one instance, i.e. Baroda, a merged area of a Part ‘A’ State) had grown up, under the active patronage of the former princely Governments, individual banks which were broadly comparable, in relation to those areas, to the Imperial Bank as it developed and spread in the former British Provinces. The amalgamation of these banks with the Imperial Bank,

and the establishment, as a result, of the State Bank of India was, therefore, *prima facie* a very valid proposition. It was only in this manner that, without damage to the existing State-associated banks, a countrywide institution could be formed which would confer benefits on all the areas concerned. Since no area could be denied the benefits envisaged, the only alternative to the amalgamation of the State-associated bank operating in that area would be the effective expansion of the State Bank of India itself into that area; but this alternative would be injurious to the bank concerned, whereas amalgamation would be a course which would give a definite place to that bank in the integrated banking structure. In this total context, which had been analysed and elaborated in the Rural Credit Survey Report, it was the whole history of development of individual banks, under the auspices of the former Governments concerned, that would be relevant, rather than any recent alternations in the long-standing basis of "State association". The real question before the Board would appear to be whether, in the solitary instance of the Bank of Baroda, the recent interruption in a long period of association with the State was in itself so significant a factor that this bank could not be classed with the rest for the purpose of the scheme of integration. In his opinion, the short interruption did not constitute a good reason for omitting the Bank of Baroda from the proposed banking structure. There was as good a case for integrating this bank with the proposed State Bank of India as there was for the remaining nine State-associated banks. It was not, of course, suggested that there should be outright amalgamation from the very beginning. As pointed out by the Governor, the ownership of each bank could first be taken over by Government and, for so long as necessary, the institution managed and run as a "subsidiary" of the State Bank. A programme of this kind would have to be pursued with determination, and delay—except such minimum unavoidable delay as may be necessitated by practical considerations—would be of no help. The alternative of voluntary amalgamation would not only cause interminable delay, but there was no assurance, even eventually, that it would result in the "countrywide" structure envisaged. Except in respect of the two or three banks which were already fully or substantially owned by the State Governments, voluntary amalgamation would, therefore, be no solution. The statute would, therefore, have to provide for compulsory acquisition.

Sir Purshotamdas Thakurdas wondered whether the largeness of the administrative effort needed and the question of availability of the trained personnel necessary had been taken into account by the Rural Credit Survey Committee while putting forward the suggestion that so huge a re-organisation of banking should be undertaken by Government. The nationalisation of the Imperial Bank was by itself a big enough task. He would caution Government to "hasten slowly", and not further enlarge and complicate the problem by seeking to tackle the State-associated banks as well. There was another aspect to which he would draw pointed attention. All these banks—he instanced the case of the State Bank of Saurashtra—were built up by local effort, served local needs and evoked local pride and sentiment. It had to be very seriously considered whether a programme of integration which involved the disappearance of these banks as individual entities would not do a great deal of harm not only to the local sentiment, but also to local usefulness, without any counter-balancing advantages from the point of view of national policy.

Sir Manilal B. Nanavati said that two main objectives seemed to underline the proposal that State Bank of India should be constituted. One of these was the wider provision of rural banking facilities, largely in the form of better and more extensive arrangements for the remittance of funds. He suggested that this objective could as well be secured by entering into an appropriate arrangement with each of the banks concerned. The other aim was the provision of agricultural credit through an adequate network of rural branches, such credit being largely based on produce in the custody of marketing societies, warehouses, etc. Most of the State-associated banks under consideration were already doing all they could in this respect; they had in most cases extended far enough into the rural areas; and when warehouses were built or marketing societies established, they would be able to expand their agricultural credit operations just as much as if they were parts of the State Bank of India. He, therefore, thought that the objectives postulated did not necessitate the amalgamation of these banks with the State Bank of India. He added that, if necessary, more control could be assumed by the State over each of these banks, if that was found to be necessary in the interests of rural credit; there was no need for absorbing the banks in the State Bank of India.

Shri C.R. Srinivasan agreed with Sir Purshotamdas Thakurdas that Government should "hasten slowly" in this matter and that the re-organisation of the Imperial Bank involved in its conversion into the State Bank of India was itself so big a task that it would be unwise to add to the administrative burden by taking on other banks as well. He agreed, however, that if and when a particular State-associated bank—e.g. Saurashtra or Patiala—was decided to be acquired, the first step should be that of constituting the bank into a subsidiary. Integration, in the sense of complete amalgamation, would come later. He added that the arguments for excluding the Bank of Baroda from the scheme of integration applied substantially to the Bank of Mysore as well; the State Government did not own any part of the share capital of this bank and it was only lately as a result of an agreement with the Reserve Bank, that the bank had come to be regularly entrusted with the cash work of certain Government treasuries in the State. The bank was essentially a commercial bank in the sense in which the Bank of Baroda could also validly be claimed to be a commercial bank as distinguished from a "State-associated" bank. For these reasons, while on the one hand the scheme of integration itself should be launched gradually and with due caution, the banks of Baroda and Mysore, on the other hand, should not be included in the scheme at all.

Shri Dharendra Nath Mitra laid emphasis on the need to avoid any undue delay in the reaching of decisions; if "hastening slow" implied that the question would be kept open for a long time to come in respect of individual banks, then those banks would live under the shadow of nationalisation and not know whether to expand or not as normal commercial banks. It was, therefore, necessary that criteria for acquisition should be considered as soon as possible and decisions on individual banks arrived at without avoidable delay. He would make the tentative suggestion that State participation in share capital might be adopted as the main criterion; on the basis of such participation being appreciable, the banks to be acquired would be Saurashtra, Patiala, Hyderabad and, possibly, Travancore and Indore. For practical reasons, he would be in favour of each of the banks selected being first taken over as a "subsidiary" of the State Bank; he would postpone complete amalgamation to a later stage.

Shri B.M. Birla said that the State-associated banks were a great facility for the small business man who, in the area served by the bank, could approach it for loans, whereas a big institution like the Imperial Bank (or, hereafter, the State Bank) would hardly care to cater to his needs. If on the ground that the Saurashtra and Patiala banks were already State-owned it was proposed to merge them in the proposed State Bank, that was something to which no objection could perhaps be taken; but the nationalisation of the other State-associated banks would be an entirely different matter to which he felt bound to object. As regards these other banks, he did not see why their amalgamation with the State Bank should be sought even on a voluntary basis. In respect of them, therefore, he would go to the extent of saying that the State Bank of India Bill should not contain a provision which would enable negotiations for voluntary amalgamation.

Sir Shri Ram said that he would like it to be placed on record as his view that Government's decision in respect of the Imperial Bank, taken without consulting the Board, was not only unwarranted by the grounds adduced, but was definitely prejudicial to the private sector of industry, trade and commerce, whose confidence in Government's policies had already been badly shaken. He was of the view that none of the ten State-associated banks should be nationalised. He agreed with Sir Purshotamdas Thakurdas regarding the magnitude of the administrative and other difficulties involved and the consequent need for Government pursuing a slow and cautious policy in this matter.

Shri B.D.V. Ramaswamy Naidu was prepared to agree to the inclusion of Saurashtra and Patiala banks, but not any other. He generally agreed with Sir Purshotamdas Thakurdas and Sir Shri Ram regarding the undesirability of nationalising the State-associated banks.

Prof. Gorakhnath Sinha said that, as he understood the position, the conversion of the Imperial Bank into the State Bank would amount to its being reserved for the public sector on the one hand and for rural credit on the other. It was necessary that the private industrial sector should have its own sources of finance; he thought that if the State-associated banks were left as they were, they would serve the purpose of financing this sector. He was, therefore, against the amalgamation of these banks with the State Bank of India, or, as a first step, their conversion into subsidiaries.

Prof. D.R. Gadgil spoke again to point out that the discussion seemed to him divorced from the basis of policy already laid down in the Finance Minister's announcement. Since the Finance Minister had said that "the Government of India accept in principle the recommendation eventually to bring about the establishment of an integrated commercial banking institution covering the whole country with effective control vested in the State", the real question before the Board was not that of the principle itself, but the mode of implementation. In fact, it was about "the details of both the manner and the phasing of so important a measure of reform" that the Finance Minister had said in Parliament that careful examination was necessary and had gone on to add that "these will in due course be carefully examined by the Government after the receipt of the views of the Board of the Reserve Bank".

Shri H.M. Patel said that it would have been of greater help to the Government of India if the members of the Board, after making such reservation as they considered

necessary in regard to the broad policy itself, proceeded to make constructive suggestions in regard to the process of implementation; there were, for example, important issues such as the criteria for selection of individual banks for the purpose of integration on which Government were expecting advice from the Board of the Reserve Bank; and there was also the suggestion referred to by the Governor, that such banks as were included for integration should in the first instance be taken over as subsidiaries, and only at a later stage, if necessary, amalgamated with the State Bank. As regards the policy of integration itself, there was, in his opinion, no doubt regarding Government's acceptance of it in principle. This was clear from the Finance Minister's speech on economic policy as well as from the specific wording of the announcement. Shri Patel then referred to one of the ideas which had been put forward during the discussion, viz. that the State Bank of India in the form of a converted Imperial Bank should extend to Part 'B' States and, wherever necessary, establish branches which would be parallel to those of the State-associated banks, without however absorbing the banks themselves. He agreed with Prof. Gadgil that such an expansion on the part of the State Bank would be gravely prejudicial to the State-associated banks concerned. He added that it was for this, among other reasons, that Government had decided to accept in principle the broad scheme of integration. Summing up the discussion, the Governor said that, while obviously there was no unanimity, the Board appeared to be substantially of the following view:

- (1) It is undesirable to provide in the statute for the compulsory acquisition of any of the ten State-associated banks;
- (2) where necessary, amalgamation can take place on the basis of voluntary negotiation; and
- (3) even so, there are only three banks which need be considered for amalgamation, viz. the State Bank of Saurashtra, the Bank of Patiala and the Hyderabad State Bank.

[2-3-1955]

At the meeting of the Central Board of the Reserve Bank on 28th February, one of the items considered was the integration of the State-associated banks with the State Bank of India. The ten State-associated banks considered were those mentioned in the Rural Credit Survey Committee Report, viz.

- i) The State Bank of Saurashtra
- ii) The Bank of Patiala
- iii) The Bank of Bikaner
- iv) The Bank of Jaipur
- v) The Bank of Rajasthan
- vi) The Bank of Indore
- vii) The Bank of Baroda
- viii) The Bank of Mysore
- ix) The Hyderabad State Bank
- x) The Travancore Bank

While a few of the members did not see much objection to the State banks of Saurashtra, Patiala and Hyderabad being taken over for the purpose, many of them were of the view that no action at all should be taken beyond that which was rendered inevitable by the decision already announced by Government in respect of the Imperial Bank, viz. the conversion of that bank into the State Bank of India. In fact, Shri B. M. Birla was of the view that the State Bank of India Bill should not contain a provision for negotiating with other banks, at the instance of Government, for voluntary amalgamation. Sir Purshotamdas Thakurdas, Sir Manilal Nanavati and Sir Shri Ram, and one or two others emphasised that a certain amount of local sentiment was attached to most of these banks, and that a programme of integration would not only injure such sentiment but also impair the usefulness of individual banks. Sir Shri Ram cited with approval the view expressed in a communication addressed by Shri J. R. D. Tata to the Governor of the Reserve Bank which was to the effect that Government's decision in respect of the Imperial Bank, taken without consulting the Board, was not only unwarranted by the grounds adduced, but was definitely prejudicial to the private sector of industry, trade and commerce whose confidence in Government's policies had already been badly shaken. Shri Gorakhnath Sinha of Bihar appeared to argue on the assumption that the action proposed in respect of the Imperial Bank amounted to converting that bank into a financier, exclusively, of the public sector and of rural credit. He went on to suggest that the other State-associated banks should be left as they were in order to finance the private sector, including urban industry. Shri C. R. Srinivasan agreed with Sir Purshotamdas Thakurdas that Government should 'hasten slowly' and interpreted this to mean that the State-associated banks should be left out altogether. Shri Dharendra Nath Mitra suggested that there was a clear case for integrating at least Patiala, Saurashtra and Hyderabad (and possibly also Travancore and Indore) banks and stressed the need for taking an immediate decision about these and other banks so that there might not be a long period of uncertainty as to which banks would be amalgamated with the State Bank and which would not. Shri B. D. V. Ramaswamy Naidu was prepared to agree to the inclusion of Saurashtra and Patiala banks but not any other. He generally agreed with Sir Purshotamdas Thakurdas and Sir Shri Ram regarding the undesirability of nationalising the State-associated banks.

With the exception of Shri Dharendra Nath Mitra and Prof. D. R. Gadgil, the non-official members of the Board were therefore of the view that most, if not all, of the State-associated banks should be left out altogether and generally implied disagreement with Government's policy of State control and integration of a certain defined sector of banks in terms of the Finance Minister's announcement. Most of the discussion took place after Prof. Gadgil had briefly mentioned the reasons set out in the Report of the Rural Credit Survey Committee in support of assumption of control over the State-associated banks and their integration into a countrywide banking structure. Prof. Gadgil also intervened at an early stage of the discussion to emphasise that in view of the Finance Minister's announcement that "the Government of India accept in principle the recommendation eventually to bring about the establishment of an integrated commercial banking institution covering the whole country with effective control vested in the State", the real question before the Board was not that of the principle itself but the mode of implementation. In fact, it was about "the details of

both the manner and the phasing of so important a measure of reform" that the Finance Minister said in Parliament that careful examination was necessary and went on to add that "these will in due course be carefully examined by the Government after the receipt of the views of the Board of the Reserve Bank".

On behalf of Government, I pointed out during the discussion that it would be much more useful if the members of the Board, after making such reservation as they considered necessary in regard to the broad policy itself, proceeded to make helpful and constructive suggestions in regard to the process of implementation; there were, for example, important issues such as the criteria for selection of individual banks for the purpose of integration on which Government were expecting advice from the Board of the Reserve Bank; and there was also the suggestion that such banks as were included for integration should in the first instance be taken over as subsidiaries, on which and connected points the views of the Reserve Bank would be of great help to Government. As regards the policy of integration itself, there could be no doubt whatever of government's acceptance of it in principle. This was clear from the Finance Minister's speech on economic policy as well as from the specific wording of the announcement. In regard to one of the ideas which had been canvassed, viz. that the State Bank of India in the form of a converted Imperial Bank should extend to Part 'B' States and wherever necessary establish branches which would be parallel to those of the State-associated banks, without however absorbing the banks themselves, I added that such an expansion on the part of the State Bank would not only be gravely prejudicial to the individual State-associated banks but would, in point of policy, be definitely contrary to the announced intentions of Government in regard to integration.

The position thus created was discussed with me by the Governor of the Reserve Bank after the Board meeting on the 28th February and again on the forenoon of the 1st March, when Shri Venkatappiah was also present. His general view appeared to be that we should proceed with the State Bank of India Bill on the assumption that it would for the time being be confined to the Imperial Bank, that another piece of legislation might later be introduced in respect of such State-associated banks as Government might eventually decide to include in the scheme and that, meanwhile, the views of the State Governments (and only incidentally the banks) concerned should be ascertained by means of a formal explanatory letter to each, followed by a visit of the officers of the Reserve Bank. Where there was willingness or, at any rate, little or no opposition from the State Governments concerned and the individual bank was on merit suitable for integration, a decision could be taken to include the particular bank in the scheme of integration; the integration itself, however, should be by stages, and in any case the substance of integration would be secured at the stage of acquiring the particular bank as a subsidiary of either the Reserve Bank or the State Bank. I said that I would report his views to the Finance Minister, but that I was myself by no means certain that the reaction of the State Government should be the main factor in deciding whether or not a bank should be integrated. The responsibility was that of the Union and, while informal consultations need not be ruled out, the decision would have to be related to the policies formulated. Whether or not there should be a separate piece of legislation, amending or other, in respect of the State-

associated banks would largely depend on the time factor. If decisions could not be reached early enough, it may, for that reason, become inevitable to confine the State Bank of India Bill to the Imperial Bank in the first instance. Even if there was to be a second bill, there could be no question of delaying it unduly, for it would be harmful from every point of view to postpone decision to a remote date. The Governor said that he contemplated very early action so far as consultation with the State Governments was concerned. I understand that he has since discussed this matter with the Finance Minister.

The Board of the Reserve Bank having reached the conclusions that it did, it is clear that as soon as the views of the Board are formally communicated to us, the whole matter will stand remitted to Government and that it will now be for Government to take decisions on all the broad issues arising from the policy already announced. It is unfortunate that these decisions have to be taken without the type of assistance, by way of formulation of criteria, modes of implementation etc., which, it was hoped could be obtained from the considered views, on all these points, of the Board of the Reserve Bank. I think the primary initiative and responsibility in respect of the consultations with State Government should now be assumed by the Finance Ministry. I think that the Finance Ministry, assisted by one or two officers of the Reserve Bank, can without much difficulty complete these consultations with the State Governments in the next two or three weeks. Apart from the issue of a sufficiently explanatory letter from the Ministry which can go to the State Governments concerned, which can be done in the next few days, my plan of action would be as follows:

The State banks of Saurashtra, Patiala and Hyderabad present a relatively simple problem. The first two are wholly State-owned; and apart from the State Government owning 51% of the share capital of the Hyderabad bank, the bank itself, by means of a resolution of the board, has recently welcomed the scheme of integration in relation to its own future as a State-associated bank. In each of these cases, the main points raised by the State Governments are likely to be concerned with the amount of compensation which the State Governments expect from the Government of India. I propose to ask Joint Secretary (Shri Barve) to visit the three States with either Shri Nangia or Shri Ramasubramaniam of the Reserve Bank. The programme will, of course, be settled in consultation with the Governor of the Reserve Bank. As regards the remaining banks, I propose, if F.M. agrees, to meet the Finance Ministers and Finance Secretaries of the States concerned as follows:

At Delhi: Rajasthan and Madhya Bharat Governments (Banks of Bikaner, Jaipur, Rajasthan and Indore)

At Bombay: Bombay Government (Bank of Baroda)

At Bangalore: Mysore and Travancore-Cochin Govts. (Bank of Mysore and Travancore Bank)

In our communication to the State Government, we will suggest the advisability of their representatives being accompanied by one or two representatives (including the General Manager) of the banks concerned, so that their advice and assistance are available to the Finance Minister and Finance Secretary of the State concerned; formally, of course, our own talks will be with the State representatives, it being important to avoid giving the impression that we are conducting negotiations with the banks and are

thus departing from the procedure adopted vis-a-vis the Imperial Bank. Informally, however, this will give us an opportunity to ascertain the reactions of the banks themselves. Separate talks will be held in respect of each bank; in other words, no attempt will be made to hold a joint conference of the representatives of different Governments and banks. For these talks with the Governments of Rajasthan, Madhya Bharat, Bombay, Mysore and Travancore-Cochin, as well as with the banks concerned, I will request the Governor of the Reserve Bank for the assistance of Shri Venkatappiah. If the programme is conveniently divided like this between J.S. and myself, I think the task can be completed reasonably early. In the letter to the State Governments as well as in the subsequent talks, every effort will be made to avoid giving the impression that the principle of integration itself is open to argument by the State Governments. The main point for discussion will be the applicability to the particular case, from the practical angle, of the general principle already accepted by the Central Government. Any special difficulties, including any special features of the banks relevant to the main issues, will be discussed, as also points connected with the manner and phasing of the programme of integration at a later stage whether any of the banks should eventually be dropped from the scheme and, if so, on what principles. The discussions will also be helpful in revealing any special features or points, of which we may not be now aware, but which, nevertheless, may have to be covered in drafting the final legislation.

If F.M. agrees, I will take further steps on the lines indicated above.

H.M. PATEL
2-3-1955

FINANCE SECRETARY
GOVERNMENT OF INDIA
NEW DELHI
March 3, 1955

D.O.No.[...]

My dear Rama Rau,

This is with reference to your conversation with the Finance Minister and our subsequent talk regarding the desirability of holding informal meetings with the representatives of the State Governments concerned on various issues connected with the proposed integration of State-associated banks with the State Bank of India. As you know, the Finance Minister agrees with you that such discussions will be useful. He appreciates that it will not be possible to complete before the 11th a whole round of visits to six or seven States. He has, therefore, asked me to write and tell you that a later date, possibly towards the end of the month, will be fixed for your discussion with him. Meanwhile, he thinks that there will be considerable advantage if the Government of India is from the start associated with the talks with State Governments. The following suggestions are made in consultation with him. Barve will visit Saurashtra, Patiala and Hyderabad, and I trust you will find it possible to ask either Shri Ramasubramaniam or Shri Nangia of the Reserve Bank to accompany him to these States, and take part in the discussions. In each of these cases the main issue raised by the State Governments is likely to be that of the amount of compensation they expect to be paid for their shares by the Central Government. I hope to be able to

meet the representatives of the Rajasthan and Madhya Bharat Governments at either Jaipur or Delhi and discuss with them the cases of the four banks with which they are concerned, viz. Bikaner, Jaipur, Rajasthan and Indore Banks. The Finance Minister would like Venkatappiah to be associated with me in these discussions. Similarly, the two of us can see the representatives of the Mysore and Travancore-Cochin Governments at Bangalore and discuss the Bank of Mysore and the Travancore Bank. It is also proposed, at Bombay, to conduct informal talks with the State Government regarding the Bank of Baroda. Since this arrangement will facilitate early completion of the programme and help Government to reach final decisions without undue delay, I am confident you will find it acceptable. A detailed programme will be drawn up in a day or two and intimated to the Reserve Bank. I am consulting Venkatappiah, who is here, about the details of the programme.

I also propose shortly to write to the State Governments. It will be suggested in the letter that, if the State Governments consider it desirable, they may arrange for their representatives to be accompanied by one or two representatives (including the General Manager) of the banks concerned, so that informal talks can be had with the latter as well. Formally, of course, our discussions will be with the State representatives, it being important to avoid giving the impression that we are conducting negotiations with the banks and are thus departing from the procedure adopted vis-a-vis the Imperial Bank. Informally, however, this will give us an opportunity to ascertain the reactions of the banks themselves. Separate talks will be held in respect of each Bank; in other words, no attempt will be made to hold a joint conference of the representatives of different Governments and banks. The letter to the State Govts. will be so worded as to avoid giving the impression that the principle of integration itself is open to argument by the State Governments. The main point for discussion will be the applicability to the particular case, from a practical angle and from other relevant points of view, of the general principle of integration. Any special difficulties, including any special features of the banks connected with the main issues, will be discussed as also points concerning the manner and phasing of the programme of integration. These discussions, as you yourself have pointed out, will incidentally help us in deciding at a later stage whether any of the banks should eventually be dropped from the scheme and, if so, on what principles. Further they would be helpful in revealing any special features or points, of which we may not be now aware, but which, nevertheless, may have to be provided for in drafting the final legislation.

With kind regards,

Yours sincerely,
[H.M. PATEL]

SECRET

BOMBAY
March 8, 1955

D.O.No.[...]
My dear Patel,

Will you please refer to your D.O. letter No.[...] dated the 3rd March 1955, regarding the informal discussions proposed to be held with certain State

Governments on the subject of the State-associated banks with which they are individually concerned?

2. I agree that it would be an advantage if both the Finance Ministry and the Reserve Bank are represented at these discussions. I have asked the officers concerned to be ready for the visits you have proposed. I understand that you yourself will first visit Mysore and thereafter Rajasthan and Madhya Bharat. Venkatappiah and Nangia will accompany you to these States. I presume that a programme for Barve and Ramasubramaniam will be drawn up as soon as possible so that Saurashtra, Patiala and Hyderabad, and possibly Travancore-Cochin, are also covered during the next few weeks. As I mentioned at Delhi, it is important that the formal invitees should be the State Governments and not the banks. I see from your letter that this is what you intend, though opportunity will also be taken to ascertain informally the reactions of the banks.

3. You say that "the letter to the State Governments will be so worded as to avoid giving the impression that the principle of integration itself is open to argument by the State Governments". I would emphasise that it is equally necessary to avoid giving the impression to the State Governments, either in your communication to them or in the subsequent discussions, that the "principle of integration" is something to which the Central Government are finally and irrevocably committed. As you know, it is theoretically open to the State Bank of India to extend to any one of the Part 'B' States concerned by either establishing its own branches in that area or by taking over the particular bank which is associated with the Government of the State. Moreover, the taking over can be in the form of either voluntary amalgamation or compulsory acquisition and, in either case, the bank can remain a distinct entity, e.g. as a "subsidiary" of the State Bank or the Reserve Bank, for such time as may be considered necessary. All these are alternative ways of establishing a countrywide State-controlled banking structure, and, so far as I know, it is to the principle of establishing such an institution, with the Imperial Bank as the nucleus, that the Finance Minister and the Government of India are committed and not to "integration" as the method of achieving the aim. Moreover, integration as a broad method covers all the different alternatives I have mentioned. One of these alternatives, viz. the compulsory acquisition of individual State-associated banks, has, as you are aware, been found unacceptable by the Central Board of the Reserve Bank. If the proposed talks with the State Governments are to be of real use, the discussions will have to cover the different alternatives involved, not excluding (1) the expansion of the State Bank to the particular area (as distinguished from amalgamation, either compulsory or voluntary), (2) the method of voluntary amalgamation (as distinguished from compulsory acquisition), and (3) in the event of amalgamation, the suggestion that the bank concerned should be converted into a subsidiary of either the State Bank or the Reserve Bank. The practical implications of all the alternatives will have to be ascertained from the point of view of the State Governments and incidentally, of the banks themselves, with a view to deciding final policy. I take it that this will be the object of the talks. The object cannot be achieved if the discussions take place on the basis that "integration", in the sense of compulsory acquisition, is a settled principle on which no views are to be expressed by the State Governments.

4. I would add, as regards the specific case of the Bank of Baroda, with which the Government of Bombay are concerned, that even the holding of informal discussions with the State Government would be inexpedient at this stage. We are awaiting Counsel's opinion about the legality of classing this bank along with the other State-associated banks for the purpose of assuming State control and acquiring State ownership. Even apart from that, as I have emphasised before, the fact has to be taken into account that the Baroda bank is no longer associated with the business of the State; Okha is the only place at which it conducts treasury work, and this too it is doing on our request and at the specific instance of the Government of Bombay. Moreover, the Bank of Baroda is one of the "Big Five" among Indian commercial banks, and any impression given at this stage that Government are pursuing the idea of nationalising this bank is bound to cause nervousness among commercial banks generally. I am of the view, therefore, that a firm decision in principle should be reached by Government before any attempt is made to discuss this case even informally with the Bombay Government. I need hardly add that, even if the State Government is of the view that the Bank of Baroda should be included in the scheme of integration, that would not be a conclusive reason for holding that the bank should be nationalised.

Yours sincerely,
[B. RAMA RAU]

Shri H.M. Patel, I.C.S.
Secretary to the Government of India
Ministry of Finance
New Delhi

State-associated banks—Proposals regarding the future of

Governor discussed this [note by B.Venkatappiah dated 17.1.1956—not reproduced here] with me and suggested that the points raised might be informally discussed with Shri H.M. Patel at Calcutta.

2. Governor's first reactions are as follows:

- I
 - A. Immediate steps should be confined to Saurashtra, Patiala and Hyderabad banks.
 - B. The control and/or ownership of these banks may be vested in the State Bank, if willing and able; in any case, the State Bank should be consulted.
 - C. Governor would personally prefer the control and/or ownership to be vested in the Reserve Bank.
- II
 - A. As regards the other six banks, the need for action seems much less urgent.
 - B. One alternative would be to take steps for more effective control over these banks while retaining them as our agents, for the custody of currency chests etc., the details of such increased control could be worked out.
 - C. Another alternative would be to allow the State Bank to extend to district headquarters in the Part B areas concerned; the State-associated bank concerned can then exist as a more or less "Private" commercial banking institution with little or no special control by the State. It would however

still be complementary, in the matter of credit to rural and semi-urban areas, to the State Bank itself.

- D. If, however, any positive steps for the assumption of statutory control and/or ownership of these banks are to be taken, it would be desirable to have the ownership etc. vested in the Reserve Bank rather than in the State Bank. This will of course mean that suitable administrative machinery will have to be set up in the Reserve Bank.

3. Governor emphasised that these are merely his tentative views and that he would like to consider the matter in greater detail after Mr. Patel's views are ascertained. Meanwhile, however, the question of assumption of greater control over the State-associated banks may be pursued by D.B.D. and D.B.O.

[B. V(ENKATAPPIAH)]
21-1-1956

[Governor has seen the above and approved]

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
January 29, 1956

My dear Venkatappiah,

You gave me in Calcutta a note recording the views of the Governor, Reserve Bank, on the subject of the State-associated banks and asked me to let you have my reactions. I have now thought over the entire question in the light of the views expressed by the Governor and feel that we should take over not only the three banks of Pepsu, Saurashtra and Hyderabad as suggested, but also the other six banks the Bank of Baroda being excluded because of the legal advice given; (I am assuming that the advice will be confirmed by the Law Ministry). I agree, however, that all these banks should be brought under the control of the Reserve Bank rather than of the State Bank. What precisely the machinery for the exercise of this control of the Reserve Bank should be, will have to be thought out further in detail, but I imagine that it should not present any insuperable difficulties. The Finance Minister is in agreement with this line of approach and has indeed indicated in writing that we should now go ahead on this basis without any delay.

2. The reasons which have influenced me in coming to this conclusion and which have also appealed to the Finance Minister are not new. They have been discussed before with you as well as with the Governor. It seems to me that the difference of opinion between the two arises from the difference in emphasis attached to some of the main considerations. One new point to which I would particularly like to invite your attention is the indication which the Finance Minister gave of Government's approach to this question when at the meeting of the Standing Committee of the National Development Council he was "reproached" for the delay in implementing the particular recommendation of the Rural Credit Survey Report. He maintained that it would not be correct to suggest as was done by Prof. Gadgil that the question had

been dropped. All that had happened was that various enquiries had to be made and that was bound to take a certain amount of time. He assured the Standing Committee of the National Development Council that proposals would soon be made in respect of these banks in the near future. Thus, in a very real sense, the Finance Minister stands committed to announcing Government's final views in regard to these banks. The reorganisation of the States which will take place within the next few months is another compelling reason for taking early action. Unlike the Governor, we feel that this is virtually the most important and compelling reason for taking immediate action. If we decide not to take over these banks and allow them to be converted into ordinary commercial banks, the State Bank will have to open branches in these areas and in particular at important centres at which these State-associated banks are functioning at present. The latter will thus have to meet severe competition which they will scarcely be in a position to meet and which might easily endanger their stability, the more so as most of them will lose Government funds and patronage. Incidentally, the necessity for opening branches in these areas would also throw considerable additional strain on the State Bank and might even reduce the pace of expansion of the branches as a whole.

3. I take it that you will now, after obtaining the orders of the Governor quickly, draw up the bill for introduction in the next session of Parliament. As you know, the parliamentary session begins on the 15th of February and if we are to have any reasonable chance of introducing the bill in Parliament, we must finalise the bill well before the 15th. That being so, if there are any points to be discussed in regard to this question, whether as to the details or as to the main question itself of how many banks will have to be taken over, I would suggest that we have an early discussion in Delhi. If you let me know what the Governor's wishes are, I shall ascertain the date and time that may be convenient to the Finance Minister.

Yours sincerely,
H.M. PATEL

D.O.No.[...]

July 22, 1957

My dear Patel,

I write this with reference to the recommendations of the Ad Hoc Committee on the taking over, as subsidiaries by the State Bank of India, certain State-associated banks. The last reference from Government on this subject was Baksi's D.O.No.[...] dated the 2nd July 1957.

2. I called a special meeting of the Board on Friday, the 19th July, to discuss the Committee's recommendations. At the meeting I stressed the following points:

- (i) This was definitely not a prelude to the nationalisation of commercial banks in the country. In fact, the Finance Minister was, at one stage, averse to taking up this issue of the State-associated banks and changed his mind only for certain overriding reasons.
- (ii) If the steps proposed were not taken, the State Bank would have to open branches in the areas now served by the State-associated banks and this process would

take some considerable time. When such branches were opened, the State-associated banks would suffer on account of the loss of certain privileges which are accorded to them by Government. The result would be considerable delay in the setting up, throughout the country, of a bank, which while maintaining its commercial character, would be responsive to the broader policies of Government in the field of co-operation, small-scale industries, etc.

- (iii) Government are hesitating to open more currency chests in areas which are not served by a bank under their control. This delays the provision of remittance facilities in areas where they are not now available.
- (iv) The handling of currency chests by State Governments is now giving rise to serious problems. Unauthorised raids on these chests are already considerable and it looks as if with deficit budgets, such raids may become larger and more frequent in future. This is potentially highly dangerous.

3. Opinion in the Board was sharply divided. I attach a copy of the decision recorded on this item. The six members, who voted against the taking over of the Bank of Jaipur, the Bank of Indore and the Travancore Bank, justified their stand on the ground that the step would be widely regarded as merely the thin end of the wedge towards nationalisation of banks. Their other argument was that a compulsory legislative process, such as the Committee had proposed, was "undemocratic"—whatever that means. They recommended that the shareholders should be approached and the change carried out only by negotiation. In this connection some of the members of the Board said that Government should buy up the shares of the State Governments and also blocs of shares from the private shareholders in the market so as to get 51% of the total shares. That, of course, under the Banking Companies Act would not give Government control in actual voting, but the holding would justify Government, without public criticism, in converting the banks into subsidiaries.

4. I do not think it would have been difficult for me to have got the Board to accept the proposals if I had brandished the big stick and said that the Government of India had virtually decided to go through with the scheme. A couple of members would then have changed their votes. But I deliberately did not pursue such tactics because I wanted the Board to express its views with complete frankness and freedom. As it is, with a sharp division in the Board and with the State Bank Board having agreed to the step, it would be quite open to the Government of India to go ahead with the proposal and submit the necessary legislation to Parliament. If it were a purely domestic matter, I would have strongly recommended the Government of India taking such a course because I do not think that the six members who voted against the idea of legislation in regard to the three banks in question are really, right. However, it seems to me necessary to consider what is likely to be the effect on foreign opinion in places like London, New York and Washington of our going ahead with the proposals at this stage. I imagine that foreign reaction in the centres mentioned will, to some extent, be dependent on domestic reaction in India. If some of our people said publicly that the Government's step was unwise and was a prelude to nationalisation of commercial banks, the cry would be taken up in foreign centres and that, however misguided, would be most unfortunate from our point of

view. While, therefore, I am convinced that the majority of my Board were quite wrong and that the Government of India would be fully justified in going ahead with the proposed legislation, I would like the public reaction aspect mentioned above, to be very carefully considered before any decision is taken. If, as I understand is the case, there is not sufficient time during the present session of Parliament to get the proposed Bill through, that would be an added reason for suspending a decision before the Minister returns from Washington. This, in fact, is what I would now recommend. I would also suggest that the Life Insurance Corporation be meanwhile told to purchase the shares of the Banks of Jaipur and Indore and of the Travancore Bank in suitable lots (as and when they become available) at reasonable prices, and without undue publicity.

Yours sincerely,
H.V.R. JENGAR

Shri H.M. Patel, I.C.S.

State-associated banks

When this matter [of the State Bank buying shares of state-associated banks from the market] was discussed at the Board meeting, the majority of the directors took the view that while they had no objection to the State Bank operating these banks as subsidiaries, the acquisition of interest in the banks should not be by compulsory process or legislation. They suggested that shares may be purchased by the State Bank and a controlling interest thus acquired. This, in their judgement, would enable us to achieve our objective without creating a public relations problem particularly in countries like the U.S.A. where we are seeking a massive amount of assistance.

I fear we did not examine this alternative in the past as carefully as we should have done. We allowed the matter to rest with Government writing to the Life Insurance Corporation suggesting the buying up of shares. It is clear, however, from the notes now prepared that the technique of buying shares is going to involve considerable loss of time and, even so, would not, in all cases necessarily give a controlling interest to the State Bank of India. On reflection, therefore, I have come to the conclusion that this proposal should be abandoned.

Two points are clear to me. The first is that we must not abandon the idea of the State Bank operating these banks as subsidiaries. That, I think, is desirable and in fact, necessary. The State Bank has begun to acquire a "new look" and is definitely taking interest in matters such as assistance to small-scale industries and provision of finance to the co-operative movement. We may expect progress in these directions to be more rapid in future. We could not possibly expect the other banks to organise their affairs in such a way as to support Government policy in regard either to the co-operative movement or small-scale industries. If progress is to be made, therefore, the State Bank would have to extend itself in the areas covered by these banks. That would be a very lengthy and difficult procedure and, therefore, I am driven to the conclusion that the State Bank must get control over the functioning of these banks. The only way in which it could do so would be to acquire a controlling interest in the share capital.

At the same time, it is clear to me that if it is possible to avoid compulsion, it is better to avoid it. It would be possible for us, as a matter of public relations, to

explain both in India and outside that the proposed legislation is not intended to be the beginning of a programme of nationalisation of commercial banks, and that it is confined to dealing only with a special category of banks. But the task will not be very easy and may not succeed in all the quarters where we want to make an impression. It would, therefore, be desirable to adopt another expedient which would absolve Government of the charge that they are compulsorily acquiring private banking institutions.

The alternative that could conceivably be tried is for us to negotiate with the banks and to get the shareholders, by a majority, to pass a resolution to the effect that they are agreeable to the banks being taken over and operated as subsidiaries by the State Bank of India. If such a resolution were passed, the question of compensation could then be decided either by agreement or, in default of the agreement, by a reference to a tribunal. In fact, such an arrangement could by itself form part of such a resolution. Should however any shareholder object and should there be a danger of the whole scheme falling through as a result of such objection, we could then, if necessary, legislate. At that stage, however, legislation will be on the basis of an agreement with the majority of the shareholders and would, therefore, cease to have the character of compulsion by Government. I would like this alternative to be examined quickly from the legal as well as the administrative points of view.

I have discussed this today with the Finance Minister and he is in general agreement.

Id/- [H.V.R.]

19-6-1958

D.G.(V) 20.6.1958

For information with connected papers.

D.G.(R)[Ram Nath] 7.7.58

It does not seem that if the banks are taken over one by one, the merger of the banks with the State Bank would involve greater administrative strain than the taking over of these banks as subsidiaries. I would, therefore, suggest that as a possible alternative to the taking over of these banks as subsidiaries under schemes of arrangement, the possibility of the banks being taken over by the State Bank under section 35 may also be considered.

[N.D. Nangia]

(14.7.1958)

D.G.(V)

I have mentioned this to the Governor. He was in favour of pursuing (at this stage) Shri Bhattacharyya's suggestion that (i) shareholders be persuaded to pass a resolution favouring the constitution of each of the concerned banks, Jaipur, Bikaner, Rajasthan, Indore, Mysore, Saurashtra, as a subsidiary of the State Bank and (ii) legislation be passed constituting the bank as their subsidiary on the same lines as would in any

case have to be passed in respect of the banks of Hyderabad, Saurashtra and Patiala. The GOI is being addressed accordingly in another file.

We may revert to C.O.'s suggestion at a later stage, if necessary.

B.V.

16.7.58

SECRET

CENTRAL OFFICE
DEPARTMENT OF BANKING
DEVELOPMENT
BOMBAY
July 18, 1958

D.O.No.[...]

[Dear Shri Morarji Desai,]

You will recall that when we last discussed the subject of State-associated banks I mentioned certain points which I said would have to be taken into account as constituting the background of this very important question. I shall briefly recapitulate the main considerations:

- (i) Almost exactly three years have passed since the conversion of the Imperial Bank into the State Bank. During this period the State Bank has, in conformity with Government's policy,
 - (a) more than doubled the number of its branches (about 200 in 1955) and in the process, carried banking and remittance facilities—the latter as agent of the Reserve Bank—to areas hitherto ill-served in these vital aspects of a developing economy;
 - (b) started a drive for providing much-needed assistance, including short-term loans, to small-scale industries in co-ordination with other financial institutions; and
 - (c) initiated a programme for helping co-operative units especially those connected with processing and marketing, by the provision of finance for working capital.
- (ii) If the State Bank is doing all this and can be expected to do much more in future, it is because of its very large resources, its unquestioned fitness to be the Reserve Bank's agent and custodian of its currency chests, its ability to meet the initial losses involved in e.g. a countrywide programme of branch expansion and several other features special to it as a State-partnered commercial banking institution. By and large, however, the new developmental activities of the State Bank have been confined to those areas which had formed the former British provinces. This is because the Imperial Bank operated in those areas alone. If banking and remittance facilities, finance for small industries, assistance to co-operatives etc. are to be extended to the rest of India at the pace at which the State Bank is able to do this, it will be necessary to bring the State-associated banks into the picture. These banks were either promoted or encouraged by the rulers of the Indian States and were to those States what the Imperial Bank was to India. They cannot, however, function effectively (e.g. they cannot be entrusted with currency chests as agents of the Reserve Bank) unless they are brought under the control

of the State Bank of India. There is only one real alternative, namely, to let the State Bank itself expand to those areas; but that would take a good deal of time and not only be wasteful in the sense of involving duplication, but would entail a great deal of effort and expenditure on the part of the State Bank at a time when it is necessary to economise on both for the purpose of meeting the growing developmental demands on the bank.

- (iii) The only way in which the State Bank could acquire adequate control over the State-associated banks would be by its obtaining a controlling interest in the share capital of each of the banks. So far as the Hyderabad, Saurashtra and Patiala banks are concerned, this would not present any difficulty since these are owned either by the Reserve Bank on the one hand or by the State Government on the other. Legislation can be passed to ensure that these banks become subsidiaries of the State Bank of India. The real problem is presented by the other banks. In regard to these, it would be desirable, if that was possible, to achieve the object without compulsion, since compulsion might be misunderstood abroad especially in America and, arguably, this would be inexpedient at a time when we are asking for substantial assistance.
- (iv) It might, therefore, be worthwhile to negotiate with the banks concerned and, if possible, get the shareholders to pass resolutions to the effect that they would be agreeable to the banks being taken over and operated as subsidiaries of the State Bank of India. Such resolutions could indicate what compensation should be paid, the figure having been previously agreed upon by negotiation. Alternatively they could provide for future negotiation and agreement and, failing that reference to a tribunal.

2. I understood you to be broadly in agreement with this line of thinking. Accordingly, I had the suggestions examined by my Legal Division and they put forward a scheme of which the main features are as follows:

- (a) The Hyderabad, Patiala and Saurashtra banks would be dealt with separately. Legislation would in any case be necessary in regard to them.
- (b) As regards the other banks, viz. Jaipur, Bikaner, Rajasthan, Indore, Mysore and Travancore, the objective would be for the State Bank to acquire 75% of the shares in each instance and thereafter to run the banks as its subsidiaries.
- (c) For this purpose, it would have to be arranged that each of the banks passes a special resolution in favour of a scheme of arrangement whereby 75% of the shares would be transferred to the State Bank. It would be necessary for the resolution to be supported by not less than 75% of the total votes available in respect of each bank.
- (d) The compensation for the shares thus proposed to be transferred would be either specified in the scheme itself or left to mutual agreement or to arbitration in the absence of such agreement.
- (e) There would be an application to the Court under Section 391 of the Indian Companies Act for calling a meeting of the shareholders to consider the scheme and for the sanction of the scheme if passed by the requisite majority. If the scheme was passed by three-fourth (in value) of the shareholders voting in person or by proxy, and if it was also sanctioned by the court, it would be

binding on the bank concerned as well as on all of its shareholders.

3. The suggestions of the Legal Division have since been examined by Bhattacharyya. I understand that he has also consulted his solicitors. I enclose a copy of his letter [not reproduced]. He regards the Legal Division's scheme as impracticable for the reasons mentioned by him. I agree with him. He makes an alternative suggestion, viz. that informal efforts be made to get the six banks to pass resolutions at their shareholders' meetings (by simple majority) indicating their acceptance of the proposal that the banks be formed into subsidiaries of the State Bank of India. These resolutions may then be regarded as constituting adequate moral support for promoting the requisite legislation. The legislation itself would be on the same lines as for the banks of Hyderabad, Saurashtra and Patiala.

4. It is clear that Government's good offices would be required in a very large measure if the banks in question are to be persuaded to pass such resolutions. It would of course have to be pointed out to each bank that it can get (or retain) the agency of the Reserve Bank only as a subsidiary of the State Bank of India. If the bank did not agree to this, the State Bank of India would extend its operations to the area concerned and establish its own branches wherever required and, through them, conduct the treasury work of the State Governments and operate the currency chests of the Reserve Bank.

5. I commend Bhattacharyya's proposal for Government's consideration.

Yours sincerely,
H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
Government of India
New Delhi

V. BANKING

A. PRUDENTIAL NORMS

Proposals for (1) Strengthening Capital Funds of Banks and (2) Raising Liquidity Requirements of banks

I

The draft letter to the Indian Banks' Association, which is placed below, as desired by Governor, has been prepared on the lines generally agreed upon at the meeting which the Governor had with the representatives of the Association and subsequently confirmed by a letter from the Association.

2. In view of the keen desire on the part of the Association to have a voluntary agreement with us in the matter of strengthening their capital funds and raising their liquidity ratios, the following *conventions* are now sought to be achieved.

- (i) *all* banks should transfer a minimum of 20 per cent of their declared profits (i.e., profits after providing for usual and necessary provisions and after making tax provisions) to their published reserves till such time as the paid-up capital and published reserves reach 6 per cent of their deposits, independent of the level of reserves in relation to the paid-up capital; and
- (ii) all banks should maintain a minimum overall liquidity ratio of 25 per cent of their *deposit liabilities* as against the present legal minimum of 20 per cent.

3. As regards the question of relating the suggested liquidity ratio of 25 per cent to deposit liabilities, the following points may be noted. The Indian Banks' Association seems to have misunderstood this issue. Our original proposal was to relate the overall liquidity ratio to deposits and not to deposit liabilities, and a figure of 27.5 per cent of deposits was suggested. In the Governor's meeting with the bankers, the Chairman of the Indian Banks' Association confirmed, in reply to a query from Dr. B.K. Madan, that the Association's suggestion was that banks should raise their liquid assets ratio to *25 per cent in relation to their total liabilities*. 25 per cent of total *liabilities* and 27.5 per cent of deposits are broadly the same and at the end of the meeting it was our impression that if we stipulate a ratio of 25 per cent of liabilities, the bankers would be willing to comply with it. It is, however, somewhat puzzling to see from the communication from the Indian Banks' Association to the Governor that they want the liquidity ratio of banks to be fixed at 25 per cent of total deposits, which in effect would mean about 22.5 per cent of their liabilities or only 2.5 per cent more than the present minimum of 20 per cent of liabilities. In any case, since we are only setting up a convention, it has to be within the four corners of the existing legislation, which prescribes liquidity ratio only in terms of total liabilities. Hence the minimum to be observed at 25 per cent should be specifically related only to 'total liabilities'.

4. In their letter, the Association has gone one step further and suggested that the items eligible for inclusion in the liquidity ratio of 25 per cent of deposits should be, not only cash, gold, and approved securities, *but also remittances through notified banks*. In the meeting, to the best of our knowledge, the representatives of the Association did not raise this issue. We have no estimates regarding the magnitude of

remittances through notified banks but unofficial enquiries with bankers reveal that it could fluctuate anywhere between 0.5 and 2.0 per cent of deposits. It will thus be seen that this suggestion of the Association, coming on top of their earlier one relating the 25 per cent ratio to deposits only, will practically result in maintaining the *status quo* in terms of Section 24 of the Banking Companies Act, namely around 20 per cent of total liabilities.

5. In the draft letter to the Association, we have not deviated from our earlier stand; we have suggested a ratio of 25 per cent of total liabilities without including "remittances through notified banks" as one of the items of liquid assets, as required by the Association.

6. Apart from the references to capital funds and liquidity ratios, the Indian Banks' Association has also made a few other points which have no direct bearing on the letter which the Governor proposes to issue now. They seek a reduction in the burden of penalty for any shortfall in reserve requirement as well as liquidity requirement. But this is an independent issue which would involve amendment to the Banking Companies Act. This apart, the question of penalty for not complying with the new conventions which we seek to establish does not arise as we are resorting only to moral suasion. The Association has also suggested that transfers to reserves upto 10 per cent of taxable profit made in addition to that required for providing for bad and doubtful debts and making other necessary provisions should be exempt from income tax. This again is a separate issue which was examined in the memorandum submitted to the Governor on the eve of his meeting with the bankers. For reasons mentioned in the memorandum, it is not considered desirable to support tax incentives for this purpose at the moment.

II

7. The draft letter to the Exchange Banks' Association deals only with liquidity requirements. In their reply to our letters on the draft proposals sent to them some time ago, the Bombay and Calcutta Exchange Banks' Associations have asked for certain facilities in the event of our implementing the liquidity requirements. These Associations also would favour informal voluntary agreement. The Calcutta Exchange Banks' Association has suggested that we should allow the exchange banks to deposit Sterling securities with the Reserve Bank, London, to the extent of 2½ per cent of their deposits towards the asset requirement of Section 24. The Bombay Exchange Banks' Association, while supporting this, has also enquired whether we would permit exchange banks whose head offices are not in the U.K. to deposit acceptable securities from their respective countries which are marketable in London.

8. Being branches of international institutions, exchange banks stand on a special footing. Most of these banks, as a whole, do maintain high liquidity ratios. In the draft letter to the Exchange Banks' Associations, these two requests have been accommodated. Lodgement of securities (U.K. Government and other trustee securities and in the case of banks whose head offices are outside the U.K. trustee securities of their respective countries and readily marketable in London) over and above the statutory minimum in terms of Section 11(2) may be allowed to count towards the new ratio upto 2 per cent of their aggregate liabilities (equivalent of 2½ per cent of deposits as suggested by the Association).

III

9. The draft letters have been prepared on the assumption that they will be addressed by the Governor to the Indian Banks' Association Bombay and the Calcutta Exchange Banks' Associations. But attention is drawn to the following points. Out of 66 Indian scheduled banks, excluding State Bank of India, only 37 are members of the Association. Although deposit-wise they account for over 90 per cent, since our proposals are mainly intended to strengthen the individual units of the system, the coverage in terms of numbers is important. It may also be noted that of the 26 Indian scheduled banks which now have a capital funds ratio of less than 5 per cent, six are non-members of the Association. As regards the liquidity ratios, in the case of most of the Indian scheduled banks¹ (members as well as non-members), it is no doubt true that the ratio has not as yet fallen below the standards now being set. However, in order to prevent a further deterioration in the liquidity standards in future it is desirable to impress upon all the individual banks the need to maintain a floor of at least 25 per cent of liabilities.

10. It is therefore suggested that instead of addressing the letter to the Association, we may issue this as a circular to all scheduled banks as well as non-scheduled banks just as we do in respect of directives.

11. Most of the foreign banks, however, maintained a liquidity ratio of less than 25 per cent of their deposit liabilities as of March 1961. A letter to the Exchange Banks' Association will serve the purpose in this case. However, if we decide to issue a general circular in the case of Indian scheduled banks, it will be desirable to follow a uniform practice and issue a similar circular to exchange banks also on an individual basis.

IV

12. Finally, the question arises of what treatment is to be accorded to the State Bank. The position relating to their liquid assets ratio is brought out in the following table:

As on the last Friday of March	Ratio of liquid assets to aggregate deposit liabilities (including P.L.480 funds)	Ratio of liquid assets to aggregate deposit liabilities (excluding P.L.480 funds)
1954	50.4	
1955	53.9	
1956	49.1	
1957	38.6	27.2
1958	50.8	23.9
1959	58.3	23.5
1960	61.8	20.0
1961	50.0	20.5

It will be observed that the liquidity ratio of the State Bank (including P.L.480 funds)

¹In the case of two member banks (Central and India) and four non-members, the ratio was below 25 per cent as of March 1961.

has all along been high. The ratio is no doubt lower than 25 per cent of their liabilities if we exclude P.L.480 funds, but for purpose of judging the adequacy of liquid assets standard, the ratio, inclusive of P.L.480 funds, is more realistic.

13. As regards the capital funds ratio, at the end of August 1961 the paid-up capital and published reserves of the Bank as a proportion of deposits stood at 4.1 per cent. The Bank's transfers to published reserves, as a percentage of their balance-sheet profit formed only 11 per cent in 1957, 15 per cent in 1958, 8 per cent in 1959 and 9 per cent in 1960. It appears that in view of our general circular to other banks asking them to transfer a minimum of 20 per cent of their balance-sheet profit to their published reserves, it will be necessary to suggest that the State Bank also should follow suit and transfer the required minimum to published reserves notwithstanding what it transfers to inner reserves. If this is not done, there will be criticism that the State Bank is being dealt with on a preferential basis.

14. It is, therefore, desirable, although the State Bank is already maintaining a high liquidity ratio, to issue the general circular to them also. The leadership of the State Bank in the matter of transfers to reserves will be of considerable assistance to us in establishing the conventions we have in view.

15. After E.A. has seen this, copies of the covering note together with the draft letters will be forwarded to the C.O., D.B.O., C.O., D.B.D. and the Legal Department for their urgent comments.

The draft reply may appear somewhat lengthy, but it seems unavoidable if we are to stress the arguments for the new convention we seek. They are being stated explicitly in public for the first time.

K.N.R. RAMANUJAM

19-12-61

MOST IMMEDIATE

CONFIDENTIAL

ECONOMIC DEPARTMENT

Proposals Relating to Capital Funds and Liquidity Ratios of Banks

The Governor desires to issue a letter to the Banks' Associations impressing upon them to set up certain *conventions* in the matter of transfers to reserves and liquidity standards. A draft letter prepared in this connection and approved by E.A. is enclosed. For ready reference, copies of letters received from the Indian and the Exchange Banks' Associations and the State Bank of India in reply to our earlier letters to them on our draft proposals in this regard are also appended. 2. We shall be glad to have the comments of the D.B.D. This may kindly be treated as very urgent.

K.N.R. RAMANUJAM

20-12-61

[draft letter not reproduced]

Govr. What is happening about the proposals re:
capital funds of banks and liquidity? It is some time (over a month) since we

had a discussion with the Indian Banks' Association and a fortnight since the Association wrote to us.

The consideration of the case needs to be expedited.

HVR

20/12

ED (M) If the request to banks is on the basis of their agreement, the agreement seems to have been watered down in respect of liquidity requirements to almost no change from the present. In view of the limits of moral suasion in this sphere, particularly in respect of an appeal issued on the eve of the busy season, we may consider whether the letter may not be restricted to the capital funds problem.

24/12

Govr. I am inclined to think that for the present we may confine ourselves, as suggested by ED (M), to the problem of capital funds. The question of the liquidity ratio may be taken up towards the close of the busy season. The revised draft may issue.

The question of having a standard form of balance-sheet need to be urgently pursued with the Assn.

26/12

B. REGULATING CO-OPERATIVE BANKS

SECRET

Bringing co-operative banks under the statutory control of the Reserve Bank of India

A meeting was held in the Governor's room on 3 September 1963 at 3.30 p.m. to consider the note on the above subject circulated by the Agricultural Credit Department. Besides the Governor, the following were present:

1. Shri M.V. Rangachari, Deputy Governor
2. Prof. D.G. Karve, Deputy Governor
3. Shri C.S. Divekar, Deputy Governor
4. Shri D.R. Joshi, Executive Director
5. Shri B.N. Mehta, Legal Adviser
6. Shri M.S. Nadkarni, Chief Officer, Department of Banking Operations
7. Shri V.G. Pendharkar, Economic Adviser
8. Shri K.C. Cherian, Deputy Chief Officer, Agricultural Credit Department
9. Dr. C.D. Datey, Deputy Chief Officer, Agricultural Credit Department

The discussions started with the suggestion made towards the end of the note, viz., that the existing powers of the Registrar of Co-operative Societies for superseding the

board of management of a co-operative bank or for taking it into liquidation are sufficient for protecting the interests of the Deposit Insurance Corporation and that the Registrar might be relied upon to take necessary legislative action on the advice of the Reserve Bank of India. It was also suggested in the note that in order to ensure that the Registrar would take certain steps following any disciplinary action by the Reserve Bank against any co-operative bank, it might be worthwhile to take an undertaking in writing from the State Government that the advice of the Reserve Bank regarding a co-operative bank would generally be followed by the Registrar in taking legislative action against it for safeguarding the interests of depositors and, ultimately, of the Deposit Insurance Corporation. The consensus of opinion was, however, that it would not be appropriate to expect the Corporation to insure the deposits of co-operative banks knowing fully well that the Reserve Bank, in close association with which it worked for the success of the whole scheme of insurance of deposits of commercial banks, would not have powers for amalgamation or liquidation of a co-operative bank. The benefit of insurance accrued in the case of a commercial bank in the event of its amalgamation with another bank or of liquidation. Both these contingencies were under the control of Reserve Bank which had statutory powers to direct either amalgamation or liquidation of a commercial bank. Deputy Governor(R) was of the view that if the benefit of insurance to co-operative banks was to be extended without vesting similar powers in the Reserve Bank, the action might be questioned as discriminatory. It was, therefore, agreed that if reconstitution of the management of a bank or its liquidation could not be provided for by any central legislation, it would be necessary to have the required provisions made in the State Co-operative Societies Acts themselves. The Governor felt that in the case of State and Central co-operative banks we would have to think more in terms of reconstruction of management than of liquidation. The State laws therefore should be amended to make it compulsory on the Registrar of Co-operative Societies firstly to supersede the committee of a co-operative bank and appoint an administrator and, secondly, to take it into liquidation, if the Reserve Bank considered either or both of them necessary for protecting the interests of the Deposit Insurance Corporation. The benefit of insurance should be made available to co-operative banks only in those States which amended their Co-operative Societies Acts as above.

2. It was agreed that the various provisions of the Reserve Bank of India Act, 1934 and the Banking Companies Act, 1949, as indicated on pp. 7-14 of the note might be extended to co-operative banks. The Governor, however, observed that it should be examined further whether it would be possible for the Reserve Bank to exclude advances to State co-operative banks under the various sections indicated on p. 8 of the note for the purpose of correlation between the statutory cash reserve under Section 17 of the Reserve Bank of India Act. The exclusion should not be discriminatory and would have to apply also to commercial banks. As regards the extension of the Bank Guarantee Scheme, the Governor observed that the facility would have to be extended to selected apex co-operative banks only. The Governor also indicated that it would be necessary to define a co-operative bank and more particularly an urban bank. It was not intended to extend the Reserve Bank's control to societies which did not conform to the definition of bank as given in the Banking Companies Act.

3. It was agreed that the proposals for bringing co-operative banks under the statutory control of the Reserve Bank for the purpose of regulation of credit and banking and for safeguarding the interests of the Deposit Insurance Corporation might be placed for consideration before the Standing Advisory Committee on Agricultural Credit. It was also felt that it would be better to explain the position to State Governments before the matter was referred to the Central Government for enactment of necessary laws.

4. It was decided that a note should be prepared indicating the amendments necessary to the various Acts as indicated below:

- i) Reserve Bank of India Act, 1934
- ii) Banking Companies Act, 1949
- iii) Co-operative Societies Acts of different States
- iv) Deposit Insurance Corporation Act, 1961

This note will be further considered before the proposals are presented to the Standing Advisory Committee.

SECRET

Bringing co-operative banks under the statutory control of the Reserve Bank of India

A meeting was held in the Governor's room on 19 September 1963 at 3 p.m. to consider the draft amendments, circulated by the Agricultural Credit Department, to the Reserve Bank of India Act, 1934, the Banking Companies Act, 1949, the Deposit Insurance Corporation Act, 1961 and the Co-operative Societies Acts of different States. Besides the Governor, the following were present:

- 1. Shri M.V. Rangachari, Deputy Governor
- 2. Prof. D.G. Karve, Deputy Governor
- 3. Shri D.R. Joshi, Executive Director
- 4. Shri B.N. Mehta, Legal Adviser
- 5. Shri M.S. Nadkarni, Chief Officer, Department of Banking Operations
- 6. Shri P.D. Kasbekar, Chief Officer, Agricultural Credit Department
- 7. Shri V.G. Pendharkar, Economic Adviser
- 8. Shri C.S. Venkat Rao, General Manager, Deposit Insurance Corporation
- 9. Shri K.C. Cherian, Deputy Chief Officer, Agricultural Credit Department
- 10. Dr. C.D. Datey, Deputy Chief Officer, Agricultural Credit Department

The following conclusions were reached:

I. Amendments to the Reserve Bank of India Act, 1934

The amendments proposed to Sections 2 and 42(6) and the deletion of Section 44 were approved. The proposed amendment to Section 18(1)(3) was intended to accord to all co-operative banks the status of banking companies for the purpose of emergency loans from the Reserve Bank. The Governor felt that this might go against the federal character of the co-operative banking structure under which an urban co-operative bank was expected to approach a Central co-operative bank first and a Central co-

operative bank to approach the State co-operative bank for any financial assistance in an emergency or otherwise. In keeping with this tradition, assistance to be given by the Reserve Bank to meet an emergency arising in any Central or Urban co-operative bank would have to be given to the State co-operative bank on behalf of those banks. He thought, therefore, that Section 18(1)(3) as proposed to be amended should include only the State co-operative banks and not the Central and Urban banks. DG(R) observed that the provisions of that Section were intended to give direct help to a bank in difficulties. The amendment as proposed by the Governor would mean that financial accommodation is to be provided to a State co-operative bank which itself might not be facing any critical situation on behalf of another bank which is in difficulty. In that case a separate sub-section under Section 18 would have to be incorporated. It was agreed that this should be done.

II. Amendments to the Banking Companies Act, 1949

Section 51 A

The Governor expressed his doubt about the legality of extending the Amending Act to co-operative banks in the different areas on different dates. He wanted the Legal Department to check up this point.

Section 24 (2A)

It was proposed in the draft amendment to Section 24 that co-operative banks might be required eventually to maintain liquidity at a total of 25 per cent of the deposit liabilities as against 28 per cent in the case of commercial banks. The consensus of opinion was against making any distinction between the commercial and co-operative banks in this regard. Considering, however, the prevalence at present of a different set of standards of fluid resources in the co-operative banks, it was agreed that powers should be given to the Reserve Bank to extend the period of transition by a further period of two years in individual cases beyond the two years already contemplated as from the coming into force of the Amending Act.

Section 35

The amendment as provided would have authorised the Reserve Bank to empower any person or agency to inspect a co-operative bank. The Governor said that the intention was to nominate only the State co-operative bank in a State, if need be, to conduct the inspections of urban co-operative banks in that State. It was, therefore, agreed that the amendment should be redrafted so as to authorise the Reserve Bank to nominate a State co-operative bank in a State for the inspections of Urban co-operative banks only in that State.

The amendments proposed to the other Sections were generally approved.

III. Deposit Insurance Corporation Act, 1961

Section 4

The proposal was to amend the section so as to increase the authorised and paid-up capital of the Corporation from Rs 1 crore to Rs 2 crores. The Governor felt that the present income from investments held in the General Fund should prove sufficient to cover the increased administrative expenditure, so long at least as the Corporation remained not liable to income-tax. The occasion to ask for an increase in the authorised and paid-up capital would perhaps arise only thereafter. It was, therefore, agreed that

the proposed amendment for raising the authorised and paid-up capital to Rs 2 crores was not necessary for the present.

Supersession

A suggestion was made in the note and also incorporated in the draft amendments that the Reserve Bank should have the power to direct the Registrar of Co-operative Societies to supersede the committee of a co-operative bank and appoint an administrator in its place. This power was considered necessary for the timely correction of the situation, particularly in respect of State and Central co-operative banks, in whose cases liquidation or cancellation of licence was likely to be impracticable for a variety of reasons. It was true that the Reserve Bank did not enjoy a similar power under the Banking Companies Act in regard to commercial banks. Under the Co-operative Societies Acts of the different States, however, the Registrar already enjoyed this power and it was intended that the Reserve Bank could use that power through him for the development of co-operative banks on sound lines. The Governor as well as DG(R) felt that the Reserve Bank could perhaps think of taking over this power in the interest of the Deposit Insurance Corporation only if the inspection of a bank revealed that its deposits had actually been eroded and that supersession of the management was necessary as a measure of stopping their further erosion. It would not be justifiable for the Bank to ask for this power merely on the ground that the bank was not properly managed or that there was fear of deposits being eroded by the continuance in office of the existing management. If it was considered necessary for the Reserve Bank to direct the Registrar to supersede the committee of a co-operative bank for proper regulation of co-operative banks, the proper place for it was not in the Deposit Insurance Corporation Act but in some other law governing the banks. If, however, it was not possible for the Central Government to legislate on this particular matter which concerned the constitution and management of societies, the alternative would be to persuade the State Governments, if that was considered absolutely necessary, to pass amendments to their Co-operative Societies laws on a voluntary basis. The Governor concluded that it would not be appropriate to include the power of supersession as one of the conditions for extending the benefit of the Deposit Insurance Corporation. He suggested, however, that the power could perhaps be taken as part of any scheme of reconstruction which the Reserve Bank might require or approve in regard to any co-operative bank. It was, therefore, agreed that the provisions relevant to supersession in the draft amendments to the Deposit Insurance Corporation Act should be deleted. The power to be given to the Reserve Bank for directing the Registrar to supersede the board of a co-operative bank might be included only as part of a scheme of reconstruction, if that was possible and considered necessary.

IV. Amendments to State Co-operative Societies Acts

It was agreed that:

- (i) no co-operative bank should be ordered to be wound up by the Registrar except with the prior approval of the Reserve Bank;
- (ii) no scheme of compromise or arrangement for reconstruction or amalgamation of a co-operative bank shall be sanctioned except with the prior approval of the Reserve Bank;

- (iii) the Registrar shall, if so required by the Reserve Bank by an order in writing, issue a final order directing a co-operative bank to be wound up;
- (iv) the Registrar may prepare a scheme of reconstruction or amalgamation of a co-operative bank with the prior approval of the Reserve Bank.

The power of moratorium might be useful for facilitating the preparation of any scheme of reconstitution or reorganisation of a co-operative bank. Provisions similar to Section 45 of the Banking Companies Act would, therefore, be useful. It was, therefore, agreed that the Legal Department should examine as to whether a moratorium could be declared by the Central Government or the State Government, whether the provision therefor could be made in the Central Acts, and whether the Reserve Bank could order the Registrar to reconstitute or reconstruct a co-operative bank in a given manner or whether the Reserve Bank could only give assistance to the Registrar if he was preparing any such scheme.

It was decided that the draft amendments would be redrafted in the light of the above decisions. It was, therefore, decided that the whole scheme of amendments to the various Acts might be placed before the next meeting of the Standing Advisory Committee for its consideration before it was circularised among the State Governments for their opinion.

C. NON-SCHEDULED BANKS IN WEST BENGAL

Office of Deputy Minister, Finance (G)

I have already handed over a note re: the banks in West Bengal. Apart from the banks which have already closed, there are 146 non-scheduled banks in West Bengal who have not been submitting any returns or report to the Registrar, Joint Stock Companies and have yet been continuing as banks. This is a scandalous state of affairs. This should be stopped at the earliest. It is no use citing legal and technical difficulties. We shall have to do something to remedy this state of affairs. I expect some effective suggestions to be made on this so as to stop this.

A.C. GUHA

15-6-1953

Extract from D.O. letter No. [...] dated the 13th June 1953 from Dr. B.C. Roy, Chief Minister, West Bengal, to Shri A.C. Guha, Deputy Minister, Finance, Government of India

I had sent for the Registrar of Joint-stock Companies and discussed this matter with L.R. and Finance Secretary also. It appears that under the present Act the Registrar has only the power to proceed against any person who does not follow the rules framed under the Act and prosecute him. But the Registrar says that in most cases he cannot trace the culprits. It also appears, that in many cases the Reserve Bank informs the non-scheduled banks people to give up banking and go to something

else. The result is that in many cases the party goes to the High Court, gets an order for altering the Articles and Memorandum of Association and start a new line, all the time cheating the depositors. On the other hand, the appointment of a Liquidation Officer would not help because the Liquidation Officer will not be able to trace these people once they have defaulted in observing the rules of the Companies Act. It is, therefore, suggested that the Reserve Bank should be asked to appoint Inspector to scrutinise the affairs of each bank and as soon as they find that a bank is not proceeding in the normal way, he should be given powers to prosecute even before the bank people are able to go up to the High Court to change their colour. Please consider this position.

Ministry of Finance
Department of Economic Affairs

This note was handed over to me by D.M.(G), Mr. Guha, after his return from Calcutta early this month.

2. A copy of this note should be sent over to the Reserve Bank for their remarks. Together with this a copy of the extract from the demi-official letter of the Chief Minister, West Bengal, to Mr. A.C. Guha dated the 13th June, 1953, with a copy of the D.M.(G)'s minute thereon should also go to the Reserve Bank. Very early remarks of the Reserve Bank may be invited.

S.G. BARVE
Joint Secretary
16-6-1953

Re: Non-scheduled banks in West Bengal [4-8-1953]

In connection with the U.O. reference received from the Ministry of Finance, Government of India, regarding the suggestions made by Shri A.C. Guha and Dr. B.C. Roy in relation to non-scheduled banks in West Bengal the Governor desired to know:

- i) whether the rights of the depositors of a banking company would be affected if it ceases to do banking business but continues to carry on other business as a non-banking company and whether the depositors invariably get notice of such change of business of the company;
 - ii) the reasons why banks which find it onerous to comply with the provisions of the Banking Companies Act are being advised by us to convert themselves into non-banking companies.
2. As regards (i) above the Legal Division's note dated the 3rd August 1953 may please be seen at flag [...]. With regard to (ii) above, it may be stated that when the original proposals for an Indian Bank Act were circulated for eliciting public opinion, clause 7 relating to minimum capital requirements came in for severe criticism especially from the smaller institutions. Some of the replies indicated that smaller banks performed a useful function in the banking system and that trade and industry in rural India would suffer considerably by their disappearance. In this connection

the ex-Governor of the Reserve Bank, the late Sir James Taylor, stated in his memorandum dated the 24th September 1940 submitted to the Central Board that the aforesaid argument could not be taken seriously inasmuch as the banks which would go under, if the proposals were brought into force, represented less than 5% of the total banking deposits of the country. He also visualised that most of these banks would continue to exist for moneylending, etc. though they would not be permitted to call themselves banks. It was further stated in that memorandum that the proposals for compulsory reserves, liquidation by the Reserve Bank and the possibility of inspection were not designed to work and would not work with petty institutions. As will be seen from the memorandum dated the 28th March 1945 submitted to the Central Board, some of the bigger banks while expressing their views on the Banking Companies Bill, 1944, preferred that the weaker and inefficient banking companies should be left to be weeded out by natural economic forces and not by legislation. Such a policy was, however, considered to be out of tune with the modern concepts of the responsibilities of the State towards economic institutions. In the memorandum dated the 7th December 1945 submitted to the Central Board it was stated that it would be practically impossible for us to undertake the work of liquidation unless the number of licensed banks was drastically reduced and that no national interest would be served by the Reserve Bank taking over the work of liquidating petty banks with numerous branches all over the country whose assets had already been dissipated by mis-management. In view of the foregoing it was considered desirable that while advising banks to take steps to comply with the requirements of section 11 of the Banking Companies Act, we should also suggest to them that they should if they so desired consider the alternative course of ceasing to transact banking business as defined in section 5(1) (b) of the Act. The draft circular letter was approved by D.G.(R) and a reference to this circular letter was made in the note submitted to Governor regarding the policy to be followed in granting extensions under section 11 of the Act.

3. A banking company which finds it impossible to comply with the requirements of the Banking Companies Act has either to convert itself into a non-banking company or go into liquidation. As stated above, the late Sir James Taylor had visualised that a number of small banks would not disappear but would continue to exist for moneylending, etc. It would not also be desirable to force the smaller banks to go into liquidation as their assets are generally frozen and the liquidation charges may, in most cases, be more than the realisable value of assets of the banks concerned. Further, it would not be practicable to ask the bank to pay its depositors in full before it converts itself into banking company as its assets may be frozen and it may not have sufficient money to make such payments. This may also force the company to go into liquidation. As regards the interests of the depositors, the position of a banking company which converts itself into a non-banking company would be the same as that of the industrial and trading concerns in Maharashtra and elsewhere in the country accepting deposits. It has been considered undesirable to prohibit the industrial concerns from accepting deposits and these concerns are exempted from the provisions of the Banking Companies Act by the explanation to section 5(1)(c) of the Act. Even if industrial concerns accepting deposits are brought

within the purview of the Act with a view to protecting the interests of the depositors, there would be two categories of banks, viz., banks which do purely banking business and companies which accept deposits though acceptance of such deposits is not their main business. It would be difficult to control under the Banking Companies Act the activities of the industrial concerns in relation to the acceptance of the deposits as the business of a company cannot be segregated and the safety of the depositors' money will have to depend on the prospects of the industrial concern. It would, therefore, be undesirable for the Reserve Bank to undertake this responsibility.

C.O.

4.8.53

DG(R[amnat])

The above note states the position with respect to banking companies which are unable to comply with the capital standards prescribed in Section 11 or are otherwise unable to qualify for a licence. As will be observed from the memorandum circulated for public opinion when the proposals for banking legislation were first mooted it has all along been the intention—of which the public no less than the banks must be deemed to have been aware—that such banks will be weeded out. There is, however, no objection to their continuing as non-banking companies, in which case their position will be identical with that of industrial or trading concerns accepting deposits.

Apart from legal considerations which stem from the scheme of the Act itself, there is the practical difficulty of imposing any restrictions on banks which have ceased to be banks but continue as trading companies, as we cannot have two sets of banks, one licensed and the other unlicensed. Once we attempt to control banks which have become trading companies, we get drawn into the difficulty of controlling other trading and industrial concerns which accept deposits. We have recently examined the question whether any restrictions should be placed on such concerns and it has been decided that it would be undesirable to do so.

4.8.53

Governor

Banking Companies in the Eastern (Calcutta) Area

On the 30th April 1953 there were 25 scheduled banks having their principal offices in Calcutta. As regards non-scheduled banks, according to our records compiled mainly on the basis of information obtained from the Registrars of Joint Stock Companies, there were 194 non-scheduled banks having their registered offices in this area, i.e. West Bengal, Bihar, Assam and Orissa and some of the Part B and C States.

Scheduled Banks

Since the 1st January 1949, 7 Bengalee managed scheduled banks have been excluded from the Second Schedule. Five of these, viz., the Calcutta Commercial

Bank Ltd., Noakhali Union Bank Ltd., Pioneer Bank Ltd., Nath Bank Ltd., and the Bank of Commerce Ltd., are under liquidation while the remaining two viz. the Mahaluxmi Bank Ltd. and the Tripura Modern Bank Ltd. are working under Schemes of Arrangement. The total outside liabilities of the above five banks under liquidation and the two banks working under scheme at Rs 9.16 crores and Rs 1.50 crores respectively aggregate Rs 10.66 crores.

The existing scheduled banks include the undernoted Bengalee managed banks:

1. Metropolitan Bank Ltd.
2. Southern Bank Ltd.
3. United Bank of India Ltd.
4. United Industrial Bank Ltd.
5. Dinajpore Bank Ltd.
6. Calcutta National Bank Ltd.

A statement showing the position of the above six banks is given in Appendix I [not reproduced] to this note. Of the six banks, one viz. the Calcutta National Bank Ltd. which has deposit liabilities aggregating Rs 2.15 crores, has been ordered by the Calcutta High Court on the 30th April 1953 to be put into liquidation. An application for leave to prefer an appeal to the Supreme Court of India from the above judgement is pending before the Calcutta Appeal Court. Another scheduled bank, viz. the Dinajpore Bank Ltd., which has deposit liabilities amounting to Rs 1.22 lakhs only, has been in a moribund condition for over a year. The remaining four scheduled banks, viz. the Metropolitan Bank Ltd., the Southern Bank Ltd., the United Bank of India Ltd., and the United Industrial Bank Ltd., appear to be functioning normally, their deposit liabilities aggregate Rs 23.56 crores of which the United Bank of India Ltd., accounts for Rs 21.46 crores.

Non-scheduled banks

Out of the 194 non-scheduled banks listed with us as on the 31st March 1953, 172 banks are in West Bengal. Of these 194 banks, only 42 are submitting returns to us under the Banking Companies Act regularly. A statement showing the State-wise distribution and aggregate paid-up capital, reserves, deposits and advances of these 42 banks is contained in Appendix II [not reproduced] to this note. It will be observed from the above statement that 26 of the reporting non-scheduled banks have their registered offices in West Bengal and their total deposit-liabilities aggregate Rs 3.10 crores. An inspection of these banks revealed that only about 16 of them having deposits of about Rs 1.86 crores may be in a position to pay their depositors in full. The remaining 10 banks whose deposits appear to have been affected on account of the depreciation in their assets have deposits aggregating Rs 1.24 crores. As regards the deposit liabilities of the 146 non-reporting banks in West Bengal, no information is available with us. We are in correspondence with the Registrar of Joint Stock Companies regarding the position of these banks which appear to be either defunct or untraceable. We are advised by the Registrar of Joint Stock Companies that some of these banks are being dealt with by him under Section 247 of the Indian Companies Act for the purpose of removing their names off the Register.

Banking Companies either under liquidation or working under schemes of
arrangement

According to the information available from the Registrar of Joint Stock Companies and the liquidators of the banks concerned, as on the 30th September 1952 there were 90 banks in liquidation, both scheduled and non-scheduled, whose total outside liabilities aggregated Rs 19.75 crores. On the above date there were also 18 banking companies working under schemes of arrangement whose total outside liabilities as on the respective dates of sanction of their schemes of arrangement aggregated Rs 6.14 crores.

[10-8-1953]

Seen and returned.

2. Government have forwarded with these papers a copy of the note on 'Banking Companies in the Eastern (Calcutta) Area'. It may be explained that during his visit to Calcutta the Deputy Finance Minister asked Shri Desai, the Deputy Chief Officer (Department of Banking Operations) for a 'personal' note in regard to banks in West Bengal. Shri Ram Nath, Deputy Governor, who is immediately in charge of banking, happened to be in Calcutta during the Deputy Finance Minister's visit. The Deputy Finance Minister, however, did not discuss any of these issues with him. In fact, he did not even meet Shri Ram Nath during his visit, although he was working in the office in an adjoining room.

3. On the basis of the note handed over to him unofficially by the Deputy Chief Officer in Calcutta, Shri Guha has passed the following comments:

"I have already handed over a note regarding the banks in West Bengal. Apart from the banks which have already closed, there are 146 non-scheduled banks in West Bengal who have not been submitting any returns or report to the Registrar, Joint Stock Companies, and have yet been continuing as banks. This is a scandalous state of affairs. This should be stopped at the earliest. It is no use citing legal and technical difficulties. We shall have to do something to remedy this state of affairs.

I expect some effective suggestions to be made on this so as to stop this."

4. This 'so-called scandal' is not of recent growth. The question of enacting comprehensive banking legislation for protecting the interests of the depositors and for fostering the growth of banking in India on sound lines was investigated in detail by the Indian Banking Inquiry Committee (1929-31). The Committee after considering the evidence tendered by commercial bodies and the public on the subject, recommended the enactment of a comprehensive Bank Act. The Central Board of the Reserve Bank considered the problem in detail and submitted certain proposals to the Government of India in November 1939 in the form of a draft bank bill. This bill was circulated by Government for eliciting public opinion, but in view of the abnormal conditions created by the war and the lack of unanimity of opinion disclosed in the replies received from public bodies, Government decided not to undertake any comprehensive legislation during the war period. The special legislation for banking companies, viz., the Banking Companies Act, was ultimately enacted in 1949.

5. There was considerable criticism in regard to the position of banking in West Bengal and Shri Chintaman Deshmukh submitted an informal note to the Central

Board on January 31, 1949, explaining the whole position. The following is an extract from this note. "These banks own their existence mostly to loan companies, whose main business was to grant advances against mortgages. Advances against property, which are not generally looked upon with favour by commercial banks, find a very high place in the advances portfolio of these banks. Many of these banks offered very high rates of interest to attract deposits, spent lavishly on advertisements and opened numerous branches even in far off places, with the result that during the war when, due to inflationary conditions, the public had large surplus funds for investment, the banks showed remarkable progress. The deposits of non-scheduled banks in Bengal rose from Rs 4.87 crores in January 1940 to Rs 30.78 crores in August 1946. The deposits of Bengalee scheduled banks also rose from Rs 5.43 crores at the end of 1939 to Rs 69.85 crores at the end of 1946. The additional resources were not, however, wisely used. In the case of the non-scheduled banks, a scrutiny of their balance sheets, an examination of their financial position in connection with applications for capital issue or branch banking and inspections conducted by us under the Banking Companies (Inspection) Ordinance, 1946, disclosed that the financial position of many of these banks was very unsatisfactory."

Subsequent figures relating to these non-scheduled banks were as follows:

	Number submitting returns	Deposits (Rs crores)
January 1947	165	21.57
June 1948	104	7.68
December 1949	57	3.67
May 1953	19	1.45

6. Soon after the Banking Companies Act came into force the Reserve Bank instituted a system of regular periodical inspection of all banks in the country, scheduled as well as non-scheduled. It took some time to train the personnel and to organise these periodical inspections. All scheduled banks and such of the non-scheduled banks as could be traced in West Bengal have now been thoroughly inspected at least once. Many of the inspected banks have been under surveillance, since their methods of working were found to be unsatisfactory. These banks are required to submit periodical returns to show what progress has been made in regard to the removal of defects noticed in the course of inspection. On the 31st July 1953, the number of banks submitting monthly progress reports and quarterly progress reports was 22 and 244 respectively. If no improvement is shown and the position of the depositors is likely to be prejudiced, we take disciplinary action, such as descheduling the banks concerned or prohibiting the receipt of further deposits (e.g. Calcutta National Bank Ltd., Dinajpore Bank Ltd., Mahaluxmi Bank Ltd. and Tripura Modern Bank Ltd.). As the Finance Minister himself explained in Parliament recently, the Reserve Bank, through its system of inspection exercises as effective control over banks as is possible in any free democratic country.

7. As stated in the note handed over to the Deputy Finance Minister by the Deputy Chief Officer in Calcutta, there are however, 146 non-scheduled banks in West Bengal which are either "defunct or untraceable". We have sought the assistance of the Registrar of Joint Stock Companies in tracing these banks, but he has not been able to

help us so far except in a few cases. If the Registrar with the assistance of the administrative machinery of the Bengal Government cannot trace these banks, the Reserve Bank cannot obviously locate them. The Chief Minister of West Bengal has suggested that the Reserve Bank should appoint an Inspector to scrutinise the affairs of each bank. As has been explained above, there is already a very efficient system of inspection and it is our aim to inspect every bank at least once a year. It is obvious, however, that it is not possible to inspect banks which are either "defunct or untraceable". We do not know of any remedy, legal or otherwise, by which we can resurrect for inspection and appropriate treatment a bank which has been dead for some time. Nor is a post-mortem examination possible until the corpse can be found.

8. Our difficulties may be illustrated by reference to the case of the Bishnupur Bank Ltd., Bishnupur (Bankura) about which a reference will be made shortly to the Government of India. This bank was inspected by us in June, 1950 for determining whether it would be eligible for a licence. The inspection revealed a number of serious defects, which were brought to the notice of the bank for rectification. The bank was asked to submit quarterly reports indicating the progress made by it in remedying the defects. It submitted its progress reports upto the quarter ended June 1952, but there were no subsequent reports in spite of several reminders. The Chairman has been guilty of malpractices, nepotism and dishonest transactions. The following is an extract from the second inspection report:

The bank appears to be in a moribund condition since the middle of 1952.

The premises where its Head Office was situated, were disposed of by it in December 1952 and the books and records of the above office were transferred to the local residence of the Chairman of its Board of Directors. The name-board of the bank is not displayed at that place. Besides its Head Office at Bishnupur, the bank had two offices at Calcutta and one each at Purulia and Bankura. One of its offices at Calcutta and those at Purulia and Bankura were closed prior to the date of inspection while its other office at Calcutta was closed on the 6th April 1953 i.e., prior to the date of commencement of inspection. Most of the books and records of all the above offices which have since been closed have also been transferred to the residence of the Chairman.

The bank's Chairman is apparently attempting to elude his creditors. A letter by us to the bank recently has been returned to us by the Dead Letter Office, Calcutta, although it was despatched correctly to the address furnished by the bank in terms of the Banking Companies Rules. The fact that in spite of such a state of affairs, none of the bank's creditors or shareholders seem to have so far made any move for taking the bank into liquidation seems to indicate that either they have lost all interest in it or they do not consider it worthwhile to throw away good money after bad. Since it is necessary to see that the acts of misfeasance etc. on the part of the bank's management, and in particular its Chairman, are thoroughly investigated by the Official Liquidator for such action as the Court may deem fit, we are addressing the Government for action against the bank under Section 35(4) (b) of the Banking Companies Act.

9. Dr. B.C. Roy has stated in his letter to Shri A.C. Guha that in many cases the Reserve Bank "informs the non-scheduled bank people to give up banking and go to something

else". The possibility of conversion into a non-banking company as a result of banking legislation was recognised as early as 1939. In his memorandum dated September 24, 1940, submitted to the Central Board, Sir James Taylor stated that on the introduction of banking legislation on the lines suggested by him, many of the smaller banks would disappear or would continue to exist for moneylending etc., though they would not be permitted to describe themselves as banks. On October 20, 1942, the Reserve Bank sent a circular letter to all Registrars of Joint Stock Companies that under the amendments to the Indian Companies Act, which became operative from November 1, 1943, all companies which described themselves as banks but were not conforming to the provisions of the law relating to banks, should change their business or, with the approval of the Central Government, their designation. The provisions in regard to the requirement of minimum paid-up capital etc. in the Banking Companies Act are mandatory and if the banks are unable to comply with these requirements, they have to convert themselves into non-banking companies or go into liquidation, which is a much more costly process from the point of view of the depositors. It is obvious that the sponsors of the legislation were fully aware of the inevitable consequences of these provisions and the facts regarding the position of the banks in Bengal were known at the time. My predecessors who had initiated this legislation had no doubt satisfied themselves at the time that the interests of the depositors would not be prejudiced by the conversion of "banks" into moneylending institutions or ordinary companies subject to the Indian Companies Act. The advice given by the Reserve Bank in the cases referred to by Dr. Roy was based on the policy that had been formulated before and is implicit in the Act. I have, however, had the legal position re-examined, and I enclose herewith a copy of the note by the Legal Division [not reproduced], which states that except in regard to one minor procedural point the position of the depositors is not in any way affected by conversion into a non-banking company.

10. I must apologise for the length of this note, but it is not usual for a responsible member of the Government to use in relation to the working of a big institution like the Reserve Bank such expressions as "scandalous" on the basis of an unofficial note given to him, at his request, by the Deputy Chief Officer of one of our branches without an official request for fuller information from the Bank or prior discussion with the senior executives. I feel, therefore, a full explanation is necessary.

B. RAMA RAU

10-8-1953

D.M.(G)

I had a discussion with the FM. When I put that note, I had no idea of putting the blame on the Reserve Bank. A responsible officer of the Reserve Bank first drew this to my notice. Then I arranged to discuss the matter with him and the Registrar of Joint-Stock Companies. Both appeared to have been foiled by those people. The letter of the Chief Minister, W.Bengal also could not suggest any redress. When we are faced with such a state of affairs, I thought it my duty to take serious notice of that.

However, I hope the suggestions made by the Secretary (E.A.) in his note will be given effect to.

A.C. GUHA

16.8

Secy. may show this to G[overnor], R[eserve] B[ank]
C.D. Deshmukh
18.8.53

D. CONSOLIDATION AND LICENSING OF BANKS

SECRET

D.O.No.[...]

July 28, 1961

My dear L.K.,

You will remember that at the meeting in the Finance Minister's room on the 1st of this month, when the general banking situation was discussed, we promised to write to you after a review of the position of the various banks as disclosed by our inspections in 1957 and the latest inspections and the lines on which we feel that further action should be taken. We have since conducted the review and this letter contains our proposals in regard to future action.

2. You will recall that the point was explained at the discussions with the Minister that it would be easier to proceed with further amalgamations if the Deposit Insurance Scheme came into effect at an early date. We sent to Government a draft bill some time ago; but, apart from a news item in the press that legislation was likely to be introduced in the coming session of Parliament, we have not heard anything on the subject. I am assuming for purposes of this letter that the Insurance Scheme will come into force in the next two or three months.

3. The present position in respect of the commercial banks is broadly as follows. Excluding the banks which are in liquidation or have been refused a licence or have converted themselves into non-banking companies or are under moratoria pending amalgamation under Section 45 of the Banking Companies Act, we have at present 298 banking companies functioning in this country. Fifteen of these are foreign companies and the rest are indigenous. Sixty-five of them have been given a licence while 223 banks, including a foreign bank, have still to be licensed. Ten of the banks do not require any licence. The licensed banks together have a deposit of Rs 1,210 crores, unlicensed banks Rs 82 crores and the banks not requiring a licence Rs 651 crores. These are round figures and give the position in accordance with the latest returns available for 1961.

4. The bulk of the smaller banks fall in the category of unlicensed banks. Of the 223 unlicensed banks 22 are scheduled banks with a total deposit of Rs 43 crores. Fifty-three banks have a paid-up capital and reserves of Rs 1 lakh and less; many of them are no more than glorified moneylending institutions and their total deposits are of the order of Rs 1½ crores. One hundred and nineteen banks have a paid-up capital and reserves between Rs 1 lakh and 5 lakhs with a total deposit of Rs 15 crores. Twenty-eight banks have a paid-up capital and reserves of over Rs 5 lakhs and their total deposits aggregate Rs 20½ crores.

5. As you know, prior to the amendment of the Banking Companies Act, last year under which Government took power to place banks under moratoria and promote schemes for their amalgamation, the only power available to the Reserve Bank when

a bank was run inefficiently or its deposits were impaired was to put it under liquidation. The wide powers recently taken by Government were intended to facilitate the orderly elimination of the weaker units from the banking system and the building up of a strong and well co-ordinated banking structure. It was not at any time intended that small banks, as such, should be done away with or only big institutions encouraged. The idea was to build up, by a process of amalgamation, banking institutions all of which would be viable and reasonably efficient. Of the 35 banks which were placed under moratoria some of them had themselves asked for it while in the case of the others it was the considered judgement of the Reserve Bank that the methods of operation or the financial position of the institutions were such that either the interests of the depositors were in jeopardy or there was no prospect of the banks becoming viable institutions in the foreseeable future. The alternative to merging these banks with other banks was to let them linger along to ultimate disaster. As you know, in each of these cases the full reasons for the view taken by the Reserve Bank about the financial position and the prospects of the institution were placed before the Government.

6. At the meeting in the Minister's room it was suggested that if, in the last two or three years, there had not been any worsening in the position of any bank there might be a case for going slow with it and giving it a chance to improve itself. The position of the various banks has been examined from this angle by comparing their financial position as disclosed by our inspection in 1957 with the position as disclosed by our latest inspection. The position has naturally varied from bank to bank; some have shown an improvement while others have shown a deterioration, but, on the whole there has not been any improvement. If we take the 298 banks functioning today, their position in 1957 was that the reserves of 183 banks had been affected but their capital and deposits were intact. In the case of about half of them the erosion was marginal or not very significant while in the case of the remaining the erosion was more substantial. Forty-seven had completely lost their reserves and had in addition lost upto roughly one half of their capital. Sixteen banks had lost their entire reserves and more than half their capital. Twenty-six banks had lost their entire capital and reserves and, in addition, a part of their deposits. The present position, taking the same banks into consideration, is that 175 are still in the position of having their reserves affected, 52 have completely lost their reserves and upto half the capital, seventeen have lost their reserves and the bulk of the capital and 23 have lost their reserves, capital and a part of the deposits. Individual banks may have improved or deteriorated but this is the broad picture taking them as a whole.

7. The banks which have only lost a part or whole of the reserves do not pose as urgent a problem as the banks which have lost their capital and deposits although every effort should be made through inspection, advice and, if necessary, directions to make these banks improve their position. Banks which have lost their capital and deposits have to be dealt with first to protect the depositors from further damage to their interests. Banks which have their deposits intact, but have only lost their capital may be dealt with a little later but before the deposits are affected. But action cannot be deferred any longer when the interests of the depositors are likely to be placed in jeopardy. Where damage has already been done or is likely to be done in the near

future, it is essential to take steps to get the banks amalgamated with other stronger units. It will be easier to do this once the Deposit Insurance scheme comes into operation although the burden on the Corporation would be somewhat heavier than if these institutions had been weeded out earlier.

8. In the light of the discussions at the meeting with the Minister I propose that our policy in regard to the future course of action should be:

- (i) In the case of banks whose reserves only have been affected, efforts should be made to get them to improve their position over the next two or three years, but no action to merge them compulsorily with other banks should be taken except in case of gross mismanagement and repeated failure to carry out our directions or accept our advice.
- (ii) In the case of banks which have lost their reserves but only less than half of their capital they should be nursed in the same way as banks which have only lost their reserves; action to merge them compulsorily with other banks should be taken only if they are grossly mismanaged and they fail to carry out our directions or accept our advice.
- (iii) In the case of banks which have lost all their reserves and the bulk of their capital there is a danger of a further deterioration resulting in the erosion of deposits also. In the interest of the depositors these banks should be taken up for amalgamation with other stronger units as soon as practicable and well before the deposits are touched.
- (iv) In the case of banks which have already lost part of the deposits after losing all their capital and reserves there is no justification for leaving them to function, as the chances of their rehabilitation are remote. These banks should be taken up for amalgamation with other banks, the programme being phased in such a way that it does not create any feeling of panic or insecurity in any part of the country.

9. The above proposals only cover the problem of dealing with the existing institutions which have, in one way or another, reached an unsatisfactory position. They do not deal with the larger question of rationalising the banking structure so as to do away with the distinction between scheduled and non-scheduled banks and licensed and unlicensed banks. I am convinced that these distinctions which are confusing to the public mind and are merely a historical relic should be done away with. With a scheme of deposit insurance in operation and all functioning banks coming within its cover, the distinction between licensed and unlicensed banks would largely lose its meaning as it is unlikely that an insured bank would be refused a licence. The distinction between scheduled and non-scheduled banks will disappear if all the smaller banks which, because of their very small capital and reserves or poor management, do not qualify for inclusion in the schedule could be amalgamated into a number of sizeable units. These units would be viable and well managed but still largely local and would qualify for inclusion in the schedule. In fact, at that stage, there would be no need for a schedule. I am convinced that this rationalisation should be effected in the interests of banking as a whole and should be kept in mind as our long-term policy. How long this process should take is for Government to decide. From the point of view of having a sound banking structure which can take on the increasing

pressures of the Third Plan, I would myself think that the less the delay in this programme or rationalisation the better it would be in the public interest.

10. I shall be glad if Government would kindly let me know their decision on the suggestions made in this letter. Meanwhile unless any bank comes forward with a proposal for a moratorium on its own to the Reserve Bank (as some of the Kerala banks did after the Palai crash) or a run develops on any bank which makes a moratorium inescapable we shall hold our hand. We shall go ahead with the schemes of amalgamation for the banks already under a moratorium but no further schemes will be formulated until Government have taken a decision on policy and the scheme of deposit insurance is introduced.

11. I have given in this letter statistics of the banks by categories. I have not deliberately given the names of the individual banks as it is not desirable that information about them should leak out.

Yours sincerely,
H.V.R. IENGAR

Shri L.K. Jha, I.C.S.

CONFIDENTIAL

No.[...]

Memorandum to the Central Board

Policy regarding the licensing of banks under section 22 of the Banking Companies Act, 1949

The policy of the Reserve Bank of India regarding the licensing of banks in terms of section 22 of the Banking Companies Act, 1949 was last considered by the Central Board at its meeting held on the 17th July 1958. The Board after considering the Deputy Governor's memorandum No.[...] dated the 5th July 1958 resolved that the policy regarding licensing outlined in the note attached to the memorandum be approved. Since the submission of that memorandum, there have been significant developments in the field of banking, particularly in regard to amalgamations and consolidation of the structure, which have accelerated the process of refusal of licences to banks. There have, however, been some adverse comments recently in the Financial Press in regard to the alleged slow progress in the matter of licensing of banks. In order that the Board may be kept apprised of the correct position in this regard, a note reviewing the progress so far made and the present position in regard to the licensing of banks is attached. If the Board is in agreement with the views contained therein, it may kindly pass the following resolution:

“RESOLVED

That the policy regarding the licensing of banks outlined in the note attached to the Deputy Governor's memorandum No.[...] dated the 30th July 1965 be approved.”

RESERVE BANK OF INDIA
CENTRAL OFFICE
DEPARTMENT OF BANKING OPERATIONS
AND DEVELOPMENT
BOMBAY, dated July 30, 1965

DEPUTY GOVERNOR

CONFIDENTIAL

Policy regarding the licensing of banks under section 22 of the Banking Companies Act, 1949

The policy followed by the Reserve Bank of India in regard to the licensing of banks under section 22 of the Banking Companies Act, 1949 was first considered by the Central Board at its meeting held on the 8th November 1954. Thereafter the policy was again reviewed by the Board at its meetings held on the 18th December 1957 and 17th July 1958. As over seven years have passed since the submission of the latter memorandum and dissatisfaction with the pace of licensing has been voiced in some quarters recently, it is proposed to review in this memorandum the Bank's policy and progress in regard to the licensing of banks. The note attached to the memorandum submitted at the meeting held on the 17th July 1958 is appended for ready reference (vide Appendix [p. 1068]).

2. Present Policy

The policy of the Reserve Bank in regard to the licensing of banks is governed by the provisions of section 22 of the Banking Companies Act, 1949. The conditions to be fulfilled by a banking company to be eligible for the grant of a licence are:

- (a) that it is in a position to pay its present or future depositors in full as their claims accrue;
- (b) that its affairs are not being or are not likely to be conducted in a manner detrimental to the interests of the present or future depositors; and
- (c) that in the case of a bank incorporated outside India, the Government or the law of the country in which it is incorporated, does not in any way discriminate against banks registered in India and it complies with all the provisions of the law.

While sub-section (1) of section 22 stipulates that no bank shall carry on banking business in India unless it holds a licence granted by the Reserve Bank, the first proviso to sub-section (2) provides that a banking company in existence on the commencement of the Act shall not be prohibited from carrying on business until it is informed by the Reserve Bank that a licence cannot be granted to it.

The basic objective underlying the provisions relating to licensing is thus to ensure that only those banks whose financial position and methods of operation are satisfactory, are given licences. In the case of foreign banks, there is an additional requirement that there is no discrimination against Indian banks in the foreign country concerned.

In judging the financial position of a bank for the purpose of granting a licence, the Reserve Bank takes into account, inter alia, the adequacy of the paid-up capital and whether the bank has been able to build up sufficient reserves commensurate with its age. The Reserve Bank also takes into consideration the quality of its advances and investment portfolios and earning capacity. It is not, however, the policy to refuse a licence to a bank—the effect of which is that it has to cease carrying on banking business—unless a reasonable chance is given to it to improve its financial position and methods of operation. In the case of a number of banks it is found that while the interests of depositors are not in immediate danger, their financial position and methods are such as do not justify the grant of a licence. The

delay in the progress of licensing has been largely due to the existence of an appreciable number of such banks which have not yet been able to set their houses in order.

3. Progress in the licensing of banks

It was stated in the memorandum submitted at the meeting held on the 17th July 1958 that 58 banks (49 scheduled and 9 non-scheduled) had been granted licences upto the 16th June 1958, and that 4 banks did not require a licence, while licences had been refused to 117 banks. As on the above date, the total number of unlicensed banks was 345. The figures relating to the grant and refusal of licences since 1951 are given below for ready reference.

Year	No. of banks granted licences			No. of banks refused licences		
	Sche- duled	Non- Sche- duled	Total	Sche- duled	Non- Sche- duled	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1951	1	—	1	—	—	—
1952	21	1	22	1	—	1
1953	8	1	9	—	4	4
1954	1	—	1	1	10	11
1955	12	—	12	—	14	14
1956	1	3	4	—	47	47
1957	3	—	3	—	30	30
1958	7	3	10	—	20	20
1959	—	7	7	—	3	3
1960	2	3	5	—	5	5
1961	—	—	—	—	4	4
1962	2	7	9	1	6	7
1963	3	2	5	—	1	1
1964	—	1	1	1	61	62
1965 (30 June)	—	—	—	—	35	35
Total	61	28	89 ¹	4	240	244

¹Includes 27 banks whose licences have since been cancelled/deemed to be cancelled on account of their merger with other banks, etc. Also includes 2 banks to whom licences have been granted to commence banking business in India subsequent to the date of last review.

It will be observed that the pace of refusal of licences has been appreciably accelerated since the beginning of 1964. The problem of licensing of banks is nearer solution now than at any time before as will be seen from the following table showing the number of licensed banks, banks not requiring a licence and banks which have not yet been granted a licence.

	Scheduled	Non-Scheduled	Total
i) Licensed banks	51	11	62
ii) Banks not requiring a licence	8	—	8
iii) Banks which have not been granted a licence	17	47	64
Total	76	58	134

Of the 64 unlicensed banks, 39 banks are working under directions issued by us; the affairs of 27 of these banks are also under our formal/informal observation. All these banks have been inspected several times and we have been taking systematic and regular steps after each inspection for improving their working with the ultimate object of enabling them to qualify for a licence. Our observers have been playing a positive role and have not only prevented at source transactions of undesirable nature but where considered necessary have also given proper guidance to the banks. The banks are also required to obtain our prior approval for the declaration of dividend, a step that helps in the strengthening of their reserves. We also impress on the managements from time to time to take effective steps to improve their working and to attain our standards of eligibility for licence.

4. Developments in the banking field and their impact on the licensing of banks

It is necessary at this stage to explain the reduction in the number of functioning banks in recent years which has declined from 407 in June 1958 to 134 as on the 30th June 1965. During the last five years, particularly after the failure in 1960 of two scheduled banks, the Reserve Bank has been following an active policy of consolidation of the banking system through compulsory and voluntary amalgamations of banks. Certain other developments, which took place in the banking and economic fields at about this time, also lent impetus to this process. The main development which influenced the position, particularly of the smaller banks, was the promulgation of the Gold Control Order in November 1962. The impact of this Order adversely affected the position of banks which had confined their business largely to advances against gold ornaments. They were also faced with the problem of meeting increased expenses on staff as a result of the coming into effect of the Bank Award or the agitation of the employees in the case of non-Award banks for equivalent scales of pay. The impact of these factors was felt so severely by some banks that, although having no insignificant resources, they of their own accord decided to merge with other banks. Even a few banks which had been granted licences earlier resorted to this course. As a sequel to our study of the position of the various banks affected by these developments informal discussions were held by us with the managements of the banks and the advantages of their ceasing to have an independent existence and merging into stronger and viable units likely to qualify for a licence ultimately, were effectively brought

home to them. Thus, as many as 162 amalgamations and transfers of liabilities and assets have taken place during the period from 1961 to the 30th June 1965, of which 121 have been on a voluntary basis. During the same period, 43 other banks converted themselves into non-banking companies or went into voluntary liquidation or otherwise ceased to function.

5. Analysis of the position of unlicensed banks

Although the number of unlicensed banks is at present 64 as against 70 licensed banks, (including 8 banks not requiring a licence) the deposits of the licensed banks (including those which do not require a licence) aggregate as much as 97% of the total deposits of all banks in India. The corresponding percentages when the policy was considered by the Board in July 1958 and in June 1954 were 93.2 and 76.5 respectively.

On an assessment of all the relevant factors it is considered that 17 banks (10 scheduled and 7 non-scheduled) are likely to qualify for the grant of a licence in the next 5 years; their position vis-a-vis grant of licence is being reviewed from time to time. Out of the remaining 47 banks, 24 banks are either taking steps for their amalgamation with/transfer of liabilities and assets to other banks or have been advised by us to take such action in view of their unsatisfactory financial position/methods of operation. 10 other banks are taking steps to go into voluntary liquidation or for conversion into non-banking companies. The remaining 13 banks include a foreign bank. Apart from the usual considerations, the question of grant of licence to this bank will depend on its compliance with section 22(3)(c) of the Banking Companies Act, i.e. reciprocity. The viability of 3 banks is not free from doubt and we may have to persuade them for amalgamation/merger with suitable banks. The question of constituting one bank, in which a State Government has a considerable stake, as a subsidiary of the State Bank of India is engaging our attention. As regards the remaining 8 banks, they are mostly dominated by their Chairman/certain directors and have been functioning mainly to subserve their interests. The managements of these eight banks have not been responsive to the various measures suggested by us to make them viable units and have not made serious efforts for improving their working. Their future set-up is under our constant consideration.

6. Feasibility of fixing a time limit for unlicensed banks to satisfy the standards of eligibility for a licence

It has been suggested that the Reserve Bank should fix a time limit, say two years, for all the unlicensed banks to satisfy the standards of eligibility for licence and declare that banks which fail to do so will not be given licence and that the public will be informed of the decision. As already mentioned, the affairs of the unlicensed banks are receiving our constant attention. They have been unable to show appreciable progress in the rectification of some of the defects such as low reserves, realisation of sticky advances, etc., as these features, by their very nature, are difficult of rectification within a short period, in spite of the steps taken by the management. However, so long as there is no deterioration in a bank's financial position and its management continues to be keen in bringing the bank's working on sound lines and the depositors' interests are not put in jeopardy, it would be desirable to allow sufficient time and

afford it an opportunity to qualify for a licence. In this context it would be difficult to lay down a hard and fast time limit for the purpose.

7. Conclusion

It will be observed from the foregoing that the main purpose underlying our licensing policy is to ensure that only banks whose financial position and methods of operation are satisfactory and which will be in a position to function as viable units, are given a licence. The fact that the 64 unlicensed banks referred to above (out of 722 which originally applied for licence) have not yet qualified themselves for a licence, is merely indicative that they have been slow in taking necessary action to come up to our standards in this regard. However anxious we may be to hasten the process of licensing, unless the banks themselves take expeditious steps to improve their working and come up to the requisite standards, it may not be possible to show accelerated progress in the matter. At the same time, so long as the interests of their depositors are not in immediate danger, the balance of advantage would seem to lie in giving them time for improving their affairs and to endeavour to make them fit for the grant of licence either by bringing their working on approved lines or by merging them with stronger units. The present policy of consolidation-cum-licensing has yielded satisfactory results and it is expected that by the end of 1965 there will be about 100 functioning banks left in the country. In the circumstances, although some unlicensed banks may be with us for some more years, the policy outlined in the foregoing paragraphs may continue to be followed.

APPENDIX TO BOARD MEMORANDUM DATED 30 JULY 1965

Policy regarding licensing of banks under section 22 of the Banking Companies Act, 1949

The policy followed by the Reserve Bank in the licensing of banks under section 22 of the Banking Companies Act, 1949 was first considered by the Central Board at its meeting held on the 8th November 1954. At this meeting the Board approved of the policy as outlined in a note submitted by the Department of Banking Operations on the subject. Thereafter the policy was again reviewed by the Board at its meeting held on the 18th December 1957. The Board, while approving of the policy as outlined in the Deputy Governor's Memorandum No.[...] dated the 6th December 1957, desired that the matter should be resubmitted to it after six months. Accordingly, the progress in regard to the licensing of banks and the developments during this period are reviewed in the following paragraphs. The note attached to the memorandum dated the 6th December 1957 is appended for ready reference (vide Appendix I [not reproduced]).

2. Present policy

The policy of the Reserve Bank in regard to licensing of banks is governed by the provisions of section 22 of the Banking Companies Act. Sub-section (1) of this section stipulates that no company shall carry on banking business in India unless it holds a licence granted by the Reserve Bank. The first proviso to sub-section (2) of the section, however, provides that a banking company in existence on the

commencement of the Act shall not be prohibited from carrying on business until it is informed by the Reserve Bank that a licence cannot be granted to it. Sub-section (3) of the section further provides that before granting a licence the Reserve Bank may require to be satisfied by an inspection or otherwise that the following conditions are fulfilled viz.,

- a) that the bank is in a position to pay its depositors in full as their claims accrue;
- b) that the affairs of the bank are not being conducted in a manner detrimental to the interests of its depositors.

In view of the provisions mentioned above and the fact that very little information was available to the Reserve Bank about the financial position and methods of operation of most of the banks, particularly the non-scheduled banks, it was decided to inspect every bank in order to ascertain whether it satisfied the criteria mentioned above. The inspections revealed that a very large number of banks were being operated under conditions under which, consistently with the provisions of the Act, a licence could not be given, and some of these were big banks with substantial deposits. This raised the question whether a licence should be refused straightaway in such cases. The policy adopted was that where the situation could possibly be retrieved and a bank made to work on sound lines, an opportunity should be given to enable it to do so and a licence refused only where the position was hopeless.

3. *Progress in the licensing of banks*

The figures relating to the grant and refusal of licences since the position was last reviewed are given below:

	No. of banks granted licences			No. of banks refused licences		
	Sche- duled	Non- Sche- duled	Total	Sche- duled	Non- sche- duled	Total
Upto the 31st October 1957	47	5	52	2	101	103
From the 1st November 1957						
to the 16th June 1958	2	4	6	—	14	14
Total	49	9	58	2	115	117

It will be seen that since the progress was last reviewed by the Board, 2 scheduled and 4 non-scheduled banks have been granted a licence while 14 non-scheduled banks have been refused a licence. The total number of banks licensed so far is thus 58. At present the deposits of all licensed banks, together with those of the State Bank of India, the State Bank of Hyderabad, the Bank of Patiala and the State Bank of Saurashtra, which do not require a licence, aggregate 93.2 per cent of the total deposits of all banking companies in India. The corresponding percentage when the question was last considered by the Board in December 1957 was 92.4. It may be added that the percentage in June 1954 was 76.5. It will be observed from the foregoing that since the work relating to the grant and refusal of licences to the existing banks was taken up in 1952, fair progress commensurate with the policy adopted by us has been accomplished.

4. Present position of unlicensed banks

The total number of licensed banks as on the 16th June 1958 was 345. Of these 320 banks (Vide Appendix II [not reproduced]) are submitting periodical reports showing the progress made by them in the rectification of defects pointed out to them. No progress reports are being called for from the remaining 25 banks for various reasons. Some of these banks could not be traced or could be inspected only recently and in the case of certain others, a change in their set-up is under consideration. It will be observed from the statement indicating the progress of inspections/re-inspections etc. given in Appendix II that a large number of banks submitting progress reports has been re-inspected during the past three years. Since the last review, 101 banks have been re-inspected. It may be stated here that re-inspections in the case of 20 banks and a rapid scrutiny in the case of one bank were undertaken to assess the progress made by them in implementing fully the conditions imposed on them. 17 scheduled and 28 non-scheduled banks are at present working under conditions as against 10 scheduled and 32 non-scheduled banks as on the 31st October 1957. Under the new section 35A of the Banking Companies Act, 1949, such conditions have since been imposed by the issue of suitable directions to 3 scheduled banks and 1 non-scheduled bank. Of these, the affairs of 10 scheduled and 4 non-scheduled banks are under observation and an officer of the Reserve Bank is being deputed to attend their Board Meetings and to keep a watch on their day-to-day working.

In cases where the inspection reports on banks disclose serious defects, it is our usual practice to call the Chairman, the Chief Executive Officer and one or two directors of the bank concerned for a personal discussion in order to impress upon them the need for taking expeditious action to remove defects. In suitable cases, the banks are also advised to explore the possibilities of amalgamation with other banks. It may be mentioned in this context that during the last several months we sanctioned four schemes of amalgamation amongst banks.

Periodical inspections carried out by us together with the scrutiny of progress reports have revealed that in most cases steps are being taken by the banks to implement the advice tendered to them. The common undesirable features observed in the working of banks, the number of cases where they have been pointed out and the number of banks that have been able to rectify them either wholly or in part are given in Appendix III [not reproduced]. While several banks have been able to rectify the procedural and organisational defects within a reasonable time, few of them have been able to show appreciable progress in the correction of operational defects such as the realisation of sticky advances, the reduction of clean advances and advances against immovable property.

5. Refusal of licence to banks in Kerala

The position of banks in Kerala was reviewed by the committee of the Central Board at its meeting held on the 14th May 1958 and it appeared that the go-slow policy adopted last year has had a salutary effect on the banking structure in the State. While this was a welcome development, two measures of agrarian reform viz., the Kerala Indebted Agriculturists Relief Bill and the Kerala Agrarian Relations Bill introduced by the State Government at the end of last year seemed to have caused considerable nervousness in banking circles. The Deputy Governor visited Trivandrum

in the middle of March this year and held discussions with the State Government and the representatives of the banks in regard to the prevailing banking situation and the problems facing banks in that area. Having regard to the discussions, the uneasiness created amongst banks by the above two Bills and the urge on their part to build up stronger units by way of merger or amalgamation, it was decided to continue the go-slow policy adopted last year for some time more.

6. Inclusion of banks in the Second Schedule to the Reserve Bank of India Act

Closely allied to the problem of licensing of banks is the question of their inclusion in the Second Schedule to the Reserve Bank of India Act, 1934. Since the position was last reviewed, 3 more banks have been so included. At present there are 50 banks the nominal value of whose paid-up capital and reserves is Rs 5 lakhs or above but which have not so far been included in the Second Schedule as their financial position and methods of operation are not satisfactory. Their position is, however, being examined from time to time simultaneously both for inclusion in the Second Schedule as well as for the grant of a licence under section 22 of the Banking Companies Act.

7. Accelerating the pace of inspections

In order to expedite the licensing of banks, it has been suggested that banks which are under our surveillance should be inspected more frequently. Even as it is, the maximum period allowed at a time for implementation of the conditions/directions is 12 months and invariably either a re-inspection or a rapid scrutiny is undertaken before the expiry of this period with a view to determining the future course of action. In the case of banks whose day-to-day affairs are under observations, the officer deputed to attend the meeting of the bank's Board of Directors carries out simultaneously a rapid scrutiny of its current affairs. It has also been recently decided to accelerate the pace of inspections and make them an annual feature. With a view to expediting the disposal of all pending applications for licence, priority is given to the inspections of unlicensed banks. In view of these arrangements, it is expected that our surveillance would become more effective and yield better results.

8. Feasibility of fixing a time limit for the rectification of defects

It has also been suggested that a licence under section 22 of the Act should be refused to a bank if it does not show any appreciable improvement within a period of three years or so. As has already been observed, while some of the banks have been able to rectify the procedural or organisational defects in their working within a reasonable time, few of them have been able to show an appreciable progress in the correction of operational defects such as the realisation of sticky advances and the reduction of clean advances and advance against immovable property. These features, mostly a legacy of the past are by their very nature difficult of rectification within a short period. In several cases, in spite of the steps taken by the management, the progress made in the rectification of these features is slow. Initially, only a short period is allowed to banks for rectification of the defects and a re-inspection is undertaken at the end of the period with a view to deciding the future course of action. However, so long as there is no deterioration in the bank's financial position and the management is keen on bringing the bank's working on sound lines, it would be desirable to allow further time and afford it an opportunity to qualify itself for a

licence. It would, therefore, be difficult to lay down a hard and fast time limit for this purpose.

9. Analysis of the position of unlicensed banks

With a view to assessing the prospects of completing the licensing process, the position of all the 345 unlicensed banks (39 scheduled and 306 non-scheduled) has been reviewed. It appears from the latest inspection reports, progress statements and other information available with us that out of these banks, 5 scheduled and 20 non-scheduled banks broadly satisfy the requirements of section 22(3) and their working did not disclose any serious defects. The grant of licence in these cases has been held in abeyance pending rectification of a few unsatisfactory features observed in their working and it is expected that they would qualify for a licence within a year's time. The total deposits of these banks as on the 31st March 1958, aggregate Rs 1,165.31 lakhs. Of the remaining banks, it is observed that 26 scheduled and 196 non-scheduled banks do not satisfy one or other of the requirements laid down in section 22(3). Though their methods of operation cannot be considered as not detrimental to the interests of the depositors, the progress reports submitted by them reveal some improvement, and they seem to be taking steps to rectify the defects pointed out to them. The financial position of a large number of banks in this category cannot admittedly be considered as satisfactory, but given time for a few years more several of them may reach the standard of eligibility. The total deposits of banks falling under this category as on the 31st March 1958 amount to Rs 7,039.30 lakhs. Of the remaining banks, 36 non-scheduled banks with a total deposit liability of Rs 55.80 lakhs as on the 31st March 1958 do not satisfy the requirements of both section 22(3)(a) and (b) and their position is practically beyond repair. With the exception of 15 banks operating in Kerala State steps are being taken to proceed with the refusal of licence in the other cases. Though the financial position and methods of operation of the remaining banks, 8 scheduled and 54 non-scheduled, continue to be unsatisfactory, owing to various considerations such as the possibility of adverse repercussions on other banks etc., they have been granted time to improve their working. But from the past experience it appears that they may not be able to rebuild themselves into viable units. The total deposits of these banks amount to Rs 1,870.85 lakhs as on the 31st March 1958 and in most of these cases it may eventually be necessary to refuse a licence. Of the scheduled banks falling under this category four of them have sizeable deposits aggregating Rs 1,281.09 lakhs and although their deposits have been affected to a certain extent the question of taking adverse action against these banks has been deferred. In the meantime, they have been advised to make earnest efforts for exploring the possibility of either amalgamating with some other banks or alternatively arranging for the transfer of their liabilities and agreed assets to such banks or entering into a compromise with their creditors.

10. Conclusion

It will be observed from the foregoing review that although the working of a large number of unlicensed banks suffer from certain serious defects, given sufficient opportunity several of them may be able to retrieve their position. So long as the financial position of these banks does not show any deterioration and so long as they

endeavour to bring their working on approved lines, the balance of advantage would appear to lie in giving them more time for improving their affairs, as any adverse action at this stage would manifestly be detrimental to the interests of their existing depositors. The present policy has yielded satisfactory results and has contributed to the adoption of sounder methods by banks. Therefore, although completion of the process of licensing may take yet a few more years, no modification in the existing policy appears to be called for.

E. BANKING SITUATION IN KERALA

SECRET

FINANCE MINISTER
INDIA
NEW DELHI
August 10, 1960

My dear Jengar,

I have just seen Rangachari's letter to Jha, regarding the action taken by the Reserve Bank of India under Section 38 of the Banking Companies Act, in relation to the Palai Central Bank. You had also informed me about it on the telephone before taking the action. Although there is nothing more to be done at the present stage, I am a little concerned at the way in which the affairs of this bank and also of the Laxmi Bank were allowed to drift, before the decision to wind them up was taken.

2. There has also been some criticism in Parliament to the effect that although the working of the Palai Central Bank was not quite satisfactory, when the bank was first inspected in 1951, its affairs were subsequently allowed to deteriorate very considerably, without any positive constructive action being taken. Because of this lapse of time, the attempts to strengthen the management and to change the methods of working, when they were actually made, proved to be too late. The general impression which this has created has been, I think, somewhat unfortunate.

3. I would like the Reserve Bank of India to consider, if possible, whether some more positive steps cannot be taken, on the basis of its inspection reports, as soon as there is an indication that the banks concerned have not been functioning properly. The Reserve Bank has now a wide range of powers under the Banking Companies Act, including the power to give directions relating to a number of matters. Perhaps, these powers might be more freely used.

4. The procedural details regarding the action to be taken against banks which are not conducting their affairs properly have necessarily to be left to your discretion, but I hope it will be possible for you to ensure that failures like those of the Palai Central Bank and the Laxmi Bank are, as far as possible, prevented in future.

Yours sincerely,
[MORARJI DESAI]

D.O.No.[...]

SECRET

August 18, 1960

Dear Shri Morarji Desai,

Will you please refer to your D.O.No.[...] dated the 10th August regarding the Laxmi Bank and the Palai Central Bank and the general question of Reserve Bank policy in the matter of banks which are being run in a manner detrimental to the interests of the depositors?

2. I naturally share your concern about the banks which have failed. On the general question of Reserve Bank policy, I would draw your attention to the concluding part of the speech that I am delivering tonight at the Annual Meeting of the Institute of Bankers. I enclose a copy of the extract for ready reference. It is always a matter involving a rather delicate exercise of judgement as to when the stage has arrived for taking drastic action against a bank by refusing it a licence or applying to the court for the appointment of a liquidator. In view of the continued failure of banks in Kerala, we received a strong representation from the Kerala Bankers Association early in 1957 asking us to go slow in the matter of refusing licences to banks. This was also, broadly, the recommendation of the Travancore-Cochin Banking Enquiry Commission. In the situation that has been developing in Kerala in the last three years, my own view is that if we had taken, in any of the years 1957, 1958 and 1959, the action that we have taken now, the Reserve Bank would have been exposed to at least as great a criticism as now and, perhaps, even greater. This has been the considered judgement of my colleagues and myself in the Bank. I am quite prepared to accept the view that someone else could have exercised his judgement differently.

3. With regard to the Laxmi Bank, your reference to the affairs of this bank having been allowed "to drift" suggests that the full facts were not placed before you when you wrote to me. Undoubtedly there were several defects and irregularities in the running of this bank. But what precipitated a crisis was a clear fraud. The fraud was assisted by the fact that the Reserve Bank gave prior notice of its inspection. We have now changed our policy and have started surprise inspections of banks.

4. I am glad that you have raised the points that you did in your letter because it is essential that the policy, procedures and techniques of the Reserve Bank should be continuously reviewed with a view to their being improved. I am examining the whole question afresh with a view to seeing what we can do to tighten things up.

Shri Morarji R. Desai

Yours sincerely,

[H.V.R. IENGAR]

SECRET

RESERVE BANK OF INDIA
DEPARTMENT OF BANKING
OPERATIONS
TRIVANDRUM
September 28, 1960

Dear Shri Iengar,

I am sending by Nadkarni a note on my discussions with the bankers in Kerala. At the time Rangachari came here the atmosphere was heavily surcharged but I

was fortunate to find the majority of the bankers in a pensive mood. The idea of mergers and amalgamations was stated by them to have been well-received but there were also surprises. I was no doubt prepared for a lukewarm or even hostile reception to the idea of amalgamations from the representatives of the Travancore Forward Bank, but I did not expect that K.T. Varghese, who is the General Manager of the Catholic Syrian Bank Ltd. and also the Secretary of the Kerala Bankers Association, who saw me this morning, would even now not be thinking in terms of amalgamations. P.K. Koruth, Managing Director of the Martandam Commercial Bank, when he saw me alone on Monday gave his wholehearted support to the idea but he again came this morning with Chacko, one of his directors, to say that they were a well-managed bank, a strong unit, and, therefore, there would be no justification to include them in any scheme of merger. This, however, does not in any way disprove that the amalgamation idea has been favourably received.

2. I have written this at some length merely with a view to emphasising the difficulties that are likely to arise in our way. After my interview with the Chief Minister and talk with the Finance Secretary (the Finance Minister is out of Trivandrum), I feel confident of a good measure of support from the State Government. Bankers in general, however, in this area are a difficult lot. As I have said in the note they are strongly individualistic, well entrenched in their present positions and in the political life of the State, and with a vocal press at their command, are a dangerous fraternity. Juxtaposed, however, with the main idea behind the recent amendment of the Banking Companies Act, i.e., safeguarding the interest of the depositors, these difficulties, howsoever formidable they may be, have to be overcome, even if in the process we are subjected to all sorts of calumny.

3. We shall require an exhaustive amendment to the Banking Companies Act to bring in the State Bank and its Subsidiaries as also to provide for entrusting the liquidation of the unrealisable assets of the banks to a special officer in the liquidator's office. As I mentioned to you over the 'phone today the Advocate General of Kerala with whom I had a talk fully supports this proposal.

4. Urgent action on our part is required mainly because of the Kottayam Orient Bank who may not be able to stand the strain of withdrawals beyond another six weeks or so.

Yours sincerely,
C.S. DIVEKAR

SECRET

The present banking situation in Kerala and the steps necessary to meet it

I held discussions regarding the present banking situation in Kerala with the representatives of the banks which had approached the Reserve Bank for financial assistance following the closure of the Palai Central Bank. Some of them are also office-bearers of the Travancore-Cochin Bankers' Association. I also met representatives of bankers in other areas and had talks with the Finance Secretary and the Chief Minister. On the basis of these discussions and the statutory returns available to us so

far in respect of both the scheduled and the non-scheduled banks in this area, the main features of the present situation appear to be as follows:

(1) The first impact of the failure of the Palai Central Bank seems to have led to a general rush for withdrawals throughout the State. The monthly returns submitted so far under Form X (section 24) of the Banking Companies Act show that out of 97 reporting banks, 76 banks experienced net withdrawals of deposits in various degrees between the 5th August and the 26th August 1960 (vide Statement I appended to this report). The total decrease in the deposits of these banks during the period amounted to Rs 4.05 crores. As against this, only 21 banks (vide Statement II) led by the State Bank of Travancore show an increase in deposits aggregating Rs 28 lakhs. Even in the case of the State Bank of Travancore, the increase is in respect of demand deposits and the time deposits show a perceptible fall. The initial rush for withdrawals was very considerable in the case of the Travancore Forward bank, the Kottayam Orient Bank, the South Indian Bank, the Catholic Syrian Bank, the Trivandrum Permanent Bank, the Cochin Commercial Bank, the Federal Bank, the Martandam Commercial Bank and the Seasia Midland Bank. The banks in the area known as "Central Travancore", i.e. those with the Headquarters at Kottayam, were the worst affected, firstly, because the Palai Central Bank had many of its branches here and secondly because this area in the State is relatively more important from the point of trade, commerce and industry. Comparatively the banks in the districts of Ernakulam and Trichur have not been subjected to very heavy withdrawals. The Calicut region in the north has been even less affected because there are a comparatively small number of indigenous banks in this area and the ubiquitous Marwari and Gujarati private bankers are said to play an important part in the credit structure.

(2) The pace of the withdrawals of deposits has somewhat slackened during the last two weeks. This is interpreted by some of the bankers as a sign of the revival of public confidence. The pressure of withdrawals is now confined more or less to the first two banks mentioned in (1) above. All the bankers, however, apprehend a recrudescence of withdrawals in case some action is not taken before the next balance sheets of the banks are published or should any large bank in the area in the meantime be forced to close its doors due to inability to meet the demands made on it. In the opinion of the bankers, the depositors now seem to be pinning their faith on the constitution of strong banking units through a process of amalgamations and insurance of at least a portion of their monies.

Statistics showing the present position of the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India, the Seasia Midland Bank and the Martandam Commercial Bank are given in Statement III.

(3) The money withdrawn from the five banks had, according to the bankers, found its way largely into the State Bank of India and its subsidiary, the State Bank of Travancore, other commercial banks with head offices outside Kerala and the Postal Savings Banks. A part of it was said to have been kept in hoards.

2. The representatives of the banks whom I met, with one solitary but important exception, seemed to have caught up the idea of amalgamation: indeed, some of them, on their own, made general suggestions for amalgamations. They seemed to have realised that for achieving stability and viability amalgamations were inevitable. The exception was the Travancore Forward Bank and here the reasons are mainly psychological. I pressed them for their constructive views for a long-term solution. After a good deal of whispering between themselves and hesitation they came out with half-hearted suggestions. In the opinion of these representatives, the two scheduled banks, namely, the Travancore Forward Bank and the Kottayam Orient Bank, being an "award" and a "non-award" bank respectively, should continue as separate units although each of them might take over some of the smaller banks belonging to its class. They thought that the Travancore Forward Bank, if granted a "provisional" licence might, over a period of a few years, be able to write off the losses in its capital from its future profits. They were clearly not helpful, were concerned with maintaining their own superior position and had no clear idea of how the situation was to be met if the withdrawals continued beyond a month or two. The representatives of the other banks were, however, in favour of amalgamations among the local scheduled and non-scheduled banks. In particular, the representatives of the Kottayam Orient Bank conveyed the impression that they would not be able to stand the pressure of withdrawals beyond a month or so. The consensus of opinion amongst the bankers appeared to be that the existing small units might be constituted into four or five big banks each having deposits of say Rs 8-10 crores. The amalgamations, in their opinion, could be brought about only by compulsion in terms of the latest amendments to the Banking Companies Act and not on a voluntary basis because of the likely opposition from the shareholders to write off losses from the capital and reserves and difficulties of reaching agreement on selection of directors and chief executive officers for the reconstituted units. One of the difficulties in the way of amalgamations, according to them, was that the grouping of the staff of the award and non-award banks would result in a substantial increase in the establishment cost of the units formed by amalgamation. At present there are only a few banks in the State which are governed by the award, the rest being non-award banks. The establishment costs of the award banks were stated to be 20 to 25 per cent higher per employee than those of the non-award banks. In the opinion of the bankers the employees of the non-award banks might, if persuaded, be prepared for a "truce" in respect of maintaining their existing scales of remuneration since the choice before them would be total loss of employment in case of closure of banks or continuing on their existing scales of pay in the amalgamated banks for a few years.

3. We have given thought to the question as to what would be the most feasible course of action in relation to the five banks mentioned above. Indeed this is the most pressing aspect of the banking problem in Kerala the solution of which will brook no delay. In my view an institution formed by the amalgamation of these banks would be a jerry-built structure with all the weaknesses of the component units, e.g. relatively large depreciation in assets and irrecoverable advances, low standards of efficiency and integrity of the existing management and of the staff. I also envisage a perpetual

conflict among the directors drawn from banks having affiliations with different religious denominations or groups, unless they are all imbued with a common sense of purpose as also a responsibility towards the interests of the depositors.

4. I do not also consider that the merger of the above five banks with any of the big banks incorporated outside the State would be a success. The managements of the two scheduled banks concerned seem to be strongly individualistic and may not fully co-operate in such an idea. Nor have we much time to devote to long-drawn negotiations or persuasion. Moreover the big banks have at present offices only at the more important centres in the State and it is unlikely that they would be willing to penetrate as far deep into the interior as some of the local banks have done. Secondly, the big banks would presumably not be willing to make advances say, against real estate, hypothecation of merchandise or on personal security to the same extent as local banks are doing. Thirdly they would not be able to serve the small traders. I have heard here that some of the local banks would advance even to the extent of Rs 10, say, against gold ornaments. It may not, therefore, be realistic to try to merge these banks with big banks from outside.

5. I have said above that the problem of these banks is pressing and considering all relevant factors it seems to me that the most practicable line of approach would be to merge these five banks with the State Bank of Travancore. This proposal may be criticised on the ground that it in effect means nationalisation of the banks through the backdoor. It seems to me that such a criticism could be effectively answered. Whatever be the grounds against nationalisation as a matter of policy, I have no doubt that the State Bank of Travancore will have a very much bigger role to play in this State. This was also the view of the Chief Minister but of that anon. The mergers with the State Bank of Travancore are to be effected on pragmatic and not ideological grounds. They have to be effected because of the difficulties of constituting viable units by amalgamating weak institutions and the impracticability of mergers with private outside commercial banks. The State Bank of Travancore is to enter upon a programme of branch expansion in the State; it may, by taking over the banks, get readymade premises, trained staff and some business from the commencement at certain centres. The State Bank of Travancore may take over good or near good assets of the banks against assumption of an equal amount of liabilities. The assets taken over may be valued by the State Bank in consultation with the Reserve Bank. After this operation is done, the banks in the attenuated form may be taken into liquidation and the Official Liquidator may be charged with the duty of recovering those assets and distributing the recoveries pro rata among the depositors and, if anything was left, among the shareholders. The whole process will mean that while the good business is transferred to the banking system the bad business is entrusted to the agency best suited to handle it because of the special powers it possesses under the provisions of the Banking Companies Act. It will, of course, be necessary to strengthen the organisation of the Official Liquidator in Kerala for the purpose by the appointment of a Special Liquidator for banking companies only. The course suggested above will, no doubt, provoke widespread criticism from the shareholders and depositors. If, however, steps are taken to explain to the depositors that this was in their best interests and any other course would have meant more loss to them, they may be

made to see light. I suggest that, in case the above proposals are accepted, the Legal Division may draw up the necessary draft legislation for transmission to Government. The legislation should empower the State Bank of India and its subsidiaries to take over assets and liabilities of banking companies on a compulsory basis, on the basis of valuation to be done in consultation with the Reserve Bank. On taking over the business of the five banks, the State Bank of Travancore may have to maintain offices at many small centres where these banks have offices at present. The State Bank of Travancore would not have in the normal course opened offices at many of those centres. There would hardly be any justification for raising the emoluments of the staff at the small centres soon after the mergers. The feasibility of making a provision in the amending law that the scales of pay and allowances of the staff at those centres would continue for a period of 3-5 years would, therefore, require to be examined. Also there should be provisions in respect of transfer of staff on the same lines as in the State Bank of India (Subsidiary Banks) Act. As stated earlier, the bankers have stressed the necessity of urgent action so that the whole process is over before the end of December 1960 when their balance sheets are drawn.

6. I found the Chief Minister during the interview to be very helpful. His personal opinion, he said, was that at least so far as Kerala is concerned there was a good case for nationalisation of banks. He emphasised, however, that he was also aware of the views held in New Delhi and deferred to them. He, therefore, suggested that the State Bank of Travancore should step in in a large way to fill the void created by the failure of the Palai Central Bank. He said, his Government's concern was that the banks in the State were managed by people of integrity and he did not seem to hold in very high esteem the local directorates concerned with the various banks. He also said that the special features of banking in Kerala State such as small borrowers, etc. will require special attention in the new set-ups. I informed him that I had found that the idea of amalgamation was generally favourably received here and the Reserve Bank will bear in mind the points suggested by him and would also wherever possible respect local sentiments etc. The Chief Minister expressed his willingness to suggest suitable names, if required by us, to form directorates of the new units.

7. I have said above that the amalgamation of the five banks will not brook any further delay. This, however, is only from the point of view of priorities. The entire banking structure in this area calls for immediate reconstruction and we will have to take it in hand at a very early date. For this purpose it seems that it would be better to divide the banks in this State into three areas, namely, Travancore Central, Trichur and Calicut. In this connection the note submitted by Gogtay will be useful as the basis for deciding the further course of action to be adopted. In the light of our discussions here we have however, reduced the number of the proposed units to seven (vide Statement IV). It also seems that so far as the Calicut area is concerned, it may be worth our while trying to persuade banks in the Mysore area, such as the Canara Bank, Canara Industrial & Banking Syndicate, etc. to extend their activities to this part. As regards other areas, if it is not possible to form local viable units, we may make an informal approach to banks in Madras, such as the Indian Bank, Indian Overseas Bank, etc., if they would be interested to come into this State. All these, however, are tentative

ideas and will require closer examination once the decision to bring about bigger units is taken.

[Statements I–IV are not reproduced here]

C.S. DIVEKAR

28/9/1960

BANKING SITUATION IN KERALA

Attached is a detailed note [pp. 1075–80] on the banking situation in Kerala after the appointment of a Provisional Liquidator for the Palai Central Bank. It is a summary of the previous note submitted after the last visit to Trivandrum in September and also embodies the conclusions reached after discussions with bankers from Trichur and Calicut areas during this trip.

2. There is at present a lull in the feeling of nervousness that had overtaken this State following the crisis. The calm, is however, only on the surface and some of the bankers are exploiting this false sense of security for their personal and political ends. The rest of India and the Reserve Bank in particular have come in as the most handy scapegoats.

3. I, therefore, feel that we have now done enough of the preliminaries and the time has come for action. No further discussions, therefore, need be held to ascertain the views of bankers on amalgamations, reconstructions or mergers. The depositing public, barring those that are swayed by communal considerations and the like, are now said to have become critical of bank managements and appreciative of the Reserve Bank's action in the case of the Palai Central Bank.

4. If we decide to take action, we shall have to adopt a definite strategy to ensure that the changeover is brought about as smoothly as possible. To this end, I have embodied some suggestions in the note. We shall have to assure the general public, the business community and the depositors that the new set-up of banks is going to be to their advantage, that banking facilities will thereby not be curtailed and may indeed grow, so that trade, commerce and industry are in no way adversely affected and the interests of the depositors if anything will be better safeguarded. We should also reduce to the minimum any possible impact of increased unemployment following the mergers.

5. There are some trouble-spots in the State with which we will have to deal both with firmness and understanding. In Trivandrum area, the Travancore Forward Bank and the Kottayam Orient Bank are said to be powerful elements with tendencies for mischief. Both, however, at present are in a bad way and, therefore, in a less recalcitrant mood. We should take immediate advantage of the situation and merge or reconstruct them with other banks. Of these, the Travancore Forward Bank is bigger and, I understand, willing to merge with the State Bank of Travancore. It is also an award bank and from that point of view, such a merger has much to recommend. Regarding the Kottayam Orient Bank, we will have to scale down their obligations and bring about a merger with some other units in the area. Proposals on these lines are contained in the note. Simultaneously we should reduce the emoluments of the higher executives of this unit and also move their headquarters to Trivandrum—away from Kottayam which is said to be a hot-bed of intrigue.

6. In the Trichur area, two units are likely to prove most troublesome, both unlicensed. They control the Chamber of Commerce as well as the Bankers' Association and are very powerful. They also seem to have an innate tendency to misinterpret and misconstrue others' intentions and actions. They will not accept any reform willingly and co-operatively and indeed can be depended upon to put obstacles in the way elsewhere. We shall, therefore, have to deal with them firmly, if necessary even changing their executives. Of the remaining banks, the Nayar group has expressed a desire to merge together, as also the other group managed by people from Palghat. In Calicut area the problem is simple.

7. We should also, to kill in the bud any possible charge of discrimination, first effect a few mergers in other States—we have already in hand one in Madras and are contemplating another in Bombay. It would be good if we bring a few units together both in Delhi and Calcutta also simultaneously.

C.S. D[IVEKAR]

16-10-1960

After the above note was finalised I went to meet the Chief Minister, the Deputy Chief Minister and the Finance Minister. The proposal made above that the time had come for us to take action found support from them, particularly from the Deputy Chief Minister, Shri Chacko, which in itself is an important fact. According to the Ministers the Reserve Bank should not now hesitate to proceed with the schemes of amalgamation bearing in mind the special features of the Kerala State. Shri Chacko said that he was of the opinion that the banks wanted to make a show of unwillingness or even of resistance so that later on they would be in a position to disown any responsibility for agreeing to the mergers.

A separate note on the discussions is being put up.

C.S. D[IVEKAR]

18.10.1960

Summary of discussions with the Chief Minister of Kerala

In Trivandrum I received a message that the Chief Minister desired to see me at 8.30 P.M. on Sunday the 16th instant. In confirmation a letter was received saying that the Deputy Chief Minister and the Finance Minister would also be present at the meeting. Accordingly I met the Ministers at the appointed time. The Ministers desired to have an idea of our assessment of the banking situation in Kerala following the closure of the Palai Central Bank. A reference was also made by them regarding the feasibility of the schemes of reconstruction submitted to the High Court.

2. I gave them a broad idea of our assessment of the banking situation in the State and the reactions of the bankers whom I had met in regard to the question of amalgamations, on the lines indicated in the note submitted separately. On behalf of the State Government it was stated that, in their opinion, it would be necessary to use compulsion in bringing about amalgamations. They indicated that some of the bankers might make a show of resistance before accepting amalgamations. They emphasised that, in effecting amalgamations, it was necessary to ensure that there was no curtailment of

banking facilities in any centre, howsoever small, and that the existing practices of the local banks of making advances for relatively small amounts against gold ornaments, landed property, etc. and for purposes of kuri business were continued. In other words, it was necessary to ensure that trade, commerce or industry in the State did not suffer as a result of the mergers. Another factor necessary to take care of was that unemployment was avoided. The units formed should be of an appropriate size—none too big—having regard to the existing pattern of growth of banking in the State. The Ministers also hoped that scaling down of deposits would be necessary only in a few cases so that there would not be much opposition from the depositors. Also action should be taken as early as possible.

3. The Chief Minister also desired to have an idea of the Reserve Bank's reactions regarding the feasibility of the schemes of reconstruction filed in the High Court. I said that the Reserve Bank was always prepared to consider any schemes of reconstruction which were workable and were in the best interests of the depositors. The schemes submitted to the High Court were being examined and our views would be placed before the High Court on the 30th. Prima facie, however, the schemes appeared overoptimistic. I also mentioned that if the bank was revived on the basis of a substantial reduction in deposits, there was the risk of the depositors withdrawing their deposits soon after reformation. Thus, the reconstruction would, for all practical purposes, mean a voluntary liquidation. The Chief Minister agreed and observed that if the bank was reconstructed, say, on the basis of a payment of 50% of deposits, the depositors would most probably withdraw their deposits. The Deputy Chief Minister and the Finance Minister said that even on the basis of a payment of 60%, the position would be no better. The Chief Minister said that, if on examination, the schemes were not found feasible, the process of liquidation should be expedited by the appointment of someone who had banking experience and preferably also experience of liquidations. He said that the Court would certainly agree to the staff of the liquidator's office being strengthened on request.

4. The Ministers also expressed the desire that Kerala Government be consulted or kept informed of any action proposed to be taken by us in regard to amalgamations of Banks.

C. S. D[IVEKAR]

18-10-1960

Governor

I think this note is a very useful one.

I suggest ED (Divekar) should have immediate discussion with Shri Bhattacharyya regarding the State Bank of Travancore taking over the Travancore Forward Bank. The deposits of this Bank are intact, so the question of putting bad, doubtful and sticky advances does not arise except perhaps in a very marginal way. Therefore no legislation will be necessary except perhaps bringing in State Bank within the purview of the recent legislation.

In the meanwhile I would like to forward a copy of the note to Finance Minister. Please let me have a draft on the lines suggested.

H.V.R.

20/10

SECRET
D.O.No. [...]

Camp: MADRAS
October 24, 1960
Kartika 2, 1882

Dear Shri Morarji Desai,

Banking Situation in Kerala

Soon after the passing of the Banking Companies (Second Amendment) Act, 1960, which gives wide powers to the Reserve Bank to prepare schemes for the reconstruction and amalgamation of banking companies, I deputed C.S. Divekar, Executive Director, to Kerala to study the local banking situation first-hand and formulate proposals for strengthening the banking structure. During his visit to Kerala, Divekar held discussions with the representatives of as many as 41 out of a total of 101 banks incorporated and functioning in the State. I enclose a copy of the report prepared by him on the 'Banking Situation in Kerala and the suggestions for meeting it', together with a copy of the relative covering note. He also met the Chief Minister of Kerala and a summary of his discussions with him is attached [for enclosures, see pp. 1075-82].

2. As a result of the discussions, Divekar has formulated certain proposals for amalgamations and mergers amongst banks in Kerala. We will pursue these proposals with the banks concerned and with Government in due course. The general sentiment in the State is in favour of amalgamations and mergers although a few of the bankers remain opposed to them. This section is very vocal, owns newspapers and has its representatives in the Central and the Local Legislature. The Ministers whom Divekar met are, however, strongly in favour of bank mergers and expressed a desire to be kept informed of the action proposed to be taken by us.

3. As will be seen from paragraph 6, page 12 of the report, the time has now come for urgent action to be taken in respect of the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India and the Seasia Midland Bank. It is proposed to constitute the last three banks into one unit, possibly with the addition of another small bank viz. the Venadu Bank. As regards the Travancore Forward Bank, which has lost deposits of over Rs 2.30 crores according to the latest available figures as on the 12th October 1960 and is still losing deposits, it seems that the most feasible course would be to ask the State Bank of Travancore to take over this bank. We are taking up the matter immediately with the Chairman of the State Bank and will let you know the result of our discussions at an early date.

4. The situation in Kerala requires urgent action in respect of some banks. Indeed, banks like the Travancore Forward Bank and the Kottayam Orient Bank are afraid to publish their latest statements of position which would show a heavy fall in their deposits and have urged the necessity for taking action before the 31st December 1960. While we are proceeding on the basis of the provisions of the Banking Companies (Second Amendment) Act, 1960 in formulating schemes of amalgamation, our detailed examination of the new provisions vis-a-vis the proposed schemes have revealed the necessity for certain further amendments to the Banking Companies Act. We are writing separately to Mathrani about this.

Yours sincerely,
H.V.R. IENGAR

SECRET

I paid a short visit to Kerala early last week. The visit was primarily to discuss with Shri K. M. Cherian the future of the Travancore Forward Bank about which there has been some correspondence with him. The Chairman of the State Bank of India, who was also at Trivandrum at that time, suggested that a meeting with Shri Cherian would be useful. The Chairman and I met Shri Cherian on the 29th November and had a long talk with him. Shri Cherian repeated the points he had already made in communications to us and the State Bank of India that the Travancore Forward Bank had turned the corner now and should be left alone. He appears to have received some encouragement for this position from the Joint Managing Director of the State Bank of India and possibly also Shri Vedamuthu. Both Shri Bhattacharyya and I pointed out that we could not agree that the bank was viable unless it could repay the amount outstanding from the Reserve Bank and there was some reasonable assurance that the bank could run with its reduced resources without erosion of deposits. The position at the moment was that the whole of the reserves and nearly the whole of the capital had been eaten up; the deposits still appeared to be intact. The bank had lost deposits of over Rs 2 crores and although the rapid outflow has considerably diminished, deposits have not started coming back and our feeling was that this was unlikely to happen for quite some time. In the larger interests of depositors we both thought that this was the appropriate time when the deposits were intact for a merger with the State Bank of Travancore.

2. Shri Cherian did not agree with this and talked of the adverse effect on the banking situation generally in Kerala if a moratorium is declared for a bank of this size. He said that there were many difficulties in his way but he hoped that with reasonable time he would be able to tide over them. So far as the merger with the State Bank of Travancore was concerned, the Chairman pointed out that the decision would be ultimately for the Reserve Bank to take but if at the time of the merger deposits still continued to be intact it would be possible to arrange for a voluntary merger without the inconvenience and psychological impact of a moratorium. But even if the bank's deposits at the moment were still intact the Reserve Bank will have to take a view of the immediate future and satisfy itself that the bank would be in a position to make enough profits and continue to function without any erosion of deposits. It was suggested that the appropriate course would be to get an agreed estimate of both the positions, the position at the present moment and the position as it is likely to be at the end of, say, six months or one year. This could be done quite informally by an officer each from the State Bank of Travancore, the Travancore Forward Bank and the Reserve Bank making the first assessment and an officer from the Reserve Bank and the Travancore Forward Bank making the second assessment. The second assessment would be on the basis that deposits would remain more or less at the present level and advances would have to be recalled and adjusted to enable the Travancore Forward Bank to pay the outstanding advances to the Reserve Bank and keep a sufficiently liquid position. After a considerable amount of hesitation Shri Cherian said that personally he saw no objection to our proposal but that he would informally consult his colleagues on the Board. Later, he sent a communication indicating that the proposal for the association of an Officer of the State Bank of

Travancore was not acceptable at present but that he would have no objection to the officer of the Reserve Bank conducting the scrutiny in regard to the future prospects of the bank on the lines suggested by us. The Chairman of the State Bank and I felt that while leaving the assessment of the present position for further discussion we should immediately accept the offer for an inspection by the Reserve Bank in regard to the future so that we could have some data on which we could take a final decision. Necessary instructions have been issued to our Deputy Chief Officer at Trivandrum.

3. The Chairman and I also took the opportunity of our visit to Kerala to meet the Chief Minister and the Finance Minister on the following day. Some pressure is being built up in Kerala against the merger of the Travancore Forward Bank with the State Bank of India. There is also considerable uneasiness, some of it artificially created, against any scheme for amalgamation of the smaller banks in the State. There is also agitation against any declaration of moratoria as it is alleged that this shakes the confidence in banking and might lead to runs on the sound banks as well. All these points were stressed to us in some detail by both the Chief Minister and the Finance Minister. We pointed out that ultimately the Reserve Bank has to take a view whether a bank already in difficulties or a damaged position could survive and there was no point in indefinitely keeping a bank which has already eaten up part of its deposits unless the position could ultimately be reversed in a reasonable period of time. We also explained that while voluntary mergers were possible when the deposits were intact without declaration of a moratorium, a moratorium will be necessary when the banks which have to be amalgamated have eroded the deposits, to facilitate the reconstruction of these banks before an amalgamation. We made it clear that it is not our intention to declare moratoria on a wide scale in a particular area in view of its damaging effect on confidence. It was the intention of the Reserve Bank to go about it reasonably slowly and arrange for amalgamations and mergers in an orderly way. We were heard quite patiently by both the Ministers but both of them again and again came back to the point that it may be best in all the circumstances to leave the situation as it is with the vigilance of the Reserve Bank securing that things do not go wrong any further. This attitude creates a somewhat difficult situation which would require careful handling.

For information.

M.V. RANGACHARI

5.12.1960

Governor—I would like to discuss this with D.G., E.D. & C.O.

H.V.R.

8/12

Discussed on 10.12.60. It was decided that the Travancore Forward Bank be left alone for the time being, but that we should go ahead with the proposed amalgamation of the Kottayam Orient Bank Ltd. with three other banks. As regards the general policy governing amalgamations, this has been dealt with

in Governor's D.O. letter of the 10th December 1960 [not traced; but see pp. 1060-63] to Shri L. K. Jha.

[M.S. NADKARNI]

11.12.60

SECRET

[See paras. 5-9]

D.O.No.[...]

[My dear Iengar,]

SECRETARY

ECONOMIC AFFAIRS

MINISTRY OF FINANCE

NEW DELHI

December 7, 1960

I hope you had a pleasant journey to Cairo and I am looking forward to meeting you in Calcutta on the 19th when we can, as usual, exchange thoughts on various matters. I thought, however, of writing to you in between partly to bring you up-to-date on recent developments as we see them and partly to seek information on one or two points which are rather urgent.

2. The state of our Sterling balances continues to cause anxiety. Between October and December, we have continued to lose Sterling. The only improvement which we have had is due to the German credit and even this credit was offset partly by a deficit which we had on the rest of our payments during the week.

3. It seems to me that it would be worthwhile making a comparative study between the figures for October and November 1960 and the corresponding months in the two previous years. Is the unfavourable trend due to a failure of exports, or an upsurge in imports, or mainly on invisible account, or a combination of all three? Whatever may be the answer, it could usefully be analysed in some detail. If exports have declined, then we ought to know what are the main commodities involved. If imports have gone up, then we ought to know whether the increase is on account of pure maintenance, or on account of developmental imports which do not however, get identified as projects, e.g., components, or raw materials for the domestic production of capital goods, or of direct developmental expenditure abroad. Finally, on invisibles it would be worth examining to what extent we have been making increased payments for past debts, and to what extent other factors are operative. It seems to me that the Reserve Bank would be in the best position to undertake such a study and you might wish to initiate it.

4. The next point relates to credit policy. Yesterday quite a few questions were asked on the subject in the Informal Consultative Committee of the Parliament. You might have seen some reports in the Press on the subject. It is unfortunate that these discussions which are supposed to be confidential should leak out—in spite of the fact that I had intervened in the discussion to point out how unfortunate it would be if those present drew inferences from what was said in the meeting and the Press had access to such impressions. The main points which the Minister made at the meeting were that he stoutly denied that there were any differences of opinion or outlook on the subject of credit control and fiscal measures between the Government and the Reserve Bank. He further stated that all the steps taken by the Reserve Bank had the

fullest support of Government, that these measures were not intended to make money unavailable for productive purposes and the prime objective was to hit at speculation and hoarding. He then went on to say that on the question of dear money, there were two schools of thought. Some people outside India were strongly pressing for raising of interest rates. In Indian conditions, there were good reasons to depart from orthodoxy in this matter and selective controls as distinct from a general credit squeeze had much to commend themselves. At this point a member asked whether F.M. was against a dear money policy. F.M. replied that no such inference could be drawn from the exposition which he had given of the pros and cons of the situation. This incidentally was the point when I intervened in the sense indicated above.

5. There was a good deal of discussion on the banking system. Some members observed that they were aware of cases where under the Reserve Bank's directive, banks had declined or cancelled credits which were for purely productive purposes. F.M. pointed out that the instructions on this subject had naturally to be in general terms and individual banks could on occasion interpret them in a manner which might not be wholly consistent with the objectives underlying the Reserve Bank's instructions. When such a thing did happen, the matter could be brought to the notice of the Reserve Bank or the Government when it could be further considered whether in view of the facts of the case any change in the instructions to the banks either in general terms or in relation to the particular case was called for.

6. The discussion on the banking system once again displayed the familiar confusion on the subject of scheduled banks, licensed banks and unlicensed banks. F.M. explained the position in some detail. The main burden of the thoughts voiced by the M.P.s was that the process of getting banks either licensed or, in cases where this was not possible, refusing them licences, should be greatly speeded up. A reference was made to the question of amalgamation. F.M. said that the task of the Government and the Reserve Bank would be greatly facilitated if the banks concerned themselves came forward with concrete proposals rather than leave it entirely to the Reserve Bank to bring about such amalgamations. About Kerala banks, many members spoke. In fact, only a day earlier, a special delegation had come out from Kerala to represent to F.M. that confidence in banks there was greatly shaken and something should be done urgently. F.M. told them, and rather firmly, that this constant talk of confidence having been shaken which responsible people indulged in, was itself contributing to the lack of confidence.

7. F.M. promised at the end of the Consultative Committee meeting to make an interim report on the steps which are being taken to strengthen the banking system and the progress achieved. This meeting is due on the 13th at 2.30 p.m. F.M. has asked me to write to you and I request you to let him have a report on the subject. Obviously, it will not be possible for F.M.—particularly in view of the leak in the Press—to take the Consultative Committee into confidence regarding any details of the operation or about the position of individual banks. It would, however, be most helpful if at this stage you were to get a note prepared and sent which would deal with the progress which has been made and perhaps also the problems which have to be resolved. In particular, is it at all possible to foresee the period of time over which the programme of amalgamations can be finalised?

8. A reference was made also to the Deposit Insurance Scheme. F.M. pointed out that

the Deposit Insurance Scheme would anyhow cover only small sums of money and could not cover the entire deposits of all banks. The timing for introducing such a scheme was an important matter for consideration. If the scheme was launched at a time when there were a large number of banks in a somewhat unhealthy state, there was some danger that the very existence of the scheme might precipitate a crisis. Also, in such a situation, the burden on the better banks would be greater. On the other hand, if the process of strengthening the banking system was carried yet another step or two, then the insurance scheme could well mean a great deal of added strength to the banking system as a whole. The whole scheme, however, was being examined by the Reserve Bank.

9. I am afraid this letter has turned out to be longer than I intended. The main points for action are the suggested comparative study of our balance of payments trends in recent months and secondly, a report on the steps being taken in regard to the strengthening of the banking system and the amalgamation of the smaller banks.

Yours sincerely,

L.K. JHA

Shri H.V.R. Iengar
Governor
Reserve Bank of India
Bombay

BY AIR FREIGHT
SECRET

RESERVE BANK OF INDIA
DEPARTMENT OF BANKING
OPERATIONS
POST BOX No. 2
TRIVANDRUM
December 15, 1960

D.O.No.[...]

My dear Deva Rao,

Amalgamation/reconstruction of banks in Kerala under section 45 of the Banking Companies Act, 1949

Please refer to your D.O. letter No.[...] dated the 27th November 1960. The tentative suggestions for the reconstruction or amalgamation of banks in this area contained in the note enclosed with your letter have been examined by us in the light of the criteria set out therein, and a note embodying our comments is enclosed. Suitable comments have been given in cases where we have suggested any readjustment in the groups suggested by Central Office. A statement showing the revised groupings suggested by us is given in the Appendix to the note. Particulars relating to the banks in each of these groups, in the prescribed forms, are also enclosed.

2. The questions whether all the banks in a particular group should be amalgamated at one stroke and whether the amalgamations should be under section 45 or section 44A(1) of the Banking Companies Act, 1949, require very careful consideration.

We are of the definite opinion that the simultaneous grant of moratorium to a number of banks is likely to lead to avoidable inconvenience to the public and cause panic as in the case of the Travancore Forward Bank, the Kottayam Orient Bank and the Bank of New India (on account of rumours to that effect). The crisis caused by the liquidation of the Palai Central Bank Ltd. was in a way unavoidable when the decision to wind it up was taken. The same cannot be said about schemes of amalgamation and reconstruction which can be put through when the time is most suitable for them. There can be no two opinions on the point that there are far too many weak and inefficient units in Kerala and that the banking structure requires to be strengthened. The question, however, is one of timing and of procedure. Section 45 should, in our opinion, be regarded as an emergency provision to be used in cases where other means are not available. It may, for instance, be used in the case of banks whose position is irretrievable and is already known to the public. It may also be used in cases where deposits are fast dwindling and where there is no alternative to the grant of a moratorium in order to ensure, as far as possible, equal treatment to the depositors. In other cases, amalgamations should be under section 44A(1) of the Banking Companies Act, 1949, but under pressure from us. Most of the banks in Kerala are no doubt small in size, but with the exception of a dozen banks (vide Annexure I), they cannot be classified as banks whose position is irretrievable or which are experiencing any panicky withdrawals. We do not, therefore, think that section 45 should be invoked in all cases. Most of the amalgamations could be brought about under section 44A(1). A possible objection to the use of section 44A(1) may be that the interval between the publication of the scheme and its eventual sanction may be utilised by the public to withdraw their deposits. Past experience does not suggest this, and even if this happens, we can immediately invoke section 45. We, therefore, feel that the proper course would be to bring about amalgamations, as far as possible, under section 44A(1), but the initiative should be taken by us. We should call the representatives of the concerned banks (i.e. banks in the group finally decided upon) together and explain to them the lines on which the scheme should be drawn up. If they take up an unreasonable attitude, section 45 can be invoked. Even when this is done, it would be desirable to make the period of moratorium as short as possible.

3. Even if it is considered appropriate to use section 45 in preference to section 44A(1), we feel that the amalgamation of banks in a particular group should not be brought about at one stroke as considerable administrative difficulties may be experienced by the banks in bringing about the amalgamation. It would be better to take the banks one by one (or at the most two banks in a group at a time) and bring about the amalgamation by stages. It would also be desirable to issue a press note to ensure, to the extent it is possible, that the grant of moratorium does not cause a panic.

4. On the question of priority, we are inclined to the view that those banks whose position is not likely to improve even if they are given some time should be taken up first. This view is based on what has already been done in the case of banks in other areas, viz., the Indo-Commercial Bank, the New Citizen Bank, the Bank of Nagpur and the Prabhat Bank. On this basis, the order of priority, so far as individual banks

are concerned, would be as follows:

- (i) Cochin Nayar Bank Ltd., Trichur
- (ii) Catholic Bank of India Ltd., Changanacherry
- (iii) Suburban Bank (Private) Ltd., Trichur
- (iv) Anthraper Bank (Private) Ltd., Shertallay
- (v) Cochin Commercial Bank Ltd., Cochin
- (vi) Latin Christian Bank Ltd., Ernakulam
- (vii) South Travancore Bank Ltd., Neyyoor

These banks are in different groups and it would be preferable to announce their amalgamation at a suitable interval of, say, two or three weeks. After effecting the amalgamation of these banks, we may take up the others. The minimum amount of paid-up capital and reserves required for a unit bank is Rs 0.50 lakh, and on the basis of a proportion of 1 to 10 between paid-up capital and reserves and deposits, we may consider banks having deposits below Rs 5 lakhs as those which are not likely to be able to work on a profitable basis. There are 36 banks in this category (vide Annexure II). The order of priority among these 36 banks may be decided, in the main, on the basis of their financial position, those whose position is comparatively worse being taken up first. In this case also, the procedure should be gradual as suggested in paragraph 3 above.

5. After the elimination of these small units, the question of amalgamating the remaining banks may be taken up. A statement showing the residual banks in each group is given in Annexure III. These banks have deposits of over Rs 5 lakhs each. In their case also, the procedure adopted for the amalgamation of the smaller banks may be followed, i.e., moratorium for only one or two banks at a time may be granted and the cases of comparatively better banks may be taken up later.

6. Please acknowledge receipt.

Yours sincerely,
[M.L. GOGTAY]

Shri K. Deva Rao
Deputy Chief Officer
Department of Banking Operations
Reserve Bank of India
Central Office
Bombay

[Annexures not reproduced]

[16-12-1960]

CONFIDENTIAL

The Chief Minister of Kerala, Shri Thanu Pillai, telephoned to me yesterday at 6 p.m. to say that he had been informed by his "banker friends" that a serious crisis had developed in the affairs of the Travancore Forward Bank and of two or three other banks, including the Kottayam Orient Bank. According to the information that he had received, the situation was so serious that an immediate moratorium was called for. The Chief Minister suggested that a moratorium should be declared immediately and also that the Reserve Bank should undertake a scheme of amalgamation and complete the process, if possible, in 4 or 5 days.

I told the Chief Minister that we have been placed in an impossible position by the Travancore Forward Bank. It had been our view that this bank should be merged with the State Bank of Travancore and this view had at one stage been concurred by the Chairman himself. Subsequently he went completely back on this proposal and wrote to us a letter making the most extravagant remarks about the soundness of the bank and its profitability, and now suddenly he has taken the view that there was a crisis. I told the Chief Minister that the deciding authority was the Government of India and that we can only make a recommendation to them. As regards the question of completing the scheme of amalgamation in a period of 4 or 5 days, I told him this was completely out of the question. A certain procedure had been laid down in the Act and this procedure will necessarily involve consultations with the institutions concerned, consideration of various matters in the Reserve Bank and subsequently also in the Government of India. I told him that I had received panicky messages but the facts were not clear to me and, therefore, I had asked the Executive Director, Shri Divekar, to fly to Travancore and let me have a report. Shri Divekar would be arriving in Travancore this morning and will be seeing the Chief Minister.

It is quite clear that the Chief Minister is not fully aware either of the legal position or even of the actual facts of the situation in Kerala. The Ministers themselves have been subject to as many swings of opinion as the banking community in Kerala. However, while this merely adds to our difficulty, it is clear that we have to take a decision on the best judgement that we ourselves can make.

I informed Shri Rangachari last night about my conversation with the Chief Minister and asked that the Government of India should be informed that we may have to call upon them to issue an order of moratorium at immediate notice. He told me he would take necessary steps for this purpose.

H.V.R.
16.12.1960

CONFIDENTIAL

E.D.(D) telephoned me yesterday and today regarding the banking situation in Kerala. I had requested the Private Secretary to the Governor to convey to him the gist of the message I had received from E.D.(D) yesterday. E.D.(D) would be speaking to the Governor today over the trunk telephone between 8 P.M. and 9 P.M. after a meeting with the Chief Minister of Kerala which is scheduled for 7 P.M. A summary of messages received from E.D.(D) indicating the reaction in Kerala of the recent moratorium granted to the Travancore Forward Bank and four other banks is given below.

2. Contrary to the expectations of some Jeremiahs, there has not been any sudden run on banks in Kerala as a result of the announcement regarding the grant of moratorium to the five banks. According to information available to E.D.(D), the only bank where there was a rush of withdrawals was the Cochin Nayar Bank Ltd., a bank whose financial position is not satisfactory and whose deposits have been eroded to a certain extent. The South Indian Bank, the only licensed scheduled bank in Kerala (apart from the State Bank of Travancore) was, however, reported to be feeding its branches with cash in anticipation of withdrawals. The Malayalam papers were stated to have

come out with leading articles saying that there was no cause for panic and that the moratorium had been granted in order to strengthen the banking system of the State. 3. E.D. also informed me today that he had personally visited the banking area in Trivandrum and did not see any sign of panicky withdrawals. There is, however, reported to be a general feeling that the period of moratorium is too long. There is also an undercurrent of nervousness amongst certain bankers who feel that holders of fixed deposits would withdraw them on maturity. E.D. further apprehends that when copies of the moratorium order are exhibited in each and every branch of the banks concerned, there may be some adverse reaction in the next few days and depositors might tend to withdraw their funds to the extent permissible.

4. Copies of the newspaper cuttings on the subject are also sent herewith.

Id/-

21.12.1960

Governor Id/- 23-12-1960

Record of talk with the Chief Minister and the Finance Secretary to the
Government of Kerala on the position of banks in the Trichur area

Shri P.S. Padmanabhan, Finance Secretary to the Government of Kerala, rang me up at 8 O' clock this morning and informed me that Shri R. Shankar, the Deputy Chief Minister, who is also the Finance Minister, had received reports that the banks in the Trichur area were experiencing a heavy run and that the Trichur Agent of the State Bank of India had refused to grant accommodation against Government securities when he was approached by these banks, the Catholic Syrian Bank Ltd. being one of them. I informed Shri Padmanabhan that according to my information, which was based on the reports of one of our officers at Trichur and those of Shri M.V. John, General Manager of the South Indian Bank Ltd. (a licensed Scheduled bank), the situation in Trichur was more or less normal. Only the Kottapadi Bank (Private) Ltd., which is a small non-scheduled bank at Kottapadi which is about 20 or 25 miles away from Trichur, was in some difficulty. I, however, informed him that I would make enquiries from the Trichur Agent of the State Bank of India and also find out from the General Manager of the Catholic Syrian Bank Ltd. whether he had approached the State Bank of India for financial accommodation against Government securities and whether the State Bank of India had refused to grant such accommodation.

2. Within a few minutes, I also got a telephone call from the Chief Minister of Kerala State. He repeated what Shri Padmanabhan had stated and said that as a result of the action taken by the Reserve Bank of India against banks in Kerala, trade and industry was being brought to a standstill and that if the State Government had earlier visualised such a situation, it would not have minded spending a crore or two so as to obviate the need for a moratorium for Kerala banks and thus ensure that the trade and industry of Kerala did not suffer. He also said that, if necessary, he would speak to the Governor of the Reserve Bank to acquaint him with the situation and request him to devise suitable remedial measures. I informed the Chief Minister on the lines of what I had stated to Shri Padmanabhan and also promised him to find out immediately from the Catholic Syrian Bank Ltd. whether they had been refused financial

accommodation and also from the Agent of the State Bank of India at Trichur whether any banks had approached him and whether he had refused financial assistance against Government securities.

3. I immediately got into touch with the General Manager of the Catholic Syrian Bank Ltd., Shri K.T. Varghese. He informed me that the situation in Trichur was more or less normal. Some of the smaller banks had withdrawn their balances from the bigger banks in order to improve their liquid position so as to be able to meet any demands that may be made on them. But for this, the situation was normal. He said that his bank had ample cash and that he did not foresee any difficulty in meeting the demands that may be made on the bank. He, however, stated that there was a rumour in Trichur that the Indian Bank Ltd., Madras, and the South Indian Bank Ltd., Trichur, were to be placed under moratorium and that some 15 other banks were going to be placed under moratorium. When I asked him who the author of the rumour was, he said that Shri Manavalan, the Secretary of the Trichur Chamber of Commerce, might have made some reports to the Finance Minister. I, therefore, requested him to ask Shri Manavalan to speak to me on the telephone.

4. Shri Manavalan told me that when the banks in Trichur had approached the State Bank of India for accommodation against Government securities, the latter had insisted on a Board resolution, Memorandum and Articles of Association, etc. and was not giving accommodation promptly. I informed Shri Manavalan that these were normal formalities which would have to be complied with by any joint stock concern and if the banks were not prepared to comply even with these formalities, they were themselves to blame. I also asked him whether he could give me any specific instances where banks had approached the State Bank of India and had been refused assistance. He said that he had none to give. I, therefore, told him that it was no use making vague generalisations and that the Reserve Bank could not investigate any complaint unless concrete instances had been furnished to it. I also told him that the Chamber should play a helpful role and not create difficulties by spreading baseless rumours and engendering a sense of panic. Shri Manavalan then said that the rumours are probably being spread by the Communist Party and that the Chamber of Commerce did not want to create any difficulties or cause panic. I thereafter told him that if any bank was in difficulty, the proper course for it was to approach me so that I could see what could be done in a particular case.

5. In the meanwhile, Shri K. Raman Nambiar, the local Agent of the State Bank of India, had got in touch with his counterpart at Trichur and he informed me that the allegation against the Trichur Agent was altogether baseless. The Catholic Syrian Bank Ltd. had lodged some bonds with him and he had sent them to the Public Debt Office of the Reserve Bank at Madras for the usual examination and had informed the bank that if in the meanwhile it needed any accommodation, he would be prepared to grant it. The same procedure was being adopted in the case of those banks which had approached him.

6. Having thus satisfied myself that there was no truth in the reports received by the Finance Minister, I spoke to the Chief Minister and gave him all the information which I had been able to collect. He seemed satisfied and said that in view of what I had stated, it was not necessary for him to trouble the Governor of the Reserve Bank.

He said that he was himself going to Trichur and would be able to find out the position. I requested him that in case anybody complained to him, it would be better to get concrete instances so that the Reserve Bank could look into them. It was difficult for the Reserve Bank to make an investigation on the basis of vague generalisations. The Chief Minister is expected to return to Trivandrum on the 29th December 1960.

7. The information collected by me was also conveyed to Shri Padmanabhan who said that he would pass it on to the Deputy Chief Minister.

8. The gist of this was conveyed by me to Shri C.S. Divekar over the telephone on Sunday afternoon. As desired by him, I shall try to get in touch with the Deputy Chief Minister and find out from him the sources which have complained to him. A further report will be made after I have spoken to him.

M.L. GOGTAY
25/12/1960

BANK FINANCE FOR PLANTATION INDUSTRY IN KERALA

I was asked to make on-the-spot enquiries at Kottayam regarding the extent to which the plantation industry, particularly the rubber and pepper industry in Kerala has suffered in the matter of obtaining bank finance on account of the grant of moratorium to some banks in Kerala. Besides obtaining certain information from the Kottayam Orient Bank, the Travancore Forward Bank and the Chairman of the Seasia Midland Bank, who is residing at Kottayam, I also interviewed the Chairman of the Rubber Board, the Secretary of the Association of Planters of Kerala and Agents of certain other comparatively large-sized banks having branches in Kottayam. It may be stated that while rubber and tea crops are grown on a plantation scale, pepper is generally grown in compounds of houses. In some cases rubber is also grown on a small-scale basis.

(i) Kottayam Orient Bank Ltd.

In the analysis of advances as on the 17th December 1960 furnished by the Bank at the time of the last inspection, the advances secured by the hypothecation of crops have been shown at Rs 18.45 lakhs. The Head Office of the bank has not consolidated the figures regarding advances made on the security of tea, pepper, rubber and rubber products given by the branches in the individual statements in Form No.7 submitted by them directly to our Department of Research and Statistics at Bombay. The Kottayam Orient Bank Ltd. has furnished me with a long list of advances to planters at its various branches; the total of such advances as on the 17th December 1960 amounted to Rs 31.20 lakhs (vide Annexure I). Another list of advances aggregating Rs 5.49 lakhs granted to dealers in plantation products was also furnished (vide Annexure II). The various types of deposits kept with the bank by the planters are shown in a separate list (not enclosed). It is seen therefrom that the current account deposits as on the 17th December 1960 amounted to Rs 2.07 lakhs. It was stated by Sarvashri Mathew and Iype, the senior executives of the bank, that the main difficulty experienced by the planters and the dealers in plantation products is the absence of

banking facilities at the various plantation centres where the Travancore Forward Bank Ltd., Kottayam Orient Bank Ltd. and, to a lesser extent, the Bank of New India Ltd., were functioning. The only other local banks which have offices in the plantation area are the Chalapuram Bank Ltd. the Perumbavur Bank Ltd. and the Federal Bank Ltd. and these have branches only in a few places. There is, therefore difficulty in purchase and collection of cheques and bills, remittance of funds and retirement of bills.

(ii) Travancore Forward Bank Ltd.

Shri M.M. Mathew, the Deputy Secretary of the Travancore Forward Bank Ltd., agreed with the views that the temporary cessation of banking facilities at the interior centres has been the cause of the difficulties of the planters in their day-to-day operations. He also mentioned that the Travancore Forward Bank Ltd. was extending direct credit facilities to the planters on a smaller scale, while indirect facilities extended by it by purchase of cheques, etc. were considerably large. He estimated that the total facilities extended by the bank amounted to about Rs 50 lakhs. Although the limits sanctioned to the borrowers were substantially reduced in many cases during the period of large-scale withdrawals of deposits the facilities extended by the bank to planters and dealers in plantation products may now amount to Rs 30 lakhs. A list of advances granted to planters and dealers showing the balance in the accounts as on the 17th December 1960 furnished to me indicates the aggregate advances at Rs 29.21 lakhs (vide Annexure III). It was stated that it was not possible for the Head Office to furnish a statement showing the current deposits in the names of planters. It is, therefore, not possible to say to what extent those who had deposits with the bank have been inconvenienced as a result of the inability to use their own money kept with the bank as deposits.

(iii) Seasia Midland Bank Ltd.

The bank has its Head Office at Alleppey but the Chairman resides in Kottayam. He informed me that the bank is not directly accommodating the planters but some bills purchase limits have been fixed for dealers in plantation products at the Kottayam and Kothamangalam branches. The extent of these facilities is stated to be within Rs 1 lakh.

(iv) Discussion with the Chairman of the Rubber Board

During the course of discussion, the Chairman of the Rubber Board, Shri K. B. Warriar, mentioned that he had received a number of complaints from planters, especially small holders as also from the dealers in plantation products that they are experiencing difficulties in the day-to-day operations on account of the moratorium granted to the banks in Kottayam which had a network of branches in or near about the plantation areas. The Rubber Board is stated to be experiencing difficulty in realising the cess from the rubber growers. The rubber planters are stated to have been handicapped in implementing the expansion programme. The Chairman stated that he had already discussed the matter with the Managing Director of the Kerala State Financial Corporation so that the question of extending facilities to rubber growers for planting new areas may be considered by that agency.

(v) Discussion with the Secretary of the Association of Planters of Kerala

I contacted Shri O.C. Mathew, the Secretary of the Association of Planters of Kerala, and enquired whether he had received any complaints that the planters are handicapped on account of the moratorium granted to a few banks. He stated that he has received some complaints that the want of banking facilities at some of the interior centres near the estates has been causing difficulties to the planters. This also applies to the bigger plantations managed by Indians who have accounts with the local banks, although it is possible for them to make alternate arrangements. Bigger plantations which are being managed by foreigners, e.g., Aspinwall & Co., Pierce Leslie & Co. and Harrisons Crosfield are not reported to be experiencing difficulties as they have been banking with bigger banks like the State Bank of India, Chartered Bank and National and Grindlays Bank. He also showed me a letter received by him from the Tea Board asking him to furnish the list of tea estates which are experiencing difficulties and the extent of finance which would be required by them for the 1961-62 season. Shri Mathew's view was that it will be difficult to estimate the extent of bank finance obtained by the estates and there may also be some reluctance on their part to disclose to the Association the exact amount of the borrowings from banks.

(vi) Discussion with some of the Agents of the bigger banks at Kottayam

I met the Agents of some of the bigger banks having their branches at Kottayam, such as the Central Bank of India Ltd., the Indian Bank Ltd. and the Indian Overseas Bank Ltd. The Agents of Central Bank and Indian Bank stated that the Travancore Forward Bank and the Kottayam Orient Bank had a number of branches in the plantation area and the temporary cessation of facilities due to the moratorium granted to them has caused difficulties to the planters even in the matter of retiring the bills on them. The bills received in Kottayam have to be retired by the parties by coming over to that place for the purpose. It is stated that these two banks do not generally entertain proposals for advances against real estate and also against hypothecation of stocks of rubber etc. They have confined themselves to granting key loans before the produce is sent to the marketing centres. The Agent of the Indian Overseas Bank agreed with the view that the withdrawal of facilities at the plantation centres has led to some difficulties, but a few proposals received from first class parties are being considered by the bank for granting advances to them.

Conclusion

The enquiries have revealed that the grant of moratorium to the Kottayam Orient Bank Ltd. and the Travancore Forward Bank Ltd. has resulted in the temporary cessation of banking facilities for the day-to-day working extended directly or indirectly to the plantation industry, especially for rubber, pepper, tea, cardamom, etc. which are the main crops in these areas. The representatives of the Kottayam Orient Bank and the Travancore Forward Bank stated that the limits made available to the planters were more or less the same as in the last season although some reduction was made at the time of large-scale withdrawal of deposits prior to the grant of moratorium. In the case of the Travancore Forward Bank Ltd., the limits were stated to have been curtailed by about Rs 20 lakhs. In many places in the plantation area, there is no other bank to fill the void created by the temporary withdrawal of banking facilities and

one or two local banks still functioning in a few places are cautious not to increase the advances portfolio on account of the uncertain conditions.

G.S. ANNASWAMI

Reserve Bank of India
Department of Banking Operations
Trivandrum

Dated the 24th January 1961

[Annexures not reproduced]

Banks in Kerala—Effects of the moratorium orders on trade
and commerce in the State

A news item regarding the above subject has appeared in *The Hindu* dated the 18th January 1961. Certain other press reports of a similar nature which had appeared in the various local dailies received from our Trivandrum Office have been flagged at [...]. In this connection the letter dated the 3rd January 1961 addressed by the Indian Chamber of Commerce to the Governor may also be seen [not reproduced].

2. The more important points made in the various press reports/representations may be summarised as follows:

- (i) In view of the failure of the Palai Central Bank and the moratoria granted to certain banks in Kerala, business has come almost to a standstill in many places; smaller rubber planters have been hard hit and the merchants, industrialists and farmers find it difficult to meet their day-to-day monetary obligations.
- (ii) The period of moratorium granted to the banks should be reduced to the minimum; three months' time is too long a period.
- (iii) The reconstruction proposals should be implemented as early as possible so that the uncertainty and dislocation in the banking and trading circles will be set at rest soon. The process of reorganisation should be carried out without causing any disturbance of trade and industry in the State.
- (iv) Since no more financial assistance can be expected from the banks under moratoria, trade in rubber and hill produce may go into the hands of the North-Indian traders or the few Keralites having dealings with branches of North Indian banks.

19.1.61

The moratorium had to be declared at the instance of the banks themselves.

C.O.

19.1.61

E.D.(D) Has spoken.
19.1.61

Govr. Did we get a reply from our Trivandrum Office re: the difficulties of rubber growers to which advances had been made by the five banks under moratorium in Kerala?

Governor
27.1.61

E.D. (D) Shri Gogtay's letter enclosing a report from Shri Annaswami has been sent to the Governor.

30.1.61

REPORT ON THE DISCUSSION HELD WITH THE
DEPUTY CHIEF MINISTER ON THE 4TH FEBRUARY 1961
REGARDING THE BANKING SITUATION IN KERALA

The discussion centred round the suggestions made by the Committee appointed by the Kerala Congress Parliamentary Party and the Citizens' Committee in the memoranda submitted by them to the State Government regarding the banking situation in Kerala. Copies of these memoranda are enclosed for Central Office information. The topics discussed are dealt with below.

1. *Palai Central Bank Ltd.*

The Deputy Chief Minister stated that the main cause of the present banking crisis was the chain reaction caused by the closure of the Palai Central Bank Ltd. which has resulted in the loss of public confidence in the other banking institutions of the State. The economy of the State has been considerably affected and the new unit proposed to be formed by the amalgamation of four banks may also be subjected to withdrawal of deposits. The Deputy Chief Minister expressed the hope that this does not happen. He, however, stated that if, unfortunately, this fear materialised, it would shatter the economy of Kerala and completely upset its Third Five Year Plan. This would also adversely affect the chances of the survival of the present Ministry. The State Government, therefore, desired to do whatever was possible to restore the confidence of the public in the banks. He felt that the absorption of the Palai Central Bank Ltd. by some bank, after suitable reconstruction, would go a long way in restoring confidence. He stated that now that the stand taken by the Reserve Bank in regard to the Palai Central Bank Ltd. had been upheld by the Kerala High Court, it could afford to be generous and it should take the initiative in drawing up the scheme. I told him that this was a matter of policy and added that only a very big bank, like the State Bank of India, would be in a position to shoulder the burden, and that this proposal, which has already been considered by the higher authorities of the Reserve Bank, has not been found practicable. Further, there was already much public criticism against the directors of the bank for their failure to repay the dues and it may be possible to take effective steps against them only in liquidation proceedings. Shri Shankar felt that nothing would be lost in making a fresh attempt. I then informed him that those who had made the suggestion did not appear to have considered the practical aspects of the case as it would not be possible to get any bank to consider the absorption of the Palai Central Bank Ltd. The Deputy Chief Minister agreed that it was not easy to suggest the bank which would be prepared to consider the absorption of the Palai Central Bank Ltd. and said that he would find out from the more prominent members of the Committee/s whether they could get some bank to absorb the Palai Central Bank Ltd. and put forward a practicable scheme. He also stated that some decision will have to be taken early, before the Liquidator commences repayment of preferential

liabilities to small depositors, because the merger of the institution with another bank may not be feasible after that stage, as a considerable portion of the readily realisable assets would have been utilised to pay off the small depositors, and no institution will be interested in taking over the remaining assets. Although he did not say so, the Deputy Chief Minister may perhaps approach the Finance Minister, Government of India, in the matter.

2. Proposed unit to be formed by the amalgamation of three banks with the Kottayam Orient Bank Ltd.

(a) Appointment of the Chief Executive Officer

The Deputy Chief Minister stated that one of the points raised in the memoranda was that an outsider should not be appointed as the Chief Executive Officer of the new unit and that the post should go to one of the top officials of the amalgamating units. I told him that the Reserve Bank did not consider any of the top officials of the amalgamating units as suitable as they had failed to exercise proper vigilance over the working of the banks and conduct the affairs of the banks in the interests of the depositors. I also told him that the Reserve Bank considered it essential to have as the Chief Executive Officer of the new unit an experienced and efficient person of high integrity who would rise above parochial considerations. The Deputy Chief Minister then enquired whether it would not be possible to appoint any of the present Chief Executive Officers to the next important post. I informed him that it is not our intention to completely break off from the past and that it is our desire to retain the present Chief Executive Officers in lower posts on reduced salaries, if they are agreeable.

(b) Transfer of Head Office to Trivandrum

The Deputy Chief Minister stated that representations have been made against the proposed move to shift the Head Office to Trivandrum. I explained to him the considerations that weighed with us. The proposed unit would have a much better chance in a different atmosphere, and it would be easier for the new Chief Executive Officer to work in Trivandrum than in Kottayam. It was also difficult to get a person who would be willing to go to Kottayam. Trivandrum is the capital of the State: there would be better liaison between the bank and the Reserve Bank and the Government. Although Shri Shankar appreciated our point of view, he stated that it would be politic on the part of the Reserve Bank to concede either this or the earlier demand regarding the Chief Executive Officer, as such a concession might placate the opponents of the scheme and make them feel satisfied that at least one of the two demands has been allowed.

(c) Board of Directors

The Deputy Chief Minister stated that there was also some objection to the Board as proposed to be nominated by us and that representations have been made to the effect that the directors of the new unit should be appointed by selection from the existing directors and by nomination of one or two directors by the State Government. I then showed him the list of persons proposed to be nominated by us as directors. I informed him that six of the persons have already accepted our offer, while Shri K. Sankaran, the retired Chief Justice, has declined it. Shri N. Krishna Iyer has gone to New Delhi and is expected to return to Kottayam on the 5th. The Deputy Chief

Minister himself then contacted Shri Sankaran but was not able to persuade him to accept the directorship. I then told him that we proposed to nominate Shri G. Kumara Pillai. The Deputy Chief Minister, however, remarked that as the list stood at present, all communities, viz., Christians, Nairs, Ezhavas, Brahmins and Muslims, were represented on the Board and it would be preferable to substitute Shri K. Sankaran, who is an Ezhava, by another person of the same community, which is the commercial community. He suggested the inclusion of Shri K. Padmanabhan, retired District Judge, (vide our D.O. letter [...] dated the 6th January 1961) and also stated that we might consider having Sarvashri Kumara Pillai and Padmanabhan on the Board instead of Shri Sankaran, who has declined, and Shri Joshua, to whose nomination there was general opposition. Incidentally, it may be stated that we have obtained a confidential report on Shri Joshua from the Kottayam branch of the State Bank of Travancore, according to which he is a person of high business integrity with means of over Rs 5 lakhs.

(d) Steps to be taken to ensure confidence in the new unit

The Deputy Chief Minister stated that apprehensions were entertained that the new unit might continue to face large-scale withdrawal of deposits after re-opening. He wanted to know whether we had in mind any specific steps to restore confidence. I told him that as the new unit would start with the status of a licensed scheduled bank and have a powerful Board and an efficient Chief Executive Officer, it was expected to inspire the necessary confidence. If required, financial assistance would be given by the Reserve Bank. The Deputy Chief Minister then informed me that it has been suggested to him that the State Government should contribute to the share capital of the new unit and also deposit funds with a view to restoring public confidence. He stated that the State Government might not be averse to taking such a step if absolutely necessary, but it would be in a position to contribute only a nominal amount, as a gesture of goodwill, say, Rs 4 to Rs 5 lakhs towards share capital and Rs 10 lakhs in the form of deposits. He also stated that, if considered necessary, the Government would have one of its nominees on the Board with a view to inspiring confidence.

(e) Reducing the period of moratorium

When the Deputy Chief Minister opened this topic, I told him that the Reserve Bank of India is doing whatever is possible to expedite the lifting of the moratorium.

3. *Forcible amalgamation of small banks*

The Deputy Chief Minister asked whether it was the intention of the Reserve Bank of India to bring about compulsory amalgamation of small banking companies, and if so, whether it could be achieved without granting a moratorium to them. I told him that as the law stood at present, amalgamation under section 45 of the Banking Companies Act, 1949, was possible only after the grant of moratorium. I added that as many of the banks in the State are small and cannot be considered as viable, they may have to be amalgamated into bigger units. I, however, made it clear that it is the policy of the Reserve Bank to encourage voluntary amalgamation.

M.L. GOGTAY
5.2.1961

F. DEPOSIT INSURANCE

ADDITIONAL SECRETARY
MINISTRY OF FINANCE
ECONOMIC AFFAIRS
NEW DELHI
October 6, 1960

D.O.No.[...]

My dear Shri Iengar,

A few days back, Divekar sent me certain notes relating to the tentative scheme for the insurance of bank deposits as prepared in the Reserve Bank. The subject is an important one and is to some extent controversial. Certain aspects of this problem also seem to require more detailed examination and consideration.

2. As you are aware, we have not yet obtained the Finance Minister's orders on this scheme and I am not also sure whether the minutes of the meeting with the bankers held on the 16th September, 1960 as recorded, fully represent his views regarding this question. My impression is that while he was prepared to have the scheme considered further he did not finally commit himself to its introduction.

3. The scheme of deposit insurance is likely, according to some of its critics, to promote an attitude of irresponsibility on the part of some banks. As it does not appear to have been tried on any large scale outside the United States, and as it is also likely to encounter some opposition in our own country, for example, from the bigger banks which may feel that they are called upon to subsidise the weaker institutions, or from co-operative banks which might think that they will be exposed to much greater competition from the insured banks, a final view cannot be taken regarding the desirability or practicability of introducing the scheme, until the question has been much more fully discussed.

4. Even if it were to be decided ultimately that the scheme should be introduced, various other points connected with the proposal, e.g. the demand for a separate autonomous corporation, the conditions on which capital may be found or advanced initially, the extent to which the fund or the corporation, as the case may be, will be responsible for the liquidation of the banks or for the realisation of the amounts which may be recoverable for liquidation, the coverage of the institutions and the deposits, and the form of the rebate, if any, will have to be discussed further. The implications of any decisions which may be taken regarding these matters will have to be examined carefully by Government in consultation with the Reserve Bank. The Central Board of the Reserve Bank is meeting on the 11th of this month. I do not know whether it is proposed to take a conclusive view on the matter at that meeting. I thought, however, that you would not mind if I mentioned the above points at this stage, to you.

5. The Finance Minister is returning on the 10th October. We shall then put up the matter to him and obtain his preliminary reactions to the scheme, including the major points of principle referred to in this letter.

Yours sincerely,
K.P. MATHRANI

volume of frozen advances. It is this I am worried about and not the current lending policy of the Bank.

Yours sincerely,
H.V.R. IENGAR

Shri V.T. Krishnamachari
Deputy Chairman
Planning Commission
Government of India

PLANNING COMMISSION
NEW DELHI
April 16, 1959

My dear Iengar,

Many thanks for your letter No.[...] dated 13th April, on financial credit to agricultural co-operatives. Shri Morarji Desai mentioned to me in a general way the point you make in your letter.

2. I had intended to discuss this subject with you. I understand, however, that you are leaving for the U.S.A. on the 19th. As soon as you return, we shall arrange a meeting.

3. Like you, we in the Planning Commission are most anxious that the Reserve Bank should not get involved in unsound financial credits to the movement.

4. In the Second Five Year Plan and a series of letters issued in connection with it, there are two patterns of rural co-operative development envisaged:

(i) The 'rural bank' or the large-sized society recommended by the All-India Rural Credit Survey Committee's Report:

The Plan set a target of about 10,000 societies covering approximately 50,000 villages. By the end of March, 1959, 6,300 societies have been formed covering 70,000 villages.

(ii) Revitalisation of village societies and forming new ones:

Targets for this have been indicated.

5. The National Development Council has laid down the policy to be followed in regard to the latter programme. The main point in this is the linking up of credit with an approved production programme of the village made up of family plans. The question to be considered now is how far the Reserve Bank should provide finance for this programme. Discussions on this are going to take place at official level with Venkatappiah and others. A final decision can be taken after you return and the Finance Minister and myself have discussed the whole question with you.

Yours sincerely,
V.T. KRISHNAMACHARI

June 20, 1959

Dear Shri Morarji Desai,

During the last week or two, I have been busy acquainting myself with some of the more important developments which have taken place while I was abroad. On one

of them I feel it my duty to write to you at once. It pertains to agricultural credit. I refer to the Rs 8 crore pilot scheme for establishing a "line of supplementary credit" from the Central Government to the cultivator through State Governments and co-operatives. The details are given in Circular Letter No.[...] of 16th May 1959 issued by the Ministry of Community Development and Co-operation. The connected papers show that the whole idea of a "supplementary credit line" has emanated from the Planning Commission.

If this had merely been a draft scheme for discussion, my comments would have been unnecessary. It is not. On the contrary, State Governments have been asked to take immediate action on it; and there has been no attempt to discuss beforehand either with them or the Reserve Bank certain features of the Scheme, and various assumptions on which they are based, which *prima facie* merited such a consultation. The point I am raising is not solely one of procedure, though even as a procedural matter it is one of considerable importance. For, firstly, the Reserve Bank is Government's statutory adviser on agricultural credit. Secondly, it operates the very credit scheme to which the present one is supposed to be "supplementary"; and thirdly, it is far and away the largest lender to co-operatives and, in that capacity, is directly interested in the effect of any such scheme on the co-operative credit structure.

My main objection to the scheme, however, is based on substantive and not merely procedural grounds. I shall be doing less than justice to the importance of the subject if I am not completely frank. It is my considered opinion that in its present form the scheme is immature and ill-advised. In justification of this comment I shall draw your attention to three or four of those features—many more can be cited—which are likely in my opinion to render the scheme harmful in certain respects and ineffective in others:

(1) One of the strongest objections to the scheme is the effect it is likely to have on the conduct of business by primary societies. According to the letter, "Central co-operative banks will be sanctioning loans to the primary societies in the normal course. A supplementary loan over and above the normal credit limits for additional finance required by the primary society to finance its members on the fuller scale envisaged above will be given by the central bank. For this purpose, special credit limits may have to be sanctioned by the appropriate authority to the primary society as well as the central co-operative bank". These additional limits will be derived from the supplementary line made available by Government and, obviously, will be specifically related to whatever is not "normal", i.e. (a) loans to new members who would not otherwise have been admitted, (b) loans to existing members who would not ordinarily have been lent anything, and (c) in respect of a member who is a 'normal' borrower, such part of the new loan as is above the 'normal' level. All this is fairly complicated since not only notionally, but in actual practice, societies will have to distinguish between what is "normal" and what is "supplementary". Moreover, the line between normal and supplementary is not static; it changes as the society grows in financial or organisational strength; it also changes if, for example, a good marketing society happens to be established in the area and a few more can be confidently given loans because there is a prospect of their being recovered through the marketing society. To introduce the idea of "normal" and "supplementary" in such circumstances,

the Department of Economic Affairs informed about the progress of the developments, from time to time.

With kindest regards,

Yours sincerely,

K.P. MATHRANI

Insurance of bank deposits

Placed below is a letter dated the 6th October 1960 [p. 1101] received from Shri Mathrani in regard to the tentative scheme for insurance of bank deposits prepared by us. He has stated that as the subject is an important one and to some extent controversial, it would require a more detailed examination and consideration. He is doubtful whether the minutes of the Finance Minister's meeting with the bankers on the 16th September 1960 prepared by us fully represent the former's views on this question and feels that the Finance Minister did not commit himself to its introduction. Although the Finance Minister did not himself raise this issue at the meeting with the bankers, some of them wanted an assurance that their Associations would be consulted before the scheme is put into operation. The Finance Minister thereupon stated that even though Government and the Reserve Bank might not see their way to accept some of the suggestions of the bankers in this connection, full opportunity will be given to the Associations to express their views on the subject. In view of the situation created by the closure of the Palai Central Bank, some of the bankers themselves have felt the need and urgency of the scheme and written to us in this connection. There have also been some questions in Parliament recently when Government stated after consulting us that the matter is under our active consideration. In view of these developments, it will not be desirable to defer consideration of the subject or postpone its introduction indefinitely.

Most of the objections mentioned by Shri Mathrani are covered by the points raised by the Indian Banks' Association and these have been separately examined. One important aspect mentioned in his letter is that co-operative banks might think that they will be exposed to much greater competition from the insured banks. Co-operative banks account for a small portion of the total bank deposits and in view of the close association of the State Governments with their working, the introduction of the scheme of deposit insurance is not likely to have any adverse effect on them. However, a copy of the draft outline of the scheme will be sent to the Agricultural Credit Department for their comments on this point.

As Shri Mathrani has stated in his letter that the proposals made by us will have to be examined carefully by Government before any final decision is taken, it is for consideration whether the matter should be discussed with the representatives of the Ministry of Finance in the light of the comments received from the Banks' Associations and our observations thereon.

29-10-1960

Insurance of bank deposits

The comments of the Indian Banks' Association and the Exchange Banks' Association on the draft outline of the scheme of deposit insurance forwarded to them have been examined and a statement giving our remarks on the main points raised by them is placed below.

I. The Indian Banks' Association does not generally seem to be in favour of any scheme for insurance of bank deposits. While admitting that the basic principle of insurance of bank deposits is wholesome, it has stated that such a measure is in operation only in the U.S.A. and it would not be helpful to make a comparison between our country and the U.S.A. in this respect. Its contention is that there were widespread bank failures in the U.S.A. 25 years ago when the scheme was introduced and such is not the case in India at present. We have made the need and urgency of the scheme clear in the draft outline forwarded to the two Associations. Apart from its utility in ensuring guaranteed repayment of deposits up to a certain extent in the event of a failure of a bank, its role in inspiring confidence in the banking system facilitating the mobilisation of a larger volume of deposits, particularly in the rural areas, is of equal importance. The recent failure of two scheduled banks, one of which is an institution with sizeable deposits, has shown that the closure of even a small or medium-sized bank could have serious repercussions on the confidence of the depositing public to a far greater extent than is warranted by its size, standing or reputation. Thus, in the present context, banking conditions in this country cannot be said to be very dissimilar to those that prevailed in the U.S.A. at the time of the introduction of deposit insurance.

The next point raised by the Association is that the protection to the depositors is only partial and even though the scheme may avoid bank failures brought about by the spread of panic, it cannot prevent bank failures resulting from unsound management. The Association feels that the scheme places the well-managed and mismanaged banks on the same footing and this will encourage unsound banking practices. It has suggested that if licences cannot be granted to all the unlicensed banks, the scheme should not be started until it is found possible to amalgamate them *inter se* or with some other better managed banks. The fears of the Association appear to be unfounded, as it is not intended that deposit insurance should be a substitute for vigilance in regulating the banking system. On the other hand, it has been decided that the Reserve Bank should devote greater and more detailed attention to the working of banks and improve the quality of their management. As for the problem of sub-standard banks, we do not propose to include banks whose financial position is considered irretrievable or whose deposits have been eroded. Reconstruction and/or amalgamation of the banks falling under the latter category as well as those which have lost a substantial portion of their paid-up capital has been taken in hand in terms of the new provisions of the Banking Companies Act and it is expected that this process will be completed by the time the insurance scheme is put into operation. In the case of the majority of the unlicensed banks, their deposits as well as a substantial portion of paid-up capital are intact and the inclusion of these banks in the scheme will not impose any undue risk on the insurance fund.

If at all a scheme of deposit insurance is to be introduced, the strongest objection of the Association is for its administration by the Reserve Bank. It has conveyed as the opinion of most of its members that the scheme should be operated by an independent statutory corporation. In this context, it has cast certain aspersions on the inspecting officers of the Reserve Bank which are wholly unwarranted. The Association apprehends that the preconceived ideas of some of the officers of the Reserve Bank as embodied in their inspection reports on banks would interfere with the functioning of the insurance organisation as an independent insurer and cause undue hardship to some of the banks. The implication seems to be that even after the introduction of the deposit insurance, the Reserve Bank will continue to refuse licences to banks on the recommendations of the inspecting officers and such action would create liabilities for the insurance fund in an unjustified manner. Another argument advanced in this connection is that if any of the insured banks fail, it will be necessary for the insurance organisation to take over their entire assets and this can be best done by a separate Corporation. When the insurance organisation is the responsibility of the Reserve Bank, it will obviously not take any action even if recommended by an inspecting officer which would be prejudicial or onerous to the insurance fund. We have made it clear in our communication to the Associations that most of the functions and powers necessary for administering a scheme of insurance of bank deposits are already vested in the Reserve Bank and even if an independent statutory corporation is constituted, it will not be possible to associate with its management commercial bankers in view of the close supervisory role which the Corporation will be required to exercise over the banking system. As for taking over the assets of insured banks that may fail, it will be open to the Reserve Bank to entrust their realisation to any other member bank or the Official Liquidator and a separate Corporation is not necessary for this purpose.

Two other points urged by the Association are that the Reserve Bank should pay outright half of the resources of the scheme and the rate of premium payable by banks should be 1/40th of 1% instead of 1/10th of 1%. The statutory deposits maintained by the scheduled banks with the Reserve Bank which do not bear any interest have been mentioned in justification of the first suggestion. It may be pointed out in this connection that the statutory deposits are intended to serve as a measure of control of the cash base of banks, which is an accepted Central Banking practice. This being so, the Reserve Bank cannot be said to be utilising the funds of commercial banks for profit and the argument advanced by the Association is fallacious. The insurance scheme is expected to result in a larger volume of deposits of banks and the cost thereof will have necessarily to be borne by them. As for the incidence of premium, we have made it clear to the Associations that if the accumulations in the fund over a period of time are considered sufficiently large in relation to insurance commitments, the question of rebate would be considered at the appropriate time. In view of this provision, the contention of the Association that the rate of premium is too onerous loses its significance.

In continuation of their letter forwarding the comments on the scheme, the Association has invited our attention to Governor's speech at the Second Indian Conference on Research in National Income wherein he mentioned that "the overwhelming proportion of the deposits, well over 90%, are held in banks which

are soundly run and although there are a few weak spots, the Indian banking system, taken as a whole, from the point of view of safety of deposits is sound and vigorous”.

II. The Bombay Exchange Banks' Association has agreed in principle with the desirability of introducing a scheme for insurance of bank deposits but has urged that the rate of premium should be based not on total deposits but on insurable deposits. They have contended that the calculation of insurable deposits does not present any difficulty and if the premium is related to the total deposits, it would weigh heavily in favour of the smaller banks and against the bigger banks. Although the calculation of the average insurable deposits may not present any insuperable difficulty, it will not be possible for the insurance organisation to verify the figures furnished by the banks. If the rate is to be based on insurable deposits, it will have to be much higher than 1/10th of 1% and the working of the medium-sized and smaller banks might become unremunerative if they are compelled to meet this heavy incidence. In any scheme of insurance the good risk always compensates for the bad one and the rate of premium on total deposits suggested by us would not cause any undue hardship to the bigger banks. The Association has also stated that although the lending rates of banks have been raised, the penal rates of interest recently prescribed on borrowings from the Reserve Bank would nullify the benefit of the increased lending rates. The penal rates on borrowings will apply only if the borrowings of a bank are in excess of the quota fixed and so long as they are kept within these limits, the banks will derive the full benefit from the higher lending rates.

While agreeing that the Reserve Bank of India is best qualified to ensure the effective operation of the scheme, the Association has indicated that it would be desirable to provide for some representation of the commercial banks on the managing body. The Working Group has suggested the formation of a high-powered Standing Advisory Committee consisting, among others, of the Chairman or Vice Chairman of the Indian Banks' Association and acceptance of this recommendation will meet the point made out by the Association.

III. The draft outline of the scheme forwarded to the Associations was considered by the Central Board in the last meeting held at Madras and the Board, while generally approving the proposals made by us, desired that if on any major point the Associations are not in agreement, such issues may be referred to the Committee of the Central Board. Although the Chairman of the Indian Banks' Association and the Exchange Banks' Association had informally signified their broad acceptance of the proposals made by us to the Governor, the consensus of opinion among the bigger banks seems to be in favour of the following:

- (1) The scheme should be administered by a separate statutory Corporation with the representatives of the commercial banks on the managing body.
- (2) The rate of premium should be based on insurable deposits and if it is related to total deposits, it should be much smaller than 1/10th of 1%.
- (3) Banks with an unsatisfactory financial position should not be included in the scheme and if this is not feasible, the scheme should be brought into operation only after they are amalgamated *inter se* or with some better managed banks by utilising the powers recently given to the Reserve Bank.

For the reasons stated in this note as also in the appended statement [not reproduced], it does not appear to be practicable to accept the viewpoint of the banks on the three major issues indicated above. Government also seem to be somewhat doubtful of the desirability of going ahead with our proposals without the concurrence of banks and a letter received from Shri Mathrani in this behalf is being put up separately. In view of the observations of Shri Mathrani and the points of view expressed by the Associations, it is suggested that we may first of all discuss the essential features of the scheme with the Ministry of Finance and then have a full-fledged discussion with the representatives not only of the Associations but also of the big, medium-sized and small banks before finally coming to a decision on the various aspects of the scheme. No reply to the Associations is considered necessary at this stage.

29-10-1960

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
October 29, 1960

D.O.No.[...]

My dear Venkatappiah,

In his letter No.[...] dated the 20th September, 1960 Divekar sent his tentative proposals of the Scheme for Insurance of Bank Deposits which is being sponsored by the Reserve Bank of India. I have communicated to Shri H.V.R. Iengar the initial reactions of the Finance Minister to the Scheme and I am enclosing herewith a copy of my letter dated the 24th October, 1960 to Shri Iengar in this behalf. One point which has been worrying us here in regard to this Scheme is its possible repercussions on the Co-operative Banks. Since Co-operative Banks, which provide the bulk of rural credit, will be left out of the Scheme, they might find themselves at a disadvantage in competing with commercial banks whose deposits will be guaranteed up to a separate amount. A fear is expressed here that the repercussions of the Deposit Insurance Scheme on Co-operative Banks may not be inappreciable. You, probably, have already considered this aspect of the matter while examining the proposals for the introduction of the Deposit Insurance Scheme. I should be grateful if you could advise us how far the fears expressed above are justified, and if they are, whether the Scheme needs any modification.

2. I have not mentioned this point in my letter to Shri Iengar because I felt that it would be desirable to have the benefit of your advice on the point before we take a definite view on it.

With kindest regards,

Yours sincerely,
K.P. MATHRANI

Shri B. Venkatappiah
Deputy Governor
Reserve Bank of India
Central Office
Bombay

Discussed with Shri Mathrani.

I said that the question of deposit insurance for co-operative banks raises issues which are quite different from that for commercial banks and that a scheme for the latter need not be held up because of the former. He agrees. He said he would record a note accordingly on his file. No reply, he said, was necessary to his letter of October 29.

[B.VENKATAPPIAH]

8.11.1960

Deposit Insurance Scheme

Further to his letter of the 6th October 1960 [p.1101] which has been separately put up, Shri Mathrani has indicated the reactions of the Finance Minister to our proposals in regard to the Deposit Insurance Scheme in his letter dated the 24th October, a copy of which is placed below.

2. The first point raised is that as the scheme has not been tried in any other country except the U.S.A., we should proceed somewhat cautiously in the matter. This point is already being borne in mind and our proposals for insuring deposits up to Rs 1,000/- each and for keeping the premium rate fairly high in the initial stages were formulated against this background. Independently of the experience of the U.S.A. where the scheme has been a success, it is felt that with a large number of small banks in the banking system, some of them playing a useful role, and the attendant risk of bank failures, a scheme of deposit insurance will go a long way in inspiring confidence in the banking system and facilitating the mobilisation of a larger volume of deposits particularly in the rural areas.

3. It is stated that although the Finance Minister has no objection to the scheme being pursued by the Reserve Bank, it should consider more fully two important aspects of the matter namely, the timing and the manner of introduction of the scheme. As regards the timing, the Finance Minister feels that it would be desirable if the programme of reconstruction and amalgamation of the banks that are not likely to qualify for a licence in the near future is initiated first. We have already taken up this task on hand and it is expected that the future set-up of at least such of the banks as have lost a portion of their deposits or a sizeable portion of their paid-up capital will be settled before the formalities required for the introduction of the scheme are completed. At the same time it may not be necessary to wait until all the contemplated amalgamations are completed, as the process of consolidation of deposits or capital in some cases, might initially generate an adverse effect on the confidence of the depositing public in the banking system as a whole. As for the manner of introducing the scheme, the Finance Minister is of the opinion that it would be desirable to take the banks into confidence and obtain their views. This has already been done and the comments of the Indian Banks' Association and the Exchange Banks' Association on the draft scheme have been examined and put up separately.

4. In regard to the nature of the organisation required for the administration of the scheme, the Finance Minister has some doubt whether the Reserve Bank should undertake direct responsibility for the operation of the scheme and would like the question to be further examined to see whether a separate autonomous or semi-

autonomous body functioning under the control of the Reserve Bank could not be set up. It is primarily in view of the need for the expeditious introduction of the scheme involving minimum legislative changes that the suggestion for administering the scheme departmentally was made. Another consideration against the formation of a separate Corporation was that it would lead to unnecessary duplication of inspection work. Shri Mathrani has stated that as participation in the scheme would be obligatory on all banks, it might not be necessary for the insurance organisation to have a separate inspecting machinery. In the U.S.A. the Federal Deposit Insurance Corporation is vested with the power to make examination and to require information and reports from insured banks and can also act as Receiver. In practice the corporation regularly examines the insured state non-member banks only but reviews reports of examination of other insured banks made by the Federal Banking agencies. An insured bank normally examined by another federal supervisory agency may be examined by the Corporation when such action is deemed advisable by the Board of Directors to determine its condition for insurance purposes. It would appear from the above that although the Corporation has independent powers of inspection, it frequently makes use of the examination reports of the Federal or the State supervisory authorities and avails itself of the use of information, services and facilities provided for by them. Thus, if a separate Corporation is constituted for administering the scheme, even though it might utilise largely the inspection reports of the Reserve Bank, it will have to be vested with concurrent powers of inspection and calling for information. The inspection machinery need not be elaborate but a skeleton staff may have to be provided for undertaking special investigations and inspections whenever considered necessary. Although there is much to be gained if at the outset the scheme is operated by a department of the Reserve Bank, as the banks seem to be generally of the opinion that the work should be handled by a separate institution, this alternative organisational set-up may be further considered at this stage. In any case, direct representation of the commercial banks on the Deposit Insurance body seems to be inappropriate. In this context it may be mentioned that in the U.S.A., the management of the F.D.I.C. is vested in a Board of Directors consisting of three members, one being the Controller of Currency and the other two, one of whom being the Chairman, appointed by the President with the advice and consent of the Senate. The members of the Board are not eligible to hold any office, position or employment in any insured bank. They are also not entitled to hold the shares of such banks.

5. On the question of resources for the scheme, the Finance Minister is of the opinion that it should be run on a purely commercial basis and should not be subsidised in any way either by the Reserve Bank or by Government. As against our suggestion that an initial amount of Rs 5 crores may be advanced by the Reserve Bank, the Indian Banks' Association has suggested that the Reserve Bank should pay outright half the resources of the scheme. Until such time as the fund accumulates a sufficient amount by way of premia, it should have some resources and the provision of an initial contribution by us may not amount to a subsidy by the Reserve Bank. If the Reserve Bank is not to make any initial contribution, the only alternative is to levy a capital contribution on the banks to which they are not at all likely to agree.

6. If, in the light of the reactions of the Finance Minister and the views expressed by

the Banks' Associations, it is felt that the Reserve Bank should not undertake direct responsibility for the operation of the scheme, a separate statutory Corporation may be constituted for the purpose. This will be a semi-autonomous body functioning under the control of the Central Government and the Reserve Bank. The management of such a Corporation may be vested in a Board consisting of 4 members nominated by the Central Government in consultation with the Reserve Bank. Two of the members will be officials, namely, a Deputy Governor or Executive Director from the Reserve Bank and a Joint Secretary from the Ministry of Finance. The other two may be non-officials but they should not be connected with any banking institution. As in the United States, no particular requirements of eligibility for membership need be laid down insofar as the non-officials are concerned and one of them may be nominated as Chairman. In the U.S.A. the term of office of the two members appointed by the President is fixed at 6 years. As this period is a little too long and as the non-official members are expected to represent the interests of the depositors in general, a term of three years for the non-official members may be fixed in our case. The chief executive and the other members of the staff will be provided by the Reserve Bank. This need not, however, be large as the Corporation will utilise the inspection staff of the Reserve Bank as well as all the information available in the Department of Banking Operations in regard to the working of the insured banks. However, as some special inspections and investigations might become necessary in due course, one or two inspecting officers may be included in the initial staff of the Corporation. If the Corporation is to undertake liquidation work whenever considered necessary, it will have to build up a suitable organisation for this purpose in course of time. In order to enable the Reserve Bank to have the necessary control over the insurance organisation, a power to issue directions to the Corporation in consultation with the Central Government may be provided in the statute. The proposed set-up is somewhat on the lines of the arrangements made by the Refinance Corporation for Industry (Private) Ltd. but as the work involved will be much heavier, separate staff will have to be earmarked exclusively for the purpose. If a policy decision in regard to the organisational set-up of the scheme is taken, the other details including the necessary legislative changes will be submitted for consideration.

4-11-1960

Governor

I have been put into a very false position in regard to the Deposit Insurance Scheme by the letter which Mr. Mathrani wrote to me a few days ago. I thought, in the first place, that the letter was extraordinary because it assumed that I did not know the pros and cons of the insurance scheme and had to be taught the elements of it by the Finance Ministry. Apart from this, it is curious that all the arguments used by Mr. Mathrani are identical with those used by the Indian Banks' Association; the only difference is in the language. Mr. Mathrani's letter is polite whereas the Indian Banks' Association's letter is offensive in its reference to the officers of the Reserve Bank. Mr. Mathrani has made things worse by saying that he has taken the instructions of the Minister. I feel wedged between the Finance Ministry on the one side and the Indian Banks' Association on the other, and feel I ought to let the Minister know about my feelings on this subject.

2. So far as the Indian Banks' Association itself is concerned, I am not at all sure to what extent it is representative of the opinion of the Indian scheduled banks. Quite a few of the bankers I have met have told me that they are in favour of the Deposit Insurance Scheme but the official letter of the Association takes a contrary line. I am inclined to think that on matters of this sort in future we ought to write directly to the banks by-passing the Association which seems to be consisting merely of a clique of bankers in Bombay who pretend to speak for the banking community in general. I am also inclined to think that in spite of the letter from the Association, we should even now do so.

3. As a basis of discussion, I place below a draft letter to the Finance Minister and would like to discuss it with D.G.(R) in Bombay. In the meanwhile, could it be ascertained informally by what process the Indian Banks' Association came to their conclusion? Was it merely a committee meeting at which they discussed the letter, or was it circulated to their constituent members and, if so, was the opinion of the constituent members unanimous or near unanimous? I have no objection to whoever is making the enquiry saying that it is being made at my instance and under my instructions.

H.V.R.
3.11.1960

D.G.(R)

I understand that the constituent members were not specifically invited to give an opinion and that the matter was decided at a meeting of the Managing Committee. This particular meeting appears to have been attended by the representatives of the Central Bank, the Bank of India, the Bank of Baroda, the Punjab National Bank, the United Commercial Bank, the United Bank of India, the Indian Bank, the Dena Bank and the Bank of Jaipur. All the bigger banks seem to have opposed the proposal except the United Bank of India which was in favour of the scheme and the United Commercial which gave hesitant support. The Jaipur Bank expressed no opinion. The smaller banks were nowhere in the picture. Sir Homi Mody spearheaded the opposition but I understand that Shri C.H. Bhabha stood by the support he had given to the proposal in the discussions with us.

M. V. RANGACHARI
5-11-1960

Governor

CONFIDENTIAL
URGENT

Deposit Insurance Scheme

A copy of the draft outline of the scheme for insurance of bank deposits of commercial banks which has been sent to the Indian Banks' Association and the Exchange Banks' Association, is attached [not reproduced]. The Agricultural Credit Department is requested to let us have their views thereon with particular reference to

the possible effects that such a scheme might have on the working of co-operative banks at an early date.

K. VARANASY
3.12.1960

Seen and returned.

2. We have to offer comments only on the effects of the scheme of deposit insurance on the working of co-operative banks.

3. The scheme of insurance of deposits of commercial banks will create a shift of deposits from co-operative banks to commercial banks. It may be mentioned that co-operative banks are already complaining that they are unable to attract enough deposits owing to competition from commercial banks and from Government. A shift of deposits occurring at this stage may create an obstacle in the growth of the co-operative movement which should, for its healthy development, depend more and more on its own resources than on borrowings from the Reserve Bank as it does today. If deposit insurance protects individuals in commercial banks alone, there will be little hope of increasing public deposits in co-operative banks. Expansion of co-operative credit, without a parallel increase in deposits, will mean expansion of Reserve Bank credit, which we want to avoid as far as possible.

4. A good part of the surplus funds of co-operative societies is kept in central co-operative banks and State co-operative banks, but surplus funds (e.g. Reserve Funds) are under the orders of the Registrars kept with co-operative Central banks and State banks. If the deposits in these banks are not insured while deposits in commercial banks are, such compulsory deposits and there are many such below Rs 1,000/- will tend to go into commercial banks which have insured their deposits. The Section of the Co-operative Societies Act which requires the Registrar's previous approval for investment in commercial banks is rarely enforced even now in many States and will be more honoured in the breach than in the observance when commercial banks get their deposits insured. There will even be a clamour from the co-operators to get that Section deleted. I, therefore, apprehend that the integrity of the co-operative structure will be adversely affected and capital formation within the co-operative movement will be retarded if the deposit insurance scheme is restricted to commercial banks.

5. It is, therefore, felt that the State co-operative banks and Central co-operative banks may also be included in the scheme. In case all these banks are not included in the scheme in the initial stages, a selection of these banks may be made for inclusion, which will give us an additional lever to improve their working. The limit for insurable deposit for these banks may also be the same as suggested for commercial banks viz., Rs 1,000/- or whatever figure is finally decided upon.

6. Urban co-operative banks in particular, contribute voluntarily in large measure to the deposits of State co-operative banks and Central co-operative banks. The urban deposits in urban banks thus help co-operative financing banks to finance agriculture in the country. If the deposit insurance scheme is not extended to urban banks, not only will their own deposits go down but also the deposits of apex and central co-operative banks will fall. Therefore, urban banks also may have to be admitted to the deposit insurance scheme, though, of course, on a selective basis. Co-operative banks

may have no cause for complaint when they are on a par with commercial banks. Co-operative banking is, or at least ought to be, as much deposit banking as commercial banking is.

7. We have to point out, therefore, that as the Indian Banks' Association and the Exchange Bank's Association have been consulted on the scheme, the State co-operative banks and a few selected Central co-operative banks having a large business turnover may also be consulted likewise and their views ascertained. If the Department of Banking Operations has no objection, we shall write to them in the matter.

J.C. RYAN
29.12.60

D.O.No.[...]

December 28, 1960

My dear L.K.[Jha],

We have given consideration in the Reserve Bank, in consultation with the Indian Banks' Association and the Exchange Banks' Association, to the question of introducing a scheme of deposit insurance for commercial banks. We have now reached a stage when we can get down to preparing details including the outlines of the necessary legislation. Before we do so however it seems necessary to ascertain from Government whether in their view, as a matter of policy, such a scheme is necessary at all at this stage.

2. As you know, the idea of deposit insurance was not a hasty afterthought following the crash of the Palai Bank. It had actually been suggested some years ago by the Shroff Committee and was shelved largely on account of the opposition of the bigger banks to any such scheme. The widespread public criticism following the failure of the Palai Bank about the hardship caused to the smaller depositors by bank failures revived our interest in the scheme. We had, as you know, drawn up a very tentative scheme on insurance of deposits in commercial banks upto Rs 1,000, to be managed by the Reserve Bank and circulated it to the two Associations of banks. I enclose for your information a copy of the communications from both the Associations containing their comments.

3. After a careful consideration of the matter in all its aspects, I am convinced that in the interests of the public and the long-term interests of the banking industry itself, it is desirable to have some form of insurance and to introduce it as early as possible. The question of the extent to which the deposits should be insured, the rate of premium to be charged, the method of computing this payment, the authority which would run the scheme are all matters of detail which could be thrashed out once the principle of having a scheme of insurance is accepted. I propose to deal in this letter only with the larger objections to and criticisms of any scheme of insurance leaving the points raised about the detailed matters which I have just mentioned for consideration at a later stage.

4. The first objection to a scheme of insurance is that no country other than the United States has one in operation, that conditions in this country are not similar to those in the United States when a countrywide scheme of deposit insurance was introduced in the early thirties and that, if for example in countries like the U.K., France and Italy there is no insurance of deposits it is not necessary to have it here.

This line of criticism seems somewhat misconceived. Conditions in a large country like ours are really comparable to those in the United States and not to those in the U.K., Italy or France. In U.K., the bulk of commercial banking is in the hands of a small number of highly organised institutions and the traditions of conservative banking which has been built up over the years and the large hidden reserves banks there carry have made insurance unnecessary there; in France and Italy banking has been largely nationalised. If (as I think) it is our policy not to concentrate too much of the banking business in a small number of larger institutions but to encourage the growth of a number of medium banks of reasonable size in which the smaller people could safely deposit their savings it is necessary to have some form of assurance to the smaller depositors that their money is safe; this is particularly important to encourage the growth of the investment habit and mobilisation of resources through the network of branches of banks in the countryside. While it is true that we do not now have a banking crisis as there was in the U.S. in the early thirties (during the period of the Great Depression), it is not correct to say that everything is all right with our banking system particularly at the level of the medium and smaller banks.

5. A second line of criticism is that any scheme of insurance would benefit only the sub-standard banks and that the money for this would be largely contributed by the bigger banks deposits in which are quite safe. This overlooks the basic principle of insurance that the larger and healthier units have to share the losses of the smaller and less healthy ones. The recent experience of the Punjab National Bank and the Indian Bank has shown that even the bigger banks are not as invulnerable as is generally claimed. Once some rumour starts about the position of a bank the smaller depositors get panicky and attempt to withdraw their money and when large queues of small people form before a bank it has a snowball effect on loss of confidence which spreads to other banks. A scheme of insurance would prevent such panic developing and enable a bank to survive any temporary run in a much more orderly way. It would thus enable us to proceed with the process of reorganisation of some of the marginal banks without needless scare affecting parts of the banking system from time to time.

6. A third criticism is that a scheme of insurance which does not cover all the deposits is not worth having. The problem is not one of protecting all the depositors but of protecting the smaller ones where numbers are much larger and to whom a bank failure is a much more severe blow than to the big depositors. It is true that insurance limited to a small sum would cover a large number of accounts but only a relatively small proportion of the total amount of deposits. An insurance covering all the deposits would, no doubt, be ideal but it is likely to be impracticable and in any case too costly. I have had certain rough figures worked out showing the cover that will be provided both in terms of accounts and in terms of the value of deposits if we had insurance limited to Rs 1,000, Rs 2,500 and Rs 5,000 and a statement containing these is enclosed [not reproduced]. It will be seen from it that a very substantial number of accounts will be covered by insurance at any of these figures. It will have a healthy effect on the public if, say, 70% or more of the depositors had the assurance that their deposits were safe whatever happened to a bank.

7. There has been some misgiving in regard to the effect of a scheme of insurance

for commercial banks on deposits in the co-operative sector. The total volume of deposits in the commercial sector excluding P.L.480 deposits is in the order of Rs 2,000 crores, while the corresponding figure in the case of the Co-operative sector, taking State Co-operative Banks, Central Co-operative Banks and agricultural credit societies, is of the order of Rs 150 crores. I do not myself expect that there will be any large diversion of deposits from the co-operative sector to the commercial sector if we had a scheme of insurance only for the latter. Theoretically, it is possible to provide for co-operative institutions also participating in the insurance scheme although I would not personally recommend it. The co-operative movement is developing under so much of State guidance and supervision that a scheme of insurance may be unnecessary for it. But this is a matter in which we need not take a final view just now; we may watch the effect of any scheme of insurance over a period and make up our minds later.

8. A point has been raised about the position of the State Bank of India and its subsidiaries in a scheme of insurance. It has been suggested that it will be inappropriate for a State-owned institution like the State Bank to participate in a limited scheme of insurance. There has also been some talk about the deposits in these institutions being in some way guaranteed by Government. I am afraid that there is some confusion in regard to this. I do not think it is correct to say that the deposits in these institutions have been guaranteed by Government. It is true that the State Bank and its subsidiaries cannot be put into liquidation except with the approval of the Central Government and it is very unlikely that these banks would share the fate of the Palai Bank or the Indo-Commercial Bank, or even have a run on them as the Punjab National Bank and the Indian Bank recently experienced. But it is not the same thing as saying that the Government of India have guaranteed the deposits in these banks. There is no legal provision for this comparable to that in Section 37 of the Life Insurance Corporation Act under which Government has specifically guaranteed the policies issued by the Corporation. So long as the State Bank of India and its subsidiaries function as commercial banks I see no reason why they should not participate in a scheme of insurance just as other commercial banks merely because their capital is very largely owned by Government through the Reserve Bank or why they should consider it as detracting from their dignity to do so.

9. I have dealt at some length with the various objections which have been raised in principle to the introduction of a scheme of insurance. As mentioned earlier, I have not gone into criticisms on matters of detail. My main purpose in writing this letter is to get a decision in principle. If Government agree that we should have a scheme of deposit insurance, we can get down to the formulation of one with due regard to conditions in this country and the criticisms which have been raised on matters of detail. On these details I have not got views myself and I am sure that once the principle is accepted we shall be able to thrash out a scheme fair and equitable to the banks and the depositors on which legislation could be based.

Yours sincerely,
H.V.R. IENGAR

.Shri L.K. Jha, I.C.S.
Secretary
Ministry of Finance
Government of India

SECRET

D.O.No.[...]

January 31, 1961

My dear L.K.,

I have been looking again at my D.O. letter to you No.[...] dated the 28th December [p.1114] on the proposed scheme of insurance for bank deposits. It seems to me that although the arguments *in favour* of such a scheme have been mentioned, that has been done extremely briefly; the letter is concerned basically with defending the scheme against arguments made in criticism of it. This imbalance in the letter was due to the previous D.O. correspondence from Government which had pointed out a number of difficulties. I think it is desirable now to set out more clearly one or two arguments which, to my mind, reinforce the case for expeditious action to set up a scheme of deposit insurance.

2. Ever since the failure of the Palai Bank and the occasional flurries in one part of the banking system or the other affecting now a big bank, now a medium bank, and all the time many of the smaller banks, a steady erosion of deposits from the banking system has been taking place. Although this is the time of the year when bank deposits are never too buoyant owing to busy season demands for conversion of deposits into currency, the behaviour of bank deposits during the last six months betrays distinct traces of after-effects of the shocks to confidence in the system administered by the alarms and excursions following the Palai crash. Since the end of July to January 20, 1961 the entire growth in money supply has been accounted for by currency expansion; indeed, an expansion in currency circulation of Rs 129 crores has been associated with a *decline* in bank deposits of Rs 40 crores (after allowing for the decline due to fall in P.L.480 deposits); this compares with an increase in currency of Rs 102 crores and Rs 81 crores during the corresponding periods of the previous two years, which was accompanied by an *increase* in bank deposits of Rs 69 crores and Rs 9 crores respectively. The detailed analysis of the trends in deposits on a regional and bankwise basis supports the view that bank deposits are stagnant owing to persistence of a substratum of apprehensiveness among a number of small depositors as a reaction to recent experiences of bank failures and moratoria. This is particularly unfortunate at a time when monetary stringency is acute and banks are depending to a somewhat alarming extent on accommodation from the Reserve Bank. Quite clearly in my judgement, the essential aim of policy must be to stimulate the flow of savings into the banking sector. This is the first major argument in favour of introducing a scheme of deposit insurance at this stage.

3. The second major reason arises out of the need for giving a fair start to the scheme of amalgamations. We have received warning from people who claim to be in touch with the state of public feeling on this matter in Kerala, that it is quite on the cards that when we do set up new units there amalgamating some older units, the new institutions may have to face a run as soon as the moratorium is over and hardly before their lease of life had started! In other words, mere amalgamation of weak units into what we consider viable units would not, having regard to the prevailing state of nervousness, necessarily prevent further runs. We have received specific warning of this possibility in the case of the four banks under moratorium in the Travancore region. I am, therefore, more than ever convinced that the steps we are taking to try and tone up the banking system do not by any means reduce the need for

expeditious action to extend the cover of insurance over it so as to eliminate the possibility of runs, with long queues of small depositors tending to undermine confidence in the whole system and posing a danger to its general stability. Indeed, the fact that we are taking action to amalgamate and reorganise a number of small and medium banks makes it all the more urgent that we enlist the aid and protection afforded by an insurance scheme to enable us to carry through the process of reorganisation in a smooth and orderly manner. The new units once set up will, in their initial stages, have to be nurtured for a period into confident and autonomous growth; and the fact that we expect to have many such units brought into existence makes it necessary that these vulnerable sections of the banking system are protected against unreasoned fits of nervousness on the part of the depositing public to which it has become more susceptible of late.

Yours sincerely,
H.V.R. IENGAR

SECRET

ECONOMIC SECRETARY
MINISTRY OF FINANCE
NEW DELHI
February 4, 1961

D.O.No.[...]

[My dear Iengar,]

I am writing to you with reference to your two letters dated the 28th December and 31st January relating to the proposed scheme of insurance for bank deposits.

2. In principle and on general considerations, Government view the scheme with sympathy. The positive points which you have made in your latter letter in favour of an early introduction of the scheme are weighty ones.

3. Before such a scheme can be implemented, however, a number of points of detail to which you have referred in para 3 of your earlier letter as well as some others will need to be considered. Some of these points, if they cannot be satisfactorily settled, may well create insurmountable difficulties in the implementation of the scheme. I would, accordingly, suggest that, in the light of what I have stated in the preceding paragraph, the Reserve Bank may prepare a detailed scheme which can then be further discussed. I hope to send you separately a brief memorandum covering some of the difficulties which should be taken care of while formulating a detailed scheme.

Yours sincerely,
L.K. JHA

ECONOMIC SECRETARY
MINISTRY OF FINANCE
NEW DELHI
February 17, 1961

D.O.No.[...]

My dear Iengar,

Madan reminded me that you were expecting a memorandum from us regarding the bank deposit insurance scheme. I am sorry it has been delayed, but as you can

amalgamation of the banks would provide a network of branches throughout the country to undertake treasury work, give remittance facilities and generally carry on and extend their operations in conformity with national interests. The Committee was well aware of overlapping at certain centres. This will have to be dealt with suitably when the State Bank of India is formed. The Committee, because of the vast field which exists for expansion, has pointed out that there would be no need for the retrenchment of surplus staff. In the Committee's appraisal of the situation, the need may well be for the recruitment of further staff e.g. by re-employment of retired personnel.

- (vii) The offices of the State-associated banks are concentrated in a few districts. The institution of a currency chest at each of these centres would be an uneconomic proposition.

Currency chests will be established after careful investigation. At present, there are over 100 district centres and over 300 sub-divisional centres where currency chests do not exist.

Conclusion

The Government of India have already taken a decision on the conversion of the Imperial Bank of India into the State Bank of India. The question now for consideration is as to whether and if so in what manner the State-associated banks should be amalgamated with the Imperial Bank. If, as suggested, the State-associated banks are run as subsidiaries of the State Bank of India for some time, these banks will continue to be placed in the respective classes under the labour awards and there would not be any increase in establishment expenses. Such subsidiaries could also continue the rates of interest on deposits and advances according to local conditions and make adjustments gradually. Their administrative standards could also be improved during the interim period i.e. till they are integrated with the Imperial Bank. One of the essential conditions for extension of banking facilities in the country is the establishment of currency chests to facilitate the movement of cash from one centre to another. As already explained, a vigorous and co-ordinated programme for the establishment of currency chests cannot be carried out so long as these banks continue as separate, and relatively smaller units. So long as these banks continue to function as private-owned (except, of course, the Bank of Patiala and the State Bank of Saurashtra), these banks will be managed by the respective Boards and effective control over them cannot be exercised. In view of the smallness of their size, lack of premises and other arrangements comparable with those of the Imperial Bank and inadequately paid managerial staff, it would not be possible to entrust currency chests to them at many of the centres. Thus, remittance facilities cannot be provided until currency chests are established and currency chests on a large scale cannot be established so long as these banks continue to operate as smaller units. The guarantee of State Governments is not an effective safeguard, considering the changes in the political set-up which have taken place in certain States. It is true that the Banking Companies Act has conferred several powers on the Reserve Bank. It is also true that banks in Part 'B' States which are appointed our agents have to comply with our scheme of control. But, by the exercise of these powers, we cannot get over the limitations arising from the smallness

do give us wide powers to direct the day-to-day working of commercial banks on approved lines. In the case of the co-operative banks even the inspection reports prepared by our inspectors are sent to the Registrars of Co-operative Societies and we have no direct statutory contact with the co-operative banks. So far as the Insurance Corporation is concerned, it may well make use of our inspection machinery for the purpose of commercial banks but the position so far as co-operative banks would be somewhat different. The large number of Urban Co-operative Banks spread over almost all the talukas and district places would also pose new problems so far as the supervision over their activities for the purpose of insurance is concerned. Besides, the relations which the depositor of a co-operative bank has with his bank are usually different from those which a depositor has with a commercial bank. In a co-operative bank the depositor may also be a shareholder of the bank in view of the restricted area of operation. In this view and having regard to the close contact which the depositor may have with a bank run on co-operative lines the possibility of a shift of deposits from co-operative to commercial banks as a result of the insurance of the deposits of commercial banks seems rather far-fetched. Even assuming that it is decided to make applicable the insurance scheme to the co-operative banks also, the selection of a few of them for insured status at once presents a number of practical difficulties and may even charge the Reserve Bank with discriminatory treatment. The selection of a few banks out of the large number of small units which forms the co-operative movement, itself may be the point of disintegration for that movement. In balance, it does not appear feasible to extend the Scheme of Deposit Insurance to co-operative banks especially when the insurance scheme as and when introduced will be more or less on an experimental basis covering deposits up to Rs 1,000/- only.

8.3.1961

VI. EXTERNAL SECTOR

SECRET

RESERVE BANK OF INDIA
BOMBAY
July 8, 1957

Dear Shri Krishnamachari,

Some time ago, I had asked the Research Division to make a statistical computation on the basis of which we could estimate to what extent the policy of the Government of India, in the international and particularly the economic field, had appealed or failed to appeal to the foreign investor. In our present position, with the possibility of serious jeopardy to the Plan if we fail to get a fairly massive degree of support from other countries, such a study is particularly important.

2. You will recall that after some initial nervousness in 1947–48 immediately after independence, the foreign investor seemed to regard India as a reasonably good risk. Between 1948 and 1953, there was a *net* investment in our country of [Rs] 132 crores of which the U.K. share was 137 crores and that of the U.S.A. 13 crores. (Disinvestment of 18 crores by other countries.) Part of this investment consisted of fresh capital brought into the country and part of the ploughing back of profits in existing concerns. Although, in relation to the general level of overseas investments of the U.S.A. and the U.K. this figure does not sound very impressive, we have to take note of two facts: (a) that this fresh investment was made during a period of intensive rehabilitation of domestic industry in the U.K., and (b) that the increase was a substantial addition to the total volume of foreign investment in India which, at the close of 1948 was 288 crores.

3. The study which has since been completed shows that in the two years between 1953 and 1955 the net increase in foreign investment was 62 crores of which 27 crores was investment by oil companies. Of the balance of 35 crores, there is some doubt as to the precise significance of the figure of 'investment' in tea companies of 15.8 crores. Since these companies are known to have made sizeable remittances out of their retained profits during the period, the increase seems to be fictitious; it appears that the increase is due to revaluation at the high prices prevailing in 1955 of their assets—which would largely be stocks. If this is so, then the foreign investment during the two years—apart from oil refineries and distribution—has been only 19 crores. Even this figure needs to be interpreted with caution since it contains an 'investment' in banking of 4 crores; this would mostly be attributable to the movement of short-term funds.

4. I am afraid it is difficult to escape the conclusion that since 1953 the foreign investor is taking a much poorer view of India than between 1948 and 1953.

5. I think it is necessary that we should ponder over this fact and decide to what extent and in what direction it would be necessary for Government either to reorient its policy or shift emphasis in the various facets of policy. Quite obviously we cannot, merely to attract foreign capital, break away from or distort certain fundamentals which are necessitated by our social conditions and political principle. But there are

points which are not fundamentals; and in dealing with them, as I think I have told you in discussion more than once, it would seem necessary to keep foreign reaction in mind and to allow for it even if we do not always consider it particularly reasonable. The figures I have mentioned in this letter seem to suggest that we have not perhaps always attached adequate importance to this point.

Yours sincerely,
H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister, India
New Delhi

SECRET

RESERVE BANK OF INDIA
BOMBAY
August 6, 1957

D.O.No.[...]

My dear Patel,

As I informed the Minister and yourself in Delhi, I am placing before my Board at the meeting to be held on the 21st of this month a paper on the Foreign Exchange situation and the amendments that would be necessary in the currency reserve provisions of the Reserve Bank of India Act. In the meanwhile I took the opportunity to discuss the subject at the Committee meeting this morning. The Committee's views were quite clear on both the points that I put before them. They felt that rather than allow the situation to slide and then face the country with an Ordinance very suddenly when our balances looked like going down below [Rs] 300 crores, it would, in every way, be desirable to put the matter before Parliament in the form of an amending bill during the current session. You will remember my telephoning to you in Delhi shortly before I left saying that in the course of my discussion with the American Ambassador, this question as a purely tactical problem of public relations arose and the Ambassador was emphatically of the view that it would be better for us to legislate now before the Minister went to Washington rather than to do so either while he was there or immediately thereafter. The second question discussed with the Committee was the actual content of the legislation. The Committee was emphatically of the opinion that it would be a serious mistake to do away altogether with the provision requiring a currency reserve in the form of foreign securities. The Committee's view was that such a change would be regarded as evidence that we had failed in our efforts to stabilise our situation and that the position had in fact become desperate. Foreign reaction to such legislation would be wholly adverse and internal reaction would also be bad. The Committee accepted the view which I discussed with you and B.K. Nehru in Delhi that we should even at this stage maintain a minimum reserve in foreign securities. What the reserve should be is a point which I will discuss at the Board meeting. In the meanwhile, I thought I should inform you of the feelings of my

Committee which, I have little doubt, accurately represent the views of the whole Board.

2. I am sure you will show this letter to the Minister.

Yours sincerely,

H.V.R. IENGAR

Shri H.M. Patel, I.C.S.
Finance Ministry
Government of India

[18-2-1958]

AIDE-MEMOIRE ON JACOBSSON'S DISCUSSIONS

During his stay in Bombay Mr. Jacobsson had a series of discussions with various authorities in the Reserve Bank and the Bombay Government as well as with individual businessmen. He also gave several talks. A list of these discussions is given in the Appendix [not reproduced]. The ground covered in the course of discussions in the Reserve Bank of India and his public lectures can be divided broadly into three sectors:

- (1) the present international economic situation,
- (2) the current Indian economic situation, and
- (3) the role of the Fund vis-a-vis (1) and (2).

(1) As far as the first sector is concerned, Mr. Jacobsson was inclined to take a somewhat more optimistic view than many of the foreign economic commentators both in the U.S.A. as well as outside it. The basis for his optimism appeared to lie in the fact that whereas in previous recessions the U.S.A. had shown strongly protectionist and also anti-foreign-aid tendencies, in the present situation the President had actually recommended measures such as continuation of Reciprocal Trade Act for a long period and increased foreign aid. Mr. Jacobsson realised, however, that the main source of difficulty for the President was his own party and not the Opposition. This change in emphasis together with increased awareness of the necessity to do something to avoid recession both on the merits of the case and on political grounds and the increased defence expenditure necessary in the present international climate were sufficient to justify the view that the recession would not be a major problem. Because of this stand Mr. Jacobsson would not say specifically what the Fund would do to help countries getting into balance of payments difficulties. He did say, though, at one of the discussions that at present the Fund had enough resources to meet contingencies foreseen now; but that if the situation became more serious the Fund would have to think of increasing its resources.

Discussing the international economic situation over a long period and in a wider context, Jacobsson made the following points:

- (i) The world as a whole was getting tired of inflation. Hence the return to 'sound' money policies.
- (ii) Therefore, a number of countries have had to cut down their investment plans. So long as America indulged in inflationary finance, the rest of the world could

afford to have an investment boom. However, with the Americans themselves checking this situation, the rest of the world would find it very difficult to continue its investment plans unaltered.

(iii) Unless investment were financed out of genuine savings it was his belief that countries would find themselves in a serious balance of payments situation and loss of reserves. Mere import restrictions were unable to meet the situation as the problem would then crop up in the form of diversion of resources from exports to import substitutes.

(iv) The present position of Germany and Italy owes very much to the policies of monetary stability pursued by their respective governments.

(v) Jacobsson frequently brought up the case of France as the most recent example of a country which has followed his prescription.

(2) Coming to the discussion of India's economic problems, Jacobsson laid great emphasis on the implications of deficit financing particularly for reserves. The framework of ideas within which he works is as follows:

(i) In his view the concept of deficit financing as used in India was equivalent to inflationary finance. He himself would use the term in a somewhat different manner. His idea was that the term deficit finance should be used to denote borrowing from the public necessary to finance government deficits; whereas it appeared to him that what we meant by deficit financing was central bank extension of credit to government.

(ii) He did not think that such a method of financing could give the government substantial additional resources for investment purposes. On the contrary, he felt that this would lead to increased demand for consumption, a rise in prices followed by a rise in wage rates. All these would finally lead to a serious loss of reserves.

(iii) He felt his theories were fully confirmed by the fact that during the year ending January 31, 1958 there was an increase of rupee securities held by the Reserve Bank of the order of Rs 405 crores, while at the same time the foreign assets held by the Reserve Bank of India declined by Rs 223 crores and in addition the country had to draw on the standby of Rs 34 crores. He thought this indicated abundantly the immediate and important (according to him) connection between Reserve Bank's extension of credit to government and loss of monetary reserves.

(iv) He realised that India had several valuable assets in the form of a stable government, a sound banking system, good administration, the people's faith in their currency and so on. He also realised the necessity of having a developmental plan of sufficiently large magnitude and the vigour with which it was being carried out. As between development and stability, however, he appeared to prefer the latter.

During the course of discussions, it was repeatedly emphasised from our side that in the first place the concept of deficit financing and its impact on money supply in relation to India's Plan was quite different from what Jacobsson appeared to think. For instance, Rs 200 crores of the deficit financing of Rs 1,200 crores was to be set off by the drawing down of Sterling balances. In other words, to that extent the increase in money supply would be reduced. Next, it was also pointed out that with the increase in the monetisation of the economy, there would be need for increase in money supply to finance the growing volume of transactions being conducted with the help of money. Then, again, with the increase in national income and standard of

living there should be an increase in the demand for cash. This would lead to a certain amount of absorption of money. Taking all these three factors together the inflationary potential of the deficit finance would be considerably reduced. Moreover, the Reserve Bank, by its policies relating to selective credit control and lending to commercial banks, can exercise the appropriate checks on the monetary and credit situation.

With reference to the current situation it was argued that, in the first place, a part of the borrowing from the Reserve Bank was due to the peculiar financing arrangements in relation to PL 480 imports. The Government of India has had to pay the Government of U.S.A. the cost of commodities purchased under PL 480 in rupees and this has been done by borrowing from the Reserve Bank and placing the amount to the credit of the U.S. Government. In the second place, it was observed that the rather large loss of reserves was attributable to two factors: (1) the rapid pace at which the private sector proceeded with its investment plans, and (2) the difficulties in arranging external assistance on a large scale within a short time. Since the Plan started with a very high level of reserves, it was found feasible to make a heavy drawing on them while all these arrangements took shape. Thirdly, it was pointed out that the balance of payments deficit was a planned deficit in the sense that it was used as the mechanism to bring the necessary resources such as capital goods, raw materials etc. into the economy from outside for the purpose of development. It was not something which arose out of consumer goods imports or out of strong price resistance to India's exports. In fact, it was pointed out that India had not experienced during the last year any such price resistance. On the contrary, India's exports were rather larger than those allowed for in the Plan. Fourthly, the balance of payments deficit provided the necessary corrective to the increase in money supply from government's budgetary operations.

It seemed that at the beginning Jacobsson took a very rigid and conservative approach to India's problems. He went to the extent of saying that India could not expect the Fund's Executive Board to approve of a third tranche drawing if the Government borrowed a single rupee from the Reserve Bank and the Reserve Bank extended credit by a single rupee to commercial banks for financing investment. He did not think it was possible to bring any substantial unemployed resources into production by deficit finance. In any case, such resources would require complementary resources from abroad and in the absence of any other arrangements for obtaining them they would lead to a pressure on the reserves. He was convinced that his theory was amply vindicated by the statistics he had before him. He was also not prepared to consider the wider implications of following a policy of no-development without either internal savings or external resources. He felt that that was irrelevant. Towards the end of his stay, however, it appeared that he realised that the problems were not quite so simple. He stated that he would think over all that he had seen and heard in India and that what he was saying here were his first hurried impressions. He was, however, frank enough to say that he did not think his basic ideas would change very much.

(3) Jacobsson's ideas as to what the Fund would do in relation to (1) and (2) above have already been briefly mentioned above. It seems pretty certain that if we were to approach the Fund for a third tranche drawing he would insist on a number of conditions as in the case of the French drawing. Jacobsson, in fact, made a good deal of use of these conditions and the role played by the Fund in working them out. He

also frequently likened the Indian situation to the French situation although we did our best to point out the striking differences between the two. He was, however, so taken up by the French example—particularly as he had played a prominent part in it—that it is doubtful if he ever gave up the comparison in his own mind. The fact that the French were waging the Algerian war and so using all their resources in a reckless manner, the instability of the French government, the substantial rate of investment in the French economy as compared to the national income, the high level of national income: none of these factors appeared to make much difference to him between the Indian and the French case. His conception was that both the French and the Indians tried to live beyond their resources. It did not matter whether the French were at a high level of prosperity and had indulged in over-investment or whether the Indians had a low level of per capita income, a high rate of population increase and an extremely low rate of investment in relation to national income. He did not think that the financing methods as outlined in the Plan would bring about the desired increase in investment in India. He thought that we should make efforts to induce more foreign investment and go in for long-term credits at governmental levels and from institutions like the International Bank for Reconstruction and Development. He thought there was a good chance of the volume of credits of the second type increasing substantially in future. He thought, moreover, that with the investment boom coming to an end in Europe and elsewhere Europe would be in a position to supply the much needed capital to the under-developed countries. This would, in fact, be one way of counteracting the present recessionary tendencies. He also thought that public opinion in the U.S.A. was considerably against giving further aid to Europe and as a result it would be possible for that country to divert more of its funds to under-developed countries. The pre-eminent condition for the success of under-developed countries in obtaining such external resources would, however, be the maintenance of monetary stability and the creation of a favourable climate for private foreign investment.

Reserve Bank of India, Bombay.
Dated the 18th February 1958.

SECRET

RESERVE BANK OF INDIA
BOMBAY
March 14, 1958

D.O.No.[...]
My dear Bijju,

This is about the smuggling of gold from the Persian Gulf area. You did not like either of the solutions I suggested and I did not like the one you put forward and there was a danger of our getting completely stuck, helplessly watching the leakage of Sterling. When I was in Delhi last week, I had a chat with the Secretary-General and discovered that he was not happy either at the suggestion that we should pull our currency out from the Gulf. He said he would prefer something less drastic. I left with the Secretary-General the suggestion that we should send a team of two officers, one from the Bank and one from the Finance Ministry to make a rapid tour of the Gulf, ostensibly to study smuggling but in reality to advise us about the question of pulling our currency out. It occurred to me that an on-the-spot study might yield suggestions

about less drastic remedies which we have not yet thought of. I expect the Foreign Secretary will discuss this with you and A.K. Roy soon. In this connection, I enclose a copy of a letter I wrote to Dutt yesterday [not reproduced]. It seems to me that by the time I go to London we may not have any cut and dried solution in our mind. I am wondering whether there would be any objection to my verbally and discreetly posing the problem to the Bank of England and asking if they have any solution to offer. I would merely say that we are bothered by the mounting dimensions of the problem, and ask how they would have met it if they were in our place. This might (or might not) lead to something useful. Would you please think this over? I would like you to consult the Secretary-General and perhaps we could have a chat when I come to Delhi next week. I am likely to be there for a day on Thursday or Friday.

Yours sincerely,

H.V.R. IENGAR

Shri B.K. Nehru, I.C.S.
Ministry of Finance
Government of India

RESERVE BANK OF INDIA

BOMBAY

June 28, 1958

D.O.No.[...]

Dear Shri Morarji Desai,

During the last few days there have been all kinds of rumours in Bombay and Calcutta about the devaluation of the rupee, and in fact I have seen three editorials in newspapers commenting about the futility of such a move. The result of these rumours has been to cause a rush for the purchase of Sterling on the part of those who would normally have waited for some time to do so. The dock strike has also created a technical situation in the exchange market which has accentuated the purchase of Sterling through the Reserve Bank. I fear therefore that the drop in the Sterling balances during the current week will be unusually heavy.

2. You will recollect my having told you that I proposed to speak on the foreign exchange situation to the Bombay Progressive Group on Monday, the 30th. I propose to take this opportunity to try and steady the situation by putting the facts in the, I hope, correct perspective. I enclose herewith for your information a copy of the text which I have proposed to use for my speech [not reproduced]. I have deliberately used guarded language but I hope you will agree that the tenor is helpful and is likely to have the desired effect.

3. I wanted to meet you personally at the airport, but I was afraid that if I did so the rumours in the market would have got accentuated.

4. I hope you are feeling better now and will have a pleasant journey to Delhi.

Yours sincerely,

H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
Government of India
Camp: Bombay

STRICTLY PERSONAL

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
August 16, 1958

[My dear TT,]

I was delighted to get your letter of the 8th August, amongst other things for the indication it gave—the first one since your resignation—that you have again begun to take some interest in affairs of which you were the centre—I should say the storm centre—for quite some time. It is because I was doubtful as to whether you would take interest in our publications that I did not have any copy sent to you. I have now asked my office to put you on the mailing list and you will regularly get our publications, including the Bank's *Bulletin*.

So far as the foreign exchange position is concerned, perhaps it is best to take the situation from the point where you left off last September in the United States. You remember that you had worked out that we would need 1,400 million dollars up to the end of the Second Five Year Plan in order to meet our commitments. It was assumed in these calculations that we would retain at the end of the Second Plan period a Sterling reserve of [Rs] 200 crores. Since then, certain changes have occurred. We got an American loan of 225 million dollars. The World Bank have given some money for the ports. The Japanese have given a credit of £ 25 million. On the other hand, there has been some increase in defence commitments. Altogether the position as was worked out by the Department of Economic Affairs some four months ago was that we would need till the end of the Plan period an additional [Rs] 560 crores, again on the assumption that we would keep a Sterling reserve of [Rs] 200 crores. So far as the quantum of assistance is concerned, there has been no basic change in the situation since last September. The Ways and Means position, however, has become more difficult. Recent calculations show that the payments to be made during the next 12 months are so heavy that, without further assistance, we shall run through all our Sterling balances and yet be compelled to default. The problem, therefore, now is (a) of finding a total of 560 crores, and (b) of finding a good part of it within the next few months so that we would not default in our obligations.

I do not think there is any evidence of a flight of capital. Some people talk about it but I have seen no evidence of this. I am however having a closer analysis made with a view to seeking whether the 'leads and lags' have been aggravated, but I should be surprised to find if this has happened to any substantial extent.

So far as hire purchase is concerned, the position is that the State Bank of India Act was amended in your time with the express purpose, amongst others, of enabling the bank to finance hire purchase transactions. So far as I know all that the State Bank has done is to advance some money to the T.V.S. finance group for the hire purchase of trucks.

You have asked to what extent I am carrying Government with me. So far as asking for external assistance is concerned, the Finance Minister is in complete agreement with the view that nothing else would save the immediate situation. He is greatly looking forward to his visit abroad. You may have heard that B.K. Nehru has been appointed Commissioner-General with the status of an Ambassador and having

jurisdiction over America, Canada and Japan. His job is to help in the matter of getting credits. Swaminathan is being appointed Commissioner-General in Europe with a similar object. I believe the Prime Minister is also convinced of the pressing need of external assistance at this stage. I had sent him a copy of my speech on the Foreign Exchange situation and met him subsequently, but he made no comment about it. I see that our friend V.K.R.V. Rao has been writing articles to the effect that we are all wrong in asking for foreign assistance and that if we adopt the Gandhian way of life, everything would be bright and serene. Fortunately V.K.R.V. Rao is not in Government—at any rate not yet. There have been frequent reports that his target is the Finance Ministership, and I do not know whether he is indulging in subtle flattery of the Prime Minister who has a temperamental aversion to ask anybody for help.

You have asked about the boycott in Bombay. Quite frankly, I have ceased to be interested in it and I have ordered my own life in such a way that I could not possibly care less. I do not think that I have accepted a single invitation from any business magnate since January and it seems to be generally known that I am averse to accepting such invitations. I feel much happier because I am getting great deal more time which I devote partly to reading economic literature and partly with my family; the latter is a pleasure which I have unfortunately denied myself for many many years.

There has been no progress with the Germans so far. Blessing himself has throughout been sympathetic. B.K.Nehru got the same impression when he called on him last month at Frankfurt. His impression of the Government however was that they were very cold. However, we shall know how their mind is working after the conclusion of the Conference in Washington convened by Eugene Black.

I am thinking of coming to Madras and Bangalore for 2 or 3 weeks towards the end of October. I hope I will be able to see you in Madras then. If you are still in Kodaikanal, I could easily run up for the weekend. I wonder what shape your cottage has now taken.

You may have heard that Blue has been down with typhoid here in Bombay. (She has now shaken off her fever.) S.R. has been here for the last 3 days. They are both going back to Delhi on Monday. I believe her intention is to return to Bombay after a week's convalescence.

My wife joins me in sending you her kindest regards.

Yours sincerely,
H.V.R. IENGAR

Shri T.T. Krishnamachari
'Blue Cairn'
Kodaikanal

[6-11-1959]

I discussed with Shri Jagannathan this morning the following questions raised in E.C.D.:

- 1) re-introduction of a basic quota for travel,
- 2) the question of a possible liberalisation of facilities to students, and

3) the reduction of the emigration quota to Rs 75,000 per family.

On the question of a basic travel quota, I pointed out that we must either do what the Japanese have done, viz., to prevent people going out altogether except in cases where travel is considered to be of real national value, or to introduce a basic travel quota. As it is, we have fallen between two stools. We have maintained restrictions, but these restrictions are being evaded wholesale; the only people who suffer from them are the decent law-abiding citizens. I did not myself foresee that the foreign exchange situation would ease for several years to come. A decision will, therefore, have to be taken not on the basis of the exigencies of any particular year, but as a general proposition covering, perhaps, the next decade. On a balance of all the considerations, I had come to the conclusion that the recommendation communicated to Government by E.C.D. was sound and I recommended it for Government's adoption. Shri Jagannathan said he would put this to the Minister for orders.

Shri Jagannathan explained to me the reasons why restrictions had been imposed, for example, on students going abroad for undergraduate training in medicine, although students were allowed to go for undergraduate training in other subjects. On the whole, we came to the conclusion that no particular change was called for, at the present time, in the existing regulations. In the particular case of Kumari Lall, which gave rise to a discussion of the student problem in E.C.D., Shri Jagannathan said that the Ministry would formally ratify the decision for a grant of foreign exchange. He thought there was danger of abuse where students were allowed exchange merely for part-time courses in languages but not where, as in this case, exceptional promise was shown in music.

We had a general discussion on the possibility of delegating wider powers to the Reserve Bank in the matter of releasing foreign exchange. We came to the conclusion that, on the whole, this was not desirable in the interests of the Bank itself. There might well be appeals to the Ministry and the paper work may not really be reduced. Shri Jagannathan promised, however, to examine whether any of the decisions taken over a period of time could be codified into instructions which the Reserve Bank could follow.

On the question of the emigration quota, I pointed out that while I had no sympathy at all with rich people who wanted to settle down in places such as the South of France or U.K., I had in mind, in dealing with this problem, the travel of persons between India and countries such as Kenya, Tanganyika, Uganda and the Fiji Islands. There was a constant traffic both ways; people who had retired were coming back and people were going out from India to take their place. I did not think it would be wise to put any restrictions on this traffic; and on an examination of the figures, I was satisfied that the ceiling of Rs 75,000 which has been suggested was fair. Incidentally, this figure would really make it difficult for well-to-do persons to settle down in the U.K. or the South of France.

I also discussed with Shri Jagannathan the following problem concerning the E.C.D., although this is not one of the briefs given to me. This was the question of transfers of capital to individuals in the non-Sterling area. A concrete case of this type was that of Mrs. Wenzel. Another case of the same type had been mentioned to me by Shri A.D. Shroff as having been put to him at a meeting of businessmen at San

Francisco. If the sum involved in the case of non-Sterling area individuals was large, I obviously could not recommend that they should be treated in the same way as Sterling area nationals, but if the sum was small, perhaps something could be done to liberalise the existing regulations. During the course of the discussion on this subject, Shri Jagannathan pointed out that if a non-Sterling area national held Indian Government Securities, he would be entitled to repatriate them at the end of 5 years. He thought that probably a satisfactory solution would be to raise the ceiling of 1½ lakhs. I would like the office to examine this. Is there likely to be any sizeable liability if we raised the ceiling to, say, (a) 2½ lakhs and (b) 5 lakhs?

H.V.R. IENGAR

6.11.1959

CONFIDENTIAL

BOMBAY

June 13, 1962

Jyaistha 23, 1884

My dear L.K.,

I enclose herewith for your information a note prepared by Pendharkar, copy of which has been sent by Madan to Anjaria.

Yours sincerely,

P.C. BHATTACHARYYA

Shri L.K. Jha, I.C.S.

Secretary to the Government of India

Ministry of Finance

Department of Economic Affairs

New Delhi

SECRET

The question as to whether the present exchange parity of the Indian rupee needs adjustment if raised at all at this juncture would be raised primarily with reference to our present difficult balance of payments situation. Before discussing this question, however, it would be as well to mention that the question could conceivably arise in the near future in another context: this is the acute balance of payments position of our neighbours who are also our chief competitors in the three important export commodities tea, jute manufactures and cotton textiles. Both Pakistan and Ceylon are in serious balance of payments difficulties. The former has actually resorted to a form of multiple currency practice besides stringent exchange control, and the latter has had to progressively tighten up its control over imports and other payments. If their difficulties persist for any length of time, as they apparently seem likely to be, and if they are forced to adjust their parities, we too shall have to take serious notice of the problem. *A fortiori* any steps we may take on our own initiative will have important repercussions on them and in any estimates regarding the consequences of our action we shall have to make suitable allowance for an appropriate defensive action on their part.

Those who might suggest an alteration of the parity in the interests of our balance of payments are likely to argue on the following lines. During the Second Five Year Plan domestic prices have risen by nearly 35 per cent (average of wholesale price index numbers for 1960–61 compared with that of 1955–56). Even if allowances are made for a part of the price rise being in the nature of a correction to an unusual price fall during 1954–55 and 1955–56, and for a part being in conformity with rise in prices in world economy, there is still a substantial portion of the price increase during the Second Five Year Plan that can only be regarded as of inflationary origin. This price rise has made the parity fixed in 1949 unrealistic. An idea of the extent to which this has happened can be obtained by comparing price increases in India with those in other important countries. By expressing the index number of prices in India for a given year as a percentage of the price index number for a particular country and adjusting for the changes in the par value of the currency of the country we get an index of over-valuation of the Indian rupee. The following table shows that in terms of this index such over-valuation varied between 3 and 28 per cent for 1961.

Over-valuation/under-valuation ratio of Indian Rupee vis-a-vis main Currencies Abroad
(Based on wholesale prices)

Source: International Financial Statistics

Country	(1953 = 100)						
	1955	1956	1957	1958	1959	1960	1961
U.K.	84	91	94	94	97	103	104
United States	87	93	96	96	100	108	112
Mexico	101	109	110	106	110	112	117
France	89	95	99	103	122	127	128
West Germany	86	94	98	98	104	108	103
Italy	87	95	100	103	111	119	122
Switzerland	86	94	98	102	109	115	120
Australia	85	92	96	99	103	104	112
Japan	89	95	98	106	110	115	115

N.B. The Indian wholesale prices have been expressed as a percentage of the foreign wholesale prices.

The argument then would be that this domestic price rise has inhibited India's exports. During the Second Five Year Plan India's export performance was not too good. Though the Plan target was slightly exceeded in terms of value the quantum of exports in 1960–61 was only about 3 per cent higher than that in 1955–56. A part of this indifferent performance of exports was due, no doubt, to the impact of recessionary tendencies in the world economy during 1957–59. However, even when these disappeared exports failed to show any spectacular improvement.

Moreover, it would be argued, such improvement in exports as has taken place since 1958–59 has required the assistance of a number of special devices like the bilateral trade and payments agreements with the East European countries and the various aids and incentives given to exports. These devices generally resulted in a

certain amount of distortion of the normal pattern of trade. They do not provide a permanent solution of the problem of exports which is uncompetitiveness due to high prices. The remedy to this would be to adjust the parity. In further support of this suggestion it would be argued that such a remedy is particularly relevant in connection with the exports of products of new industries. Often these industries have a high cost structure in their initial stages. The scale of operations is not large enough, the degree of skill is low and so on. They have, therefore, little incentive to export especially as the domestic market, which is sheltered by severe import restrictions, exerts a great pull on them. One way of making exports of these items attractive would be to adjust the parity. Since these products are sold in highly competitive markets they have fairly high price elasticities. An adjustment in their foreign prices would be more than recouped by increased sales.

The argument could be extended to the invisibles account also. Receipts on invisibles account have in the past few years progressively dwindled. Some part of this diminution can be attributed to special factors such as restrictions placed by other governments (for balance of payments reasons) on remittances to India, and a decrease in maintenance remittances to families of emigrants when the families also migrate. But, by and large, the decrease is due to the possibilities of acquiring far more rupees by selling foreign exchange in the free markets, where the rupee is quoted at discounts ranging upto 35 per cent, than through official channels. An adjustment of the parity would bring back some of this foreign exchange to official channels.

Moreover, as regards control on imports and other payments it could be argued that if there were a proper adjustment of the parity it would not be necessary to maintain control with such a high degree of restrictiveness as at present. The demand for imports would be restricted indirectly as a result of the higher costs of imports. Along with a reduction in the degree of restrictiveness there would also be less need to alter the detailed commodity composition of imports through control. Similarly, in the case of some payments like foreign travel, the increased cost would exercise a check of its own.

This would be the core of the argument. It has been spelled out in some detail in order to enable a proper appreciation of it. It would be seen that as it stands it looks fairly formidable at first sight. The facts regarding prices and exports can hardly be disputed. However, the real question is, is this the only proper remedy to the situation? An adjustment of parity is indeed a grave step. It is capable of doing serious mischief to a country's economy if it is ill-conceived, as it undermines the confidence in the currency to some extent. Moreover, it has to be accompanied by a series of complementary measures so that the full benefit of devaluation can accrue to the economy. Chief amongst these are measures which will counteract its possible inflationary consequences. Before we discuss this question it might be advantageous to dispose of the arguments concerning the utility of a parity change in relation to imports and other payments in our present context.

As far as restrictions on imports and other payments are concerned, they perform two basically distinct functions. In the first place they are designed to restrict the use of foreign exchange. But more important than that in the present context is their function of rationing foreign exchange among the different uses. For instance, foreign

exchange is severely rationed for importing consumer goods. This is in line with the principle that in a period of rapid investment it is necessary to restrict the use of resources for domestic consumption. The uses for which foreign exchange is made available are those which are considered essential in the context of our development Plans. In other words, in this sense they become a part of the whole apparatus of planning. The object in working out these restrictions is to ensure investment projects getting foreign exchange according to their order of priority. Since the priorities change from time to time depending on the availability of domestically produced goods a certain amount of change in details of commodity composition of imports is inevitable. It is, therefore doubtful whether except in some marginal cases a change in parity will succeed in reducing the degree of restrictiveness or the frequency of change in controls in this sphere.

We now come to the discussions of the arguments relating to exports. Now there is a general consensus of opinion that where exports have become incompetitive due to inflationary tendencies in the domestic economy, the first priority should be given to checking these tendencies rather than to an adjustment of the parity. It follows that a really effective argument against an adjustment of the parity has to proceed from the assumption that all the necessary steps will have been taken in this regard. At this point one can refer with some satisfaction to the fact that the continuously accelerating price rise which was such a disturbing feature of the Second Five Year Plan has been halted for the best part of a year now. In other words, to the extent the arguments for an adjustment in parity are based on an assumption of continued price inflation, they now apply with much less force. However, the relative price stability enjoyed so far should not lull us into slackening our efforts in this matter. For, the course of prices is still too much dependent on the agricultural situation and although considerable efforts have been and are currently being made to reduce the dependence of agriculture on the vagaries of the monsoon, the situation is still liable to go out of gear.

The size of the overall government deficit and more particularly the manner of its financing are other main targets of criticism. The taxation proposals in the Government of India Budget for 1962-63 would to some extent reduce the force of this criticism. It would be still better if the State Governments also showed equal awareness of their responsibilities and did their share of raising resources through taxation. The resort to deficit financing (net total Reserve Bank credit to the Government) during 1961-62 has been of the order of Rs 166 crores. The figure for overall bank financing of Government deficit during the same period is Rs 210 crores. It will be necessary to restrict the quantum of such finance so that the target specified in the Plan of Rs 550 crores is not exceeded. Any slackening of effort in this direction would only strengthen the case for a change in the parity. There is also the point about the cost of such finance—particularly in relation to its cost to the private sector. It could, of course, be pointed out that in recent years there has been a certain amount of leveraging up of yields on Government debt. Further determination along the same lines would clearly be necessary.

As far as monetary policy is concerned, the record so far has been well appreciated by bodies, such as, the I.M.F. and the I.B.R.D. The Bank has in its armoury a wide array of weapons to meet the needs of the situation. Besides, there are the proposals

relating to the maintenance of minimum standards of liquidity by banks which will enable still greater control on bank credit extension.

Given a right 'mix' of taxation, government debt and monetary policies and with satisfactory behaviour on the part of the weather, there is no reason why the price stability achieved in the recent past should not be maintained. As far as exports as such are concerned, the performance during the first year of the Third Five Year Plan has been promising. Exports during 1961-62 are estimated at Rs 660-665 crores (E.C.D. data), an increase of Rs 28-33 crores or about 5 per cent over the previous year. More important, the performance in each of the three quarters of 1961-62 for which data are available has been definitely better than in the corresponding quarter of the previous year.

Quarterly Exports (f.o.b.; Rupees crores)
(E.C.D. data)

	1960-61	1961-62
April-June	153.6	160.0
July-September	146.7	160.3
October-December	171.6	179.7
Total	471.9	500.0

Analysing exports commodity-wise it is easily seen that except for groundnut oil in which Indian prices have generally always been high and cotton textiles, which are subject to extremely keen competition as well as discriminatory restrictions in several developed and under-developed countries, a number of commodities have done a little better than last year.

Commodity Composition of Exports
(D.G.C.I. & S. data; Rupees crores)

	1960-61	1961-62
Tea	124	121
Jute Manufactures	134	140
Cotton Textiles	58	48
Raw Cotton	9	14
Vegetable Oils	9	6
Oil Cakes	14	17
Cashew Kernels	19	18
Coffee	7	9
Sugar	3	15
Ores	39	37
Hides and Skins and Leather Manufactures	34	34
New Manufactures and Others	183	203
Total	633	662

Since the improvement is fairly widespread it throws considerable doubt on the hypothesis of price resistance to India's exports as a whole which is at the root of the suggestion of alteration in the parity. As for the part played by special aids and incentives it may be mentioned that over the past two or three years the scope of these schemes in terms of percentage of exports covered has not materially altered. Including textiles they cover about 18–19 per cent of total exports by value. However, the incentives for textiles are reported to have been of not much value. Excluding this item they cover only 8–9 per cent of the exports. It must be admitted, however, that a sizeable part of the improvement in exports in 1961–62 is attributable to the bilateral trade and payments agreements. The D.G.C.I. & S. data indicate that exports (including re-exports) to the East European countries increased from Rs 49.6 crores in 1960–61 to Rs 63.7 crores in 1961–62.

While a change in parity does not appear necessary to prevent a fall in exports brought about by price-resistance—exports have on the contrary increased albeit moderately—it might still be urged that on a longer-term view of exports an adjustment now may prove beneficial. Three general observations need to be made in this connection. First, it must be recognised that the scope for expansion of exports through cheapening them to the foreign buyer is governed (a) by obstacles placed by importing countries in the way of these exports and (b) by the supply and demand factors. The obstacles consist of straightforward quota restrictions and discriminatory tariffs and internal duties having a similar effect. A list of some of the important of these is given in the appendix. Since in several of the important industrial countries there is a strong prejudice against allowing imports of manufactured items from low income countries, it is obvious that attempts to further cheapen them would merely be wasted on them. As regards exports to the under-developed countries the difficulty is that in many of them their own development plans are designed to produce goods of the type we are able to export. Any measures to reduce the cost of our exports to them are, therefore, not likely to yield fruit as they would be met with appropriate restrictive measures on the part of these countries. Second, the major proportion of India's exports are based on agriculture. Here the main problem is not so much one of price incentives as of stabilising and securing a steady rate of growth of agriculture. In the case of jute manufactures, for instance, the output of raw jute has fluctuated in the past from 29 lakh bales in 1954–55 to 63 lakh bales in 1961–62. Lack of attention in the matter of price policy for raw jute has been one of the most important factors responsible for this enormous range of variation. The part played by weather too has not been insignificant. The production of cotton is another case in point. This again has varied from 29 lakh bales in 1950–51 to 54 lakh bales in 1960–61, and has made it difficult to adopt a stable export policy for raw cotton. It also introduces fluctuations in prices of cotton textiles. Besides the uncertainties of Indian agriculture, transport and other bottlenecks are much more significant than prices in a number of important items. Third, even if it can be established that a cheapening of exports would result in larger foreign exchange receipts, an alteration of parity is not the only way to achieve it. The use of appropriate production and price policies coupled with a judicious use of excise duties can achieve much the same result.

These general considerations apart it will be useful to spend some time on the commodity composition of our exports in relation to the Plan targets. The Plan envisages total exports of Rs 3,700 crores or an average of Rs 740 crores per year. Since exports in the first year of the Plan are estimated to have been of the order of Rs 665 crores, for the remaining four years of the Plan exports have to total Rs 3035 crores or an average of Rs 760 crores per year. An important assumption in the Plan was that the invisibles account would completely balance itself. This assumption has to be changed to one of a net deficit of invisibles of the order of Rs 250 crores during the Plan period. Failing a rise in external assistance of that order, this deficit will have to be distributed between further cuts in imports or increase in exports. However, in what follows we have not taken this into account and confined ourselves to the original target.

The commodity breakdown of the export target is not available in the published Plan. The figures in the following table are, therefore, taken from Exports in the Third Plan—Programme and Measures prepared for the Cabinet by the Additional Secretary, Planning Commission. This table shows for the several commodities (i) the actuals for 1961–62, (ii) the Plan annual average and (iii) the shortfall or the excess for the Plan as a whole if the 1961–62 rates are maintained.

India's Exports of Principal Commodities during the Third Plan Period (Estimates)
(Rs crores)

	Actual Exports in 1961–62	III Plan Target (annual average)	5 years' exports at the rate of 1961–62 actuals	III Plan Targets (total exports during 5 years)	Shortfall(–)or excess (+) (based on exports at 1961–62 actuals)
Tea	121	140	605	700	–95
Jute Manufactures	140	121	700	605	+95
Cotton Textiles	48	65	240	325	–85
Raw Cotton	14	10	70	50	+20
Vegetable Oils	6	22	30	110	–80
Oil Cakes	17	24	85	120	–35
Cashew Kernels	18	22	90	110	–20
Coffee	9	12	45	60	–15
Sugar	15	5	75	25	+50
Ores	37	52	185	260	–75
Hides & Skins and Leather Manufactures	34	30	170	150	+20
New Manufactures and others	203	262	1015	1310	–295
Total	662	765	3310	3825	–515

It is not possible to discuss in detail the prospects of reaching each of these targets. However, a few brief observations in respect of the important ones would be useful to understand the nature of the problem.

Tea: Given favourable weather conditions there are not many difficulties as regards increasing domestic production. Even then it seems rather difficult to attain the export target. This is so because of the competition from other countries. It is of course assumed here that any price incentive that may be given by us is bound to be matched by appropriate incentives to their tea exports by other countries.

Jute Manufactures: The performance of jute manufactures during the current year has been quite satisfactory. It must be remembered, however, that a part of this was due to the rather high prices for jute manufactures obtaining during the early part of last year. However, one promising feature of the situation is that raw jute prices, which, thanks to a very good crop, have receded from the high levels of last year, will from now on be stabilised through the operations of the buffer stock agency in such a way as to assure a steady supply of the raw material to the industry. Assuming a reasonable degree of success in these operations and appropriate response on the part of the industry one can hope for a good export performance in respect of jute manufactures. It does not look as if jute manufactures are in need of a price incentive at this stage. However, one has to take into account the actions by Pakistan in respect of her export incentive scheme and planned increases in productive capacity of which pose a serious threat to us. Any price incentive that we may give will, of course, be matched by Pakistan.

Cotton Textiles: As regards cotton textiles, the future is not very hopeful. A price incentive may have only a limited effect in view of the reluctance of industrialised countries to allow substantially larger exports of textiles from countries, such as, India, the ever-growing competition from other countries in our export markets and the import restrictions which one can expect from under-developed countries to which we are at present exporting and which may begin their development with the establishment of textile mills.

Raw Cotton: During 1961-62 exports of raw cotton have been quite satisfactory. The real problem here is that of organising raw cotton production in such a way that a sufficient and steady volume of raw cotton exports will take place. For this purpose it would be necessary to make up our mind and announce a quota much before the annual crop comes in. Since these exports are of a special type of cotton, it is not really necessary to give any price incentive to this commodity.

Ores: Here the difficulty is one of inelastic supply in the wider sense of the term, i.e., production of ore and its transportation to the export points. A price incentive is, therefore, not of much help.

Vegetable Oils: In these items we are priced out of international markets. The reason is the high domestic demand. It appears, however, that rather than give a price incentive in the export market, which is likely to be negated by a further rise of prices in the domestic market, it would be necessary to give priority to the production of oilseeds.

Oilcakes: Much the same comment applies to this commodity also.

Coffee: Normally there should be no difficulty in reaching the target for coffee except for the fact that the international price of coffee is highly variable.

Sugar: As far as sugar is concerned, more than the export target was reached even in 1961–62. However, this was achieved only with the help of heavy subsidies. The effect of a parity change will mainly be to alter the amount of subsidies. It is not likely to result in substantially greater exports.

Hides and Skins: As regards hides and skins, the difficulty is mainly one of inelastic supply. The item does not require any price incentive as the demand is quite strong.

New Manufactures: It will be seen from the table that the Plan places a major reliance for achieving the overall export target on increase in exports of this group, which consists mostly of products of newly established industries. In many cases the costs are rather high because of initial difficulties, the scale of operation being small, etc. These are also items the exports of which have to be made in highly competitive markets. There is competition not only as regards prices as well as credit facilities but also in such matters as packaging, advertising, etc. Besides, there is the problem of overcoming brand name resistance. As regards credit facilities appropriate steps are being taken through the agency of the Refinance Corporation of India to provide the necessary credit facilities. However, in view of the other factors mentioned it is obvious that a mere price incentive will not be adequate.

The sum and substance of this brief examination is that a price incentive, provided by a change in parity, has a somewhat limited role to play in the present context of our export problem. The more important need of the hour is to devote attention to the supply side of the picture. Since a large proportion of exports is agriculturally based, it is essential to ensure that the agricultural part of the Plan is successful in raising the output, particularly of those crops which have an important bearing on exports.

The arguments in the foregoing paragraphs may be summed up as under:

- (i) During the Second Five Year Plan prices showed a rise of 35 per cent while exports remained more or less static. However, in the first year of the Third Plan both these trends were reversed; prices have showed a welcome degree of stability for the best part of a year and exports have shown an improvement of some 5 per cent over the previous year's level. The part played by special export incentives in this improvement appears to be marginal.
- (ii) As far as the fiscal and monetary policies are concerned the authorities have shown a determination to hold inflationary pressures in check. More could and should be done in this direction.
- (iii) Insofar as the case for a change in parity is based on an assumption of continuing inflation it loses a considerable amount of its force in view of what has been stated in (i) and (ii) above.
- (iv) The kind of price incentive a change in parity offers is for a number of reasons likely to be of a limited benefit only to our exports. For, in the first place, several of them are subject to quota and tariff restrictions. The price advantage that a parity change can give is likely to be neutralised by obstacles of this type. Secondly, as our exports are heavily dependent on agriculture, it is the supply side of the picture that needs to be set right. Thirdly, in a number of cases success in exports depends upon

success in removing various bottlenecks, such as transport and power, or upon developing the requisite skill in packaging, advertising, salesmanship, etc.

(v) Finally, a change in parity is not the only way of giving a price incentive to exports. The same effect can be achieved through appropriate production and price policies. The latter type of measures are preferable to the former as not only do they not have the adverse psychological effects which a change in parity brings about but what is more important is they are the basic determinants of the success of the Plan. A change in parity should be regarded as a measure of the last resort to be adopted when costs have become so high and rigid that it is the only way left to bring about the desired changes in the balance of payments or alternatively when similar action on the part of a country's competitor threatens its balance of payments.

[V.G. P(ENHARKAR).]

11.6.1962

APPENDIX

Quota restrictions in certain overseas markets of India

(Mainly European & American)

Cotton Textiles: There is a voluntary ceiling on imports of cotton textiles of 195 million sq. yards for the year 1962 into the United Kingdom. France, West Germany and Austria are the other three countries who impose import quota restrictions on cotton textiles. They are as follows:

France: upto 1200 tons

West Germany: 5 million D'marks

Austria: 125 tons

Vegetable Oils: Quantitative restrictions—Government controlled imports, mixing regulations and other non-tariff devices are in force in West Germany, France and Italy. Imports of castor oils restricted by Belgium and Netherlands.

Carpets: Quota restrictions in France.

Sewing Machines: Quota restrictions in France and West Germany.

Coir Manufactures: Quota restrictions in France and West Germany.

Cashew Kernels: Indirect restrictions in Italy to support almonds.

Spices: High revenue duties. Quota restrictions in France for pepper.

Tobacco: (i) High revenue duties.

(ii) Monopoly purchases in France and Italy.

Jute goods: In most cases of Common Market countries, apart from Benelux, they enjoyed the benefit of a highly protected home market. Italy, however, relaxed import curbs considerably during 1960 and West Germany will end all quantitative restrictions after 1964.

Although the duty is 'nil' in the U.K. for imports from India, the Jute Controller, who is the sole importer for certain types of jute goods applies a uniform mark up of 20 per cent in respect of common hessian cloth (40" 10 oz. hessian in 40" at 36" widths and 45", 11 oz. hessian in 45" width used for making bags, are still subject to a mark up of 40 per cent).

SECRET

BOMBAY

December 7, 1964

D.O.No.[...]

Agrahayana 16, 1886

My dear Krishna Moorthi,

This is in continuation of my talk with you regarding Anjaria's cable dated 24th November on the subject of quota increases and gold subscriptions.

While I agree generally with the line of action proposed by Anjaria in paragraph 12 of the cable, I would suggest the following modification. We should announce like the U.S.A. that even if a waiver is granted, we would be prepared to pay 25 per cent of our quota increase in gold subscription. This should not be difficult with the stock that Government has at its disposal. Our argument for a complete waiver of gold subscription can then be made to appear as a disinterested and objective argument based on the merits of the case.

Outright payment of gold by us at this stage has, in my view, several advantages. Firstly, it would strengthen our position as a member of the First Five on the Fund Board. Secondly, it would help us as regards the tranche position and therefore as regards a drawing on the Fund. This should be of considerable help to us in the immediate future if we have to undertake next year an operation of the 1961 type to fulfil our current repurchase obligations. Moreover as I have already said above, our advocacy of the use of Article III, Section 4(a) would be strengthened when it is known that we ourselves are not interested in availing of it, but it may help us on the next occasion of a quota increase. If Government agrees with this line, would you kindly issue the necessary instructions to Anjaria and send a copy to me? I shall not send anything to him from here.

With kind regards,

Yours sincerely,
P.C. BHATTACHARYYA

Shri C.S. Krishna Moorthi
Joint Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

GOVERNOR

RESERVE BANK OF INDIA
CENTRAL OFFICE
Camp: NEW DELHI
March 4, 1965

Dear Mr. Schweitzer,

I am afraid we have run into a little snag in our negotiations regarding our proposed request for a standby arrangement with the Fund. I would have myself come to Washington to represent our point of view to the Management. But both my wife and I are not keeping well so that it is rather difficult for me to leave India at short

notice. I am taking this opportunity, therefore, of writing to you and I am requesting I.G. Patel who has been associated with the discussions here with the Fund team to meet you. He will be able to answer any questions that you may have.

2. Our approach in these negotiations from the beginning has been that we should ourselves take whatever measures are necessary in our own interest and that we welcome assistance from the Fund in this respect. Accordingly, we welcomed the suggestion of the Fund team that apart from the fiscal and monetary measures we have already taken—including higher interest rates, a balanced budget, general fiscal restraint on imports and promotion of exports—we should have a monetary budget to guide our course of action during the coming months. We were able on this basis to work out a mutually agreed programme with the Fund team. We also agreed that since we ourselves would want to adhere to policies which we consider in our own interest, there might be a clause in the standby agreement that we should consult the Fund in case unforeseen circumstances lead us to depart from any of the policies or intentions outlined in the letter of intent and that, if necessary, we would arrive at fresh understandings before making further drawings.

3. We were given to understand, however, that we must specifically undertake in the standby agreement to consult the Fund and refrain from further drawings if the credit ceilings mentioned as part of our intentions in the letter of intent are exceeded at any time. Our view is that while we would consider any such eventuality as a shift in policy calling for consultations and renegotiation of understandings, if called upon, a direct link between credit limits only and further drawings would be unfortunate.

4. In the ultimate analysis, relations between the Fund and its members have to be based on mutual trust and the policies that the Fund considers appropriate can be made acceptable only to the extent that member countries consider them as their own rather than those stipulated by the Fund as a precondition to drawings. As you can well imagine, there is criticism here that some of the measures we have taken must be at the request of the Fund and political susceptibilities within member countries cannot be ignored when, as in our case, the Fund and the member are agreed on the substantive issue. In the present standby, we have agreed to go much further in our letter of intent than we had done in the past; and we are rather at a loss to understand why a specific binding in regard to credit ceilings is considered more important than our express intention to consult and come to mutual agreement regarding further drawings, if required, whenever a shift in any aspect of policy outlined in our letter of intent becomes necessary.

5. There is also a further point about the phasing of the standby. We ourselves would not like to draw more than is absolutely necessary and we are prepared, in view of the latest trends in reserves, to agree that we would not draw more than \$125 million before the end of April, 1965. But, if as is suggested, we cannot draw more than \$125 million before the end of May, the very purpose of the standby is likely to be defeated as we cannot be sure that the present position in which we are just able to avoid suspending legal foreign exchange reserve requirements will not appear again in May. From the point of view of restoring confidence also, it is desirable that we have a little more freedom in drawing than what might be absolutely necessary in relation to our minimum foreseen needs.

6. We are deeply conscious of the helpful spirit in which the Fund management and staff have approached our proposed request for a standby. But perhaps the importance of the point of view I have mentioned, viz. that the policies being adopted by a member in its own interest should not be made to appear as if they are stipulated by the Fund as a precondition to drawing, might not be fully appreciated from a distance. I have every confidence that you would suggest an arrangement which would meet our point of view as well as the requirements of the Fund.

With best regards,

Yours sincerely,
P.C. BHATTACHARYYA

Mr. P.P. Schweitzer
Managing Director
International Monetary Fund
Washington D.C.

TOP SECRET

Discussions with the I.M.F. and the World Bank
(February 1 to 8, 1966)

Dr. I.G. Patel and I visited Washington D.C. to explore the possibility of a drawing from the International Monetary Fund and to discuss in a preliminary way with the World Bank the time-table for meetings of the Aid-India Consortium. We had a clear brief for our discussions with the Fund. As for the Bank, it became clear very soon that a Consortium meeting to consider our needs for the Fourth Plan could not take place before the autumn of 1966. It was also doubtful if our requirements for 1966-67 could be considered earlier in their entirety. Accordingly we decided to explore with the Bank whether an approach could not be made to the leading members of the Consortium during the next few weeks regarding some relief in respect of our heavy debt repayment obligations to them during 1966-67 so that we could have a better basis on which to frame our policy for import licensing for the coming fiscal year.

2. Mr. Schweitzer, the Managing Director of the Fund, was most anxious to help from the outset, particularly in view of the fact that the drought has added to our balance of payments difficulties. However, in view of the opposition he had met from the Fund Board in the past—particularly in respect of a drawing from the U.A.R.— he was hesitant to commit himself to a normal drawing by us without a fundamental reform of our exchange system. He accordingly proposed at first temporary relief to us in the near future to be followed by a substantial line of credit of the order of 300 to 400 million dollars at a later stage on the basis of an agreed programme in regard to fiscal, monetary and exchange policies. The temporary relief could take two alternative forms, viz., postponement of the repayment of \$75 million due in March to July or a credit of \$100 million or so to be repaid in one year. Even this temporary relief, Mr. Schweitzer argued, will have to be justified as emergency relief to meet the difficulty created by the drought. A normal drawing or standby would not be feasible as our

budgetary and general monetary outlook was not such as to commend itself to the Fund Board.

3. We resisted these suggestions and argued in favour of a normal drawing in the near future for a number of reasons. A drawing repayable in one year as distinct from a drawing repayable normally within three to five years was not consistent with our status as one of the Big Five in the Fund; and, like the postponement of \$75 million till July, a short-term drawing might raise speculation regarding our future intentions. We were also not in favour of linking a fundamental reform of the exchange system with a drawing from the Fund in view of the fact that this matter had received considerable comment in the Indian press. While our needs were larger than the drawing of \$200 million requested, we were not in favour of a large drawing from the Fund, as in our circumstances, we needed long-term money for import liberalisation. It was for this reason that we were discussing simultaneously the question of postponement of some of our debt obligations with the Bank. At the back of our mind, there was also the consideration that agreement with the Fund on a programme relating to fiscal and monetary matters might prove difficult as long as we have not been able to make satisfactory arrangements to ensure greater fiscal discipline on the part of the State Governments. We, therefore, pressed strongly in favour of a straight drawing or standby in the near future for an amount of approximately \$200 million.

4. It is, I think, mainly a reflection of the goodwill and statesmanship of Mr. Schweitzer that ultimately he agreed to recommend to the Fund Board a straight drawing on our part in the near future. The preference for drawing rather than a standby is in view of the fact that we were not in a position to agree to any quantitative ceilings on the budgetary deficit or on monetary expansion. The drawing will have to be justified essentially in terms of the impact of the drought on the balance of payments. It will be a normal drawing repayable within three to five years. Mr. Schweitzer, however, was unable to indicate to us the exact amount of the drawing as he wished to consult the Executive Directors from important countries before making up his own mind. He indicated that the drawing will be larger than \$125 million which we have to repay to the Fund between now and July 1966. While he was unable to commit himself at this stage to a drawing of \$200 million, he assured us that he would like to see that we were left with a sufficient margin after meeting our dues to the Fund. We can, therefore, reasonably expect a drawing of the order of \$150 or 175 million if not \$200 million. The exact amount will be made known to our Executive Director Mr. Anjaria in a week or two.

5. Our request for the drawing will have to be made as usual in the form of a letter from the Finance Minister to Mr. Schweitzer. Apart from justifying our needs for an immediate drawing in terms of the effect of the drought on the balance of payments the letter should specify the policies we are pursuing to deal with our agricultural, fiscal and monetary problems. We will also have to say that we recognise that we have a continuing foreign exchange problem, that we are examining ways and means of solving our chronic difficulties and that we propose to remain in continuous touch with the Fund in our search for an enduring solution.

6. It would also be necessary for our Executive Director to inform Mr. Schweitzer

orally at the time that he transmits our formal request for a drawing to him that the Government of India have decided in favour of a formal change in the par value of the Indian Rupee to be made in June 1966. In view of the brief already given to me, I have authorised Mr. Anjaria to make the necessary statement orally to Mr. Schweitzer at the appropriate time. After the drawing but well before June, Mr. Schweitzer would also like us to discuss with him and the Fund staff the question of the adequacy of the measure we propose to take in June and the accompanying adjustments we propose to make in fiscal and other related matters. I have agreed that we shall do so.

7. On this basis we can count on a drawing from the Fund in March 1966. If need be, we could also request the Fund for another drawing later in the year. I have kept the door open for such a request to guard against the possibility that our attempt to refinance debts and to get other aid that we need may not succeed to the extent desired.

8. The suggestion was made that we might repay the \$75 million due in March a little earlier—say, three or four weeks before the drawing; and I have agreed that we shall be prepared to do so if the Fund informs Mr. Anjaria that this would be desirable.

9. Throughout our discussions, the Bank and the Fund were in continuous touch with each other. At first, there was some question whether the Bank or the Fund should take the initiative regarding the refinancing or postponement of our debt obligations. It was, however, agreed that the Bank will take initiative in this regard. The bulk of our debt repayments next year are due to the World Bank, the United States, the United Kingdom, West Germany, Japan and Canada—i.e. the original members of the Aid-India Consortium. It was also agreed that the approach should be made to only these countries as inclusion of other countries to whom we owe smaller amounts might raise unnecessary arguments. There was also some question whether the refinancing should be in respect of repayment of principal only or should include interest repayments as well. We have suggested that, to the extent possible, we would like both principal and interest to be covered in any arrangement for postponement or refinancing. Our preference is also for new loans which would enable us to repay the amounts due rather than an actual postponement of the amounts due. What is feasible, however, would only emerge in the course of discussions with the countries concerned. I was assured that it was not the intention of the Bank to insist on a uniform response from all the countries.

10. We also put it up to the Bank that although our obligations to the Bank cannot be refinanced directly, the Bank should consider giving us a loan for the import of industrial components and materials, as such a loan would serve the same essential purpose as refinancing, namely, that it will enable us to import on a more adequate scale. It was agreed that the World Bank would give us a loan of \$50 million for the import of industrial components, particularly for capital goods industries. This would be in addition to normal Bank financing of this nature. The figure of \$50 million represents the amount we owe to the Bank in 1966-67 by way of repayment of principal. The loan will be on terms which will avoid any repayment obligations during the Fourth Plan.

11. As for the five countries mentioned earlier, the Bank has agreed to get in touch with the Governments concerned immediately to explore the possibility of debt

refinancing or postponement of debt obligations. Simultaneously, we ourselves should also get in touch with the Governments concerned through their representatives in New Delhi to explain what we are after. After the preliminary soundings of the Governments concerned, the Bank will either convene a meeting of the representatives of the five countries to secure the necessary pledges or advise us to open bilateral negotiations with the Governments concerned.

12. In a general way, we also discussed with the Bank our requirements for assistance in all forms during 1966-67. In a sense, we need immediately assurance not only in regard to debt refinancing but also in regard to non-project assistance as well as assistance for continuing projects where this has not been already fully arranged. While assistance for taking up new projects may not be considered before the full-fledged consortium for the Fourth Plan as a whole which may not take place till the autumn of 1966, it may well be that an earlier meeting of the Consortium will be necessary to consider our total requirements for 1966-67. We have advised the Bank that, apart from debt refinancing, we would need non-project assistance for 1966-67, at least on the same scale as in the recent past and that we shall consult them further on this point when the debt-refinancing problem for 1966-67 is out of the way.

13. We have given the Fund and the Bank such information as was readily available with us. The Fund has, however, given us a questionnaire to which replies have to be sent in the near future. The Bank will also send a similar questionnaire as soon as possible. They have, however, indicated to us that they will require information from us not only in regard to debt repayments but also in regard to our general balance of payments position in 1966-67, the impact on the economy and on the level of imports of debt refinancing and any other relief we get simultaneously from the Fund, and an explanation of why any relief thus secured without a corresponding relief from the Soviet Union and other East European countries would not work to the detriment of consortium members. Above all, the impact of the emergency on balance of payments will have to be clearly spelt out. While we have given tentative answers to all these questions, more formal answers will have to be given in the near future.

14. It remains for me to say that both Mr. Schweitzer and Mr. Woods were extremely friendly and sympathetic. But for their determination to be helpful to us and to override the objections of their own staff, we would not have been as successful in our negotiations as we have been. We have reason to believe that apart from the assistance from the Fund on the scale already indicated, we shall also be able to have a significant part of our debt obligations for the next year postponed or refinanced.

P.C. BHATTACHARYYA
12.2.1966

D.O.No.[...]

September 12, 1966

TOP SECRET

My dear Bhoothalingam,

This is with reference to your D.O.No.[...] dated [...] regarding the problem of insulating our Sterling balances against any unilateral action by the U.K. As desired by you, a self-contained note containing a description of the present position etc. has been prepared and is enclosed herewith.

The broad conclusion of the note is that the action we have taken recently has resulted in a considerable running down of the Sterling component of our foreign exchange reserves and to that extent has reduced the importance of the problem of any unilateral action on our foreign exchange reserves. Sterling balances are now less than 50% of these reserves whereas in recent years they used to be 70-85%. This trend will continue so long as the arrangements referred to also continue.

An attempt has been made in the note to assess the prospect during the rest of the financial year. In the absence of details regarding foreign exchange budget prepared by Government from time to time this assessment is rather incomplete. On the basis of such information as is available with us in the Bank, it seems to me that we have now come to a stage where the highly liquid portion of our Sterling balances e.g. cash and Treasury Bills are in fact inadequate to meet the expected net outgo during September to November. According to our calculations, payments in non-Sterling currencies during this period are likely to amount to as much as Rs 27.6 crores while payments in Sterling would be Rs 66.5 crores. In terms of the present policy of meeting all payments obligations from the Sterling balances, therefore, this would involve some liquidation of the holdings of the dated securities whether by us or by the High Commission and in fact we have already initiated some action to liquidate a small portion of our dated security holdings.

To meet the payments liabilities during September to November of Rs 27.6 crores in non-Sterling currencies, the best way would be to convert the requisite amount of Sterling in the spot market into dollars or the actual currency required for repayment. This operation should be spread over a period of three to four weeks. Unless the U.K. position deteriorates very seriously, there may not be much opposition from the U.K. authorities to it.

As to the commitments in non-Sterling currencies during the period December-March, there is considerable amount of difficulty. The normal way to make arrangements for such payment would be to buy the required currencies forward. However, at this juncture the U.K. authorities would be considerably perturbed if we were to make purchases in forward market of such large amounts. There is a dilemma here. If the unilateral action by the U.K. is expected to come in the immediate future, then the transaction would be too large even to be handled through the market let alone the question of its being acquiesced in by the U.K. authorities. But even if it were possible to put it through the market there is still the question whether the U.K. authorities will allow it. In fact, I understand that they have already taken action to check the pressure on forward Sterling by directing all foreign exchange dealers to bring about a sharp reduction in their holdings. of

foreign currencies. This would reduce their ability to take up bear positions. This is a departure from their earlier practice of controlling the forward market through judicious intervention. In other words, from a market device they have moved on to a more direct control. I doubt, therefore, whether they will agree to our purchasing such large amounts of forward dollars. Insulating our holdings in the form of securities poses an even greater degree of difficulty for here there is the problem of liquidation of the securities in an orderly manner so as not to incur excessive capital loss, as well as the problem of insulating the value of the Sterling proceeds through the forward market.

My view, therefore, is that we may continue the present policy and try to insulate as much of the non-Sterling commitments as we can through the spot market as possible taking care at the same time not to upset the market. The first action should be to transfer Rs 27.6 crores required to meet non-Sterling obligations from September to November. Thereafter balance Sterling available in liquid form should be so transferred. In addition, proceeds of such of the securities that can be liquidated without attracting notice could also be transferred to U.S.A. and invested there. If you agree, I suggest that you initiate action on this behalf.

It will not be advisable to force the pace too much. Even if we are left with some Rs 100–115 crores worth of Sterling on which we have to take a loss in the event of any unilateral action, such Sterling could be utilised to make payments within the Sterling area. In fact, because of the responsibility placed on the Reserve Bank of India under Section 40 of the Reserve Bank of India Act and the order made by the Government under it the Bank is required to buy or sell spot Sterling from any authorised person in India and therefore it requires a fairly large working balance in order to be able to do this. Such a position is likely to continue because of certain natural factors irrespective of whether the U.K. takes any unilateral action or not.

Before concluding this letter I should like to say a word or two about the Sterling area arrangements as well as the legal and other responsibilities of the Reserve Bank in the matter of foreign exchange reserves. As far as the Sterling area arrangements are concerned, it seems to me that their importance to us has diminished very considerably after the acceptance by the U.K. of the convertibility obligation under Article VIII of the I.M.F. and more importantly because of the steps we have taken in recent years to diversify our foreign exchange reserves. *Pro tanto* the significance of the understandings between ourselves and the U.K. would also seem to have diminished. This is not to say, however, that the U.K. authorities will not raise any questions at all regarding our current policy of conserving non-Sterling currencies and using Sterling for meeting non-Sterling obligations and thus causing a pressure on the Central Reserves. As they get more and more into a tight corner, they may try to persuade us to reduce our resort to the central reserves. If this is done, we may accommodate them upto a point as it certainly is not in our interest that the U.K. should take the unilateral action. We can afford to be a little accommodating because we have already reduced the proportion of our Sterling in our foreign exchange reserves to a small amount and we should normally have to make large payments in Sterling.

On the question of management of foreign exchange, it seems to me that both in terms of the law as well as in terms of the actual practice, it is the Government

which has the primary responsibility in this matter. Both under the Reserve Bank of India Act as well as the Foreign Exchange Regulation Act, certain obligations are placed on the RBI by the Central Government and it is the Central Government which has the powers to suspend them. Indeed, it appears that except for the foreign exchange that we hold in order to fulfil the requirements under Section 33(2) of the Reserve Bank of India Act regarding the assets of the Issue Department, all other foreign exchange is held by us on behalf of the Central Government in terms of the Foreign Exchange Regulation Act. This apart, the actual management of the foreign exchange is really done by the Government. The foreign exchange budget is prepared by the Government and the import licences and foreign exchange sanctions to various Government departments are given by the Government. We are not fully informed of the detailed break-up of such payments obligations to be in a position to make previous arrangements currencywise for payments. Further, the broad features of exchange control policy are also decided by the Government albeit in consultation with the Reserve Bank. Any shortfall in the foreign exchange is also made good by the Government through short- or long-term borrowing. Even as regards the week-to-week management of the Bank's foreign assets the mechanism of H.C.I.'s Special Investment Account and the ISM account is used by Government to absorb fluctuations and maintain them at a predetermined level. In view of all this, I think you will agree that it is only the Finance Ministry who can take a comprehensive view and decide on the appropriate line of action from time to time. We, of course, will continue to bring to the notice of Government any features in the world economic situation which, in our view, would warrant a review of the situation.

Yours sincerely,
P.C. BHATTACHARYYA

Shri S. Bhoothalingam
Economic Secretary
Ministry of Finance
Government of India
New Delhi

VII. THE BANK AND GOVERNMENTS

A. RESIGNATION OF B. RAMA RAU

PERSONAL

FINANCE MINISTER

INDIA

NEW DELHI

March 15, 1955

D.O.No.[...]

My dear Rama Rau,

As I explained to you personally, both the Prime Minister and I have come to the conclusion that it would be an advantage to call off the arrangements made about your relief. The Prime Minister will find it very difficult to spare Pillai. In the circumstances I felt that I should request you to continue as Governor for a couple of years more. You know what great importance we attach to the recommendations of the Committee of Direction: All-India Rural Credit Survey. You have been so closely associated with their work that I am quite certain it will be a gain from the point of view of both the Reserve Bank of India and Government if we could have your assistance when these recommendations are in the process of being implemented. This is, therefore, to request you in writing, as I have done so verbally, to agree to continue as Governor for a couple of years more. I have spoken to the Prime Minister about this and he agrees with me that you should be prevailed upon to continue. If this should necessitate any reconsideration of some of your present terms, we shall be glad to have your suggestions in the matter, but both the Prime Minister and I do hope that it will be possible for you to accede to this request.

Yours sincerely,

[C.D. DESHMUKH]

Shri B. Rama Rau

Governor

Reserve Bank of India

Central Office

Bombay

SECRET

NEW DELHI

D.O.No.[...]

December 12, 1956

My dear Rama Rau,

The Finance Ministry have sent me your letter dated 10th December addressed to H.M. Patel with which you have sent a memorandum issued by you on the 10th December to the Central Board of the Reserve Bank. In this memorandum you have examined the implications of certain provisions of the Finance Bill, 1956. I have read this memorandum with great surprise. Apart from the contents of the memorandum, the whole approach appears to me to be improper. It is, if I may use the words, an agitational approach against the Central Government. To address your Directors in this way seems to me extraordinary.

Further, it has also surprised me that you should refer in a memorandum of this kind to a private talk with the Finance Minister. I am told that the report of that talk is not accurate. But whether it is accurate or not, this kind of reference to a private talk in a memorandum of this kind appears to me to be against all conventions and practice.

When you talked to me, I pointed out to you that it was for the Central Government to lay down policies and the Reserve Bank could not obviously have policies contrary to those of the Central Government. You agreed with this. And yet I find in your memorandum a different viewpoint expressed.

The Central Government, as you know, is directing its policy to attain certain objectives laid down in the Five Year Plan. It would be completely absurd if the Reserve Bank followed a different policy because it did not agree with those objectives or with the methods of achieving them.

You have laid stress on the autonomy of the Reserve Bank. Certainly it is autonomous, but it is also subject to the Central Government's directions. The question of fixing the bank rate is a matter for the Reserve Bank to consider. The stamp duty proposed by the Central Government is not the same thing as varying the bank rate, although it has certain effects upon it. That decision in regard to stamp duty was taken by the Cabinet after full consideration and I cannot accept any plea that Cabinet should not do so till the Reserve Bank approved. It is certainly desirable that the Reserve Bank's views on such matters should be obtained for us to consider. In fact, even according to your letter, this matter was mentioned to you six days before the Bill was introduced in Parliament and you were asked to advise as to what the rate should be.

Monetary policies must necessarily depend upon the larger policies which a government pursues. It is in the ambit of those larger policies that the Reserve Bank can advise. It cannot challenge the main objectives and policies of Government.

There are apparently some sections of the business community who disapprove of our basic policies and who have in fact criticised them. They have every right to do so. But it is surprising that the Reserve Bank should encourage this criticism and indirectly participate in it itself.

Yours sincerely,
[JAWAHARLAL NEHRU]

SECRET
D.O.No.[...]

December 13, 1956

Shri H.M. Patel, I.C.S.
Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
Dear Sir,

I am directed to forward herewith a copy of the Governor's memorandum No.[...] dated the 10th December 1956 regarding the implications of certain provisions of the Finance Bill, 1956. This memorandum was discussed by the Central Board of Directors

at an emergency meeting held at Bombay on Wednesday, 12th December 1956. A copy of the resolution passed by the Board is also attached.

Yours faithfully,
Secretary

SECRET

No.[...]

MEMORANDUM TO THE CENTRAL BOARD

Implications of certain provisions of the
Finance Bill, 1956

Under Section 49 of the Reserve Bank of India Act, the Bank is required "to make public from time to time the standard rate (commonly referred to as the Bank Rate) at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act". A change in the Bank rate is one of the important methods by which the central banks of most countries control the credit structure and one of the most important statutory duties of the Board of the Reserve Bank is to determine this rate in accordance with market conditions and the state of the economy in general. The Committee of the Central Board of Directors, which has all the powers of the Board announces this rate at its weekly meeting every Wednesday.

2. Until the end of 1951, the Reserve Bank did not buy or rediscount bills of exchange on any appreciable scale and the Bank rate was in practice the rate at which advances were made by the Reserve Bank to scheduled banks against Government securities held by them. In January 1952, with a view to introducing an element of elasticity in the credit structure, the Reserve Bank introduced the Bill Market Scheme, under which banks could borrow from the Reserve Bank against usance bills created "on the basis of bonafide commercial or trade transactions bearing two or more good signatures one of which is that of a scheduled bank". It was thus possible for the bank concerned to borrow money not only against Government securities but against these usance bills. The Bill Market Scheme which had originally been confined to a few big banks was subsequently extended to all licensed banks.

3. When the Bill Market Scheme was first introduced in 1952, advances against these usance bills were granted at a concessional rate, i.e. $\frac{1}{2}$ per cent below the Bank rate, and the Reserve Bank also paid half the stamp duty. These concessions were made in order to encourage the banks to make use of the Bill Market Scheme for financing themselves during the busy season. The Scheme, however, proved to be a phenomenal success and the advances obtained by the licensed banks under the Bill Market Scheme since January 1956 have amounted to nearly Rs 354 crores. The concession of $\frac{1}{2}$ per cent was, therefore, no longer necessary, and it was withdrawn in two stages during recent months. The rate at which advances against these bills are given at present is therefore the standard Bank rate of $3\frac{1}{2}$ per cent (per annum) and the banks also pay the stamp duty on these usance bills, which until the introduction of the recent Finance Bill was only 2 annas per Rs 1,000.

It is now proposed to increase the stamp duty to Rs 10 per Rs 1,000 for bills of one year's maturity, i.e. the new ceiling rate will be 80 times the present rate. It was, however, announced that the present intention was to operate on the basis of half

these rates. In other words, the rate for usance bills will be Rs 5 per Rs 1,000 or 8 annas per Rs 100 per annum. The banks will thus be required to pay $3\frac{1}{2}$ per cent per annum to the Reserve Bank as interest on the advances and $\frac{1}{2}$ per cent per annum extra in the form of stamp duty. The increase in the duty in respect of bills will in effect be equivalent to an increase in the Bank rate by $\frac{1}{2}$ per cent per annum.

4. This increase was decided upon without any prior consultation with the Governor or the Board of the Reserve Bank, on whom rests the statutory responsibility for altering the Bank rate. The decision of the Government was announced to the Governor and senior officers of the Bank six days before the introduction of the Bill, but it was made quite clear that it was a definite decision of Government on which the views of the Bank were not invited. The Bank's opinion was asked for only on the question whether the immediate increase be Rs 5 per Rs 1,000 or Rs 10 per Rs 1,000. A few days after the introduction of the bill, I attempted to discuss the implications of this measure with the Finance Minister, but he stated that he took full responsibility for the Government decision, that the Bank was a "section" of the Finance Ministry of the Government of India and that we would have to accept the decision whether we liked it or not.

5. The decision of the Government and the procedure adopted raise important issues. As the Board is aware great importance is attached to the independence of the central banks in most democratic countries, for it is expected to consider economic problems dispassionately and offer considered advice to the Government. The independence of the Reserve Bank of India has been safeguarded in the Act, and it has been emphasised by the convention that the Governor and the Deputy Governors should retire from Government service, if they are Government servants at the time of their appointment. The relations between the Government of India and the Reserve Bank of India have also been clearly defined in the Act. The Government can, under section 7 of the Act, "give such directions as it may, after consultation with the Governor of the Bank, consider necessary in the public interest". "Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank." In actual practice, however, no directive has been issued to the Bank since nationalisation in 1949. The relationship between the Reserve Bank of India and the Ministry of Finance has since its establishment, and certainly during my tenure of office, been one of the closest and most harmonious co-operation. In view of the responsibility imposed on the Reserve Bank for deciding monetary policies and other matters, it is hardly necessary for me to emphasise the grave consequences of treating the Bank as a department of the Government of India.

6. The Finance Minister stated in Parliament in regard to the stamp duty that the proposal was a fiscal measure "with a monetary intent". As I have explained already, the immediate increase of the stamp duty on bills to Rs 5 per Rs 1,000 or 40 times the present rate will in effect be equivalent to an increase in the Bank rate of $\frac{1}{2}$ per cent per annum. Actually, there has, however, been no difference of opinion between the Government and the Reserve Bank on this question. After detailed discussion with the Reserve Bank, the Government have recently agreed that it would not be desirable to raise the Bank rate at present.

7. If the Finance Bill were passed, there would be two authorities who would operate the Bank rate—the Reserve Bank in the usual manner under section 49 of the Act, and the Government by variation of the stamp duty by executive order of the Finance Ministry. The consequences of this dual control of the Bank rate need hardly be emphasised.

8. The new measure would also seriously affect the working of the Bill Market Scheme, which has been regarded by the banks and the business community as one of the outstanding achievements of the Reserve Bank in recent years. At the recent meetings the Finance Minister and I had with the bankers in Calcutta and Bombay, the banks pressed for further liberalisation of the Bill Market Scheme, and we have been considering at the request of the Finance Minister the question of increased facilities under the Scheme. Far from liberalising the Scheme, the present proposal will severely discourage the creation of usance bills for Bank advances. Banks would now obtain funds as far as possible either by borrowing against Government securities in their portfolio or by selling them. This would not be a desirable tendency, for an adequate portfolio of unencumbered Government securities is an important safeguard for the depositors, if there should be a run on any bank.

In this connection I may explain why the duty on bills was imposed at a nominal rate of 2 annas per Rs 1,000. In December 1938, the Reserve Bank advised the Government of India that the development of the bill habit was essential if the Reserve Bank was to fulfil its role of assisting and regulating banking development in India and, as the incidence of stamp duty on usance bills had been an obstacle to the use of time bills, it was suggested that early steps should be taken to reduce the stamp duty. After careful consideration of the issue, the Government of India agreed to the suggestion and issued a notification in 1940 reducing the duty on usance bills with a maturity not exceeding one year to 2 annas for every thousand rupees. The duty has now been increased 40 times and the Government have taken powers to raise it to 80 times.

9. For the information of the Board I may state that in a letter dated December 3rd, the Chairman of the State Bank, which has used the Bill Market Scheme to the extent of Rs 212 crores in the present year has, after consulting his experts, stated that “with the stamp duty enhanced as proposed by the new Finance Bill the cost will, of course, be increased substantially and the bank could no longer make use of the Bill Market Scheme without loss to themselves”. I have also just received a copy of a telegram sent by the Indian Banks Association to the Government of India in which they have expressed their strong feeling that the “unprecedented increase in stamp duty will prove of great harm to functioning of banks and increase cost of credit facilities for business and industry”.

10. In view of the facts stated above, I consider that we should explain to the Government the full implications of this proposal and request them to reconsider it.

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
10th December 1956

B. RAMA RAU
GOVERNOR

Resolution passed at the emergency meeting of the Central Board of Directors of the Reserve Bank of India held in Bombay on Wednesday, 12th December 1956

“The attention of the Board has been drawn to the implications of the steep revision of the stamp duty proposed by the Finance Minister. Although this may be claimed to be a fiscal matter it has, as stated by the Finance Minister, monetary implications which cannot be ignored. The views of the Reserve Bank should, therefore, have been sought on the subject. The Board feels that the revision of the stamp duty on the scale announced, apart from the general repercussions on the credit facilities available to trade, industry and commerce, in effect adds substantially to the Bank rate, which it is the statutory responsibility of the Reserve Bank to fix every week. The Board requests the Government to consult the Reserve Bank in advance on all matters which significantly affect the monetary structure and policy.”

SECRET

NEW DELHI

D.O.No.[...]

December 17, 1956

My dear Shri Rama Rau,

The Finance Minister has seen the minutes of the meeting of the Central Board of the Reserve Bank held at Bombay on the 12th December, 1956. He would be glad if he could have, for his confidential information, a brief summary of the discussion that took place at the meeting with reference to the item 7 of the agenda with a copy of the draft resolution as originally placed before the Board by the Governor and of the amendments, if any, which might have been proposed and discussed, leading upto the resolution as passed by the Board.

Yours sincerely,
[G. SWAMINATHAN]

SECRET

BOMBAY

D.O.No. [...]

December 24, 1956

My dear Swaminathan,

Your letter No. D.O. [...] of December 17th 1956 reached me just as I was leaving my house to catch the plane for Calcutta, and since the papers were all in Bombay, I could not reply earlier.

We do not keep any record of the discussions at Board meetings except the memoranda circulated to the Board and the resolutions finally passed. If any member dissents from the resolution and desires that his dissent should be recorded, his views are recorded briefly in his own words. This has been the invariable practice from the inception of the Bank. Members sometimes express an opinion, which they change after hearing the other members. Their final views are embodied in the resolution, which in this case was unanimous.

No draft approved by the Governor was circulated with the memorandum to the members of the Board in this case. To facilitate discussion, I asked the office

to prepare a draft more or less on the basis of the views I had expressed in my memorandum to the Board. This was prepared and circulated to the Board at the meeting as a basis for discussion. One or two members did not like this draft, and two of the members present were requested to submit alternative drafts. One of these drafts was accepted by me and it was adopted unanimously. I enclose herewith copies of the original office draft circulated for discussion and of the final resolution.

Yours sincerely,
[B. RAMA RAU]

Shri G. Swaminathan
Government of India
Ministry of Finance
New Delhi

SECRET

BOMBAY
December 29, 1956

My dear Srinivasan,

I enclose herewith a letter for the Prime Minister. I should be grateful if you would place the letter in his hands when he has sufficiently rested after his strenuous tour abroad. If by any chance, he wishes to see me in this connection, kindly telephone or write to my Calcutta address —

C/o Reserve Bank of India
8, Council House Street
Calcutta
Tel. No. 23-6111

Yours sincerely,
[B. RAMA RAU]

Shri C.R. Srinivasan
Private Secretary to the Prime Minister
New Delhi

SECRET

BOMBAY
December 29, 1956

My dear Prime Minister,

I am puzzled—and pained—by the tone and contents of your letter of December 12th, which reached me after you had left Bombay. As you know, after the Finance Minister's remarks to me, it was my intention to resign, but I refrained from doing so only because of my personal regard for you and your expressed wish that I should stay. After having given you (and subsequently to Pantji) my assurance that I would not go against your wishes, is it conceivable that I could be adopting an "agitational approach" in placing the facts before the Board? I have never in all my life resorted to underhand tactics. Strict privacy has always been maintained in regard to the proceedings of the Board meetings. In the course of the last 7½ years that I have been

in charge of the Bank, the Board had differed—sometimes strongly—from the government on several issues, but absolutely nothing has ever leaked out regarding such differences of opinion. It is now nearly three weeks since my memorandum was circulated to the Board, but so far there has not been any reference to any difference of opinion in this matter between the Bank and the Government in any of the newspapers or financial journals as a result of the reference to the Board. The Board consists of very responsible businessmen and eminent economists, who are fully aware of the importance of secrecy.

After explaining all the circumstances to the Board, I stated in the concluding paragraph of my memorandum that “in view of the facts stated above, I consider that we should explain to the Government the full implications of the proposal and request them to reconsider it”. After discussion, the Board passed the following resolution.

“That the attention of the Board has been drawn to the implications of the steep revision of the stamp duty proposed by the Finance Minister. Although this may be claimed to be a fiscal matter it has, as stated by the Finance Minister, monetary implications which cannot be ignored. The views of the Reserve Bank should, therefore, have been sought on the subject. The Board feels that the revision of the stamp duty on the scale announced, apart from the general repercussions on the credit facilities available to trade, industry and commerce, in effect adds substantially to the Bank rate, which it is the statutory responsibility of the Reserve Bank to fix every week. The Board requests the Government to consult the Reserve Bank in advance on all matters which significantly affect the monetary structure and policy.”

I may add, for your information, that one or two members, who knew the facts, wanted to discuss the issue of the Finance Minister's rude behaviour to me, as they thought this affected the dignity and status of the Governor. I, however, refused to let the Board discuss this issue and stated that it was entirely a matter between the Finance Minister and myself. I ruled that the Board should only discuss the proposals of the Government and their implications. I leave it to you to judge whether it would be fair to draw any inference that there has been any “agitational approach” in the consideration of the issues by the Board.

2. After I had seen you in Delhi in the evening on December 6th and given you an assurance that I would not go against your wishes, I had to face a very difficult problem. Before my interview with you I had, of course, taken into confidence two or three of my trusted friends and two prominent members of the Board. The general consensus of opinion before the interview was that I could not with any self-respect continue in office. Under the Act, the general superintendence and direction of the affairs and business of the Bank is entrusted to the Central Board of Directors. It was, therefore, my statutory duty to explain the implications of the proposal to them and draw their attention to the fact that I had not been consulted before the decision had been taken. It was suggested to me that the best course under the circumstances would be to place all the facts before the Board, and after careful consideration I decided to convene a special meeting of the Board to consider the matter and to give them an opportunity of making such representations to the Government as they considered necessary. I have worked with the Board harmoniously for nearly 7½

years and I was confident that whatever the provocative nature of the Finance Minister's remarks as to the status of the Bank, etc. I could guide the deliberations of the Board in such a way that no embarrassment would be caused, especially as I had agreed at your request to continue in office. You must trust my judgement in such matters and judge me by the results. The Board have had their say and the result was quite satisfactory from every point of view. Nothing has leaked out about any difference of opinion.

The very recent public attacks by the Finance Minister in Parliament and outside on the Reserve Bank have, however, provoked a lot of comment and speculation. I refer to these in the last portion of my letter.

3. As you are naturally not acquainted fully with the past working of the Reserve Bank, I may explain that the Bank have on several occasions considered it to be their duty to offer objectively their comments even on issues on which the Government had already come to a decision—not, of course, with the intention of raising an agitation but entirely with the object of placing their views before the Government. I will mention one issue which you had to deal with as Finance Minister a few months ago. In December 1954, the Government had announced their decision in Parliament in connection with the nationalisation of the Imperial Bank that it was their intention to take over the State-Associated Banks in course of time. The Board considered the question and expressed their opinion by a majority that it was undesirable to take over these banks (most of which were working satisfactorily) and that if for constitutional reasons it was absolutely necessary, only the banks owned or completely controlled by the State Governments might be absorbed. I had myself considerable sympathy with the views of the majority and Deshmukh agreed to this compromise. Since the Constitution was subsequently amended, you as Finance Minister asked me whether there were any other reasons for taking over the State-owned banks, except the Hyderabad State Bank. After discussion with me, you agreed with the views of the Board, although the Government had made a statement in Parliament at an earlier stage as to the Government's policy in regard to this matter.

To give you another instance, (which is rather relevant in the present context) the Government suggested over two years ago that, while it was absolutely necessary that the Governor of the Bank should not be a serving official, the convention which requires even the Deputy Governors to retire from service should be relaxed, since it was becoming difficult to get suitable non-officials, and officials were reluctant to resign unless they were on the verge of retirement. The Board unanimously turned down the request, since they strongly felt that the independent status of the Bank under the Statute would be affected, if the Deputy Governors were serving officials. The Government acquiesced in this view.

4. You have stated that my reference in the memorandum circulated to the Board to a private conversation with the Finance Minister was against all conventions and practice and that my statement was inaccurate. I had seen him in order to discuss an important official matter and the conversation was 'private' only in the sense that no one else was present and my version was inaccurate only in one respect—and that is, I refrained from reproducing in the memorandum the very rude language in which the Finance Minister's remarks were couched. He has not concealed his view that the

Reserve Bank is only "a section of the Finance Ministry". He has repeated this statement to several people and two well-known and responsible non-officials (one of them a member of our Board) have repeated this expression to me. In one case, the expression used was "a department" and in the other case it was "a section" of the Finance Ministry. It seemed obvious that his failure to consult the Reserve Bank on an important matter that impinged on the statutory responsibilities of the Bank was not due to an oversight but to his definite view that as a mere department of the Finance Ministry, the Reserve Bank was not entitled to be consulted. Was it not my duty to bring this issue to the notice of the Board, especially as the definite intention of the Reserve Bank Act was to establish an autonomous body, which was to discharge its functions subject only to such directives as may be issued by Government in consultation with the Governor? The authors of the Act (which was passed by your Government in 1949) obviously attached great importance to the autonomous status of the body, especially as it was expected to maintain the stability of the currency, examine financial problems and to give its advice dispassionately whatever the party in power. The Government have, of course, the right to reject the advice but the important point is that the Reserve Bank should be given an opportunity of placing all the facts and of expressing their views to the Government before they come to a decision on technical and sometimes complicated monetary issues.

5. In the course of your letter you have made the following statements which have puzzled and hurt me very considerably:

- (1) "The Central Government, as you know, is directing its policy to attain certain objectives laid down in the Five Year Plan. It would be completely absurd if the Reserve Bank followed a different policy because it did not agree with those objectives or with the methods of achieving them."
- (2) "Monetary policies must necessarily depend upon the larger policies which a government pursues. It is in the ambit of those larger policies that the Reserve Bank can advise. It cannot challenge the main objectives and policies of Government."
- (3) "There are apparently some sections of the business community who disapprove our basic policies and who have in fact criticised them. They have every right to do so. But it is surprising that the Reserve Bank should encourage this criticism and indirectly participate in it itself."

If I may say so with all respect, I take strong exception to these statements, which are absolutely unwarranted and not justified by the facts of the case. May I request you to read again my memorandum to the Board (or if you have not got the time ask one of your Secretaries to read it) and point out a single sentence which could justify these inferences. You have in the course of your letter admitted that the Reserve Bank is certainly an autonomous body and that it is certainly desirable that the Reserve Bank's views on such economic matters should be obtained for the Government to consider. It has never been disputed by me or by the Board that the Government have the power, after consulting the Reserve Bank, to come to any decision they like in the interests of the country. These are the only two points which have been raised in the memorandum. In the case of the stamp duty, the Government had come to a decision before the Finance Minister met me and the senior officers of the Bank. In announcing

this decision, he made it quite clear that the Reserve Bank was not being consulted on the proposal and that he was seeking our advice only on the question whether the rate should be 40 times or 80 times the previous rate. This can hardly be regarded as consultation.

I am, however, more disturbed by your remarks on the other points. In the memorandum to the Board there is no reference whatever to the Five Year Plan. You may remember that when you were Finance Minister you asked me to send you my observations on a memorandum circulated by the Finance Ministry to the Cabinet on the inflationary and other aspects of the Second Five Year Plan. In my letter to you D.O. No.[...] dated August 28, 1956, I have explained my views in regard to the Plan. To enable you to refresh your memory, I quote below the relevant paragraph from this letter:

"This statement is not, of course, intended to be a criticism of the economic policy of the Government or of the magnitude and structure of the Plan. My object is to emphasise that all development expenditure must inevitably result in a certain measure of inflation in the initial stages though the pressure is, of course, comparatively greater in the case of deficit financing. Indeed, my definite view is that in the present circumstances we would be fully justified in proceeding with our development plans by taking calculated risks in regard to inflation. As I stated last year at the International Bank meeting in Istanbul in reply to certain indirect comments of President Black on India's economic policy, we have to demonstrate that within the framework of a democratic structure we can develop at a pace comparable to that in totalitarian countries. The target for a higher standard of living in the Second Five Year Plan is comparatively modest, and unless we reach this target, we should not be surprised if our people, the vast majority of whom are ill-fed and ill-clothed, turn their attention to some other economic or political creed which offers at any rate hopes of a better existence. Democracy and freedom cannot have any significance for these classes unless they result in some relief for them from the life-long struggle to satisfy their elementary physical requirements. Development is imperative if the democratic system is to survive. We must, therefore, be prepared to face a certain measure of inflation and must devise appropriate monetary, fiscal and possibly administrative measures, to ensure that the inflationary situation does not get out of control. The utmost vigilance in regard to economic development will, of course, be necessary in the next few years."

I have strongly supported the Plan as a whole, both in India and abroad, though I have differed on minor details. When there was a suggestion at the meeting of the World Bank last September that we were embarking on too ambitious a Plan, I vehemently defended the Government policy in undertaking a Plan of this magnitude. I attach a brief extract from my speech at the World Bank meeting. I have certainly not opposed the Government's economic policy based on a socialist pattern of society. I am also strongly of the view that as much of the money required for the Plan as possible should be met from increased taxation and borrowing. I have certainly no sympathy with any sections of the business community which are not functioning in

the national interests and which have opposed the Government's basic policies. I am very astonished by the allegation that the Reserve Bank has encouraged this criticism and indirectly participated in it itself. I do not know what justification there is for such a serious allegation and I am sure after what I have said you will recognise that it was not a fair statement to make about the Reserve Bank's outlook.

6. When you prevailed upon me not to submit my resignation, I had made up my mind to forget all that had happened and to co-operate wholeheartedly with the Finance Ministry in the solution of the very difficult economic problems that they will be faced with in the immediate future. I expected, however, that there would be some reciprocity in this matter, but the recent public outbursts from the Finance Minister against the Reserve Bank both in Parliament and outside have created a very difficult situation. You have stated in your letter that my reference to a private conversation with the Finance Minister in a secret memorandum circulated to the Board was against all "conventions and practice". I do not know how you will describe the unprecedented attacks of a Finance Minister on the Central Bank of the country, not on a question of policy but on its capacity or competence to discharge the functions imposed by the Statute. I need hardly explain that such statements by a responsible Minister of Government on the authority responsible for the stability of the currency would shake the confidence in India and outside in the currency of the country. Nor need I point out the gross impropriety of such an attack on a public institution which cannot reply publicly to such criticism.

The Reserve Bank has to its credit a record of which it can be proud. India has today one of the stablest currencies in the world in spite of the enormous expenditure on development in the First Five Year Plan. The price level at the end of the First Five Year Plan period was actually slightly lower than the price level in 1951 when the Plan was put into operation. The part played by the Reserve Bank has received wide appreciation from World Bank and I.M.F. Missions and from well-known foreign financial journals such as the London *'Economist'*.

The Finance Minister has described the Reserve Bank as 'reserved' and has expressed doubts in Parliament as to whether it is capable of doing any thinking. He has stated that the Bank has a 'clerical' mentality and that it believes in a policy of 'stay put'. We have today a very high status among the central banks of the world. Like all other central banks we are 'reserved' and do not publicise our achievements. Since you have not been directly in touch with the working of the Reserve Bank, may I summarise briefly some of our major achievements, which have sometime been described as "revolutionary" in regard to the working of the Bank? Apart from the maintenance of the stability of the currency, our achievements are briefly as follows.

- (1) The institution of a system of regular and periodical inspection of all banks has contributed enormously to the standard of integrity in, and the stability of the banking system in India according to observers both in India and abroad. There has been no failure of any scheduled bank since 1951.
- (2) The monetary policy of the Bank during the last 5 or 6 years has not only contributed to the remarkable stability of the currency but also to the maintenance of a remarkably steady level of prices. The economists attached to the I.M.F. and World Bank have appreciatively referred to this as

'development with stability'. One Central Bank has cited India's monetary administration as a model for undeveloped countries in Asia.

- (3) The introduction of a self-liquidating credit instrument under the Bill Market Scheme which has been regarded both by the business and financial communities as a 'memorable' and outstanding achievement. During the present year the advances obtained by banks amounted to over Rs 364 crores.
- (4) The nationalisation of the Imperial Bank of India with a view to a wide extension of credit facilities all over India, the mobilisation of the rural and semi-urban savings all over the country for development purposes, and the provision of credit facilities for co-operative organisations. It need hardly be explained that no large-scale development of agriculture and small industries can take place without credit facilities.
- (5) We have during the last 2 years evolved with the assistance of the Rural Credit Survey Committee a colossal plan for the provision of credit facilities in rural areas with a view to the rapid development of agriculture and small-scale industries. This has been described by eminent observers as a revolutionary measure designed to promote the rapid development of Rural India.

I have only mentioned some of the major achievements with a view to enabling you to assess the truth of the Finance Minister's remarks that the Reserve Bank is "clerical-minded" and believes in a policy of "stay put".

7. I assured you that I would not go against your wishes in regard to my resignation, but the public attacks of the Finance Minister on the Reserve Bank have created a new situation in which it will be absolutely impossible for me to continue in office. I hope you will appreciate my position and allow me to submit my formal resignation through the Finance Ministry. I am leaving for Calcutta by plane on Sunday, December 30th, and expect to be there for a week or two. I will await your reply there.

8. I must apologise for the length of this letter, but the observations in your letter are very serious and require detailed reply. When I am quitting office, I cannot possibly let you be under the impression that I could be in any way disloyal to you or to your Government.

Yours sincerely,

B. RAMA RAU

Shri Jawaharlal Nehru
Prime Minister
New Delhi

SECRET

D.O.No.[...]

NEW DELHI

January 1, 1957

My dear Rama Rau,

I have received your letter of the 29th December. I wrote to you on December 12th on the basis of the note you had circulated to the members of your Board. That

note appeared to me to be improperly worded and did convey an impression to me of, what I called, "an agitational approach". I did not say anything about underhand tactics, nor did I refer to any previous incident or complaint. So far as I am concerned, I had no reason to complain previously of your not working in co-ordination with the Government. I have not of course been in intimate touch with these matters.

2. My letter was, therefore, confined to this particular instance and I thought that I should let you know what my own reactions were to the memorandum circulated to the Board. I still think that that was not a proper memorandum.

3. You refer to the Finance Minister using the expressions "a Department" and "a Section", in regard to the Reserve Bank. I think that these expressions can only be understood in a larger context. Obviously the Reserve Bank is a part of the various activities of the Government. Obviously also it has a high status and responsibility. It has to advise Government, but it has also to keep in line with Government.

4. You have quoted some sentences from my letter and say that you take strong exceptions to those statements. Those statements lay down a policy which I think the Reserve Bank and the Government of India should follow. I think the tone of the memorandum you issued was not in keeping with these broad policies.

5. I agree with you that it is not desirable to carry on such controversies in public.

6. When you spoke to me about your resignation on the previous occasion, I asked you not to resign. I did not think that any need for such a resignation had arisen. But since you feel now that it is absolutely impossible for you to continue in office, I do not know what further advice I can give you. If you so wish, you can submit your formal resignation to the Finance Ministry.

Yours sincerely,
[JAWAHARLAL NEHRU]

BOMBAY
January 7, 1957

My dear Prime Minister,

With reference to your letter No.[...] dated January 1st 1957, I enclose herewith for your information a copy of my letter of resignation which I have sent to the Finance Minister.

Unless there is fresh provocation, I do not propose to issue any public statement even after I relinquish office for obviously any public controversy between the Reserve Bank and the Finance Ministry might have repercussions in this country and abroad.

Yours sincerely,
[B. RAMA RAU]

BOMBAY
January 7, 1957

Dear Shri Krishnamachari,

I was shocked to read the reports of the unwarranted and insulting remarks about the Reserve Bank in the recent public speeches you delivered at the South Indian

Chamber of Commerce at Madras and elsewhere. Such attacks by the Finance Minister on the Central Bank of the country are absolutely unprecedented and grossly unfair, especially as requirements of propriety do not permit me publicly to reply to these criticisms so long as I am in office. Such a reply is perhaps unnecessary at any stage, since the Reserve Bank has a record of achievement of which the country could be proud and which is well-known to all sections of the public who are interested in finance and development.

2. While maintaining the independent status assigned to the Reserve Bank by statute, I have always considered it my duty to co-operate fully with the Government in the implementation of their national policies in the economic sphere. I have worked in complete harmony with the Finance Ministry for 7½ years in the course of which we had to deal with very difficult monetary and other economic problems. I have more than once protested against your personal rudeness in the past, but I was prevailed upon to overlook it. Since, however, you have now thought it necessary to make public attacks on the Reserve Bank, it is not possible for any self-respecting Governor to offer that wholehearted co-operation with the Finance Ministry, which is absolutely necessary in the interests of the country during the critical times ahead of us.

3. I, therefore, submit herewith my resignation of the office of Governor. I should be obliged if you would make arrangements for my relief as early as possible.

Yours sincerely,
[B. RAMA RAU]

PURSHOTAMDAS THAKURDAS

NAVASARI CHAMBERS
OUTRAM ROAD
FORT, BOMBAY

January 8, 1957

Dear Mr. Governor,

The happenings in the last couple of weeks in the relation between the Board of the Reserve Bank and the Central Finance Ministry are so extraordinary, one-sided and unprovoked that I feel it is not to the interest of the country that any non-official should avoidably keep up his connection with the Reserve Bank. I therefore hereby request you to do the needful, so that I may not be re-nominated after what has been happening lately.

I wish to thank you most cordially for all the courtesy you have shown to me during your term of office as Governor and wish you complete happiness and peace of mind hereafter.

Yours sincerely,
[PURSHOTAMDAS THAKURDAS]

SECRET

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
(DEPARTMENT OF ECONOMIC AFFAIRS)
NEW DELHI
January 9, 1957

D.O.No.[...]

From : Shri H.M. Patel, I.C.S.
Secretary to the Government of India

To : Shri B. Rama Rau
Governor, Reserve Bank of India, Bombay

Dear Sir,

I am desired to acknowledge receipt of your D.O.letter of January 7, 1957 addressed to the Finance Minister in which you have tendered resignation of your appointment as Governor, Reserve Bank of India. I am to convey Government's acceptance of your resignation.

2. The Finance Minister does not wish to offer any comments on the reasons which have led you to take the decision to resign except to say that his views on the working of the Reserve Bank generally were explained by him to you when you last met him in Delhi.

Yours faithfully,
[H.M. PATEL]

SECRET

RESERVE BANK OF INDIA
CENTRAL OFFICE, BOMBAY
January 12, 1957

D.O.No.[...]

My dear Ambegaokar,

Since I am handing over charge to you on Monday next, I shall not, of course, be present at the special meeting of the Central Board to be held on Wednesday, January 16th. The members of the Board are entitled to know why I have resigned and they may naturally ask you to explain the facts. You may, therefore, read the contents of this letter at the Board meeting.

2. The members of the Board have, no doubt, seen the reports of the unwarranted and rather offensive remarks about the Reserve Bank in the recent public speeches of the Finance Minister at the South Indian Chamber of Commerce in Madras and elsewhere. Such public attacks by the Finance Minister on the Central Bank of the country are without precedent and extremely unfair, especially as it would not be proper for the Reserve Bank to enter into a public controversy with the Government by replying publicly to these criticisms. While maintaining the independent status assigned to the Reserve Bank by statute, I have always considered it my duty to co-operate fully with the Government in the implementation of their national policies in the economic sphere. Throughout the period I have been Governor of the Bank, I have worked in complete harmony with the Finance Ministry. It will be realised that in view of these public attacks it would be difficult for the Finance Ministry and myself to maintain the harmonious co-operation that is absolutely necessary in the interest of the country. I, therefore, decided to submit my resignation, which has been accepted by the Government.

3. I have refused to make any statement to the press about the reasons which have led to my resignation and I have no doubt that the members of the Board will, as they have done in the past, in such cases treat this statement as strictly confidential.

4. I would like to take this opportunity of conveying to the members of the Board, individually and collectively, my deep appreciation of the valuable advice and unfailing support they have always given to me during the last 7½ years. My association with the Board has been one of the pleasantest experiences in my career and I cannot adequately express my gratitude to them.

Yours sincerely,
[B. RAMA RAU]

Shri K.G. Ambegaokar
Reserve Bank of India
Bombay

B. AFTERMATH OF THE MUNDHRA AFFAIR

No.[...]

MEMORANDUM TO THE CENTRAL BOARD

Representation of the Reserve Bank on Statutory and other Organisations

Recent developments have underlined the need for a more precise definition of the functions and responsibilities of statutory corporations and suggested the advisability, in this context, of reviewing the relationship of the Reserve Bank with various Boards and Committees, statutory and otherwise, on which it is at present represented. The objective of such re-examination should be to minimise the scope for possible misunderstanding of its position in the interest of upholding the highest public confidence in the monetary management of the country. It is necessary at the same time constantly to bear in mind, in carrying out such a review, that the Reserve Bank of India, as it has developed historically, has acquired a wider conception of central banking functions than similar institutions in the more industrially advanced countries. Thus the Bank takes a great deal of initiative not only in the field of economic research and advice but also in the improvement of the systems of agricultural and industrial finance. It is necessary therefore that the Bank should not, on the one hand, remain in an "ivory tower"; on the other, its functions should not be so diffused as to jeopardise its ability to carry out its primary responsibility as the monetary authority of the country.

2. The organisations on which the Bank is represented or to which its officials are nominated may be broadly classified into the following :

- (1) Institutions engaged in the provision of financial accommodation. This category may be further sub-divided as under:
 - (a) Institutions on which the Bank's representation is statutory, e.g., the Industrial Finance Corporation, the National Co-operative Development and Warehousing Board, the Central Warehousing Corporation, the State Bank of India, the State Bank of Hyderabad, etc.,

- (b) Institutions with which our association is non-statutory and arises from contractual arrangements, e.g., the Bank of Mysore which is working as our banker in the territories of the former Mysore State under the agreement executed between the Reserve Bank and the Bank.
 - (2) Institutions which formulate, or assist in the formulation of policies, such as the Small-Scale Industries Board, the Standing Advisory Committee on Agricultural Credit, the Central Committee for Co-operative Training, the Bombay State Advisory Council for Small Savings, the Small Savings Board of the Government of India, Governing Board of the Indian Statistical Institute, etc.
 - (3) Miscellaneous official bodies and committees such as the Co-ordination Committee of the Central Government for economic questions, the Working Group on Small-Scale Industries appointed by the Government of India, the Central and Local Co-ordination Committees and the Central Working Party constituted for working the Pilot Schemes of the State Bank, etc. The Bank's representation on the Central Statistical Organisations and Conferences of Central and State statisticians may also be mentioned, which reflect a wider interest on the part of the Bank in the organisation of the country's statistical services than could perhaps be justified in terms of a strict interpretation of the Bank's own sphere of operations. The attendance of the Bank's London Manager on the Commonwealth Liaison Committee could also be classified similarly. In the same category would fall numerous Committees appointed from time to time by the Government of India on which staff members of the Bank serve, such as the Foodgrains Enquiry Committee and Working Party on Fiscal Monopolies, to mention only two recent instances.
 - (4) Organisations or associations constituted by or with the approval of Government to administer specific fields of financial activity or operations such as (i) the Export Risks Insurance Corporation, (ii) the Board of Referees to decide on appeals under the Income Tax (Amendment) Act, 1957, regarding deposits of company reserves, (iii) the Bombay Bullion Association, (iv) the Boards of the Stock Exchanges in Bombay, Calcutta and Madras and (v) the East India Cotton Association and the Oilseeds Exchanges, Bombay and Madras.
 - (5) In a fifth category may be placed the proposed association of the Bank with two bodies—one statutory and another non-statutory. The former is the proposed Investment Board of the Life Insurance Corporation, a bill in respect of which has been introduced in the Lok Sabha on 30th August 1957; the latter is the proposed Refinance Corporation which is intended to be a private company under the Companies Act for the purpose of channelling funds to the extent of Rs 26 crores (equivalent to \$55 million) which are being made available to it out of the counterpart funds of the P.L.480 imports of commodities from the U.S.
3. Reference has been made above to the broad distinction between the Bank's relationship with institutions which derives from statute and that which is non-statutory. The statutory relationship is based either on the Bank's own statute or on statutes

under which various other institutions are established; it may alternatively be divided into that relating to organisations for rural credit on the one hand and industrial finance on the other. The non-statutory representation may be further split up into representation of its staff members on the Boards of bodies like, e.g., Stock Exchanges, which function under or administer specific statutes and rules and regulations thereunder, or representation on Committees, etc. set up in the course of executive discharge of Government's functions in fields where the Bank either has coterminous operational responsibility (e.g., small-scale industries) or has special ability to assist by virtue of its being equipped in its technical Departments to take a wider view of the Central Bank's responsibility in policy formulation (e.g., small savings policy).

4. To consider first the statutory representation. The association of the Reserve Bank with organisations engaged in the business of agricultural credit and with State co-operative banks, or latterly with the Board of National Co-operative Development and Warehousing or the Warehousing Corporation or other co-operative institutions flows from the special responsibility of the Reserve Bank in relation to agricultural credit under its own statute, progressively extended from time to time since the Bank's establishment. As such it does not require any re-examination in the present context.

In the field of industrial finance, our association with the Industrial Finance Corporation and the State Financial Corporations derives from the respective statutes under which the various Corporations are established. We are represented on their Boards by virtue of financial participation in the share capital of these Corporations. The State Financial Corporations are required to consult us regarding the issue or sale of bonds, the deposit of their funds with banks, and in other ways. Our advice on conditions in the money market is thus available to these institutions and the demands made on the money market by the different institutions are co-ordinated. The statute also provides for periodical inspection of the State Financial Corporations by the Reserve Bank. The efforts of the Reserve Bank are directed in general to assisting in the establishment of an adequate institutional structure for meeting the medium and long-term credit requirements of industries and to co-ordinating the credit operations of different agencies catering to the needs of small-scale industries, the development of which has been assigned an important place in the Second Five Year Plan. The advice which is sought from the Reserve Bank could no doubt be made available even without the Bank being represented on the Boards of the Corporations. But our representation on the Boards gives us a sound working knowledge of the functioning of the Corporations and puts us in a better position to tender advice. Therefore no change in the present arrangements seems called for.

5. Our representation on the State Bank of India, the State Bank of Hyderabad, the Bank of Mysore, the Bank of Patiala and other banks hardly calls for comment, as the Bank rather than Government is obviously better able to co-ordinate the activities of State-owned and State-partnered banks. It is in recognition of this fact that the State Bank of India Act provided that the Reserve Bank shall always have a minimum shareholding of 55 per cent in the paid-up capital of the State Bank. Also, the State Bank and State-associated banks act as agencies of the Reserve Bank.

6. Our association with the Small Savings schemes derives from our interest in the promotion of these schemes in our capacity as banker to Government and manager of

the country's public debt. We are also managing two of the small savings scrips, namely, 10-year Treasury Savings Deposit Certificates and 15-year Annuity Certificates. Our representation on the Small Savings Board is intended to assist Government in reorganising the Postal Savings Bank system on banking lines.

7. It is hardly necessary to explain the Bank's participation in respect of boards, committees and other bodies mentioned in the third category. The Bank's representation on these bodies is of considerable benefit to the Bank in coming to an understanding of the economic policies of Government and no doubt, Government themselves find the participation of the Bank of value in reaching their decisions.

8. The fourth category relating to the administration of specific economic legislation or operation of stock and commodity markets can be broadly divided into administration and regulation of the working of markets like stock, bullion and commodity markets and administration of other schemes. To take the other schemes first, the Bank's representation on the Export Risks Insurance Corporation (through the Director, Division of International Finance) followed a phase of assistance to Government rendered through the same official in the completion of the preparatory work for setting up the Corporation. The Bank was specially well equipped to render such co-operation owing to the specialised attention given in its Division of International Finance to problems of international trade and balance of payments, with particular reference to the country's export trade, owing to its importance as a foreign exchange earner and contributor to the country's monetary reserves. The participation of the Bank's nominee is understood to have been found of special value to the Corporation in arranging consideration of proposals to stimulate the export trade which involve the co-operation of the banking system. Now that the Corporation has had a start, it is perhaps not essential for the Bank's representative to continue on the Board. This point may be examined further in consultation with the Commerce and Industry Ministry. The work of the Board of Referees under the Income Tax Act appears to have devolved on an officer of the Bank for personal reasons by virtue of the special assistance rendered by him in the examination of rules for deposits of company reserves. There is little in the administration of the Rules which could be said to be of direct concern to the Bank, particularly as banks are excluded from the obligation to deposit any part of their reserves. The association of the Bank through a senior officer with the administration of the Rules for deposit of company reserves can only be said to have some justification from the point of view—to which the Government attach importance—of creating confidence in the reasonable operation of these Rules with due regard to the salutary functioning of the corporate sector rather than in the narrow context of revenue or related considerations which are likely to weigh with tax officials; the Bank official concerned in turn gains an intimate view of the working of corporate enterprise in the country from the vantage angle of the use of its reserves. On the whole, though there would appear good grounds for suggesting that the Reserve Bank as such should not be represented on the Board, I would suggest no change for the present as it might embarrass Government a great deal if our nominees were withdrawn.

9. It is when we consider the association of the Bank's officers with the working of stock, bullion and commodity exchanges, however, that the disadvantages of such

relationship appear to outweigh the advantages. With the exception of the Bombay Bullion Association, the association of the Reserve Bank with the management of stock and commodity markets is of very recent origin. Since its establishment in the latter part of 1948, one of the two Bombay Government directors on the Board of the Bombay Bullion Association has been an officer of the Reserve Bank. The Bombay Government was keen that the Reserve Bank should be associated in the running of the Bullion Association. As regards the other commodity markets, the Bombay Government did not ask for the services of the Bank officers to work as directors. Even after the regulation of futures trading passed into the hands of the Government of India in 1953, in terms of the Forward Contracts (Regulation) Act, 1952, the Reserve Bank did not come into the picture. It is only since March 1957 that officers of the Bank have been nominated, by the Government of India at the instance of the Forward Markets Commission, on the Boards of East India Cotton Association, Bombay, and the Boards of the Bombay and Madras Oilseeds Exchanges. As regards stock exchanges, the all-India legislation came into force only about a year ago and the recognition of stock exchanges under this Act is being granted only since September last. So our officers have been serving on the Boards of Stock Exchanges at Bombay, Calcutta, Madras, Delhi and Ahmedabad only since very recently. In all cases, the officers of the Bank have been serving as nominees of (the Union) Government with the Bank's approval.

10. The main benefit to the Bank presumed to flow from the association of its officers with the organised markets in stocks and commodities is that it gives the Bank an intimate and up-to-date knowledge of the developments in these markets, which is of some help to the Bank in performing its role of regulator of credit in the economy. However, the importance of this link from the point of view of the Bank could be exaggerated. By virtue of its acting as the fiscal agent of Government and also on account of its own open market operations the Bank receives daily visits from important stock brokers who furnish it with detailed information regarding the happenings in the stock markets. It is primarily from the point of view of Government that the association of Reserve Bank officers with the Boards of the Stock Exchanges has been suggested to assist in their proper administration in terms of the respective statutes and rules and bye-laws. It is, however, when the association of Bank officials with the Exchanges is considered in terms of assistance in the administration of the Exchanges, rather than in fashioning the broad framework of their operation, that the disadvantages of such intimate association with the affairs of the Exchange come into relief. Though the Bank officials attend the Boards as nominees of Government, they are naturally presumed by the public to represent the Bank. There are, therefore, chances of the Bank's name being occasionally drawn into controversy when action to deal with crises which are liable to occur is called for. It is desirable in the interest of maintaining the implicit confidence of the public in the absolute impartiality of the Bank's administration of the monetary affairs of the country on broad national considerations that no opportunity is afforded for any possible misunderstanding of the Bank's part in relation to specific markets, such as might have occurred, for instance, if a Bank official were associated with the Board of the East India Cotton Association during the eventful winter of 1955-56. It is as important for Government

as for the Bank that such a possibility of the Bank being embroiled in controversy is avoided. That it is necessary in such a matter to take a long view would be apparent if we visualise a situation in which the Bank did not see eye to eye with Government in regard to a particular measure of regulation in the operation of an exchange, say, in regard to imposition of margins, requirement of deposits by operators, suspension of a bye-law, etc. In such a situation the outcome might be equally embarrassing if the Bank official acquiesced in Government's action or if he did not and openly expressed his disapproval. This clearly points to the need, in the interest of proper allocation of responsibility, of one authority—and, therefore, Government—being entrusted with the function of administration of the Exchanges. The Exchanges are distinguished from other Boards and Committees, such as have been mentioned, by the fact that the monetary interest of large numbers of operators is affected by particular measures of regulation, because of which possible differences of views in regard to the manner of handling particular situations have larger implications than similar differences in the course of work of other Committees and Boards. I would, therefore, suggest that the Board approve the proposal that the Bank's officers nominated to the Boards of the Stock and Commodity Exchanges may be replaced by Government by other persons.

11. The above reasoning applies *pari passu* to the bullion exchange as well. In fact, the bullion exchange furnishes the longest experience of working of the arrangement by which a Bank officer nominated by Government (in this instance the Bombay Government) has held a watching brief on the Bank's behalf in the management of market in which, because of its implications for monetary management, traditional and otherwise, the Bank has a greater measure of interest than in other commodities; the Bank's nominee has also made his contribution to the salutary functioning of the bullion market. Although, by and large, the Bank's 'representation' has not given cause for embarrassment—the Bank's representative has, as a convention, always stood above contending market forces and never exercised his vote—there have been occasions for dissatisfaction, in howsoever slight a measure, with the role in which the Bank has been made to appear. In one instance, our nominee on the Exchange failed to report proceedings in the Exchange promptly enough to the Bank to enable the Bank in turn to report them to Government—the Bank nominee is treated in effect as the eyes and ears of the Central Government who are not otherwise represented on the Exchange—at the time of the famous Mudgal affair. This was also reflected in the evidence before the Enquiry by the Bank nominee (Shri B.R. Shenoy). During the crisis in March 1955, again, the Bank was not happy with the line of action adopted by the Bombay Government to deal with the election of the President which led our nominee to propose that the Bank should discontinue its association with the Exchange. This was, however, continued at the request of the Bombay Government after the incident. The working of the bullion exchange has now been tightened up in a manner which leaves much less scope for embarrassing situations. On the other hand, the position regarding Government supervision of the affairs of the Exchange is not satisfactory. The Forward Markets Commission started considering from 1955 the question of extension of the Forward Markets Act to bullion. The Commission carried out during 1956 an enquiry with a view to determining the scope of forward trading to be permitted in the country and the exchanges which should be recognised. The

Bombay Government in the meantime—partly in view of the impending shift in responsibility for supervision—has considerably relaxed its supervision of the affairs of the exchange to the point when the only ‘Government’ Director usually attending the Board meetings is the Reserve Bank official. This is obviously not a very desirable position for the Bank nominee to be placed in.

12. There remains the question of our proposed representation on the Refinance Corporation and the Investment Board of the Life Insurance Corporation. The proposed Refinance Corporation in which the Reserve Bank would participate by contributing to share capital to the extent of Rs 5 crores (40% of the capital), will have a Board of seven Directors with the Governor of the Reserve Bank as Chairman and a Deputy Governor as a member; the other members would be the Chairman, Life Insurance Corporation, the Chairman, State Bank of India and three Directors representing other participating banks. In addition, the Chief Officer of the Industrial Finance Department will be the General Manager of the Corporation, the affairs of which will be looked after by the Industrial Finance Department of the Bank. The constitution of the Corporation is based on its close integration in operation with the Reserve Bank. In fact, the alternative of its funds being vested in the Reserve Bank and lent out by the Industrial Finance Department of the Bank was also considered, but the present form of arrangement under which the Corporation remains a separate entity with other participating institutions entitled to a say in the management, was preferred. Inasmuch as the Corporation will be dealing with lending to commercial banks and would have the advantage through the proposed arrangement of drawing on the knowledge and experience of the Reserve Bank’s various Departments (including the Department of Banking Operations), there is much to be said for the Bank’s association with the Corporation in the manner proposed.

13. Lastly, we come to the proposed “Investment Board” for the Life Insurance Corporation. Under the Life Insurance Corporation (Second Amendment) Bill, 1957, it is proposed to entrust the work of investment of the funds of the Life Insurance Corporation to an Investment Board, so that, according to the Statement of Objects and Reasons of the Bill, “the Life Insurance Corporation may be able to devote greater attention to its primary task of acquiring new business”. The Investment Board would consist of the Governor of the Reserve Bank as Chairman, the Chairman of the Central Board of the State Bank of India and the Chairman of the Life Insurance Corporation as members. Apart from the merits of this proposal which would divest the Life Insurance Corporation of responsibility for investment of its funds, the association with the Board of the Governor of the Reserve Bank as its Chairman is likely to lead to difficulties. The Board would presumably be responsible for investment of the funds of the Corporation primarily in the interest of policy-holders of the Corporation. The Bank and its Governor, on the other hand, are charged “generally to operate the currency and credit system of the country to its advantage” viz., to the advantage of the whole economy and “to secure monetary stability”. The dichotomy of responsibility of the Governor in his capacity as Chairman of the Investment Board and as head of the country’s Central Bank is thus apparent, and the proposed arrangement is likely to lead to complications. Any alternative arrangement under which a Deputy Governor or other senior staff member of the Bank might represent the Bank is also not likely to be free from objection.

14. In the result I make the following recommendations:

- (a) Government should be advised to nominate their own officials, rather than Reserve Bank officials on the Boards of the Stock Exchanges and the Commodity Exchanges including the Bullion Exchange.
- (b) Government should be advised to revise the Life Insurance Corporation (Second Amendment) Bill so as to exclude the Governor of the Reserve Bank from any responsibility for investment of the funds of the Corporation.
- (c) For the rest the present arrangements may continue subject to a further examination of the Bank's representation on the Export Risks Insurance Corporation.

H.V.R. IENGAR
GOVERNOR

RESERVE BANK OF INDIA
CENTRAL OFFICE, BOMBAY
27th February, 1958

Camp: NEW DELHI
March 10, 1958

My dear Roy,

I have had some correspondence with Shri T.T. Krishnamachari on the Life Insurance Corporation (Second Amendment) Bill insofar as it concerns the inclusion of the Governor of the Reserve Bank as a member of the proposed Investment Board and also on the subject of the nomination of officers of the Reserve Bank on boards of the stock exchanges and the commodity exchanges. In my last letter I had informed him that, in view of recent developments, I had considerable doubts about the wisdom of the representation of the Reserve Bank on the abovementioned bodies and that I proposed to consult my Board.

2. I enclose for the information of government a copy of the memorandum which I submitted to the Board on this subject and which they discussed at a meeting a couple of days ago. The Board generally approved of the approach contained in the memorandum, that is to say, that the Reserve Bank should not isolate itself in an "ivory tower"; that insofar as its statutory responsibilities are concerned either in the field of agricultural credit or finance to small-scale industries, it should continue, as it has been doing hitherto, to function on a liberal rather than on a narrow interpretation of its functions and responsibilities; but on the other hand, it would be anomalous and might well lead to embarrassment, both to the Bank and Government, if officers of the Bank were nominated on behalf of Government on statutory bodies like the stock exchanges and commodity exchanges. Insofar as the Life Insurance Corporation (Second Amendment) Bill is concerned, the Board specifically accepted the view put forward in the memorandum that it would be undesirable for the Governor to be included as a member of the proposed Investment Board.

3. The Board approved of the proposals contained in paragraph 14 of the memorandum subject to the change that they saw no objection to the Bank being represented on the Export Risks Insurance Corporation.

4. I shall be grateful if Government will now take steps to nominate their own officials rather than Reserve Bank officials on the Boards of the stock exchanges and the commodity exchanges and revise the Life Insurance Corporation (Second Amendment) Bill in such a manner as to leave the Governor of the Reserve Bank out of any proposed Investment Board. In the ordinary course I would have felt some embarrassment in making this request because I had personally expressed concurrence with the decisions previously taken by the Finance Minister. But in view of the proceedings before the Chagla Commission neither Government nor the Reserve Bank need feel any hesitation in examining afresh the whole issue of the relationship between the Bank and Government. I am now quite clear in my mind that the views expressed by the Board are in the public interest from the point of view of enabling the Reserve Bank to function, in an atmosphere free of possible controversies, as the instrument charged with preserving the country's monetary stability.

Yours sincerely,
[H.V.R. IENGAR]

Shri A.K. Roy
Ministry of Finance
Government of India
New Delhi

MINISTRY OF FINANCE
NEW DELHI
May 10, 1958

D.O.No.[...]

My dear Iengar,

Please refer to your letter dated the 10th March 1958 regarding the representation of the Reserve Bank of India on certain bodies like the investment board of the Life Insurance Corporation and the commodity and stock exchanges. As far as the Life Insurance Corporation is concerned, the question is now only academic, as the Life Insurance Corporation (Second Amendment) Bill, 1957 is being withdrawn. The Reserve Bank's representation on the Bombay Bullion Association, as you have pointed out, is not very recent, and it is not also a matter with which we are directly concerned. The Bank, I believe, is in correspondence with the Bombay Government on this matter. This leaves for consideration only the question of the Bank's representation on the recognised stock and commodity exchanges, including the East India Cotton Association and the Oil Seeds Exchanges.

2. Without prejudice to the general question of the relations of the Reserve Bank with the Government of India and the State Governments and their executive organisations, the Finance Minister is prepared to agree that the Reserve Bank of India may be allowed to withdraw its representatives from the bodies or associations mentioned below:

- (i) the Stock Exchanges at Bombay, Delhi, Calcutta, Ahmedabad and Madras;
- (ii) the East India Cotton Association;
- (iii) the Oilseeds Exchanges at Bombay and Madras.

3. We shall be nominating other representatives in respect of the organisations mentioned at (i) and have asked the Ministry of Commerce and Industry to take similar action in regard to (ii) and (iii). We hope, however, that the Bank will be able to continue its present nominees on these bodies till alternative arrangements can be made in each case.

Yours sincerely,
B.K. NEHRU

Shri H.V.R. Iengar

INDEX

The index is confined to the narrative.
Page numbers in bold refer to illustrations.

- Abs, Herman, 646
- Abu Dhabi, 691
- ad hoc treasury bills, 17, 21, 28–30, 36–40,
102, 133, 149, 170, 172, 173–78, 182,
192, 707, 764
- Adarkar, B.N., 25, **112**, 165, 202–04, 415,
446–47, 686, 710, 832, 839, 840
- Administrative Reforms Commission (1967),
701, 828
- agricultural credit, *see* rural/agricultural
credit and cooperative banks/credit
- Agricultural Credit Department, *see under*
RBI
- Agricultural Credit, Standing Advisory
Committee on, *see under* RBI
- Agricultural Credit Funds, *see under* RBI
- Agricultural Refinance Corporation, 113, 251,
259–63, 309
- Ahmed, Naziruddin, 458
- Ahmedabad, 441
- Aid India Consortium, 626, 637–44, 657,
658, 661, 662, 666, 679, 681, 683, 687,
688, 689
- Air-India, 841
- Ajman, 691
- Ajmer, 191n, 269
- Allahabad Bank, 146, 526n
- Ambeagaokar, K.G., 17, 34, 38–39, 139, 147,
148, **149**, 150, 151, 152, 171, 175, 177,
223, 320, 345, 381, 400, 441, 465, 525,
533, 558, 560, 561, 609, 620, 636, 707,
710n, 751, 753, 757, 841
- American Development Loan Fund, 638, *see*
also P.L.480
- American Express Banking Corporation, 763
- American Securities Corporation, 533
- American Technical Cooperation Mission, 528
- Anantharamakrishnan, S., 516n
- Andaman and Nicobar, 269
- Andhra Pradesh, 74, 146, 149, 196, 197, 200,
221, 223–24, 226, 254, 255, 257, 269,
270, 281, 284, 291, 306, 504, 557, 567
- Anjaria, J.J., **112**, 667, 668, 672, 677n, 681,
685, 710, 844
- Anthraper Bank, 481
- Assam, 200, 272, 305, 306, 365, 489, 506,
508, 557, 558
- Augusti, K. Joseph, 767, 768, 769, 772, 773,
774, 776, 777, 778, 782, 783, 787
- Australia, 74, 603
- Bahrain, 690, 691
- Baksi, A., 710
- balance of payments, 17, 19, 34, 50, 87, 89,
108, 625–56, 673
- Balasubramanian, G., 29–30
- Bangalore, 439
- Bank Award Commission, 116, 117
- Bank for International Settlements, 636
- Bank of Baghelkhand, 358, 364, 395, 484
- Bank of Baroda, 99, 121, 169, 333, 355, 364,
375, 526n
- Bank of Barwani, 356
- Bank of Bhopal, 266, 358
- Bank of Bikaner, 189, 333, 361, 363, 364,
384, 385, *see also* State Bank of
- Bank of China, 500
- Bank of England, 56, 101, 318, 581, 601,
602, 612, 616, 617, 620, 629, 657, 667,
668, 675, 690, 698, 699, 712, 756–57,
811, 840, 843, 851, 852
- Bank of India, 99, 169, 526n, 546
- Bank of Indore, 186, 189, 333, 360, 361,
364, 375, 377, 384, 385, 386, 387,
see also State Bank of
- Bank of Jaipur, 186, 189, 333, 360, 361, 363,
364, 384, 385, 386, 387, *see also* State
Bank of

- Bank of Kerala, 483
 Bank of Kurundwad (Junior), 358
 Bank of Mysore, 136, 186, 188, 333, 360,
 361, 362, 364, 367, 374, 377, 384, 387,
 389, *see also* State Bank of
 Bank of New India, 475, 476, 479, 480, 483
 Bank of Patiala, 186, 189, 333, 342, 355,
 358, 359, 360, 361, 363, 364, 367, 368,
 374, 375, 376, 379, 380, 382, 384, 385,
 386, *see also* State Bank of
 Bank of Rajasthan, 186, 189, 333, 358, 360,
 361, 363, 364, 384, 385, 387, 389, 393
 Bank of Sirmur, 266, 358
 Bank rate, *see under* RBI
 Banker, 597
 Banking Companies Bill/Act (1949), 3,
 42–43, 46, 47, 56, 71, 80, 319,
 357–59, 362, 366, 380, 386, 387,
 397–401, 403, 406–08, 411, 414, 416,
 423, 426–30, 434–37, 439, 453–56,
 458, 459–60, 462–69, 472, 474,
 476–78, 483–84, 486–87, 489, 491,
 493, 498, 500, 504, 534, 704, 768, 775,
 778, 779, 790–93, *see also* Banking
 Regulation Act (1966)
 Banking Companies (Control) Ordinance
 (1948), 70, 457
 Banking Companies (Inspection) Ordinance
 (1946), 397, 767
 Banking Companies (Restriction of
 Branches) Ordinance (1946), 397
 Banking Companies (Second Amendment)
 Act, 477
 Banking Department, *see under* RBI
 Banking Development, Department of, *see*
 under RBI
 Banking Laws (Application to Cooperative
 Societies) Bill/Act (1966), 439–40
 Banking Laws (Miscellaneous Provisions)
 Bill (1963), 431, 444, 702
 Banking Operations, Department of, *see*
 under RBI
 Banking Regulation Act (1966), 299, 440,
 491, *see also* Banking Companies Act
 Banking Regulation (Cooperative Societies)
 Rules (1966), 440
 banks, commercial, 84–86, 104, 151–52,
 161, 165, 201, 261, 263, 555, 741–42
 branch licensing policy, 486–90
 capital adequacy norms, 405–16
 consolidation, 453–55, 466, 477, 478–79,
 480, 482, 483–86, 488, 741–42
 credit, 1, 41–49, 50, 54, 62–66, 67, 71–80,
 83–85, 90, 93–95, 98–100, 102–04,
 106, 107, 109–12, 122, 125, 131, 508,
 576
 credit-deposit ratio, 62, 63, 67, 80, 85, 95,
 105, 125, 348–49, 417, 519, 532
 deposits/deposit rates, 1, 42, 53, 76–80,
 90, 95, 98, 103, 111, 114, 116–25, 154,
 156, 507–08, 584, 705
 and exports, 580, 582, 583, 584–85
 guarantees, 405
 and industrial finance, 514, 517–18, 520,
 523, 524, 553, 564, 566, 567, 569,
 571–75
 inspections, 401–05
 inter-bank agreements, 76, 114–25, 586
 lending rates, 82, 83, 91, 114–16
 licensing, 466–70, 486–90
 liquidity of, 59, 75–77, 80, 84, 416–23
 management and control, 423–33
 reserve requirements, 41–49, 75–78, 80,
 82, 86, 94, 103–04
 scheduled/non-scheduled, 1, 3, 42, 50,
 52–53, 56–57, 98, 101, 104, 110, 112,
 122, 130, 173, 405–06, 409, 426, 449,
 493, 506–11, 521, 525–26, 542, 546,
 567, 576, 704–05
 Barve, S.G., 332, 370, 371
 Beale, P.S., 535
 Belgium, 838
 Bell, Bernard, 665, 666, 676
 Bengal, *see* West Bengal
 Bengal Central Bank, 455
 Benthall, Paul, 328
 Bernstein, Edward, 13, 518, 626, *see also* IMF
 Bhabha, C.H., 119, 122–23, 495–97, 727
 Bhagat, B.R., 262
 Bhatt, R.S., 546–47, 550, 572
 Bhatt, V.V., 20n, 618, 620, 622, 764
 Bhattacharyya, P.C., 24–25, 48, **95**, 108–09,
 111, **112**, 122, 125–27, 164, 165, 173,
 349, 351, 413, 429, **432**, 443, 446, 447,
 456, 459, 476, 480, 542, 570, 572, 588,
 612, 710, 711, 712, 733, 734, 741, 756,
 757, 800, 801, 803
 Bank rate, 94–95, 96–97, 101
 cooperative/agricultural credit, 306, 308,
 433, 434

- Credit Guarantee Scheme, 306, 308
 deposit insurance, 433–34, 436
 exchange control, 816, 818, 831–32
 external finances/payments/aid, 635, 653,
 654, 659, 662, 667, 668, 669, 851–52
 IDBI, 536–37, 539
 IMF drawings, 842–44
 loans/overdrafts of states, 199–203, 225,
 734, 740
 monetary policy, 6, 97, 109, 125–26,
 732–34, 741
 rupee devaluation, 676–82, 684, 686
 state-associated banks, 383, 387–89, 392,
 394
 Bhavnagar Darbar Bank, 357
 Bhide, M.R., 246, 280, 283, 284, 287, 293,
 307–09, 437
 Bhoothalingam, S., 612, 668, 669, 676–78,
 682, 686
 Bhopal, 191n, 266, 269, 272
 Bihar, 193, 196, 197, 200, 275, 300, 305,
 306, 365, 489, 504, 506
 Bilaspur, 191n
 bilateral payment arrangements, 626, 814–15,
 845–55
 Bill Market Scheme, 37, 56–63, 79, 81, 82,
 85, 95, 96, 113, 176, 351, 521, 576,
 579, 580, 582–84, 588, 715–21
 Birla, B.M., 341, 708
 Birla, G.D., 535
 Birla, K.K., 582
 Black, Eugene, 531–34, 635, 638, 639,
 641–44, 649, 658, 659
 Blessing, Karl, 635, 636
 Bombay, 267, 343, 344, 345, 382, 405, 411,
 441, 496, 497, 507, 545, 546, 549, 841
 Bombay Mint, 759
 Bombay Port Trust, 25
 Bombay Presidency/State, 146, 150, 153,
 194, 210, 212, 215, 223, 232, 267, 272,
 291, 373–75, 382, 383, 442, 453, 469,
 529, 554, 557, 559, 567, 753
 Bombay Provincial Cooperative Institute,
 267, 268
 Borkar, D.G., 408–11, 586
 Bose, Vivian, Justice, 803, 805
 Bowles, Chester, 645
 Boyle, Edward, 611
 British India Corporation, 796, 797, 799, 801
 British Supply Mission, 608
 Bukharin, Nikolai, 73
 Bulganin, Nikolai, 798
 Bulgaria, 854
 Burma, 347
 Burma Monetary Arrangements Order
 (1937), 752
 Burmah Oil Company, 657
 Calcutta, 343, 344, 405, 411, 449, 456, 461,
 507, 545, 546, 549
 Calcutta Exchange Banks' Association, 831
 Calcutta Mint, 759
 Calcutta National Bank, 458
 Calcutta Stock Exchange Association, 216
 Canada, 602, 608, 610, 621, 643, 651, 759,
 818, 836, 841–43
 Canara Bank, 99, 476, 483
Capital, 334
 Catholic Bank of India, 481
 Central Bank of Ceylon, 172n
 Central Bank of India, 70, 99, 360, 526n
 Central Banking Enquiry Committee, 235,
 441, 442, 489, 521, 541, 553
 Central Warehousing Corporation, 251
 Ceylon, 346, 621–23, 675
 Chablani, S.P., 586
 Chagla, M.C., Justice; and Chagla
 Commission, 794, 795, 800, 802, 803,
 805
 Chandavarkar, A.G., 20n
 Chandigarh, 269, 506, 557
 Chartered Bank, 526n
 Chaturvedi, B.N., 800
 Chaudhuri, Sachindra, 125–27, 202, 347,
 680, 682, 685, **686**, **687**, 712, 734
 Chetty, Shanmukham, 319, 320, 336, 339,
 554, 599, 601
 China, 90, 160, 657, 678n, 836, 837, 839,
 851, *see also* Taiwan
 Chisholm, Roderick, 58, 61, 169, 321, 322,
 328–31, 332, 714
 Chittagong, 346
 Chokshi, N.M., 121
 Churchill, Winston, 699
 Cobbold, Cameron, 601, 602, 621
 Cochin, 789
 Cochran, Merle H., 631
 Coimbatore, 757, 786n
 Coinage Act (1906), 752
 Coinage Amendment Bill (1955), 754

- Colombo, 347
 Colombo Plan, 425
 Comilla Banking Corporation, 455
 Comilla Union Bank, 455
 Commerce and Industry, Ministry of, 566, 570, 571, 582, 588, 628, 701, 847, 848
 Commonwealth Development Finance Company, 530, 532, 534
 Community Development and Cooperation, Ministry of, 287, 289, 296–97, 300, 301, 308, 437–38, 701, 731, *see also* Food and Agriculture, Ministry of
 Community Projects Administration, 248
 Companies Act (1956), 357, 388, 394, 405, 426, 429, 443, 444, 484, 522, 526, 554
 Company Law Department, 443
 Congress Party, 142, 275, 320, 432, 482, 735, 795, 803
 Constituent Assembly, 319–20, 457, 458, 554
 Constitution of India, 185, 190, 199, 338, 341, 380, 541, 747, 792
 Cooper, John Sherman, 645
 Cooperative Administration, Committee on, 300
 cooperative banks/credit, 231, 235–52, 254, 261–63, 264–315, 350–54, 358, 521, 528–29, 565, 567, 568, 573–76, 578, 702, 704–05, 731, 740, 741, *see also* rural/ agricultural credit
 deposit insurance, 501–05
 primary societies, 272–302, 439
 regulation of, 433–40
 Cooperative Credit, Committee on, (Vaikunth Lal Mehta Committee), 260, 293, 294, 296, 297, 301, 304, 308, 502, 503
 Cooperative Planning Subcommittee, (R.G. Saraiya Subcommittee), 233
 Coorg, 191n, 269, 272
 Craft, Robert, 533
 Credit Authorization Scheme, 109
 credit controls/policy, 18, 25, 41–49, 51–53, 66–86, 89–101, 111, 112, 114, 126–27, 156, 165, 179, 730, 743
 moral suasion, 84–86, 120, 123, 412, 422
 net liquidity ratio, 84–94, 96–98, 100, 101, 108, 111, 114–15, 586, 588
 quota-slab system, 82–84, 91, 94, 96, 98, 114
 reserve requirements, 41–49, 75–78, 80, 82, 86, 94, 103–04
 selective credit controls, 18, 48, 70–75, 84, 89, 98, 105, 107
 Credit Guarantee Scheme, 529, 569–76
 currency, 16, 17, 30–34, 36, 41–42, 175, 746–59, **748**, **749**
 decimal coinage, 753–54
 design of notes, 747–50
 high-denomination notes, 750–51
 manufacture of notes, 754–59
 one-rupee notes, 752–53
 Custodian of Enemy Property, 346
 Czechoslovakia, 845, 846, 854
 Dacca, 346
 Dadra & Nagar Haveli, 557
 Darling, Malcolm, 240
 Darling Report, 231
 Datar, T.V., 58–59, 772
 de Lattre, Andre, 676
 Deb, R.C., 460
 Defence of India Rules, 808
 deficit financing, 6, 11, 12–49, **23**, 64, 65, 93, 103, 126, 165, 732, 737, 740, 741 and inflation, 25–27
 Delhi, 191n, 344, 408, 445, 449, 506, 507, 546, 549, 557, 559, 672, **838**, 839
 deposit insurance, 455, 490–505, 518, 520, 742
 Deposit Insurance Corporation, 120–21, 433–37, 490, 499, 500, 503, 505, 550
 Deposit Insurance Corporation (Amendment) Bill, 505
 Deposit Insurance Corporation Bill/Act (1961), 490, 491, 499–501
 Deposit Insurance Fund, 499, 500
 Desai, Morarji, 18–19, 24, **92**, **161**, 262, 345, **420**, 451, 542, 712, 732, 733, 765
 cooperative/rural credit, 277–79, 289, 290, 292, 731, 741
 external aid, 639, **640**, **643**, 644, **648**, 652, 654, 660, 661
 government loans and borrowings, 155, 158, 162, 164
 Kerala banking crisis, 404, 479, 483, 787–91
 overdrafts of state governments, 199–200, 205
 state-associated banks, 388, 389
 Desai, R.K., 460, 463
 Deshmukh, C.D., 51, **53**, 57, 71, 148, 168,

- 170, 196, **218**, 245, 381, 402, 441–42, 458, 464, 465, 561, 627, 628, 673, 674, 704, 709, 713, 727, 732, 756, 797
- deposit insurance, 491, 496–99
- financing industry, 515, 522
- Imperial Bank, SBI and subsidiaries, 319–21, 331, 334, 343–44, 364, 368, 369, 376–78
- National Plan Loan (1964), 142, 143, **145** and Rama Rau, B., 714–15
- state loans, 206–07, 214
- sterling balances/sterling area, 599, 601, 605–06, 609, **610**, 611, 615, 619, 624
- Deshmukh, Durgabai, **145**
- Deshmukh, S.D., 202, 547, 620, 622, 627, 656
- D'Souza, V.L., 580
- Development Assistance Fund, 537, 539
- Devkar Nanjee Banking Company, 526n
- Dewas, press at, 759
- Dey, S.K., 287, 438, 504
- Dharwar central cooperative bank, **270**
- Dillon, Douglas, 644, 647
- Divekar, C.S., 474, 478, 479, 710, 785, 786
- dollar (Canadian), 584, 810, 811
- dollar (US), 609, 613, 617, 618, 623, 809–11, 841
- Dubai, 691
- Dulles, John Foster, 631
- Dutt, B.K., 491, 492, 516n
- east Europe, *see* bilateral payment arrangements
- Eastern Economist*, 334, 672, 673
- Economic Survey*, 537, 625n, 681
- Economic Times*, 686
- Economic Weekly*, 240
- Education, Ministry of, 820
- Egypt, 601, 604, 611, 620, 840
- Engineering Export Promotion Council, 582
- Ernakulam, 360, 771, 790
- Estimates Committee, 165–66, 756, 850
- Evening News*, 841
- Exchange Bank of India and Africa, 3, 453
- Exchange Banks' Association, 496, 585
- exchange control, 628–29, 808–35, **819**, 820, **820**, *see also* sterling, dollar
- authorized dealers, 830–32
- and emigration, 822
- Enforcement Directorate, 834–35
- Exchange Control Department, *see under* RBI
- exchange for foreign travel, 815–22
- and foreign/NRI investments, 825–30
- and investment abroad, 823–25
- P form, 628, 816–17, **817**, 818
- exchange rate policy, 592, 593, 622, *see also under* rupee
- Exim Bank, 763
- Export Bills Credit Scheme, 93, 586
- export controls, 811–13
- Export Credit and Guarantee Corporation, 579, 586, 813, *see also* Export Risks Insurance Corporation
- Export Credit Guarantee Committee, 582
- Export Credit (Interest Subsidy) Scheme, 579
- export finance, 113, 579–89
- Export Finance, Committee on, (Mathrani Committee), 587
- Export Promotion Committee, 579–82
- Export Risks Insurance Corporation, 579, 582–85, *see also* Export Credit and Guarantee Corporation
- External Affairs, Ministry of, 822
- FERA (Foreign Exchange Regulation Act, 1947), 593, 628, 797, 808, 809, 823–25, 827, 830, 832–35
- F. & C. Osler (India) Ltd., 795, 797
- Federal Deposit Insurance Corporation, 492
- Federal Reserve Bank of New York, 623, 843
- Federation of Indian Chambers of Commerce and Industry, 46
- Finance Commission, first, 194–95, **195**
- Finance for the Private Sector, Committee on (Shroff Committee), 2, 4, 5, 136, 406, 490–92, 494, 514–24, 532, 533, 540, 541, 713
- Finance, Ministry of, 22, 29, 31, 39, 43, 54, 100, 102, 137, 160, 166–67, 170, 174, 176, 177, 189, 191, 197, 198, 201, 203, 209–10, 225, 245, 247, 261, 309, 320, 327, 350, 368–70, 376, 379, 456, 459, 460, 465, 492, 497, 522, 532, 533, 545, 558, 559, 582, 605–07, 609, 612, 619, 628, 632, 635–37, 656, 661, 668, 669, 675, 678, 679, 685, 692, 701, 707, 708, 710–13, 717, 719, 720, 724, 728, 732, 737, 738, 765, 776, 798, 799, 809, 815, 818, 820, 826, 830, 832–35, 845, 847, 848

- financial/credit institutions, 2, 6, 91, 234–35, 564, 742
Financial Express, 550
Financial Times, 597
 First Boston Corporation, 532
 First National City Bank of New York, 763
 Food and Agriculture, Ministry of, 245–49, 275, 287, 296, 309, 701
 Ford Foundation, 302, 303, 304
 Foreign Exchange Dealers' Association of India, 587, 810, 830
 Foreign Exchange Regulation (Amendment) Ordinance/Act (1951/52), 824, 833
 foreign exchange reserves, 13, 15, 17, 30–36, 64–66, 102, 652, 655, 693
 Foreign Travel Scheme, 818
 Formosa, *see* Taiwan
 France, 109–10, 636, 651, 836, 842, 843
 Franks, Oliver, 646
 Frere, Maurice, 636
 Frost, J.A., 770–73
 Fujairah, 691
- Gadgil, D.R., 14, 74, **220**, 234, 246, 268, 285, 341, 350, 368, 376, 377, 383, 436–38, 440, 765
 Gajendragadkar, P.B., Justice, 116, 117
 Gandhi, Indira, 679, 681–83, 685
 Gandhi, V.B., 34
 George, K.M., 778, 779
 Germany (West), 581, 616, 633, 635, 636, 638, 639, 641, 643, 647, 651, 655, 836–39, 841, 843, 851
 Giori, 758
 Goa (and Daman & Diu), 269, 506, 557, 649
 Goenka, Badridas, 328
 Gogtay, M.L., 475, 480, 481
 Gold Bonds, 160, 164–65
 Gold Control Order, 484
 gold reserves, 606, 607, 613, 653, 669
 gold tranche, 652, 840–44
 Gorwala, A.D., 234, 251, 332, 579, 790
 Government of India, *see under* respective Ministries
 Government of India Acts (1919, 1935), 184, 554
 Green Revolution, 302–10, 689
 Guha, A.C., 250, 343, 458, 463–65
 Gujarat, 255, 258, 267, 268, 299, 304, 306, 445, 506
- Gulf rupees, 628–29, 690–92
 Gupta, Bhupesh, 34
 Gupta, Ramkishan, 393
 Gurupadaswamy, M.S., 34
- Habib Bank, 500
 Haj notes, 821, 822
 Handloom Board, All-India, 578
 handloom cooperatives, 577–78
 Handloom Finance, Advisory Committee on, 578
 handloom (and small-scale) credit, 553–78
 Handoo, S.K., 521
 Committee (on underwriting), 522
 Hanifa, K.M., 540, 542
 Haryana, 269, 301, 506, 557
 Hawker, Cyril, 617, 618, 620
 Hidayatullah, M., Justice, 793
 High-yielding Varieties Programme, 305–06
 Hilton Young Commission, 174n
 Himachal Pradesh, 191n, 266, 301, 506, 557
 Himmatsinghka, 431
Hindu, 241, 334
 Hoffman, Michael, 646
 Hooghly Bank, 455
 Hoshangabad paper mill, 756, 758
 Humphrey, Hubert H., 645
 Hungary, 811, 845, 846
 Hussain, Ashfaq, 569
 Hyderabad, 190, 215, 269, 360, 362, 373, 374, 557, 572, 576
 Hyderabad (Sind), 346
 Hyderabad State Bank, 136, 186, 188, 333, 342, 355, 358, 360–62, 364, 367, 368, 373–76, 379–81, 384–86, 702, *see also* State Bank of
- Iengar, H.V.R., 35, 62, 67, **68**, 69, 72–74, 75, 85, 119–21, 155, 197, **220**, 395, 420, **420**, **563**, 621, 633, 635–37, 647, 674, 703, 704, 709, 711, 712, 718, 726–28, 732, 757, 763, 822, **838**, 840, 845–46
 ad hoc treasury bills, 39–40
 agricultural/cooperative credit, 260, 275, 276–80, 282, 284–87, 289, 290, 292, 296, 731
 and Bank-government relations, 702, 740–41
 banking crisis and consolidation, 474–75, 478–80, 483–85, 780, 784, 790–92

- capital adequacy norms, 408, 409, 411–13
- deposit insurance, 408, 495, 497–98, 501, 502
- financing of second plan, 18–19, 21, 22
- government borrowings, 153, 158, 174, 209, 221
- industrial finance, 526, 535
- inspection of banks, 403–04
- and Krishnamachari, T.T., 726, 732
- and Mundhra affair, 733, 794, 799–803, 805, 806
- State Bank and subsidiaries, 349, 350–52, 381, 383, 384, 385–86, 387–88, 389, 722
- Imperial Bank of India, 2, 4, 52, 57, 58, 135, 136, 145, 148, 167, 169, 170, 186, 188, 189, 195, 235, 318–38, 343–44, 346–47, 349, 358, 360, 361, 363, 365–69, 372, 374, 485, 516n, 518, 520, 521–22, 712, 750, 770, 771, *see also* State Bank of India
- Act, 318, 329, 522
- nationalization, 317, 318–47, 364, 377, 702, 714
- Rural Credit Survey's recommendations, 232, 238, 240, 247, 251
- import controls, 813–15, *see also* Open General Licence
- Inchcape Committee, 757
- Income Tax Act, 834
- India Office, 318
- India Supply Mission (ISM) balances, 608–13, 761
- Indian Bank, 473, 498, 526n
- Indian Banks' Association, 46, 116, 119, 121–22, 404, 406, 411, 412, 421, 422, 423, 430, 448, 462, 496, 497, 585, 727, 753
- Indian Civil Service (ICS), 709–10, 803
- Indian Cooperative Congress, 249
- Indian Evidence Act, 833
- Indian Finance*, 59, 240
- Indian Institute of Bankers, 84, 792
- Indian Investment Centre, 546, 547
- Indonesia, 838
- Industrial Cooperative Banks, All-India Federation of, 440
- industrial credit/finance, 2, 64–65, 75, 513–51
- handloom and small-scale, 553–78
- Industrial Credit Fund, *see under* RBI
- Industrial Credit and Investment Corporation of India, 91, 523, 525, 526, 530, 536, 537, 539, 540n, 546, 547, 564
- Industrial Development Bank of India, 96, 514, 530–40, 540n, 547, 557, 564, 589, 712
- Industrial Finance Corporation of India, 91, 515, 516n, 518–19, 521, 524–26, 533, 536, 538, 539, 540n, 542, 546, 553–59, 561, 564
- Industrial Investment Trust, 541
- Industrial Policy Resolution, 516, 566, 825, 827
- Industrial and State Financial Corporations (Amendment) Bill, 558
- Industries (Development and Regulation) Act, 516
- inflation/price fluctuations, 12–19, 25–27, 50, **53**, 64–66, 70, 74, 76, 77, 87, 88, 89, 93, 97, 100, 106, 108, 128, 221, 275, 579, 626
- Institute of Economic Growth, 408, 409
- Insurance Act, 522
- Intensive Agricultural Areas Programme, 303–05
- Intensive Agricultural District Programme, 303–05
- International Bank for Reconstruction and Development, *see* World Bank
- International Development Association, 649, 662, 687, 688, 813
- International Finance Corporation, 530
- International Monetary Fund (IMF), 13, 14–15, 35, 78, 83, 84, 90, 91, 101–03, 106, 159, 201, 350, 518, 601, 604, 606, 607, 610, 612–16, 622, 626, 630–32, 639, 641, 642, **648**, 649, 650, 652–56, 666–72, 675–80, 682–85, 688, 729, 736, 765, 809, 836–44, **838**
- Investment Corporation of India, 541
- Iran, 811
- Issue Department, *see under* RBI
- Istanbul, 616–18
- Italy, 636, 649, 838, 839
- Iyer, A.S.E., 572
- Jacobsson, Per, 14–16, 25, 632, 641, 652, 655, **838**
- Jain, Ajit Prasad, 249, 280
- Jammu & Kashmir, 224, 301, 305, 393–95, 489, 506, 508

- Jammu & Kashmir Bank, 394, 395
 Japan, 571–73, 581, 641, 643, 651, 836, 839, 841, 843
 Jeejeebhoy, P.J., 617, 618, 809, 833
 Jessop & Co., 796, 797, 799, 801, 805
 Jha, L.K., **112**, 127, 162, 199–200, 205, 261, 483, 498, 502, 654, 662, 663, 666–69, 675, 676, 678, 681, 682, 709, 711, 730, 733, 734, 765, 818, 826
 Johar, V.P., 304
 Johnson, Lyndon B., 663, 688
 Joseph, K. George, 777
 Joshi, D.R., 121, 404, 413
 Joshi, J.V., 515, 516n, 604, 615
 Joshi, Subhadra, 427
- Kalba, 691
 Kamaraj, K., 685
 Kamat, G.R., 307, 606, 607, 794, 801–03
 Kamel, Hassan, 691
 Kanpur, 60
 Kanpur Cotton Mills, 795, 804
 Kappen, Cherian J., 432
 Kapur, J.L., Justice, 793
 Kapur, T.C., 585, 586
 Karnataka, 373, 374, 377, *see also* Mysore
 Karve, D.G., 203, 245, 262, 280, 291, 503, 565, 710
 Kennedy-Cooper resolution, 645, 646
 Kennedy, John F., 645
 Kerala, 197, 200, 223, 299, 375, 377, 382, 383, 403, 432, 468, 470–86, 498, 506, 562, 776, 777, 778, 781, 783, 786, 790
 Kerala Bankers' Association, 791
 Keynes, J.M., 595, 697–98, 711, 729
 Khadi and Village Industries Commission, All-India, 293
 Khatkhate, D.R., 20n, 764
 Khrushchev, Nikita, 798
 Kilachand, Tulsidas, 119–21, 412, 421, 430
 King, Ben, 659
 Kirloskar, S.L., 582
 Kodaikanal, 805
 Korea (South), 838
 Korean boom/war, 12, 41, 50, 63, 579, 672, 674
 Kottayam, 770
 Kottayam Orient Bank, 473, 475, 478–81, 483
 Krishna Ram Baldeo Bank, 355
 Krishnamachari, T.T., 24, 36, 40, 72, 73, 117, 153, 174, 200, **220**, 221, **222**, 223, 260, 330–31, 350–52, 381, 386, 393, 570, **634**, 667, 702, 703, 704, 713, **716**, 722, 726, 728, 732, 734, 741, 756, 843
 cooperative credit, 275–76, 440, 731
 devaluation, 676, 677, 679
 external aid, 629, 635, 637, 660, 662, 665, 669–70
 financing the second plan, **15**, 18, 21
 Industrial Development Bank of India, 531–37
 monetary and credit policy, 67, 106, 108–09
 Mundhra affair, 387, 733, 794, 797–803, 805, 806
 and Rama Rau, B., 66, 712, 713–26
 Unit Trust of India, 541–42, 545, 547, **548**
 Krishnamachari, V.T., 185, 288–89, *see also* States Finances Enquiry Committee
 Krishnaswamy, K.S., 516n, 794
 Kuruvilla Vellukunnel, Joseph, 792
 Kutch, 191n
 Kuwait, 690
- Lahore, 347
 Lakshmi Commercial Bank, 473
 Lalbhai, Kasturbhai, 535
 land mortgage banks, 238, 239, 244, 250, 252, 253, 254–59, 260, 261, 262, 263, 268, 302, 314
 Andhra, 257
 Bombay/Maharashtra, 254, 256, 258, 259
 Gujarat/Saurashtra, 257, 258
 Madras, 254, 256
 Mysore, 254, 259
 Orissa, 254, 257
 Travancore-Cochin, 254
 Latin America, 637, 644, 766, 837
 Law, Ministry of, 186, 199, 337, 358, 833, 834
 Laxmi Bank (Akola), 404, 455, 470, 791
 League of Nations, 699
 Lewis, John, 663, 765
 Life Insurance Corporation of India, 25, 123, 159, 163, 221, 224, 226, 256, 262, 386, 387, 514, 526, 527, 541, 542, 546, 560, 564, 704, 733, 794, 795, 799–802, 804–07
 Limaye, Madhu, 710
 Lloyds Bank, 526n

- Lyallpur, 346
 Lyons Range, 795, 800

 Macmillan Committee, 513
 Madan, B.K., 14, 32–33, 37–39, 44, 45, 78, 80, 175, 176, 194, **195**, 234, 408–10, 413, 414, **415**, 418, 419, 422, 524, 538, 542, 547, 572, 615, 623, 673, 710, 729
 Madhya Bharat, 190, 215, 266, 272, 360–62, 373
 Madhya Pradesh, 74, 197, 210, 212, 213, 223, 254, 259, 269, 373, 375, 377, 489, 505, 507–08
 Madras, 146, 147, 149, 184, 192, 194–96, 207–08, 210, 212–17, 219, 221, 224, 226, 238, 242, 243, 255, 281, 284, 291, 300, 306, 343, 436–37, 445, 453, 469, 503–04, 506, 507, 546, 549, 554, 559, 567, 739
 Madras Industrial Investment Corporation Ltd., 554, 557, 561, 565, 569, 574
 Madurai, 771
 Mahajan, M.C., Justice, 199
 Mahalanobis, P.C., 641, 728
 Maharashtra, 224, 255, 259, 267, 300, 304, 306, 440, 442, 445, 466, 506, 507
 Mahindra, K.C., 171
 Malaya, 603, 653
 Maluste, D.N., 809, 848
 Manipur, 191n, 269, 299, 306, 557
 Manipur State Bank, 364, 395
 M.V. *Marilu*, 841
 Marshall plan, 598, 601, 649
 Martandam Commercial Bank, 479
 Masani, M.R., 431, 702
 Massachusetts Institute of Technology, 645
 Mathalone, R., 460
 Mathrani, K.P., 497, 501, 502
 Matthai, John, 140, 320, 321, 332, 344, 347, 458, 516, 601, 673, 713, 757
 Mayurbhanj State Bank, 358, 364, 395
 Mazumdar, D.L., 441
 Mehta, Asoka, 109, 343, 681–84
 Mehta, B.N., 191, 542
 Mehta, G.L., 547
 Mehta Vaikunth Lal, 260, 268, 280, 286, 293, 436, 437, 502, 721, 722, *see also* Cooperative Credit, Committee on
 Mercantile Bank, 526n
 Middleton, C.W., 516n

 Mirpurkhas, 346
 Mitra Committee, (Banks' Liquidation Proceedings Committee), 460–62
 Mitra, Dharendra Nath, 343, 368, 460, 461, 477
 Mittra, K.C., 564
 Mody, Homi, 497
 monetary policy/control, 1, 3–6, 9–11, 12–131, 178–79, 696, 698, 699, 706, 708, 713, 732, 743
 Mookerjee, Biren, 535
 Morarka, R.R., 444
 Motilal, Chimanram, 797
 Mudaliar, Ramaswami, 535
 Mudholkar, J.R., Justice, 793
 Multi-unit Cooperative Societies Act, 268
 Mundhra, Haridas; and Mundhra affair, 387, 402, 424, 541, 542, 703, 704, 706, 712, 733, 794–807
 Muscat, 691
 Mussoorie conference, 273–74
 Muvattupuzha, 783
 Mysore, 149, 153, 190, 202, 215–17, 223, 255, 267, 268, 269, 272, 286, 291, 293, 301, 362, 373, 382, 383, 437, 504, 506, 507, 567, 774

 Nadkarni, M.S., 516n
 Nagaland, 269
 Nagpur, 841, 843
 Nair, Govindan, 682
 Nanavati, M.B., 245
 Nangia, N.D., 187, 758
 Naraingunge, 346
 Narasimham, M., 26n, 94, 96, 107, 110, 122–23, 586, 667, 668
 Narayan Prasad, P.S., 51, 234, 600, 607, 614–15, 631, 632, 652, 837
 Narayan, Shriman, 296
 Nasik printing press, 754–55, 758
 Nath Bank, 3, 453, 455, 458
 National Bank of India, 526n
 National Bank of Lahore, 473
 National Bank of Pakistan, 500
 National Cooperative Development Corporation, 256
 National Cooperative Development Fund, 239
 National Cooperative Development and Warehousing Board, 239, 240, 251

- National Defence Bonds, 160
 National Defence Loans, 164
 National Defence Remittance Scheme, 677, 830
 National Development Council, 72, 160–61, 278–83, 285–88, 296–97, 376, 565, 731
 National Extension Services Block, 248
 National Industrial Development Corporation, 525, 535
 National Plan Bonds (1967), 157
 National Plan Bonds (1968), 154
 National Plan Bonds (First Issue), 141
 National Plan Bonds (second series–1965), 148, 342
 National Plan Loan (1964), 141–49, 154, 156
 National Savings Certificates, 257
 National Small Industries Corporation, 565, 566, 569
 National Small Industries Development Corporation, 525
 National Warehousing Development Fund, 239
 Natu, W.R., 614
 Nayar, Raman, Justice, 792
 Negi, H.S., 29–30
 Nehru, B.K., 31, 533, 534, 608–11, 633, 638, 639, 641, 642, 644, 646, 649, 661, 662, 668, 678, 679, 718, 719, 724, 801–02
 Nehru, Jawaharlal, 17, 72, 73, 142, 176, 199, 275, 276–77, 280, 281, 283, 284, 347, 379, 381, 404, 542, 600, 607, 627, 628, 633, 644, 654, 713, 715, 718–25, 727, 728, 731, 734, 791, 797, 803, 845–46
 Nepal, 621
 Netherlands, the, 571, 631
 New Bank of India, 473
New York Times, 598, 682
 Nixon, Richard, 645
 non-bank deposit institutions, 441–51, 464–66, 705
 non-bank sources of finance/credit, 2, 83, 94, 109, 234–35, 576
 Norman, Montagu, 699, 709
 Northwest Frontier Provinces, 192
 Oman, 691
 Open General Licence (OGL) imports, 601, 689, 813, *see also* import controls
 Oriental Bank of Commerce, 473
 Orissa, 74, 192, 193, 196, 197, 219, 257, 275, 300, 306, 365, 504–06, 508
 P Form, 628, 816–17, **817**, 818
 PEPSU, 190, 191, 269, 359–63, 373, 374, 382, *see also* Punjab
 P.L.480, 21–22, 77, 172, 180n, 260–61, 523–25, 527–28, 531, 536, 551, 560, 633, 643n, 647n, 688, 760–66, **762**, 851
 P.L.665, 764
 Pai, D.D., 805
 Pakistan, 108, 346, 461, 593, 594, 600, 605–08, 622, 672, 673, 675, 678n, 751, 798, 810, 811, 830
 Palai Central Bank, 399, 403, 404, 408, 417, 454, 455, 470–78, **471**, **472**, 479, 485, 490, 495, 767–93, **788**
 Pant, G.B., 283, 284, 638, 719, 802
 Pant, K.C., 505
 Parekh, H.T., 546–47
 Patel, H.M., 368, 369, 372, 377, 382, 385, 387, 558, 732, 733, 794, 797, 800–04
 Patel, I.G., 163, 646, 652, 661, 676, 677, 679, 681, 682, 839
 Patil, R.K., 285
 Patna, 249
 Pendharkar, V.G., 26n, 107–08, 120, 123, 415, 429, 445, 446, 542, 544, 545, 547, 549, 551, 581, 586, 620, 622, 627, 651, 656, 675, 813, 814, 831, 840, 841, 850
 Persian Gulf, *see* Gulf rupees
 Philippines, 838 *
 Pillai, N.R., 710n
 Pillai, Parameswaran G., 286
 Pillai, Sivashanmugham J., 803
 Pillai, Thanu P., 479, 480
 Pinto, P.J.J., 123
 Planning Commission, 109, 157, 207, 209, 220, 225, 226, 245, 247, 275–78, 280–84, 293, 296, 304, 306, 307, 515, 565, 628, 656, 701, 706, 715, 728, 729, 731, 738, 739, 765
 plans, 10, 12, 40, 54, 137, 166, 174, 178, 330, 527
 annual, 12
 first, 5, 12, 13, 27, 51–64, 141, 515, 553, 742
 second, 12–22, 64–86, 149–57, 249, 273–74, 286, 302, 493, 529, 592, 625–44, **640**, 674, 713, **716**, 736–38
 third, 11, 13, 19–20, 22–24, 40, 87–127, 157–65, 279, 297–99, 592, 644–56, 662–64, 678

- fourth (draft), 24–25, 307, 664, 666
 Poland, 845, 846, 850, 854
 Pondicherry, 259, 269, 506
 Poona, 441, 442
 Portals, 755, 756, 757
 Premium Prize Bonds, 158n, **161**
 Preobrezhensky, 73
 Presidency Banks, 318, 324
 Primary Agricultural Credit Societies, 231n,
 237, 241, 242, 243, 244, 272–302, 439
 Public Accounts Committee, 165, 167
 Public Debt (Central Government) Act
 (1944), 135, 190, 191
 Punjab, 146, 147, 219, 269, 300, 304, 306,
 359, 363, 373, 382, 383, 386, 397, 453,
 461, 506, 507, 556, 557, 559, *see also*
 PEPSU
 Punjab National Bank, 99, 146, 147, 150,
 214–15, 217, 403, 473, 478, 498, 526n

 Qadir, Abdul, 346
 Qatar, 691
 Quotas, *see* IMF

 Radcliffe Committee, 78, 725, 727, 728
 Raisman, Jeremy, 598
 Raj, K.N., 790
 Rajagopal Naidu, P.S., 286
 Rajagopalachari, C., 213, 215, 216
 Rajasthan, 190, 191, 200, 219, 266, 272, 301,
 306, 360–63, 382, 383, 392
 Ram Nath, 30, 148, 194, 196, 383, 400, 425,
 443, 520, 533, 554, 583, 705, 710, 711
 bank liquidation proceedings, 456, 459–60
 missing banks in West Bengal, 464–65
 Mundhra affair, 796, 797
 Palai Central Bank, 770, 772, 773, 778,
 781
 Rama Rau, B., 13, 30, 31, 46, **52**, 117, 142,
 148, 168–70, 381, 400, **424**, 492, 673,
 709, 712, 713, 727–29, 735–37, 797
 Bank as sole banker to state governments,
 191, 194
 Bankers Training College, **424**, 425
 Bill Market Scheme, 58–62, 717
 Imperial Bank, State Bank and
 subsidiaries, 321, 328–36, 338–41, 344,
 345, 347, 364, 367–69, 371–73, 376–78
 industrial finance, 515, 516, 521, 532, 533,
 540
 and Krishnamachari, T.T., 66, 712, 713–26
 missing banks in West Bengal, 463–65
 new monetary policy, 51, 53, 55
 rural credit survey, 233, 245
 second plan, 14, 17, 627
 state government finances, 211, 212, 215,
 216, 361–62, 705
 sterling policy, 601, 607, 609, 611,
 615–16, 618, 619
 Raman, A., 413, 798, 799
 Ramanujam, K.N.R., 422, 445, 446, 449,
 493, 494, 585
 Ramasubramaniam, T.K., 528
 Ramaswami, V.K., 682
 Rangachari, M.V., 22, 160–62, 171, 172,
195, 198–99, 201, 202, 436, 474–75,
 479, 480, 542, 710
 Rangoon, 347
 Ras-al-Khaimah, 691
 Reddy, N. Sanjiva, 572
 Refinance Corporation for Industry, 261, 514,
 523–31, 535–38, 540, 547, 557, 576,
 579, 585
 Reiffeisen formula, 273
 Reserve Bank of India
 Agricultural Credit/Rural and Cooperative
 Credit, Standing Advisory Committee
 on, 229, 232, 241, 245, 247, 251, 252,
 258, 261, 269–70, 276, 299–301, 304,
 308–09, 433, 435, 436, 438, 502, 503,
 578n
 Agricultural Credit Board, 309
 Agricultural Credit Department, 240, 242,
 251, 255, 266–67, 279, 299, 300, 308,
 350, 433–35, 501, 504, 567
 Agricultural Credit Funds, 102n, 239, 243,
 248, 252, 255
Annual Report, 14
 Balance of Payments Division, 600
 Bank rate/lending rate, 3, 51–56, **53**, 61,
 68–69, 77–79, 81, 83, 84, 89, 90, 91,
 93–99, 101, 114, 115, 119, 581, 585,
 586, 587, 588, 670, 717, 741
 Banking Department, 37, 38, 102n, 175,
 176, 519, 596
 Banking Development, Department of,
 494, 495, 496, 569, 570, 571
 Banking Operations, Department of, 46, 58,
 61–62, 80, 120, 122, 364–65, 371, 410,
 413, 460, 474, 492, 493, 496, 500, 519,

- 523, 581, 772–73, 779, 780, 781, 786
 Banking Research, Division of, 408, 409,
 410, 419, 421, 428, 493, 494, 495, 567,
 584, 585
Bulletin, 20n, 524, 540, 627, 628, 764, 765
 Central Accounts Section, 193, 202
 Central Board of Directors and Committee
 of, 14, 31, 35, 43, 58, 66, 67, 69, 74, 78,
 143, 233, 247, 250, 261, 325, 328, 329,
 339, 341, 343, 347, 361–62, 367, 368,
 369, 370, 371, 375, 379, 384, 390, 403,
 414, 417, 425, 429–30, 431, 459, 462,
 470, 477, 482, 485, 492, 495, 496, 518,
 521, 527–28, 540, 555, 556, 561, 577,
 584, 585, 586, 624, 627, 700, 704, 708,
 709, 717, 719, 724, 769, 781, 788, 806,
 823, 833, 834
 credit controls/policy, 18, 25, 41–49,
 51–53, 66, 86, 89–101, 111, 112, 114,
 126–127, 156, 165, 179, 730, 743
 Economic Department, 120, 122, 203, 406,
 415, 447, 449, 495, 496, 540, 689, 816,
 827, 830, 847 *see also* Research and
 Statistics, Department of
 Exchange Control Department, 584, 809,
 813, 815, 830, 832
 financing central and state governments,
 133–227
 Foreign Aid Forecasting Section, 815
 Industrial Credit Fund, 537, 539, 564
 Industrial Finance Department, 528, 539,
 564
 International Finance, Division of, 816
 Issue Department, 17, 21, 28–40, 102n,
 174–77, 185n, 596, 605, 653, 654, 692,
 739, 746, 750, 752, 844
 Legal Department, 199, 388, 538
 Local Boards, 700, 708, 767, 787
 Non-banking Companies, Department of,
 449
 relations with governments, 695–744
Report on Currency and Finance, 846
 Research and Statistics, Department of, 38,
 39, 43, 80, 406, 442, 519, 522, 571, 581,
 603, 673, *see also* Economic
 Department
 Trade, Division of, 850
 Reserve Bank of India Act (1934), 1, 4, 30,
 33–37, 41–43, 57, 80, 82, 135, 173–74,
 184–86, 190–92, 229, 231, 232, 251,
 265, 267, 268, 380, 393, 397, 399, 400,
 404, 417, 434, 435, 437, 439, 444, 454,
 475, 491, 521, 527, 537, 561, 562, 567,
 573, 577, 579, 585, 586, 596, 629, 691,
 709, 713, 720, 746, 752, 755, 767, 768,
 775, 777, 840
 Reserve Bank of India (Amendment) Act
 (1951), 187
 Reserve Bank of India (Amendment) Act
 (1956), 34–35
 Reserve Bank of India (Amendment) Act
 (1957), 35–36
 Reserve Bank of India Bill, Select Committee
 on, 174n, 187, 232–33
 Richardson & Cruddas Ltd., 796, 799
 Rihand dam, 760
 Rockefeller foundation, 660
 Rooth, Ivar, 614, 615, 837
 Rostow, W.W., 645
 Rowan, Leslie, 616
 Roy, B.C., 139, 209, 343–44, 463–65
 Royal Commission on Agriculture, 272
 Roychand Premchand, 541
 Rucinski, Joseph, 533
 rupee
 and convertibility, 613–21
 devaluation, 88, 89, 111, 592, 672–92,
 686, 687, 852–55, **853**
 Rupee Export Bills Credit Scheme, 586–88
 rural/agricultural credit, 1, 4, 5, 70–74, 113,
 229–315, 704, *see also* cooperative
 banks/credit
 Rural Banking Enquiry Committee
 (Thakurdas Committee), 4, 185–87,
 229, 231–32, 265, 320–32, 360, 361,
 363, 469, 490, 491, 750
 Rural and Cooperative Credit, Standing
 Advisory Committee on, *see under* RBI
 rural credit, informal conference on, 229,
 231, 232, 233, 256, 265, 266, 302, 577
 Rural Credit Review Committee, All-India,
 (Venkatappiah Committee), 254, 256,
 258, 287, 309–10
 Rural Credit Survey, All-India, 2, 4, 5, 190,
 229–30, 232, 233–51, 255, 256, 257,
 259, 264, 272, 273, 282, 288, 293, 301,
 309, 310, 317, 323, 332–34, 338, 351,
 353, 364–81, 485, 516, 520, 702, 712,
 715, 731, 790
 Rural Electrification Corporation, 309

- Russia, *see* USSR
- Ryan, J.C., 242–45, 267, 279, 280, 289, 501
- Sachdeva, R.C., 547
- Sangli Bank, 395
- Saraiya, R.G., 171, 233, 268, 269, 280, 286, 350, 431, 529, 572
- Cooperative Planning Subcommittee, 233
- Sastry, N.S.R., 234
- Saudi Arabia, 821–22
- Saurashtra, 215, 217, 257, 266, 272, 362, 373, 374, 379, 380, 382, 385, 557, 558
- Schweitzer, Pierre-Paul, 668, 670–71, 677–81, 683–85
- Scindia shipping, 841
- Seasia Midland Bank, 473, 475, 476, 479, 480, 483
- Securities Contracts (Regulation) Act (1956), 702, 703
- selective credit controls, *see under* credit controls/policy
- Sen, Dhirendra Nath, 459
- Sen, S.K., 459
- Services (Discipline and Appeal) Rules, All-India (1955), 803
- Seshadri, R.K., 225, 446, 449, 710
- Setalvad, M.C., 803–05
- Shah, J.C., Justice, 793
- Shah, Manubhai, 685
- Sharjah, 691
- Shastri, Lal Bahadur, 23–24, 164, 200, 676, 679
- Shenoy, B.R., 674, 763–65
- Shri Ram, Lala, 340, 584, 585, 708
- Shroff, A.D., 535, *see also* Finance for the Private Sector, Committee on
- Shroff, M.R., 682
- Simha, S.L.N., 20n, 39, 44, 45, 80, 168, 176, 408–11, 428, 495, 501, 753
- Sind, 192
- Singh, Tarlok, 245, 246, 283
- Sinha, B.P., Justice, 793
- Sinha, Tarakeshwari, 262
- Sivabhushanam, C.N., 778
- Sivaraman, B., 309
- Sivaraman, T.R., 789, 790
- Small Farmers' Development Agency, 309
- Small Industries Corporation, 566
- Small Industries Service Institutes, 565, 568, 573
- Small-scale Industries Development Board, 565, 567
- Smith, Osborne A., 700, 709
- Somani, G.D., 34
- Sonalkar, V.R., 516
- South Africa, 603, 751
- South-east Asia, 603, 837
- South India Chamber of Commerce, 722
- South Indian Bank, 789
- Southard, Frank, 631, 680, 684
- Southern Rhodesia, 649n
- Soviet Union, *see* USSR
- Special Drawing Rights, 842
- Sproul, Allan, 646
- Sri Ramchandra Laxman Bank, 355
- Srinagar, 394
- Srinivasan, C.R., 708
- Srinivasan, O.R., 771, 772
- Standing Advisory Committee on
- Agricultural Credit/Rural and Cooperative Credit, *see under* RBI
- State Agricultural Credit Corporations Bill, 307
- State Aid to Industries Act, 554, 565, 566
- State Bank of Bikaner, 360, 389, 392, *see also* Bank of
- State Bank of Bikaner and Jaipur, 393
- State Bank of Dholpur, 393
- State Bank of Hyderabad, 389–90, 526n, *see also* Hyderabad State Bank
- State Bank of India, 4, 21, 70, 73, 77, 83, 96, 98–100, 102, 103, 117–18, 123, 125, 135, 136, 150, 153, 156, 158, 165, 170, 171–72, 191, 224, 226, 230, 238, 239, 247, 256, 258, 260, 293, 317–54, 404, 417, 420, 421, 474, 476, 477, 479, 483, 484, 487, 488, 495, 498, 521, 523, 524, 525, 526, 528, 542, 546, 553, 565, 566–69, 570, 572–76, 582, 586, 672, 702, 711, 712, 718, 722, 760, 761, 763, 764, 789, 797, 799, 800, 821, 822
- subsidiaries, 355–96
- State Bank of India (Subsidiary Banks) Act, 390, 392
- State Bank of India Bill/Act, 342–43, 346, 368, 371, 372, 393, 528
- State Bank of Indore, 389, *see also* Bank of
- State Bank of Jaipur, 389, 392, *see also* Bank of
- State Bank of Kurundwad, 393
- State Bank of Mayurbhanj, 484–85

- State Bank of Mysore, 389, *see also* Bank of
 State Bank of Pakistan, 172n
 State Bank of Patiala, 389, *see also* Bank of
 State Bank of Saurashtra, 186, 188, 333, 342,
 357, 358, 360–64, 368, 374–76, 382,
 384, 386, 389
 State Bank of Travancore, 389, 474, 476,
 479, 483, *see also* Travancore Bank
 State Cooperative Banks
 Andhra, 267, 529
 Bhopal, 267
 Bombay, 231, 266–68, 529
 Hyderabad, 266
 Madhya Bharat, 267
 Madhya Pradesh, 266
 Madras, 231, 529
 Maharashtra, 529
 Mysore, 267
 Punjab, 231
 Saurashtra, 267
 Vindhya Pradesh, 267
 State Cooperative Banks' Federation,
 All-India, 439–40
 State Cooperative Development Fund, 239
 state financial corporations, 91, 521, 524,
 526, 528, 529, 531, 536, 539, 540n, 553,
 555–65, **563**, 566, 568, 570–72, 573,
 574, 575, 576
 Andhra, 558
 Assam, 557, 558
 Bombay/Maharashtra, 557
 Delhi, 557
 Gujarat/Saurashtra, 557, 558
 Haryana, 557
 Himachal Pradesh, 557
 Kerala/Travancore-Cochin, 559, 562
 Madras, *see* Madras Industrial Investment
 Corporation Ltd.
 Punjab, 556, 559
 West Bengal, 559
 State Financial Corporations Bill/Act, 555,
 556, 558, 561–63
 State Financial Corporations (Amendment)
 Bill (1962), 562–63
 States Finances Enquiry Committee
 (V.T. Krishnamachari Committee), 185,
 359–60
 States, Ministry of, 189
 States Reorganization Commission/Bill, 267,
 364, 373, 715
 sterling
 balances, 29, 33, 175, 579, 591, 593,
 595–607, 611, 612, 617, 619–23, 629,
 637
 convertibility, 592, 594, 612–16, 619, 622
 devaluation, 592, 593–94, 602–03, 605,
 612, 616, 619, 623
 transactions, 618, 673, 809, 841
 sterling area, 610, 628, 810–11, 824
 Subedar, Manu, 541
 Subramaniam, C., 221, 682
 Suez crisis, 611, 619, 628, 639, 839
 Sullivan, Mr. 544–45
 Sundaresan, N., 54, 139, **139**, 140, 142, 146,
 168, 170, 194, 210–12, 244, 607, 705,
 710, 711, 757
 Switzerland, 611, 636, 656
 Taiwan (Formosa), 631, 836, 837, 839
 Tata, J.R.D., 417
 Tata Sons, 515, 541
 Taxation Enquiry Commission, 516
 Taylor, James B., 709
 Thackersey, K.M.D., 448
 Thakur, B.T., 516n
 Thakurdas, Purshotamdas, 185, 231–32, 321,
 322, 329, 332, 341, 708, 724, *see also*
 Rural Banking Enquiry Committee
 Thomas Cook & Co., 830
 Thomas de la Rue, 756–59
 Thomas Kottukapally, George, 783, 784
Times of India, 240
 Tirumalai, R., 503
 Travancore Bank, 189, 333, 361, 364, 374,
 375, 384–87, *see also* State Bank of
 Travancore-Cochin, 190, 215, 216, 266, 269,
 272, 360–62, 468, 471–73, 767, 769,
 772, 776, 779
 Travancore-Cochin Banking Inquiry
 Commission, 469, 487, 779, 791
 Travancore Forward Bank, 473, 475, 479–83
 Travancore National and Quilon Bank (TNQ
 Bank), 471n, 472, 474, 783
 treasury bills, 84, 104–06, 111, 123–26,
 167–78, 182–83, 831, *see also* ad hoc
 treasury bills
Trend and Progress of Banking in India,
 398n, 511
 Trevor, Cecil, 400
 Tripura, 191n, 269, 306, 506, 557

- Trivandrum, 360
 Trivandrum Permanent Bank, 473, 479
 Truman, Harry, **762**
 Turkey, 811
 Turner Morrison & Co. Ltd., 796
 24-Parganas, 457

 USAID, 663, 765
 USSR/Soviet Union/Russia, 626, 649, 836,
 845, 848, 850, 852, 853–55
 Umm-ul-Awain, 691
 Union Bank of India, 99
 Union Public Service Commission, 803
 Unit Trust of India, 5, 514, 540–51, **548**,
 549, 712
 Unit Trust of India Bill/Act, 542, 545, 546,
 551
 United Bank of India, 455, 491, 516n, 526n
 United Commercial Bank, 516n, 526n
 United Kingdom/Britain/England, **92**, 346,
 417, 489, 513, 532, 534, 535, 540, 542,
 549, 550, 554, 579, 581, 583, 585, 591,
 593–602, 608–22, 635–39, 641, 643,
 644, 647, 651, 655, 657, 658, 661, 664,
 666, 667, 690, 698, 757, 796, 798, 808,
 809, 811, 814, 818, 822, 823, 825, 836,
 837, 840, 842, 851
 United Nations Economic Commission for
 Europe, 672
 United Nations General Assembly, 646
 United Provinces, 753
 United States of America, 71, 417, 490, 492,
 493, 497, 501, 523–29, 531–33, 535,
 540, 541, 545, 549, 571, 573, 583, 584,
 595, 596, 598, 600–03, 608–11,
 613–14, 621, 631, 632, **634**, 635–39,
 641, 643–47, 649–51, 655, 657, 658,
 661–64, 666, 682, 683, 686, 687, **687**,
 757, 758, 760–65, **762**, 811, 818, 826,
 827, 836, 837, 839, 840, 842, 850
 University Grants Commission, 627

 Uttar Pradesh, 210, 212, 214–15, 217, 226,
 272, 275, 300, 301, 489, 507

 Vaidyanathan, L.S., 794, 801–03
 Venadu Bank, 476, 479, 481, 483
 Venkatappiah, B., 194, 234, 251, 261, 262,
 268, 269, 279, 281–84, 286, **291**,
 291–93, 323–28, 332–33, 347, 349,
 366, 374–77, 381–83, 501–03, 525,
 568, 572, 710, 712, 731
 Village and Small Industries (second five
 year plan) Committee, 565
 Vindhya Pradesh, 191n, 269, 272

 Wagle, V.G., 38, 175
 Waight, Leonard, 609–11
 Ward, Barbara, 645
 Warehousing Corporation, All-India, 240
 Weights and Measures Act (1870), 753
 West Asia/Middle East, 653, 751, 837, 838,
 see also, Gulf rupees
 West Bengal, 139, 146, 207, 209, 210,
 212–15, 219, 221, 266, 269, 272, 275,
 305, 306, 343, 365, 397, 445, 453,
 455–60, 463–66, 467, 472, 489–91,
 507, 516, 518, 519, 559
 West Germany, *see* Germany (West)
 Woods, George, 532, 533, 544, 659–61, 665,
 667, 676, 679, 683
 Working Group on Cooperative
 Development, 281, 283–86, 297
 World Bank, 521, 530–35, 543, 544, 615,
 626, 632, 635, 637–39, 641–44, 646,
 648, 649–52, 656, 657–67, 672, 678,
 681–83, 686, 688–89, 692, 736, 813,
 838, 852
 Wright, Peter, 659, 661, 665

 Yugoslavia, 845, 846, 854

 Zurich, 840