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RESERVE BANK OF INDIA

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History of The Reserve Bank of India

Volume 1: 1935-1951

Volume 2: 1951-1967

Volume 3: 1967-1981

Summary

The history of a central bank is important not only for capturing its evolving role *per se*, but also to show how effective and influential that role has been in shaping the events of an economy over the years. Accordingly, the history of the Reserve Bank of India (RBI) is not just the history of an institution but also a part of economic history of India. As the apex institution of the financial system of the country, it has played and continues to play a critical role in managing the Indian economy. The decision to document the history of the RBI dates back to 1969 when the compilation of a comprehensive history of India's monetary sector and its management was commenced.

The underlying philosophy in documenting the history of the RBI has been to capture its functional evolutionary process by drawing upon the knowledge of those who were connected intimately with the Bank over its various phases. Furthermore, as a part of that endeavour, the approach adopted has been to document the history through a series of three volumes with each of them covering a time span written after some time lag so as to view the evolution in the kind of time perspective that history needs. Accordingly, Volume 1 covering the period 1935-1951 was published in 1970 and Volume 2 spanning the period 1951-1967 was published in 1998. Volume 3, which is being released now, covers the period 1967-1981. These history volumes would prove interesting and useful not only to students and practitioners of central banking but also to those concerned with the problems of a developing economy. It was decided to document the history in a sufficiently detailed fashion so as to be of practical use for posterity. These volumes are based on official records, published sources and discussions with persons intimately associated with different events. This series of volumes covering the history of the RBI has been sponsored by the Bank, but it should by no means be viewed as an official account since considerable freedom was available to the compilation team in choosing its focus and expressing its opinion. The endeavour should be regarded as an exercise of transparency and accountability through an objective, independent and retrospective scrutiny of the functioning of the RBI.

The first volume deals with the formative years of the RBI and the critical issues faced by the country and the Bank in the immediate post-independence period. The second volume focuses upon the Bank's pioneering efforts in public policy and institutional building in roughly the first one-and-half decades of planned economic development. Thus, while the first volume documents the foundations of central banking in India, the second volume captures the next stage of the evolutionary process of the RBI whereby the practice of central banking in India began to gather force in the 1950s and 1960s. The second volume brings to the fore a 'novel departure' whereby the RBI laid the foundations of institutional credit to agriculture and industry in India: functions that are not usually seen among the stylised traditional functions of central banking normally pursued by other central banks. The third volume covers a period that was marked by phenomenal expansion and diversification of the financial sector and attempts to closely align financial and regulatory policies with plan and development priorities.

The Reserve Bank of India: Volume 1 (1935-1951)

Shri L. K. Jha, the RBI Governor in 1967 initiated the project to record the history of the RBI in its formative years. These years were very eventful in that the RBI had to adapt its central banking functions and techniques to an economy *sans* a modern banking system; to shoulder special responsibilities including those of exchange control with the outbreak of World War II; and to transform itself from a privately owned institution to a nationalised undertaking. The first Volume was compiled by Shri S.L.N. Simha (senior economist in the Bank) as Member-Secretary under the guidance of an Editorial Committee chaired by Dr. C. D. Deshmukh (the first Indian Governor of the RBI) and comprised Shri R.G. Saraiya, Dr. Bhabatosh Datta and Shri J. J. Anjaria.

The first volume documents the history subject-wise chronologically across the formative phase (1935-1939), the war years (1939-1945) and the post-war years (1945-1951). Volume 1 ended at 1951, the year which launched India's First Five-Year Plan. A salient feature of Volume 1 is that it also gives a brief and yet comprehensive account of developments in money, banking and exchange in India for almost a century prior to establishment of the RBI in 1935. This is of great help in order to understand the rationale of central banking in India and the gestation phase leading to the passage of the Reserve Bank of India Act, 1934. A Royal Commission on Indian Currency and Finance was set up in 1925 in recognition of the growing Indian economy and the increasing demands being made on the financial sector. It recommended, *inter alia*, that an entirely separate institution called the Reserve Bank of India (RBI) be created with the central task of maintaining monetary stability in India. A notification was issued by the Government on December 20, 1934 and on January 14, 1935 the RBI came into existence, though it was formally inaugurated only on April 1, 1935. The Central Board of Directors held its first meeting on January 14, 1935 in Calcutta. The Bank, which was instituted initially as a privately owned statutory entity, was nationalised in January 1, 1949.

The functions of the RBI, as laid down by statute, were traditional in nature, *viz*., issue of currency, bankers' bank and banker to the Government. The only non-traditional responsibilities entrusted to the Bank included development of agricultural credit and rural cooperatives. Second, being established in a colonial context, limitations were imposed on the Bank's operational freedom. The first Volume notes,

'The early years of the period were characterised by lack of harmony among the top executives in the Bank as also between the Governor and the Finance Member, leading to the former's resignation (p. 839).'

The fundamental objective of establishing the RBI was the unification of the authority to discharge functions which, *hitherto*, were undertaken by the Government's Currency Department and the Imperial Bank of India, thereby enabling pooling of country's monetary reserves and their deployment in accordance to the needs of the economy. In the sphere of currency management the RBI undertook the responsibility of increasing the number of currency chests and the places where they were kept. As banker to the banks, it managed the twin responsibility of acting as a source of reserves to the banking system, especially for meeting its seasonal requirements, apart from acting as lender of the last resort. As the credit off-take from the organised financial system was quite low, commercial banks had adequate fund availability and turned to the RBI only during seasonal upsurges in credit off-take which were met by the latter through purchase of Government securities from the banks by the RBI under open market operations (OMO). Apart from emphasising the need to the banks of safeguarding depositors' interests, the RBI also remained proactive in building adequate machinery in the areas of banking regulation and supervision. It took various interim measures such as setting up a Department within the Bank for discharging these responsibilities after the nationalisation of RBI and the passage of the Banking Companies Act, 1949.

The first volume notes that 'the most active' of the RBI's operations during the period covered was its role as banker to the Government. The formative years were relatively smooth with the Government essentially following a policy of *laissez-faire* in the Indian colony and firmly believing in balanced budgets. The need for credit extension to it was only modest and temporary. The occurrence of World War II, however, necessitated the RBI to finance war expenditures on behalf of the Allies, which led to considerable expansion of currency against foreign exchange resources. The RBI also tried to systematise the system of loan floatations of the Central and Provincial Governments and the issue of Treasury Bills. The first Volume also throws light on the criticism of the mode of war financing through the RBI, a private shareholders' bank, making available rupee resources freely to the Government against sterling assets thereby accelerating money supply and fuelling inflation to levels never witnessed in India. The RBI, while showing great concern, had to treat the situation necessitated by abnormal conditions.

There was not much scope for monetary policy making in the RBI during the period covered in the first Volume. During the pre-war years monetary expansion was restrained reflecting low levels of economic activity, with a pegged exchange rate foreign exchange management presenting a major challenge to monetary management, which was dealt with by varying its sterling purchase policy by tender and modifying the extant Treasury Bill policy. In the war and post-war years, however, the focus of monetary policy shifted to managing inflation through OMO and through providing interest rate signals by modulating yields on Government paper, as the Bank Rate remained fixed after a one-time reduction from 3.5 per cent to 3.0 per cent in 1935. The first Volume notes that the RBI resisted Government's wishes of easy money policy by skilfully raising the yields.

This Volume also notes transparently the criticisms levied on the roles played by the RBI in the spheres of rural credit and in implementing proposals for linking the unorganised and organised money markets. Whereas the RBI had played a largely advisory role in the promotion of rural credit as envisaged at the time of its establishment, the introduction of a concessional element in the interest rate on RBI's credit to cooperatives in 1942, and notification of the Banking Companies Act, 1949 made the RBI's role more proactive in the field of agricultural credit. This led to the appointment of the Rural Banking Enquiry Committee in 1949 and All-India Rural Credit Survey Committee in 1951. While the RBI was not successful in the linking of the organised and unorganised money markets, it started building adequate machinery in the field of financing industry by setting up the Industrial Finance Corporation of India and passing of legislation for setting up of State Financial Corporations.

The Reserve Bank of India: Volume 2 (1951-1967)

The project for initiating work on the second volume dates back to 1990 when Shri R N. Malhotra was the Governor. Shri. U.K. Sarma collated basic information over a period of four years before Dr. G. Balachandran took charge of drafting the second volume in 1995. Having overseen this process as Governor, Dr. C. Rangarajan released the second volume of the history of the RBI in the fiftieth year of India's independence. Dr. Balachandran prepared the volume in association with Ms C. J. Batliwala and the History Cell of the RBI's Department of Economic Analysis and Policy, under the guidance of the Committee of Direction with S/Shri. S. Venkitaraman, M. Narasimham, P. L. Tandon, S. S. Tarapore and Dr. Y. V. Reddy as members. It may, however, be noted that Dr. Balachandran had unrestricted access to the RBI's documents and had complete freedom in reading and interpreting them while preparing the second volume of the history of the RBI. This 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. It focuses on the RBI and public policy and it is the first account 'from inside, as it were, of the functioning of a major public institution in post-independent India' (p.vii). In particular, the book sets out the challenges and demands typical of a developing economy as faced by the RBI, a process through which it was also transformed considerably. This book sets out views quite objectively supported by the documentation. Notably, it also publishes a selection of the Bank's documents in an unabridged fashion.

The second volume of the history begins with the terminal year of the first volume, *i.e*., 1951 and ends with 1967, which was a watershed year due to the crisis in the mid-1960s and the policy responses that emerged. In particular, this volume discusses the laying down of four pillars of central banking in India in the 1950s and 1960s.

Monetary policy was the first pillar of the RBI and this volume describes how, with the onset of the planning process, monetary policy had to manage not only short-term pressures but also to be sensitive to the financing requirements of the Government for building the Indian economy. The volume vividly captures how the process of financing of budget deficits was initiated through the automatic issuance of *ad hoc* Treasury Bills whenever the balances of the Government went below the stipulated minimum balances of Rs. 50 crore at the end of each week. The volume also discusses the migration to a system of maintaining a stipulated minimum of foreign exchange reserves to back issuance of currency, from that of keeping a stipulated proportion of the foreign exchange reserves that was necessary to avoid imposition of a 'very sharp limit' to deficit financing and the country's ability to run a payments deficit. Furthermore, it also discusses the move made towards a system of varying cash reserve ratio (CRR) and its operation with the Statutory Liquidity Ratio (SLR) largely as prudential instruments to ensure sufficient liquidity with banks to capture the evolving role of monetary policy instruments of the RBI during the first three Plan periods.

The second pillar of central banking which the RBI had to build was the regulation and promotion of orderly development of commercial banks. The timing and context of the erection of this pillar were determined by the banking crisis, which was still abating in 1951, and the newly entrusted responsibility to the RBI for overseeing and strengthening India's weak and unwieldy banking system. The second volume discusses efforts made by the RBI to strengthen and consolidate the banking system which faced crises in some regions for several years after the war and later in 1960. This volume also discusses the origins and early years of the Deposit Insurance Corporation (DIC), alongwith the scheme of insuring bank deposits which came into existence from 1962 as a consequence of the banking crisis in 1960. 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. As a result of the RBI's policy of reconstruction and amalgamation of small and financially weak banks for improving viability of the banks, there was a drop in the number of insured banks.

The RBI's vigorous involvement in promoting the institutionalisation of credit to agriculture from the 1950s provided the third pillar of central banking. The initiation of the All-India Rural Credit Survey reflected its determined efforts for promoting agricultural credit institutions and expanding institutional credit to agriculture in rural India. With the establishment of the State Bank of India from the Imperial Bank of India in 1955, and its expansion coupled with the growth and spread of the cooperative movement, the RBI became steadily more involved in developing the cooperative movement and meeting its financial requirements. The second volume, however, admits that despite its impressive quantitative expansion, the cooperative credit system did not measure up to the expectations that had been generated.

The fourth pillar of central banking erected by the RBI was institutionalisation of credit to industry from the 1960s. The Shroff Committee had recommended a more active role for the RBI in promoting availability of finance to industry. The RBI, with a commitment to its developmental responsibilities set up institutions capable of mobilising and channelising long-term funds into industry in the 1960s.

The RBI's promotional initiatives to institutionalise credit were soon complemented by those to institutionalise savings in the economy which came to be recognised as the 'institutional dimension' of monetary policy in India by the mid-1960s. The second volume interprets this as

'conditions for the effective mobilisation of the supply of actual and potential savings through 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 (p.6).'

Notably, the complementarity between channelising credit to neglected sectors and promoting savings mobilisation by institutionalisation also had direct implications for the second pillar of the Bank's edifice of deepening and widening the financial system. Efforts were also made to facilitate channelising household savings directly into the capital market by promoting the Unit Trust of India.

The second volume notes that 'institutionalisation of savings' and 'institutionalisation of credit' were judged not only to be complementary but also to be inseparable for monetary policy purposes for 'at least three reasons'. First, a well developed financial system would provide effective channels for transmitting impulses and assist the RBI in implementing its credit policies. Second, growth of bank deposits would enable the banks to reduce their dependence on accommodation from the RBI. Once the banks became capable of meeting expanding credit demand from their own resources, other traditional instruments of monetary policy could be expected to come to full play. Finally, mobilisation of savings by institutional agencies would lead to a better match of supply and demand of investible funds. Furthermore, the larger savings and their mobilisation by the Government, either directly or through the banking system, would contribute to moderate deficit financing and enhance effectiveness of monetary policies.

The volume also covers developments in India's external sector, including India's efforts to raise long-term foreign assistance for development and the rupee devaluation in 1966. It concludes by attempting to draw together the political, ideological, intellectual and institutional influences on the RBI's perspectives, attitudes and development. It also surveys the evolution of these relations in the Indian context, which is unique for any central bank in the background of the wide diversity of responsibilities entrusted to the RBI and the intellectual and institutional influences to which it was subject.

The Reserve Bank of India: Volume 3 (1967-1981)

The compilation of the third volume of history was concluded as the RBI completed 70 years of its existence in 2005. This volume extends the history of the RBI further to cover the time period from 1967 to 1981, arguably the time span of heightened regulation and direction of the Bank in 'every sphere of financial activity' undertaken in principle with an aim to correct market failures. After the demise of Dr. S. Ambirajan, an economic historian who was originally entrusted with the project, this volume has been prepared by the History Cell of the RBI with the help of outstanding consultants: Dr. A. Vasudevan, former Executive Director of RBI, Ms. C. J. Batliwalla and Shri T. C. A. Srinivasa Raghavan. The team received overall guidance by the Advisory Committee, chaired by Dr. C. Rangarajan, and benefited from discussions with the top officials of the RBI and the Government. Dr. Y. V. Reddy, Governor and Dr. Rakesh Mohan, Deputy Governor of the RBI were deeply involved in facilitating the completion of this volume.

The 'defining event' of the period 1967-1981, elaborated in this volume, was the nationalisation of major commercial banks which, as argued in the volume, essentially reflected deep rooted economic consideration debated over a long time although the timing of the event may have been a political one. This led to a 'dramatic shift' in the orientation and operation of commercial banks. Post nationalisation there was an impressive and unparalleled spread of the banking system and significant directing of credit to the *hitherto* neglected sectors. In order to push rural branch expansion, banks were required to open two rural branches for every one branch opened in an urban area. Furthermore, in order to address the declining trend of credit-deposit ratios in lower population centres, the Lead Bank Scheme was started in the 1970s whereby a lead bank was designated for each district to carry out the task of expanding credit to customers *hitherto* not served. The volume notes that this also had an effect on viability and efficiency of the banks which reflected starkly only in the subsequent period. The emergence of the Government as the owner of the major banks also created a new situation of 'dual control' over the banking system to which the RBI had to adjust.

The budget deficits of the Government rose sharply and fiscal policy held centre stage from the 1970s. The volume notes that there 'was abandonment of monetary policy as a tool of economic policy and corrective intervention'. It also notes, in this context, that on balance after a full consideration of evidence, the RBI had to become overtly accommodative to the Government. While monetary policy in conjunction with other measures was actively used to control inflation when it reached alarmingly high levels, during the rest of the period it had to accommodate the fiscal policy. Thus, the RBI's monetary management became a delicate balancing act between the compulsions of fiscal policy and price stability considerations. The inflation threshold was regarded as being 7 per cent and it was only beyond that level 'that the efforts to reduce money supply started' (p.782). In order to contain inflationary pressures, monetary policy used non-price instruments like raising the SLR and CRR. The SLR became an instrument of mobilising resources for the Government from a captive financial system. While deficit financing through *ad hocs* was meant to be temporary, the practice of renewal of these Treasury Bills on maturity after 91 days laid the seeds of automatic monetisation of Government deficits. The CRR was operated to neutralise the monetary impact of increasing RBI's accommodation of Government. The RBI's monetary policy had to focus on credit as an indicator rather than through demand management. The formulation and conduct of monetary policy by the RBI was mainly guided by the supply-side, particularly persistent shortfalls in agricultural production, the resulting inflationary pressures and developments in Government finances.

As Government progressively mobilised greater resources from the banking system, problems arose regarding allocation of scarce credit, which led to rationing of credit. While directives were issued to lend to the priority sector and also to the weaker sections through the Differential Rate of Interest (DRI) Scheme, the credit to remaining private sector was rationed. The incentive to extend priority sector loans was provided by the RBI through the mechanism of refinance. Accordingly, short-term lending to agriculture, small scale industries and primary cooperative credit societies were eligible for refinancing. The banking system operated under a system of administered interest rates and credit allocation which had an important bearing on the scope and the instruments of credit control.

The volume also vividly describes the challenges faced by the RBI to fine tune inspection procedures so that viability of the banking system was not compromised in the wake of geographical branch expansion of the banks. First, the sheer multiplication of branches necessitated a change from inspection of all branches of public sector banks from once a year to once in three years. Furthermore, a procedure of centre-wise inspection took-off whereby the performance of the branches of different banks at the same centre was assessed in the context of achieving social objectives and to relieve the financial assessment type of inspection from the burden of inspecting too many branches. The scope and coverage of inspection were designed accordingly to include, apart from an examination of the affairs of the bank branches, an assessment of the business potential at the centre, a study of local problems and their pragmatic solutions. In the field of deposit insurance, the Deposit Insurance Corporation Act was amended in 1968 to extend the insurance scheme to deposits of cooperative banks. There was also strong growth and consolidation of the deposit insurance fund consequent upon the expansion of bank deposits. The Credit Guarantee Corporation of India limited was merged with DIC leading to the formation of the Deposit Insurance and Credit Guarantee Corporation of India with the ‘twin and cognate’ objectives of giving protection to small bank depositors and providing guarantee cover to credit facilities extended to small and weak borrowers. On the issue of regulation being overly bureaucratic and process-driven, this volume clarifies that in the absence of well trained bankers during this period, rule-based banking was the only option. Another important development pertaining to the financial sector vividly captured in this volume is the delinking of the Industrial Development Bank of India (IDBI) and Unit Trust of India (UTI) from the RBI to address the coordination problems.

A distinctive feature of this volume is that it provides a backdrop of several successive shocks – economic, political, military, diplomatic and social – while discussing the history of the RBI during the period covered. In particular, the RBI had to face several uncertainties associated with two oil shocks, the breakdown of the Bretton Woods system of exchange rates and the Bangladesh war. Furthermore, there were frequent changes in the finance minister and Governor of the RBI. As a result, the policy regime had to take nuanced positions at an unsettling frequency. Crises led the policy makers to experiment with shifts in policy and priorities particularly in banking, exchange rate management and exchange controls. Operationally, the RBI had to reorient its financial and credit policies in a manner consistent with the economic and institutional aims of the Government which may not have been consistent with sound economic management. This was a period with endemic and severe foreign exchange shortages. Coping with the uncertainties of the time took a great deal of effort and sagacity and the RBI played an important role especially in the dealings with the International Monetary Fund (IMF). On the external side, the RBI was active in coping with the aftermath of the Bretton Woods system and the two oil shocks in the 1970s.

The breakdown of the Bretton Woods system in 1971 created problems for all the countries, especially the developing ones. The RBI had to cope with the adjustment in a period of huge uncertainty. The third volume of history analyses the anatomy of exchange control and exchange rate management in this context. The developing countries were also pressing for reform of the international monetary system and the RBI made several important contributions in this debate.

The main responsibilities of the RBI in respect of currency management covered in the third volume included: (i) finalisation of the design, form and material of new denomination bank notes and reviewing the design of existing notes; (ii) establishment of new issue offices for efficient management; (iii) ensuring smooth distribution of currency; (iv) withdrawal of defective/soiled notes for destruction; (v) prescribing conditions under which value of any lost, stolen, mutilated or imperfect currency notes would be refunded under grace; (vi) establishment and inspection of currency chests; and (vii) security arrangements in the issue offices of the RBI. The third volume also narrated the developments regarding the growth of organisation and office structure of the RBI over the period since 1951 as the second volume had not dwelt on this specifically. In order to meet increasing responsibilities, the Government expanded the management team of the RBI. The number of departments and offices also grew in tune with expanding responsibilities of the RBI.

The release of the third volume along with the two earlier volumes would facilitate the reader to capture the evolving phase of the RBI over a 46-year period. It may be noted that the history is based on official records, published sources and discussions with persons who were closely involved with the events. The volumes are an institutional but not an official history as considerable freedom has been available to those who worked on it.

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