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### **Currency, Exchange and Banking Prior to 1935**

Prior to the establishment of the Reserve Bank of India in 1935, the principal functions associated with a central bank were performed, however inadequately, by the Government of India primarily, and to a smaller extent, by the Imperial Bank of India, since its establishment in 1921. The regulation of note issue, the management of foreign exchange and the custody of the nation's metallic and foreign exchange reserves were the responsibilities of the Government of India. The Imperial Bank acted as banker to Government and to a limited extent as a bankers' bank, in addition to its primary functions as a commercial bank. By the time the Reserve Bank came to be established, organised banking in India had developed to an extent by no means insignificant, though an important element of this sector comprised foreign banks, which were generally referred to as exchange banks. There was in addition a fairly extensive indigenous banking sector, having rather loose links with the organised banking system, which itself was not an integrated one. Principally on account of the dual system, the Indian money market was characterised by inelasticity, bringing with it deficiencies and defects, such as seasonal and regional imbalances between the need for and supply of currency and credit and marked variations of interest rates. The currency and exchange arrangements were such that the principal channel through which expansion or contraction of money occurred was foreign remittance, though this was to an extent inevitable on account of adherence to an international monetary standard with a fixed exchange rate. This feature was predominant in India owing to the absence of a central bank for co-ordinating the external and internal sectors of the money market so as to meet the varying requirements of domestic industry and commerce

and the country's international transactions. As already explained in Chapter 1, the disadvantages of the absence of a central banking institution had long been recognised, although corrective action came slowly.

The object of this chapter is to give a brief account of the history of Indian currency and exchange during the hundred years or so prior to the establishment of the Reserve Bank, and to describe briefly the structure and organisation of the Indian money market as it stood prior to the establishment of the Bank. The history of Indian currency and exchange is highly complicated. Even the brilliant John Maynard Keynes, who did considerable work on problems of Indian currency and finance, was constrained to remark that ' Indian currency is too complicated a subject to be mastered at a moment's notice '. Several committees and commissions considered Indian currency and exchange problems. The evolution of policies in these matters was the result not so much of Statutes as of notifications and administrative practice. In the words of Keynes :\*

The evolution of the Indian currency system since 1899 has been rapid, though silent. There have been few public pronouncements of policy on the part of Government, and the legislative changes have been inconsiderable. Yet a system has been developed, which was contemplated neither by those who effected nor by those who opposed the closing of the Mints in 1893, and which was not favoured either by the Government or by the Fowler Committee in 1899, although something like it was suggested at that time. It is not possible to point to any one date at which the currency policy now in force was deliberately adopted.

### **HISTORY OF INDIAN CURRENCY AND EXCHANGE**

The principal issues that figured in the various discussions and deliberations on Indian currency were the appropriate monetary standard for India, the exchange rate of the rupee and the composition and location of monetary and exchange reserves of the country. In these matters there were, not infrequently, fairly sharp differences of opinion between the Government of India, that is to say, the representatives of the British Power in India, and the Home Government, as represented by the Secretary of State for India ; needless to say, the ultimate decision lay with the latter. Undoubtedly, many of the decisions of the Secretary of State were guided by what were considered to be the interests of British trade and industry, but there is no doubt that, to some extent, the decisions were in accordance with contemporary thinking on matters

\* Indian Currency and Finance, 1913.

of monetary standard, exchange rate and reserves. Notwithstanding the long period of experimentation with currency and exchange, it would appear, if one overlooks the shortcoming of inelasticity, that the monetary arrangements were reasonably stable and coherent.

### **SILVER STANDARD: 1835-93**

#### *The Uniform Rupee*

Although the Directors of the East India Company had given their approval for the introduction of a uniform currency in India in 1806, the era of such currency began only in 1835 when, in terms of Act XVII of that year, the silver rupee of 180 grains troy, 11/12ths fine, was declared the sole legal tender throughout British India; this was, in fact, the coin that had been in circulation in parts of the country, such as, Madras and Bombay. The mints were opened to the public for free coinage of the metal; thus, India was put on a monometallic silver standard. It should be mentioned that although the Directors of the East India Company favoured a silver standard, they were by no means opposed to the circulation of gold coins. The Act of 1835 permitted the minting of gold coins (i) of the same weight and fineness as the silver rupee, that is, 180 grains troy, 11/12ths fine, and this was to be the gold mohur equivalent in value to Rs. 15, and (ii) of five, ten and thirty rupee pieces. It was declared that gold coins would not be legal tender, but, the public Treasuries, in terms of a notification issued in 1841, were to accept the coins on the basis of Rs. 15 for one gold mohur, in payment of taxes and other public dues.

Besides the silver and gold coins, currency notes were also in circulation, these being issued mainly by the Presidency Banks -of Bengal from 1809 and those of Bombay and Madras from 1840 and 1843, respectively. These notes were not, however, legal tender and their circulation was practically confined to the Presidency towns.

#### *Paper Currency Act, 1861*

Some years later, on account of the discovery of new gold mines in the U.S.A. and Australia, the price of gold fell relative to that of silver, and, effective January 1, 1853, Government cancelled their earlier order regarding the acceptance of gold at any public Treasury on the basis of Rs. 15 per gold mohur. There were representations from Chambers of Commerce for the introduction of gold currency, but Mr. James Wilson, the first Financial Member, was opposed to it. He saw no reason to change the silver standard and in his view the defects of the currency system would be remedied by a well-regulated

paper currency system. In 1860, he introduced the Paper Currency Bill, but did not live to see it enacted. This was carried out in 1861 by Mr. Laing, Mr. Wilson's successor. In terms of this Act, the sole right to issue notes rested with Government. As regards reserves against the note issue, whereas Mr. Wilson had favoured the proportional reserve system, Mr. Laing based the issue of currency on the British model, as embodied in the Bank Charter Act of 1844, in terms of which there was to be a very limited fiduciary issue against Government securities and the rest was to be backed wholly by metallic holdings, in coin and bullion. The Paper Currency Reserve was to consist of silver coin and bullion and of Government securities up to a maximum of Rs. 4 crores initially. Provision was also made for the inclusion of gold coin and bullion in the reserve, up to a limit of 25 per cent of the note issue; this was done to facilitate the introduction, at a later stage, of gold currency, which Mr. Laing favoured.

#### *Mansfield Commission*

However, the demand for the introduction of gold currency continued in business circles. Sir Charles Trevelyan, the Financial Member, who studied the situation in 1864, recommended that gold sovereign and half sovereign, minted in England, Australia or India, should also be declared legal tender in India, besides the silver rupee. The Government of India approached the Secretary of State for his consent, but all that the latter permitted was (i) acceptance of gold coins by Government in payment of public dues, a practice which had been in existence from 1841 to December 1852, and (ii) issue of notes in exchange for gold coin or bullion as provided for under Section IX of the Paper Currency Act of 1861. The Government of India issued the relevant notifications in November 1864, the rates fixed being Rs.10 for a sovereign and Rs. 5 for a half sovereign.

In January 1866, the Bengal Chamber of Commerce urged the Government of India to hold an enquiry into 'the whole currency question'. The Government of India thereupon appointed a commission, with Sir W. R. Mansfield (later, Lord Sandhurst) as President, to inquire, in the first instance, into the operation of the Paper Currency Act and suggest improvements in the system. The Commission was also to report upon any extension of the monetary system considered necessary to meet the increased currency requirements of the country, the intention being that it should deal with the question of gold currency.

The Commission submitted its report in October 1866. On the working of the Paper Currency Act, it suggested certain administrative changes and also the introduction of a 'universal note' encashable anywhere in the country rather than in a particular geographical area,

called circle. As regards introduction of gold in the currency system, the Commission was satisfied that the demand for gold currency was unanimous throughout the country, that gold coins of Rs. 15, 10 and 5 would be preferred by the people to notes of equivalent value and that the currency should, therefore, consist of gold, silver and paper.

#### *Decline of Silver -1874-93*

No action was taken on the Mansfield Commission's recommendations, though the indications were that the Government cherished the hope of making gold legal tender. But these hopes were belied by a very important announcement which the Government of India made in May 1874, to the effect that the Governor-General in Council was not then prepared to take any step for the recognition of gold as legal tender in India.

In the next 20 years, the price of silver recorded a sharp and continuous decline in relation to that of gold. As a result, the exchange rate of the rupee fell steadily from 1S. 10.351d. in 1873-74 to 1S. 2. 985d. in 1892-93. Much light on the changes in the relative values of precious metals was thrown by the British Royal Commission, specially appointed for the purpose, in 1886. The Commission pointed out that while the annual average production of silver rose from 1.34 million kgs. during 1866-70 to 1.97 million kgs. during 1871-75 and further to 2.86 million kgs. during 1881-85, gold output declined from an average of 0.20 million kgs. during 1866-70 to 0.17 million kgs. during 1871-75 and further to 0.15 million kgs. during 1881-85. As against the reduction in output, there was considerable increase in the demand for gold as a result of the adoption of gold standard by a number of countries. As regards silver, while the demand for the white metal for currency purposes diminished in some countries, there was large silver coinage in the United States, with the result that it was doubtful, the Commission stated, whether there was any great reduction in the use of silver for coinage purposes. According to the Commission, the fact that despite vast changes in the relative production of the two metals prior to 1873 there was no corresponding disturbance in their market value, indicated the existence of some steadying influence, which had since been removed. That influence was the existence of the bimetallic law in the Latin Union countries, with a fixed ratio of 15½ to 1 between silver and gold. When that link was broken in 1874 by the suspension of free mintage of silver by the Latin Union, 'the silver market was open to the influence of all the factors which go to affect the price of a commodity'.

Apart from other effects, the depreciation of the rupee also created a budgetary problem for the Government of India, as the burden of

meeting the ' Home Charges ' -payment in sterling for meeting the various obligations such as interest on debt, pensions, payments to the War Office, cost of Government stores, etc. -increased. However, little action was taken to meet the situation, the Secretary of State's view being 'it is better to sit still, than to have recourse, under the influence of panic, to crude legislation the result of which cannot be foretold, and the effect of which cannot be measured'. Meanwhile, the U.S. Government, under the pressure of their silver producing interests, made efforts to restore the monetary status of silver through the establishment of bimetallism. There was more than one international conference for this purpose, in which India also participated, but they did not bear fruit. The fate of bimetallism was sealed in 1892, after the Fourth Conference, and thereafter the U.S. Government gave indications that they might discontinue silver purchases.

#### *Herschell Committee*

In these circumstances, the Government of India proposed that the mints should be closed to the free coinage of silver and urged the early establishment of a gold standard. To consider the situation afresh and suggest appropriate measures, the Secretary of State appointed, in October 1892, a committee presided over by Lord Herschel, the Lord Chancellor. In its report made next year, the Committee endorsed the Government of India's recommendation that the mints be closed to the public for free coinage of silver, but with the modification that an announcement should be made to the effect that Government might coin rupees, if required by the public, in exchange for gold at a ratio to be fixed, in the first instance not much above the then prevailing rate,\* say, at 1S. 4d. per rupee (against Government's recommendation of 1S. 6d.) and arrange for Government Treasuries to receive gold at the same rate, in satisfaction of public dues. Thus, the Herschell Committee recommended neither the demonetisation of silver nor the introduction of a full-fledged gold currency. The rupee was to continue to be unlimited legal tender. The Committee's proposals were intended for a period of transition and were to be regarded as providing the first step towards the eventual introduction of the gold standard. The Government accepted the recommendations and effected legislation on June 26, 1893 amending the Indian Coinage Act, 1870 and the Indian Paper Currency Act, 1882. The amending Act provided for the closure of the Indian mints to the free coinage by the public of both gold and silver; however, Government retained the power to coin silver rupees on their own account. Notifications were issued on the same day announcing that (i) the mints would accept gold in exchange

\* The rate was Is. 2 5/8,d.on May 31, 1893, the date of the Herschell Committee's Report.

for rupees at the rate of 7.53344 grains of fine gold, corresponding to an exchange rate of 1S. 4d. per rupee, (ii) sovereigns and half sovereigns would be accepted at the rate of Rs. 15 for a sovereign, in respect of payments due to Government and (iii) currency notes would be issued to the Comptroller-General in exchange for gold. It is to be noted that while it was thus binding on Government to accept gold and give rupees/notes in exchange, there was no obligation on them to provide gold against rupees/notes. Consequently, the rupee became a token coin, its intrinsic value, of course, varying with the international price of silver.

#### *System of Council Drafts*

An attempt was made by the Secretary of State to raise the exchange rate to 1S. 4d., by a temporary cessation of sale of Council Drafts (Bills and Telegraphic Transfers) or the practice of supplying rupees in India against sterling tendered in London, at a price below 1S. 3 ¼ d. per rupee ; but the effort did not succeed and was given up, as intending buyers of Council Drafts instead shipped silver to India, which worked out to be a cheaper means of remittance.

It has to be explained that the sale of Council Drafts (and Reverse Councils or sterling against rupees tendered in India) 'was the flywheel of the machinery for the management of Indian currency, exchange, and finance '. Remittance of funds through this arrangement was a unique operation for a Government to perform, this being a legacy of the East India Company. Normally, India ran a surplus on trade account; on the other hand, payment had to be made in sterling to meet the 'Home Charges'. The arrangement mentioned above provided a convenient mechanism for offsetting the receipts and payments thereby avoiding unnecessary shipments of gold between England and India. The basic procedure was for the Secretary of State in Council (hence Council Drafts) to invite tenders for delivery of sterling in London against payment in rupees from Government funds in India. While originally the system of Council Drafts was used only to enable the acquisition of sterling by Government for meeting the Home Charges, the system was extended in 1898 and further in 1904 to meet the requirements of others for Indian currency.

In 1904, the Secretary of State announced a standing offer to sell Council Bills, that is rupees, at specified rates which were within narrow limits of the exchange rate; this ensured an upper limit to the exchange value of the rupee. Thus, in 1904, the rate was fixed at 1S. 4 1/8 d. per rupee, the theoretical gold export point corresponding to the ratio of 1S. 4d. The Government also provided sterling for rupees, by the sale of Reverse Councils. Of course, the occasions for this were not many,

as, by and large, India had a surplus trade balance and so exchange remained strong. Presumably for this reason, there was no standing commitment on the part of Government to sell Reverse Councils. When exchange turned weak, generally speaking, Government supplied sterling by sale of Reverse Councils, subject to Government's reserves position, at rates slightly below the lower point of exchange for sale of Council Bills. However, prior consent of the Secretary of State had to be obtained for the sale of Reverse Councils.

### EFFORTS TO ESTABLISH A GOLD STANDARD

#### *Fowler Committee*

Notwithstanding the closure of mints to the free coinage of silver, the exchange rate fell steadily, reaching a low of 1S. 013/32 d. in January 1895. Thereafter there was a steady rise, and the rate of 1S. 4d. was reached in January 1898, that is, after an interval of about six years. Meanwhile, there had developed a widespread feeling in official as well as non-official circles that steps should be taken, without further delay, to establish a full-fledged gold standard and a stable exchange. To ensure the stability of the exchange value of the rupee, Government intended to withdraw redundant rupees from circulation. A gold reserve was to be established in India and for this purpose a loan not exceeding £20 million was to be raised in England, of which one-fourth in the form of sovereigns was to be shipped to India in the first instance.

There were other schemes, prominent among which was one put forward by Mr. A.M.Lindsay, Deputy Secretary of the Bank of Bengal. Briefly, Mr. Lindsay recommended not a conventional gold standard but a scheme similar to what later came to be known as the gold exchange standard, under which gold was not to circulate as currency in the country, but there would be an obligation on the part of the Government to provide sterling, which being on the gold standard was as good as gold. To consider these matters, the Secretary of State appointed, in 1898, a committee, presided over by Sir Henry Fowler. This Committee recommended the introduction of a full-fledged gold standard. The Committee favoured the declaration of the British sovereign as legal tender and current coin in India and recommended that the mints should be thrown open to the unrestricted coinage of gold. The Committee, by a majority, suggested the fixation of the exchange rate of the rupee at 1S.4d. which was the prevailing rate. As regards the status of the rupee coin, the Committee expressed the view that while under an effective gold standard the rupee would be a token coin, the then existing conditions in India did not warrant the



imposition of a limit on the amount for which rupees should constitute legal tender. The Committee recommended that fresh rupees should not be coined so long as the proportion of gold in the currency did not exceed the requirements of the public. Another recommendation of the Committee was that the profits on coinage should be kept in gold in a special reserve, entirely separate from the Paper Currency Reserve. This reserve, the Committee suggested, should be freely available for foreign remittances, when the exchange rate fell below specie point. In the Committee's view, Government should not be bound by law to give gold for internal purposes, as such an obligation made them liable 'to find gold at a moment's notice to an amount which cannot be defined beforehand'.

The Committee's recommendations were accepted by the authorities in India and England, but what emerged in due course was not a gold standard but broadly the gold exchange standard of Mr. Lindsay, who had always maintained that 'they must adopt my scheme despite themselves'. Whether deserved or not, in course of time India got bouquets for being the first country 'to adopt it in a complete form'. Sovereigns and half sovereigns were made legal tender at Rs.15 to the £, but Government's efforts to popularise the circulation of gold coins were unsuccessful, since there was little demand from the public for these coins. One explanation for this was the prevalence of famine conditions in the country about that time; another was that the value of English gold coins was too high for convenient use for an average Indian with low income.

Steps were taken towards setting up a mint in India for gold coinage, but the scheme was dropped in 1902 mainly at the instance of the U.K. Treasury which argued that the failure or only partial success of a gold mint, on account of the poor demand for gold coins, would 'be pointed to by the opponents of the gold standard policy (although without justification), as evidence of the breakdown of that policy'.

### *Gold Reserve*

The recommendation to constitute a reserve out of the profits on coinage was implemented, not by the keeping of gold in India as the Government of India desired, but by investment in sterling securities, for which purpose, gold was shipped to London, this gold being taken out of the Paper Currency Reserve in exchange for the freshly coined rupees. The new reserve though saw gold, came to be known as the 'Gold Reserve'! Later, it was realised that shipment of gold from India to augment the reserve was 'needlessly expensive' and it was decided to use the device of Council Bills. In 1904, the Secretary of State announced a standing offer to sell Council Bills, without limit,

at 1S. 4 $\frac{1}{8}$ d. Later, in 1906, a branch of the Gold Reserve was established in India, called Silver Branch, consisting of coined rupees, to meet the demand for rupees and prevent the rupee going above 1S. 4d. The London reserve was intended to prevent the rupee from going below 1S. 4d. and also to enable the Government of India and the Secretary of State to meet their sterling obligations, in the event of an inadequate demand for Council Bills. The name of the reserve was changed to 'Gold Standard Reserve', with two parts, sterling and rupee.

#### *Chamberlain Commission*

A few years later, i.e., in 1907-8, the exchange arrangements were put to severe test with the balance of trade turning against India. Government were requested by exchange banks to issue telegraphic transfers on London, but they refused to accede to the request, as in view of the low Treasury balances the request could only be met by drawing on the gold in the currency reserve in London, and that would have been contrary to the purposes for which the gold was maintained. Government also restricted the issue of gold for export to £ 10,000 to any individual in one day; they, however, continued to give gold for internal purposes. In the result, the exchange rate declined to 1S. 3  $\frac{23}{32}$  d. on November 23, 1907. In the meantime, on November 21, 1907, the Secretary of State urged the Government of India to ascertain from the banks the amount of gold they wished to take and to allow them to have it, if it was not excessive; such an action, he observed, would restore confidence in the exchange position. The Government agreed to meet the banks' requirements of gold, but they feared that a serious position would arise, if the further demands were substantial and they were unable to meet them. In this context, the Secretary of State suggested that Government, in addition to releasing gold, should invite tenders for telegraphic transfers of £ 250,000 on London at rates not exceeding 1S.3  $\frac{27}{32}$ d. However, it did not become necessary to implement this suggestion, as the exchange rate improved in the meantime. Later, the exchange rate again weakened and so, in March 1908, weekly sale of Reverse Councils on London at the rate of 1S.3  $\frac{29}{32}$ d. was resorted to and this went on till September 1908, by which time the exchange became strong. Following this crisis, steps were taken to make the Gold Standard Reserve more liquid and an earlier decision to spend half of the coinage profits on capital expenditure on railways was also rescinded.

Thus, by 1913, when another commission was appointed, no definite standard had been established in India. The proposals for gold coinage and a gold mint were revived in India in 1911-12 and a resolution to this effect was also moved in the Legislative Council. A Royal

Commission, headed by Mr. (later Sir) Austen Chamberlain was appointed to enquire into this and other currency matters; Mr. J. M. Keynes was a member of this Commission. On the Indian currency and exchange arrangements the Chamberlain Commission remarked:

The system actually in operation has accordingly never been deliberately adopted as a consistent whole, nor do the authorities themselves appear always to have had a clear idea of the final object to be attained. To a great extent, this system is the result of a series of experiments.

But the Commission went on to endorse the prevailing system! In other words, the Chamberlain Commission recommended the continuance of what around this time came to be labelled by Keynes as the gold exchange standard, as in its view the people of India neither desired nor needed 'any considerable amount of gold for circulation', and the currency generally suitable was one consisting of rupees and notes. The Commission made detailed recommendations on other matters too. In the Commission's view, the profits from coinage should continue to be credited exclusively to the Gold Standard Reserve, a much larger proportion of which should be held in actual gold; the Indian branch of the Gold Standard Reserve should be abolished, that is to say, the whole of the Reserve was to be located in London. With a view to imparting greater elasticity to the paper currency system, the Commission recommended an increase of the fiduciary issue from Rs. 14 crores\* to Rs. 20 crores, with adjustments in the future to a level equivalent to the notes held in the Reserve Treasuries plus one-third of the note circulation. In the Commission's view, the independent Treasury system was not an ideal one; it was responsible, to some extent, for the recurrence of stringency in the Indian money market, and compared unfavourably with the system of keeping Government balances at a bank. The busy season in India coincided with the season of maximum revenue collection, and as the funds were not immediately needed by Government, the Commission suggested grant of secured loans to the Presidency Banks with a view to relieving stringency. Finally, the Commission recommended that Government should definitely undertake to sell Reverse Councils (that is, sterling on London) at the rate of 1S.3 29/32d., to the full extent of their resources.

#### *Impact of World War*

Soon after the Commission's report was submitted, war broke out and so action could not be taken on all the recommendations. The war had a tremendous impact on the currency mechanism. Initially, the

\* The fiduciary issue had been raised from time to time from Rs. 4 crores in 1862 to Rs. 14 crores by 1911.

exchange weakened and the situation was met by sale of Reverse Councils between August 1914 and January 1915. Thereafter, the system worked smoothly, on the whole, till about the end of 1916, when it broke down. There was exceptional demand for rupees on account of a favourable trade balance and the large expenditure in India on behalf of the Imperial Government. In normal times, imports of precious metals would have played an important part in liquidating a favourable trade balance, but during the war, restrictions were imposed on exports of gold by belligerent countries, while there was a shortage of silver. As the Indian rupee was a silver coin, there was a phenomenal increase in the demand for the metal, the price of which in the international market shot up from 27 ¼ d., the highest in 1915, to over 43d. per standard ounce by August 1917 -the point at which the exchange value of the rupee at 1S.d. became equivalent to the value of the bullion contained in it. The price of silver rose further to 55d. by September 1917, and reached 79d. by December 1919. The rise beyond 43d. in the price of silver had to be followed by a corresponding stepping up of the exchange value of the rupee, as sale of Council Drafts at the old rate would have involved considerable loss to Government ; also, the rupee, undervalued at 1S. 4d would have disappeared from circulation for melting and export. In these circumstances, in August 1917, the Government abandoned the old rate and, shortly afterwards, announced that in future the price at which Council Drafts would be sold would depend on the price of silver. Consequently, the rate of exchange was stepped up until it reached the level of 2s.4d. (for T.Ts.) in December 1919. The rapid increase of the currency circulation and the difficulties of obtaining sufficient quantities of precious metals for coinage purposes and as backing for note issue also called for substantial increases in the fiduciary portion of the note issue, which was taken to Rs. 120 crores by 1919. Measures were taken to economise the use of silver, through the issue, for the first time, of Rs. 2 ½ and one rupee notes and by extending the use of nickel for the small coins. Further, facilities for encashment of notes at district Treasuries were withdrawn in a large measure. Despite these measures, large quantities of silver had to be imported. Also, gold mohurs and sovereigns were coined and issued to supplement the silver currency. Government also effected substantial gold sales. Several fiscal measures were also taken to mobilise resources through taxation and extensive borrowing; from October 1917, short-term Treasury bills were issued.

*Babington Smith Committee*

In the meantime, in May 1919, the Secretary of State appointed another expert committee under the chairmanship of Sir Henry

Babington Smith to examine the effects of the war on the Indian exchange and currency system and practices and to make recommendations for 'ensuring a stable gold exchange standard'. In other words, the terms of reference precluded the Committee from considering alternative monetary standards, its main responsibility being to suggest measures for the re-establishment of the gold exchange standard, which had been overthrown during the war period by the steep rise in the price of silver. The main recommendation of the Committee (Majority Report) was the stabilisation of the rupee at 2s. gold ; the rupee was to have a fixed exchange value in terms of gold at the rate of 11.30016 grains of fine gold, i.e., 1/10th of the gold content of the sovereign. The view was that the high exchange rate of the war time had mitigated a rise in Indian prices and had resulted in substantial saving in Home Charges in terms of rupees. The Committee recommended that the Government of India should be authorised to announce, without previous reference to the Secretary of State as was the practice till then, their readiness to sell Reverse Councils (i.e., sterling bills) during periods of exchange weakness. It should be noted that the exchange rate on the eve of the appointment of the Committee was IS. 8d.; it had risen to 2s.4d. by December 1919. The Committee agreed with the Chamberlain Commission that it was not in India's interest to encourage the use of gold coins. Further, in view of the then shortage of silver, it recommended that the obligation on the part of Government to give rupees for sovereigns should be withdrawn. With a view to imparting elasticity to the note issue, the Committee recommended that Rs. 5 crores of additional note issue, based upon commercial bills of exchange, should be made by way of an experiment; the issue was to take the form of loans to Presidency Banks on the collateral security of bona fide commercial bills endorsed by them and having a maturity not exceeding 90 days. Mr. Dadiba Merwanjee Dalal, who disagreed with his colleagues 'on vital currency principles', and, in particular, the 2s. ratio, submitted a Minority Report; he advocated 1s.4d. ratio. The recommendations of the Majority Report were accepted by the Secretary of State, but the efforts to implement them proved disastrous. There was apparently little faith among the public in the ability of the authorities to maintain the high rate of exchange and so there was strong demand for remittance to the U. K. As a result, Reverse Councils had to be offered by Government on a large scale; the rate varied from 2s.3 29/32d. sterling to 2s.10 29/32d. sterling, corresponding to 2s. gold. The attempt to fix the price of sovereign at Rs.10 was a failure; the coins disappeared from circulation. As the efforts to hold the rupee at 2s. gold failed, Government attempted, from June 24, 1920, to maintain the exchange rate at 2s. sterling, but even this effort had to be given up in September

1920, and the rupee was allowed to find its own level. Applications for sterling continued to be substantially in excess of the amounts offered; as against the weekly offer generally maintained at £ 2 million up to April 22, 1920, and at £ 1 million thereafter, the amount applied for was over £100 million in several weeks. Reverse Councils sold since the beginning of the year till September 28, 1920 aggregated £ 55.4 million; the resultant currency contraction was insufficient to arrest the downtrend in the exchange rate, which fell even below 1S. 3d. sterling or 1S. gold in early 1921. But gradually, conditions began to improve and the rupee reached 1S. 4d. sterling in January 1923 and rose further to 1S. 6d. sterling (or 1S. 4d. gold) by October 1924. With the return of sterling to gold in April 1925, the exchange rate of the rupee (1S. 6d.) came to be on a sterling cum gold basis.

#### *Hilton Young Commission*

After a period of what has been called 'masterly inactivity', the Government appointed in August 1925 a Royal Commission on Indian Currency and Finance, under the chairmanship of Lt. Comdr. Edward Hilton Young, 'to examine and report on the Indian exchange and currency system and practice, to consider whether any modifications are desirable in the interests of India, and to make recommendations'. The report of the Commission, submitted in July 1926, was a very comprehensive one; the Commission's recommendations were also of a far-reaching character. On a review of the Indian currency system, it came to the conclusion that the system as it existed was far from simple and that there was:

a cumbrous duplication of reserves, with an antiquated, and dangerous, division of responsibility for the control of credit and currency policy.

The Commission characterised the Indian system as inelastic and remarked:

the system does not secure the automatic expansion and contraction of currency. Such movements are too wholly dependent on the will of the currency authority.

Further, the Commission observed:

India is perhaps the only country, among the great trading countries of the world, in which the Government exercises direct control over currency in general and over the note issue in particular. The banking and currency reserves of the country are thus separated, which diminishes their capacity to effect their specific purpose of stabilization in the most economical and efficient manner.

After considering the various alternatives, the Commission came to the conclusion that:

in order to secure public confidence in India, the currency of the country must be linked with gold in a manner that is real and conspicuously visible, or, in other words, that it is necessary to establish a true gold standard.

What the Commission recommended, however, was not the traditional gold standard, but a gold bullion standard, that is to say, gold would not circulate as money, but the currency authority would be under an obligation to buy and sell gold, without limit, in quantities of not less than 400 fine ounces 'at rates determined with reference to a fixed gold parity of the rupee'. The legal tender feature of the sovereign and the half sovereign was accordingly to be removed.

The Commission was against putting gold into circulation, for a number of reasons ; the more important of these were: (i) if gold in the reserve was transferred to circulation, it would result in a reduction in the structure of credit that could be built on the reduced reserve and the elasticity of the currency system would thus be lessened; (ii) any large extra demand for gold from India would increase competition for gold among the leading gold consuming countries and would lead to a substantial fall in gold prices of commodities and a curtailment of credit; and (iii) the amount of gold needed for currency purposes could not be estimated. The last of the reasons just mentioned requires some explanation. In view of the great attraction the Indian public evinced for gold, it was feared that even those in the habit of using notes might turn to the use of gold coins. Further, the fall in the value of silver, which was expected to result from the introduction of gold currency, might shake public confidence in the white metal as a store of value and enhance the demand for gold.

As regards the rates at which the currency authority should buy and sell gold, the Commission remarked that though the obligation on the currency authority to buy and sell gold at a price equivalent to the par value of the currency was implicit in a sound gold standard, India's case was different. India needed gold not only for monetary purposes, but absorbed large quantities for purely social uses, and there was an organised bullion market through which the demand for gold could be met. Hence, the conditions governing sale of gold by the currency authority had to be so framed as to free it from supplying gold for non-monetary purposes in normal times. The Commission, therefore, recommended the fixing of the selling price of gold above Rs. 21-3-10 per tola the fixed parity of the rupee-when the telegraphic transfer rate on London was below the upper gold point. If this was not done, the currency authority would become the cheapest market

for gold in India. Also, sale of gold at above the parity price would enable the currency authority to replenish its gold stock without loss by importing from London.

The Commission recommended the amalgamation of the Paper Currency Reserve and the Gold Standard Reserve.\* The composition of the combined reserve was to be fixed by Statute, gold and gold securities forming not less than 40 per cent of the reserve. The silver holdings in the reserves were to be gradually reduced and the legal obligation to convert the paper currency into silver rupees was to be terminated in respect of new notes to be issued. Another of the Commission's recommendations was to reintroduce one rupee notes, which were to be full legal tender but were not to be convertible by law into silver rupees. With regard to the parity of the rupee, the Commission recommended 1S. 6d., to which rate, in its view, prices in India had adjusted substantially vis-a-vis the world at large. Finally, the Commission also recommended the establishment of a central bank for India and made detailed proposals in this behalf; this has been dealt with in Chapter 1.

There was a minute of dissent by Sir Purshotamdas Thakurdas, covering a wide ground; in particular, it opposed the 1S. 6d. ratio, advocating instead 1S.4d. Sir Purshotamdas considered that the level of 1S. 6d. attained for some time past was an artificial appreciation. He was also, as mentioned in Chapter 1, in favour of developing the Imperial Bank of India into a full-fledged central bank instead of setting up a new institution.

The Commission's recommendations were accepted by Government and, in January 1927, the Government published three Bills embodying the recommendations, namely, the Gold Standard and Reserve Bank of India Bill, a Bill to amend the Indian Coinage Act, 1906, and the Indian Paper Currency Act, 1923, and finally a Bill to amend the Imperial Bank of India Act, 1920. The fate of the first Bill has already been described in the preceding chapter. The third Bill is not of direct relevance for our purpose here. So far as the Currency Bill was concerned, progress was rapid; it was passed in March 1927 and came into effect on April 1. In terms of the Act, the exchange value of the rupee was established at 1S. 6d., the gold equivalent of the rupee being

\* On March 31, 1926, that is, a little prior to the submission of the report the Gold Standard Reserve of E40 million was all held in sterling securities; the composition of the Paper Currency Reserve, amounting to Rs. 193 crores, was as follows :

	Rs. crores.
Gold Coin and Bullion	22.32
Silver Coin and Bullion	84.91
Sterling Securities	29.00
Rupee Treasury Bills	47.11
Rupee Securities	10.00

See Tables at the end for the composition of the two Reserves for some selected years till 1935.



8.47512 grains fine. Sovereigns and half sovereigns were demonetised, but Government were to receive them, at all Currency Offices and Treasuries, at their bullion value. A statutory obligation was imposed on Government to purchase gold at Rs. 21-3-10 per tola fine in the form of bars containing not less than 40 tolas (equivalent to 15 oz.) fine gold and to sell, in exchange for Indian legal tender currency, gold for delivery at the Bombay mint, at the rate of Rs. 21-3-10 per tola, or, at the option of the Controller or the Deputy Controller of the Currency, sterling for immediate delivery in London at an equivalent rate, in amounts of not less than 1,065 tolas (approximately 400 oz.) fine gold, or the corresponding amount of sterling, respectively. This was the first time that a statutory obligation was imposed on the currency authority to buy and sell gold at a fixed parity. As regards sales, it will be noticed that an option was given to Government to give gold or sterling. So long as sterling was on the gold standard, it made little difference. It may thus be said that the Currency Act of 1927 established a gold bullion cum sterling exchange standard.

The fixation of the rupee at 1S.6d. was effected in the face of strong opposition from the Legislature as also the public at large. Sir Basil Blackett, the Finance Member, justified the 1S.6d. rate on the ground that :

The de facto ratio holds the field, has held the field for nearly two years, is working reasonably well, has brought about stability and increased confidence all round, has helped enormously to restore balance and stability to budgets and in a special degree to secure for the agriculturist a fair price for his produce. And the onus of proof that some other ratio ought to be substituted for it rests with the advocates of that other ratio.

Sir Purshotamdas Thakurdas, who gave the toughest fight to Government on the ratio question, in the Legislature and outside, questioned why Government did not fix the rate at 1S.4d. in October 1924 when 1S .4d. gold was the prevailing rate at that time, pointing out : ‘ If you leave exchange uncontrolled whenever there is a balance of trade in favour of India, exchange must go up ‘. He also asked Government whether it was a fact that they had accelerated the policy of working up the ratio beyond 1S.4d. gold by starving the country of normal expansion of currency during 1921 to 1927. According to Sir Purshotamdas :

We ask for 1S. 4d. because 1S. 4d. was on the Statute-book till 1914 . . . . India’s is the only currency which got least disturbed because 1S.4d. gold was only disturbed for a period of three years, and even then it was 1S.5d. and not 1S.6d.. . . .1S.4d. gold was longest in existence during the last 12 years and as a matter of fact it was exceeded only for about 18 or 20 months.

Sir Purshotamdas, however, lost the battle; the 1S.6d. ratio was put on the Statute-book by the Currency Act of 1927. The ratio controversy, however, did not subside. It went on even after the Reserve Bank was set up.

### **TOWARDS AN EXCHANGE STANDARD (1927-35)**

The subsequent events relating to money and exchange till the establishment of the Reserve Bank may be referred to briefly. In the first three years or so, with substantial favourable trade balance, exchange remained on the whole strong and the 1S.6d. rate appeared to work all right. From 1930, however, India also shared in the world-wide economic depression. Prices of agricultural commodities registered a steep fall, while redundancy of floating money characterised the economy, resulting in severe strain on foreign exchanges. Politically also the situation was quite disturbed on account of the civil disobedience movement launched by the Indian National Congress. There was a tendency on the part of investors to remit their money abroad; a contributory factor was anticipation of a lowering of the exchange rate of the rupee as a result of political pressure. Consequently, Government had to effect sales of sterling in some months. Attempts were also made by Government to withdraw short-term money through issues of Treasury bills.

Abroad, the economic situation changed from bad to worse. The Bank of England, which had made liberal credits abroad, found itself in difficulties. The British Bank rate was raised in stages from 2 ½ to 4 ½ per cent in July 1931, substantial credits were obtained from abroad, and an emergency budget providing for drastic taxation and retrenchment was introduced. Finally, on September 21, 1931, Great Britain was forced to abandon the gold standard; the Bank rate was raised further to 6 per cent and a system of exchange control was introduced.

Earlier, in India, Government had to sell sterling, amounting to £11million, between the beginning of August and September 19, 1931, to maintain the rupee at the lower exchange point. Following the British Government's decision to abandon the gold standard, the Governor-General in Council issued on the same day (September 21) an Ordinance removing the obligation placed by the Currency Act of 1927 to sell gold or sterling. This was followed by an announcement on September 24 that the rupee would be linked to sterling at 1S.6d. On the same day, another Ordinance, called the Gold and Sterling Sales Regulation Ordinance\*, was promulgated, repealing the Ordinance issued on September 21 and practically restoring the Currency Act of 1927. However, gold or sterling was to be sold only to recognised

\* This was repealed on January 30, 1932.

banks for financing (i) genuine trade requirements, (ii) contracts completed before September 21, and (iii) reasonable personal or domestic needs, and was not to be made available for financing imports of coin or bullion or for liquidation of over-sold exchange position. The control was to be exercised through the agency of the Imperial Bank of India.

Following the departure from gold, sterling depreciated in terms of gold. Since the rupee-sterling ratio remained unchanged, this meant depreciation of the rupee too in terms of gold, or, in other words, a rise in the price of gold in terms of rupees. The price in Bombay rose from around Rs. 21-4 per tola in August 1931 to Rs. 30-12 in December 1931. In the next three and odd years, while there were fluctuations in the quotations, the trend was upward, the highest quotation before April 1935 being Rs. 36-12. However, the price of gold in India, on the basis of the exchange rate of the rupee around 1S.6d., was lower than the price prevailing abroad practically throughout; the disparity in prices made the export of the metal profitable, which phenomenon continued for almost a decade. Thus, in 1931-32, there were net exports of 7.7 million ounces, valued at Rs. 57.98 crores. In the following year, both the quantity and the price rose further, net exports totaling 8.4 million ounces, valued at Rs.65.52 crores. In the ten years ended March 1941, total net exports were of the order of 43 million ounces valued at about Rs. 375 crores, or an average price of Rs. 32-12-4 per tola.

There was a great deal of controversy on the reasons for this unprecedented export of the metal. One view was that it reflected the economic distress following the depression; another view was that the sales were commercial transactions intended to benefit from the rising trend of prices. There was also a view that the rupee was undervalued in terms of gold on the basis of the prevailing price of the metal abroad and the exchange rate of 1S.6d. Whatever be the reasons-and undoubtedly these various factors were at work-public opinion in India was extremely critical of the failure of Government to check the exports and its unwillingness to buy the gold to build up the country's metallic reserves. The official view was that, while it was probably true that a certain proportion represented distress sales, the larger proportion was sold to realise profits from exports, it was not proper for Government to interfere with this and that in any event, the exports had strengthened the country's foreign exchange reserves, exchange rate and credit abroad.

Unfortunately, Government did not take advantage of the improved external reserves position to initiate a policy of reflation which the Indian economy needed badly. Had there been such a policy, it could have been argued by the authorities that sterling accruals from

the export of gold were as helpful as direct purchases of gold by the authorities in India. It needs to be pointed out, however, that in those years of uncertainty, gold possessed certain advantages over holdings of sterling as currency reserve and some increase in official gold stocks would have been in order. It turned out later, during World War II, that gold had to be imported at substantially higher prices, in order to restrain inflation. In the midst of these controversies, one thing was clear, viz., that Indian gold exports contributed to a substantial extent to the strengthening of the Bank of England's reserves.

Following sterling's departure from gold, the price of silver in terms of sterling and rupees also recorded some rise after the continuous fall for several years. Government sales, mainly in the form of rupee coins, were made in larger quantities. The bulk of it was exported. In the four years 1931-35, India was a net exporter, for the first time, to the extent of 117.7 million ounces, valued at Rs. 14.2 crores.

### **SUMMING UP**

In the hundred years prior to the establishment of the Reserve Bank of India, the country remained on a silver standard for a period of almost sixty years, that is, until the closure of Indian mints to the free coinage of silver in 1893. During this period, there was also the introduction of paper currency, in 1862. From 1893 onwards, while efforts were made by Government towards the establishment of a gold standard, in response to the persistent demand from Indian interests, none of the systems which were adopted in practice fulfilled the essential requirements of a gold standard. The 'effective establishment in India of a gold standard and currency based on the principles of the free inflow and outflow of gold' envisaged by the Fowler Committee in 1899 did not materialise. Government's efforts to popularise circulation of gold coins were largely infructuous. Perhaps, the public demand for a gold standard in India was motivated more by the desire to ensure free availability of gold for investment of savings and a stable exchange rate for safeguarding its commercial interests than by the desire to have gold coins in circulation. With sterling on a gold basis and the maintenance of the rupee at 1S. 4d. for a fairly long period, the system, which emerged in due course, operated as a gold exchange standard. Of course, gold could be procured freely through imports which were at no time, except during the war, subjected to restrictions. However, the price of silver continued to be the dominant factor in determining the external value of the rupee as was clearly demonstrated during the First World War. Although the Hilton Young Commission (1926) recommended a full-fledged gold bullion standard, it was whittled down in the Currency Act of 1927 by freeing the currency

authority from the obligation to sell gold without limit. Since Government had the option of giving gold or sterling against rupees, in terms of that Act, and since sterling was on a gold basis, the system continued to work, in effect, as a gold exchange standard, until September 1931. With the departure of sterling from gold, only the link with sterling remained and the currency system came to be on a sterling exchange standard.

The controversies and debates on monetary matters in the years prior to the establishment of the Reserve Bank of India hardly referred to the sterling link. Rather, they centred round the matters of reflation of the economy from the slump and of the exchange rate of the rupee. The two were inter-connected, in that, after the depression set in, a lowering of the exchange rate would have assisted recovery of the economy. The Indian national opinion was near unanimous in the view that the 1S. 6d. ratio meant substantial overvaluation of the rupee and was responsible for deepening and prolonging the economic depression. A lower ratio, such as, 1S. 4d., if not an even lower one, was widely favoured. The unwillingness of the Government to heed the national sentiment in the matter of the exchange rate would appear to be due to a number of reasons. Perhaps, to an extent it was a prestige issue. Having accepted, rightly or wrongly, the recommendation of the Hilton Young Commission for 1S. 6d. ratio, apparently Government were reluctant to lower it, preferring to sustain the ratio through downward adjustment in domestic prices and costs mainly by fiscal devices. But it would seem that two other factors were at work in support of the 1S. 6d. ratio. One was the interests of the British officials in India, civil and military. Since their salaries were fixed in terms of rupees, a high ratio enabled them to obtain a larger remittance in sterling. They were not exposed to the hazards of any resultant unemployment! A higher rupee ratio was also favoured by the India Office, obviously in the interests of British manufacturers. In those years, when the British economy was trying to recover from the effects of world depression, some overvaluation of the rupee provided an incentive to British exports, though an expanding Indian economy would have provided an even better stimulus to British exports. Government spokesmen also argued about the budgetary difficulties that would arise from a lowering of the exchange rate, as it would have meant larger rupee requirements for meeting the Home Charges. This was, however, a restricted view since, with an expanding economy, it would not have been difficult to mobilize sufficient resources for meeting the Home Charges. It should be added that the exchange rate controversy not always ran in terms of pure economic issues; politics and economics were mixed up a great deal.

It should, however, be noted that not always was there identity of views between the British Government at home and the British Government representatives here, especially the Finance Members. For instance, in respect of the 2s. ratio, Sir Chintaman Deshmukh, in an address\* delivered in 1948 at the Gokhale Institute of Politics and Economics, Poona, stated: 'It is not so well known that Sir Malcolm Hailey, the then Finance Member, was bitterly opposed to the idea and yet had no alternative, short of resigning his office, but to defend it in the Assembly and the country generally'. Gradually there was some shift of responsibility, in monetary and exchange matters, from the Secretary of State to the Governor-General (and his Finance Member). An example of this was the substantial modification made in the system of sale of Council Bills in the year 1923-24. While the Secretary of State continued to invite weekly tenders in London, the sale of intermediate Bills was discontinued, its place being taken by purchase of sterling, in India, from exchange banks and recognised firms, through the agency of the Imperial Bank. Later, purchase of sterling in India became the normal method of remittance from India. From April 1927, the purchases were made through public tender, intermediates being accepted between the tenders. The object underlying the new system was 'that the factors influencing the immediate course of exchange can be gauged more accurately and more promptly in India, and by regulating the purchases with reference to the varying conditions of the market, the operations of Government could be conducted so as to avoid violent fluctuations in rates with benefit both to trade and to the country generally'. In these and other ways there was a gradual modification of the system under which 'the India Office was blind to the impossibility of conducting business in this fashion after the introduction of the Reforms, and unfortunate Finance Members had to stand up in the Assembly and defend policies to which they were themselves opposed and the absurdity of which was often locally manifest'.\*\*

## MONEY MARKET AND THE BANKING SYSTEM

### *Characteristics of the Money Market*

Attention may now be turned to a brief account of the Indian money market and the banking system, prior to the establishment of the Reserve Bank of India. A substantial volume of literature is available on the subject thanks to the exhaustive enquiry into the organisation

\* Central Banking in India-A Retrospect.

\*\* Quoted by Sir C. D. Deshmukh, op. cit.

and functioning of the Indian money market and banking carried out in 1929-31 by the Provincial (including some of the princely States) Banking Enquiry Committees and the All-India or the Central Committee. The Central Committee's Report covered wide ground. It traced the development of banking in India, described at length the functioning of the banking system and the money market, including, in particular, the working of the Imperial Bank, and considered in detail the subject of regulation of banking. It also made a detailed survey of rural finance and the financial requirements of industries and trade. On all these matters, the Committee made detailed recommendations. This Report is still the most comprehensive single source of information for the period and is a fairly well-known document too. It is not necessary, therefore, to give here a detailed account of the growth and structure of Indian banking.

The outstanding feature of the Indian money market was its dichotomy; it consisted of two fairly distinct sectors, the organised and the unorganised. These two were not entirely unconnected, but the links were rather loose. The constituents of the organised sector of the Indian money market were the Imperial Bank of India, the exchange banks and the Indian joint-stock banks. The unorganised sector comprised the indigenous bankers, moneylenders, chit fund, nidhis, etc., etc. The co-operative credit institutions occupied a somewhat intermediate position. In the absence of a central bank, the Indian money market suffered from certain defects and deficiencies. On account of the loose links between the several constituents of the money market and the absence of elasticity in the note issue system, the market was characterised by fairly sharp imbalances between the supply of and the demand for money and credit, both regionally and seasonally. The spread in interest rates between the busy and the slack seasons, for instance, was quite sharp, as much as 5-6 percentage points. Similarly, the regional variations in interest rates were also marked.

It was mentioned in Chapter 1 that the Imperial Bank was also a quasi-central bank. However, as will be explained later, there were severe limitations to the Imperial Bank's role as a bankers' bank, in meeting the residual requirements of the money market for funds. To an extent, the requirements of the busy season were met by the inflow of funds through the exchange banks. Although there was an inter-bank call market, it was not an integrated one. The Imperial Bank operated in a world of its own. Likewise, the exchange banks and the Indian joint-stock banks had not much contact with one another.

If the links within the organised money market were weak, they were even weaker as between the organized and the unorganised sectors. The main channel of transmission of funds from the organised sector

was the discounting of hundis\*, done on a modest scale, by the Imperial Bank of India and some leading Indian joint-stock banks. The cooperative institutions also provided some link between the two sectors; primarily they channelled resources to the unorganised sector, especially the rural sector, and, to some extent, got credit facilities from the organised sector, especially the Imperial Bank of India.

## GROWTH OF COMMERCIAL BANKING

### *Imperial Bank of India*

A brief account may now be given of the growth of Indian banking, which may well begin with the Imperial Bank. Something has already been said, in various contexts, in the previous chapter, on the organisation and functioning of this bank, and its predecessor institutions, the Presidency Banks. Some further aspects of the bank's working may be briefly mentioned now. The table below sets out the data relating to the Imperial Bank, in 1921 (its first year), 1928 and 1934 (the year prior to the Reserve Bank's establishment).

As at the End of	(Rs. crores)		
	1921	1928	1934
Capital and Reserves	9.64	10.85	10.98
Deposits	72.58	79.25	81.00
Government :	6.80	7.95	6.72
Others	65.78	71.30	74.28
Credit Extended	53.90	61.60	29.01
Investments	12.46	21.76	41.56
Government Securities	11.17	19.04	41.56
Other Securities	1.28	2.72	
Cash	13.68	10.65	19.03

The sharp decline in the credit extended by the bank, between 1928 and 1934, was largely due to the economic depression.

The Imperial Bank was permitted under its Statute to engage in nearly all types of commercial banking business, except dealing in foreign exchange. The bank also functioned as a bankers' bank, in the sense that voluntarily most banks maintained balances with it and could obtain accommodation from it. The Imperial Bank also managed clearing houses and provided remittance facilities between its branches, to other banks and the public. The bank's obligation to open 100 branches within five years of its establishment was also of considerable help to the banks and the public generally. Reference has already been made to the bank's acting as banker to Government.

\* Loosely referred to as indigenous bills of exchange, these are really promissory notes, generally of an unsecured character, repayable mostly within 90 days.



There were severe limitations to the Imperial Bank's role as a bankers' bank. The fact that the Imperial Bank was a commercial bank was a deterrent to other institutions obtaining accommodation from that bank. Further, since the Imperial Bank did not have the power of issuing notes, it had to turn to Government now and then for replenishing its resources, but the arrangements in this behalf were not elastic. Some provision was made for this through advances from the Paper Currency Reserve. Originally, the Imperial Bank could borrow notes up to Rs. 5 crores against bills of exchange; in 1923, this was raised to Rs. 12 crores. The bank had to pay interest at its current Bank rate, subject to minima varying from 6 to 8 per cent on the different slabs of borrowing. Later, there was some lowering of the upper limit of the minima to 7 per cent. Besides the high cost of this accommodation, there was another difficulty, namely, that the bank had to get the demand promissory notes of its constituents converted into usance bills, since the credit had to be against trade bills, and there was a dearth of these bills. This meant some expenditure on stamp duty apart from the reluctance of the constituents to make this change. In 1931-32, on account of the paucity of trade bills, the Government advanced monies to the Imperial Bank from the Paper Currency Reserve against Government of India rupee securities bought from the bank under a repurchase agreement.

A feature of the Imperial Bank's lending operations was the wide seasonal fluctuations in its Bank rate and Hundi rate. The Bank rate was the rate at which the Imperial Bank was prepared to grant demand loans against Government securities and the Hundi rate was the rate at which the Imperial Bank would discount or rediscount first class commercial bills with a maturity of not more than three months. The Hundi rate was generally equal to or a little higher than the Bank rate. Up to the end of 1932, the rates charged generally varied widely every year; in the period 1921-32, the Bank rate ranged from 4 to 8 per cent. During the busy season, the practice of the bank was to raise the Bank rate up to 7 or 8 per cent in order to cope-with the heavy pressure on its funds. The level of the bank's busy season rates was dictated partly by the high rate at which the bank itself had to borrow from the Government, as explained in the previous paragraph, and partly by its policy of maintaining a high level of cash. However, from 1933 onwards, the Imperial Bank rate was altered not more than once in a year, if any, its range in the period 1933-51 being between 3 and 4 per cent.

In one respect, however, the Imperial Bank was of assistance to the money market, that is, in mitigating, on a modest scale, the impact of budgetary operations, by virtue of the bank's being banker to Government. Thus, for instance, in times of large payments to Government by

the public, the bank came in possession of interest-free balances, which it could put back at the disposal of the money market through lending.

The only other matter concerning the Imperial Bank, which should be referred to here, is that there was considerable public criticism about its functioning. While obviously much of it was unwarranted, there was a general belief that the bank's operations favoured the European business interests in India and that small industrialists and traders had little access to it. These views, in fact, persisted for many years even after the establishment of the Reserve Bank of India.

Following the passing of the Reserve Bank of India Act, the Imperial Bank of India Act was also amended. Under the amended Act, the Imperial Bank ceased to be banker to Government; it was, however, authorised to enter into an agreement with the Reserve Bank providing for its appointment as sole agent of the Reserve Bank in places where it had a branch but where there was no branch of the Banking Department of the Reserve Bank. The amended Act made certain changes in the constitution of the bank, modified government control over it and also removed some of the restrictions on its activities, such as engaging in foreign exchange business, imposed by the original Act. A few restrictions, like those on land mortgage business, period of loans and advances, loans against shares, etc., however, were retained, since the bank was to continue to conduct Government Treasury business in many places as the sole agent of the Reserve Bank.

#### *Indian Joint-Stock Banks*

Turning to the growth of joint-stock banks generally, other than the Presidency Banks, it may be said that banking in India on modern lines was started by the English Agency Houses of Calcutta and Bombay. As in the West, for quite some time these institutions were functioning on the basis of unlimited liability. They also issued currency notes until the privilege was withdrawn in 1862. Though some of the banks were successful, several of the early banks failed on account of speculation and mismanagement.

In 1860, the principle of limited liability was permitted under Indian law. This and the boom conditions in the cotton trade generated by the American Civil War led to a spurt in the establishment of banking companies. Most of them, however, went into liquidation in the wave of speculation and crisis which followed the boom; the sharp fall in the price of silver from 1873 onwards was another contributor factor.

The Swadeshi movement of 1906 gave a fillip to Indian joint-stock banking and several of the present leading banks were established in the next seven or eight years. The period 1913 to 1918 was again a

bad one for Indian banks, with many failures. In the 13 years prior to the establishment of the Reserve Bank, while there was a fair increase in the number of banks, there was hardly any net increase in deposits ; a substantial decline occurred between 1921 and 1928, which was made up later. The growth of joint-stock banks in India since the turn of this century is given in the table below.

(Rs. crores)

On Dec 31		Banks with Paid up Capital and Reserves of Rs.5 lakhs and over		Banks with Paid-up Capital and Reserves of Rs.1 lakhs and over but less than Rs.lakh		
	No.	Paid up Capital and Reserves	Deposits	No.	Paid up Capital and Reserves	Deposits
1900	9	1.28	8.08	..	..	..
1910	16	3.76	25.66	23*	0.50*	1.51*
1921	27	12.40	76.90	38	1.00	3.26
1928	28	11.10	62.85	46	1.20	3.50
1934	36	12.67	76.77	69	1.49	5.11

\* Data relate to 1913.

The size and standing of the banks varied quite considerably. In the main, like commercial banks in the U.K., Indian joint-stock banks specialised in the provision of short-term credit, mostly for trade. Bank credit was mainly extended in the form of cash credits and overdrafts, rather than bills. The Indian joint-stock banks played very little role in providing finance for agriculture except for the movement of crops in the urban and semi-urban areas. They did not also undertake foreign exchange business, which was the virtual monopoly of the exchange banks.

The matter of bank failures received considerable attention at the hands of the Central Banking Enquiry Committee. After analysing the principal causes, such as insufficient capital and reserves, inadequate liquidity of assets, payment of exorbitant interest rates to attract deposits, injudicious advances, speculative investments, and dishonest and incompetent management, the Committee recommended that a special Bank Act be passed, incorporating the existing provisions of the Indian Companies Act in regard to banking and including new provisions relating to (i) organisation, (ii) management, (iii) audit and inspection and (iv) liquidation and amalgamation. This object was not, however, accomplished till 1949, though efforts in this behalf were made from 1939 onwards.

### *Exchange Bank*

The exchange banks, which numbered 17 on the eve of the establishment of the Reserve Bank, were engaged predominantly in the financing

of foreign trade ; but their share in the financing of internal trade requirements, especially for moving goods between port towns and the interior, was not insignificant. In point of deposit resources, it is interesting that the exchange banks, the Indian joint stock banks and the Imperial Bank were, more or less, on par -around Rs. 70 to 80 crores (see table below).

(Rs. crores)

On Dec 31.	Imperial Bank	Indian Joint-Stock Banks*		Exchange Banks	
	Deposits	No.	Deposits	No.	Deposits
1900		9	8.08	8	10.50
1910		16	25.66	11	24.79
1921	72.58	65	80.16	17	75.20
1928	79.25	74	66.35	18	71.14
1934	81.00	105	81.88	17	71.40

\* Relate to banks with paid-up capital and reserves of Rs. 5 lakhs and over up to 1910 and to Rs. 1 lakh and over thereafter.

Originally, the exchange banks, i.e., all branches of foreign banks, depended primarily on funds from home for meeting their requirements of additional funds in India and this was criticised as unsound and undesirable for the Indian money market. Later, however, these banks developed their Indian deposit business substantially, and this led to complaints of unfair competition vis-a-vis the Indian joint-stock banks!

There was a widespread feeling in the country that all possible steps should be taken for encouraging Indian banks to engage in foreign exchange business and that the restriction on the Imperial Bank's financing of foreign trade should be removed. There was also the suggestion that an Indian Exchange Bank should be established.

The feeling was also strong that national interests demanded some regulation of the operations of the exchange banks. The Central Banking Enquiry Committee made several recommendations for this purpose. Apart from those relating to their method of operations, an important suggestion was the licensing of Indian offices of the exchange banks by the proposed Reserve Bank, with a view to giving the latter some control over the foreign banks operating in the country. For obtaining a licence, the banks were to be required to satisfy certain conditions, viz., (a) furnishing the Reserve Bank with annual statements showing the assets and liabilities relating to their Indian business and periodic reports of Indian and non-Indian business handled by them, and (b) fulfilling such other stipulations as might be imposed on them on the basis of reciprocity.

*Banking Offices*

A word may be said regarding the number of banking offices in India on the eve of the establishment of the Reserve Bank of India. The distribution of offices among the major categories of banks was as follows:

	Head Office	Branches
Imperial Bank .	3	160
Exchange Bank	---	98
Indian Joint- Stock Banks.	320	688
	323	946

This gave roughly one office per 3 lakhs of the population. The position was, in fact, worse, as these 1,269 offices were located in only about 475 towns \*. The remaining 2,100 or so towns and the villages where the bulk of the population lived were not provided with banking facilities, other than the limited services provided by co-operative institutions and indigenous bankers. The scope for expansion of banking facilities was thus immense.

**CO-OPERATIVE INSTITUTIONS**

For some decades, that is, since long before the organisation of the Reserve Bank, great faith has been placed in India in the potentialities of the co-operative organisation to serve the credit needs of the country, especially of the rural sector. The Royal Commission on Indian Agriculture (1928), while talking about the co-operative movement, observed that 'if Co-operation fails, there will fail the best hope of rural India'. The Central Banking Enquiry Committee agreed wholeheartedly with the opinion of the foreign banking experts on commercial banks, expressed in the following terms:

The co-operative movement in spite of imperfections and of unavoidable set-backs deserves every possible assistance from all quarters, because there is no better instrument for raising the level of the agriculturist of this country than the co-operative effort, and a strong appeal to the banking interests of the country to assist this movement seems not at all out of place.

\* The census code provided for the treatment as a town of every municipality, all civil lines not included in municipal limits, every cantonment and every other continuous collection of houses, inhabited by not less than 5,000 persons, which the Superintendent of Provincial Census Operations decided to treat as urban. In making this decision the Census Superintendent was instructed to take into consideration the character of the population, the relative density of the dwellings, importance in trade and historic associations, and to avoid treating as towns overgrown villages without urban characteristics.

Though a few co-operative institutions had been organised in the closing years of the 19th century and registered under the Companies Act, it may be stated that the real start to the co-operative movement was given by the passing of the Co-operative Societies Act of 1904. It became evident that no real advance in the organisation of cooperative societies was possible without legislation and that the Companies Act, with its 256 sections and elaborate provisions was wholly unsuited for this purpose. The Act of 1904 was simple and elastic, the aim being to lay down merely the general outlines and leave the details to be filled in gradually on the lines which the experience of failure or success and the natural development of the societies might indicate as best suited to the different parts of the country. The Government of India also advised the local Governments that, until further experience had been gained, their intervention should be limited strictly to essentials so as to permit spontaneous growth of the societies. The Act enabled the formation of thrift and credit societies by any 10 or more persons over the age of 18 and living in the same town or village. Such societies were given a legal personality and authorised to raise funds and carry on their business in a corporate capacity. The societies registered under the Act were classified as rural or urban according to the composition of their membership. The liability of a member in a rural society was to be unlimited while in the case of an urban society the choice was given to the society to have unlimited or limited liability. Loans could be made only to members on personal or real security but not on chattel security. The interest of a member in the share capital of a society was strictly limited. The societies were subject to audit and inspection by officers deputed by Government and were exempt from income-tax, stamp duties and registration fees.

The example of credit societies registered under the Act led to the setting up of co-operative societies for purposes other than credit, in particular distribution, and also to the formation of various central agencies for financing and controlling the credit societies registered under the Act. These institutions, which did not come under the purview of the 1904 Act, ran all the risks attendant on a status unprotected by legislation. A new Act was, therefore, passed in 1912 to give legal recognition to these types of societies and also to solve many of the problems which arose while administering the earlier Act. It was observed that the immediate effect of the 1912 Act was to infuse a fresh energy into the movement. It also led to a rapid growth in the number of central institutions.

The next important development in the growth of the co-operative movement was the publication of the Report of the Maclagan Committee on Co-operation in 1915. One of the recommendations made by the Committee was the establishment of provincial co-operative banks.

By 1930, such banks had been established in all the major Provinces in India except the United Provinces, where it was established in 1944. The co-operative organisation for agricultural credit thus came to be established in three tiers, namely, the provincial co-operative banks at the apex level, the central co-operative banks at the intermediate level and the primary credit societies at the base, the last constituting the pivot of the movement,

Co-operation became a Provincial subject in 1921, in terms of the Government of India Act, 1919. In the early years after the transfer, the Development Ministers of the Provincial Governments evinced much interest in the movement and by the time the Central Banking Enquiry Committee submitted its report in 1931, there had been a large addition to the number of societies all over India. Some of the Provincial Governments passed their own Co-operative Acts in replacement of the all-India Act of 1912. After the initial enthusiasm, somewhat indiscriminate expansion, exploitation by a few influential members and widespread failures, the Provincial Governments found that attention should be directed towards the consolidation and rectification of existing societies rather than to a further rapid expansion. For this purpose, they instituted committees of enquiries into the working of the co-operative movement in their respective Provinces.

An important feature to be noticed about the co-operative movement in India was that it was largely Government-sponsored, As Sir Horace Plunkett, a co-operator of international repute, remarked:

the widely spread and numerous supported Indian Co-operative Movement would more accurately be called a Co-operative Policy. It was created by 'resolutions' (to all intents and purposes laws) of the Central Government and has been administered almost wholly by the ablest civil service in the world. A huge posse, now nearly all Indian, of Registrars, Assistant Registrars, Auditors and Accountants, inspects, supervises, and largely controls the co-operative societies scattered over the continent.

Right from the beginning up to the Second World War, the co-operative movement was predominantly of the credit type and confined to rural areas. The Central Banking Enquiry Committee had this to say on the subject:

It must, however, be mentioned that in spite of the removal of the limitations imposed by the original Act (Act of 1904), and the creation of scope for several forms of non-credit activities, the preponderating element in Indian co-operation is still credit. This appears to be natural not only because credit is the simplest example of co-operative endeavour that can be introduced among a rural population which is largely illiterate, but also because credit continues to be the most

insistent need of the Indian cultivator, who is weighed down by the burden of usury and chronic debt which crush the “life and thought ” of rural India.

The growth of the co-operative institutions between 1916 and 1934 is given in the table below. The figures reveal a rapid growth up to 1930, while the growth thereafter was slow. In some respects there was even a decline, which should be attributed largely to the ‘great’ depression. The figures also indicate that the magnitude of funds handled by the co-operative sector was small in relation to those handled by the commercial banks.

(Rs. lakhs)

<i>As on June 30</i>	1916	1920	1930	1934
<i>Provincial Co-operative Banks</i>				
Number of banks . . . . .	5	7	10	10
Capital and reserves. . . . .	13	30	1,01	1,30
Loans and deposit resources . . . . .	64	2,12	7,61	9,71
Loans advanced during the year . . . . .	46	1,55	7,63	6,07
<i>Central Banks</i>				
Number of banks . . . . .	239	393	588	603
Capital and reserves . . . . .	57	1,22	4,71	5,83
Loans and deposit resources . . . . .	2,66	5,21	26,19	25,04
Loans advanced during the year . . . . .	1,42	4,00	17,79	9,38
<i>Agricultural Co-operative Societies</i>				
Number of Societies. . . . .	17,729	36,299	91,786	92,226
Capital and reserves . . . . .	1,37	2,51	10,07	12,94
Loans and deposit resources . . . . .	3,79	7,14	24,86	21,05
Advances. to individuals during the year . . . . .	2,28	4,96	12,05	4,21
Outstanding credit to individuals . . . . .	4,55	8,18	29,73	27,03
<i>Non-Agricultural Co-operative Societies</i>				
Number of Societies . . . . .	1,019	2,662	10,255	11,118
Capital and reserves . . . . .	50	1,17	5,43	7,07
Loans and deposit resources . . . . .	66	1,74	9,63	12,79
Advances to individuals during the year . . . . .	1,11	2,55	10,57	12,18
Outstanding credit to individuals . . . . .	95	2,20	11,58	14,51
Overdues . . . . .	13	19	1,34	2,29

The Royal Commission on Agriculture, which examined the position of the movement in 1926-27, found that ‘so far as numbers go, the movement has made remarkably rapid progress’. It summed up the result of the spread of the movement in the following terms:

The main results achieved may be said to be the provision of a large amount of capital at reasonable rates of interest and the organisation of a system of rural credit, which carefully fostered, may yet relieve



the cultivator of that burden of usury which he has borne so patiently throughout the ages. Knowledge of the co-operative system is now widespread; thrift is being encouraged; training in the handling of money and in elementary banking principles is being given. Where the co-operative movement is strongly established, there has been a general lowering of the rate of interest charged by moneylenders; the hold of the moneylender has been loosened, with the result that a marked change has been brought about in the outlook of the people.

The Commission, however, noted that except in the Punjab, Bombay and Madras, the movement had reached only a small part of the rural population, though in all the Provinces there were districts where considerably greater progress had been made than in others.

Enquiries made by the Commission revealed that the increase in the number of societies had not always been accompanied by improvement in quality. It found that in the Central Provinces and Berar, 'a thoroughly unsound system was allowed to develop into a top-heavy organisation'. In the United Provinces, 'the condition of a large number of societies gave cause for anxiety'. In Madras 'considerable anxiety has been caused by the steady increase in overdue loans'. According to the Commission, the financial solvency of the movement was generally beyond dispute and that it was the working of the societies that was defective. It found that:

The members of societies delay the repayment of loans even when able to repay; understanding of the principles of co-operation and knowledge of the essentials of rural credit are lacking; office-holders refrain from taking action against defaulters and the spirit of self-help is not as prominent as it should be, if the movement is to be a live force in village life. Even where defects are obvious and admitted, there is reluctance, as dangerous as it is regrettable, to liquidate societies whose condition is beyond remedy.

The situation deteriorated considerably during the period 1930-34 an account of the economic slump. Advances declined while over dues increased considerably, not only in respect of principal but also of interest.

Mr. (later Sir) Malcolm Darling, who was deputed by the Government of India to submit (i) a report on the condition of the co-operative movement in the major Provinces in 1935 and (ii) proposals for the organisation of the Agricultural Credit Department of the Reserve Bank, summarised the effects of the depression on the movement in the following terms:

the fall in prices has had a shattering effect upon every form of agricultural credit except advances against gold and ornament. Whether we look to the Imperial Bank in Burma or to the Loan Offices in

Bengal, the effect has been the same -an almost complete paralysis repayment with a corresponding restriction of credit. Making, however, full allowance for this, it must, I fear, be admitted that co-operation has not answered early expectations. Almost everywhere it is weak and halting and unequal to its task, and it is difficult to resist the conclusion that agricultural co-operative credit cannot stand on its legs, except perhaps in a period of rising prices. It requires the support of some ally which will either prevent waste, increase resources, or secure punctual payment. Thrift will do the first, and thrift and credit should always go hand in hand, but in India they have been the barest acquaintances. . . .Thrift has not been entirely ignored, but it has been far from playing its appropriate part in the movement.

Overdues of principal were everywhere high and in four major Provinces, namely, Bombay, Central Provinces and Berar, United Provinces and Madras, the over dues formed 69, 82, 58 and 6r per cent, respectively, of the outstanding loans. Owing to poor recoveries, which were mainly due to the fall in prices, advances had to be restricted considerably. Also, in a large number of cases, liquidation of societies had to be resorted to ; altogether, in eight major Provinces, over 25,000 societies, or roughly one-fourth, had to be liquidated since the movement was organised, representing ' a prodigious waste of time, money and effort'.

Such was the state of the co-operative movement on the eve of the establishment of the Reserve Bank of India. Mr. Darling anticipated that on account of the unsatisfactory position of the co-operatives, the financial accommodation which the Reserve Bank could provide for agricultural purposes through the co-operatives would only be of modest dimensions, for some years. To quote him:

One reason why high hopes have been raised in many minds by the proposed Agricultural Credit Department of the Reserve Bank is the belief that the Bank will be able to relieve the peasant of his burden of debt and raise his whole standard of living, to everyone's advantage\* . . . all I need say here is that for some years the help that the Reserve Bank will be able to give to the agriculturist is likely to be of the most modest description, and if there were no co-operative movement, it would probably be unable to help him at all. This then is a further reason for strengthening the movement, for it is no use attempting to fit an old bullock cart with a powerful engine.

The co-operative movement also attempted to provide long-term credit to the agriculturists through special institutions called land mortgage banks. The first of such banks was started in the Punjab in 1920 and a few banks had been established in the Punjab, Madras and Bombay by 1930, but progress in the field was noticeable only much later, i.e., in the late 'thirties. Even so, the progress was confined mainly to Madras, which passed a special Co-operative Land Mortgage

Banks Act in 1934. The ninth and tenth Conferences of the Registrars of Co-operative Societies held in 1926 and 1928, the Royal Commission on Agriculture (1928), and the Central Banking Enquiry Committee (1931) all emphasised the need for organisation of a network of land mortgage banks under the co-operative system and made many recommendations indicating the guidelines for their working. These formed the basis for the organisation of co-operative land mortgage banks (now called land development banks) in India.

A brief reference may also be made to the role of the Government themselves in the provision of agricultural finance. Even as early as in 1793, the British administration in India framed various Regulations for the issue of taccavi advance to proprietors, farmers, subordinate tenants and ryots, for embankments, tanks, water courses, etc. These Regulations were followed by the Land Improvement Loans Act of 1883 and the Agriculturists Loans Act of 1884, which are still in operation. The former Act enables the Government to provide long-term loans, repayable within a maximum period of 35 years, for effecting permanent improvements in agriculture, while under the latter Act, short-term loans are granted, especially during periods of distress, for current agricultural needs, such as purchase of seed, cattle, manure, implements and any other purpose not specified in the former Act, but connected with agriculture. The extent of loans provided by Government under these Acts, in the years prior to the Second World War, formed a very small part of the finance required by the agriculturists, the annual loans given being less than Rs. 1 crore.

The Royal Commission on Agriculture found the working of these Acts to be satisfactory on the whole, but suggested that steps should be taken to make the benefits available under them more widely known to the cultivators, and also to avoid delay in sanction of loans. It suggested the retention of the second Act on the Statute-book until the spread of thrift or co-operative credit or both of them rendered it obsolete. Though there has been considerable progress in the co-operative movement since then, the stage of rendering this Act obsolete has not yet been reached. Government finance under these Acts has still an important part to play in supplementing co-operative finance, especially in areas where the co-operative movement is not adequately developed.

### **THE UNORGANISED SECTOR**

The unorganised sector of the money market may be divided into two broad categories, namely, the indigenous bankers (known by such names as Multani Shroffs, Marwari Shroffs, Gujarati Shroffs and

Chettiars) and the moneylenders. This sector was in itself heterogeneous, with a few indigenous bankers of fairly large resources, at one end, and the smallest of moneylenders financing petty personal needs, at the other. The extent of the unorganised money market has always been a matter of conjecture and was particularly so 30 or 40 years ago; it was generally believed that this was, at least, as large as the organised sector. In a large number of towns and the villages generally, the indigenous bankers and moneylenders constituted the main channels of credit.

The main features of the operations of indigenous bankers, as distinct from those of moneylenders, were as follows. They received deposits and had also credit arrangements with joint-stock banks, generally in the form of discounting of hundies. They financed mainly trade and small industry and also provided general banking facilities through buying and selling of remittances. The advances of indigenous bankers were mostly on a secured basis; their lending (discounting) rates were higher than the rates charged by the commercial banks, but were not by any means extortionate. The moneylenders, on the other hand, did not generally receive deposits, had very little borrowings from the organised banking sector and primarily financed nonproductive expenditure, the loans being generally unsecured and carrying exorbitant rates of interest. Many of the moneylenders in the rural areas were prosperous landholders, while the majority of indigenous bankers combined banking with some form of trade and the capital employed by them in banking was hardly distinguishable from that employed in trade. The operations of the indigenous bankers and the moneylenders were characterised by flexibility and easy accessibility, features which drew towards them the small borrower, rural and urban.

The Central Banking Enquiry Committee, which made a detailed study of the unorganised sector, noted a decline in the banking business of indigenous bankers, largely as a result of competition from joint-stock and co-operative banks. The Committee, however, considered that their activities should not be allowed to decline further and that ' some action should be taken to improve the position of the indigenous banker and to make him a useful member of the Indian banking system ', the aim being ' to try to restore these bankers to the place which they enjoyed in India until the middle of the last century '. It, therefore, suggested that as soon as the Reserve Bank of India was established, the indigenous bankers should, along with joint-stock and co-operative banks, be brought into direct relationship with the Reserve Bank and thereby provided with rediscount facilities. The Committee, however, recommended that only such of the indigenous bankers, as were engaged in banking proper or were prepared to shed their non-banking business, should be brought into such direct relationship

with the Bank. Accordingly, one of the first activities to be undertaken by the Reserve Bank after its establishment was the preparation of a scheme for implementing this suggestion of the Central Banking Enquiry Committee.

The moneylender remained the most important constituent in the rural credit machinery of the country, both from the point of view of number and volume of business. The main reasons for his importance in the credit system are best stated in the words of the U.P. Banking Enquiry Committee:

It is to him that the needy peasant turns for help in every trouble. It is he who finances the marriage ceremonies and law suits -one almost as inevitable as the other. He does not keep the borrower waiting for his money till the time for its profitable spending has passed. He does not press for repayment at due date, if he knows such repayment is inconvenient. He does not conduct embarrassing enquiries into his client's *haisiyat* (financial condition) ; for what it is worth, he knows it already, and the element in it to which he attaches most importance is the client's reputation for prompt and regular payment.

This almost indispensable position occupied by the moneylender made him really extortionate; his rates of interest were unconscionably high. The rates, which varied a great deal from Province to Province, ranged between 12 and 24 per cent, though after 1931, under the impact of the economic depression, they declined to some extent. Besides, he indulged in malpractices of various sorts. To quote, again, from the report of the U. P. Banking Enquiry Committee:

He is certainly no philanthropist, his object is to make money, and he is always not particular regarding the means by which he does it. He will deduct future interest from the principal before he pays it; he will debit his client with all incidental expenses. We will cause an illiterate borrower to put his thumb impression on a blank form and subsequently fill it with a sum in excess of the amount actually lent. He charges a rate of interest which is always high and often extortionate and compounds it at frequent intervals.

The protection of agriculturist debtors from the malpractices of moneylenders and the provision of relief to them engaged the attention of Government right from 1879. The Deccan Agricultural Debtors' Relief Act of 1879 authorised the courts of law to examine the history of a farmer's debt and determine the amount due from him, to withhold payments of unreasonable rates of interest, and to protect the agriculturist from arrest and sale of land, unless the land was specifically mortgaged. This was followed by Land Alienation Acts passed in some Provinces, for instance, the Punjab, United Provinces and Central Provinces & Berar, with similar provisions. The Usurious Loans Act

of 1918 sought to protect the debtors against hard and unconscionable bargains by allowing courts to reopen, on their own, old cases and settle the terms equitably. The rule of Damdupat, under which no debtor was liable to pay by way of interest an amount exceeding the principal of the loan, also came to be applied.

While the above steps represented the early attempts to protect the agriculturists from the malpractices of the private lending agencies, the problem of the accumulated debt burden, most of which was inherited, remained to be tackled. The Royal Commission on Agriculture felt strongly that the 'worst policy towards debt is to ignore it and do nothing'. In this connection, it recommended a simple Rural Insolvency Act, the object of which was to relieve the debtor of what he could not pay, whilst insisting on his paying the utmost he could within a reasonable time. It also suggested the appointment of debt conciliation boards or committees, but left it to the Governments to decide whether they should be in addition to the Rural Insolvency Act or as an alternative to it. The problem became acute during the period of the depression, when on account of the steep fall in agricultural prices, the agriculturists were unable to meet even their current debt obligations, not to speak of old debts. A spate of suits for attachment of land and execution of decrees followed. The Provincial Governments considered that special steps were necessary to protect the agriculturists from these conditions; the United Provinces, Punjab, C. P. and Berar and Madras Governments issued notifications declaring a moratorium on the execution of decrees. Taking the clue from the recommendation of the Royal Commission on Agriculture referred to above, the C. P. and Berar Government took the lead in passing a Debt Conciliation Act in 1933, followed by the Punjab (1934), Assam (1935) and Bengal and Madras (1936) Governments. These Acts facilitated the adjustment of debts and their repayment in a reasonable number of installments, although certain debts like rent, debts to Government, co-operative institutions and banks were either partially or wholly exempted from their purview.

Legislation was also undertaken during this period to regulate the activities of moneylenders. The Punjab Regulation of Accounts Act of 1930 and the Moneylenders Acts passed by the various Provincial Governments fall under this category. These laws, though not uniform in all respects, generally provided for the maintenance of proper registers of transactions by moneylenders, furnishing debtors with statements of accounts in respect of each transaction with the principal and interest shown separately, and issue of receipts for all payments made by the debtor. Some of the later Acts provided for the compulsory registration and licensing of moneylenders, the unregistered moneylenders being debarred from recourse to courts of law for the recovery

of their dues. The regulation (i.e., fixation of maximum) of rates of interest charged by moneylenders was carried out by the Provincial Governments under the Usurious Loans Act of 1918, with suitable adaptations.

The legislative measures referred to above had many loopholes and the moneylenders took advantage of them. Further, the agriculturists were generally unwilling to expose the offending moneylenders, to whom they had to go back again, in the absence of an alternative credit agency. However, as the Central Banking Enquiry Committee noted, there was a gradual decline in the business of professional moneylenders mainly as a result of the agricultural slump and the growth of co-operative societies. The Committee was not in favour of either voluntary or compulsory licensing of moneylenders, and felt that a rigorous enforcement of existing legislation, together with the extension of joint-stock and co-operative banking and better education of the people, would bring about a reduction in the rates of interest charged by moneylenders. In regard to their future role in the credit system of the country, the Committee desired consideration of their suggestions that (i) moneylenders be brought within the fold of the co-operative movement, and (ii) their activities be dovetailed to those of the banking system on an agency basis or through development of partnership on the lines of the 'Kommandit' \* practice prevalent in Germany.

### POSTAL SAVINGS BANKS

Before concluding this account of Indian banking, a brief reference may be made to postal savings banks, which also played some role in mobilising savings and developing the banking habit. Savings bank business in India was conducted by Government right from the time of the East India Company. Government savings banks were established first in the three Presidency towns between 1833 and 1835 and later at selected district Treasuries in 1870. In 1882 and 1883, savings banks were opened at post offices throughout the country and these took over the business of the district savings banks in 1886 and of Presidency savings banks in 1896. The rate of interest on these deposits was reduced steadily from 4 1/6 per cent in 1879 to 3 per cent in 1905 and to 2 1/2 per cent in 1933. The growth of postal savings banks, which were particularly meant to mobilise the savings of the middle and lower classes, is indicated in the following table.

\* Under this system, a bank, instead of opening a branch, became the financing partner of a local moneylender whose advantages of unlimited liability and local knowledge were thus retained without involving the bank in the expense and heavy liabilities of a new branch.

As on March 31	No. of Banks	No. of Accounts	Deposits balance Outstanding (Rs. Crores)	Deposits* of Commercial Banks (Rs. Crores)
1900	6,479	7, 86	9.65	34.27
1910	8,767	13, 79	15.87	86.99
1921	10,713	18, 78	22.86	227.93
1928	12,326	26, 06	32.67	216.74
1935	12,679	31, 00	58.30	234.28**

\* Figures relate to end-December; those for 1900 and 1910 include joint-stock banks with paid-up capital and reserves of Rs. 5 lakhs and over, while figures for the remaining years cover joint-stock banks with paid-up capital and reserves of Rs. 1 lakh and over.

\*\* Relate to end-December 1934.

It will be seen that postal savings deposits were not insignificant in relation to commercial bank deposits. It will also be observed that between 1928 and 1935 the expansion of postal savings deposits was very considerable, unlike that of the commercial banks. The official view was that a substantial part of this increase represented the proceeds of large gold sales during this period.

The majority of the depositors belonged 'to the agricultural class, professional classes and the intelligent middle-class people'; industrial workers had not started making much use of the savings facilities provided by these banks. The Central and the Provincial Banking Enquiry Committees made a number of recommendations for improving the facilities given by postal savings banks. These included, increase in the number of savings bank offices, raising of the limit of deposits in respect of accounts of minors, introduction of a system of cheques both for withdrawing and for depositing, permitting the opening of joint accounts and the incorporation of a provision for the designation of nominees of account-holders.

## INDUSTRIAL FINANCE

Prior to the establishment of the Reserve Bank, there had been from time to time discussions on ways and means of ensuring availability of adequate finance, especially medium and long-term, for the development of Indian industries and the role of commercial banks in this sphere. In this connection, there were also reviews of the role of the managing agency system, a form of management cum financing organisation unique to India.

There was a general aversion on the part of the commercial banks to engage in industrial financing. This was due not only to the influence of British banking practices but also to the lessons conveyed by the failure of certain banks, which had financed industrial enterprises



on a long-term basis, without being equipped for judging the business prospects of a concern or its commercial value. Several committees since 1907 had considered the question of 'State aid to industry' and 'mixed banking', but had not arrived at any definite or satisfactory conclusion. The various 'State aid to industry' Acts, which were in operation in the Provinces, and special institutions set up by two Provinces, viz., the U. P. and Bengal, had failed to achieve the objects they were designed to serve.

The Central Banking Enquiry Committee generally favoured close ties between industry and commercial banking. It recommended, in the light of the constitutional position then in prospect, under which the promotion of industry was expected to be a Provincial subject, the creation of Industrial Credit Corporations in the Provinces to ensure supply of financial assistance to industries. The Corporations were to obtain the share capital from the public as far as possible, Government taking such portion as could not be raised by public subscription. At the same time, the Committee did not rule out the formation of an all-India institution for the purpose of meeting the requirements of industries of national importance, the development of which might fall within the scope of a Federal or Central Government. The Committee also recommended that such of the existing commercial banks, as were well established and carried on their ordinary banking business on conservative and sound lines, might with advantage follow, so far as possible, the German system of 'mixed banking', the Imperial Bank giving a lead in this direction; the banks could participate in the issue of share and debenture capital. In fact, there had been a tendency already for some of the bigger groups of industries to have a trust company, an insurance company and a bank within their controlling fold. The Committee envisaged the appointment by banks of their Managing Directors or Managers as directors of the companies assisted by them.

Progress in the direction of establishing adequate institutional facilities for industrial finance was made only after the attainment of freedom. Although, eventually, the desire of the Central Banking Enquiry Committee for industry-banking relationship of the German type was not realised, the role of commercial banks in the provision of finance for industry, mainly loan finance, increased gradually, both directly and indirectly. However, the provision of institutional finance for industry came to be organised mainly through special long-term financing agencies with Government/Reserve Bank participation at the all-India level as well as in the various States, the Reserve Bank taking considerable initiative in this matter. The first of these institutions was the Industrial Finance Corporation of India, established in 1948. In 1949 a financial Corporation was set up in the Madras State,

under the Indian Companies Act ; financial Corporations in the other States were set up from 1953 onwards, under a special Statute.

### **CONCLUSION**

To conclude the brief history of money and banking in the hundred years prior to 1935, it will be seen that there was the necessary framework for a central bank to begin operations although the Indian money market was deficient in several respects. Even though banking habit had not developed extensively, the use of bank money was not insignificant. About the time the Reserve Bank was inaugurated, deposit money of the order of Rs. 100 crores constituted 40 per cent of total money supply -a somewhat higher proportion than at present.

In many countries, including, in particular, Sweden and the U. K., where central banks have been in existence for about 275 years or over, the evolution of central banking has been slow, haphazard and controversial. In the case of the very old central banks, it was only after several decades that it came to be accepted that the central bank should have a monopoly of note issue, that it should be a banker to Government and a bankers' bank. For a long time, therefore, the so-called central banks were functioning in that capacity only partially. In India too, there was experimentation in respect of the monetary standard and banking arrangements for Government, but when the establishment of a central bank came to be pursued actively in the years 1927-34, there was hardly any controversy with regard to objectives and functions of the proposed institution. The Statute for the Indian central bank was an amalgam of the country's experience and aspirations in monetary and banking matters; central banking principles and organisation evolved abroad and devices intended to safeguard the interests of the foreign power in India. This forms the subject matter of the next chapter.

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1951 confirming the restoration of the Reserve Bank's freedom of operations which had been taken away in August 1947. This was, of course, to be subject to prior consultation between the Reserve Bank and the Bank of England as in the past, so as avoid any undue disturbance in the Landon market as also to enable the former to avail itself of the advice of the Bank of England