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Introduction

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

This difference was constituted principally by the insufficient depth and the underdeveloped nature of the Indian financial system. Central bank practices and conventions were widely premised in the 1950s upon the existence of a well organized financial sector characterized by articulate markets and institutions. Not to speak of institutions of the money market, even the country's commercial banking system was poorly evolved and thinly spread at the start of our period. There were 566 commercial banks in India in 1951 with 4,151 branches, the overwhelming majority of which were confined to the larger towns and cities. Each office of a scheduled commercial bank served, on an average, a population of 1,36,000.[1] Savings accounted for nearly a tenth of the national income. But if one may make a stock-flow comparison in passing, savings held in the form of bank deposits amounted to a little under 9 per cent

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

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

The poor development of the banking system reflected and reinforced the more general lack of depth in the country's financial system. Assets of financial institutions amounted only to about a third of India's national income in 1950. Nearly half these assets were owned by the Reserve Bank. Organized credit institutions were, besides, a negligible presence in rural India. According to the Report of the All-India Rural Credit Survey commissioned by the Reserve Bank in 1951 and carried out over the next two years, only about 3 per cent each of the total amount borrowed by cultivators in 1951–52 came from the government and cooperatives, and less than one per cent from commercial banks. Moneylenders accounted for 70 per cent of the total, and traders for about 6 per cent. The Committee on Finance for the Private Sector (which too was appointed by the Bank in 1953 and was known popularly as the Shroff Committee) mentioned in its Report that indigenous bankers were estimated to finance 75 to 90 per cent of the total internal trade of the country. Based on such estimates, it has been calculated that indigenous bankers and rural moneylenders perhaps accounted for nearly a third of the assets of financial institutions in 1951.[2] If the estimate is right, the former's assets exceeded those of the commercial banking system in 1950–51.

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

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

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

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

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

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

II

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

The Reserve Bank's vigorous involvement in promoting the

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III

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

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

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

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

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

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