

Conclusion

To be convinced of what is right even if the reasons are wrong is more than half the battle won. This is not, it should be noted, the same as saying that the end justifies the means. The distinction is important because, over the last two decades, the perception has been fostered that the nationalization of banks in 1969 by Prime Minister Indira Gandhi belonged to the latter category. As those who have read this volume carefully will be able to testify, it was only the *timing* of that decision which was prompted by the end, namely, wresting control of the Congress party. The debate about the role of the state in banking, on the other hand, had been going on for almost a decade, and it was only a matter of time before the government took charge. It is arguable, of course, that nationalization was a rather extreme step when other options were available. But it can equally be asked if social control, which in legal terms as encoded in company law, really meant nothing. It would have, at best, enabled the government to tinker at the margin and hope for the best, rather than use brute force to take banking deeper into the country and spread its reach wider. Doubtless, given time, the private sector too would have achieved somewhat similar results, possibly even more efficiently. But, for the political leadership, it was time that mattered most. In the end, it had to be a trade-off between the gradual but more efficient spread of banking and a rapid but somewhat less glittery extension. The government of the day chose the latter option and exercised it at a time when it could derive the maximum political advantage from it. It can be faulted for turning a major economic decision into a political exercise. It can also be criticized for not taking into account the practicality of the operational elements of the decisions. At a more fundamental level, there can also be grievance that bank nationalization essentially meant the end of monetary policy because captive banks would be unquestioning sources of funds for government paper.

However, where the core logic of the decision itself is concerned, one would have to be more careful in judging. There were a very large number of

positive externalities, broadly captured in the rubric 'deepening and widening' of the financial system, which also need to be kept in view. For, subsumed in the idea of state control of banking was an even deeper notion that sat well with the national ethos of the time, namely, that the poor must not be forced to rely only on the goodwill and whims of the rich: instead, they must have properly defined entitlements that are not purely socially determined. This was a new and in some ways noble idea. It fell victim later on to vested interests but that must not be used to judge an event that took place in a different context. There can be no gainsaying that without nationalization things would have been different. But whether they would have been better is an altogether different question, which can never be properly answered.

When the 1960s began, Indian banking was concentrated in the cities and major towns. In the rural areas, there was practically nothing. This had led to the growing perception that rural savings were not being tapped by the banking system, which was also not providing credit to agriculture. Bank managements were considered insensitive to the needs of society. These perceptions of the political class led to demands for state intervention. At first the idea was confined to 'social control', whatever that meant, but soon it gave way to outright nationalization. This gave a strong push to branch expansion, especially in the rural areas. The number of branch offices increased from 5,098 at the end of 1961 to 5,858 by the end of 1964, or by 14.9 per cent. But this was not considered satisfactory. Governor Jha in his address to Bombay bankers on 18 August 1967 went to the extent of suggesting 'slowing down of branch expansion in urban areas'. The bankers privately told the Governor that they would welcome this so long as their competitors as well as foreign banks were also kept in check. However, foreign banks were, as Jha observed, 'obliged to confine themselves to port towns only' in order to make profits. A week later, in a policy note to Morarji Desai, Jha noted that more bank offices be opened in smaller places rather than in urban areas. In the context of the 1960s, the enhancement in the geographical coverage of banks implied the opening of additional branch offices in the country. Banks were required to observe a 2:1 ratio between banked and unbanked areas for opening their offices within their geographical spheres of operation. This meant that for every branch they opened in a banked area, they had to open two in an unbanked area.

The essential point to note is that it was a period of experimentation and trial-and-error. But it also becomes quickly apparent that some of the best brains in the country were applying vast energies to the problem. There was a huge outpouring of ideas and some of those were implemented. It is true that most of them were deeply bureaucratic in their provenance. But that did

not make them any the less innovative. For example, the Lead Bank Scheme provides a vivid example of how banking became an instrument of social and political policy. The concept can be traced to the recommendations of the Study Group whose report became the template for banking policy after nationalization. The report addressed itself mainly to the task of identifying the major territorial and functional credit gaps, and making recommendations to fill them. As of April 1969, said the report, as many as 617 towns out of 2,700 in the country had not been covered by commercial banks. Of these, 444 did not have cooperative banking facilities either. And, worst of all, out of about 6,00,000 villages, hardly 5,000 had banks. While the credit–deposit ratio was as high as 89 per cent in centres with a population above 10 lakhs, the declining trend in lower population centres was equally glaring. Centres with population groups with less than 10,000 averaged a credit–deposit ratio of 41 per cent. It was an inevitable step to designate a lead bank for each district to carry out the task of expanding credit to hitherto unserved customers. The efforts in this direction were truly heroic. With the benefit of hindsight, it can be argued that this or that was wrong or right. But the fact remains: the 1970s saw credit going to the poor and the issue ceased to be a political stick to beat the government with. The failures would come later, but for the moment a sea change had been achieved in the economic sociology of the country.

The problem was not restricted to the uneven spread of banking. There was not enough credit to go round either. Even if bank branches expanded, they did not have enough to lend. This led, inevitably, to the only solution that was possible in a democracy, even though it was a political solution: the rationing of credit while deposits were being ‘mobilized’. Once this had become the cornerstone of policy, the next step was to determine who would get how much, for what purpose and, most importantly, at what price, that is, the rate of interest to be charged. But who was to decide all this? Central to this worthy endeavour was the concept of the priority sector. The problem was that no one ever asked, whose priority and for what purpose? But the answer became clear when the Differential Interest Scheme was introduced for the very poor. The scheme was based on the budget speech for 1970–71 by Prime Minister Indira Gandhi, who had kept the Finance portfolio with herself after the split in the Congress party in July the previous year. She had said, ‘The weaker sections of the society are the greatest source of the potential strength and with our limited resources, a balance has to be struck between outlays which may be immediately productive and those which are essential to create and sustain a social and political framework which is conducive to growth in the long run.’ The scheme was probably the brain-

child of Ashok Mitra, Chief Economic Adviser at the Finance Ministry. In 1977, he became the Finance Minister of West Bengal under the first communist government of the state. Politics entered banking through these two doors and has still not gone away. The logic of the situation also led to the Finance Ministry and the Reserve Bank becoming the arbiters of India's financial destiny in ways that had never been envisaged, at least in the manner that took shape over the 1970s.

With this role came power, to be used or misused. In the event, during the period under consideration, barring a few isolated cases involving some well-connected political figures, there was no misuse. That was to come later. But there was plenty of what the British so charmingly call muddling along. One question that can be reasonably asked: is if the Bank did not become overly accommodative of the government in these years. On balance, after a full consideration of the evidence, it appears difficult to conclude otherwise. Equally, however, it would be wrong to say that the process started during the early years of the 1970s, immediately in the wake of the nationalization of banks. The Bank's autonomy in certain matters had been rudely snatched away as far back as 1956 when the Finance Minister, T.T. Krishnamachari, had berated the Governor, Sir Benegal Rama Rau, in front of the Cabinet room, and the Prime Minister, Jawaharlal Nehru, had sided with TTK [A full account of this incident is available in Volume 2 of this history]. But it cannot also be gainsaid that a qualitative change in the relationship between the Bank and the Finance Ministry occurred in the 1970s.

Just how imperious the Finance Minister (Ministry) had become was clear not just in the appointment of Governors but also in the tone and tenor of its routine dealings with the Bank. Worst, perhaps, of all was the perception that the Bank was standing in the way of progress when it was doing no more than its duty by being faithful to its charter, contained in the Reserve Bank of India Act, to maintain the monetary stability of India. However, the Bank's relationship with the government was not exceptional. Other institutions seeking to apply the law as it stood (most notably the Supreme Court) had their brushes with a government impatient for change. The solution lay in changing the law or the rules so that the institutions could apply those with equal diligence. Until that happened, however, there was tension. The 1970s witnessed this tension in full because it takes time for new laws and rules to be put in place.

Perhaps the single most important consequence of this subtle struggle was the abandonment of monetary policy as a tool of economic policy and corrective intervention. Throughout the 1970s and much of the 1980s, it was fiscal policy that held centre stage. The inflation threshold was regarded

as being 7 per cent and it was only beyond that level that efforts to reduce money supply started. But even these usually consisted of non-price instruments, such as raising the SLR and the CRR. Such changes in interest rates that were made mostly impacted on the private sector, which, in any case, was faced with over 200 rates by the middle of the 1980s. The idea of a benchmark rate was known but only as something that other countries had. It was not until the late 1980s that the structure of rates at the short end began to be unified. Monetary policy thus had a very small role to play in overall economic management. Fiscal policy came to dominate the field and would continue to do so for two decades.

One of the most significant developments in the early 1960s was the establishment of the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI) in 1964. The former was intended to provide long-term capital to industry; the latter was designed to provide a safe haven for small savers. The Bank's initiatives in their setting up were discussed in Volume 2 (1951–67). By the end of the 1960s, both institutions had begun to function well; and, in the 1970s, a certain amount of tension developed between the Bank, these institutions and the government. Coordination was a major irritant and the eventual consequence of this tension was the 'delinking' of IDBI and UTI from the Bank in 1976. There were four areas of relationship between the Bank and the two financial institutions. From the Bank's point of view, they were: management participation, staff and organizational support, financial support and policy support. Of these, the first two areas were not critical—they were expected to be fulfilled because both IDBI and UTI were, after all, set up by the Bank. It was only in respect of the latter two that the relationship became a little fraught owing to its flexible nature. This happened despite the fact that the Bank's participation at the highest management level in the two differed. Thus, the RBI Governor was ex-officio chairman of the IDBI, and a Deputy Governor acted as the vice-chairman. The Bank and IDBI had an identical board of directors. However, in the case of UTI, although the chairman, the executive trustee and four other trustees were nominated by the Bank, the chairman was not from it. Also, the executive trustee was of the rank of executive director of the Bank. This created some anomalies. The financial and policy support, meanwhile, was influenced by the culture that the Bank exported via the secondment of its clerical and officer-level staff.

This was also a period when foreign exchange shortages were endemic and severe. Coping with the uncertainties of the time took a great deal of effort and sagacity, and the Bank played an important role here, especially in the dealings with the IMF. The abandonment of the Bretton Woods system

in 1971 created problems for all countries, but for the developing countries these were especially severe. The Bank had to cope with the adjustment challenges in a period of huge uncertainty. The anatomy of exchange control and exchange rate management are analysed in this context. The developing countries were also pressing for reform of the international monetary system and the Bank made several important contributions to the debate.

Safety and prudential issues also came to the fore and the Bank dealt with them in a satisfactory manner. Of late, there has been some criticism that these tended to be overly bureaucratic and process-driven, with the result that even normal risk-taking in banking was discouraged. There is some truth in this but before arriving at a judgment it is important to bear the context in mind, an important feature of which was that the country did not really have a very large cadre of trained bankers at the time. In the absence of skills, experience and market knowledge in the quantities required, rule-based banking was the only option.