

**TEXT FLY WITHIN  
THE BOOK ONLY**

**PAGES MISSING  
WITHIN THE  
BOOK ONLY**

UNIVERSAL  
LIBRARY

**OU\_148387**

UNIVERSAL  
LIBRARY









**MODERN CENTRAL BANKING**  
WITH  
**A SPECIAL STUDY OF THE RESERVE  
BANK OF INDIA  
UNDER PLANNED ECONOMY**

BY  
**Prof. Sukumar Roy Choudhury, M. A., B. Com.,**  
*Head of the Department of Commerce,  
Marwar College, Bhagalpur,  
Formerly fellow of the  
Patna University*

FIRST EDITION

**GHOSH & CO.**  
BOOK-SELLERS & PUBLISHERS  
*12/1, Bankim Chatterjee Street*  
CALCUTTA

Price 

*Published by—*  
S B. GHOSH, M Sc  
GHOSH & CO  
*12/1, Bankim Chatterjee Street*  
CALCUTTA

*Printed by—*  
FAKIR CHANDRA GHOSH  
ANNAPURNA PRESS  
*53A, Madan Mitter Lane*  
CALCUTTA

DEDICATED

To

The Sacred Memory

Of

my father, late Rajendra Lall Roy Choudhury, M.A., B.L., who sacrificed his life in defence of his honour and religion during the great communal frenzy of October, 1946, at Noakhali in East Bengal.



## PREFACE

The period between two World Wars was marked by important banking developments in the world. In the economic upheaval caused by the wars, Central Banking, like other economic activities, had to operate in the midst of a radically altered environment. Both theory and practice of Central Banking have undergone a radical change from their traditional moorings in recent years. Moreover, the post-war period has also witnessed many new changes in the pattern of Central Banking developments. This book aims at a mere exposition of some important trends in the Central Banking of various countries with special reference to the Reserve Bank of India. In this book, an attempt has also been made to describe the post-war developments of Central Banking in various countries within a short compass.

The book is divided into two parts, the first part dealing with the evolution of the principles and theoretical aspects of Central Banking ; and the second part, with the functions and working of the Reserve Bank of India in the light of the subsequent developments arising from the partition of India.

In Chapter XVI of this book, some suggestions with regard to future role of the Reserve Bank of India under planned economy have been made. In the post-war period, as the "full employment" pledge embodied in the United Nations Charter has been accepted by all member countries of the United Nations Organization, the Central Banks have changed their old monetary objectives to one of attaining and maintaining "a stable level of good

employment". Like the Central Banks of other countries, the objective of the Reserve Bank of India should be to attain "a stable level of good employment". With a view to achieving this objective, it is essential that the Reserve Bank should be re-orientated and reformed. No doubt, the Reserve Bank now stands nationalised, yet things remain as they were with the exception that the capital of the Bank is owned by the Government of India. If it is merely owned by the state for the sake of form, the objective of attaining and maintaining "a stable level of good employment" will not be achieved. Therefore, I have made an attempt in this book to suggest a few changes in the structure, organization and working of the Reserve Bank of India.

Various economic sectors of our country, namely, agriculture, industry, trade and commerce have been starving since the last few decades. The Reserve Bank should feed them with necessary credit facilities in order to assist an all-round economic development. With this in view, the Bank should go ahead with a predetermined plan. The Reserve Bank which is regarded as the "pivot of the financial system" of the country and on which depends the well-being of the society to a great extent, should allow credit to percolate to various sectors of economy in accordance with the country's production plan. For this purpose, the Reserve Bank should be vested with the power of using credit rationing which is regarded as a necessary accompaniment of a planned economy. Changes and reforms in all the existing departments of the Reserve Bank of India, namely, the Issue Department, the Banking Department and the Exchange Control Department, should

be introduced and a new department, namely, the Industrial Credit Department, like the Industrial Finance Department of the Commonwealth Bank of Australia, should be set up for rapid and planned industrial development of our country. Again, a suggestion has been made for the creation of a Central Co-ordinating Board for the purpose of formulating the general policy for the successful working of each department. Lastly, amalgamation of the Imperial Bank of India with the Reserve Bank has been suggested because such amalgamation will increase the financial resources of the Reserve Bank and will enable it to assist the various economic sectors with necessary credit through the existing network of branches of the Imperial Bank (which will be branches of the Reserve Bank after amalgamation).

The materials for the book have been collected from official and authoritative sources. With regard to the materials of the Reserve Bank of India, I have mainly depended upon the Bank's publications.

I must acknowledge my indebtedness to those authors whose works I have consulted in writing this book

Malavika House,  
Bhagalpur,  
The 26th July, 1951

**S. Roy Choudhury,**  
Author.

## ACKNOWLEDGEMENTS

I am indebted to Dr J. P Niyogi, M A., Ph D., Head of the Department of Economics, and Dr. S K Basu, M. A., Ph D., Reader in Economics and Head of the Department of Commerce, Calcutta University, for the encouragement received from them in pursuit of my studies on the subject.

I must express my gratitude to my uncle Dr M. L. Roy Choudhury, M A., LL B, P. R S, D Litt, Sastri, Head of the Department of Islamic History and Culture, Calcutta University, who always encouraged me in writing the book and without whose help the book would not have seen the light

I must also thank my colleagues, Prof. A K Bose, M. A., B. Com, Prof. J B Ghose, M. A. and Prof S P Singh, M A, B. Com, who helped me in more than one way

My special thanks are due to Prof. S B Ghose, M sc., proprietor, Ghosh & Co, publishers, Calcutta, for his kindly undertaking to publish the book and doing it in a very efficient way.

Malavika House,  
Bhagalpur,  
The 26th July, 1951

S. Roy Choudhury,  
Author

# CONTENTS

## PART I

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |       |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|
| CHAPTER I—The use of Central Banking—War-time development and the post-war development                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | 1—4   |
| CHAPTER II—Functions of Central Banks —A Central Bank's right of note issue—A Central Bank as banker, agent and adviser to the state, as the holder of the cash reserve, as a Banker's Bank and as a lender in the last resort, as the holder of Metallic Reserves                                                                                                                                                                                                                                                                                                                                      | 5—11  |
| CHAPTER III—The Central Bank as a bank of issue Principles of note issue—Currency and Banking principles Methods of note issue—Fixed Fiduciary System—Maximum Fiduciary System—Proportional Reserve System—Minimum Percentage Reserve System—Foreign Exchange Reserve System, Note circulation during World War No II and in the post-war period                                                                                                                                                                                                                                                        | 12—19 |
| CHAPTER IV—The Central Bank as controller of credit, Bank Rate, Effects of bank rate upon external and internal situations of a country—Hawtrey's line of thought and Keynes's line of thought, Limits of bank rate, —Bank rates in the war-time and in post-war years, Open-market operations—its meaning—Operations in the U. S. A, in Great Britain and in other countries, Limits of openmarket operations, Its operation during the World War No II and in the post-war period, Variable Reserve Ratio —Its use in various countries, its defects—Its use in the war-time and the post-war periods | 20—45 |
| Rationing of Credit —Its use in the Soviet Russia, Rationing of Credit in the post-war period                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | 46—49 |
| Direct action—Moral suasion, Publicity Limits of central banks as controllers of credit and price level                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | 50—55 |

- CHAPTER V—Central banks and trade cycles , Relations between banks and trade cycles , Co-operation between central banks and commercial banks—Co-operation between central banks and the Treasury for reducing cyclical fluctuations , Public works policy , Deficit financing 56—60
- CHAPTER VI—Recent trends in central banking —Relation between the state and central banks , Trend towards a restriction of direct dealings with the public—Trend towards the greater use of open-market operations—Trend towards the centralisation of cash reserves—Trend towards the reduction of the legal cover ratio—Trend towards the extension of advances and discounts of central banks—Trend towards the greater co-operation among central banks—Trend towards the use of foreign exchange as a legal reserves—Trend towards broadening the objective of central banks—Trend towards the use of selective instruments of credit control ... 61—72
- CHAPTER VII—Full Employment and Nationalisation of central banks—Why nationalisation ? Nationalisation of the Bank of England—Nationalisation of central banks in other countries , Nationalisation of the Reserve Bank of India . . . 73—83
- CHAPTER VIII—The International Monetary Fund and the International Bank for Reconstruction and Development —Objectives of the I M F.—Plan of the Fund , I M. F. and gold standard , merits and demerits of the Fund plan , its Constitution , Operations of the Fund , \*Objectives of the International Bank—Capital , Purposes of Bank's guarantee , Operations of the Bank ... 84—106

## PART II

- CHAPTER IX—The origin of the Reserve Bank of India—Constitution—Offices and Branches—Management . . 107-114
- CHAPTER X—The Reserve Bank of India as a Bank of Issue —Monopoly of note issue—Reason for separation of the

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |         |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|
| Issue Department from the Banking Department—<br>Adoption of the Proportional Reserve System of note issue,<br>Note issue since the establishment of the Reserve Bank—<br>Partition of India and the Issue Department of the<br>Reserve Bank                                                                                                                                                                                                                                                                   | 115—122 |
| CHAPTER XI—The Reserve Bank of India as the Banker to the<br>Government —Relation between the Central Government<br>and the Reserve Bank—Relation between the provincial<br>governments and the Reserve Bank—Adviser to the<br>Government on financial matters .. ..                                                                                                                                                                                                                                           | 123—129 |
| CHAPTER XII—The Reserve Bank of India as a banker for<br>other banks, Relation of scheduled banks with the<br>Reserve Bank—Loans and advances to scheduled banks<br>—Relation of non-scheduled banks with the Reserve<br>Bank, Remittance facilities .. ..                                                                                                                                                                                                                                                     | 130—137 |
| CHAPTER XIII—Exchange obligation—Exchange control in war-<br>time and in the post-war periods ...                                                                                                                                                                                                                                                                                                                                                                                                              | 138—142 |
| CHAPTER XIV—The Issue and Banking Departments of the<br>Reserve Bank of India —Issue Department— Liabilities<br>and assets—Banking Department of the Reserve Bank of<br>India since 1935-36 . ...                                                                                                                                                                                                                                                                                                              | 143—151 |
| CHAPTER XV—The Reserve Bank of India as a controller of<br>credit —Difficulties of credit control—Weapons of credit<br>control, Bank Rate—Factors determining the application<br>of Bank Rate—Papers eligible for re-discount and other<br>loans and advances of the Reserve Bank, Restrictions<br>in the choice of customers, Level of Bank rate—Self-<br>sufficiency of scheduled banks and unique position of the<br>Imperial Bank of India, Nature of discounts and loans<br>policy of the Reserve Bank .. | 152—166 |
| Open-market operations —The Reserve Bank's capacity<br>in the use of open-market operations, Quality and<br>volume of securities in which the Reserve Bank can<br>deal, Open-market operations of the Reserve Bank<br>between 1935 and 1939—Operations in the war-time<br>and in the post-war periods. Other weapons of credit                                                                                                                                                                                 |         |

|                                                                                |        |         |
|--------------------------------------------------------------------------------|--------|---------|
| control —Variable reserve ratio and selective instruments<br>of credit control | ... .. | 166—182 |
|--------------------------------------------------------------------------------|--------|---------|

**CHAPTER XVI—The Reserve Bank of India under Planned Economy —**

- (1) The Industrial Credit Department—Need for its creation ,  
Capital structure—Functions , Scope of the I C D ,  
Methods of providing finance—Liaison Department ,  
Procedure for dealing with applications for financial  
assistance , Safeguards for repayment of loans , Relation  
with the International Bank ... .. 184—190
- (2) The Agricultural Credit Department—Defects of the  
Department , Suggestions for the future—Suggestions to  
re-organise Indian Agriculture—Organisation and manage-  
ment of the A C D —Its Capital resources , Functions  
and powers—Relation with the co operative banks ,  
Methods of granting loans and Methods of repayment of  
loans , Relation with the International Bank , Functions  
of the co-operative banks—their capital and reserves—  
Functions and activities . . . 190—204
- (3) The Exchange Control Department , International aspects  
of full-employment policies , India's Balance of payments  
—Foreign Trade Budget , Suggestions for the improve-  
ment of the Exchange Control Department 204—213
- (4) The Issue Department—Need for an ideal currency  
system and stable Rupee—Elasticity—Currency reform  
vis-a-vis full employment , How to ensure stability and  
elasticity ? Suggestions . . . 213—219
- (5) The Banking Department—Drawbacks of the depart-  
ment , Full employment programme vis-a-vis the Banking  
Department of the Reserve Bank 21. —224  
Need for a Central Co-ordinating Board—Organisation—  
Functions and powers 224—225

**APPENDIX —Special powers of the Reserve Bank of India  
under the Banking Companies Act, 1949 [ 1 ]—[ x ]**

# MODERN CENTRAL BANKING

## WITH

### A SPECIAL STUDY OF THE RESERVE BANK OF INDIA UNDER PLANNED ECONOMY

#### CHAPTER I

#### **The rise of Central Banking**

The economic history of the 18th & 19th centuries is replete with occasional price fluctuations of a violent nature. Such price fluctuations have, it is supposed, been caused more by monetary factors than by anything else. These two centuries were noted for a conspicuous absence of any institution to which the authority of regulating price could be safely entrusted. In a word, the present conception of a Central Bank as a controller of currency & credit had not yet been born. Before the beginning of the 20th century there was no clearly defined concept of Central Banking. "A gradual evolution had been taking place in various countries over a long period of years, but the process had not always been a conscious one and a systematic and consistent technique had not yet been developed and formulated"<sup>1</sup> Originally they were known as banks of issue or as national banks, because they gradually acquired the sole right of note issue and conducted the banking operations of the state.

( The oldest central banks originated in commercial banks the principal of them being the Bank of England which was established in 1694. Though the State Bank of Sweden was established in 1668, the Bank of England was the first to operate as a central bank, when it was granted the right of issuing notes subject to certain limitations. Later on, it was granted the privilege of functioning as a banker to the Government. Gradually the Bank of England, owing to its privileged

1. Dakook—Central Banking (1936) p. 1.

position as a bank of issue and a banker to the Government, created confidence in the London money market and was able to establish contact with the private banks. These private banks deposited their funds with it and maintained only a small portion of their funds for the requirement of their day to day needs. In this way the Bank of England became the custodian of the cash reserves of the banks. Its position as the custodian of cash reserves of other banks was further strengthened in the 1st half of the 19th century when joint-stock banks, established during that period, deposited their funds with the Bank of England. The successful management of the currency and credit system of England by the Bank of England as a bank of issue in the periods of economic crisis of 1847, 1857, 1873 and 1890 respectively, raised its prestige and "established it financially as the central bank of Great Britain". It also encouraged the development of central banking in other countries of the world. The 19th century witnessed the establishment of banks under the state patronage, with a monopoly of note issue, like the Bank of France (1800), the Bank of Netherlands (1814), the National Bank of Austria (1817), the Bank of Norway (1817), the National Bank of Belgium (1850), the Reich Bank of Germany (1875) and the Bank of Japan (1892).

Banks with the sole right of note issue were also established in Roumania, Bulgaria, Turkey and Egypt in the 19th century. But the present concept of full-fledged central banking was not born till the beginning of the 20th century. Countries like China, India, the Republics of South and Central America, Canada, Austria etc. were without central banks until the end of the Great War of 1914-18. The United States of America had no full-fledged central bank till 1914, when a central banking system in the form of 12 Federal Reserve Banks was brought into being.

The question of establishment or reorganisation of central banks was taken into consideration by the various countries of the world owing to the economic instability which obtained during and after the Great War of 1914 on account of the unsound currency and credit system then prevalent. At the International Financial Conference held in Brussels, in 1920, one of the resolutions passed was that "in countries where there is no central bank of issue one should be established".<sup>1</sup> In

1. Kisch Elkin—Central Banks (1932), p. 2.

the following years, the advice of the Brussel's Conference was widely followed. Many existing banks of issue were reorganised and re-orientated and more than 30 new central banks were brought into existence between the years 1931 and 1939.]

During the last world war, as the Germans occupied different countries, they made changes in the existing central banks and even established new ones. As for example, after the occupation of Yugoslavia by the Germans, the National Bank of Yugoslavia was liquidated and in its place two new central banks were created—one in Croatia and another in Serbia in May, 1941. In the post depression and the recent war period the theory and practice of central banking underwent many changes. At present central banking is in a state of formation. "Central banking today is standing, as it were, at the cross-roads—and the signposts unmistakably point further ahead."<sup>1</sup>

#### Post-war development of Central Banking

The post-war period is marked by a spectacular development of new central banking institutions in war-affected countries and in those countries where there were no central banks.

Since the occupation of Germany by the Allied powers, the problem of rehabilitation of banking and credit drew their attention. Early in 1948, somewhat similar to U. S. A. Federal Reserve System, a central banking system was created in Germany with four Lander Central Banks in the U. S. Zone, and four in the French Zone and five in the Russian Zone, mainly to regulate monetary circulation and credit supply and to facilitate relations of payments with other Lander and foreign countries. These banks had not the right of note issue. On 1st March, 1948 a new bank of German states was established to replace the old Reich Banks with a capital of  $\text{RM } 100$  million which was subscribed by the Lander banks in proportion to their deposits.<sup>2</sup> The bank issues not only currency but also controls the monetary and credit policies of Lander banks and maintains control over foreign exchanges as is deemed necessary by the British and American military Governors.

1 Dr. S. K. Basu—Recent Banking Development (1946), p. 8.

2 Report of currency and finance (Reserve Bank of India), 1947-48, pp. 11-12.

In 1946, a bank of issue and clearing in each "Laender" of the Soviet Zone of Germany was established and in May, 1948, a German Issue and Clearing Bank (Deutsche Emission und Giro Bank) was started as a Central banking agency for the whole of the Soviet Zone. Subsequently, in July, 1948, this was changed into the German Bank of Issue (Deutsche Noten Bank) with a capital of D M 100 million, of which D M 55 million were subscribed by the finance and certain other departments of the German Economic Commission and the balance by the five banks of issue and clearing of the "Laender". The Bank has the sole right to issue currency. It actively helps national economic planning by means of a suitable currency and credit policy. It promotes capital formation and helps with direct funds according to economic needs. From 1st October, 1947, a national bank of Burma was established known as the Union Bank of Burma with a capital of Rs. 4 crores.

Under an act passed by the Government of Cuba on 30th Dec, 1948, a central bank (Banco-de-Cuba) was established to take over the function of note issue so far exercised by the Treasury and to co-ordinate the monetary and credit policies of the country.<sup>1</sup> The Central Bank of the Philippines was also established in June, 1948. The State Bank of Pakistan with the head office at Karachi also commenced its operations on 1st July, 1948. The Bank has a capital of 3 crores, 51 lakhs, being subscribed by the Government of Pakistan and the balance by the public. The Government provided a sum of Rs. 3 crores in securities towards the reserve fund of the Bank. Under the provisions of the State Bank of Pakistan Order 1948, the Bank's objectives are to secure monetary stability in Pakistan and generally to operate the currency and credit system to the country's advantage.

In recent years, central banks of many other countries were re-organised and nationalised.

---

1. See Report on currency and finance (Reserve Bank of India), 1948-49, pp. 13-14.

# MODERN CENTRAL BANKING

The table given below will indicate the changes in the value of monetary stocks of gold of the Central Banks and Governments of certain countries.  
(In million of dollars)

| Name of Countries. | 1939  | 1938   | 1939   | 1940   | 1941   | 1942   | 1943    | 1944     | 1945   | 1946   | 1947   | 1948   |
|--------------------|-------|--------|--------|--------|--------|--------|---------|----------|--------|--------|--------|--------|
| United States      | 3,900 | 14,512 | 17,644 | 21,995 | 22,737 | 22,726 | 21,938  | 20,618   | 20,065 | 20,529 | 22,868 | 24,998 |
| United Kingdom *   | 710   | 2,690  | ...    | ...    | ..     | ..     | .....   | .....    | .....  | .....  | ....   | .....  |
| France             | 1,633 | 2,430  | 2,709  | 2,000  | 2,000  | 2,000  | 2,000   | 1,777    | 1,090  | 2,587  | 2,085  | 1,828  |
| India              | 128   | 274    | 274    | 274    | 274    | 274    | 274     | 274      | 274    | 274    | 274    | 255    |
| South Africa       | 37    | 230    | 249    | 367    | 366    | 634    | 706     | 814      | 914    | 939    | 762    | 183    |
| Argentina          | 484   | 431    | 466    | 363    | 354    | 658(a) | 939 (a) | 1,111(a) | 403    | 1,072  | 322    | 142    |
| Belgium            | 163   | 581    | 609    | 734    | 734    | 735    | 734     | 733      | 716    | 735    | 594    | 624    |
| Mexico             | 7     | 29     | 32     | 47     | 47     | 39     | 203     | 222      | 294    | 181    | 101    | 45     |

(a) Includes in addition to gold of the Central Bank held at home, gold of the Central Bank held abroad and gold belonging to the Argentine Stabilization Fund

1. See Report on currency and finance (Reserve Bank of India), 1946/47 & 1948/49

Gold holding of the Bank of England reduced to nominal amount by gold transfer to British

## CHAPTER III

### A Central Bank as bank of issue

It is an essential function of a central bank to maintain the stability of the monetary standard. This involves the control of the monetary circulation and the central bank has been entrusted with the sole right of note issue. In modern times, the right of note issue entrusted to central banks is recognised almost everywhere as being its most important function. Formerly the state and commercial banks had the right to issue notes. Gradually in course of a few years that right was withdrawn from other banks and the state also abandoned its right of note issue. When the right of note issue was withdrawn from the other banks they were allowed a certain period of time in which to redeem these notes and to withdraw them, after which the central bank enjoyed monopoly rights in this direction. This happened in Sweden, Switzerland, the Union of South Africa, and New Zealand. In many countries such as in France, Spain and Japan the central banks took over the note issues of the other banks subject to certain conditions. In England, under the Act of 1844, the other banks were allowed to issue notes up to their individual limited amounts. Later on provision was made for their lapsing and by 1920 the right was completely withdrawn.

The central banks were entrusted with the sole monopoly of note issue due to the following reasons: (1) It achieves uniformity in respect of the note currency, (2) Possessing the right of note issue that the central banks enjoy it is granted "a special sort of prestige which is of very great value in emergencies", (3) it meets domestic needs for currency entailing no loss of gold through the presentation of the notes for redemption, (4) it gives the central bank some measure of control over undue credit expansion on the part of the commercial banks. For the above reasons central banks are known as banks of issue.

### Principles of note issue

There are two schools of opinion about the principles of note issue. One school represents the currency principle and the other the banking

## MODERN CENTRAL BANKING

**principle** The advocates of the former hold that notes are issued as economic substitutes for coins. In order to maintain the convertibility of these notes, there should be cent percent backing of gold. According to their opinion, notes should be issued up to the amount of gold held by the Issuing Authority. The volume of notes will expand or contract according to the inflow and outflow of gold into and from the country. It is desirable to restrict their notes up to the amount of gold held by the Issuing Authority from the point of view of public confidence. But the main defect of this school is that under the currency principle the currency system lacks elasticity, and this is very important for meeting the legitimate needs of business and the needs of general public.

The latter represents the banking principle. The exponents of the banking principle held that instead of maintaining cent percent gold reserves against note issue, it will be desirable to keep a certain proportion of the outstanding note issue covered by metallic reserves. Under this principle, "the note circulation should operate automatically and be capable of expanding freely according as the demand for currency increases, owing to expansion of trade, larger pay-rolls, or seasonal factors such as harvesting and holiday periods, and of contracting according as the demand for currency declines because of contraction of trade, smaller pay-rolls or seasonal factors." "Under this system the currency system is made flexible and responsive to the demand of Trade and Commerce."

This controversy has been going on for years. The solution lies in a happy combination of the two principles, for both lay stress on the necessity of maintaining adequate reserve against note issue.

Different methods have so far been evolved to regulate note issue.

1 *Fixed Fiduciary System* —Under the fixed fiduciary system a central bank is allowed to issue notes up to a certain fixed limit without any backing of gold, all notes issued in excess of this amount must be covered by cent percent gold. Notes uncovered by gold are known as fiduciary issues. But they are covered by Govt securities. This system was adopted in England in 1844 by the Bank Charter Act of 1844, according to which the Bank of England was permitted to make fiduciary issues to the limit of £14 millions. This method of note issue was criticised on many occasions as being deficient in elasticity.

In order to make the system elastic, the limit of the fiduciary issues was raised to £260 millions. Again it was raised to £300 millions and to £1250 millions in 1944 to meet the currency demands under changing circumstances. By raising the limit of fiduciary issues the system has been partially successful in increasing the elasticity of the currency to meet business needs and trade requirements. On many occasions, the Bank Charter Act of 1844 had to be suspended to provide for the issue of notes beyond the limit. For example, it was suspended in war times. The Macmillan Committee recommended the abolition of this method of note issue on account of its defects.

2. *Maximum Fiduciary System* —Under this system the maximum limit up to which the central bank is permitted to issue notes without gold reserve is fixed. This system of note issue prevailed in France from 1870 to 1928. It was abandoned in France, because the system "was altogether too rigid and incapable of sufficient adjustment to the requirements of the present-day money market"<sup>1</sup>. But Macmillan Committee recommended the system for Great Britain<sup>2</sup>. In 1937 the Australian Royal Commission on Monetary and Banking Systems also recommended that the Commonwealth Bank of Australia should be permitted to issue notes up to a fixed maximum subject to the right of the Commonwealth Bank to exceed the maximum limit with the consent of the Treasury<sup>3</sup>.

3. *Proportional Reserve System* —This system fixes a percentage, generally varying from 25 to 40 percent of gold reserves. Under this system the central bank is allowed to issue notes by maintaining a certain percentage of gold reserves and the remainder of the notes are to be covered by Government securities, trade bills and other securities. But it is provided that the reserve ratio may fall below the legal minimum subject to certain conditions and penalties. This system was followed in Germany and in the U S A after the Federal Reserve System was brought into existence. France adopted the system after 1928. The Hilton Young Commission recommended its adoption in India in 1926.

---

1. Foreign Banking System, Edited by Wills and Beckhart, p. 635.

2. Macmillan Committee Report, p. 142.

3. Deacock—Central Banking, p. 28.

4 *Minimum Percentage Reserve System* —This system stipulates for a minimum percentage, that is, a fixed proportional reserve against the note issued. This method of regulating note issue was adopted by the Bank of Belgium and the Bank of Spain Denmark, Holland and the Union of South Africa followed the system. The weakness of the system is that the gold reserve is rendered useless and unavailable at a time when it ought to be indispensable to the banker. If there is withdrawal of gold due to export the quantity of notes in circulation has also to be reduced. According to Keynes, "the percentage system has no sound foundation in logic or common-sense" He says, "I have never seen in print a reasonable defence of its provisions. It appears to combine all the possible defects of the system of note regulation"<sup>1</sup>

5 *Foreign Exchange Reserve System* —Under this system the central bank is allowed in some countries to hold part of its reserve in foreign exchange including foreign currency, deposits in foreign banks and bills. In India the Reserve Bank is allowed to keep part of its reserve in sterling bills

#### *Note Circulation during World War II*

One of the striking features of war-time central banking was a spectacular increase in the note circulation. This tendency was witnessed even before the outbreak of the war in 1939. It was accelerated after the outbreak of the war and continued undisturbed throughout the war period. During the war time there was heavy demand on the part of the belligerent countries for supply of funds to meet war expenditure and for this central banks had to increase the supply of notes. At the beginning of the war, in the U. K., Germany, the U. S. A. and Japan, the rise in note circulation was "merely a part of the general monetary expansion caused by actual or prospective war expenditure accompanied by increasing prices and turn over"<sup>2</sup>. But in a large of countries such as Belgium, Norway, Egypt, Finland etc., increase in note circulation was not the result of a change in the aggregate money supply, but was an outcome of the conversion of bank deposits into cash. Moreover, the increase of pay-rolls as a result of higher wages in the armament industries, prolonged working hours

1 See Keynes—*Treatise on Money*, Vol II (1930), p 268.

2 See Dr. S. K. Basu's *Recent Banking Development* (1946), p. 25.

payment to soldiers, cash holdings of individual households, the decline in the velocity of circulation of money in trade and business due to transport difficulties and the curtailment of banking facilities were some of the many factors responsible for the rise in note circulation.<sup>1</sup> In some countries special factors were responsible for the increase. For example, the conquest of new territories by Germany and the payment of wages to millions of foreign workers caused the Reich Bank to increase the note circulation. In India the peculiar method of war finance tended to increase note circulation. In England tax evasion and increased black market dealings along with other factors served to cause a sharp rise in note circulation towards the end of the war. Central banks in different countries followed different methods for increasing the note issue. In several countries central banks increased note issue by simply converting "large amounts of cash held in the form of deposits already owned by private credit institutions".<sup>2</sup> In France and Germany, the basis of the increase in note circulation was decided upon by increasing "the borrowing facilities available to Government from central banks".<sup>3</sup> In many cases notes were issued against gold held in foreign countries as in Sweden in 1940. Lastly, the basis was provided by the revaluation of the gold holdings of central banks as in France, Netherlands and Yugoslavia.

During the war period, the expansion of note circulation varied from country to country. The increase was at the highest in Greece where it rose up to 31,24,22,000% while its expansion was up to 25% in Uruguay. The increase in the note circulation varied from 500 to 1000% in India, Iran and the countries of South-east Europe. Australia, Canada and the U. S. A. came next. In the U. K. the increase was comparatively smaller.

During the war time one striking feature was that more notes of higher denominations were issued relatively to those for lower denominations. In the U. S. A. notes comprising of 50 dollars to 10,000 dollars increased by 45% and 39% in 1943 and 1944 respectively. In India notes of Rs 100 and Rs 1000 increased from 32.1% and 5.9%

---

<sup>1</sup> See Twelfth Annual Report of the B. I. S., p. 208.

<sup>2</sup> & <sup>3</sup>, See Dr. Basu's Recent Banking Development (1946), p. 27.

DURING THE WAR PERIOD NOTE CIRCULATION ( IN 0.00,000's )  
BANK AND STATE NOTES

| Name of Countries   | 1938(Dec) | 1939(Dec) | 1940(Dec) | 1941(Dec) | 1942(Dec) | 1943 (Dec)      | 1944 (Sept)     |
|---------------------|-----------|-----------|-----------|-----------|-----------|-----------------|-----------------|
| United Kingdom (£)  | 504 7     | 554 6     | 616 9     | 751 7     | 92, 4     | 1,088 7         | 1,154 6 *       |
| United States (\$)  | 4,966     | 5,452     | 6,416     | 8,675     | 12,780    | 17,863          | 21,100          |
| Japan (Yen)         | 2,775     | 3,818     | 4,787     | 5,934     | 6,921     | 9,667           | 13,730          |
| Greece (Drachma)    | 7,239     | 9,453     | 15,369    | 48,800    | 8,06,000* | 12,76,000 (Sep) | 25000000000000* |
| France (Franc)      | 1,10,935  | 1,51,322  | 2,18,383  | 2,70,144  | 3,82,774  | 5,00,386        | 5,84,820        |
| Germany (Reichmark) | 8,605     | 12,755    | 15,146    | 20,538    | 21,639    | 34,733          | 43,339 (Sept)   |
| Canada (\$)         | 270       | 323       | 444       | 569       | 765       | 917             | 1,018 (Sept)    |
| India (R)           | 1,803     | 2,245     | 2,386     | 3,211     | 5,704     | 8,408           | 9,413 (Sept)    |

See Money and Banking 1942/44 (League of Nations), pp 11-30

\* The publication of the periodic returns of the Bank of Greece was suspended in April, 1941 A new currency was introduced on Nov 11th, 1944

in 1939 to 34.9% and 10% in 1943. In many countries, notes of higher denominations being used as a means of payments in the black market and other illegal transactions, they were withdrawn from circulation. For example, in Great Britain notes of £10 and upwards have been withdrawn from circulation from 1943. In India from January 2, 1946 notes of Rs 500, Rs 1000 and Rs 10,000 have been discontinued by an ordinance passed by the Government of India. According to Sir Archibald Rowlands, "the principal objects of the Demonetisation Ordinance were to strike at the black marketers, to rope in the tax-dodgers to deprive public servants, who had betrayed their trust, of some of their ill-gotten gains and to bring under control a potential threat to a sound monetary system."

#### NOTE CIRCULATION IN THE POST-WAR PERIOD

The circulation of notes in the post-War period is evident from the following figures<sup>1</sup> —

( IN MILLIONS )

| Name of Countries  | End of 1945                   | End of 1946                          | End of 1947                   | End of 1948                   |
|--------------------|-------------------------------|--------------------------------------|-------------------------------|-------------------------------|
| United Kingdom (£) | 1,380                         | 1,422                                | 1,350                         |                               |
| Australia (£)      | 200.0                         | 207.0                                | 205                           |                               |
| Canada (\$)        | 992                           | 1,042                                | 1,046                         |                               |
| United States (\$) | 27.2 (in 1,000 millions)      | 27.6 (in 1,000 millions)             | 27.5 (in 1,000 millions)      |                               |
| France (Franc)     | 570 (in 1,000 millions)       | 722 (in 1,000 millions) <sup>1</sup> | 921 (in 1,000 millions)       |                               |
| India*             | 1,21,089 (in Lakhs of rupees) | 1,22,457 (in Lakhs of rupees)        | 1,22,536 (in Lakhs of rupees) | 1,18,820 (in Lakhs of rupees) |

<sup>1</sup> See P 8, Report on currency and finance 1946/47 (Reserve Bank of India)

\* See P 178, Report on currency and finance 1946/47 (Reserve Bank of India).

The expansion of note circulation which had been very striking during the war years, was quite moderate in most of the countries during the post-War period. The figures given above give the volume of notes in circulation from 1945 to 1947. It may be observed that although there was a check on the expansion of notes in circulation, it had no effect on the general price level. The volume of notes in circulation remained high in most of the countries of the world in 1947 and 1948.

In countries like France, Newzealand and Canada notes in circulation increased by 27.6, 3.6 and 1.5 per cent respectively in 1947. In China, where inflation entered the spiral, confidence in currency was being gradually undermined, seriously affecting internal price and exchange. In the U.K. the circulation declined by 5% in 1947 as compared with that of the previous year. In 1948, the expansion of currency circulation was high in a majority of the important countries except in the U.K. and the U.S.A. Japan, Italy and Mexico showed increases of 62.2 per cent, 23.2% and 20.3 per cent respectively over 1947 the corresponding figures for Egypt, Turkey, France and Canada being 11.6 per cent, 8.0 per cent, 7.3 per cent and 6.5 per cent respectively. In the United Kingdom and the United States the decline was by 6 per cent and 3.4 per cent respectively, the fall in the United States was partly due to a decrease in the country's export surplus<sup>1</sup>.

In India, notes in circulation (excluding Burma notes) increased only by Rs. 23.26 crores on 29th March, 1946, to Rs. 1,242'03 crores on 28th March, 1947. The total notes issued stood at Rs. 1,258.08 crores at the end of 1946-47 as compared with Rs. 1,238.41 crores at the end of the previous year, showing an increase of 1.59 per cent. Thus the percentage increases in the notes in circulation and the total notes issued during the year under review have considerably declined compared to the increase in the preceding two years of 22.93 per cent and 22.33 per cent in 1945-46 respectively<sup>2</sup>.

---

See S. K. Basu's Recent Banking Development (1946), p. 31

1 See Report on currency and finance 1948-49 (Reserve Bank of India), pp. 8 & 9

2 See Report on currency and finance 1946-47 (Reserve Bank of India), pp. 106 & 110.

## CHAPTER IV

### The Central Bank as the controller of credit

Credit plays an important part in the settlement of monetary and business transactions of all kinds and it has, therefore, become a powerful force for good or evil. Therefore, it is universally agreed that credit should be created, distributed and controlled by the central banks.

It is the supreme function of the central bank to control credit in the interests of the national economy. "It must have an unchallengeable voice in deciding the volume of credit to be available from time to time"<sup>1</sup> for which it should be entrusted with certain privileges and powers.

There are differences of opinions regarding the objective of credit control. According to some, it is to maintain a stable exchange rate and according to others it is to maintain the stability of internal price level. Again, it is held by many that the purpose of controlling credit is to smooth out the trade cycle. The two objectives, namely the maintenance of exchange stability and the internal price stability of a country, can be ensured only by the formulation of a correct policy of credit control by the central bank. In order to secure effective control over credit the central bank should have "access" to all forms of credit, not only bank credit but also other forms of commercial credit, such as book credits, bills of exchange and promissory notes etc. as the other forms of credit which are used for purchasing commodities, securities or real estate etc. have the same effect as money. If the central bank can control the volume of credit created by commercial banks, it can help to a great extent in the establishment of internal stability. If the cash reserves of commercial banks are in the hands of the central bank the latter is enabled to regulate the credit as required by changing circumstances.

Let us, now, discuss the different instruments of credit control generally used by central banks.

1. See Kisch and Elkin—Central Banks (1932), p. 106

## BANK RATE

The oldest and the principal instrument of credit is the bank rate. Bank rate is the minimum rate at which the central bank rediscounts bills of exchange and grants advances on approved securities. It is also called the discount rate. The bank rate is said to be effective when the central bank can dictate its own terms and conditions being a lender of the last resort and the ultimate source of cash. It is normally higher than the market rate, at which bill brokers, discount houses and commercial banks grant discounting facilities to merchants. If bill brokers, discount houses etc. intend to rediscount bills of exchange held by them with the central bank they will have to do it at a higher cost than the rate ruling the market. Consequently, the market rate will follow the bank rate. By making changes in the bank rate, the central bank can bring corresponding changes in market rates and these changes in the market rates will, "through their operation on the supply of and demand for money and on the flow of foreign short-term capital, tend to have the effect of readjusting the domestic levels of prices, costs, production and trade, and correcting any disequilibrium in the balance of payments"<sup>1</sup>. In other words, by the use of the bank rate the central bank can correct disequilibrium on the external and internal economic situation of a country.

(a) Effects of bank rate upon the external situation of a country —

There may be an outflow of gold from a country when its balance of payments is adversely affected. A country's balance of payments is adversely affected due to the excess of imports over exports or due to the excessive outflow of capital as a result of over investment in foreign countries or withdrawal of foreign balances or the flight of capital caused by fears regarding currency and other factors.

When the gold reserve of a country is depleted for meeting the adverse balance of payments, the central bank will raise the bank rate. Such a step, on the part of the central bank, will raise the internal interest rates, contract credit, lower the internal price level and balance the payments. Since the internal interest rate is high on account of the higher bank rate, this will attract foreign capital and discourage its

1 See Dekrook—Central Banking (1939), pp 177-78.

## MODERN CENTRAL BANKING

withdrawal from that particular country, as the foreigners will be tempted to invest their funds in that country in the expectation of higher returns. This will not only check the outflow of gold but "even reverse the flow and bring about recovery of gold lost, which would in turn relieve the credit stringency, reduce money rates, and revive general business activity"<sup>1</sup>

Hence a change in the bank rate influences the foreign exchange market through the short-term rates. Again, change in the short term rates spreads to the long term market and lastly to the balance of payments.

But the efficacy of bank rate to readjust disequilibrium in the balance of payment by regulating the flow of short-term funds depends upon two conditions (1) the country affected must possess a well developed market for short term funds and (2) those who are induced to acquire the country's currency must have confidence in the future of foreign exchange value.

There is scope for the development of market for short-term funds if there are channels for short-term credit and there be borrowers or guarantors whose credit worthiness is internationally recognised. In this connection Sayers says—"More commonly, in great centres and small alike, the borrowers whose credit worthiness secures international recognition are the leading commercial banks with whom the money may be deposited. It is important to realise here that the essential condition is not that the bank (borrowing) must be 'sound' but that it must be internationally recognised as such"<sup>2</sup>. So the market for short-term fund has developed in London because the accepting houses, the discount houses and the commercial banks in England have acquired international reputation for credit worthiness. But in countries like Latvia and San Salvador, and India the market for short-term funds has not yet been well-developed due to the lack of confidence of foreigners in the banks of these countries. Therefore, the bank rate in these countries is ineffective in regulating the flow of short term funds.

Again, the efficacy of bank rate depends upon the confidence in the future foreign exchange value of the currency.

1 See Deacock—Central Banking (1939), p. 179

2 See Sayers—Modern Banking, (1938), p. 180-81

In the summer of 1931 there was withdrawal of funds from <sup>London</sup> in spite of the rise of short-term rates there far above those of New York and Paris and on account of the rise of bank rate at the very high level of 6% the confidence of the people of lending countries was shaken in the exchange value of sterling. Similarly, in France rise in the bank rate became ineffective to stop the fall in the value of Franc in 1923-24 and 1933-36, rather the rise in the bank rate aggravated the French Budget deficit. Before high bank rate had exercised any serious deflationary effect, the budget deficit caused the authorities to take recourse to inflation. It is held that the lender can protect himself in the forward exchange market by arranging cover against the risk of falling exchange value of the currency. But it is difficult to check it by arranging cover, because such a step gives rise to discounts and premiums in the forward exchange market out-weighting "the widest conceivable difference in interest rates"<sup>1</sup>. This has been evident on many occasions in the forward exchange market for "gold block" currencies in recent years. Sayers aptly says—"Even in the field of regulating the flow of short term funds, therefore, bank rate though perhaps a 'delicate and beautiful instrument' cannot work under all circumstances." Externally, the bank rate indirectly influences the relation between income and costs at home and abroad and therefore affects the balance of trade.

#### (h) Effects of bank rate on internal situation of a country

Bank rate can, also, influence the internal economic situation. Changes in the bank rate bring changes in the internal price level and production through pressure on the interest rates. There are two lines of thought regarding the way in which the changes in the bank rate influence prices and production—one is Hawtrey's and the other Keynes's. According to the former the bank rate having direct influence on short-term rates of interest, influences the activities of dealers of stocks of finished and semi-finished goods, while the other is of opinion that bank rate directly influences the long-term rates and the producers of capital goods. According to Hawtrey, when the bank rate is raised, the short-term rate of interest also rises. It increases the cost of holding stocks. Therefore, dealers, in order to check the rising cost, will

1 See Sayers—Modern Banking (1938), p 184

## MODERN CENTRAL BANKING

with to reduce their stocks by buying less than they are selling. Producers will find their sales falling off and will be forced to reduce the price of their articles and will also curtail the output. As the output will be reduced, factors of production will be less employed and consequently money income will contract. Reduction in money income will lead to a decline in retail sales and to reduced purchases by retail dealers. Deflationary tendencies will be visible in the market. Producers being depressed will stop the replacement of and addition to plant and machinery which, in its turn, will affect the production of capital goods.

Conversely, if short-term rates fall, the cost of holding stocks also falls. Dealers begin to increase their stocks by buying more than what they are selling. This purchase will increase orders to producers who will increase production, consequently, employment of factors of production increases. As a result of this money income increases, retail sales rise and signs of inflation become visible.

The forcefulness of Hawtrey's argument depends upon the proportion which interest charges bear to the total cost of stocks held and the elasticity of demand relating thereto.

The view of Keynes, though seemingly contrary, only lends support to that of Hawtrey. They both view the same thing and arrive at the same conclusion though from different angles of vision. According to Keynes, bank rate influences the internal economic situation through changes in the long-term rates of interest. Changes in the long-term rates are closely associated with the changes in the short-term rates. A change in the short-term rate will lead to a change in the long-term rate in the same direction. If the short-term rate of interest rises, while the long-term rate of interest remains the same, the borrowers and investors will sell the long term securities in the market and will prefer to invest in short-dated securities. They will be attracted to invest in time deposits from where they can expect higher returns. Consequently, the prices of the long-dated securities will go down. A decrease in prices means an increase in the yield and an increase in the long term rates of interest. So, a rise in the short term rates will lead to a rise in the long-term rates and vice versa.

If the long-term rate of interest rises with the rise of the bank rate, investment in capital goods is retarded. "If the profit earned in capital

goods remains the same, the rise of the long term rate of interest has influence in raising the cost of capital goods which may conceivably affect the prospective price of the real yield"<sup>1</sup> Consequently, it will be less attractive for the entrepreneurs to invest in capital goods or to replace existing capital goods or to replace existing capital. As a result of this, trade contracts and money income diminishes. Production and employment in the consumption goods trade also decline, consequently the cost is further shrinkage in the capital goods industry.

Conversely, if the long-term rate of interest falls, entrepreneurs, expecting higher profits, are encouraged to make capital investments, consequently new plants and machineries are installed, the old and worn-out plants are replaced. As a result of this increased production is ensured. Employment increases. Wage earners are paid more than what they received before. Consequently, money incomes of wage-earners rise. This increase in money income is utilised on consumption goods which induces further production and investment in capital goods.

But experience shows that trade and prices are not responsive to the rate of interest policies. During the Great Depression, in certain countries attempt was made to stimulate trade by a cheap money-policy by reducing rates of interest. But it took a long time for trade to response to the rate of interest. This efficacy of the long-term rate of interest policy depends upon the elasticity of demand for capital.

The more elastic the demand, the more quickly effective will be the policy. "But in extreme trade conditions like depression, when no amount of reduced interest will stimulate new production, and in times of boom when things look so rosy, an increase in the rate will not deter any entrepreneur from some investment, the businessman's demand for capital may be somewhat inelastic."<sup>2</sup>

Hawtrey's line of thought and Keynes's line of thought has each the same starting point. "Both see banking policy as effective because it influences the cost of holding goods"<sup>3</sup> "Their difference lies in the

1 See Sayers—Modern Banking, (1938) p 152

2 & 3 See Sayers—Modern Banking, pp 162 163 & 146

class of goods, the variation in the holding of which is considered more important.<sup>1</sup> The difference is primarily a difference of emphasis only.

### (c) Limits of bank rate

It is not possible for bank rate to produce the desired results in all circumstances. It has its limitations. Changes in the bank rate unaccompanied by similar changes in other rates may not produce any effective change in the loan policy of the banks. If the bank rate is made effective by raising it, it may be possible to raise money rate of interest. But there is no certainty that money rates will fall with the lowering of the bank rate. It may be possible for the central bank to give a support to inflation by making variation in the bank rate, but it cannot prevent a slump in the money market. Whenever the bank rate has been successful in producing certain results, it could do so "by throwing capital market into disequilibrium and creating for a time a thoroughly disturbed state of trade in the country." Before the Great War of 1914 the bank rate was effective in London money market on account of its reputation as the only real international money market. In other countries, such as Holland, Belgium, Denmark etc. the bank rate policy did not prove as effective a weapon as in the case of the bank of England due to the following reasons: first, there was no well organised discount market in those countries, secondly, there was no need to use bank rate for protecting their gold reserves, for, certain central banks held foreign exchange as their first line of defence of exchange rates.

In the U S A, the Federal Reserve Banks adopted bank-rate (better known as discount rate in the U S A) policy with the aid of open-market operations when necessary for the purpose of making their rates effective. But the bank rate in the U S A was not much effective on account of the following reasons<sup>2</sup> —

1 the absence of conventional relationship between the official discount rate and certain money rates,

2 the existence of surplus gold reserves during the greater part of the year,

1 See Sayers—Modern Banking (1936), p 147

2 See Deacock—Central Banking, (1939), p 188

3 the wide scope and strong inclination for speculative activity in the United States ,

4 the lack of independence on the part of Federal Reserve Banks in the matter of fixing discount rates ,

5 the discount rate not being higher than market rate Like the Bank of England's bank rate it should be "penal" rate

In recent years, the bank rate as a weapon of credit control has lost its significance This decline in the significance of the bank rate is primarily due to changes in money market conditions and in the economic structure and also to considerations of public policy In the first place the use of the bills of exchange for financing domestic trade and foreign trade has considerably declined So the efficacy of the bank rate has been lost Secondly, there has been development of competition in international money markets in various countries of the world This has limited the utility of the bank rate

Thirdly, since the Great War of 1914 there has been the predominance of short-term treasury bills This has brought a radical change in the structure of the discount market Fourthly, abundance of liquid funds in the money market resulting from inflow of capital and gold or revaluation of gold stocks or favourable balance of payments, is not helpful towards the smooth and efficient working of the bank rate policy Fifthly, the scope of the bank-rate policy has been narrowed by an increased rigidity in the economic structure The successful working of the bank-rate policy depends upon the elasticity in the economic structure so that prices, wages, production and trade might respond to changes in money rates and credit conditions

According to Keynes, the bank-rate policy can be regarded as an out-of-date instrument of credit control He now considers that "the equilibrium between investment and saving should be attained by means of state organization of investment, or failing this, compensatory planning of public works rather than by means of bank-rate policy"<sup>1</sup>

Contrary to the view of Keynes, Robbins holds that the discount rate 'is an indispensable instrument, an instrument which we must at all times be prepared to use with speed and vigour if the circumstances appear to call for such action'

1 See Keynes—General Theory of Employment Interest and Money (1934), p 164 and also pp 195-96 Central Banking—DeLoek (1939)

**Bank rates in the War time**  
**UNITED KINGDOM**

|     | 1939 | 1940 | 1941 | 1942 | 1943 | 1944 |
|-----|------|------|------|------|------|------|
| I   | 2 00 | 2 00 | 2 00 | 2 00 | 2 00 | 2 00 |
| II  | 2 00 | 2 10 | 2 00 | 2 00 | 2 00 | 2 00 |
| III | 3 00 | 2 00 | 2 00 | 2 00 | 2 00 | 2 10 |
| IV  | 2 00 | 2 00 | 2 00 | 2 00 | 2 00 | —    |

**UNITED STATES**

|     |      |      |      |      |      |      |
|-----|------|------|------|------|------|------|
| I   | 1 46 | 1 21 | 1 21 | 1 17 | 1 00 | 1 00 |
| II  | 1 46 | 1 21 | 1 21 | 1 00 | 1 00 | 1 00 |
| III | 1 41 | 1 21 | 1 21 | 1 00 | 1 00 | 1 00 |
| IV  | 1 21 | 1 21 | 1 21 | 1 00 | 1 00 | —    |

**INDIA**

|     |      |      |      |      |      |      |
|-----|------|------|------|------|------|------|
| I   | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 |
| II  | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 |
| III | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 |
| IV  | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 | 3 00 |

**FRANCE**

|     |      |      |      |      |      |      |
|-----|------|------|------|------|------|------|
| I   | 2 00 | 2 00 | 1 92 | 1 75 | 1 75 | 1 75 |
| II  | 2 00 | 2 00 | 1 75 | 1 75 | 1 75 | 1 75 |
| III | 2 00 | 2 00 | 1 75 | 1 75 | 1 75 | 1 75 |
| IV  | 2 00 | 2 00 | 1 75 | 1 75 | 1 75 | —    |

## CANADA

|     |      |      |      |      |      |      |
|-----|------|------|------|------|------|------|
| I   | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 |
| II  | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 |
| III | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 |
| IV  | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 | 2 50 |

**Bank-rate operations during and after the World War No. II**

During the World War No II, bank rates quoted by central banks of various countries from 1939 to 1944 are given above.<sup>1</sup> From the table given above it is evident that in leading countries bank rates during the War years were more or less uniform with occasional changes in it. In the United Kingdom the bank rate changed on August 24th, 1939, from 2% to 4%, on September 28th, 1939, to 3%, on October 26th, 1939, to 2%.<sup>2</sup> After October, 1939, it was maintained uniform by the Bank of England. The Bank of England raised the bank rate from 2% to 4% at the early beginning of 1939 to check speculative dealings in the London money market. In the United States the discount rate of the 12 Federal Reserve Banks fluctuated very greatly. The figures above show simple arithmetic average of daily rates of the 12 Federal Reserve Banks charged to member banks for advances secured by Government securities. In October, 1942, all Federal Reserve Banks charged a new rate of  $\frac{1}{2}$ % for advance to member banks of Government securities maturing or callable in one year or less.<sup>3</sup>

In France, it changed on January 3rd, 1939, from  $2\frac{1}{2}$ % to 2%, on March 17th, 1941, to  $1\frac{1}{2}$ %.

In Canada it varied from  $2\frac{1}{2}$ % to  $1\frac{1}{2}$ % on Feb. 8th, 1943. In other countries bank rates were uniform with little variations. In India the bank rate was all through uniform at 3% as the Reserve Bank of India had hardly any important role to play on account of easy conditions and sufficient funds available in the Indian money market.

<sup>1</sup> See pages 69 to 74, Money & Banking (League of Nations), 1942-44.

<sup>2</sup> & <sup>3</sup>. See page 74, Money and Banking (League of Nations), 1942-44.

*Bank rates in the post-War years*

| Names of Countries | 1945                                    | 1946                                    | 1947             | 1948             |
|--------------------|-----------------------------------------|-----------------------------------------|------------------|------------------|
| Yugoslavia         | 3 00                                    | 2 50                                    | 1 00—4 00        | 1 00—3 00        |
| Hungary            | 3 00                                    | 7 00                                    | 5 00             | —                |
| Norway             | 3 00                                    | 2 05                                    | —                | —                |
| Bulgaria           | 5 00                                    | 4 50                                    | 4 50             | 3 50             |
| Denmark            | 4 00                                    | 3 50                                    | —                | —                |
| Greece             | 7 00                                    | 10 00                                   | 10 00            | 12 00            |
| Belgium            | (7-11 45)<br>1 50<br>(19 12 45)<br>2 50 | (7 11-46)<br>2 50<br>(19 12 46)<br>3 00 | 3 50             | —                |
| Finland            | —                                       | 4 00                                    | 4 50             | 7 25             |
| France             | —                                       | 1 75 }<br>2 25 }                        | 2 50 }<br>3 00 } | 3 00 }<br>4 00 } |
| Italy              | —                                       | 4 00                                    | 3 50             | —                |
| U S A              | —                                       | —                                       | 1 25             | 1 50             |

Bills purchased and discounted by the Reserve Bank had hardly attained any significant volume except for the early months of the year 1939. There was hardly any existence of "other loans or advances" granted to scheduled banks by the Reserve Bank of India as there were sufficient funds at the disposal of the big banks.

*The bank rate in the post War period*

In the post War years from 1945, bank rates in most of the important countries of the world remained unchanged. In a few European countries they changed. Changes in bank rates are evident from the table given above <sup>1</sup>

<sup>1</sup> See Report on currency and finance (Reserve Bank of India), 1946-47 1947-48 1948-49

In 1946, of seven countries only three revised the bank rate upwards probably to check further inflation which had already reached dangerous proportions. The Belgian National Bank raised its discount rate in two stages—first on 7th November, 1946, from  $1\frac{1}{2}\%$  to  $2\frac{1}{8}\%$  and for the second time on the 19th December, 1946, from  $2\frac{1}{8}\%$  to  $3\%$ . In the case of other leading countries the bank rates were either maintained steady or lowered slightly.

In 1947, seven countries raised their bank rates, the aim in most cases being to restrict as an anti-inflationary device. The Bank of France split up and raised its discount rate of  $1\frac{1}{2}\%$  percent to  $1\frac{3}{4}\%$  percent for discounting treasury bills and short-term commercial bills representing sales and  $2\frac{1}{2}\%$  percent for discounting other commercial paper on 10th January, 1947. Subsequently, these rates were raised to  $2\frac{1}{2}\%$  and  $3\frac{1}{4}\%$  percent respectively on 5th October, 1947, for initiating a deflationary policy in pursuance of the rehabilitation programme. The bank rate of the Bank of Finland was similarly raised first from  $4\frac{1}{4}\%$  to  $4\frac{1}{2}\%$  percent in June, 1947, and again to  $5\frac{1}{4}\%$  percent in December, mainly to curb the heavy rediscounting pressure from the commercial banks. In Italy, the bank rate was raised in order to restore control over the money market and increase the cost of credit as an anti-inflationary measure.<sup>1</sup> The discount rate of the Federal Reserve Banks was also raised from  $1\%$  to  $1\frac{1}{4}\%$  in January, 1948, for discouraging member banks from borrowing from the Federal Reserve Banks against short-term Government bonds.<sup>2</sup> In 1948, again, the discount rates of the Bank of France were raised from  $2\frac{1}{2}\%$  for treasury bills and from  $3\%$  for other commercial bills to  $3\frac{1}{2}\%$  and  $4\%$  respectively. Towards the end of September, the French Government introduced a uniform discount rate of  $3\%$  applicable to all commercial bills, irrespective of whether or not they represented sales, in order to check inflationary tendency.

The discount rate of the Bank of Greece was raised from  $10\%$  to  $12\%$  on July, 1948, in the hope that the new rate would permit of more effective enforcement of interest rates legally fixed. Finland was faced with the problem of fulfilling its reparation obligations while at the same time controlling the expansion of currency and credit. The

1 & 2 See page 11, Report on currency and finance (Reserve Bank of India) 1947-48

Finish Bank raised its bank rate to 7.25% in Feb, 1943, from 5.25% in 1947 this was intended to discourage heavy rediscounting by the commercial banks. In Mexico, although the general discount rate remained unchanged at 4.50%, differential rates of 3.50% and 8.00% were fixed for agricultural and commercial paper respectively towards the end of January, 1947.<sup>1</sup> After the nationalisation of the Central Banks in Roumania, Bulgaria and Yugoslavia, the bank rate in those countries was reduced.

### *Open-market operations*

In recent years, "open market operations" are often widely undertaken by a central bank to exercise control over credit. The pre-War method of open-market operations by "selling consols spot and buying for the account" and "borrowing in the market" is hardly of any importance now a days for exercising control over money market. In recent years, central banks of various countries have been authorised by banking legislation to undertake open-market operations.

### *Meaning of the term "open market operations"*

The term "open-market operations" is used in two different senses. In the wider sense it signifies the purchase and sale of Government securities, of public securities, of banker's acceptances and of trade bills by the central bank in the market. In a narrower sense it signifies the purchase and sale of Govt securities by the central bank. In recent years, the term "open-market operations" is accepted in a narrower sense. The significance of open market operations lies in the fact that the central bank will increase or decrease the supply of cash reserves, of the commercial banks by buying and selling securities in the open market. By increasing or decreasing the supply of cash reserves, it will proportionately increase or decrease the quantity of money and thus "bring about corresponding changes in money rates and credit conditions, which will in turn bring about corresponding adjustments in the price level and general business activity".<sup>2</sup>

For example, when the central bank finds the money market tight and if it considers to ease the credit conditions in the market, it will purchase securities from the open market. On account of the purchase

1. See Report on currency and finance (Reserve Bank of India), 1947-48, p. 11.

2. See Deacock—Central Banking (1939), pp. 217-18.

of securities by the central bank, money will be coming into the hands of the public who will deposit with then bankers. This will increase bankers' deposits and their cash reserves with the central bank and this will represent the credit base of the community. Conversely, when the central bank finds surplus of reserves with the commercial banks which may inspire the latter to follow the policy of credit expansion and if it thinks that expansion of credit is harmful to economic stability of the money market, the central bank will at once sell securities in the open market. By selling securities it reduces bankers' deposits, because purchasers of securities draw cheques upon their respective bankers which will deplete the cash reserves of commercial banks. These commercial banks will then be persuaded to curtail the expansion of credit.

The policy of open-market operations takes different forms in different countries. In England joint-stock banks do not borrow directly from the Bank of England. When the Bank of England sells securities for curtailing the expansion of credit, and consequently, when the cash reserves of the other banks are depleted, joint-stock banks will stop granting of further advances and will recall the advances they already made to the bill brokers or the discount houses. They will be replenishing their cash reserves by credit restriction.

#### **Open-market operations in the U S A**

In the U S A, when a Federal Reserve Bank sells Government securities in the open market, it receives cheques drawn by purchasers of securities on some other member banks. These cheques are chargeable against the cash reserves of member banks at the Federal Reserve Bank. Consequently, cash reserves of member banks lying with the Federal Reserve Bank become deficient unless there is some other instrument for offsetting credit. In order to replenish their deficiency in cash reserves, unlike joint stock banks of England, member banks in the U S A either borrow directly from a Federal Reserve Bank against approved securities or rediscount their bills or throw the burden on some other banks by selling investments or calling loans to brokers in the open market. The result is usually an increase in member bank borrowings or in some other form of Reserve Bank credit, which in turn places some pressure on the credit situation without any decrease

in the volume of credit. Sales of securities by the Federal Reserve Bank also lead the member banks to adopt less liberal policy of investment. Consequently, rates of interest tend to rise and the official discount rate in response thereto, is increased by the Federal Reserve System.

Conversely, when a Federal Reserve Bank purchases securities it makes payment from its funds to the sellers of securities who deposit these funds in their own banks and those banks in turn deposit the funds in the Federal Reserve Bank. Thus it finds itself in the possession of additional funds which may be used for making additional loans or investments and thus may form the basis for an increase in the volume of bank credit for which they lower their interest rates. But in practice it seldom takes place. Whenever the securities are purchased by the Federal Reserve Bank, member banks try to pay off their debt to the Reserve Bank. Thus the usual effect of a purchase of Govt. securities is not of increasing the volume of credit, but rather of reducing the pressure on the banks. The effect of purchases of securities is not only limited to member banks borrowing, it may, also, result in the reduction in dealing bills by the Reserve Bank or in the reduction of loans to member banks as it makes it easier for member banks to adopt more liberal lending and investing policies. Consequently, they reduce rates of interest, and official discount rate in response thereto, is reduced by the Federal Reserve System.

In the U S A it can be thus noted that open-market operations have not only independent effect on the credit situation, but "may be often used as a means of preparing for discount rate changes and making them more effective",<sup>1</sup> as member bank's capacity for increasing and decreasing the amount for borrowing depends upon buying and selling securities by the Federal Reserve Bank subject to the discount rate. If member banks do not borrow, any change of discount is ineffective. On the other hand, if member banks borrow heavily, even a small change of discount rate is effective. Therefore, the effectiveness of discount rate changes largely depends upon the amount member banks borrow.

---

1 See Burgess—The Reserve Banks and the Money Market (1936), p. 239

**Open-market operations in Great Britain.**

Since the War of 1914-18 open-market operations as undertaken by the Bank of England had the following objectives —

(1) to make bank rate effective or to prepare the ground for a change in bank rate ,

(2) to avoid disturbances in the money market as a result of movements of Govt funds or seasonal movements generally ,

(3) to offset the inflow and outflow of gold ,

(4) to support Government credit in connection with the issue of new loans or the conversion of existing loans ,

(5) to create and maintain conditions of cheap money as an aid to business recovery

The Bank of England has adopted open market operations as a supplement to bank rate policy when it considered it desirable to bring the market rate closer to bank rate

In order to avoid disturbance in the money market owing to seasonal movement of funds the Bank of England used to buy securities (stocks or treasury bills, mostly the latter) in December when heavy withdrawals were met before the Christmas holiday and sold those securities in January when notes returned from circulation. It also undertakes to buy securities at the time of heavy tax payment and sell them when heavy disbursements are made by the Government. It was undertaken by the Bank of England to prevent, as far as possible, the market and its rates from being disturbed on account of the financial operation of the Government

The Bank of England adopted open-market operations during the War of 1914-18 and the period following, to support the Government in raising new loans and converting the existing ones. For instance, there was occasion in respect of the conversion of the £2 billions 5 p c war loan on a 3½ p c basis in July, 1932

The open-market operations were undertaken by the Bank to increase the credit, and to create and maintain conditions of cheap money as an aid to business recovery. The increase in the credit basis as a result of open-market operations was not as successful in Great Britain as it was in the U S A

### **Open-market operations in other countries**

In a few years after the War of 1914-18, the question of open market operations by central banks gained prominence in the continent and elsewhere. Formerly, such operations were described as an "Anglo-Saxon Vice". In many countries, such as Holland, Norway, Belgium, France and Germany, central banks were prohibited by law from undertaking open-market operations for their own account. In the years after the Great War of 1914-18 the statutes of several central banks were modified so as to enable them to undertake open-market operations while provisions in the statutes of newly established central banks enabled them to adopt open-market operations as a method of credit control.

In October, 1933 the Reich Bank of Germany was authorised to buy and sell certain specified securities. It was not allowed to purchase Government bonds on its own account except a limited amount for the investment of its pension funds. In June, 1939, the Reich Bank was permitted to buy and sell fixed interest-bearing securities admitted into stock exchange in order to regulate the money market.

Similarly, in 1935 the Bank of Poland, the Bank of Norway and in 1937 the Riksbank of Sweden were authorised to engage in open market operations.

The Bank of France was empowered to undertake open-market operations "in order to influence the volume of credit and to regulate the market," by a decree in June, 1938. Newly created central banks of countries like Argentina, New Zealand, Canada and India were granted the powers to engage in open-market operations from the beginning. The Reserve Bank of India adopted these operations to keep up the value of Government securities and to smoothen the way for the flotation of new loans in the market.

In some of these countries open-market operations were successful, but in others they were not. The success of open-market operations depends primarily upon, first, the existence of a broad and well-organised capital market and secondly, the maintenance by commercial banks of a relatively stable cash ratio.<sup>1</sup>

Owing to the lack of widely well-organised capital market and

<sup>1</sup> See Plumtree—Central Banking in the British Dominions, p. 290

unstable cash ratio maintained by commercial banks, the Commonwealth Bank of Australia was not able to use its open-market powers successfully. Similarly, in India the same factors stood on the way of the Reserve Bank's using open market operations as a successful weapon of credit control.

### Limits of open-market operations

Like the bank rate, open-market operations cannot produce certain desired results. They have their limitations.

In the U S A, when the Federal Reserve Banks purchase securities with a view to expand credit, the member banks may choose to pay off their debts to the Federal Reserve Bank. Thus the usual effect of a purchase of Government securities is not of increasing the volume of credit, but rather of reducing the pressure on the banks. Again, when the Federal Reserve Banks sell securities to contract the volume of credit, the member banks can offset the contraction by taking rediscounting facilities or by taking loans directly from the Federal Reserve Banks on approved securities.

When central banks want to increase cash reserve of banks by purchasing securities, it may so happen that the public might be withdrawing cash from those banks out of panic. Consequently, the desired result cannot be achieved. Even if the banks choose to expand credit, the businessmen may not like to take advantage of the same, apprehending depression.

There is no scope for the open-market operations in countries where money and capital markets are ill-organised or do not exist at all. Thus according to Dehock—"In any particular country the extent to which open-market operations can be successfully employed at any particular time will depend upon such factors as the prevailing economic, political, and social conditions, the temperament of the people, the make-up of the banking structure, the experience, skill and prestige of the central bank, the state of public finance, the degree of co-operation between the central bank on the one hand and the commercial banks and the Government, on the other, and the extent and activity of the security markets."<sup>1</sup>

1 See Dehock—Central Banking (1939), p. 225.

### Open-market operations during the World War No II

During the World War No II there was extensive use of open-market operations by the central banks of various countries. The National Bank of Belgium was permitted to raise its holding of Government securities acquired through open-market operations from 1500 million francs to a total of 5000 million francs by a royal decree on August 24, 1939. At the same time it was provided against the unrestricted use of open-market operations that the treasury would be required to publish quarterly statements of the public debts and the National Bank of Belgium would be required to report on the same dates its holdings of the "three classes of securities". The Irish Central Bank established in Feb., 1943, was authorised to deal in those securities of the free state admitted to stock exchange.

During the War open-market operations were intended to preserve interest rates and the price of Government securities in most of the belligerent countries. In countries with highly developed banking system, devices were adopted through such operations for increasing the reserve balances of the member banks so that they could subscribe to Government loans.

From the table given below the extent to which Government securities and direct claims on Government came to figure in War time among the assets of central banks in a number of countries will be evident.

Direct claims on Government and Governmental securities as % of total central bank assets <sup>1</sup>

|                | End of 1938 | 1944 |
|----------------|-------------|------|
| Canada .       | 45          | 89   |
| France .       | 26          | 81   |
| Finland .      | 10          | 86   |
| Germany .      | 81          | 96   |
| United Kingdom | 45          | 99   |
| U S A.         | 17          | 49   |

The Federal Reserve Banks purchased large amount of Government securities in order to enable the commercial banks to invest in Govern-

1. See World Economic Survey (League of Nations), 1942-44 p. 185

ment securities and to maintain the stability of the market. The Bank of England through open-market operations wanted to provide adequate cash to the commercial banks "for preventing the cash reserves of the commercial banks from being reduced as a result of the public's increased demand for currency"<sup>1</sup>

After the outbreak of the War there was a revolutionary change in the traditional policy of open-market operations in England. The traditional practice was that the commercial banks did never approach the central banks directly for rediscounting facilities which they achieved through the intermediary of discount houses. During the War direct contact was established between the Bank of England and commercial banks which could get all possible central banking assistance from the former. The Bank of England purchased short-term bills from the commercial banks on the understanding that they in turn would purchase long-term bills from the discount market. Thus there has been "a curious and highly significant reversal of the traditional machinery of credit control in the country"<sup>2</sup>

In India, during the War open-market operations were intended for maintaining the values of the Government operations. Thus the Reserve Bank of India followed a carefully laid-out plan for this purpose. The technique of open-market operations followed by the Reserve Bank of India in War time will be discussed in detail later on. In countries like Sweden and Argentine those operations were aimed at absorbing the excess of liquid funds in the market and capital markets.

#### **Open-market operations in the post-War period**

After the last World War, the open-market operations were extensively used by central banks of many countries in the world. The open-market operations were adopted by the central banks of many countries either to stabilise existing low yields on Government securities or to carrying them to lower levels. In the United Kingdom cheap money-policy was pursued with vigour, the Government trying to establish a long-term rate of  $2\frac{1}{2}\%$  not only for Government borrowing, but also for borrowing by Home Corporations and Public Boards. In the United States, policy was directed towards preventing excessive

<sup>1</sup> See Dr S K Basu—Recent Banking Development (1946), p. 86

<sup>2</sup> See The Economist, August 1, 1942

rise in Government bond price, with a view to avoiding the monetisation of public debt and the consequent inflationary effect <sup>1</sup>

In contrast to the buoyant conditions prevailing during the greater part of 1946 due to cheap money-policy followed by the authorities of the leading countries, gilt edged markets ruled comparatively quiet and was even somewhat weak in most of the leading countries in 1947. There appeared to be a general desire on the part of the authorities in most countries to stabilise the levels of interest rates rather than lower them further and in a few countries even a reversal of the cheap money-policy was in evidence, mainly, perhaps, as an anti-inflationary measure. Consequently, official support to the market was of a selective and limited character. There was a setback to the cheap money-policy in the United Kingdom where yields of the long-dated securities rose from about  $2\frac{1}{2}\%$  to  $3\%$  with appropriate upward adjustments in the yields of short-dated securities. The main reasons for the retreat of the market in that country were the fuel crisis, the low level of savings and the declaration by the Chancellor of the Exchequer of his desire to consolidate the cheap money rather than to push it further <sup>2</sup>

The Federal Reserve authorities, since early 1946, prevented the commercial banks from purchases of long-term bonds from the market and from sales to the Federal Reserve Banks of short-dated bonds whose interest rates were pegged low, as this action of the commercial banks had an inflationary effect in as much as they could extend credit six times the reserves they acquired from the Reserve Banks. In order to check this, in July, 1947, the Federal Reserve authorities unfroze the fixed rate of  $\frac{3}{8}\%$  on 3 months Treasury Bills, this rate gradually going up nearly to  $1\%$  by the end of the year. As a consequence, the rate of  $\frac{7}{8}\%$  percent on one-year certificates was also gradually allowed to rise to  $1\frac{1}{2}\%$ . The above measure had a tightening effect on the money market, the short term rates going up from  $\frac{3}{8}\%$  to  $\frac{1}{2}\%$ . As a result of this measure, prices of the Government bond declined. The decline was accentuated, on the one hand, by the sharp rise in the volume of new corporate financing, which was more attrac-

1. See page 12, Report on currency and finance (Reserve Bank of India), 1946-47

2. See page 9, Report on currency and finance (Reserve Bank of India), 1947-48

tive to investors and, on the other, by the considerable amount of uncertainty regarding the support policies of the Federal Reserve Banks<sup>1</sup> Following the lowering of support prices by the Federal Reserve Board towards the end of 1947, there was for a time uncertainty and confusion, but soon the market steadied up, partly owing to a further rise in short term rates and partly to the accumulation of investible funds In the third quarter of 1948 owing to the increased reserve requirements from member banks (which were raised by the Federal Reserve Board from Feb 27, 1948<sup>2</sup>) as well as a further rise in short-term rates, the rate of one-year certificates from  $1\frac{1}{8}\%$  to  $1\frac{1}{2}\%$  and the discount rate of the Federal Reserve Banks from  $1\frac{1}{2}\%$  to  $1\frac{3}{4}\%$  were raised<sup>3</sup>

#### **Variable Reserve Ratio**

We have witnessed the limited scope of open-market operations in a narrow market Naturally there has been the increasing recourse to the use of Variable Reserve Ratio as a new type of credit control It has been advocated to raise it largely in countries where money and capital markets are ill-organised or do not exist at all It may happen that a central bank finds itself short of securities, which are to be offered for sale in the market and also finds it unprofitable to purchase securities when the prices are high

When there is surplus fund in the hands of the member banks to expand credit, the central bank, if it thinks desirable to contract credit, may ask the member banks to keep a much higher cash ratio than the scheduled ratio Naturally the member banks will have to stop expansion of credit

"Whereas the other two methods (bank rate and open-market-operation policy) are designed to bring about an actual quantitative change to reserve holding and thereby in free reserves, a change in reserve requirements serves to create or destroy free reserves by a stroke of the pen"

Lord Keynes recommended for the application of variable reserve ratio as a method of credit control by a central bank He wanted that

1 See page 17, Report on currency and finance (Reserve Bank of India), 1947-48

2 See page 16, Report on currency and finance (Reserve Bank of India), 1948-49

3 See page 20, Report on currency and finance (Reserve Bank of India), 1948-49

the Bank of England should adopt it. As such, the Bank of England should be empowered to vary the cash reserves between 10 percent and 20 percent for demand deposits and between 0 and 6 percent in respect of time deposits.<sup>1</sup> Similar recommendation was made by the Macmillan Committee which urged that joint-stock banks should vary their cash ratio at the dictates of the central bank.<sup>2</sup>

The United States of America adopted this method of credit control first. By the Banking Act of 1933 the Federal Reserve Board was given power to vary the statutory reserve requirements of the member banks. During that period, there was an excess of reserves with the member banks partly as a result of the continuous inflow of gold. Being threatened by the impending danger of credit expansion, the Federal Reserve System with the consent of at least four members of the Board of Governors, was authorised to alter the cash ratios of the member banks within certain limits by the Banking Act of 1935. During 1936 and 1937, the Federal Reserve System raised the cash ratios of the member banks by the full amount permissible under law, to combat credit expansion. In April, 1938, the reserve requirements were reduced to  $\frac{1}{2}$  of the basic requirements to stimulate recovery from recession. In Nov., 1941, they were again raised to the legal maximum.

In New Zealand, the Reserve Bank with the authority of the Minister of Finance was authorised to alter the reserve ratios of trading banks from time to time by the Reserve Bank (Amendment) Act of 1936. In Belgium, the Banking Commission had the right to vary the reserve ratios as and when occasion demanded. In Australia, the Royal Commission did the same recommendation in the case of the Commonwealth Bank of Australia. Provisions for variable reserve ratios are also to be found in the case of Latin American Central Banks *e.g.* in Mexico and Costarica and Ecuador. The Bank of Mexico has been allowed to vary the cash ratios of private banks from 5% to a maximum of 50% of deposits. It is suggested that variable reserve ratio, as a weapon of credit control, may be successful in countries where capital and money markets are ill-organised and the supply of securities are inadequate. Countries like Australia, New Zealand,

1 See pp 76-77 and also pp 260-261, Keynes—A Treatise on Money, Vol II

2 See Report of the Macmillan Committee, 1930, Para 860

land, India and South Africa may be suitable for adopting variable reserve system as a technique for controlling credit. But in estimating the efficacy of variable reserve system in these countries, the nature of money markets of the countries and the normal behaviour of the banks functioning in them should be taken into consideration. The ordinary markets in those countries are generally accustomed to maintain flexible reserve ratios for which the variable reserve system is rendered a crude and insensitive weapon of credit control<sup>1</sup>. Again, in countries like Australia, Newzealand, South Africa, which maintain large liquid assets in London, variable reserve system will be shorn of its effectiveness so long as the ordinary banks are able to substitute their London assets by increased domestic assets with the central bank. The figures given below will show how variable the ratios are in the case of the Australian trading banks. During 1925-28 the average quarterly ratios fluctuated between 18.47 and 21.24%. During 1932-35 it fluctuated round about 15%. During 1925-1938 it moved between 13 and 10%<sup>2</sup>. But in Canada there is a case for variable reserve ratios, because she does not maintain large liquid assets in London as her money market is well developed and there the banks are usually accustomed to maintain fairly large reserve ratios varying between 9.5% and 11.4%. But in the case of the above countries, Mr Plumptre suggested that "a more effective weapon would be a variable minimum ratio between liquid assets as a whole and the deposits, rather than between simply cash and deposits alone"<sup>3</sup>. But the system admits of many defects. Even in the U.S.A. where the variable reserve ratio has been already applied, it has not yet developed as a delicate and sensitive instrument of control. The system is "clumsy", "discriminatory in its effect" and is "inflexible".

It is also held that the variable reserve system lacks precision, because it is uncertain and inexact as regards changes in the amount of reserves and also as regards the place where changes can be made effective.

It also affects different banks differently. It has hardly any effect

1 See Plumptre—Central Banking in the British Dominions, page 278

2 See p. 249 and also Appendix Table II, pp. 432-33, Plumptre—Central Banking in the British Dominions

3 See Plumptre—Central Banking in the British Dominions, pp. 270-271

upon a bank with large margin of excess reserves while banks with narrow margin will be hard hit.

Changes in reserve requirements may not be well-adjusted to meet "small or localised situations of reserve stringency or superfluity" as it had been hardly possible for the Federal Reserve Banks to relieve reserve stringency in Newyork and Chicago

The variable reserve ratio is likely to exercise a depressing effect on the security market. If member banks are required to maintain high cash reserve, they may do so by selling their holdings of long-term securities. But if sales are not what is just needed to meet the altered reserve requirements, it will have a depressing effect upon the security market.

A severe criticism is levelled against the variable reserve ratio—it is that the central bank is endowed with sweeping power over the member banks. This may be equally spoken against any weapon of credit control used by central bank if it were abused. In order to use variable reserve ratio successfully, the central bank should change the ratio as Keynes suggested with due notice and in small degrees.<sup>1</sup>

Formerly the primary purpose of maintaining cash reserve by commercial banks was to impart liquidity to them, but in recent years it is maintained by commercial banks with central banks in order to enable the latter to exercise some measure of control over the commercial banks. It is suggested by Whittlesey in recent years that open-market operations and the variable reserve ratio should be jointly applied in order to remove defects attached to each instrument of credit control.

For instance, increased reserve ratio may lead a depressing effect on the security market. In order to do away with this depressing effect on the security market, open-market-purchase policy may be adopted only to that extent which will support the prices of security in the market. Again, a lowering of the reserve ratio may lead to credit inflation to an undesirable extent. In that case open-market-sale policy may be adopted to counteract the effects of the undesirable credit inflation.

If open-market-sale policy is adopted independently by a central

1 See Keynes—*A Treatise on Money*, Vol II (1930), pp 76-77.

bank, it may lead to fall in prices of securities. In order to remove this defect of the open-market policy, the reserve ratio may be lowered down so that commercial banks may have some fund to purchase the government securities. It should be kept in mind that the lowering of the reserve ratio should be carried out to that extent which will provide a breathing space for commercial banks.

Similarly, if an adoption of open market-purchase policy leads to an undesirable credit inflation, an increase in the reserve ratio may counteract the same.

### Variable Reserve Ratios in the post-War period

In the post-War period, the necessity for a wider and stricter control of commercial banks, particularly in the conditions created by the War, attracted the attention of different Governments. Moreover, this was considered necessary in some countries either for checking the inflationary creation of credit by commercial banks or for directing its flow along desired channels.

Consequently in the United States, in July, 1946, the Board of Governors of the Federal Reserve System recommended the introduction of a system of secondary reserves applicable to commercial banks, i.e., the Board pleaded for an additional power to raise reserve requirements within some specified limit against net demand deposits.<sup>1</sup> Following the principle of the recommendation on 27th February, 1948, the Federal Reserve Board increased reserve requirements against demand deposits. Demand deposits of Central Reserve City Banks were raised from 20 to 22% which were again raised to 24% on 11th June. But as excess balances of member banks continued fairly high, the Board, in September, 1948, further raised demand deposits to 26% for the Central Reserve City Banks and 22 and 16% for Reserve City Banks and country banks respectively. Reserves against time deposits were raised to 7½% for all the three classes of member banks.<sup>2</sup>

1 See Report on currency and finance (Reserve Bank of India), 1946-47, p. 12

2 See Report on currency and finance (Reserve Bank of India), 1948-49, p. 16

### RATIONING OF CREDIT.

Rationing of credit as an instrument of credit control was used by central banks before the formulation of a systematic discount-rate policy and the assumption of the responsibilities by them as lenders of the last resort. The Bank of England used it towards the end of the 18th century. After the adoption of the Bank rate as a primary weapon of credit control by the Bank of England since the passing of the Bank Act of 1844, the Bank of England abandoned rationing of credit as a method of controlling credit. This situation developed also in the case of other central banks which began to adopt systematic discount-rate policy. It was only in extraordinary conditions like war that some central banks in the continent used credit rationing from time to time. After the Great War credit rationing was used in one form or another on several occasions by the central banks. In Germany its use was made in 1924, when the currency which had been stabilised by the introduction of the Rentenmark, was endangered. Again in 1931, the Reich Bank of Germany raised credit quotas to prevent the collapse of large banks while there was a run on German currency. But this policy of credit rationing was not without its evils, as many firms and industries had to suffer and many had to close their doors for lack of credit.

It is argued that credit rationing can be employed only in extraordinary situations. Deacock observes, it can be justified only as a temporary expedient or a measure of despair or as part of a comprehensive scheme of national economic planning.

Credit rationing may be both qualitative and quantitative. The former makes discrimination for certain types of bills against others as the latter limits the volume or amount upto which credit may be granted. In recent years with the introduction of economic planning in many countries, both qualitative and quantitative credit rationings were adopted. Rationing of credit as a weapon of credit control was particularly adopted in France, Italy and Russia.

#### Credit-rationing in the Soviet Russia

In the Soviet Russia, the rationing of credit by the State Bank is regarded as a necessary accompaniment of a planned economy. The

financial plan of the Soviet economy runs parallel to the production plan as certain financial adjustments are necessary in order to enable the monetary flow to fit in with the structure of production. Thus the way in which the financial plan is geared to the Production Plan is an important feature of the Soviet economy. For that purpose a costing datum about production programmes into money terms is prepared and from this there is built up a system of prices of output on the one hand, and a Credit Plan and a Cash Plan, on the other hand governing the relation between the banking system and productive organization. The Banking System of the Soviet Russia can only grant credit within the limits of the credit plan though some flexibility, however, is allowed for, by the provision of certain "unplanned credits" to meet unforeseen delays or breakdowns in the flow of production and supplies. But this "unplanned credit" can only be granted for strictly limited periods, the maximum being one month. Each enterprise in the Soviet Russia finances its "normal" level of expenditure out of its own working capital, and expenditure needs above the "normal" level is met by the State Bank. In this connection it may be observed that a complaint was made, in the case of heavy industry, that the smallness of its reliance on bank credit reduced the possibility of the State Bank exercising a control over the industry's expenditure and hence over the detailed implementation of the plan, thereby weakening the "discipline of the rouble".

Accordingly in 1939, certain engineering enterprises have transferred on to a new system of credit which rendered bank credits a larger source of working capital for them. Therefore, it was arranged that 20 p.c. of the value of unfinished stocks and 50 p.c. of the value of finished products in stock should be covered by credit.<sup>1</sup>

The State Bank is entrusted with powers for controlling the use of "planned credit" to ensure that they are not used for purposes other than those for which they have been assigned. A similar control over the use of long term credits by an industrial concern is entrusted to the Industrial Bank which is charged with the duty for controlling the use of credit by industry, in accordance with the production plans.

Thus, in Russia, rationing by the State Bank is freely applied as

1. See Maurice Dobb—Soviet Economic Development since 1917, p. 356

a general economic policy. This can be evident from the following observation: "The State Bank is guided by another principle in regard to the investment of its inflow in funds, namely, the allocation of funds among financially sound credit applicants in accordance with a definite plan and at times when the demand for credit exceeds the State Bank's available resources, the State Bank is obliged to divide these funds in some definite way among the enterprises which have need of them."

### **Use of Rationing of Credit in the post-War period**

In the conditions created in the recent years particularly by the last War, the attention of Governments of different countries was attracted for the purpose of introducing a better system of control over commercial banks. It was so desired for checking the inflationary creation of credit by commercial banks or for directing credit along the lines and in the measure indicated by development schemes or full-scale economic planning. Consequently, after the last War, legislations were passed from time to time in many countries to increase the power of the Central Bank over the commercial banks for the purpose of controlling unhealthy creation of credit. The field of activities of the Commonwealth Bank of Australia was widened under the Act of 1945 by the establishment of the Industrial Finance Department, the introduction of housing loans and the extension of the net of branch banking for undertaking general banking business. Far-reaching proposals for strengthening control over the expansion of credit by commercial banks were contained in the Annual Report of the Federal Reserve Bank of Governors published at the end of July, 1946. They recommended additional powers (1) to limit the volume of long-term marketable securities held by a commercial bank against net demand deposits, (2) to require all commercial banks to hold a specified percentage of treasury bills and certificates as secondary reserves against net demand deposits, and (3) to raise reserve requirements within some specified limit against net demand deposits. In Argentina, by a Decree in April, 1946, all the commercial banks were brought completely under the dominance of the Central Bank. Under this Decree, all commercial banks' deposits are guaranteed by the Central Bank. They are prohibited from employing depositors' resource except at the direction or with the authority of the Central Bank. Under another Decree a

new banking institution with a capital of 100 million pesos was established to exercise regulatory functions over the security market <sup>1</sup>

In Roumania, under the New Guatemalan Bank Law of 1946, it is provided, in order to ensure the stability of the banking system, that the paid-up capital and reserves of every bank must be at least 5% of its investments in Government Securities, 10% of its investments in other securities and loans and 50% of its investments in furnishings, real estate and other fixed assets. Under the same law Monetary Board was established with power to increase any of these above percentages, if it thinks it advisable, for checking unhealthy expansion of credit by any bank. It is also empowered to establish both absolute portfolio ceilings and maximum rates of increase in the portfolios including any group or sub-group of loans or investments of the banks.

In France, the Bank Control Commission, at the suggestion of the Bank of France, fixed from 27th February, 1948, the minimum proportion of liquid assets to be held by banks at 60%. Legislation introduced in the Mexican Senate in January, 1949, provides for a larger proportion of investments of private banks in the long-term Government loans and industrial securities <sup>2</sup>

'Credit facilities for development purposes have been liberalised by extending currency, fixed by law, of loans for commercial and agricultural purposes and by permitting larger percentages of assets in long term credit for various classes of banks'

In Czechoslovakia, under the act passed in July, 1948, People's co-operatives extend small credits in accordance with the approved financial plans drawn by the Minister of Finance. In order to direct credit along desired channels and also to check the inflationary creation of credit by commercial banks, under the planned economy the whole banking system was nationalised in many countries particularly in the countries of the Eastern and the Central Europe. 'Credit Rationing as a weapon of credit control surpasses all other instruments of credit if it is adopted under planned economy

1 See Page 15, Report on currency and finance (Reserve Bank of India), 1947-48.

2 See Page 16, Report on currency and finance, 1947-48

### DIRECT ACTION

Central banks used at various times, direct action and moral suasion either as alternatives to discount rate and open-market operations or in conjunction with them.

Direct action involves direct dealing with the individual bank. A central bank may take direct action by refusing to grant rediscounting facilities to certain banks whose credit policy may be contrary to the maintenance of sound credit conditions or by refusing to grant further advances to member banks which are already indebted to the central bank in excessive quantity in relation to their capital and reserves.

In 1928-29 it was used in the United States by the Federal Reserve Banks as a means for meeting the abnormal speculative situation.

Under the Banking Acts of 1933 and 1935 which explain the objective to lending policy of Federal Reserve Banks as "the maintenance of sound credit conditions, and the accommodation of commerce, industry and agriculture," the Federal Reserve System was invested with wider powers over the lending operations of member banks. If in the opinion of the Board of Governors of the Federal Reserve System, a member bank misuses bank credit, the board may stop such bank from the use of Federal Reserve credit facilities. A member bank may be prevented from further increase of its commitments against stock or bond for any period up to one year "under penalty of suspension of all rediscounting facilities at Federal Reserve Banks." It may also fix the proportion of such advances against stock or bond to the bank's capital.

Direct action aims at qualitative control of credit in contrast to discount rate and open-market operations which aim at quantitative control. The policy is not without its limitations.

† Dekock points out, "In practice, however, direct action has not been found to be satisfactory and effective for purpose of qualitative control, partly because the element of force associated with it is not generally conducive to the attainment of positive results, and partly because commercial banks themselves find it very difficult to control the ultimate use of credit and to make clear-cut distinction in all cases between essential industries, productive and unproductive activities, investment and speculation, or between legitimate and excessive speculation."<sup>1</sup>

1. See Page 258—Dekock—Central Banking, 1949

Burgess points out two important limitations —(1) the difficulty of coming to a decision at any time and for any bank when there arises an increase of bank credit inconsistent with the maintenance of sound credit conditions, (2) the effect of such decision on the part of the central bank will be to make the commercial banks slacken their vigilance on their real position and throw on the central bank the onus of ascertaining the true position <sup>1</sup>

#### 4 MORAL SUASION

By moral suasion we mean that the central bank tries to achieve its object of credit control "by making suitable representation" to the individual bank concerned and "relying on moral influence and power of persuasion" Like that of direct action, moral suasion aims at qualitative credit control which the central bank endeavours to secure by personal relationship with commercial banks or by exerting its moral influence on them It creates "less unfavourable psychological reaction", as it does not involve any punitive measure of administrative compulsion If there is any element of compulsion, it is in the nature of a moral obligation In the opinion of Burgess "the Reserve Banks may at times exercise an important influence on the general credit situation through the informal suggestions which they may make to bankers," but that "it is an influence to be exercised with the utmost discretion and would vanish with excessive use" <sup>2</sup> On the basis of Federal Reserve experience many American writers observe that moral suasion cannot be a successful instrument of credit control "unless it is set with teeth in the form of statutory powers of intervention and control" <sup>3</sup> In the U S A, there are thousands of independent unit banks, then policies might have neutralised the effect of moral suasion But in countries like Great Britain where central banking is long established, the central bank exercises its moral influence with an appreciable measure of success Moral suasion has been used with success in countries where branch banking system is prevalent

1 See Page 256—Burgess—Federal Reserve Banks and Money Markets, 1936

2 See Page 257—Burgess—The Reserve Bank and the Money Market, 1936.

3 See Page 261—Dekker—Central Banking 1939

In Germany, it had been used by the Reich Bank with success "to force greater liquidity upon the German commercial banks and check stock market speculation "

As instruments of credit control direct action and moral suasion are to be regarded as subsidiary to discount-rate policy and open-market operations Dekock observes that "for moral suasion there is in general a wider scope than for direct action, and in countries where there are highly liquid monetary conditions and where the central bank either cannot undertake open market operations at all or cannot do so on a scale sufficient to counteract the undue liquidity, it is advisable if not essential for the central bank to use moral suasion as far as possible in spite of its limitations "1

The central bank tenders advice from time to time to the member banks about the nature of investment risks and pitfalls by describing to them the peculiarities of general market conditions In India, immediately after the outbreak of the World War No II the Reserve Bank of India issued directives to the member banks to avoid financing and speculative dealings in bullion, Govt securities, shares, marketable goods etc

### Publicity

Central banks of various countries use publicity as an instrument of credit control Many of them use it by publishing regularly weekly statements of their assets and liabilities, make monthly reviews of credit and business conditions of money market

Publicity as an instrument of policy has been extensively used in the U S A , there the Board of Governors publishes a weekly statement of the conditions of the Federal Reserve System, issues a monthly bulletin on credit and general business conditions and 12 Federal Reserve Banks publish separately monthly review of conditions of their districts The Reich Bank also made extensive use of publicity The Reserve Bank of India has been doing extensive use of it It issues weekly statements of its assets and liabilities and publishes monthly reviews of credit and business conditions of money market

It is very difficult to judge the efficacy of publicity as an instrument

1 See Dekock—Central Banking (1939), p. 263

of control, for some give a great deal of importance to it, while others place little importance. In the opinion of Dekock, "owing to the increasing public interest and intervention in matters of monetary and banking policy, some publicity by the central bank appears to be essential"<sup>1</sup>

### ✓ Limits of Central Bank as a controller of credit

Various weapons of credit control used by central banks have been discussed above. But the question of effective control of credit by central banks requires consideration of various matters.

In the first place they have no control over non-banking credits, such as book and trade credits which, in practice, have been found to play very important part in the financing of trade, commerce, industry, agriculture, commodity and security markets. Therefore, owing to the use of book and other trade credits central bank's power to control credit is impaired as other forms of credits are not entirely based upon bank credits.

(Though all forms of bank credits are within the possible range of influence of central banks, even they find it difficult to control credit effectively. Sometimes commercial banks have no direct dealings with the central bank. For example, in the U.S.A. more than one-half of the commercial banks with one-fifth of the total resources remain outside the Federal Reserve System. This difficulty can only be removed by passing law if not by custom. Even if all the banks become member banks of a central bank there are still limits to the credit-controlling capacity of a central bank. It may face difficulties "for controlling the non-banking elements in the financial structure and the ultimate distribution and use of bank credit." First, the central bank cannot dictate commercial banks how the central banking credits should be used by them.

Secondly, the central banking credits may be utilised by a borrowing bank as loans and advances to stock or produce brokers, but it may so happen that those funds may ultimately flow to non-borrowing banks which may employ them as speculative loans.

In spite of the best efforts on the part of a central bank to prevent

1. See Dekock—Central Banking (1939), p. 271

its credit from being used for other than commercial loans it becomes difficult for it to prevent commercial banking credit to be employed as a basis for speculative loans. So an opinion is held that a central bank should try to achieve what is humanly possible. Notwithstanding this, the extent to which a central bank can control credit depends upon --

"(1) the stage of development of the local money market and the degree of interdependence and contact between the central bank and the money market ,

(2) the proportion of commercial banks which are active members of the central banking system and their relative dependence upon the central bank for rediscounting or collateral loans ,

(3) the degree of co operation between the central bank and the commercial banks

(4) the moral influence of the central bank not only over the banks but ~~over~~ also the other financial institutions, the money market and the stock and commodity markets"<sup>1</sup>

All these factors, again, depend upon the degree of control-exercised by the central bank over the money market. Experience has shown that different weapons of credit control used by the central bank had been partly successful and partly unsuccessful to direct the credit along the desired channels. Although efforts have been made to increase the control over the whole banking system, to be exercised 'by central banks for the purpose of credit control by passing legislations in many countries at different times, central banks cannot achieve their objective of credit control unless all other banking institutions of respective countries, which are sources of credit, are nationalised at the time when their central banks come to be state owned and state-controlled.

#### **Central bank as controller of price level**

It is held by many economists that it is one of the objectives of central banks to maintain the stability of price level<sup>2</sup> for national economic welfare. The success of central bank as a controller of price level depends upon the following assumptions —first, it is possible to construct indices accurately and promptly , secondly, there is a close and consistent relationship between the quantity of money (paper and

1 See Deacock—Central Banking (1939), p 161

metallic currency in circulation and bank deposits) and the price level thirdly, central banks are always able to achieve the contraction or expansion of the quantity of money in an exact degree. But in reality these assumptions do not hold good.

Experiences have showed that it is not possible to prepare accurate index numbers which may be taken as an effective guide for the purpose of control. There is no close and consistent relationship between the quantity of money and the general commodity prices as bank credit is one of many forms of credit used for the purchase of commodities. It is not only used for the purchase of commodities but is also employed for the purchase of other objects, such as real estate, securities and services. Sometimes an increase in the quantity of bank credit may be accompanied by a decrease in the level of commodity prices. In the U.S.A., during the period 1923-29 when there was an expansion of bank credit, the general commodity price level declined little while the prices of stock exchange securities and real estate rose very high, another reason for the lack of correlation between the quantity of money and price level is the velocity of the circulation of money on the one hand and the volume of trade on the other since the velocity of the circulation of money and the volume of trade are variable, they do not provide solution of the problem of controlling the price level by controlling the quantity of money and a central bank cannot counteract them.

Besides these, there are non-monetary factors which influence the price level, such as climatic crop conditions, wars, political and industrial upheavals, changes in methods of production etc. It is beyond the scope of central banks to counteract the effects of non-monetary factors by monetary actions.

Moreover, a central bank, while it observes signs of over-expansion of bank credit, cannot check the tendency by raising discount rate or by open-market operations or by varying the minimum reserve ratios for the commercial banks if the prospect of business is attractive to entrepreneurs, investors, purchasers, and speculators and if the commercial banks have surplus cash reserve. Again, at the time of depression, a central bank may not check the tendency of the falling prices by adopting various weapons of credit control. During the period from 1930 to 1934 central banks, in many countries, could not offset the effects of distrust, pessimism, contraction and liquidation by means of their credit policy. "The technique of credit and price level control may improve in future, but as matters stand at present, price or credit control may be possible of achievement in special circumstances and for short periods."

## CHAPTER V

### Central Banks and Trade Cycle

In recent years emphasis has been laid on the maintenance of the fullest possible employment of men and resources which should now be the declared objective of the post-War economic system in every country and for this there should be elimination of cyclical fluctuation in general economic activity. In capitalistic countries, the economic activity shows the recurrence of alternate periods of prosperity and depression. This phenomenon recurs as a result of the cyclic nature of fluctuations in trade and industry. Any business cycle consists of four successive phases, viz. prosperity, recession, depression, and revival. Economists differ in their opinion with regard to the causes of the recurrence of business cycles. Some attribute them to monetary phenomena while others try to explain them by attributing them to non-monetary phenomenon i.e., in terms of business psychology. Whatever may be the differences among economists as to the causes responsible for the cyclical fluctuations, they are caused by the action and interaction of various economic as well as non-economic forces.

With regard to the relation between banks and business cycles, non-monetary factors may not have influence over the activities of banks although for monetary forces or credit policy, banks play an important part in business cycles.

It is held that "in most cases banking operations merely reflect the results of cyclical fluctuations in business activity and do not themselves constitute the prime causal factor, although at times they may appear in the role of a substantial contributing factor"<sup>1</sup>

Banks do not ordinarily take the initiative in business finance. In times of boom customers apply for discounts, advances and overdrafts to the banks which meet credit needs of their customers on the available banking resources according to the merit of each proposal. Moreover, bank credit itself emerges partly from the liquid resources of business concerns, which appear in the form of bank deposits. Soon after a

<sup>1</sup> See Page 278—DeLoeck—Central Banking, 1939.

boom there may ensue depression. Consequently, there is the possibility of developing a serious credit strain. The signs of over-production may appear due to the discrepancy between saving and investment. In a period of prosperity expanding activity and rising prices in speculative dealings increase. Forward buying may take place in anticipation of higher prices and still higher profits. Consequently, a maladjustment may start from a disparity between production and consumption. On account of this cyclical fluctuation there may be disparity between investment and saving. In such cases how can a central bank control the situation? It is held by many that central banks, which enjoy certain special privileges and powers, should control the business cycle by controlling the volume and cost of credit. Regarding the limitations of credit control by a central bank discussion has already been made. It becomes difficult for a central bank to control credit effectively owing to the extensive use of non-banking credit in business and speculation. Even in the sphere of bank credit they face various difficulties. Bank credit alone cannot control business cycle, since its velocity is so changeable according to the influence of some non-monetary factors that their effects cannot be countered by monetary action. According to the Macmillan Committee the economic difficulties were due to "unusually large and rapid changes on the part of what are rightly described as non-monetary phenomena, these non-monetary factors again themselves producing monetary changes"<sup>1</sup>. So it becomes a difficult task for a central bank to check cyclical fluctuations in business activity. In spite of these handicaps, a central bank should, in co-operation with commercial banks, aim at reducing cyclical fluctuations as far as possible. It may succeed in its attempt by "the timeliness of action" as to what to do and how far to go. For this purpose, there should be closer co-operation between the central bank and the commercial banks which can observe at close distance what kinds of money are being placed to the credit of customers, and how that money is being distributed and thus this can help the central bank with statistical data and information to apply quantitative control of bank credit.

There should be closer co-ordination between the central bank and

---

<sup>1</sup> See The Macmillan Committee Report, Page 93

the capital market in order to avoid the evils of over-investment as well as under-investment. For, according to Keynes, "the sustained enjoyment of prosperity requires as its condition that as near as possible the right proportion of the national resources, neither too much nor too little, should be devoted to active investment."

Besides these, there should be a closer co-operation between the central bank and the treasury in order to formulate correct monetary policy of a country. This co-ordination is essential as the Government is assuming wide responsibility for monetary policy, exchange control, and control and regulation of other economic activities. Another reason for co-ordination with the treasury is stressed due to the fact that public works constitute an important subject in the Government programme of mitigating business cycles. Public works should be encouraged at times of depression and be postponed at times of boom. In recent years economists and statesmen gave attention on public works planning as a necessary constituent of practical monetary policy to prevent the evils of business cycles.

According to Keynes, disequilibrium between saving and actual investment is the primary cause of cyclical fluctuations in business activity. Therefore, by retarding investment in times of active trade and speeding up investments in times of declining trade, public bodies could help to restore equilibrium between saving and investments.<sup>1</sup>

As Keynes observed "the best we can hope to achieve, is to use those kinds of investments which it is relatively easy to plan as a make-weight, bringing them in, so as to preserve as much stability of aggregate investment as we can manage at the right and appropriate level."<sup>2</sup>

Cole, Henderson and Robbins also have argued in favour of some planning of public works to smooth out the business cycles. In the U. S. A., the Federal Reserve Board observed that "the Government must be looked upon as a compensatory agency in this economy to do just the opposite to what private business and individuals do."

According to the Board of Directors of the Commonwealth Bank of Australia "expenditure on public works should be relatively low in

1 See Page 172-84—Keynes—Treatise on Money (1930), Vol I

2. Article in London Times, 1937.

times of prosperity and that plans should be ready for expansion in times of depression." The central bank can help the treasury a great deal in pursuing the correct public works policy. There should be a combination of public works planning and credit control by the central bank to achieve jointly whatever is possible to smooth out the business cycle. The Australian Monetary and Banking Commission observed, "since the monetary and the banking system was an integral part of the economic system, the objective of a central bank would be to assist in the attainment for these ends with every means at its disposal."

As for example, in Sweden during the period 1930-35, in the U S A in Nov, 1937, and in several other countries a deliberate programme of public works was translated into practice to prevent the cyclical fluctuations in business activity.

In Sweden it was provided for an emergency Budget of 250 million kroner for public works in the event of depression in 1938 by passing an act.

Similarly, a provision was made to encourage industrial investment in the sphere of private industry during the periods of depression. For that purpose companies were exempted from income tax on such part of their net profits as could be shown to have been funded for depression investment purposes, subject to a limit of 10% of annual profits on 2% of share capital for building investments and 20% of profits or 4% of capital for investments in accessories and inventory. This fund was required to be used only in years fixed by the Govt for levelling the trade cycle.

In Finland, a Budget Equalisation Fund was created in 1934 with a view to counteracting business fluctuations.

In the United States, a Public Works Administration and a National Planning Board were established in 1933, and the Govt deliberately used the unbalanced budget to meet a great emergency.

In recent years, particularly in post-War period, further attention was paid to the theoretical and practical application of expenditure on public works and deficit financing, and also of taxation as instrument for supplementing monetary policy for smoothing out the cyclical fluctuations in business activity.

For example, after pointing out that in the majority of highly industrialised communities, expenditure on private investment was the most usual and most potent cause of instability in total expenditure, and consequently in employment. The British White Paper on employment policy (published in May, 1944) laid down the following as the guiding principles in maintaining total expenditure "Everything possible must be done to limit dangerous swings in expenditure on private investment". Therefore, Govt policy should be directed to securing the co-operation of local authorities and public utility concerns and "to encouraging privately owned enterprise to plan their own capital expenditure in conformity with a general stabilisation policy".

The Australian White Paper on full employment (published in May, 1945) emphasised "the part which public capital expenditure must play in maintaining full employment and in stabilising the level of total expenditure", the Govt and the local and semi-Govt authorities should "be prepared to take advantage of the opportunity to employ those resources in accelerating and expanding their own programmes for national works, housing, improvement of capital equipment and provision of facilities for social and cultural activities" when private investment declines.

The Social and Economic Planning Council in South Africa also recommended that "Government expenditure should be increased during depression, as far as possible, in such a way that it generates further increases in total expenditure", "that a system of anti-cyclical budgeting be adopted, whereby deficits are incurred during depression and surpluses collected during prosperity". In the United States a full employment Bill passed in recent years provided for flexible public works programme which was to be expanded or contracted according to the fluctuations in private employment.

## CHAPTER VI

### RECENT TRENDS IN CENTRAL BANKING

#### Relation between the state and central banks

In recent years a striking feature was remarked in the direction of the relationship between the state and the central bank. The trend was towards the participation in the ownership and control of the central bank by the state in the depression and post-depression periods, in marked contrast with that of the period after the Great War of 1914 when a great emphasis was laid on freedom of state ownership and control. This principle of less state intervention and control was clearly expressed in the resolutions passed at the Brussels and Genoa conferences in 1920 and 1922 respectively. After the Great War of 1914-18 "the tendency was towards the state intervention in the workings of central bank". Hence, almost all the central banks which were established after the War of 1914-18 enjoyed political independence. In the depression and the post-depression periods, the trend was towards state control and ownership of central banks. This tendency manifested partly as a result of the ineffectiveness of monetary instruments used by central banks to prevent evils of depression and partly as a result of narrow perspectives on their part. Many old established central banks which functioned as private shareholders' banks and also many newly created central banks were converted into state banks. The central banks which are owned by the state are the following — Riksbank of Sweden, State Bank of Russia, Bank of Finland, National Bank of Bulgaria, Bank of Batavia, etc.

In Denmark and New Zealand, the former privately owned central banks were converted into entirely state banks in 1936. In the same year, the Government indirectly participated in the ownership and administration of the Bank of Italy. The Bank of Canada also became a full-fledged state bank in 1938. Though the Reich Bank was privately owned it was purely under the direct control of the Fuehrer and Chancellor. In the U S A all the members of the Board of

Governors of the Federal Reserve System are being appointed now-a-days by the President. In course of time the central banks have become the technical instruments for carrying out the monetary policy of the Government and sources of technical information and advice.

During the War time state control over central banks increased enormously. It is reflected in the emergency powers obtained by Governments to change by decree central banking regulations. The trend towards state ownership of central banks which was noticed in the post-depression period continued during the War-time years. In August, 1939, the Central Bank of Bolivia was nationalised. The Bank of Japan which was a semi-Govt institution was converted into a state bank in 1942. The Central Bank of Ireland was established in 1943 as a state bank.

With greater state participation and control central bank's role as adviser to the Government has increased enormously. During the War period the central bank had to help with financial accommodation for which the legal limits fixed in previous years for granting advances to Governments had to be raised in several cases. Raising up of financial accommodation from 50,000 million francs in 1940 to 426,000 million in 1944 granted by the Bank of France to the French Government is a good instance in this respect. After the War, in many countries, central banks have been nationalised, for example, the Bank of England and the Reserve Bank of India have been nationalised in 1945 and 1949 respectively. A separate chapter is devoted for nationalisation of central banking.

### **The trend towards a restriction of direct dealings with the public**

Formerly central banks had been accustomed to deal in commercial banking business in addition to performing their central banking functions. Now a-days they avoid commercial banking business. Consequently they have been trying to curtail their direct dealings with the public. There are instances of this trend. For example, after the transformation of the Bank of Italy into a "public law" institution in 1936 it was provided that the Bank of Italy should liquidate its direct dealings with private persons within a certain period. In

Mexico, the Bank of Mexico was authorised by the Banking Law of 1936 to deal only with member banks and not with the general public

The restriction of direct dealings with the public is governed by the following considerations —

(i) A central bank is to maintain a **highly liquid position** in normal times not only to meet with seasonal demands for credit but also to cope with emergent financial strain

(ii) If the central bank deals with the public as a commercial bank does, its liquidity will be affected and, therefore, it will be difficult on the part of the central bank to act as the lender of the last resort and to help commercial banks at the time of emergency

(iii) Direct dealings with the public involve a responsibility on the part of the central bank to meet customer's credit requirements. When contraction of credit generally is to be enforced by the central bank, it will fail to fulfil its function as a controller of credit by disobliging its own customers

(iv) Commercial banks keep either by convention or statute minimum reserves with the central bank. If the central banks compete with commercial banks in private business, commercial banks may resent keeping statutory deposits with the central bank, which will be applied against them in competition for business

(v) For the successful workings of the central banking functions, the central bank is to depend upon whole hearted support and co-operation of the commercial banks for which it should refrain from competing directly with the commercial banks

#### **The trend towards the greater use of open-market operations**

One of the striking features of the recent years' central banking development is the trend towards the greater use of open-market operations as a measure of credit control. The policy of open-market operations gained prominence not only in Great Britain and the U. S. A., but it also became prominent in other countries of the continent not as a subsidiary instrument but as an independent weapon of credit control. The extensive use of it may be attributed to—"first, the decline of the discount rate as an instrument of credit control owing to the changes in the money-market conditions, the increased rigidity of the economic structure, the growth of state control and intervention,

the suspension of the gold standard, and the adoption of managed currency, secondly, the wider scope for open-market operations arising out of the considerably increased volume and variety of Government securities outstanding, particularly short-term securities such as treasury bills, and thirdly, the increased needs of the state and its increased influence over the money market, resulting in a large measure of subservience on the part of the central bank, whether forced or voluntary to the requirements of state finance' <sup>1</sup>

In the post-depression years, the statutes of several countries were modified so as to enable central banks of those countries to undertake open-market operations. In October, 1933, the Reich Bank, in 1935 the Bank of Poland, in 1938 the Bank of France and newly created central banks of countries like Argentina, New Zealand, Canada and India were granted powers to engage in open-market operations. In some countries open-market operations were successful while in others they were not.

During the last World War they had been extensively used in various countries such as Belgium, the U.S.A., the U.K., Canada and India.

*There is a tendency towards the centralisation of cash reserves on the following grounds —*

(i) When bank reserves are centralised in a central bank, it may be possible to use reserves during the periods of seasonal strain and emergency in the interests of banking and business as a whole.

(ii) Being assisted by rediscounting facilities offered by the central bank, centralisation of cash reserves promotes economy of their use and also serves to increase the liquidity of other banks.

(iii) Statutory centralisation places at the disposal of a central bank a minimum of funds with which it can operate control over the banking and credit situation. Provision has been made for minimum reserves to be kept with the central bank by the commercial banks in South Africa, New Zealand, India and Argentina. In recent years, by varying the statutory reserve requirements of the member banks, central banks of various countries have been making efforts to control credit.

<sup>1</sup> See Page 338—Deokok—Central Banking, 1939.

### **The Trend towards the reduction of the legal cover ratio**

One of the striking trends of the recent central banking legislation is the reduction of the legal ratio with a view to imparting greater elasticity in the employment of "primary reserves". Before the pre-depression period a central bank maintained high legal reserve ratio against note circulation with the result that sometimes it became unable to provide an adequate reserve for international currency. During the depression and post-depression periods there was urgency for greater elasticity in the reserve requirements of the central bank to meet the discrepancies in international balance of payments. Accordingly, opinion crystallised in favour of the reduction of the legal cover ratio. The Gold Delegation Committee and the Monetary and Economic Conference held in London in 1933 recommended the reduction to 25%. Czechoslovakia, Bulgaria, Denmark, Yugoslavia, Mexico, Canada and other countries reduced it to 25%.

During the last World War many countries such as Italy and Germany went so far as to abolish the legal reserve. It is now being universally recognised that the credit of a central bank does not so much depend upon its "cover" reserve as much as on its international "currency" reserve.

### **Tendency towards the extension of advances and discounts of central banks**

The traditional feature of the central banking was that central banks were very conservative about the eligibility to their help. During the War and after the War there had been a remarkable departure from the traditional policy of central banking and the tendency is towards the extension of the scope of discounts and advances by central banks. Papers which were considered formerly as lacking in securities and liquidity, have since been declared eligible. Moreover, central banks have been empowered to accept new types of securities as collateral for loans and advances. The most interesting feature of the period is that in most countries central banks have been authorised to grant industrial credit.

To tide over the temporary difficulties of the money market, to finance the growing needs of the government, to help certain branches

of the economic system for which funds were not easily available, are many of the objectives responsible for the enlargement of central banking operations

The Bank of France was authorised to rediscount treasury bills and various kinds of special bills which it could not rediscount formerly In the U S A finance paper, construction loan notes and consumer's paper were declared eligible for discount The Glass Steagall Act of 1932 did away with the artificial distinction between "eligibility" and "acceptability" of different papers which were created after the first World War According to this Act, any bank might borrow on security of sound assets from the Federal Reserve Bank

During the depression and post-depression years central banks of various countries showed greater interest in furnishing industrial credit to industries In the U K the Bank of England organised the Bankers' Industrial Development in 1934, and contributed a part of its capital Such a step would hardly have been taken by central banks in the years before and after the Great War of 1914-18 The Bank of England is found also to have associated itself with the "Credit for Industry"

In the U S A the Federal Reserve Bank Act of 1934 empowered the Federal Reserve Banks to discount or buy from any bank, trust company, mortgage company, credit corporation for industry or other financing institute obligations maturing within 5 years In exceptional circumstances, the Federal Reserve Banks can make direct capital advances to established private industries Different industrial concerns availed of this facility and by 1938 the total industrial advances of the Federal Reserve Banks amounted to 16 million dollars

In war time central banks took very important part in financing the countries' industrial war efforts In the U S A by the President's executive order of March 26, 1942, the Federal Reserve Banks were authorised "to arrange loans and guarantees thereof whenever they would be considered to be contributing towards the expeditious maximisation of war production" In Canada the Industrial Development Bank established in June, 1944, is subsidiary to the Bank of Canada which has subscribed its capital up to 25 million dollars The Bank of England has also subscribed to the share capital of the British I C F C and F. C. I

In India, the Reserve Bank of India has also subscribed 2000 shares of Rs 5000 each of the Industrial Finance Corporation established in 1948

### **The Tendency towards greater co-operation among central banks**

The need for co-operation among central banks was emphasised by the Brussels Conference in 1920, the Genoa Conference in 1922, the Macmillan Committee in 1931, the League of Nations Gold Delegation Committee in 1932 and the World Economic Conference in 1933. In order to foster co-operation among them the Monetary and Financial Commission passed a resolution which runs as follows —

“There should be continuous co-operation between central banks and the Bank for International Settlements, it should be regarded as an essential agency for central bank action designed to harmonise conflicting views and for joint consultation.” Since 1930 the Bank for International Settlements was used as a valuable medium for improving and facilitating co-operation among central banks. In the crisis period of 1931-32 it granted emergency credit to many central banks such as the National Bank of Hungary, the National Bank of Austria, the Reich Bank and the National Bank of Yugoslavia. The Bank for International Settlements also organised syndicates of central banks to which the Bank of England, the Bank of France and the Federal Reserve Bank of New York jointly contributed a fund to the common constructive cause. After the last War, the co-operative spirit of central banks has found expression in the formation of the International Monetary Fund and the International Bank for Reconstruction and Development. A separate chapter is devoted for the International Monetary Fund and the International Bank for Reconstruction and Development.

### **The tendency towards the use of Foreign Exchange as a Legal Reserve**

While there was a trend towards the reduction of metallic reserves in recent years, the tendency towards the greater use of foreign exchange as a legal reserve was perceptible.

Prior to the World War I, little use had been made of foreign exchange as a direct and specific reserve against note issue. At that time, it was used by backward countries like Java, India, the Philippines,

Mexico, Egypt and Panama which adopted the one or other form of exchange standard. Besides these countries, Sweden, Norway and Denmark maintained foreign exchange partly as a reserve against their note issues, although their notes were legally redeemable only in gold. After the War of 1914-18, with the adoption of the gold exchange standard in many countries for the purpose of economising gold, foreign exchange was included by law as a part of the minimum reserve to be held by central banks in a large number of countries, such as Germany, Italy, Belgium, Austria, Hungary, Roumania, Poland, Bulgaria, Greece, Chile, Mexico, Argentine, Peru, Bolivia, Ecuador, Salvador and India. In some of these countries, the proportion of the amount of foreign exchange varied from  $\frac{1}{10}$ th to  $\frac{1}{2}$ , whereas in others, the relative proportions of gold and foreign exchange were left to the discretion of the central bank.

During the depression period, on the suspension of gold payments by Great Britain and the depreciation of the sterling in terms of gold, sterling was rendered ineligible as a reserve for central banks which had to continue gold exchange standard. But the formation of a "sterling area" comprising those countries which maintained their currencies linked with sterling or subsequently relinked their currencies with sterling at old or new parity saved the situation and the countries within the sterling area adopted a "sterling exchange standard" with sterling as the whole or part of the legal reserve. Similarly, a "dollar area" with a dollar exchange standard came into existence. As regards the remaining countries it was clearly defined that those foreign currencies which were payable in the leading world markets, or not subject to extraordinary fluctuations or not subject to restrictions in the countries concerned were to be included in the legal reserves.

Since that time most of the central banks kept foreign assets as the legal reserves, not always against their note issues, but, "either as a natural development in credit and exchange control or as an emergency measure, to play as an increasingly important part in foreign exchange operations and to aim at maintaining balances and liquid investment in the centre or centres with which their countries had important commercial and financial relations." "Their foreign assets, in addition to being a source of revenue, performed the functions of "

"buffer" or "shock absorber" and served as an instrument for the regulation of exchange rates, while their dealings in foreign exchange were also used as one of the means of regulating money market conditions"<sup>1</sup>

In Great Britain the Bank of England did not participate directly in foreign exchange transactions. After the suspension of the gold standard in September, 1931, the Bank operated in the exchange market till the establishment of the Exchange Equalisation Account, but, did not hold foreign exchange as secondary reserve. Since then it participated in exchange transactions as agent of the Account in addition to carrying out transactions for account of the many central banks which deal with the London Exchange Market. Since the beginning of the World War II, the Bank of England, as agent of the treasury, imposed exchange control under the defence (finance) regulation.

In the United States the Federal Reserve Banks held foreign exchange as a secondary reserve and operated directly in the foreign exchange transactions for their own accounts inspite of the development of the Newyork money market and the recognition of the dollar as an international currency till the suspension of the gold standard in the U S A in the beginning of 1933. One of the striking trends of the recent central banking practices in many countries is to undertake rigid exchange control. It was widely followed in Central and Eastern Europe, Latin America and Asia during and after the great depression of 1930-33.

With the outbreak of the World War II, it was necessary to adopt exchange control in belligerent countries as well as in neutral countries. As a result of the War, gold and foreign exchange reserves of many countries diminished considerably to a large extent due to the unfavourable balance of payments position. Therefore, it was necessary for those countries to continue exchange control for 'correcting maladjustment in the balance of payments position and to avoid undue depreciation of their currencies. For this reason, according to the provisions of the International Monetary Fund Agreement, member countries are allowed to continue exchange control on current transactions as well as on capital transfers for a transitional period.

1. See Deekock—Central Banking (1949). pp 90-91.

### **The tendency towards the use of Selective Instruments of Credit Control**

While some of the well-known traditional weapons of credit control proved ineffective, selective instruments of credit control gained wide popularity amongst various central banks as a new technique and device for controlling credit in recent years. Methods of selective instruments of credit control are used by regulating margin requirements against loans and advances in order to check inflationary tendencies in particular economic sector or speculative excesses in a particular area. This new technique received much popularity in the Federal Reserve System after the speculative boom and crash of 1929-31. As many of the banks failed in 1933 in the U. S. A. due to their much speculative investment in the stock exchange market, the Board of the Governors of the Federal Reserve System was empowered by the Securities Exchange Act of 1934 to regulate margin requirements against security loans to restrict the use of credit for the purchase and carrying of securities. Margin, which was 30 p. c. in October, 1934, was raised to 40 p. c. in January, 1936, and to 55 p. c. in March, 1935. At the end of the second World War the percentage of the margin requirements was fixed at 100 p. c. by the Board of Governors of the Federal Reserve System in January, 1946, on account of highly inflationary tendencies due to war-time expansion of currency and of speculative excesses in the share market. The use of this new technique by the Federal Reserve System helped considerably to check the uninterrupted speculative activities on the stock exchange.

The question of the use of the applicability of the selective instruments of credit control assumed greater importance in India during and after that stock exchange boom of 1946. At that time it was suggested that "legislation on American lines empowering the Reserve Bank of India to regulate the margin which the banks may demand from their constituents before making loans against shares should be introduced in our country"<sup>1</sup>. After analysing and examining the causes and effects of the stock exchange crash of 1946 it was thought proper to introduce the legislation for regulating margin requirements against security loans on the above lines. And the Reserve Bank of India was empowered to

1. See Dr. S. K. Basu—Recent Banking Development (1947), p. 120.

govern the margin requirements to be maintained in respect of secured loans and advances by the Banking Companies Act, 1949 (X of 1949)<sup>1</sup>

### **Trend towards broadening the objectives of Central Banks**

In the post-depression period, objectives of central banking underwent a remarkable change from their traditional moorings. Before the Great War of 1914, statutes of central banks did not define the objectives of the central banking system. In the statutes of central banks created after the World War I, definitions of objectives were, no doubt, embodied, but they were narrow and limited in their scopes. Their objective was either to secure exchange stability or to attain internal price stability.

In the post-depression period, many of the central banks broadened the scope of their objectives. "Regulation of the money market, promotion of the best interests of the economic life of the community, monetary policy, economic stability etc form a wide range of objectives".<sup>2</sup>

The Board of Governors of the U.S. Federal Reserve System, while issued a statement on "Objectives of Monetary Policy", gave emphasis on the fact that "economic stability rather than price stability should be the general objective of public policy". "Economic stability is defined as the maintenance of a full employment of labour and of the productive capacity of the country as can be continuously sustained".<sup>3</sup>

The Australian Monetary and Banking Commission recommended that the chief objective of the Commonwealth Bank of Australia should be "the reduction of fluctuations in general economic activity in Australia, thereby maintaining such stability of internal conditions as is consistent with the change which is necessary if economic progress is to take place".<sup>4</sup>

The Bank of Guatemala has adopted a wide-range objectives in its statute. Its domestic and international aims have been clearly distinguished. The chief objective of the Bank is 'to promote the establish-

1 Ibid.

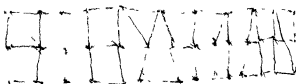
2 See Dr S. K. Basu—Recent Banking Development (1946), pp. 135-136

3 See International Currency Experience (League of Nations), 1944, p. 109

4 See Report of the Australian Monetary and Banking Commission (1937), p. 234

ment and the maintenance of the monetary, exchange and credit conditions most favourable to the orderly progress of the national economy"

In the inter-war period, the emphasis shifted from mere price or exchange stability to the employment stability. The conflict between these two objectives *i.e.*, exchange and price stability could only be resolved "if the various countries spontaneously adopted the same objective—a stable level of good employment"<sup>1</sup>. Experiences of the objectives of monetary policy during the inter-war period have a great lesson for central banks in the post-war period while practically every member country of the International Monetary Fund has pledged to achieve and to maintain the employment stability. The Reserve Bank of India is quite indifferent to this new objective and is still adhering to the traditional objective *i.e.*, "Monetary Stability", which is vague and undefined. A suggestion has been made elsewhere in this book that the chief objective of the Reserve Bank should be to attain and to maintain "a stable level of good employment", for which, accordingly, its whole structure and organization should be reorientated.<sup>2</sup>



<sup>1</sup> International Currency Experience (1944), p. 110.

<sup>2</sup> See Ibid—Chap. XVI.

## CHAPTER VII

### Full employment and nationalisation of central banking

"Unemployment cannot be conquered by a democracy until it is understood by them. Full productive employment in a free society is possible but it is not possible without taking pains. It cannot be won by waving a financial wand. It is a goal that can be reached only by a conscious and continuous organization of all our productive resources under democratic control. To win full employment and keep it, we must will the end and must understand and will the means" <sup>1</sup>

After the end of the last World War, there were schemes for post-war economic planning in almost all countries to overcome the ravages of war. Achievements of full employment became one of the objectives of post war planning. The United Nations Organization recognises 'that the avoidances of unemployment or underemployment through the achievement and maintenance in each country of useful employment opportunities is not of domestic concern alone, but is also a necessary condition for the well-being of all other countries' <sup>2</sup>

Therefore, we see the creation of the International Monetary Fund, the establishment of the International Bank for Reconstruction and Development and the International trade organization. As the maintenance of fullest possible employment of men and resources is now the declared objectives of the post-war economic system in every country, the central banking system which is passing through a phase of evolution under the present international situation, has its part to play. A publication of League of Nations in 1944 pointed out that the maintenance of "a stable level of good employment" should be the aim of central banks. According to Beveridge, "the banking system must clearly function in accord with the general financial policy of the state" <sup>3</sup>

---

1 See Beveridge—Full Employment in a Free Society (1946), p 16

2. See Page 6, Chapter II, United Nations Conference on Trade and Employment at Havana. Final Act and related documents

3 See Beveridge—Full Employment in a Free Society, p 178

Therefore, there is the need of a close relationship between a central bank and a Government. It is neither possible nor desirable to separate finance from politics. The former idea of keeping politics separate from finance has to be given up. In order to adopt successfully the planned policy of full employment it is not only desirable but absolutely necessary to obtain a much closer relationship between the central bank and the Government than what is obtainable if the former remains a shareholders' bank. For this reason, the status and the structure of central banks have undergone a great change. Thus it is intended that the central bank should be nationalised. Nowadays, monetary policy the management of which lies with the central bank, plays a very important role in general economic policies of the Government. For the successful prosecution of the economic policy of a Government, the authority for managing the credit and currency, namely the central bank, should be linked to the Government.

One of the methods of securing full employment is to take recourse to deficit spending on the part of the Government. According to this method, the Government is to spend on public investment in a contra-cyclical direction. For example, if it spends large sums of money on public works during a depression or provides subsidies to stimulate mass consumption in the shape of family allowances etc., this will increase effective demand directly and lead to full employment. During the depression, the Government should not attempt to balance the budget. The budget should be run into a deficit to provide sufficient outlay for the maintenance of full employment. Again, during booms surplus should be utilised for wiping off the accumulated deficits of the years of depression. If deficit spending be adopted for promoting full employment, the rate of interest has to be maintained at a certain level. If the rate of interest is allowed to rise at the time when the Government spends on public works with a view to promoting employment, the effect of Government spending will be neutralised by a decline in private investment. Therefore to keep the rate of interest stable, the control over it has to be exercised by the Government, not in its capacity as a "borrower" but in that of a controller of central bank. Hence the

## MODERN CENTRAL BANKING

central bank becomes a part of the Government machine and as such it has to be nationalised

In the post-war period, the question of nationalisation of central banks assumed great importance due to the establishment of the International Monetary Fund. As the International Monetary Fund aims at the maintenance of the external value of the currencies of the respective countries which are members of the Fund, the co-operation between the Govt and the central bank of each country becomes absolutely necessary. This may be ensured by nationalising central banks so that "they may form an integral part of the public machinery of economic regulations in the field of international as in that of national affairs" <sup>1</sup>

During and after the last World War, there was a trend towards greater Government intervention in the economy of almost all countries of the world. The "complete negation" of monopoly capitalism which strongly prevails even now, is recognised along with the socialization of production, although in many countries private ownership still continues to exist.

The victory over Nazi Germany in the last War helped in the development of new democracies in Europe and Asia and thus opened the way to social progress.

Immediately after the formation of the new democratic Governments of the working class in central and Eastern European countries, the Government of each country rushed through democratic reforms and carried out nationalisation schemes in their respective economic systems. The most important measure in this respect was the nationalisation of the key industries including mines, transport and banking. Though a nationalisation programme was carried out in some sectors of the national economy, in the rest of it individual ownership continued to be recognised. "As a whole, capitalist relations of production continued, within a mixed economy in which state enterprise and state regulation play a central role" <sup>2</sup>

---

1. See Dr S. K. Basu—Recent Banking Development (1946), pp. 74-75

2. See James S. Allen—World Monopoly and Peace (1947) p. 267

### **Nationalisation of the Bank of England**

In Great Britain monopoly capitalism, although considerably able to maintain its position, greatly weakened in the post-war period. This was witnessed when the Labour Party in the post-war election came into power with a clear majority. The Labour Party, among its schemes of nationalisation included nationalisation of the Bank of England. Immediately after coming into power, the Labour Government took steps to nationalise the Bank of England which, according to Mr G. D. H. Cole, possessed the tradition of a "great city institution, belonging to the world of high finance rather than to that of Government and proud of its independence vis-a-vis the state" <sup>1</sup>

The Bank of England was nationalised in 1946. Under the Bank of England Act of 1946, things were to remain much as they were before, with the exception that the stock of the Bank would be held by the treasury. Besides the structural changes introduced by the Act, no attempt was made to effect any revolutionary change. Care was taken not to disturb the central banking mechanism that had been developed in England over more than two centuries. Thus the court, with a reduced number of directors, was retained, the inner reserves of the Bank of England remained untouched and the Bank is still allowed to accumulate fresh reserves as freely as possible. Therefore the Economist observed that "the Bank of 1946 will not differ significantly from that of 1945" <sup>2</sup>

Before the passing of the Act, the Bank of England was independent of the treasury. In the case of disagreement between the Bank and the Government, the voice of the Government did not prevail. But after the passing of the Act, the Bank of England becomes subordinate to the treasury and the word of the latter is final in matters of financial policy. Another change which has been introduced is that "henceforth the credit of the Bank of England will be tied to the apron-strings of the British Government"

Under Section 4, Subsection 3, the Bank of England was empowered to request information and make recommendations to commercial

<sup>1</sup> See Cole—Money, its Present and Future (1944), p. 193

<sup>2</sup> See The Economist, Feb. 16, 1946, p. 259

banks and to issue directions to them with the consent of the treasury. Protests were raised from different quarters against this clause. It was argued that it would infringe the legitimate secrecy of the bank customer relationship and the Bank of England would become an instrument of exercising control over joint-stock banks in furtherance of the policy of the Labour Government. Consequently, a subsection has been added that "no such request or recommendation shall be made with respect to the affairs of any particular customer of the bank". But the Economist pointed out that even though the clause was amended, "it will not prevent the Bank from taking action with respect to a group of customers however small"<sup>1</sup>

Wide powers have been given to the treasury in order to assure the successful working of the five-year plan of the Labour Government. "The Treasury, the Central Bank and the clearing banks would have to pull well together". The Bank of England has been empowered to direct other banks to use their funds in particular channels of investment which, in the opinion of the Bank of England and the state, would be deemed necessary "in the interest of a planned priority with a view to securing full employment and building up export trade and other necessary elements" of the national economy.<sup>2</sup>

Let us now discuss the structural changes introduced by the Bank of England Act of 1946. The Act provides for the transfer of the capital stock of the Bank of England to the Treasury. The crown is to appoint a Governor and a Deputy and Directors whose number has been reduced from 24 to 16. The Act also provides that the Treasury, after consultation with the Governor, can entrust the management of the Bank to a court of directors. The Act provides compensation for the stock-holders. The basis of compensation is that the stock-holders of the Bank of England will receive £400 of new Government stock for every £100 of Bank of England stock held by them. Government stock bears 3% rate of interest per annum which is reducible at the option of the

1 See Page 838 - The Economist, December, 1945

2 See Page 911 - The Economist, December 22, 1945

Government only after April-5, 1966. Thus the stock-holders continue to receive a 12% return for the next twenty years.

The Treasury will receive from the Bank of England, each half year, the equivalent of what it has to pay to the stock-holders.

The Chancellor of the Exchequer is responsible for the banking policy. Normally, there will be no interference by the Treasury in the day-to-day work of the bank. But in case of disagreement between commercial banks, the Bank of England and the Treasury, the final say lies with the Treasury.

It seems from the provisions of the Act that its effect is hardly noticeable to the general public. In the opinion of the Chancellor of the Exchequer the measure brings into legal form what has long been accepted in practice. Under the circumstances, leading financial circles found little to criticise the measure. The Economist wrote "the basic question remains—why do the Government think it worthwhile to introduce a Bill in which any real substance has been so carefully whittled away? one must conclude that the Bill is a symbolic sacrifice on the altar of party doctrine and that it is not intended to make contact with reality at any point. It will do very little harm at least in present conditions"<sup>1</sup>

#### Nationalisation of Central Banks in other countries

Besides England, in many other countries the central bank has been nationalised. The Commonwealth Bank of Australia was nationalised by the passing of the Commonwealth Bank Act in 1945. But later on, this measure was declared ultra vires by the Federal Court of Australia so that there was no such nationalisation in Australia.

The Bank of France was also brought under public ownership and control but the basis of compensation to shareholders differed from that adopted in England. The French Government chose market values, rather than dividends, as the basis of compensation and the average value in the year ending August 31, 1945, was fixed as a maximum. The State Bank of Pakistan came into existence in July, 1948, when the Reserve Bank of India ceased to be a banker to the Government of

<sup>1</sup> See The Economist, October 13, 1945

**Pakistan** The Banco Central de la Republica Argentina was nationalised by a Government decree at the end of March, 1946. Under the nationalisation scheme half the capital of the Bank till then held by private banks was taken over by the Government, which repaid it in cash or in special encashable treasury bonds carrying interest at  $2\frac{1}{2}\%$ , the remaining 50% of the capital being already held by the Govt. The new board of directors consists of thirteen members, excluding the President and the Vice-President. Of thirteen members five members are from Government departments—the Ministers of Finance, Agriculture, Public Works, Industry and Labour. Three others are presidents of banks under Govt. control, the rest representing industry, commerce, labour, agriculture and stock raising.<sup>1</sup>

The nationalisation of central banks gained further momentum during 1947 especially in Europe. The National Bank of Roumania was nationalised from 1st January, 1947, by a law passed on 28th December, 1946. Under the Law, the Ministry of Finance was to deposit at the Bank within three days of the publication of the Law an amount equal to the value of the Bank's shares valued at the Bucharest stock exchange rate ruling on 1st Dec. The shareholders were paid compensation in cash based on the average official market price of shares between 1st Jan. and 1st Dec., 1946.

The Netherland Bank was nationalised early in 1948 as contemplated in the previous year. The Bank remains as a limited-liability company with all its shares held by the Government. The shareholders were paid twice the nominal value of their shares in  $2\frac{1}{2}\%$  Government stock, the basis of compensation being the past dividends paid to the shareholders. All the directors are to be nominated by the Government, and the Finance Minister will have power to issue directions to the Managing Director of the Bank after consulting the Advisory Council.

The nationalisation of the Bulgarian National Bank was effected towards the end of 1947. The nationalisation scheme provides for compensation in cash and interest-bearing bonds to Bulgarian shareholders. The Hungarian National Bank also became a state bank.

<sup>1</sup> See Page 9—Report on currency and finance (Reserve Bank of India), 1946-47.

from November, 1947. All shares held by shareholders were transferred to the Hungarian State against suitable compensation. The Bank of Czechoslovakia was nationalised by passing a law in March, 1948. The share of the Bank was bought by the Government at their face value plus a bonus. It is managed by an administrative board of nine members including the Governor and two Vice-Governors.

The National Bank of Egypt and the Bank of Norway were nationalised in 1948.

In July, 1948, the capital of the National Bank of Belgium was doubled the new shares being contributed by the state. The regulations against block voting have been waived in favour of the state. The controlling interest of the Government has been increased.

Apart from nationalisation, in many of the countries, the Government was empowered by law to strengthen its control over the central bank and monetary policy. Thus under the Law of 28th Dec., 1946, the National Bank of Roumania is to assume the direction and control of credit according to the directives given by the Supreme Economic Council. From January, 1947, the Bank of Spain was relieved of its many central banking functions, such as the fixing of the discount rate, conducting open-market operations, directing credit policy, etc. which were to be performed by the Minister of Finance with the approval of the Council of Ministers.

#### **Nationalisation of the Reserve Bank of India**

† In India, in the post war period opinions formed in favour of nationalising the Reserve Bank of India. The National Planning Committee appointed by the Indian National Congress gave its opinion in favour of state ownership of the Reserve Bank of India. In his budget speech, the then Finance Minister announced that the policy of the Government was to nationalise the Reserve Bank of India. The issue was shelved till Feb. 4, 1948, when the then Finance Minister in his budget speech announced that the Government would take steps to nationalise the Reserve Bank after the 30th September, 1948, when the Bank would cease to be banker to the Govt of Pakistan. As regards the compensation to be paid to the shareholders, he stated that it was the intention of the Govt to acquire the shares of the Reserve Bank of India at the average

of the monthly market value of the shares during the period from March, 1947, to Feb., 1948, taking the opening quotations for each month<sup>1</sup> The average value worked out at about Rs 118-8 as per share and the acquisition of the entire share by the Govt. was estimated to cost about Rs 6 crores less the amount of the shares of the face value of Rs 2,20,000 held by the Govt. It was also announced that 3% long dated stocks of equivalent value would be issued to the shareholders.

There was difference of opinion in the country as to whether the proposal for the nationalisation of the Reserve Bank of India at that stage would be in the best interest of the country. We have seen that it became the policy of almost all countries to nationalise central banks in the post-war economic period. The Govt. of India did not sleep over the issue.

In the autumn session of the Dominion Parliament in 1948 the Government of India introduced the Reserve Bank (Transfer to Public Ownership) Bill. The Finance Minister, Hon'ble Mr. K. C. Neogy, while introducing the Bill, in the Dominion Parliament, gave two explanations in the course of his introductory speech. One was that "it is in the fitness of things that the first piece of legislation to bring about their (the Government) ideas of nationalisation should relate to an institution which is really the pivot of the financial system of the country and on which, to a very large extent, depends the economic well-being of the society." The other explanation was that the fashion of the day was that the central banking institution of a country should be owned by the state and not by the private shareholders and India was simply following the fashion. Nationalisation of the central bank is absolutely necessary if the Government has any economic plan to implement for national well-being. But the Reserve Bank (Transfer to Public Ownership) Bill introduced only the minimum changes necessary to effect the transfer of ownership and left the other functions of the Reserve Bank undisturbed. Things remained as they were before. Ownership had been transferred from the shareholders to the Govt. The Bill also introduced the basis of compensation to shareholders which was proposed to be Rs 118-10 as per

1 See the Budget speech of the then Finance Minister, February, 1948

share The shareholders would be paid in the form of 3% Govt Promissory Notes repayable at par on such date as might be fixed by the Government The value of the compensation was based on the formula announced on Feb 4, 1948 In cases where the amount of compensation due was not an exact multiple of Rs 100, the difference would be paid in cash

With regard to the constitution of the Bank, it was provided that all the Directors of the Central Board would be appointed by the Government of India who would also appoint the members of the local Boards

In connection with management the Government is empowered to give such directions to the bank as it may consider necessary in the public interest after consultation with the Governor of the Reserve Bank of India Subject to these directions, the Central Board is to supervise the affairs of the Reserve Bank and subject to such regulations as the Central Board may make with the consent of the Government of India, the Governor will exercise all powers vested in the Central Board The Reserve Bank of India has the obligation under Article IV of the International Monetary Fund Agreement to buy and sell all foreign currencies at such rates as the Govt may decide So the present bill amends Sections 17 and 33 of the old Reserve Bank Act enabling the bank to hold in the Issue Department not only sterling securities but also other foreign currencies and other securities which are payable in the currency of those countries which are members of the International Monetary Fund

The Reserve Bank of India (Transfer to Public Ownership) Act was enacted on the 3rd Sep, 1948 The Government of India announced on October 18, 1948, that the Reserve Bank of India would be nationalised from Jan 1, 1949, from which date the shares of the Reserve Bank were to be acquired by the Govt The Govt paid to the shareholders 3% Government Promissory Notes as compensation at Rs 118-10 as for every share of Rs 100 repayable on the 18th October, 1975, or with three months' notice on an earlier date on or after the 15th October, 1970

The Reserve Bank of India now stands nationalised with effect from Jan. 1, 1949.

## **Part II**

### **CHAPTER IX**

#### **The Reserve Bank of India**

**The rise of the Reserve Bank of India** —The Reserve Bank of India came into existence under the provisions of the Reserve Bank of India Act of 1934. At present, it stands nationalised from January 1, 1949, in accordance with the provisions of the Reserve Bank (Public Ownership) Act of 1948. It is now a state bank. Formerly, it was a shareholders' bank.

In this connection it may be recollected that the Reserve Bank Bill was introduced in January, 1927, by the then Finance Member Sir Basil Blackett, in the Legislative Assembly, on the lines suggested by the Hilton Young Commission in 1926 which recommended a shareholders' bank for India. The Bill was referred to a Select Committee in which there was a sharp difference of opinion as to whether the Reserve Bank should be a state or a shareholders' bank and as to the Constitution of the Central Board. At that time, the majority in the Select Committee opposed the Bill on the ground that a state bank alone would inspire confidence among people and that a shareholders' bank would make domination by private interests possible. An influential minority was in favour of a shareholders' bank on the ground that it alone would ensure freedom from interference in its working, by political parties. The Government accepted the majority proposal in principle of the state bank scheme but as no agreement was reached regarding the composition of the directorate, the Bill was dropped.

In January, 1928, the Government again introduced a Bill proposing a shareholders' bank but for technical reasons it could not be moved in the Assembly. Thereupon they wanted to proceed with the old Bill, but on the 10th Feb., 1928, the Government expressed their intention not to proceed with the matter as the consideration of the old Bill might raise the old controversies. The question of the establishment of the Reserve Bank assumed great importance again in 1933.

when the White Paper on the Indian Constitutional Reforms was published. The White Paper, in paragraph 32 of the introduction, made it a condition that before transferring responsibility of finance to the Centre, a Reserve Bank should be established in India free from political influence. On the 8th September, 1933, a fresh Reserve Bank of India Bill was introduced by Sir George Schuster who was then the Finance Member of the Government of India. The Bill as approved by the Legislature became an Act in 1934 and the Reserve Bank came into being on the 1st April, 1935, as a shareholders' bank.

After the World War No. II, with the nationalisation of the Bank of England, but more particularly with the formation of the Interim Government at the Centre, there was a move for the nationalisation of the Reserve Bank of India and a non-official resolution was moved in the Central Assembly on the 18th Feb, 1947, proposing for the nationalisation of the Reserve Bank by Mr. Tamizuddin Khan, Ex-M.L.A. It was, however, withdrawn on the assurance of the Finance Member that the Government would consider the proposition most carefully and sympathetically and if they were convinced that nationalisation of the Bank would be in the country's interests, the Government would not fail to take steps in that direction. The assurance was followed by an announcement on the 28th Feb, 1947, by the Finance Member in course of his budget speech that the Government had decided to nationalise the Reserve Bank of India. He observed, "I have since given further thought to the matter and am convinced that the advantages of nationalisation outweigh any possible disadvantages. I have, therefore, come to the conclusion that the Reserve Bank of India should be nationalised, the time and manner of effecting the change being a matter for separate consideration in due course"<sup>1</sup>.

The issue was shelved till Feb 4, 1948, when the then Finance Minister, Hon'ble Sri Shanmukham Chetty in his budget speech declared that the Government would take steps to nationalise the Reserve Bank after the 30th September, 1948, when the Bank would cease to be a banker to the Government of Pakistan. In the autumn session of the Dominion Parliament in 1948, the Government of India introduced the Reserve Bank (Transfer to Public Ownership) Bill and

1. See Report on currency and finance (Reserve Bank of India), 1946/47, Page 118,

## MODERN CENTRAL BANKING

the Bill became an Act in due course with the assent of the Governor-General. From January 1, 1949, the Reserve Bank of India became state bank in accordance with the provisions of the Reserve Bank Act of 1948

**Constitution** —Under the Reserve Bank Act of 1934, the Reserve Bank of India was a shareholders' bank having a share capital of 5 crores divided into fully paid-up shares of Rs 100 each. The entire share capital was owned by private shareholders with the exception of shares of the nominal value of Rs 220,000/- only which had been owned by the Central Government under Section 4(8) of the Reserve Bank Act of 1934. Shares were held by the Government for disposal at par to Directors of the Central Board of the Bank seeking to obtain the minimum share qualification. Under Section 4(3), any person domiciled in India, any company registered under the Indian Companies Act, and any co-operative society registered under the Co-operative Societies Act could become a shareholder. In the case of persons who were ordinarily resident in India but domiciled in some other part of the Empire and companies which had branches in India but were incorporated in some other part of the Empire, it was a condition of shareholding that the Government of the parties concerned should not be discriminating against Indians in any way.

Separate registers of shareholders were maintained at Bombay, Calcutta, Delhi, Madras and Rangoon. Under Section 4A of the Reserve Bank Act [Section 2 of the Reserve Bank of India Act (Second Amendment)], 1940, no person after the 26th of March of 1940, was allowed to hold any additional shares whether in his own name or jointly with another person or persons in excess of a total nominal value of Rs 20,000/- only. Moreover, one vote was allowed to be cast for each five shares at elections to the local board and the maximum number of votes for each shareholder was fixed at 10. The reason for such provisions was to prevent accumulation of power in particular parts of India or in the hands of a few capitalists. But, as no legal provision was made to prevent transference of shares from the register of one area to the others, a large number of shares was transferred to Bombay area from other areas particularly from Calcutta and Delhi.

This will be evident from the following figures —<sup>1</sup>

*Distribution of shares (in Lakhs of rupees)*

|          | Original | Dec 31st,<br>1938 | Dec 31st,<br>1939 | June 30th,<br>1941 |
|----------|----------|-------------------|-------------------|--------------------|
| Bombay   | 140      | 206               | 207               | 213                |
| Calcutta | 145      | 123               | 121               | 122                |
| Delhi    | 115      | 93                | 93                | 87                 |
| Madras   | 70       | 60                | 60                | 60                 |
| Rangoon  | 30       | 18                | 19                | 19                 |

It is also interesting to observe that the total number of shareholders since the establishment of the Reserve Bank declined by nearly 38 per cent and the Bank's shares concentrated in the hands of the few capitalists

The following table<sup>2+3</sup> further indicates the trends in the distribution of the Bank's shares as between the different areas

|          | 1st Apr,<br>1935 | 31st Dec,<br>1936 | 30th June,<br>1946 | 30th June<br>1947 | 30th June,<br>1948 |
|----------|------------------|-------------------|--------------------|-------------------|--------------------|
| Bombay   | 1,40,000         | 1,89,838          | 2,36,321           | 2,36,629          | 2,38,788           |
| Calcutta | 1,45,000         | 1,31,423          | 1,24,629           | 1,26,318          | 1,27,602           |
| Delhi    | 1,15,000         | 97,314            | 79,230             | 78,955            | 78,723             |
| Madras   | 70,000           | 61,217            | 51,042             | 49,660            | 49,459             |
| Rangoon  | 30,000           | 20,208            | 8,778              | 8,438             | 5,428              |
|          | 5,00,000         | 5,00,000          | 5,00,000           | 5,00,000          | 5,00,000           |

<sup>1</sup> See Report on currency and finance, 1940-41, p 35

<sup>2</sup> See Report of the fourteenth Annual general meeting of shareholders of the Reserve Bank of India, 1948, pp 7 & 8

<sup>3</sup> See Report of the thirteenth Annual general meeting of shareholders of the Reserve Bank of India, 1947, p 7

| NUMBER OF SHAREHOLDERS AS ON                             |                  |                   |                    |                    |                    |
|----------------------------------------------------------|------------------|-------------------|--------------------|--------------------|--------------------|
|                                                          | 1st Apr,<br>1935 | 31st Dec,<br>1936 | 30th June,<br>1946 | 30th June,<br>1947 | 30th June,<br>1948 |
| Bombay                                                   | 28,000           | 22,342            | 17,366             | 17,362             | 17,230             |
| Calcutta                                                 | 23,890           | 15,571            | 10,590             | 10,457             | 10,403             |
| Delhi                                                    | 23,000           | 16,744            | 10,589             | 10,317             | 10,117             |
| Madras                                                   | 14,000           | 9,702             | 6,510              | 6,392              | 6,279              |
| Rangoon                                                  | 3,157            | 1,914             | 535                | 503                | 371                |
|                                                          | 92,047           | 66,273            | 45,692             | 45,031             | 44,400             |
| Average No<br>of shares held<br>by each share-<br>holder | 5.4              | 7.5               | 10.9               | 11.1               | 11.3               |

It is evident from the above table that there was a further decline in the total number of shareholders from 45,692 on the 30th June to 45,031 on the 30th June, 1947, and to 44,400 on the 30th June, 1948. The tendency noticed since 1944 for the number of shares on the registers of the Bombay and Calcutta areas to expand, continued at the expense of the remaining areas, the increases during the year 1948 being 2,159 and 1,248 respectively. The increase in the shares on the Bombay and Calcutta registers was due to the transference of shares amounting to 3,010 held by persons on the Rangoon register to the registers in India as the Rangoon register was wound up in terms of the Reserve Bank of India (Amendment Act of 1947)<sup>1</sup>

In this connection it will be pertinent to observe that the majority of the Select Committee appointed by the then Legislative Assembly on the proposal of the Reserve Bank Bill of 1927, objected to a shareholders' bank.

One of many grounds for objection was that a shareholders' bank was likely to involve domination of the Bank by large capitalists in big cities. This assumption of the Select Committee proved a fact by 1941 in the case of the Reserve Bank of India.

The Act under Section 5 provided that the share capital of the Bank could be increased or reduced on the recommendation of the

<sup>1</sup> See Report of the fourteenth Annual general meeting of shareholders of the Reserve Bank of India, 1948, p. 8

Central Board, with the previous sanction of the Governor-General-in-Council and with the approval of the Central Legislature to such extent and in such manner as may be determined by the Bank in the general meeting

In recent years, particularly before and after the last war, a striking trend was witnessed in other countries towards the participation in the ownership and control of the central bank by the state. Central banks which were owned by the states, before the war, are the following —Riks Bank of Sweden, State Bank of Russia, Bank of Finland, National Bank of Denmark, National Bank of Bulgaria, Bank of Latvia, Reserve Bank of New Zealand, Bank of Canada, Bank of the Republic of Paraguay, Bank of the Republic of Uruguay. After the last war, central banks of various countries have been nationalised, such as, The Bank of England (1946), The Bank of France (1945), The Banco Central de la Republica of Argentina (1946), Central Banks of the East and Central European countries like Poland, Rumania, Bulgaria, Yugoslavia and Hungary have been also nationalised with the formation of the new democratic Governments in those countries. We have seen that it became the common policy of almost all countries to make the central bank a state-owned bank. Following the same policy the Government of India by passing the Reserve Bank (Public Ownership) Act of 1948, has converted the Reserve Bank of India from a shareholders' bank to a state bank from 1st January, 1949. According to the provisions of the Act on the basis of the formula contained in the announcement of the 4th February, 1948, the value of the compensation payable to shareholders was fixed at Rs. 118-10 as per share to be paid in the form of 3% Government Promissory Notes and repayable on the 15th October, 1975, or by three months' prior notice on an earlier date on or after 15th October, 1970. In cases where the amount of compensation was not an exact multiple of Rs 100, the difference would be paid in cash. By a notification dated 19th October, 1948, the Government fixed the 1st of January, 1949, as the date on which the shares of the Reserve Bank would be acquired by the Central Government. Out of a total of 5 lakhs shares (including 2,200 shares held by the Government for disposal at par to Directors seeking to obtain the minimum share qualification), the total number tendered for payment of compensation up to 30th June, 1949, was 388,389, the total amount of

compensation paid in the form of the 3% first Development loan 1970-75 being Rs 4,15,68,700 and in the form of cash Rs 20,20,483 4-0 <sup>1</sup>

### Offices and branches —

Under Section 6 of the Reserve Bank Act of 1934, the Reserve Bank have established offices in Bombay, Calcutta, Delhi, Madras, and Rangoon and a branch in London. It may open branches or agencies in any other place in India with the previous sanction of the Government of India. The Bank established, however, branches of its Banking Department at Calcutta, Karachi and Lahore. After the partition of the country Lahore office was transferred to the Government of Pakistan and a Issue Department was opened at the Bank's Delhi office from 1st December, 1947. A branch of the Issue Department was also opened at Dacca on 1st April, 1948, but it was ultimately transferred to the Govt of Pakistan.

### Management under the Act of 1934

The general supervision and direction of the affairs of the Bank are entrusted to a Central Board of Directors.

Under Section 8(1) of the Reserve Bank Act of 1934 the Central Board consisted of 16 members, *viz* —

(a) a Governor and two Deputy Governors appointed by the Governor General in his individual judgment,

(b) four Directors nominated by the Governor General,

(c) eight Directors elected on behalf of shareholders by local boards of five areas on the basis of two Directors each from Bombay, Calcutta and Delhi and one Director each from Madras and Rangoon.

(d) one Government official nominated by the Government of India.

A local Board constituted for each of the five areas consisted of—

(a) five members elected from among themselves by the shareholders who were registered on the register for that area and were qualified to vote, and

(b) not more than three members nominated by the Central Board from among shareholders of that area and representing territorial and economic interests not already represented, and particularly representing agricultural interests and the interests of co-operative banks.

Local Boards advise the Central Board on such matters as may be generally or specifically referred to them and perform such duties as the Board delegates to them.

<sup>1</sup> See Report of the Central Board of Directors (Reserve Bank of India), 30th June, 1949, p. 7.

### **Management under the Act of 1948**

According to the provisions of the Reserve Bank Act of 1948 all the Directors of the Central Board are appointed by the Government who appoint also the members of the local Boards since the Reserve Bank has become a state bank.

The Central Board consists of (1) a Governor and (2) two Deputy Governors appointed by the Central Government and (3) ten Directors (instead of twelve—eight elected and four nominated—previously) and (4) one Government official, all nominated by the Central Government. The Directors are now to hold office for a period of four years instead of five, as formerly. As before a local Board has been constituted for each of the four areas, Bombay, Calcutta, Madras and Delhi, consisting of five nominated members (instead of eight—five elected and three nominated—previously) to represent territorial and economic interest as well as the interests of co-operative and indigenous banks.

In connection with management of the Bank, the Government has power to give such directions to the Bank as they may consider necessary in the public interest after consultation with the Governor of the Reserve Bank of India. Subject to these directions, the general supervision and direction of the affairs and business of the Bank is entrusted to the Central Board and subject to such regulations as the Central Board may make with the consent of the Government of India, the Governor will exercise all powers vested in the Central Board.

During and after the World War No II a greater Governmental intervention was manifested in the economy of almost all countries of the world. Therefore, we see a close relationship between a central bank and the Government of a country. The former idea of separating politics from finance was given up. In Great Britain the Bank of England becomes subordinate to the Treasury whose word will be final in matters of financial policy in accordance with the provisions of the Bank of England Act of 1946. The Treasury is also empowered to entrust the management of the Bank of England to a Board of Directors appointed by the Crown, after consultation with the Governor of the Bank. Similarly, the Reserve Bank of India has, now, become subordinate to the Government of India according to the provisions of the Reserve Bank (Public Ownership) Act of 1948.

## CHAPTER X

### The Reserve Bank of India as a Bank of Issue

*Monopoly of note issue* —It is stated in the preamble to the Act that the Reserve Bank of India was constituted "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage "

The essential function of a central bank is to maintain the stability of the monetary standard. This implies that the Central Bank should be entrusted with the sole right of note issue in order to keep control over the monetary circulation.

Under Section 22 of the Reserve Bank Act, the Reserve Bank is given the sole right of note issue. Prior to the establishment of the Reserve Bank of India, the Government of India was the sole authority for issuing notes in India while the management of credit was entrusted to the Imperial Bank which performed functions partly as a Central Bank. The duality in control of currency and credit was highly responsible for the disorganisation of the monetary system in this country. In almost all the advanced countries of the world the right of issuing notes was withdrawn from the other banks; and the government. In connection with the right of note issue by the state, the Irish (free state) Banking Commission observes—"Mindful as it is of the disasters of past years in all countries where currency was issued by the Government and recognising the hazards which come from changes of Government, the Commission is definitely of the opinion that the management of the legal tender note issue should be placed in the hands of a non-political and independent body, which shall have full control and custody of the securities it holds", because, a needy Government may not hesitate to take recourse to printing notes. But in the past, in the matter of note issue, the Central Bank was never influenced by any other interest than the public welfare.

"Experience has shown that the functions of issuing notes and controlling credit should be closely co-ordinated and could most satis

factorily and efficiently be exercised by a single authority, which would then be the Central Bank rather than the state" <sup>1</sup>

The sole right of note issue to be vested in the Reserve Bank of India was the theme of one commission and committee after another to unify the control over the banking and currency reserves of the country

It is generally recognised that in the interest of stability, a central banking authority should regulate note issue not primarily impelled by the profit motive and at the same time it is required by law to maintain an adequate proportion of reserves against its notes

For the issue of notes, like the Bank of England, the Reserve Bank of India maintains its Issue Department separately from the Banking Department. This separation of two departments is, however, not an uncommon feature with central banks. The Commonwealth Bank of Australia, the Central Bank of China, the Bank of the Republic of Uruguay, and the National Bank of the Costa Rica maintain the two departments separately

In England, the reason for this separation of the Issue Department from the Banking Department was due to the prevalence of the views of the Currency School over the Banking School. According to the currency principle which was accepted in England by the Bank Charter Act of 1844, the volume of notes would expand or contract according to the inflow and outflow of gold into and from the country. It was desirable to restrict the note issue up to the amount of gold held by the Issuing authority. Other forms of means of exchange such as bank deposits, bill of exchange etc., were not regarded as money. Therefore, the management of the note issue should be entrusted to a separate department quite distinguished from the Banking Department which performed the commercial banking business with the exception of the note issue.

During those early years historical events amply proved that an artificial distinction between notes and bank deposits did not exist. Notes and bank deposits were easily interchangeable. The Currency Principle lost all its significance during the crisis of 1847 when the note circulation of the country did not fall with the outflow of gold but only deposits fell and subsequently there was enormous growth of deposits.

In connection with this separation, the Macmillan Committee pointed out "the only solid reason" for this arrangement is that "the

1 See Deacock—Central Banking (1939), p. 39

separation of the Issue Department has provided convenient formula for dividing profits of the Bank of England between the Treasury and the Bank itself" <sup>1</sup> According to the British practice, profits earned by the note issue belong to the treasury. The separation of the Issue Department from the Banking Department facilitates calculation of these profits <sup>2</sup> This argument has no relevance to the Reserve Bank of India as profits of the Reserve Bank is distributed on an altogether different basis. Such a separation is maintained in order to publish separately balance sheets for the Issue and Banking Departments for two reasons. Firstly, it is essential to set out in a separate statements the assets and liabilities in respect of the note issue as such a separation would inspire greater confidence in the note <sup>3</sup> Secondly, the notes held in the Banking Department show deposit liabilities of the Reserve Bank to the scheduled and non-scheduled banks.

The Reserve Bank of India adopted the proportional reserve system like the Federal Reserve Banks of the U S A and the Bank of France. Section 33 of the Reserve Bank Act prescribes the assets of the Issue Department against which notes can be issued by the Bank. Of the total assets not less than  $\frac{2}{3}$  i.e. 40 p.c must consist of gold coin, gold bullion, sterling securities, provided the amount of gold coin and gold bullion is not anytime less than Rs. 40 crores in value. In other words, gold is valued at 8.47512 grains of gold per rupee, rupee coin at its face value and Government securities at the market rate i.e. 8.47512 gold issued coin could be made use of to cause a deflation to the extent of Rs.  $2\frac{1}{2}$  in notes. "It is clear from this that calculations of the excess notes which are available for issue with existing reserves cannot be simple or obvious under our system" <sup>4</sup> Though it is provided in Section 33 of the Act that with the previous sanction of the Central Government, however, the Reserve Bank of India may hold gold coin, gold bullion or sterling securities of less than 40 p.c of the assets for limited periods provided that it pays specified tax on the deficiency, the Bank, however, has so far maintained since 1935 a much higher percentage of gold and sterling securities against its total liabilities in the Issue Department. This will be evident from the figures given below <sup>5</sup>

<sup>1</sup> See The Macmillan Committee Report, pp. 143-144

<sup>2</sup> See S. K. Muranjan—Modern Banking in India (1948), p. 297.

<sup>3</sup> See The Hilton Young Commission Report, p. 137

<sup>4</sup> See S. K. Muranjan—Modern Banking in India (1948), p. 299

<sup>5</sup> See Statement XLI, Report on currency and finance (Reserve Bank of India), 1948-49, p. 222

**THE ISSUE DEPARTMENT SINCE 1935-36.**  
( In lakhs of Rupees )

| Average Friday<br>Figures | Liabilities              |                                        |          | Assets                   |                        |                |                     |                                                                      |
|---------------------------|--------------------------|----------------------------------------|----------|--------------------------|------------------------|----------------|---------------------|----------------------------------------------------------------------|
|                           | Notes in<br>Circulation. | Notes held<br>in the Bank-<br>ing Dept | Total    | Gold coin<br>and Bullion | Sterling<br>securities | Rupee<br>coins | Rupee<br>securities | Percentage of<br>gold and ster-<br>ling securities<br>to total notes |
| 1935-36                   | 164.06                   | 27.58                                  | 191.64   | 44.42                    | 62.09                  | 55.51          | 29.62               | 55.58                                                                |
| 1936-37                   | 175.81                   | 25.81                                  | 201.62   | 44.42                    | 69.57                  | 64.01          | 23.62               | 56.54                                                                |
| 1937-38                   | 186.15                   | 25.61                                  | 211.76   | 44.42                    | 79.92                  | 60.53          | 27.19               | 58.72                                                                |
| 1938-39                   | 182.36                   | 23.23                                  | 210.64   | 44.42                    | 66.95                  | 67.11          | 32.16               | 52.91                                                                |
| 1939-40                   | 209.32                   | 18.79                                  | 228.01   | 44.42                    | 78.63                  | 67.52          | 37.44               | 53.97                                                                |
| 1940-41                   | 241.41                   | 17.26                                  | 258.67   | 44.42                    | 129.92                 | 35.87          | 48.46               | 67.39                                                                |
| 1941-42                   | 307.68                   | 12.31                                  | 319.89   | 44.42                    | 165.00                 | 35.28          | 75.19               | 65.47                                                                |
| 1942-43                   | 513.41                   | 11.80                                  | 525.21   | 44.42                    | 319.11                 | 22.33          | 139.38              | 69.21                                                                |
| 1943-44                   | 777.17                   | 10.50                                  | 787.67   | 44.42                    | 643.52                 | 14.28          | 85.45               | 87.84                                                                |
| 1944-45                   | 968.69                   | 10.93                                  | 979.62   | 44.42                    | 863.73                 | 13.53          | 57.95               | 92.70                                                                |
| 1945-46                   | 1,102.64                 | 16.41                                  | 1,119.05 | 44.42                    | 1,061.28               | 15.53          | 57.84               | 93.78                                                                |
| 1946-47                   | 1,232.96                 | 32.61                                  | 1,265.57 | 44.42                    | 1,132.98               | 13.43          | 57.84               | 93.85                                                                |
| 1947-48                   | 1,237.82                 | 47.12                                  | 1,284.95 | 44.42                    | 1,135.32               | 32.36          | 62.84               | 92.53                                                                |
| 1948-49                   | 1,231.84                 | 22.02                                  | 1,253.86 | 42.19                    | 907.47                 | 42.96          | 265.62              | 76.43                                                                |

The above statement shows the yearly average of the liabilities and assets of the Issue Department of the Reserve Bank of India since the commencement of the operation of the Bank in 1935

The note circulation showed a remarkable increase towards the end of 1936 owing to the gradual revival from the depression and thereafter there was no marked rise in the note circulation till the outbreak of the War in Sep, 1939

On the liabilities side, note circulation began to increase from 1939-40 till 1945-46 which can be evident from the above figures. Large expansion of note issue during the war period was mainly against sterling securities. Notes in circulation (excluding Burma notes) increased only by 29.26 crores or by 1.91 per cent from Rs 1,218.77 crores on 29th March, 1946, to Rs 1,242.03 crores on 28th March, 1947. The total notes issued stood at Rs 1,258.08 crores at the end of 1946-47 as compared with Rs 1,238.41 crores at the end of the previous year showing an increase of 1.59. Thus the percentage in the notes in circulation and the total notes issued during the year 1946-47 considerably declined compared with the increases in the preceding two years of 22.93% and 23.33% in 1944-45 and 12.34 per cent and 13.13 per cent in 1945-46 respectively<sup>1</sup>. In 1947-48 notes in circulation increased by Rs. 62.33 crores or by 5.02 per cent. The total notes issued in 1947-48 stood at Rs. 1,319.49 crores as against Rs. 1,258.08 crores in 1946-47 showing an increase of 4.88 per cent. The increase was due to higher price level, the widening of the free sector of trade and by the large refugee and capital expenditure of the Govt.<sup>2</sup> During 1948-49 there was a contraction of notes in circulation to the extent of about Rs 135 crores. Of this Rs 127 crores are accounted for as follows: Rs 44.98 crores withdrawn in Pakistan by the Reserve Bank against the issue of Pakistan inscribed notes during the period from 1st April to 30th June, 1948, and Rs 82.20 crores of India notes returned by the State Bank of Pakistan till 31st March, 1949. The balance of Rs 8 crores was contracted in the Indian Union during 1948-49<sup>3</sup> but the net contraction in note circulation in Indian Union alone during the year ended 30th June, 1949, was Rs 32.91 crores.

1 See Report on currency and finance (Reserve Bank of India), 1946-47, pp 106-110

2 See Report on currency and finance (Reserve Bank of India), 1947-48, p 109

3 See Report on currency and finance (Reserve Bank of India), 1948-49, p 143

On the assets side, gold coin and bullion remained unchanged at Rs 44.42 crores till 1947-48, their percentage to total notes issued began to decline from the year 1941-42 while the Bank's holding of sterling securities began to increase. The percentage of gold coin and bullion to total notes issued further declined from 3.59 as at the end of the year 1946 to 3.53 by March, 1947. In this connection it may be noted that the valuation of the gold holding continued to be based on the statutory rate of Rs 21-3-10 per tola while the market rate for gold stood at Rs 103-8-0 on 31st March, 1947. The Bank's holding of sterling securities increased enormously during the war period. This increase was due to the heavy purchase of war materials from India by the United Kingdom and the Allies. The Reserve Bank of India issued notes enormously against these sterling securities kept as reserve in the Bank of England. The Bank's holding of sterling securities did not increase much during the year 1947, the total of such securities standing at Rs 1,136.32 crores on 28th March, 1947, as compared with Rs 1,120.32 crores on 29th March, 1946. Consequently, the percentage of sterling securities to total notes issued and the percentage of gold and sterling securities together to total notes issued declined from 90.46 and 94.05 at the end of 1945-46 to 90.24 and 93.77 at the end of 1946-47.<sup>1</sup>

The valuation of the gold holding of the Reserve Bank at the old statutory price of Rs 21-3-10 is far from justification as a revaluation of gold reserves of the Reserve Bank at the market price would provide an adequate cover for note issue even if a large portion of our sterling balances were liquidated. In recent years a large number of countries revalued their gold reserves and afforded a wide scope for the expansion of notes. The Federal Reserve Bank revalued their central gold holding in January, 1934. They were followed by the National Bank of Australia, the National Bank of Belgium. In 1936 Italy, Switzerland and France also revalued their gold reserves. In recent years many other countries such as Argentina, Japan, Latvia, Roumania and the Netherlands revalued gold reserves three or four times above the original value.

It is evident from the above table that there was an appreciable decline in the holding of rupee coins from the year 1940-41. This was

<sup>1</sup> See Report on currency and finance (Reserve Bank of India), 1946-47, p. 110.

due to hoarding owing to the uncertainty created by the war At that time the Government of India handed over to the Reserve Bank one-rupee notes to the value of Rs 12 crores which was shown under rupee coin under a notification The coins held (including Government of India one-rupee notes) were, however, a little higher on an average and stood at Rs 20 50 crores at the end of March, 1947, which came up to 36 91 crores at the end of March, 1948, and Rs 42 02 crores on March, 1949

After the partition of India, there was division of the Assets of the Reserve Bank of India under the provisions of the Pakistan (Monetary and Reserve Bank) Order, 1947, as amended in March, 1948 According to the provisions of the Pakistan (Monetary and Reserve Bank) Order, 1947, as amended in March, 1948, on 1st July, 1948, assets of the Issue Department amounting to Rs 51.57 crores were allotted to the State Bank of Pakistan against an equivalent liability of Pakistan inscribed notes, outstanding as on 30th June, 1948, taken over by the State Bank of Pakistan A further portion of the assets in the Issue Department was transferable in terms of the Pakistan Order, 1947, as amended in 1948, to the State Bank against the return of India notes in circulation in Pakistan on 30th June, 1948 This process started in November, 1948 and was completed by 30th June, 1949 Assets transferred amounted to Rs 82 20 crores against the return of India notes up to the end of March, 1949 Subject to the later adjustments the details of the assets, amounting to Rs 133 77 crores provisionally, allocated to the State Bank of Pakistan till March, 1949, are as follows <sup>1</sup>

|                                | Rs Crores |
|--------------------------------|-----------|
| Gold coin and Bullion          | 4 40      |
| Sterling Securities            | 89 55     |
| Rupee coin                     | 4 31      |
| Govt of India Rupee Securities | 35 51     |

On the assets side of the Issue Department of the Reserve Bank, gold coin and bullion which had remained at Rs 44 42 crores since the beginning of the operations of the Bank till 1947-48 declined in 1948-49 as a result of the allocation from time to time of assets

<sup>1</sup> See Report on currency and finance (Reserve Bank of India), 1948/49, p 142

to the State Bank of Pakistan and stood at Rs. 40.02 crores at the close of the year 1949.

In connection with the holding of securities on the Issue Department by the Reserve Bank of India, a new provision was added by amending Sections 17 and 33 of the Reserve Bank Act enabling the Bank to hold other foreign currencies in addition to sterling, as India, with effect from 1st January, 1949, assumed the obligations as a member of the International Monetary Fund under Article IV of the I M F Agreement.

In accordance with the provisions of the Reserve Bank Act as amended in 1948, the Issue Department's holding of foreign securities stood at Rs. 1,135.32 crores till 25th June, 1949. On 2nd July they declined to Rs. 1,100.80 crores, the difference representing the allocation to the State Bank of Pakistan. Under the provisions of the Pakistan (Monetary System and Reserve Bank) Order, 1947, as amended in 1948, on 20th August foreign securities were further reduced by Rs. 248.16 crores to 796.64 crores on account of the payment to the U K Government in terms of the Indo U K financial Agreement for the purchase of stores and installations and pension annuities.<sup>1</sup> By the end of 1948/49 they were reduced to Rs. 741.62 crores, the major part of this reduction being due to allocation to the State Bank of Pakistan against return of India notes. The percentage of foreign securities to total notes issued and the percentage of gold and foreign securities to total notes issued declined from 86.04 and 89.41 per cent respectively at the end of 1947/48 for India and Pakistan to 62.26 and 65.62 at the end of 1948/49 for the Indian Union only.<sup>2</sup>

Another noteworthy feature was that rupee securities which stood at Rs. 102.84 crores on March, 1948, increased to 127.84 crores by 14th May and continued at that level till June, 1948. From July they declined to Rs. 114.15 crores as securities worth Rs. 13.69 crores were transferred to the State Bank of Pakistan. But on 20th August the Reserve Bank's holding of rupee securities increased about Rs. 264 crores due to the creation of *ad hoc* Treasury Bills to replace the sterling securities in terms of the Indo U K financial Agreement. By March, 1949, they stood at Rs. 367.45 crores.

1 See Report on currency and finance (Reserve Bank of India), 1948/49, p. 143.

2 See Report on currency and finance (Reserve Bank of India), 1948/49, p. 143.

## CHAPTER XI

### **The Reserve Bank of India as the Banker to Govt**

Like central banks of other countries of the world the Reserve Bank of India fulfils its function as a banker to the state

In its capacity as Government's banker, under Section 20 of the Reserve Bank Act of 1934, the Reserve Bank keeps the banking accounts of the Government of India, the provincial Governments and of the approved states, accepts moneys for their accounts and makes payment up to the amount standing to the credit of their accounts respectively. The Bank also carries out their exchange, remittances and other banking operations, including the management of the public debt.

Under paragraph 4(2) of Part II of the India and Burma ( Burma Monetary Arrangements ) Order, 1947, the Bank had the right to carry out the banking transaction of the Government of Burma. But the right of the Bank to function as a banker to the Government of Burma ceased from 1st April, 1947. In order to enable the Reserve Bank of India to wind up its affairs in Burma, the Reserve Bank of India Act, 1934, was amended in March, 1947, to provide for the deletion of all references to Burma appearing in the Act.

After the partition of India into two Dominions from 15th August, 1947, under the Pakistan ( Monetary System and Reserve Bank ) Order, 1947, the Reserve Bank of India was to continue as a banker to the Government of Pakistan up to 30th Sep, 1948. This arrangement was done with a view to maintaining a unified monetary system for the two Dominions of India and Pakistan. Later on, as a result of discussions held in March, 1948, between the Bank and the representatives of the Governments of the two Dominions, the Order of August, 1947, was amended by the Pakistan Monetary System and Reserve Bank (Amendment) Order, 1948, on 31st March, 1948. In accordance with the provisions of the amendment the Reserve Bank continued as the currency authority in Pakistan and a banker to the Government of Pakistan up to 30th June, 1948 only and not 30th Sep, 1948, as laid down in the original Order of 1947.

From 1st July, 1948, when the State Bank of Pakistan was established, the Reserve Bank ceased to function in Pakistan

### **Relation between the Central Government and the Reserve Bank**

In terms of an agreement with the Central Government concluded on the 5th April, 1935, the Reserve Bank of India is required to transact the general banking business of the Central Government and for this purpose to keep such accounts in its books as the Government may direct for which the Bank is not entitled to any remuneration except the advantage accrued from the holding of the Government's cash balance free of interest. Under the provision of the Act, the Bank is also entrusted with the management of the public debt and the issue of loans. For the management of the public debt, the Bank is entitled to charge half-yearly a commission at the rate of Rs 2000 per crore per annum. The Bank is required to maintain currency chests of its Issue Department at places prescribed by the Government and to keep the chests supplied with sufficient notes and coins to provide currency for the transactions of the Government.

Since the establishment of the Reserve Bank, the rupee loans of the Central Government are being floated through the public debt office of the Bank.

The Central Government borrows for short periods from the public by selling treasury bills through the Reserve Bank. These bills are usually sold for a term of 3 months through the offices and branches of the Banking Department of the Reserve Bank of India either by tender or at an intermediate tap rate. They are available in the following denominations —Rs 25000, Rs 50000, Rs 1 lakh, Rs 5 lakhs, Rs 10 lakhs and Rs 50 lakhs.

On maturity, treasury bills are paid at the office of the Reserve Bank from which they were issued.

The Central Government also borrows from the Bank in the form of ways-and-means advances.

The details of the loan flotations, of treasury bills sold and of ways-and-means advances taken by the Central Government from time to time since 1938-39 will be evident from the figures given below <sup>1</sup>

1. See Report on currency and finance (Reserve Bank of India), 1948-49, pp 102 and 130

| 666         | In crores of rupees |          |          |          |                      |          |
|-------------|---------------------|----------|----------|----------|----------------------|----------|
|             | 1938-39             | 1939-40  | 1940-41  | 1941-42  | 1942-43              | 1943-44  |
| Rupee loans | 437.87              | 450.23   | 574.55   | 611.85   | 744.74               | 1,006.55 |
| Treasury    |                     |          |          |          |                      |          |
| Bills and   |                     |          |          |          |                      |          |
| Ways and-   |                     |          |          |          |                      |          |
| Means ad-   |                     |          |          |          |                      |          |
| vances      | 46.30               | 54.70    | 84.90    | 136.98   | 264.70               | 110.61   |
|             | 1944-45             | 1945-46  | 1946-47  | 1947-48  | 1948-49<br>(revised) |          |
| Rupee loans | 1,212.14            | 1,492.20 | 1,529.73 | 1,517.09 | 1,478.39             |          |
| Treasury    |                     |          |          |          |                      |          |
| Bills and   |                     |          |          |          |                      |          |
| Ways and-   |                     |          |          |          |                      |          |
| Means ad-   |                     |          |          |          |                      |          |
| vances      | 86.70               | 83.33    | 79.20    | 85.84    | 373.33               |          |

The huge cost of the last world war and the enormous loan requirements of the Government of India placed a heavy burden upon the credit structure of the country. Under the stress of the burden the Reserve Bank of India had to help the Government in the flotation of Rupee loans. During the war period loans floated by the Government increased from Rs. 437.87 crores in 1938-39 to Rs. 1,212.14 crores in 1944-45. Greater use was made of ways-and-means advances and the treasury bills by the Reserve Bank to help the Government during the war, particularly in 1941-42 and 1942-43. The increase was, during the year 1941 and 1942, by 14.6 per cent and 21.9 per cent respectively. A large series of loans were floated by the Government through the Bank after 1945-46 to give practical shape to post-war economic planning and also to discharge permanent debt. In the year 1946-47 loans were floated in the shape of non-negotiable, non-interest-bearing securities for Rs. 139.25<sup>1</sup> crores for the payment of the subscription to the International Monetary Fund and for a part payment for the purchase of India's quota of shares in the International

1 See Report on currency and finance (Reserve Bank of India), 1946-47, p. 82

Bank for Reconstruction and Development The proportions of the outstandings of undated and dated loans and treasury bills to total rupee debt declined respectively from 14.7 per cent and 62.4 per cent at the end of 1946-47. Due to a further reduction in expenditure as well as borrowing from the market, the total rupee debt of the Central Government at the end of 1947-48 showed an actual decrease of Rs. 7.03 crores. This fall was due primarily to non-monetary factors such as the unsettled political conditions before and after the partition of India into two Dominions and the recurrence of the communal trouble in parts of the country during the year 1948-49. The rupee debt of the Central Government increased by Rs. 237.81 crores.<sup>1</sup> New loans were floated in the year under review in order to discharge permanent debt.

The amounts of new loans floated and permanent debt discharged in India by the Central Government through the Reserve Bank of India are given below.<sup>2</sup>

| Year              | (In crores of rupees) |                             |
|-------------------|-----------------------|-----------------------------|
|                   | New loans             | Discharge of permanent Debt |
| 1938-39           | 20.31                 | 26.61                       |
| 1939-40           | 38.23                 | 25.94                       |
| 1940-41           | 143.40                | 19.54                       |
| 1941-42           | 125.08                | 87.56                       |
| 1942-43           | 138.28                | 1.15                        |
| 1943-44           | 276.35                | 16.68                       |
| 1944-45           | 207.72                | 0.30                        |
| 1945-46           | 335.43                | 55.59                       |
| 1946-47 (Revised) | 375.09                | 334.49                      |
| 1947-48 (Revised) | 40.95                 | 57.96                       |
| 1948-49 (Revised) | 55.04                 | 98.96                       |
| 1949-50 (Budget)  | 85.00                 | 68.85                       |

From the year 1944-45 treasury bills sold by the Government showed a marked decrease till the year 1948-49 when there was a distinct increase of sale of treasury bills by 14.9 per cent.

This increase was due to sale of Treasury Deposit Receipts by the

1. See Report on currency and finance (Reserve Bank of India), 1948-49, p. 120.

2. See Report on currency and finance (Reserve Bank of India), 1948-49, p. 120.

Government through the Reserve Bank of India with a view to catering to institutional investors seeking media for short-term investment.<sup>1</sup> The Government's balance of Ways and Means Advances with the Reserve Bank also declined since 1944-45.

The highest, lowest and average month end balance of the Central Government with the Reserve Bank for each of the years 1939-40 to 1948-49 together with the year-end balances are shown in the Table below.<sup>2</sup>

| In crores of rupees |                |               |         |          |
|---------------------|----------------|---------------|---------|----------|
| Year                | Highest        | Lowest        | Average | Year-end |
| 1939-40             | 15 65 (March)  | 5 03 (July)   | 8 29    | 15 65    |
| 1940-41             | 23 08 (Feb.)   | 3 97 (April)  | 10 19   | 13 57    |
| 1941-42             | 58 68 (Feb.)   | 5 49 (June)   | 15 77   | 15 15    |
| 1942-43             | 25 88 (Feb.)   | 1 57 (August) | 12 10   | 17 41    |
| 1943-44             | 83 49 (March)  | 8 39 (June)   | 30 25   | 83 49    |
| 1944-45             | 270 54 (Jan.)  | 56 27 (May)   | 173 69  | 268 79   |
| 1945-46             | 527 20 (March) | 296 61 (May)  | 402 14  | 527 20   |
| 1946-47             | 538 06         | 422 85        | 469 01  | 422 85   |
| 1947-48*            | 422 85 (March) | 260 86 (Feb.) | x       | 274 85   |
| 1948-49†            | 242 27         | 210 36 (July) | x       | 218 90   |

#### The relation between the Provincial Governments and the Reserve Bank of India

Under Section 21(1) the Reserve Bank of India has entered into separate agreements with each of the Provincial Governments settling the terms on which it has undertaken to transact their banking business.

With the inauguration of the Provincial Autonomy on the 1st April, 1937, the Provincial Governments opened separate accounts with the Reserve Bank of India. From the 1st April, 1938, they agreed to keep certain minimum cash balances with the Reserve Bank and the Provincial Governments were allowed to meet any temporary deficits

1 See Report on currency and finance (Reserve Bank of India), 1948-49, pp. 122-23.

2 See Report on currency and finance (Reserve Bank of India), 1946-47, p. 83.

\* See Report on currency and finance (Reserve Bank of India), 1948-49, p. 121.

† See Report on currency and finance (Reserve Bank of India), 1947-48, p. 89.

either by obtaining Ways-and-Means Advances from the Bank or by issuing their own treasury bills. Under Section 163 of the Government of India Act, 1935, subject to certain restrictions each Provincial Government is allowed to borrow on the security of the revenues of the Province and in exercise of this power, several Provincial Governments have floated loans through the Reserve Bank from the 1st April, 1937. Since then these loans have been more or less a regular feature of the money market. In terms of the Bank's agreement with each of the Provincial Governments, the Provincial Governments have also borrowed from the Bank in the form of Ways-and-Means Advances for short periods.

If any Provincial Government desires to remit funds outside the area within its jurisdiction, in supersession of the terms of agreement entered into with each of the Provincial Governments, the Reserve Bank is entitled to make a charge for such remittances at rates not exceeding those which the Bank charges to scheduled banks subject to a minimum charges of 4 annas for each remittance.

The details of the Provincial debt position since 1938-39 will be evident from the table<sup>1</sup> given below.

Provincial debt position (gross total debt which includes (1) permanent debt, (2) floating, (3) loans from Central Government, and (4) unfunded debt

| Year                | Amount (In crores of rupees) |
|---------------------|------------------------------|
| 1938-39 ..          | 163.20                       |
| 1939-40             | 167.61                       |
| 1940-41 .           | 169.91                       |
| 1941-42             | 169.15                       |
| 1942-43             | 170.26                       |
| 1943-44             | 196.28                       |
| 1944-45             | 174.35                       |
| 1945-46             | 162.97                       |
| 1946-47 (Revised)   | 157.79                       |
| 1947-48 (Revised)   | 119.88                       |
| 1948-49 (Revised) . | 154.92                       |

<sup>1</sup> See Report on currency and finance (Reserve Bank of India), 1948-49 pp. 102 & 103

After the year 1944-45 the need for provincial borrowings was to implement the several blue prints for post-war development schemes prepared by the provinces. After the partition, the outstanding total debt of all the provinces in the Dominion of India showed a decline of Rs 37.91 crores from Rs 157.79 crores at the end of 1946-47 to Rs 119.88 crores at the end of 1947-48.

The table below shows the year-end cash balances of the Provincial Governments with the Reserve Bank since 1945-46.

| Year    | Amount (In lakhs of rupees) |
|---------|-----------------------------|
| 1945-46 | 31.61 (March)               |
| 1946-47 | 30.89 ( " )                 |
| 1947-48 | 21.10 ( " )                 |
| 1948-49 | 28.18 ( " )                 |

#### Adviser to Government on financial matters —

By virtue of its position as the central bank of the country and its close association with the banks and money market, the Reserve Bank of India is in a position to render advice to the Central and the Provincial Governments on financial and banking matters. The Bank advises Governments and Government Departments in connection with the flotation of new loans, conversions, investment of funds, legislation affecting banking and credit etc. In recent years the Central Government sought the advice of the Reserve Bank in connection with the establishment of the Industrial Finance Corporation and in the passing of the Banking Companies Act of 1949. In connection with the flotation of new loans, in its capacity as a banker to the Central and Provincial Governments, it is able to co-ordinate their borrowing programmes so as to minimise any risk of uneconomic competition. With the consent of the governments, the Reserve Bank has drawn up a system of underwriting Provincial loans with the co-operation of the larger scheduled banks and broker's firms which has materially facilitated the flotation of such loans. In carrying out the borrowing operations of the Government, efforts are made by the Bank, on the one hand, to minimise the effects of such operations on trade and industry and on the other, to obtain the best possible terms for the Government.

## CHAPTER XII

### **The Reserve Bank of India as a banker for other banks**

Like every Central Bank which acts as a holder of the cash reserves of commercial banks with a view to regulate the credit and currency of the country, the Reserve Bank of India, under Section 42 of the Act, has the right to hold the cash balances of all banks included in the second schedule. Therefore, the Indian joint-stock banks are divided into two classes, namely, Scheduled Banks and Non scheduled Banks.

The Section 42(6) of the Act provides that a bank having a paid-up capital and reserves of an aggregate value of not less than 5 lakhs is entitled to be included in the second schedule to the Reserve Bank of India Act. The words "aggregate value of paid-up capital and reserves" mentioned in this Section are interpreted to mean the real or exchangeable value of the paid-up capital and reserves and not merely the book value as shown in the balance sheet.

Under Sub-section (6) of the same Section, a bank is liable to be excluded from the schedule if the value of its capital and reserve falls below the prescribed minimum or if it goes into liquidation or otherwise ceases to carry on banking business.

Moreover, before a bank is included in the second schedule, the Reserve Bank institutes an inspection of the affairs of the bank and permission is granted, if satisfied. The inclusion of a bank in the second schedule is no continuing guarantee of its soundness or stability, but the inclusion may be cancelled if the Reserve Bank subsequently found that the affairs of any such bank are not being conducted satisfactorily.

The number of banks included in the second schedule and of banks excluded from the second schedule is known from the following figures

| Year    | Inclusion | Exclusion |
|---------|-----------|-----------|
| 1946-47 | 8         | 1         |
| 1947-48 | 6         | 1         |
| 1948-49 | 3         | 4         |

Prior to the promulgation of the Banking Companies (Inspection) Ordinance, 1946, which was, later on, incorporated to the Banking

Companies Act of 1949, the Reserve Bank carried out its inspections of banks under Section 42(6) of the Reserve Bank of India Act with the object of testing the eligibility of banks for inclusion or retention in the second schedule to the Reserve Bank of India Act. The scope of an inspection under the Banking Companies (Inspection) Ordinance, 1946, was much wider, "covering, as it did, not only a quantitative assessment of the bank's paid-up capital and reserves, but also a qualitative assessment of its management, policy and methods of business from the point of view of the depositors' interests" <sup>1</sup>

Therefore, during the year 1946-47 inspections of banks including those for the purpose of testing the eligibility of banks for inclusion or retention in the second schedule were carried out by the Reserve Bank under the Ordinance. But the inspection of banks incorporated outside British India was carried out under Section 42(6) of the Reserve Bank of India Act as the inspection of such banks did not fall within the provisions of the Ordinance.

Accordingly the Reserve Bank carried out its inspection

During the year 1946-47, 19 banks and in the year 1947-48, 12 banks were inspected under the Ordinance and 8 banks in the same two years under Section 42(6) of the Reserve Bank of India Act <sup>2</sup>

#### **Relation of scheduled banks with the Reserve Bank**

Like "member banks" of the U S A and other countries, scheduled banks are compulsorily to maintain under Section 42(1) of the Act a minimum balance equal to 5 per cent of their demand and 2 per cent of their time liabilities with the Reserve Bank. In case any scheduled bank is unable to comply with the above requirements, the Reserve Bank can charge the bank the penal interest at the rates prescribed in Section 42(3). By the Reserve Bank of India (Third Amendment) Act, 1940, this penalty has been made rigorous, the Reserve Bank is empowered to prohibit defaulting banks from accepting fresh deposits if the balance continues below the prescribed minimum and is also empowered to penalise directors, and other officers who knowingly and wilfully are parties to a default.

<sup>1</sup> See the 13th Annual Report of the Reserve Bank of India, 1947

<sup>2</sup> See the 13th and the 14th Annual Reports of the Reserve Bank of India, 1947 & 1948

A scheduled bank is further required to submit a weekly return of its position in the form prescribed by Section 42(2) to the Central Government and to the Reserve Bank

Failing to submit the statement, a scheduled bank is liable to pay penalty of Rs 100/- for each day during which the failure continues

With regard to the holding of legal cash reserves of commercial banks, the Reserve Bank of India copied the Federal Reserve System. The centralisation of cash reserve by a central bank is a means of control over the banking and credit situation. In 1931, the Macmillan Committee observed that "the main reason for expecting banks to keep reserves above the minimum needed for daily convenience is no longer primarily the safety and solvency of the banks themselves, as it was in the former times, but the necessity of providing the Central Institution with adequate resources wherewith to manage the monetary system and safely furnish the member institutions with precisely those conveniences, for rapidly liquidating earning assets, upon which the latter depend when determining the amount of their Cash Reserves"<sup>1</sup>

In the same year, the Committee, on Bank Reserves of the Federal Reserve System, pointed out "that the two main functions of legal requirements for member bank reserves under the present banking structure are, first, to operate in the direction of sound credit conditions by exerting an influence on changes in the volume of bank credit, and secondly, to provide the Federal Reserve Banks with sufficient resources to enable them to pursue an effective banking and credit policy."<sup>2</sup>

Experience has shown that by mere enforcing the statutory obligation of maintaining cash reserves by commercial banks with a central bank, the central bank could not keep control over the banking and credit situation of a country unless it adopted a system of varying reserve requirements of commercial banks with it. In many countries, such as, the U. S. A., New Zealand, Mexico, Costa Rica, etc., by varying reserve requirements of member banks, central banks of those countries succeeded fairly to enforce control over the credit situation in recent years, particularly in the post-war period

<sup>1</sup> See the Macmillan Committee Report, p 158

<sup>2</sup> See the Report of the Committee of the Federal Reserve System on Bank Reserves, p 5

In India, the purpose in demanding minimum cash balances from the scheduled banks by the Reserve Bank of India, was explained in the following words

"The accumulation of these balances with the Reserve Bank places it in a position to use them freely in emergencies to support the scheduled banks whenever they seek its assistance as a lender of last resort"<sup>1</sup> Again, it is stated that "the real purpose of these balances is not to guarantee the deposits of the public with banks.. The primary purpose of these reserves is to enable the Central Bank to exercise some measure of control over the banking system"<sup>2</sup>

The Reserve Bank of India is not yet legally empowered by any legislation to vary the legal ratios of scheduled banks with a view to enforce control over the credit structure of the country though the Reserve Bank itself has recognised that the primary purpose of the statutory balances is to enable the Bank to exercise some amount of control over scheduled banks

This question of applying the variable reserves ratio by the Reserve Bank for controlling credit in India will be taken up later on

It is also necessary to bear in mind that as non-scheduled banks were outside the control of the Reserve Bank, the Reserve Bank's authority to exercise control over the banking system could be questioned. Though the Bank tendered advice to the non-scheduled banks when asked for, it had no direct touch with them till the promulgation of the Banking Companies (Inspection) Ordinance in 1946 and till the passing of the Banking Companies Act of 1949

Under the Banking Companies Act of 1949, the Reserve Bank is empowered to exercise some measure of control over non-scheduled banks

Therefore, with regard to the cash reserve position of non scheduled banks, Section 18 of the Banking Companies Act of 1949 provides that "every banking company not being a scheduled bank shall maintain by way of cash reserve in cash with itself or in an account opened with the Reserve Bank, or partly in cash with itself and partly

1. See Functions and Working of the Reserve Bank of India (Published by the Reserve Bank of India, 1941), p 8

2. See Functions and Working of the Reserve Bank of India (Published by the Reserve Bank of India, 1941), p 40.

in such account, a sum equivalent to at least two per cent of its time liabilities and five per cent of its demand liabilities and shall file with the Reserve Bank before the fifteenth day of every month three copies of a statement of the amount so held on Friday of each week of the preceding month with particulars of its time and demand liabilities on each Friday "

In accordance with the provisions of the Banking Companies Act of 1949, as stated above, an attempt is made to exercise control over the banking structure of the country. But it is questionable how far the Reserve Bank will be able to influence the credit situation of the country as it has been observed that mere statutory provision for keeping minimum cash reserves by commercial banks may not be sufficient for controlling the credit situation of the country.

#### **Loans and advances to Scheduled Banks**

Scheduled banks, under Section 17 of the Reserve Bank of India Act, may expect to enjoy the facility of financial accommodation in the shape of the rediscount of eligible bills or loans and advances against eligible securities from the Reserve Bank. Section 17(a) provides kinds of paper which the Bank may accept for rediscount. They include —

(1) *bona fide* commercial or trade bills, or promissory notes as defined in the Indian Negotiable Instrument Act drawn on and payable in India, maturing within 90 days and bearing at least two signatures, one of which is that of a scheduled bank ,

(2) bills issued or drawn for the purpose of holding or trading in Government securities and in certain other public securities, but otherwise having the same qualification as above ,

(3) agricultural bills drawn for the purpose of financing seasonal agricultural operations or the marketing of crops, bearing two or more signatures, one of which is that of a scheduled bank or a provincial co-operative bank and maturing within nine months , and

(4) bills including treasury bills drawn in or on any place in any country outside India which is a member of the I M F, maturing within 90 days, and endorsed by a scheduled bank

The Act also provides under the same Section for the extension of loans and advances to scheduled banks for a maximum period of 90 days against the security of (a) gold or silver or documents of title to

the same, (b) trustee securities, (c) bills of exchange and promissory notes eligible for purchase or rediscount by the Bank, (d) promissory notes of any scheduled bank or provincial co-operative bank "supported by documents of title to goods which have been transferred, assigned or pledged to any such bank as security for a cash credit or overdraft granted for *bona fide* commercial or trade transactions, or for the purpose of financing seasonal agricultural operations or the marketing of crops" (which in the clause referred to "documents of title to goods" and not to "goods")

The lending policy of the Reserve Bank as well as the kind of accommodation which scheduled banks may obtain from the Bank are explained in the following words

"In conformity with the usual practice of Central Banks in other parts of the world and with a view to promoting the development of banking on sound lines in this country, the Reserve Bank in extending its credit to the scheduled banks has to take into consideration not only the nature of the security offered to it but also the general character of the investments of the applying bank, the manner in which its business as a whole is being conducted, whether for instance it offers excessively high rates of interest in order to attract deposits, whether it seeks help from the Reserve Bank in normal times when funds in the money market are ample and whether it has been overtrading and extending an undue amount of credit for speculative purposes in commodities or securities or indulging in unsecured business to an excessive extent. It is to be noted in this connection that the Reserve Bank is empowered by the Act to grant only temporary accommodation. With a view to ensuring that its credit facilities are not abused in the way the Reserve Bank may call for such information or impose such conditions on the borrowing scheduled bank as it may consider necessary, and a scheduled bank requiring assistance from the Reserve Bank is expected to supply such information as may be called for"<sup>1</sup>

So it is clear from the above few lines that a scheduled bank is not entitled to rediscount bills or to secure loans and advances from the

---

<sup>1</sup> See Functions and Working of the Reserve Bank of India (Published by the Reserve Bank of India, 1941), pp. 41 & 42

**Reserve Bank** It has to qualify for such aid by satisfying the bank about its soundness and stability. A bank included in the second schedule may gain prestige in the eyes of the public. But it is quite erroneous to believe on the part of the public that the Reserve Bank gives guarantee about the solvency of the scheduled bank.

It is necessary to bear in mind that mere scheduling as such is no assurance that a bank in difficulties will receive help from the Reserve Bank. The Reserve Bank is to be satisfied about a bank's ability to liquidate its assets before it assists a bank in its difficulties. Therefore, the Reserve Bank always insists upon a bank for holding Government securities as they assure the safety and ultimate realisation of Reserve Bank funds lent to the bank. By the inclusion in the second schedule only a small number of banks under the provisions of the Reserve Bank of India Act, the Act did not envisage a radical transformation of the existing banking structure. All that it attempted was to bring the scattered and organised elements of the Indian banking system into the orbit of the Reserve Bank system and to give that structure a loose unity and coherence among them.

#### **Relation of Non-scheduled Banks with the Reserve Bank.**

A large number of small banks having their paid-up capital and reserves below 5 lakhs for which they have not been included in the second schedule of the Reserve Bank Act, remained outside the influence the Reserve Bank of India for a long time.

On account of its lack of control over the important sections of the money market, and as a result of bank failures, the Reserve Bank of India published a memorandum in 1940 for banking reforms in India.

Though efforts were made by the Reserve Bank to give guidance to non-scheduled banks, the response was insignificant in comparison to offers made by the Bank.

Power of the Reserve Bank over all other banks other than scheduled banks is increased by the Banking Companies Act of 1949 with a view to draw all banking institutions into the orbit of the Reserve System so that the Reserve Bank may exercise certain amount of control over the banking structure of the country.

Under the provisions of the Banking Companies Act of 1949, the Reserve Bank is now empowered to control the entire joint-stock bank

ing system in India. Under Sections 20 & 21 it may give directions to banking companies in regard to lending policies, the purpose for which loans or advances may or may not be made, the margins to be maintained in respect secured advances and the rates of interest to be charged on advances. If any loan or advance granted by a banking company appears to the Reserve Bank as detrimental to the interest of the depositors, the Reserve Bank may prohibit or may caution the bank from granting any such further loans and advances. It may call for periodical as well as *ad hoc* returns and in the public interest may also publish such informations in any consolidated form the Bank deems fit. Under Section 35 of the Act the Reserve Bank may, in its own initiative or according to the direction of the Central Government, cause inspection on any bank.

The Reserve Bank's permission is required if a banking company intends to open a new branch or to transfer an existing one.

The Reserve Bank, under the provisions of the Act, has been given certain powers in respect of voluntary winding up and amalgamations of banking companies, and it may be appointed as the official liquidator by a court.

From the above-stated provisions of the Banking Companies Act of 1949 it appears that powers are vested to the Reserve Bank of India with a view to increase the stability of banking companies in the public interest.

#### **Remittance facilities.**

Both scheduled banks and non-scheduled banks have been granted remittance facilities at concessional rates. Non-scheduled banks desirous of availing themselves of the concession rates are to fulfil the following conditions as stated in the Reserve Bank's circular letter No ACD 764/24A-40, dated the 23rd October, 1940 :—

- (i) They must be companies registered under the Indian Companies Act,
- (ii) they must be doing banking business in British India in accordance with the provisions of the Indian Companies Act relating to banking companies, and
- (iii) they must have a minimum paid-up capital and reserves of Rs 50,000/- .

## CHAPTER XIII

### Exchange obligation

The Reserve Bank of India is entrusted with the duty of maintaining the stability of the external value of the rupee. For this purpose, under Sections 40 and 41 of the Reserve Bank of India Act of 1934, the Bank was obliged to sell and buy sterling within certain fixed rates provided the amount offered or demanded in any transaction was not less than £ 10 thousand. The Bank was to sell sterling to anyone at a rate not below 1 s 5½ d for a rupee and buy sterling at a rate not higher than 1 s 1½ d for a rupee. The Bank is also obliged to meet the exchange requirements of the Government for which the Bank purchases sterling from the scheduled banks by weekly tender or at an intermediate tap rate. This method of purchase helped the banks to transfer their funds from London to India in the busy season and thus it tended to relieve the seasonal stringency in the Indian Money Market. Any change in these rates could be made only by a special legislation subject to the approval of the Governor General of India.

Consequent on India's membership in the International Monetary Fund and the International Bank for Reconstruction and Development, and fixing of par value in accordance with the Articles of the Fund Agreement, sterling ceased to be the sole determinant of the external value of the rupee. Therefore, Sections 40 and 41 of the Reserve Bank of India Act of 1934 were repealed, and by the enactment of the Reserve Bank of India (Second Amendment) Act, 1947, the convertibility of the rupee into other currencies was provided for. The Reserve Bank is empowered to buy and sell other foreign currencies besides sterling at such rates and on such terms and conditions as determined by the Central Government in conformity with their obligations as a member of the Fund.

### Exchange control in war time

The exchange control became an important feature of the Reserve Bank's working after the outbreak of the last World War of 1939. Part XIV of the Defence of India Rules issued under the Defence of

India Act, 1939, provided for the control of all dealings in foreign exchange

Rule 91 of part XIV of the Defence of India Rules imposed the following restrictions —

(i) Acquisition of any foreign exchange by residents in India was prohibited,

(ii) persons authorised by the Reserve Bank of India had the authority to deal in such foreign exchange

(iii) Foreign exchange could be acquired for only meeting reasonable business requirements, reasonable travelling or personal expenses, etc., subject to the approval of the Reserve Bank of India

On the outbreak of war the Reserve Bank issued licences to deal in foreign exchange to all recognised exchange banks and also to other scheduled banks which had dealt in foreign exchange in the past

By a notification, the Reserve Bank granted these banks free remittance facilities from India to other countries within the sterling area. No remittance could be done in countries outside the sterling area without the previous sanction of the Reserve Bank

Remittances were divided into five categories —

- (i) Payment of imports
- (ii) Petty private remittances
- (iii) Travelling expenses
- (iv) \* Other trade purposes (i.e., freight, profits and royalties etc)
- (v) Capital remittances

The object of exchange regulations in regard to remittances was to prevent any flight of capital and to make speculative or arbitrage operations in exchange impossible. In order to attain this objective, authorised dealers were permitted to deal in foreign exchange under the following conditions

Each authorised dealer was permitted to sell exchange against (i) payment of imports provided the applicant could prove that goods had been imported into India by producing custom entry forms as evidence,

against (ii) petty private remittances and (iii) travelling expenses upto certain limits laid down in those exchange regulations, against (iv) other trade purposes supported by certificates from recognised auditors.

An authorised dealer was allowed to sell foreign exchange against remittances of capital nature in exceptional circumstances with the previous sanction of the Reserve Bank

Moreover, each authorised bank was to submit to the Reserve Bank every day a statement of its actual sales of foreign exchange supported by the application forms. The Exchange Control Department of the Reserve Bank of India scrutinised those applications and satisfied itself about the observance of those exchange regulations

In order to control the proceeds of export from India to countries outside the sterling area, the export control scheme was instituted. The objects of the export control scheme were to ensure first, that the foreign exchange proceeds of export were returned to India and not retained abroad, and secondly, that exports were financed in certain specified ways so that the maximum exchange value was obtained

Authorised dealers were required to submit a weekly statement to the Reserve Bank indicating their exchange position and if they were heavily over-bought, those authorised dealers were required to sell their surplus foreign exchange to the Bank of England unless they could satisfy the Reserve Bank that they were required for local sales

The general basis on which exchange control was operated was laid down with the beginning of the war in September, 1939, but later on, the policy was modified from time to time during the war period on account of constant changes in the political situation caused by war and the increased necessity for conserving foreign exchange

As for instance, the Reserve Bank of India granted licences to a few cotton dealers to purchase dollar exchange as restriction on such exchange made cotton business impossible with the U. S. A.

Under the Defence of India Rules 91, 93 and 94 the Reserve Bank was permitted to acquire certain American securities by March, 1941. This arrangement was intended to facilitate exchange between India and the U. S. A. as the political situation changed owing to the latter's entry into the war.

#### **Exchange control in the post-war period**

The financial provisions of the Defence of India Rules were extended by the Emergency Provisions (Continuance) Ordinance, 1946, which expired on 31st March, 1947.

Although there were no changes in the Exchange Control System, certain events took place after the war which had considerable influence on the system in the future. Consequent on the obligation to negotiate settlement of sterling balances with India by the United Kingdom as a result of the Anglo-American Loan Agreement and consequent on India's membership in the International Monetary Fund, India's future foreign exchange relationship went under a considerable change.

In terms of the Articles of the Fund sterling ceased to be the sole determinant of the external value of the rupee and the convertibility of the rupee into other currencies was therefore provided for by the enactment of the Reserve Bank of India (Second Amendment) Act, 1947, by repealing Sections 40 and 41 of the Reserve Bank Act of 1934.

The financial provisions of the Defence of India Rules which were extended by the Emergency Provisions (Continuance) Ordinance, 1946, were given statutory recognition with certain modifications by the passing of the Foreign Exchange Regulation Act, 1947, which came into force on the 25th March, 1947. The effect of the Act is to continue the system of Exchange Control for a period of 5 years with power to continue it for a further period of three years.

The Act *inter alia* makes provisions for the following —

- (i) Restrictions on dealing in foreign exchange
- (ii) Restrictions on import and export of certain currency and bullion
- (iii) Acquisition by the Central Government of foreign securities
- (iv) Regulation of export and transfer of securities

Under the provisions of the Foreign Exchange Regulation Act of 1947, the Reserve Bank of India continues the same system of Exchange Control as framed under the Defence of India Rule 91. But one important change is introduced under Section 5 of the Act from the Defence of India Rules. In order to extend control to operation in rupees with non-residents, Section 5 of the Act prohibits payment to, for or on behalf of persons resident outside India except with the permission of the Reserve Bank of India. This Section is similar to the previous Defence of India Rule 92 except that it prohibits transactions with any person resident outside India, while the

Defence of India Rule only prohibited transactions with persons resident outside the sterling area

In the absence, therefore, of a general permission from the Reserve Bank the effect of this Section is to bring to an end the freedom of transfer between India and other countries in the sterling area

The Foreign Exchange Regulation Act of 1947 is designed giving wide powers to Central Government and the Reserve Bank to control transaction in foreign exchange and securities and the import and export of bullion and currency notes

The manner and degree of control are to be decided by the policy of the Government, which is to be influenced by the Balance of Payments positions of the country and Government of India's obligation to the International Monetary Fund

The main objective of the Act is to restrict the movement of capital unless directly connected with the furtherance of trade and also to aim at the multilateral convertibility of the rupee as soon as possible. Meanwhile, it was the intention of the Government to take help of the Act in order to maintain equilibrium in India's Balance of Payment. Therefore, by taking advantage of the transitional period allowed by the International Monetary Fund rules, under which India could continue exchange control for a period of three years, the Government empowers the Reserve Bank of India to continue import control and to postpone making its currency freely convertible.

## CHAPTER XIV

### The Issue and the Banking Departments of the

#### Reserve Bank of India

Under Section 53 of the Reserve Bank of India Act of 1934, the Reserve Bank of India is required to prepare a weekly statement of its accounts of the Issue Department and of the Banking Department and is to submit the statements to the Government of India every week in a form prescribed by the Government. This statement of accounts of both departments is published weekly in the Gazette of India and leading financial periodicals throughout the country and reflect the conditions prevailing in the money and financial markets during the week it relates. Under the provisions of the same Section of the Act, the Annual Balance Sheet of the Bank and the Profit & Loss Account appended thereto, duly certified by the auditors, is also published in the same prescribed form as the weekly statement closing the accounts of the Bank as at the 30th June every year.

The following is the example of a weekly statement published by the Reserve Bank which reflects the important operations of the Bank

#### Issue Department

| <i>Liabilities</i>                   |                    | <i>Assets</i>                                          |       |
|--------------------------------------|--------------------|--------------------------------------------------------|-------|
| Notes held in the Banking Department | Rs                 | A Gold coin and Bullion                                | Rs    |
| Notes in circulation                 | (a)                | Held in India                                          |       |
|                                      | (b)                | Held outside India                                     |       |
| Total notes issued                   | Foreign securities |                                                        | _____ |
|                                      | Total of "A"       |                                                        |       |
|                                      | B                  | Rupee coin                                             |       |
|                                      |                    | Government of India                                    |       |
|                                      |                    | Rupee Securities                                       |       |
|                                      |                    | Internal Bills of Exchange and other commercial papers |       |
|                                      |                    | Total assets                                           | _____ |

**Banking Department**

| <i>Liabilities</i> |       | <i>Assets</i>            |       |
|--------------------|-------|--------------------------|-------|
|                    | Rs    |                          | Rs    |
| Capital            |       | Notes                    |       |
| Reserve fund       |       | Rupee coin               |       |
| Deposits --        |       | Subsidiary coin          |       |
| (a) Government     |       | Bills purchased          |       |
| (1) Central        |       | and discounted           |       |
| Government         |       | (a) Internal.            |       |
| (2) Other          |       | (b) External             |       |
| Governments        |       | (c) Government           |       |
| (b) Banks          |       | Treasury Bills           |       |
| (c) Others         |       | * Balance held abroad    |       |
| Bills payable,     |       | Loans and advances       |       |
| Other liabilities  |       | to Governments           |       |
|                    |       | Other loans and advances |       |
|                    |       | Investments              |       |
|                    |       | Other Assets             |       |
|                    | ----- |                          | ----- |
| Total              |       | Total                    |       |

**Issue Department Liabilities**

On the liabilities side of the Issue Department there are two main items, viz, notes held in the Banking Department and notes in circulation. In regard to the first item the amount of notes held in the Banking Department agrees with the total notes shown on the assets side of the Banking Department. These notes form part of the total cash balance of the Reserve Bank. The second item is notes in circulation. Formerly notes circulated in India and in Burma were shown separately. Since the termination of the Burma Monetary Arrangements Order, 1937, from 1st April, 1947, notes in circulation in Burma are not shown in the Balance Sheet. Notes in circulation, as shown in the weekly statement, comprise all notes issued by the Reserve Bank other than those held in the Banking Department and include notes held by Government treasuries and commercial banks and by the public. Changes in note circulation which can be perceived from the weekly statement reflect the currency requirements of the country.

\* Includes cash and short term securities

**Assets —**

The assets side of the Issue Department shows the cover which is held against the notes issued by the Reserve Bank. The first item which is shown in the statement is the gold coin and gold bullion held by the Bank under Section 33 of the Reserve Bank of India Act of 1934 against the notes issued by it. Though this item is shown under two heads namely gold held in India and gold held outside India, it is interesting to note that at present the entire stock of gold is held in India. It will not be out of place to mention that gold coin and bullion which had remained at Rs 44 33 crores since the beginning of the operations of the Bank till 1947-48, declined as a result of the allocation of assets to the State Bank of Pakistan. At present they stand at Rs 40 02 crores.

The next important item is the foreign securities against which notes are issued. Formerly the Reserve Bank was allowed to issue notes against sterling securities only in terms of Section 33(6) of the Reserve Bank Act of 1934. Consequent on India's membership of the International Monetary Fund in terms of the Fund agreement a new provision is added by amending Sections 17 and 33 of the Reserve Bank of India Act enabling the Bank to hold other foreign currencies in addition to sterling as a part of the legal cover for the note issue.

The rupee coin held within "B" group of assets in the Issue Department comprises whole rupees held by the Reserve Bank for giving facilities to the public to convert notes into coin. Under Section 33(4) of the Act, the coin is valued at its face value in the weekly statements and in the Balance Sheets. Since July, 1940, the one-rupee notes issued under the Currency Ordinance No IV of 1940 are also grouped under rupee coin, sufficient amount of rupee securities is kept also as a legal cover against note issue on the assets side of the Issue Department. In order to ensure elasticity to the note issue, provision is also made for the issue of notes against assets of internal bills of exchange and other commercial bills within the group "B". But due to complete absence of eligible commercial paper in the Issue Department the yearly average amount of total notes held in the same Department on the liabilities side and the amount of Assets held as legal cover against such note issue within groups "A" and "B" can be estimated from the table given in P 148.

### Banking Department Liabilities

On the liabilities side of the Banking Department, the first two items are the paid-up capital and the reserve fund. It was stated before that the capital of the Reserve Bank of India was 5 crores consisted of shares of Rs 100/- each held by the public with the exception of Rs 2,20,000 which was held by the Government for disposal to directors to enable them to obtain the minimum share qualification. Under the provisions of the Reserve bank (Public Ownership) Act of 1948, the total amount of capital is now being held by the Government.

The amount of reserve fund was provided for by the Government of India in the form of Government securities.

The deposits of the Bank are shown under three main heads namely Government, banks and others. The Government deposits are divided into two heads namely Central Government deposits and deposits from other Governments. The deposits from other Governments means deposits received under Provincial Governments Accounts. Generally the Central Government as well as Provincial Governments maintain certain minimum balances with the Reserve Bank. These balances normally increase when taxes are paid in and decline when the Central Government and Provincial Governments have to make disbursements.

Deposits shown in the liabilities side of the Banking Department under the head "banks", comprise the deposits maintained by the scheduled banks in terms of Section 42 of the Act. The changes in these deposits are important to the conditions prevailing in the money market. During the busy season i.e., from November to May, the excess deposits of the scheduled banks with the Reserve Bank usually show a decline but they generally increase during the slack season from June to October.

Other deposits include those of non-scheduled banks, big railways, big utility companies and of semi-public bodies. Non-scheduled banks are permitted to open accounts under certain conditions. In terms of section 18 of the Banking Companies Act of 1949 non-scheduled banks may keep 2 per cent of their time liabilities and 5 per cent of their demand liabilities with the Reserve Bank of India.

Of the remaining two items on the liabilities side of the Banking Department namely "Bills payable" and "other liabilities", the

former comprises mainly the various forms of bills drawn by the offices of the Bank upon each other. The latter includes the various amounts held in suspense, principally transactions in transit between the offices of the Bank and profits for payment to the Government.

#### Assets —

On the assets side the first three items are notes, rupee coin and subsidiary coin. They form the cash balance of the Reserve Bank. Notes held in the Banking Department appear also on the liabilities side of the Issue Department. Under rupee coin one-rupee notes are now included since 1940.

Bills purchased and discounted are divided under three heads namely internal, external and government treasury bills. The Reserve Bank of India has so far discounted commercial bills of small amounts, owing to cheap money conditions. On the other hand, the Bank discounts a large number of treasury bills of the Central and Provincial Governments.

The Balances held abroad include cash and short-term securities held on account of the Reserve Bank of India by the Bank of England. The short-term securities consist entirely of United Kingdom treasury bills. Other United Kingdom securities are held under "Investment".

"Loans and Advances to Governments" refer to such advances which are made to the Central Government and Provincial Governments by way of ways-and-means advances under Section 17(5) of the Reserve Bank Act of 1934 and are repayable in each case within three months from the date of advance. "Other loans and advances" include such advances which are made to the Bank's other customers.

The investments consist of rupee securities of the Government of India and of the Government of United Kingdom. They also include those securities which were delivered to the Bank by the Central Government in respect of its reserve fund.

The item "other assets" refers to furniture, fittings, stationery and certain items in course of collection.

The following table shows the annual averages of liabilities and assets of the Banking Department of the Reserve Bank of India from 1935-36 to 1948-49.

**RESERVE BANK OF INDIA    Banking Department, since 1935-36.**  
*Average Friday Figures (In Lakhs of rupees)*

| Liabilities                                                     | 1935-36 | 1936-37 | 1937-38 | 1938-39 | 1939-40 | 1940-41 | 1941-42 | 1942-43 | 1943-44 | 1944-45 | 1945-46 | 1946-47 | 1947-48 | 1948-49 |
|-----------------------------------------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
|                                                                 | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   | 10,00   |
| 1 Paid up Capital                                               | 11,26   | 9,83    | 11,37   | 14,90   | 6,84    | 10,03   | 9,65    | 13,99   | 29,31   | 182,67  | 396,93  | 469,54  | 366,79  | 222,67  |
| 2 Reserve Fund                                                  | 27,26   | 26,55   | 24,96   | 16,19   | 17,82   | 96,84   | 37,73   | 8,10    | 13,16   | 16,93   | 20,68   | 22,62   | 16,93   | 16,62   |
| 3 Bankers' Deposits                                             | 9       | 41      | 69      | 75      | 1,05    | 1,91    | 3,89    | 3,30    | 6,65    | 13,25   | 16,56   | 14,24   | 34,21   | 80,53   |
| 4 Other Deposits                                                | 91      | 1,13    | 87      | 1,28    | 1,54    | 2,65    | 4,33    | 7,91    | 10,82   | 14,06   | 16,82   | 18,32   | 14,56   | 56,52   |
| 5 Other Liabilities                                             |         |         |         |         |         |         |         |         |         |         |         |         |         | 19,33   |
| <b>Assets</b>                                                   |         |         |         |         |         |         |         |         |         |         |         |         |         |         |
| 1 Notes and Coin                                                | 27,66   | 25,90   | 25,70   | 26,38   | 18,83   | 17,39   | 12,35   | 11,92   | 10,67   | 11,19   | 16,72   | 32,85   | 47,24   | 22,12   |
| 2 Bills purchased and discounted                                |         | 1       | 6       | 1,53    | 2,87    | 97      | 27      | 68      | 91      | 1,46    | 3,35    | 2,33    | 2,62    | 4,28    |
| 3 Balances held abroad (include cash and short term securities) | 14,99   | 13,61   | 13,48   | 4,21    | 12,84   | 39,32   | 46,08   | 70,11   | 111,72  | 237,38  | 488,33  | 528,83  | 406,95  | 307,78  |
| 4 Loans and Advances to Govts                                   | 86      | 1,54    | 79      | 1,73    | 1,05    | 2,01    | 4,09    | 1,49    | 49      | 43      | 22      | 5       | 1,57    | 1,71    |
| 5 Other Loans and Advances                                      |         |         |         |         |         |         |         |         |         |         |         |         |         |         |
| 6 Investments                                                   | 5,47    | 6,04    | 7,12    | 6,96    | 7,35    | 7,78    | 8,96    | 7,12    | 7,61    | 13,13   | 24,65   | 31,70   | 81,53   | 3,94    |
| 7 Other Assets                                                  | 51      | 89      | 79      | 90      | 1,76    | 1,17    | 1,76    | 3,30    | 3,68    | 3,78    | 7,43    | 22,18   | 4,85    | 4,14    |

\* See Report on Currency and Finance, 1948-49, p 218

On the liabilities side of the Banking Department, Government deposits showed a large increase after 1938. This was due to the fact that since 1st April Provincial Governments maintained certain minimum balances with the Reserve Bank of India in accordance with the terms of the agreements entered into with them. Government deposits remained steady till 1943-44; they showed a marked increase. In 1944-45 the deposits of the Central Government increased to Rs. 162.67 crores from Rs. 29.31 crores in 1943-44. In the year 1945-46 and 1946-47 the average deposits of the Central Government was much higher than previous years. In 1947-48, the deposits of the Central Government fluctuated enormously, they showed a continuous downward trend and stood at Rs. 267.47 crores on the 26th March, 1947.<sup>1</sup> This decline can be accounted for by the payment made to the Government of Pakistan in settlement of their claims to the balance of the undivided Central Government.

The deposits of the Provincial Governments also showed uncertain trends. Before the partition, they fluctuated between Rs. 10.98 crores and Rs. 29.62 crores. The same uncertain trend continued thereafter, the deposits of the Provincial Governments in India moving between Rs. 24.41 crores and Rs. 7.82 crores and those in Pakistan between Rs. 5.51 crores and Rs. 0.08 crore.<sup>2</sup>

During the first half of 1948-49 deposits of the Government of India fluctuated considerably showing a declining tendency between Rs. 261.32 crores and Rs. 202.69 crores.<sup>3</sup>

### **Bankers' Deposits**

Bankers' Deposits with the Reserve Bank of India indicate the trend of the money market. The large balances towards the end of 1935 indicated the easiness of the monetary situation while the decline in 1938-39 indicated the stringency of money and the increased demand for finance from trade and industry. During the early part of the War, Bankers' Deposits fluctuated greatly owing to uncertainties prevailing in the money market and occasioned by the demand of the scheduled banks for cash in order to meet the demands for withdrawal made upon them by their clients. Towards the end of the war, they

1 & 2 See Report on Currency and Finance (Reserve Bank of India), 1947-48, p. 108.

3 See Report on Currency and Finance (Reserve Bank of India), 1948-49, p. 141.

showed a large increase despite the increased trade activity consequent on the war as there was no stringency of money in the money market owing to the steps taken by the Reserve Bank to increase the note circulation. During the year 1947-48 the average deposits of banks with the Reserve Bank of India amounted to Rs. 103'47 crores, recording an increase of Rs. 17'43 crores over the average for the previous year. From February 20, 1948, they showed a declining tendency and fell to Rs. 78'90 crores by the 26th March, 1948<sup>1</sup>

During the year 1948-49 the average Bankers' deposit with the Bank was Rs 80'58 crores. They fell mainly owing to the transfer of balances of banks operating in Pakistan to the State Bank of Pakistan and owing to heavy demand for funds by the scheduled banks in the last quarter of 1948-49

#### Notes, rupee coin and subsidiary coin.

On the assets side, notes, rupee coin and subsidiary coin form the cash balances which the Reserve Bank of India possesses to meet withdrawal of deposits and their proportion to total deposits is the ratio of liquid assets to current liabilities. This ratio was very high till the outbreak of the last World War. In respect of the statement for the week ended August 25, 1939, the ratio was over 88 per cent, but by the week ending April 11, 1941 it was a little below 25 per cent.<sup>2</sup> This tendency was observed during the war years owing to the uncertainty created by the war and partly owing to withdrawal of cash by scheduled banks to meet the increased demand of the public. From the year 1945-46 the average cash balances showed rising tendency and during the year 1947-48 they stood at Rs 47'24 crores. Again in 1948-49 it declined and fell to 22'12 crores which was less than half the previous year's average of Rs 47'24 crores. This steep fall was mainly owing to the transfer of assets to the State Bank of Pakistan.

During the years following the establishment of the Reserve Bank of India, there was practically no demand on the Reserve Bank for the rediscount of commercial bills as well as agricultural bills provided under Section 17 of the Reserve Bank Act. The Bank, on the other

1. Report on Currency and Finance (Reserve Bank of India), 1947-48, p. 108.

2. A Study of the Indian Money Market by B. C. Ghose (1949), p. 63.

hand, showed its inclination to rediscount the treasury bills of the Central and Provincial Governments. During and after the war, the rediscounting of treasury bills by the Reserve Bank showed an increasing tendency.

Balances held abroad include cash and short-term securities. The average balances held abroad including cash and short-term investments showed a rise from the year 1940-41 and particularly from the year 1943-44 onwards, the increase was spectacular. While during the year 1945-46 the balances continued to increase and reached the maximum in March, 1946, they showed a continuous fall reaching the lowest level of Rs 474.49 crores during February, 1947. The average balances held abroad showed a decline from Rs 528.83 crores in 1946-47 to Rs 406.95 crores during the year 1947-48 on account of the deficit in the country's balance of payments. In 1948-49 they fell to Rs 307.78 crores mainly owing to the transfer of assets to the State Bank of Pakistan and due to heavy imports which were facilitated by the relaxation of import restrictions.

The amount of "Loans and Advances to Governments" as well as other loans fluctuated in the years following the establishment of the Bank. During the war period they showed an increase with a sudden fall to 49 lakhs in 1943-44 in which year other loans and advances increased to Rs 15 lakhs from Rs 4 lakhs of the previous year. In 1947-48 and 1948-49 loans and advances to Governments stood at Rs 1.57 crores and Rs 1.71 crores respectively.

The investments in the Banking Department indicated comparatively little fluctuation as is evident from the table. After the outbreak of the war the Reserve Bank increased its holdings of rupee securities. The scheme of the Government of India for the repatriation of their sterling debt was mainly responsible for this, as the scheme was partly financed by the issue of rupee counterparts to the Bank.

## CHAPTER XV

### **The Reserve Bank of India as a Controller of Credit**

Like any other central bank it is the principal function of the Reserve Bank of India to regulate credit in the national interest

To discharge this function effectively the Reserve Bank must be able to control both currency and credit, as the control over currency ultimately does ensure the control over bank credit. To ensure the control over currency it has been entrusted with the sole right of note issue by statute whereby it is enabled to determine, to a large extent, the total supply of media of payment as well as of cash basis for credit expansion.

It is also interesting to observe that cheques as media of payment which were not in much use in India as compared to other countries like the U S A and England, are gaining much popularity in this country every year. Moreover, the Reserve Bank maintains the cash reserves of the scheduled banks and also the balances of the non-scheduled banks under certain conditions. Under the provisions of the Banking Companies Act of 1949, the joint-stock banks other than the scheduled banks are required by law to keep 2 p c and 5 p c of their time and demand liabilities respectively either with itself or with the Reserve Bank of India. This holding of cash balances of commercial banks with the Reserve Bank enables it to exert some measure of control over the banking and credit situation of the country, as through those cash reserves the Bank ultimately may exercise control over the lending policy of commercial banks. Besides this, the Reserve Bank holds the Government balances and carries out the banking transactions of the Government and as it does so, they provide useful means to the Reserve Bank for exercising control over the credit situation of this country. "

The effectiveness of a central bank's control over the credit depends upon the nature and the character of the money market in which it operates.

It is possible for a central bank to control credit, to a great extent, in an organised money market where its constituents are linked together

through definitely related interest rates. As for example, interest rates in the London money market are fixed in a definite relationship to the bank rate. In an undeveloped money market like that in India there is no precise definiteness about inter-relations between different money rates as it exists in the well-organised money markets of the world. Therefore, in an undeveloped money market the control over credit is comparatively difficult to achieve.

It is an admitted fact that the Indian money market is unorganised and undeveloped. It is composed of the loosely knit units, which are not correlated to each other. It is divided into two sections namely 'the organised sector of the money market' and 'its indigenous sector'. The former is composed of the commercial banks, the co-operative banks, the land mortgage banks and the stock exchanges, while the latter is composed of money-lenders scattered all over the country and of indigenous bankers located mostly in the urban areas. Each unit of both sectors is self-contained in its respective sphere and often follows independent policies which might clash and weaken the monetary structure.

The indigenous sector of the money market is so wide apart from modernised banking institutions that it falls, even to-day, outside the ambit of centralised banking control.

As a result of this heterogeneous mass of financiers in the Indian money market, the wide range of money rates in different parts of India is witnessed. The indigenous bankers sometimes charge interest more than 20 p.c. The rates quoted by money-lenders vary between 25 and 150 p.c. Even in the organised sector "there is no functional relationship in interest rates". In this connection, the Central Banking Enquiry Committee observed "the fact that a call rate of  $\frac{1}{2}$  per cent, a hundi rate of 3 per cent, a bank rate of 4 per cent, a Bombay Bazar rate for bills of small traders of  $6\frac{1}{2}\%$  and a Calcutta Bazar rate for bills of small traders of 10% can exist simultaneously indicates an extraordinary sluggishness in the movement of credit between the various markets".<sup>1</sup>

1. See K N Raj—The Monetary Policy of the Reserve Bank of India (1948), p. 41.

2. See the Central Banking Enquiry Committee Report.

The prominent position of the Imperial Bank of India in the Indian money market is a serious impediment to the establishment of credit control by the Reserve Bank of India over the money market. Before the establishment of the Reserve Bank, the Imperial Bank discharged certain functions as a central bank. But it "provided no adequate solution to the crucial problem of currency inelasticity and the seasonal stringencies to which it gave rise"<sup>1</sup>

The anomaly in maintaining the divorce of currency from banking control was highly responsible for currency and credit inelasticity in India. The limitations of the Imperial Bank as a central bank were rooted in its constitution. The sense of responsibility of its management appears to have fallen short of those requirements which were of vital importance to a backward country like India. Even after the establishment of the Reserve Bank of India, the Imperial Bank is to discharge, though as an agent of the Reserve Bank, some of the central banking functions in places where the Reserve Bank has no branches of its own, including the management of the treasury affairs, keeping of government accounts etc., while it also competes with commercial banks in ordinary banking business. This anomaly is partly responsible for weakening the influence of the Reserve Bank of India in the money market for controlling the credit situation.

Again, the influence of exchange banks in the Indian money market is predominant. As they possess huge resources and have branches spread all over the world, exchange banks may frustrate a policy initiated by the Reserve Bank. As India is now free from the yoke of an alien Government, the Reserve Bank of India is no longer to face the difficulty which it experienced before in carrying out its policy in the face of opposition from the exchange banks. Moreover, there is little possibility of clash between the Reserve Bank and exchange banks, as India is now pursuing the policy of enlarging credit rather than that of contracting credit.

The fact remains that, so long as the supply of money in the greater part of India is in the hands of the heterogeneous financiers whose business habits are not on a par with those of modernised banking institutions, the control of the existing institutions may not

1 See K. N. Raj—The Monetary Policy of the Reserve Bank of India (1948), p. 57

be of any great significance. Notwithstanding the Reserve Bank is provided with all the external forms of regulation which central banks in more advanced system are known to possess, it has an official Bank Rate published at regular intervals at which the Bank rediscounts approved bills and securities.

It is empowered to undertake open-market operations when necessary and it has also statutory right to hold cash reserves of the scheduled and may also hold cash balances of the non-scheduled banks under certain conditions.

Technically the Reserve Bank is fully equipped with all necessary weapons for control of currency and credit.

Let us now examine the various weapons which the Bank can use to regulate credit.

### **Bank Rate**

Prior to the Great War of 1914-18, under the International Gold Standard, the object of the use of discount rate was to maintain the equilibrium between the internal and external cost price structures by keeping the gold reserves at a fairly stable level. Therefore, trends in the flow of gold (in or out) were due to discount policy.

But with the suspension of the gold standard and side by side with the adoption of managed currency which gave precedence to the needs of the external economy over everything else in various countries in the thirties, the policy of the discount rate underwent a radical change.

In the United Kingdom the discount rate of the Bank of England was the sole and a supreme instrument of credit control for a long period as the London Money Market was active and well-organised, where it was possible to establish a close relationship between the discount rate and that of money rates.

On the other hand, in the United States the discount policy of the Federal Reserve System did not prove as effective a weapon as in the case of the Bank of England owing to the existence of a money market with different sections and with a loose structure of interest rates and also to the establishment of a differential relationship between official discount rates and other money rates due mainly to different conditions.

Again, in the absence of organised money markets and sometimes even in the absence of adequate and well-spread banking facilities in

the majority of countries, official discount rates in those countries did not prove a success as a weapon of credit control, rather their role in such countries was quite different from the bank rate in England

The discount rate as a penalty rate, which the Bank of England accepted as an effective weapon of credit control, did not get prominence among central banks of the countries under review where, on the other hand, its role was in the shape of an "accommodation" rate of discount

In the midst of its diverse role in different countries, the problems of discount policy as a successful instrument of credit control became more and more complex

The successful application of the bank rate policy depends upon three important factors —(1) the types of papers which may be considered eligible by a central bank for purposes of rediscounting and lending, (2) the restrictions in the choice of customers who may approach a central bank for discounts, (3) the level of the bank rate *i.e.*, the relation of the bank rate to money rates

The Reserve Bank of India has its official bank rate published at regular intervals in accordance with the provisions of the Reserve Bank Act

The effectiveness of its discount rate is to be judged from the standpoint of the factors cited above. The rate of the Reserve Bank is a minimum rate at which it undertakes to discount certain defined bills for scheduled banks. Section 17 of the Reserve Bank Act defines the kinds of paper which the Reserve Bank is allowed to accept for rediscount. They include (1) domestic *bona fide* commercial or trade bills maturing within ninety days, endorsed by a scheduled bank, (2) bills of the same limited maturity, drawn or issued for the purpose of holding or trading in Government securities and in certain other defined public securities, (3) bills maturing within nine months and arising out of the financing of seasonal agricultural operations or the marketing of crops endorsed by either a scheduled or a co-operative bank, and (4) treasury bills

Alternative to rediscount, the Reserve Bank of India is allowed to make loans and advances for a maximum period of ninety days to scheduled banks, provincial co-operative banks and certain public authorities against (1) trustee securities except immovable property, (2) the security of gold or silver or documents of title to the same,

(3) bills of exchange or promissory notes of any scheduled bank or of a provincial co-operative bank supported by "documents of title to goods"

The Reserve Bank is allowed also to resort to direct discounts and direct loans if a special occasion arises for "regulating credit in the interest of Indian trade, commerce, industry and agriculture"

Although provisions have been made in the Act to provide credit by the Reserve Bank against the securities stated above, the bank in its memorandum dated the 8th December, 1938 explained its lending and discounting policies. It observed that in accommodating credit to scheduled banks, it would consider not merely the nature of security offered but also the general character of the investments of the applying bank, the manner in which its business as a whole was conducted whether for instance, it received deposits at high rates of interest, whether it sought help from the Reserve Bank in normal times when the funds in the market were adequate, whether it was over trading and expanding undue amount of credit for speculative purposes

The observation of the Bank became crystal-clear when the Travancore National and Quilon Bank, one of the leading banks of South India was forced to suspend payments and the other scheduled banks were affected by the subsequent banking crisis

When these banks sought assistance from the Reserve Bank first, against promissory notes payable on Demand and secondly against security supported by "documents of title to goods", the Bank pointed out with regard to the former that these notes were not the same as the promissory notes maturing within 90 days against which the bank was entitled to make advances and with regard to the latter it explained that the word "which" in Section 17(4)(d) after the words "documents of title to goods" referred to such documents only and not to goods themselves, which, according to its interpretation, meant, in substance, warehouse keeper's certificates

Therefore, the scheduled banks received little help from the Reserve Bank during the crisis. It was difficult for the scheduled banks to produce warehouse certificates when there was no warehouse system in India. The Reserve Bank could have followed liberal policy to tide over the crisis when the provisions of the Reserve Bank Act was doubtful in its meaning

The importance of the nature of help which the Reserve Bank of India may render in the form of rediscount and loans and advances, has to be considered in the light of the quantity of such assets and liabilities of the scheduled banks shown in the table below —

Assets and Liabilities of the Scheduled Banks since 1935-36<sup>1</sup> (In Lakhs of rupees)

| Average<br>Friday<br>figures | Demand<br>Liabilities | Time<br>Liabilities | Total<br>Liabilities | Cash  | Balances<br>with the<br>Reserve<br>Bank | Advances | Bills<br>Discounted |
|------------------------------|-----------------------|---------------------|----------------------|-------|-----------------------------------------|----------|---------------------|
| 1935-36                      | 121.90                | 98.66               | 220.56               | 5.95  | 31.86                                   | 87.70    | 3.56                |
| 1936-37                      | 128.56                | 101.32              | 229.90               | 6.01  | 26.27                                   | 95.11    | 4.70                |
| 1937-38                      | 126.88                | 103.99              | 230.85               | 6.37  | 24.57                                   | 108.15   | 6.00                |
| 1938-39                      | 123.81                | 103.30              | 227.11               | 6.38  | 15.88                                   | 111.34   | 4.60                |
| 1939-40                      | 132.64                | 101.95              | 234.59               | 6.73  | 17.30                                   | 121.47   | 4.97                |
| 1940-41                      | 155.79                | 101.19              | 256.98               | 7.95  | 36.09                                   | 117.70   | 3.69                |
| 1941-42                      | 200.13                | 103.37              | 303.50               | 9.16  | 36.15                                   | 115.32   | 4.84                |
| 1942-43                      | 306.28                | 104.21              | 410.49               | 12.97 | 55.73                                   | 95.68    | 2.18                |
| 1943-44                      | 456.63                | 142.78              | 599.41               | 20.57 | 63.63                                   | 156.14   | 5.59                |
| 1944-45                      | 584.80                | 194.12              | 778.92               | 27.91 | 89.25                                   | 224.22   | 11.16               |
| 1945-46                      | 654.53                | 259.52              | 914.05               | 34.80 | 89.91                                   | 285.07   | 16.05               |
| 1946-47                      | 725.64                | 223.11              | 1,048.65             | 41.11 | 81.25                                   | 406.39   | 21.32               |
| 1947-48                      | 706.65                | 243.89              | 1,050.54             | 39.92 | 100.81                                  | 427.54   | 16.82               |
| 1948-49                      | 674.56                | 303.88              | 978.44               | 37.51 | 76.63                                   | 424.85   | 16.44               |

1 See Report on Currency and Finance<sup>†</sup> (Reserve Bank of India), 1946-47 & 1948-49, pp. 166 & 205 respectively

On the assets side, the bills discounted by scheduled banks showed a negligible increase as compared with the aggregate of cash in hand and balances at the Reserve Bank. During the years from 1935 to 1939 till the outbreak of the last World War, the volume of bills discounted by scheduled banks was, on the whole, at a low ebb due to the economic stagnation caused by the slump in trade and agriculture. During the years in the war and after, it did not show any increase as is evident from the figures ; while the totals of cash and balances at the Reserve Bank registered a substantial increase which showed a rising tendency during the years after the war with a spectacular increase in 1947-48.

It is to be noted that a portion of the volume of bills held by scheduled banks does not come upto the standard and quality prescribed for or insisted on by the Reserve Bank. Therefore, during the year under review, the rediscounting facilities of the Reserve Bank were not of much value to most scheduled banks.

On account of high cash reserves of scheduled banks as compared with the low ebb of the volume of the bills held by them, the effectiveness of the Bank Rate as a means of credit control can be reasonably doubted in India.

Since the beginning of the operation of the Reserve Bank of India the figures in given tables present a sad record in regard to its relation with the money market.

TABLE<sup>1</sup> (In lakhs of rupees)

| Average Friday<br>figures | Loans Advances<br>to Governments | Other Loans<br>& Advances | Bills purchased<br>& discounted |
|---------------------------|----------------------------------|---------------------------|---------------------------------|
| 1935-36                   | 86                               | 1                         |                                 |
| 1936-37                   | 1,54                             | 1                         | 1                               |
| 1937-38                   | 79                               | 2                         | 6                               |
| 1938-39                   | 1,72                             | 2                         | 1,53                            |
| 1939-40                   | 1,05                             | 11                        | 2,87                            |
| 1940-41                   | 2,01                             | 7                         | 97                              |
| 1941-42                   | 4,09                             | 4                         | 27                              |
| 1942-43                   | 1,49                             | 4                         | 68                              |
| 1943-44                   | 49                               | 15                        | 91                              |
| 1944-45                   | 43                               | 11                        | 1,46                            |
| 1945-46                   | 22                               | 12                        | 3,35                            |
| 1946-47                   | 5                                | 82                        | 2,33                            |
| 1947-48                   | 1,57                             | 21                        | 2,62                            |
| 1948-49                   | 1,71                             | 3,34                      | 4,28                            |

TABLE (In crores of rupees)

|           | Bills discounted<br>(Internal) | Bills discounted<br>(Treasury bills) | Bills discounted<br>(External) |
|-----------|--------------------------------|--------------------------------------|--------------------------------|
| 1 9 1939  | —                              | 1 16                                 |                                |
| „ 40      | —                              |                                      |                                |
| „ 41      | —                              |                                      |                                |
| „ 42      | —                              |                                      |                                |
| „ 43      | —                              |                                      |                                |
| „ 44      | —                              |                                      |                                |
| 29 9 45   | —                              | 3 65                                 |                                |
| 27 9, 46  | —                              | 2.41                                 |                                |
| 26 9, 47  | —                              | 2.02                                 |                                |
| 24, 9, 48 | —                              | 2.14                                 |                                |

1. See Report on Currency and Finance (Reserve Bank of India), 1948-49, p. 218

It is evident from the above Tables that the Government was the regular customer of the Reserve Bank of India. The loans and advances indicate that during these years loans and advances to Governments registered a higher proportion than those of other loans and advances despite the fact that the investments of the banks were composed largely of eligible Government securities.

The discount policy of the Bank was conspicuously absent for a long time. Its discounting operation, since 1938, was mainly in a limited extent directed to discounting of treasury bills. It may be offered as an explanation for this that the demand for loanable funds by scheduled banks was, on the whole, at a very low ebb during this period as the period under review was remarkable for easy conditions and abundance of funds due to the cheap money-policy pursued by the Government.

The Reserve Bank's discount policy is also hardly of any use in the circumstance created by the Imperial Bank of India due to its unique position in the Indian money market. The Imperial Bank is much more connected with the money market than the Reserve Bank as will be evident from the following figures for September, 1948

(In crores of rupees)

| <i>Imperial Bank of India</i> | 24. 9 1948 | 26. 9 1947 |
|-------------------------------|------------|------------|
| Loans ..                      | 17.74      | 25.75      |
| Cash credits & overdrafts     | 52.84      | 48.56      |
| Bills discounted & purchased  | 3.49       | 3.58       |
| <i>Reserve Bank of India</i>  |            |            |
| Bills purchased & discounted— |            |            |
| (a) Internal .                | 0.41       | Nil        |
| (b) External                  | Nil        | Nil        |
| (c) Treasury bills            | 2.14       | 2.02       |
| Other loans & advances        | 4.27       | 0.31       |

It appears from the given figures that the majority of commercial banks receive accommodation from the Imperial Bank when they require it. Therefore, the Reserve Bank has hardly any important role to play while it has been possible for the Imperial Bank to meet all the demands for accommodation from the money market owing to its huge resources at its disposal and to its liberal lending policy.

As observed previously, one of the factors on which depend the effectiveness of the bank rate is the level of its rate *i.e.*, the relation of the bank rate to money rates. It raises an issue as to whether the official rate of discount is to be a "penalty" rate or an accommodation rate. The official bank rate of the Bank of England which is somewhat in the nature of a penalising rate, is usually higher than the market rate of discount. Under normal conditions, the Bank of England keeps itself away from the market and encourages other banks to use their funds in the discount market. The Bank is approached by the agencies in the market when their funds are exhausted and only after all outside resources have been tapped. As soon as a credit stringency develops and the market has to seek the help from the Bank of England, the bank rate forces up the market rate of discount. This Anglo-Saxon principle of penal rate of discount operates successfully as an instrument of credit control in a country with active and well-organised money market like that of London as changes in bank rate could bring corresponding changes in market rates working under narrow margin and as a result of the general recognition of the leadership of the central bank.

Alternative to the penalty rate of discount, there is an official bank rate in the nature of an accommodation discount rate which is usually lower than the market rate and operates in countries with undeveloped and unorganised money markets. In the U S A the official discount rate of the Federal Reserve System which is applied to the promissory notes of bank customers endorsed by the borrowing member banks or to the short-term collateral notes of the member banks themselves, is adopted for accommodation of the market. Therefore, a different relationship is set up there between the official discount rate and other money rates.

In India, the Reserve Bank Act is silent in regard to its discount and loans policy.

Realising the difficulties arising out of the undeveloped and ill-organised Indian discount market, the Central Banking Enquiry Committee emphasised on the Reserve Bank of India as a bank of accommodation, as the Reserve Bank should take all possible steps to encourage the creation of discount market in India within the shortest possible time,

so that all agencies hitherto untouched by the modern banking development can receive financial assistance

From the foregoing observation it appears that the discount and loans policy of the Reserve Bank of India is to be in the nature of an accommodation rather than that of a penalising one

In the Indian money market where a larger section, particularly of the indigenous sector, remains outside the control of the Reserve Bank of India, the official bank rate of the Reserve Bank as an instrument for controlling credit has very little use

If the Reserve Bank of India makes avail of its right to make direct loans and advances without the mediation of scheduled banks and co-operative banks which it is allowed to do by the provisions of the Act, then it appears that the discount rate of the Bank is for all practical purposes a penalty rate. This fact cannot be entertained as the bank rate of the Reserve Bank is lower than the bazar bill rate and, moreover, its rate has no significance at all in the absence of a discount market for bills in India. Therefore, the bank rate of the Reserve Bank of India can be described as an accommodation rate, as its objective is to assist in the development of the market for giving effect to its discount policy

The level of the bank rate is also not by itself a means of credit control. Because, it is known by experience that even in countries in which the bank rate is higher than the market rate, its level is not higher than the average rate earned by banks on all their assets taken together<sup>1</sup>. It is far more difficult to make the bank rate effective in a country like India where wide difference in rates in different parts of the country is perceived. The wide range of money rates in different parts of India will be testified from the following table.

---

1 See Muranjan—Modern Banking in India (1946), p. 303

TABLE 1  
Indian Money Rates per cent

| Year | Yield on 3½ p c Govt Security on April 1 | Bank Rate | Call Money Rates |                   | Imperial Bank Hundi Rate | Bazar Rates |        |
|------|------------------------------------------|-----------|------------------|-------------------|--------------------------|-------------|--------|
|      |                                          |           | Bombay           | Calcutta          |                          | Calcutta    | Bombay |
| 1935 |                                          | 3½        | 1 to 2           | 2 to 3½<br>1 to 1 | 3½                       |             |        |
| 1936 | 3.5                                      | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1937 | 3.6                                      | 3         | 2 to 1           | 1 to 1            | 3                        |             |        |
| 1938 | 3.5                                      | 3         | 2 to 2½          | 2 to 3½           | 3                        |             |        |
| 1939 | 3.79                                     | 3         | 1 to 1           | 2 to 1            | 3½                       |             |        |
| 1940 | 3.84                                     | 3         | 1 to 2           | 1 to 1            | 3½                       |             |        |
| 1941 | 3.67                                     | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1942 | 3.80                                     | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1943 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1944 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1945 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1946 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1947 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1948 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |
| 1949 |                                          | 3         | 1 to 1           | 1 to 1            | 3                        |             |        |

1 See Report on Currency and Finance (Reserve Bank of India) 1948-49, p. 201

Since the beginning of the operation of the Reserve Bank of India, though the Bank maintained the uniform bank rate at 3 p.c., it must have proved either too high for certain areas or too low for certain others in its relation to money rates. Therefore, a suggestion may be made for different official bank rates for different areas but different regional rates may be of no use for the purpose of credit control as they may be frustrated on account of the recent development of branch banking in India<sup>1</sup>

Though the efficiency of the bank rate as an instrument of credit control could not yet be tested, the uniformity in the rate has achieved certain results in eliminating disparity between the Calcutta and Bombay bazar rates and in narrowing down the great differences between different rates.

Since its inauguration, the Reserve Bank showed much interest in the development of a discount market as keeping pace with the spirit of the Reserve Bank Act.

It submitted reports in 1936 to the Government of India under Section 55(1)(b) of the Reserve Bank of India Act, suggesting various schemes for the extension of facilities of the Bank to the indigenous sector of the Indian money market for agriculture financing with the object of bringing the indigenous bankers into the Reserve Bank System. It suggested that the Reserve Bank would extend to the indigenous bankers facilities of direct discounting, of securing advances against Government securities and of remittances but subject to the conditions that they would maintain proper books of accounts and file periodical statements with the Bank. But as the indigenous bankers were getting assistance from the Imperial Bank, when they needed, they showed no eagerness to implement the scheme.

During the war and the post-war periods, the bill market in India did not make any progress though there was a nominal expansion of the value of bills discounted by scheduled banks. This increase was merely a reflection of the inflated price and the real expansion was nil. Since 1936 the bank rate of the Reserve Bank remained unchanged at 3 per cent. Therefore, the effectiveness of the bank rate is practically nil in India. What is needed, to make it effective, is to bring the bank-

1. See Muzarajan—Modern Banking in India (1949), p. 303.

ing system as a whole within the Reserve Bank's fold and to create an organised money market in India

### Open-market operations

In view of the aloofness of the Reserve Bank of India from the money market through the normal channels of loans and discounts, the Reserve Bank is legally empowered to undertake open-market operations in its own initiative for the purpose of controlling credit. Open-market operations may be used either as a subsidiary instrument with the object of making bank rate effective or independently of the bank rate for effecting changes in the supply of money with a view to bringing about changes in money rates and credit conditions.

In examining the open-market operations of the Reserve Bank of India, we will accept the wider definition and will include the purchase and sale of bills of exchange, promissory notes, Government securities, gold coin and bullion in the open market as well as the operations undertaken by the Bank in the management of the public debt. Due to the absence of an organised discount market in India, the marketability of bills of exchange and promissory notes is limited. Therefore, assets which the Bank may buy and sell, are Government securities, gold coin and gold and silver bullion. Debt operation of the Government is to be included as it can cause the following immediate effects in the market: (1) shifts of cash reserves between the banks and the Central monetary authority, (2) changes in bank holdings of Government obligations which increase or decrease their deposit liabilities by equivalent amounts, and (3) changes in the holdings of non-bank investors which affect their cash reserves. In the open-market operations of the Reserve Bank, we shall also include the purchase and sale of sterling and other foreign currencies by it at such rates and on such terms and conditions as determined by the Government in conformity with its obligation as a member of the International Monetary Fund. Before the passing of the Reserve Bank of India (Second Amendment) Act of 1947, the Reserve Bank, in order to discharge its function of maintaining the rupee-sterling exchange rate, had to buy sterling in India at a rate not higher than 1 s 6½ d for a rupee from scheduled banks and sell sterling at a rate not higher than 1 s 5½ d for a rupee

to them provided the amount demanded at any time was not less than £10,000, but between these two fixed rates the Bank was forced to purchase or sell sterling at any rate it liked. Thus, through this method of purchase of sterling from scheduled banks by weekly tender or at an intermediate tap rate the Reserve Bank was in a position to influence the cash reserves of scheduled banks.

### **The Reserve Bank's capacity in the use of open-market operations**

As to the capacity of the Reserve Bank to undertake open-market operations, it depends on—first, the resources at the disposal of the Bank derived from several sources for the purpose of open market operations, secondly, the quality and volume of the assets it is allowed to deal in or hold, and lastly, the character of the market in which open-market operations are to be carried out.

As regards the resources of the Reserve Bank, first, there is the capital and the reserve which amount to Rs 5 crores each. Secondly, there are deposits from the Government of India and Provincial Governments. The funds kept in the Govt. accounts are of two kinds,—those which accrue in the course of the collection and disbursement of ordinary revenues and those which move in and out on account of its management of the public debt. Debt operations of the Government have far-reaching effects on the money market, because, if the operations are closely spaced, they can be systematically and effectively employed to make quantitative adjustments in the market.

The third source is the statutory deposits of scheduled banks which are required to keep 5 per cent and 2 per cent of their demand and time liabilities respectively with the Reserve Bank. These are not the only sources for acquiring the funds by the Reserve Bank of India. According to the provisions of the Reserve Bank Act, the Bank has enough powers to issue notes against gold coin and bullion, sterling securities, rupee securities and rupee coin. Section 33 of the Act provides that, of the total amount of assets held in the Issue Department, at least  $\frac{2}{5}$  must be in the form of gold coin, gold bullion, or sterling securities and foreign currencies of member countries of the Fund provided the amount of gold coins and gold bullion is not less

than 40 crores. The Reserve Bank Act only prescribes the minimum limit and there is no maximum limit placed to the holdings in them. Therefore, the Bank has enough scope to expand currency against these assets provided they are available in the market.

While the Reserve Bank possesses sufficient powers to inflate, let us see if it has similar powers to cause deflation. With regard to this issue, there are two opinions. One holds that the powers of the Reserve Bank to deflate are strictly limited as the Reserve Bank Act provides no statutory powers for the Bank either to create and sell its own debentures and short-term bonds or to raise the proportions of the compulsory reserves of scheduled banks with it.<sup>1</sup>

The other is of opinion that the Reserve Bank has the powers to cause deflation as much as it has the powers to cause inflation.<sup>2</sup> Because, it can sell the sterling assets and investments held in the Banking Department in the first instance. When these are exhausted, the Bank can dispose of its assets in the Issue Department—first its gold till the legal minimum of Rs 40 crores is reached and then its sterling and rupee securities upto 2/5 of the total assets held in the Issue Department. Therefore, it will be wrong to say that the Reserve Bank possesses only "one-sided power" to inflate. It has the powers to deflate but not to that extent it can cause inflation.<sup>3</sup> Therefore, the lack of symmetry between the Bank's inflating and deflating powers is sure to exist.

The quality and the volume of the securities in which the Reserve Bank can deal is specified in Sections 17(7) and 17(8) of the Reserve Bank Act. Under Section 17(7) of the Reserve Bank Act, the Bank is permitted to buy and sell securities of the United Kingdom maturing within ten years from the date of purchase. Under Section 17(8) it is allowed to purchase and sell securities of the Government of India or of a Provincial Government of any maturity or such securities of a local authority in India or of Indian States as may be specified by the Government of India on the recommendation of the Central Board of the Reserve Bank. But its power of acquiring securities for the Banking

1 See Muranjan—Modern Banking in India (Second Edition, 1948), p 310

2 & 3 See K N Raj—The Monetary Policy of the Reserve Bank of India (1948), pp. 103-104.

Department is limited. It cannot hold in the Banking Department Government securities and other public securities to the value of more than its capital and the reserve fund and three-fifths of the deposit liabilities. Of these securities, the aggregate value of securities maturing after one year must not exceed the capital and the reserve fund of the Bank and two-fifths of its liabilities in respect of deposits. Similarly, the total value of securities maturing after ten years cannot exceed the aggregate amount of the capital, the reserve fund and one-fifth of the deposit liabilities.

Reasons for imposing these restrictions are quite clear. As the open market operations of the Reserve Bank of India are mainly intended for avoiding fluctuations in prices and maintaining liquidity of assets, the operations of the Bank is confined to short dated securities and the Bank is precluded from dealings in long-dated securities. In this connection, it can be mentioned that in the case of many central banks such as the South African Reserve Bank and the Bank of Canada, statutory restrictions were imposed as a result of the unfortunate experiences which central banks had with the Government during the War of 1914-18 and post-war periods though, after 1930, under the pressure of the severe depression and of the increased needs of the Govt for the World War II, many of these restrictions were withdrawn. As to the nature and organisation of the market in which open-market operations are to be carried out by the Reserve Bank of India, the Bank finds it difficult to operate them due to the lack of broad and active markets for securities. It is evident from the fact that "the total membership, active and inactive, of the Bombay stock exchange market is about 450 as against 1100 in Newyork and 4000 in London"<sup>1</sup>. It is difficult to express an opinion on the open-market operations of the Reserve Bank while the scope for operations is very limited. In this connection, the Governor of the Bank of Norway observed—"We should not close our eyes to certain defects of our securities market which, to a rather large extent, limit the possibility of conducting operations of this kind," and "we may at times make purchases, but it is difficult to put through sales of securities in large proportions, because the market is so limited, and a driving down

1. See Muranjan—Modern Banking in India (1948), p. 313

of the prices may produce harmful subsidiary consequences" <sup>1</sup> The above statement is aptly applicable to Indian conditions as the market for securities in this country is limited

Let us now examine the Reserve Bank's open-market operations since the commencement of its business

### Open market operations between 1935 and 1939

In examining the Investments held in the Banking Department of the Reserve Bank of India, it is worth observation that there were small variations in the investment portfolio of the Reserve Bank from 1935 to 1939. From the small amount of Rs 5 crores, contributed by the Government to the formation of the Reserve Fund in the form of Government securities, investments of the Bank rose above Rs 83 crores within four years in 1939. During these years the Bank bought and sold securities in the market either sometimes to maintain prices of gilt-edged securities at a steady level, or at other times, to help the Government in the flotation of a new loan and to relieve seasonal stringency. During this period, what is most striking is that the range of variations was not remarkable.

The purchases of sterling by the Reserve Bank on its own account and the sales of Treasury Bills to the public on behalf of the Government, during the years under review, reveal certain interesting facts. With the continued export of gold and the rise in prices and exports due to general economic revival, the purchases of sterling by the Bank increased during the first two years in April, 1935, and March, 1937. But after March, 1937, the set-back in trade and the diminution of the gold export caused a remarkable decline in the purchases of sterling. This will be evident from the following figures <sup>2</sup>

1 Monthly Report of the Bank of Norway, February 1936

2 Compiled from the monthly statistical summaries published by the Reserve Bank

|                                    | (In million)                                                       |                                 |         |
|------------------------------------|--------------------------------------------------------------------|---------------------------------|---------|
|                                    | Total sterling require-<br>ments of the Secy of<br>State for India | Amount<br>purchased<br>in India | Balance |
| From April, 1935<br>to March, 1936 | 27                                                                 | 34                              | + 7     |
| From April, 1936<br>to March, 1937 | 41                                                                 | 54                              | +13     |
| From April, 1937<br>to March, 1938 | 37                                                                 | 25                              | - 12    |
| From April, 1938<br>to March, 1939 | 36                                                                 | 26                              | - 10    |

This weakened the rupee-sterling rate and the value of the rupee began to fall in terms of sterling

Wide variations in the case of the sales of the Treasury Bills were perceptible in the years 1935-39. In 1935-36 the Treasury Bills outstanding with the public were worth Rs 18.27 crores which increased to Rs 27.34 crores in 1938-39. Reasons for the increase in the sales are, first, to raise the yield on Treasury Bills at a time when the balances of banks with the Reserve Bank were diminishing and, secondly to attract capital from abroad for investment in them. On account of the increased sales of the Treasury Bills the Government balances held with the Banking Department increased while balances of the banks diminished which will be known from the following figures

|               | (In crores of Rs)                                     |                                                    |
|---------------|-------------------------------------------------------|----------------------------------------------------|
|               | Balances of the Govt<br>(held in the Banking<br>Dept) | Balances of banks<br>(held in the Banking<br>Dept) |
| April, 1937   | 11.2                                                  | 25.5                                               |
| July, "       | 10.0                                                  | 33.0                                               |
| October, "    | 12.6                                                  | 24.9                                               |
| January, 1938 | 11.0                                                  | 17.3                                               |
| April, "      | 16.8                                                  | 14.1                                               |
| July, "       | 15.3                                                  | 21.3                                               |
| October, "    | 12.7                                                  | 21.3                                               |
| January, 1939 | 13.6                                                  | 11.6                                               |
| April, "      | 14.5                                                  | 11.9                                               |

The Reserve Bank of India, during the years between 1935 and 1939, undertook to purchase sterling and to sell Treasury Bills with a view to attract more sterling into the country in order to maintain the exchange rate, and to avoid expanding the liabilities of the Issue Department of the Reserve Bank.

Therefore, the open market operations of the Bank during these years were in question.

### Open-market operations in the war time

In the war period, the objectives of open-market operations in most of the belligerent countries were to preserve interest rates and to support the price of securities. One of the objectives of the open-market operations of the Reserve Bank of India was to maintain the price of Government securities issued by the Government from time to time in the war time. A close study of the course of prices of some of the securities of the Government of India will make it clear about the nature of the Reserve Bank's operations in the open market. The statement, given below, will show the highest and lowest prices touched by representative rupee securities of the Government of India from 1939 '0 upto 1941-42<sup>1</sup>.

(In rupees)

|         | 5 p c rupee loans 1915-55<br>(free of Income tax) |        | 4 percent rupee loans<br>1960-70 |        |
|---------|---------------------------------------------------|--------|----------------------------------|--------|
|         | Highest                                           | Lowest | Highest                          | Lowest |
| 1939-40 | 114½                                              | 102    | 111½                             | 94     |
| 1940-41 | 112½                                              | 105½   | 109                              | 99     |
| 1941-42 | 111½                                              | 104    | 111½                             | 99     |

---

|         | 3½ p c rupee loans |        | 3½ p c rupee loans (non-terminable) |        |
|---------|--------------------|--------|-------------------------------------|--------|
|         | Highest            | Lowest | Highest                             | Lowest |
| 1939-40 | 104½               | 92½    | 97½                                 | 80½    |
| 1940-41 | 104½               | 98½    | 96½                                 | 84½    |
| 1941-42 | 103½               | 96½    | 96½                                 | 84     |

One of the reasons for the decline in prices of securities was due to the sales of securities by the Reserve Bank in the open market, for instance, the price of 3½ p c Government paper which was quoted upto June 2,

1. See Report on Currency and Finance (Reserve Bank of India), 1941-42, p. 76

1942, at Rs 91-1-0, did not move up as the Reserve Bank was selling that paper at Rs 91

The paper shot up to Rs 91-9 0 on the next day when the Bank stopped selling <sup>1</sup> Therefore, variations in prices of securities which are evident from the above statement, were to a great extent affected by the open-market operations of the Reserve Bank of India

In the war period, with an increasingly favourable balance of trade due to heavy purchase of materials from India by the Allies, the Reserve Bank's purchases of sterling increased to a high figure, which the Bank partly utilised for repatriation of sterling debt In the table<sup>2</sup> below are given the sources of the supply of sterling and its disposal from the beginning of the war to the end of 1941-42

|                                                                                | Rs crores  |
|--------------------------------------------------------------------------------|------------|
| 1 Sterling assets held by the Reserve Bank, August, 1939                       | 64         |
| 2 Sterling purchased by the Reserve Bank                                       |            |
| Septr, 1939--March, 1940                                                       | 86         |
| April, 1940--March, 1941                                                       | 76         |
| April, 1941--March, 1942                                                       | 98         |
| 3 Sterling payments by his Majesty's Government                                | 258        |
|                                                                                | <u>582</u> |
| 1 Sterling amounts utilised for repatriation scheme<br>(Upto the end of March) | 218        |
| 2 Other sterling commitments                                                   | 80         |
| 3 Sterling holdings of the Reserve Bank at the end of March, 1942              | 234        |
|                                                                                | <u>582</u> |

Therefore, during the war period, the main object of open-market operations of the Reserve Bank of India was to support the price of Government securities in the gilt-edged market

#### Open-market operations in the post-war period.

During the post-war years, the security market reflected the features of an economy in transition from war to peace In 1946-47, the gilt-edged market showed a sharp rise in the early part of the year and the recession towards the latter part The immediate cause of the decline in security prices was the political disturbances in the country which had

<sup>1</sup> See Commerce, 13th June, 1942

<sup>2</sup> See Report on Currency and Finance (Reserve Bank of India), 1941/42 p 20

shaken the confidence of the dealers in the market. The general lack of confidence produced a situation in which investment demand was lacking and there was withdrawals of deposits from banks. Consequently, commercial banks had to sell securities in the market to replenish their cash resources with a view to meeting any possible contingencies. In this situation, the Reserve Bank of India came to the support of the market by purchasing securities on a substantial scale in order to maintain security prices and to stabilise the financial structure of the country. This support had an effective influence on the market and in the banking system and was a contributory factor to the recovery in security prices.

During the year 1947-48, the gilt-edged market showed signs of hesitancy and weakness due to uncertainties in the political situation, communal disturbances and the general doubts regarding the Government's willingness or ability to maintain cheap money, but this did not lead to any severe fall in security prices. The comparative stability of the market was mainly due to the continued support of the Reserve Bank.

There was a heavy slump in gilt-edged securities in the year 1948-49.

Deposit liabilities of scheduled banks fell by about Rs 95 crores from July, 1948, to March, 1949. There was for the first time since 1936-39 a contraction in note circulation of about Rs 8 crores during 1948-49. The Reserve Bank continued to support the gilt-edged market in order to maintain prices of securities stable and to stabilise interest rates. Heavy withdrawal of funds from Banks compelled commercial banks to liquidate their investments in Government securities. According to information gathered by the Reserve Bank during the 10 months ended June, 1949, Scheduled Banks' investments in Government securities declined by no less than Rs. 139.17 crores. Practically, the whole of this amount was taken up by the Reserve Bank of India for the purpose of avoiding the pressure on such a huge sale of securities in the open market.<sup>1</sup>

Therefore, during the post-war years, open-market operations were undertaken by the Reserve Bank of India to support the gilt-edged market to recover from the slump.

---

1 See Commerce, Annual Review Number, December, 1949, p. 1225

All through these years, the object of the Reserve Bank was to maintain easy condition and, therefore, the Bank always aimed at to maintain that condition by supporting the market. The effectiveness of the open-market operations will be tested when the Reserve Bank will be called for using them for the purpose of contracting credit.

### **Other weapons of credit control**

In view of the fact that the bank rate and the open-market operation policies of the Reserve Bank are less efficacious in India than elsewhere due to the diversity of interest rates in several parts of the country, the absence of an organised money market, the unavailability of assets which fall on the eligibility rules of the Reserve Bank and to the existence of small banks outside the orbit of the Bank, the Reserve Bank, under the provisions of the Act, is authorised to deal directly with the public in kinds of paper which are deemed "eligible" but only under certain special conditions without the mediation of a scheduled or a provincial co-operative bank for regulating credit in the interests of Indian trade, commerce, industry and agriculture. This power of the Bank is intended to be used only in very exceptional cases. Instances are not wanting in history of granting this kind of power to central banks. For instance, the Relief Emergency Act of 1932 and the Act of 19th June, 1934, conferred power on the Federal Reserve Banks to deal directly with the public but the Federal Reserve Banks had not occasions to use them. In India, this provision of the Act invests the Reserve Bank with considerable power to force the commercial banks to follow particular policies initiated by it.

Under the provisions of the Banking Companies Act of 1949, the Reserve Bank is vested with powers, on a permanent basis, to control the entire joint-stock banking system in the Indian Union. Under Section 21 of the Banking Companies Act, the Bank may give directions to banking companies in regard to their lending policies "the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances and each banking company shall be bound to comply with any directions as so given." Under the provisions of the Act, it may caution or prohibit banking companies generally, or any

banking company in particular, against entering into any particular transaction or class of transactions. It may call for periodical as well as *ad hoc* returns, and in the public interest may also publish such information as it deems fit. Thus by controlling the lending policies of the joint-stock banks, the Reserve Bank will be able to regulate the credit in the market in the right direction.

Of the other instruments of credit control, rationing of credit and the taking of direct action against commercial banks are of little practical importance in India as these banks are not large borrowers of the Reserve Bank's credit. Moreover, the rationing of credit as an instrument of control available to a central bank can only be successfully used in a country under the planned economy of which India, so far, has shown no indication.

Moral suasion also has not been of much value in India, but just after the outbreak of the war, the Reserve Bank advised scheduled banks to avoid financing any speculative dealings in bullion, Government securities, shares and marketable goods etc. and fixed appropriate margins against advances on security of bullion.

### **A case for the variable reserve ratio**

As the discount rate and the open-market operations of the Reserve Bank of India are useless for all practical purposes for the purpose of controlling credit owing to the existence of the indigenous bankers outside the orbit of the Reserve Bank of India and to the absence of wide and well-organised market for gilt-edged securities, it has been suggested that the variable reserve ratio as a weapon of credit control may be adopted in India. In this connection we may mention the views of Sayers who holds that in a country where extensive open market operations by the central bank are subject to great difficulties, the mere existence of the reserve ratio as a weapon of credit control will enormously increase the influence of central bank to regulate credit.<sup>1</sup>

Therefore, it has been suggested that the Dominions of Australia, New Zealand, South Africa and India are places fit for using the variable reserve ratio successfully as the scope of open-market operations are restricted there owing to the narrowness of markets.

---

1. Sayers—Modern Banking (1941), p. 295

Let us now examine carefully the question whether the variable reserve ratio will be an effective instrument of credit control in India. Plumptre points out that in narrow markets ordinary banks are likely to be wedded to the practice of maintaining flexible reserve ratios. As the maintenance of flexible reserves by ordinary banks with a central bank makes open-market operations ineffective in narrow market, the same factor will render the variable reserve ratio a crude and insensitive weapon of credit control.<sup>1</sup>

In Australia, New Zealand and to some extent in South Africa, banks keep highly elastic reserve ratios and maintain large liquid assets in London. Consequently, "they can avoid the effect of raised reserve requirements upon their credit policies by replenishing their reserve resources with the Central Bank by selling to it a portion of London funds."<sup>2</sup>

Therefore, the variable reserve ratio will be ineffective so long as the banks are able to substitute their London assets by increased domestic assets with the Central Bank.

In India, too, the scheduled banks maintain flexible reserve ratios with the Reserve Bank of India as fluctuations in the ratios will be evident from the following table.<sup>3</sup>

| Average of Friday<br>figures | Total Cash and Balances<br>with the Reserve Bank<br>as percentages of total<br>Liabilities |
|------------------------------|--------------------------------------------------------------------------------------------|
| 1937-38                      | 13.40                                                                                      |
| 1938-39                      | 9.80                                                                                       |
| 1939-40                      | 10.24                                                                                      |
| 1940-41                      | 17.14                                                                                      |
| 1941-42                      | 10.65                                                                                      |
| 1942-43                      | 16.73                                                                                      |
| 1943-44                      | 14.05                                                                                      |
| 1944-45                      | 14.96                                                                                      |
| 1945-46                      | 13.64                                                                                      |
| 1946-47                      | 11.67                                                                                      |
| 1947-48                      | 13.40                                                                                      |
| 1948-49                      | 11.67 (Indian Union)                                                                       |

1 Plumptre—Central Banking in the British Dominions, p. 279

2 Dr S. K. Basu—Recent Banking Development (1946), p. 56

3 Report on Currency & Finance (Reserve Bank of India), 1948-49, p. 205

The variation in the ratios is a real obstacle to the use of both open-market operations and the variable reserve ratio in India. Moreover, assets held abroad by commercial banks, though not published in India, are believed to have been important.

As the variable ratio is ineffective in the case of Australia, New Zealand and South Africa owing to the maintenance of flexible reserves by ordinary banks, it may be also inoperative in the case of India for the same reason.

### **A case for selective instruments of credit control**

The obstacles to effective credit control by the general weapons raised the question of the applicability of selective instruments of credit control. Methods of selective credit control are used by regulating margin requirements for the purpose of checking inflationary tendencies in particular economic sectors or speculative excesses in particular areas. It would clearly be a mistake to restrict credit all round and to bring about a general depression while a level of full employment is not reached generally. They should be used "with certain branches of credit such as real estate credit, consumers' instalment credit, stock exchange credit, which permit credit being restricted to these purposes without forcing a general contraction of credit."<sup>1</sup> The concept of selective credit control owes its origin first in the U.S.A. to its development in the security market during the formative period of the Federal Reserve System. It received wide popularity in the United States after the speculative boom and crash of 1929-31. During that period member banks were engaged in speculative activities, directly invested huge amount in industrial shares and bonds and made enormous security loans and, therefore, the crash came in 1929. Consequently, several thousand banks came into grief in the subsequent banking crisis of 1933. In 1934, the Federal Reserve Board of Governors was empowered to regulate margin requirements "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities." Margin which was 30 per cent in 1934 was raised to 40 per cent in January, 1936. A rising tendency in stock

1. See League of Nations—Economic Stability in the Post war World, Part II (1945), p. 161.

prices in 1942 and 1943 prompted the Board of Governors to consider the desirability of raising margin requirements.<sup>1</sup> The Board took cognisance of the possibility that "a run away stock market might contribute to inflationary sentiment in the country as a whole"<sup>2</sup> At the end of the Second World War, on account of highly inflationary tendencies, due to the war-time expansion of currency and of speculative excesses on the stock exchange, the Board of Governors of the Federal Reserve System fixed the margin requirements to 100 per cent in January, 1946 This step had stopped borrowing from banks for further flow of money into the stock markets The use of selective instruments of credit control has, no doubt, served the purpose of checking the speculative excesses on the stock exchange market in the U S A.

Let us now examine the question of the applicability of selective instruments of credit control under Indian conditions The bullish activities in the Indian stock exchange market due to high prices of securities and the speculative enthusiasm of the Indian banks to make huge advances in security loans and the subsequent banking crisis in India in recent years made to suggest for introducing legislation on American lines enabling the Reserve Bank of India to regulate the margin requirements with regard to security loans made by banks<sup>3</sup>

The boom which was witnessed in the government securities market and the industrial share market in the war time continued unabated in the post-war period Prices of government securities and industrial shares went on rising higher and higher The Economic Adviser's index number of the prices of government securities and of industrial securities (1927-28=100) rose from 1172 in 1943-44 to 1238 in August, 1946, and from 2297 in March, 1944, to 3999 in July, 1945, respectively The upward movement in the stock exchange market was due to various factors, namely, the procurement and distribution of food by the government, control of capital issues, the vigorous pursuit of the cheap money-policy by the government, the abolition of the Excess

1. See A Youngman—The Federal Reserve System in War Time

2. See Department of Agriculture, Bureau of Agricultural Economics—The Agricultural Situation, April, 1944, pp 12-17

3. See B K. Basu—Recent Banking Developments (2nd Edition) p 190

Profit Tax and the prospects of greater profitability of industry and therefore of higher dividends. Therefore, the bull movement continued uninterrupted and the speculative fervour was at the highest peak. Optimism and enthusiasm were so high that even small investors who had never before taken any interest in the stock exchange market were attracted to deal in the stock exchanges. A large number of banks, mostly non-scheduled banks, made considerable advances against speculative shares and invested heavily in them. This pressure of money-seeking investment, and accommodation granted by a number of banks for speculative purposes tended to bring about a rise in prices of government securities and industrial shares.

The boom in the stock exchange market which developed after the presentation of the Central Government budget in February, 1946, was arrested and a mild decline set in by the middle of August, 1946. This was followed in September by a violent break in prices, following the outbreak of communal disturbances in various parts of the country. The decline was accentuated by other factors, such as the political uncertainty, wide-spread strike-wave, the slump in Wall Street, and the expectation that the Interim Government might pursue vigorous anti-inflationary and anti-profiteering policies. Share prices declined to abnormally low levels. The Economic Adviser's general index of security prices fell from 314.9 in August, 1946, to 282.0 in September and 26.5 in October. The first reactions were extremely panicky. There was heavy rush in Calcutta and Bombay stock exchange markets for liquidating scrips of all categories. The downward trend of the market went a further heavy decline with the announcement of the new taxation proposals in the central budget for 1947-48 and the markets in Calcutta, Bombay and Madras had to be closed for some time to prevent a crisis.

A large number of banks, mostly non scheduled, which made a heavy investment in speculative shares, had to face a serious banking crisis. Signs of smaller banks in Bengal getting into difficulties were noticed early in November, 1946. When the speculative fervour in the stock exchange market, was in full swing in the middle of 1946, the Reserve Bank cautioned all banks, scheduled and non-scheduled, against the dangerous practice of making large loans against stock exchange

securities By issuing the other circular, the Reserve Bank drew the attention of banks to the need for restricting advances against shares to a reasonable proportion of their resources or total advances and the advisability of fixing maxima for advances per share in the case of speculative counters At that time the Reserve Bank of India was considering the desirability of introducing legislation for regulating margin requirements on the American lines to curb unhealthy speculation The fixation of margin requirements by the Reserve Bank has got its place in the Banking Companies Act of 1949 Under Section 21 of the Banking Companies Act, the Reserve Bank has been given power to determine the margins to be kept in respect of secured loans

Methods of selective credit control can be effectively used in a particular sector of economy by raising the margin requirements when inflationary tendencies are witnessed in that sector But it would be a mistake to assume that they would be able to restrict credit all round It is doubtful whether the depression would be cured by lowering the margin requirements as the depression is caused more by fundamental defects inherent in the economic system than by monetary factors In the case of a localised depression or when a depression occurs in a particular economic sector, in spite of the fact that trade as a whole is active, it may be possible to cure partial or localised depression and to bring recovery by lowering margin requirements if depression in that locality or in that economic sector is due to monetary factors In India, selective methods of credit control could only be used to prevent speculative dealings in the stock exchange market in 1946-47 At present there is no need of using them in India as no speculative excesses are noticed in any economic sector

The present economic problem of India is quite different Like other countries of Asia, India is an undeveloped country Her huge resources have remained unemployed They should be employed in different economic sectors—industrial, agricultural and commercial As the objective of the Reserve Bank of India should be to attain a stable level of good employment, like central banks of other countries, the Bank as a controller of credit has its part to play for helping all-round economic development of India It should take the advantage of the cheap money policy which the Government of India has so far vigorous

ly pursued. What is at present necessary is that a consolidation of the progress already made towards cheap money is very essential and the Reserve Bank should assist in percolating money so available proportionately to various economic sectors, namely, industry, agriculture, trade and business. In India there has been no reason to revert the cheap money-policy as the easy money condition is vitally essential for her all-round economic development. In order to create an easy money condition, the Govt of India should pursue the cheap money-policy, if necessary, till level of full employment is reached in India. Cheap money, no doubt, "beyond a certain limit, not only ceases to be beneficial but in certain conditions, as for instance, when inflation outlives the forces that engendered it, becomes harmful to the economy"<sup>1</sup>. But, in India, inflationary tendencies which are witnessed are due to the variety of reasons, namely, the British methods of war finance during the great World War No II, artificial creation of scarcity of goods by hoarding etc., and black marketing.

In order to assist with necessary credit the various sectors of our economy, the Reserve Bank should be vested with powers of using rationing of credit which is regarded as a necessary accompaniment of a planned economy. For that reason the Reserve Bank of India should not only be state-owned but its whole structure and organization should be reorientated and its power should be enlarged so that the Reserve Bank can truly act as guide, friend and philosopher to our economy in future. A separate chapter is devoted to deal with what should be the structural organization and the role of the Reserve Bank of India to achieve its objective of "a stable level of good employment".

---

1 See the 13th Annual Report of the general meeting of shareholders of the Reserve Bank of India, p. 47,

## CHAPTER XVI

### The Reserve Bank of India under Planned Economy

"The lessons of the inter-war period teach by implication, the essential objectives of an international monetary system. Such a system must be based on international co-operation through a permanent institution"<sup>1</sup> We saw the creation of International Monetary Fund and International Bank for Reconstruction and Development in the post-war period. These two institutions will "attempt to harmonize the monetary and general economic policies of their member countries"<sup>2</sup>

In the post-war period every country has pledged to maintain or achieve "a stable level of good employment". While we notice changes all round in the monetary objectives of central banks, our Reserve Bank of India is quite indifferent to these changes and is *still maintaining the objective of monetary stability*. What this monetary stability means? Monetary stability is quite a vague objective and will not serve the purpose in the post-war period. Therefore, there is a strong ground for changing monetary objectives of the Reserve Bank of India and it should be entrusted with wide powers to achieve the universal monetary objective—"a stable level of good employment". The reorientation of the Reserve Bank of India is quite essential. Not only its scope and functions are to be enlarged, there should be structural and organizational changes of the Reserve Bank.

All the existing departments of the Reserve Bank, namely, the Issue Department, the Banking Department, the Exchange Control Department and the Agricultural Credit Department should be reoriented, and the Reserve Bank Act should be amended accordingly. Besides the reorientation of the existing departments of the Bank, a new department, namely, the Industrial Credit Department of the Reserve Bank, should be created with a view to finance the Indian industries.

In the next few pages, an attempt will be made to give a few suggestions to introduce structural, organizational and functional changes of these departments of the Reserve Bank.

---

1 See Hahn—*Monetary Theory*, p 264

2 See " " " " " 265

### Industrial Credit Department

Indian industries have been deprived of long-term finance for a long time. No attempt for opening specialised institution for providing long-term finance was made upto the close of the second World War. The popular demand for such specialised institutions in India has been for the last three decades. After the first Great War of 1914-18 the Indian Industrial Commission gave much emphasis to the establishment of such financial institutions like industrial banks. "In 1924 the External Capital Committee also recommended the formation of specialised institutions for tackling the problem of industrial finance in India."<sup>1</sup> Some of the Provincial Banking Enquiry Committees also recommended for setting up "industrial banks" on provincial lines. Central Banking Enquiry Committee also opined for setting up Provincial Industrial Corporations and All India Industrial Corporation. "But the reports of these Committees and Commissions had been resting in utter oblivion among the dust and cobwebs of the upper shelves of the Secretariat and no action, except a half-hearted attempt in one or two provinces, had been taken on their recommendations."<sup>2</sup>

But during the post-war period we saw the establishment of the Industrial Finance Corporation of India to meet the needs for long term finance. The Corporation has been set up "for the purpose of making medium and long-term credits more readily available to industrial concerns in India, particularly in circumstances where normal banking accommodation is inappropriate or recourse to capital issue methods is unpracticable."<sup>3</sup> It is said that its purpose is not to meet the financial requirements of basic and nationalised industries but only to provide finance for the needs of private industry. Thus, the basic or key industries have been deprived of the legitimate financial help. There is no reason why basic industries would be deprived of the financial aids of the Corporation. Moreover, the Corporation is interested only in public limited companies and co-operative societies. Thus, the Corporation entirely neglected the economic significance and potentialities of partnerships and private limited companies. If India is going to be

<sup>1</sup> See F. K. Basu—*Financing of Post war Industry*, p. 49

<sup>2</sup> See S. K. Basu—*Financing of Post war Industry*, p. 50.

<sup>3</sup> See Industrial Finance Corporation Act, 1948

industrialised in the post-war period, it is meaningless to exclude basic industries and medium-sized and small-sized industries run by partnership firms and private limited companies

The scope of the Finance Corporation is limited and it is doubtful that such organization will be of any help for the rapid industrialisation of the country with this half-hearted spirit of the Indian Finance Corporation. We cannot march forward along the path of industrialisation leading to our destination *i.e.*, "a stable level of good employment"

India is one of the under-developed countries of the South-east Asia. But India's industrialisation will help the rapid industrialisation of the South-east Asian countries. India will play a dominant role in the economic progress of these sister countries of South-east Asia. So India's industrialisation has great economic significance. And for the rapid and planned industrial development of our country, the Government should abolish the present Corporation and open an Industrial Credit Department under the control of the Reserve Bank like the Industrial Finance Department of the Commonwealth Bank of Australia.

### **Creation of the Industrial Credit Department**

For the rapid and the planned industrial development an Industrial Credit Department should be created within the Reserve Bank of India by passing a separate legislation like the Industrial Finance Department of the Commonwealth Bank of Australia, its accounts and transactions should be kept separate in order to assess the achievements of the department.

The Industrial Credit Department should be placed under a departmental manager who will be appointed by the Govt. in consultation with the Governor of the Reserve Bank. The departmental manager will hold office for a period of five years and will be eligible for re-appointment. The Governor of the Reserve Bank will direct the manager of the said department in every important matter. It is expected that the departmental manager should possess the knowledge of industry, finance and specialised technique of industrial banking and that a Board consisting of different types of experts will be created.

**Capital structure** —It is very difficult to lay down a particular amount regarding the capital resources of the Industrial Credit Department. The question as to what the exact amount of such capital should be, can be settled only after a careful assessment of the responsibilities which the I C D is intended to undertake. Evidently, the amount should not be too low like the I F C considering the requirements of key industries, defence industries, Public Utilities concerns and other existing and future industries.

The capital should be completely state-owned. Like the I F D of Australia one-fourth of the capital should be transferred from the general reserve account of the Reserve Bank of India, and the rest of the capital funds may be supplemented by issuing bonds to the public or by the Treasurer's advances to the Reserve Bank of India for the purpose of I C D like I F D of Australia. It may also attract deposits on long-term basis by paying a fine rate of interest.

### Functions of the Industrial Credit Department

The functions of the I C D should be as follows —

1. to provide finance for the existing Basic (Defence Industries, Iron and Steel, Transport, Ship building, Arms and Ammunition) and key industries which should be nationalised immediately for the best interests of the nation ,

**Defence Industries** —(1) Fire-arms, (2) Munitions, (3) Tanks and armoured cars and other equipments for military purposes, (4) War-ships, (5) Military craft, (6) Gases for warfare

**Key Industries** —(1) Power (i.e., electricity etc.)—both hydro and thermal, (2) Coal, Mineral oil, power alcohol etc., (3) Metals including mining of ore for them, (4) Industries for making machinery and machinery parts, (5) Industries for making machine tools, (6) Heavy engineering industries for the building of ships, locomotives, wagons, automobile, aircraft etc., (7) Chemicals—heavy chemicals and fine chemicals including dyes and fertilisers

**Public Utilities** —(1) Distribution of electricity, gas etc., (2) Public transport and communication services, (3) Water supply, (4) Sanitation

2 to assist in the establishment and development of capital goods industries or such industries which are expected to promote the rapid industrialisation of the country ,

3 to assist in the establishment of consumers' goods industries (or producing articles of consumption) ,

4 to advise on the working and operations of industrial undertakings with a view to promoting the efficient organisation ,

5 to provide financial assistance either by way of a loan or by direct investment in an undertaking (by purchasing shares and securities).

### **Scope of the Industrial Credit Department**

The main function of the I C D will be providing finance for the rapid and planned development of large industrial undertakings and particularly small undertakings, for which financial accommodation is not available through ordinary banking channels. The I C D will cover a large field, and finance any type of business.

### **Method of providing Finance**

The methods in extending financial aid should not be rigid and must vary in accordance with the circumstances. The method should be best suited to the needs of the particular case.

The principle should be flexible and not rigid. Like the British I C F C, "the prime factors should be the type of finance the applicant really requires and the best way of providing him with it"<sup>1</sup>. Thus the financial facilities may take the different forms. As regards state-owned industries, they may take the forms of direct loans, overdrafts and fixed loans.

With respect to industries owned by private interests, they may take the forms such as —

- (1) direct loans ,
- (2) overdrafts ,
- (3) fixed loans ,
- (4) hire purchase finance ,
- (5) subscription of capital to a company ,
- (6) underwriting the issue of shares by a company ,

---

1. See Art by General Manager, I C F C, in "Banker".

- (7) underwriting or purchasing securities issued by the borrower ,
- (8) participating preference shares ,
- (9) redeemable preference shares , and
- (10) ordinary shares

The activities of the Industrial Credit Department will be of a specialised nature and it shall not adopt the principles of orthodox banking standard in making loans to industrial concerns. Inability of the industrial concerns to give full security will not deprive them of the financial aids given by the I C D. If the Department thinks that the industrial concerns have the prospects of success if helped in the beginning, the I C D will not hesitate to finance them.

The business of the I C D will be a highly specialised undertaking. It must have its own staff possessing wide knowledge of industrial banking. Besides experienced banking staff, the Department must have on its staff experienced industrial engineers, cost accountants, chartered accountants, insurance experts, legal experts, pioneers of industries, geologists and explorers of minerals, and other technicians.

**Liaison Department** —The I C D will provide long-term and medium-term loans for the key industries, defence industries and Public Utilities concerns. In such circumstances it must keep close contact with the Board of such industries, Board of key industries, Board of defence industries and Board of Public Utilities concerns and other industrial concerns. And for that purpose a Liaison Department like the British I C F C should be started. The function of this Department will be to make contacts with the industrial concerns and to study the nature of their business problems and to advise them on important matters.

Its aim should be to provide finance at minimum cost. Therefore, a minimum rate of interest should be charged on loans.

#### **Procedure for dealing with Applications for Financial Assistance.**

Different Boards of different industries should apply directly to the I C D for finance.

Board of industries shall submit their proposals containing a statement of the amount and the purposes for which finance is required. In respect of nationalised industries such as all key industries, defence industries and Public Utilities concerns, the I C D. will give

particular importance and consider their applications for finance most favourably keeping in view that the national interests may not be jeopardised. In the case of old or new industries except the nationalised industries, the applicants should send copies of Balance Sheet and Profit and Loss Account and a clear statement containing the total amount of money the promoters themselves intend to provide.

All the applications should pass through the following stages —

(1) Examination Department —This Department will scrutinize the applications in order of prime necessity *i. e.*, nationalised industries (key, defence and Public Utilities industries) will be given first importance and then other applications in order of their national importance. Not only this, it will see that there is a *prima facie* case for a loan.

The various departments will scrutinize the proposal in its different aspects and these departments may be such as A/c Dept, Cost A/c, Technical Department, Economic Intelligence Department, Legal Department.

(2) Finally, the Departmental manager with its Board shall approve or disapprove the proposals.

The I C D will also see that the industries will prosper in the future even without its help and after repayment of loans the industries concerned will be able to stand on their own legs and sustain all possible hard days and crises.

### **Safeguards for Repayment of Loans**

As regards state owned industries the question of repayment of loans granted by the I C D does not become a problem. The particular industry will be able to repay loan after a certain period when it will begin to operate under decreasing cost. The difference between the selling cost and the turnover cost will be sufficient for repayment of loans. Of course, the tenure of the loan can hardly be as rigid as loan granted to private-owned industries. As the I C D has to depend on the profit margin of the state owned industry, this margin can never be kept at the highest level always. The industry has to look primarily into the interest of the consumers in general. Therefore, the margin may be deliberately varied from time to time according to circumstances. Thus, with the variation of the profit

margin of the industry concerned, the repayment of loan will also vary. However, a dead time may be fixed up beforehand.

Vast powers shall be granted to the I C D to secure repayment of loans even before the agreed period. If a particular industrial concern fails to comply with the requirements and conditions of contracts with the I C D or fails to comply with the demand for immediate repayment, the I C D will be authorized to sell the mortgaged property or to take over the industrial concern.

#### **Relation with the International Bank for Reconstruction and Development —**

With the opening of the I C D, the Reserve Bank of India will transfer to it the responsibility of arranging loans from the I B R D. As the I C D will possess all the informations regarding industrial potentialities of the country, it will help the Investigations Department of the I B R D in making survey and exploring the potentialities of certain new industries. Thus, our I C D will help a lot in arranging international loans to certain industries.

#### **Agricultural Credit Department —**

The Reserve Bank of India created a special Agricultural Credit Department under the statutory obligation of Sec 54 of the Reserve Bank of India Act, 1934, the functions of which are —

- (a) "to maintain an expert staff to study all questions of agricultural credit and be available for consultation by the Central Government, Provincial Governments, Provincial Co-operative Banks and other banking organisations ,
- (b) to co-ordinate the operations of the Bank in connection with agricultural credit and its relations with Provincial Co-operative Banks and any other banks or organisations engaged in the business of agricultural credit "

What is the purpose behind this creation of special Agricultural Credit Department? Sec 55(1) of the Reserve Bank Act of 1934 clearly shows and emphasizes the purpose. Under the above Section the Bank shall submit to the Central Government a report within three years under Sec 55(1)(b) on "the improvement of the machinery

for dealing with agricultural finance and methods for affecting a closer connection between agricultural enterprise and the operations of the Bank "

Needless to say that there is a great importance of co-ordinating and linking the rural finance with the money market. It is a problem on which no two opinions exist in the country. But it is also a problem which, again, by common consent, admits of no easy or immediate solution. The Statutory Report of the Reserve Bank of India, 1936, says—"We must also make it clear unless the co-operative banks can put their long term debts on a business footing and separate them from other business, the Reserve Bank of India will not be in a position to be of assistance to them." Thus, it is evident that the Reserve Bank of India will not assist rural money-lenders unless they modernize themselves on new lines. Since the year 1938 it has published many circulars stating principles and conditions under which it would be ready to finance the co-operative banks. This Department is a department for gathering informations and making intensive study of the problems relating to rural finance and advising to provincial agencies for rural credit.

The Reserve Bank have totally failed to assist agricultural credit not only by direct monetary help but also by giving any indication of the lines on which it would be prepared to grant such help.

It has always neglected the legitimate financial needs of the "national industry" (Agriculture) on which the complete majority of population depends for livelihood. The then authority of the Reserve Bank of India turned down all our criticisms and suggestions on the plea that these (criticisms) were due to a misapprehension of the legitimate functions of a central bank in the sphere of agricultural and other credit and tried to explain some of the fundamental facts regarding the constitution and functions of the Reserve Bank of India.

The preamble to the Act says that monetary objective of the Reserve Bank of India is to secure monetary stability in British India generally to operate the currency and credit system of the country to its advantage. Is the term monetary stability itself not vague? Does it mean "Price stability" or "Exchange stability" or "employment

stability" ? Has the Reserve Bank of India operated the currency and credit system of the country to its best advantage ? Is it not one of the legitimate functions of the Reserve Bank of India to operate the credit system to the advantages of the most important sector of economy, namely, Agriculture ? The authority has failed to understand the implications and the wide area that it covers. For, in the first place, the preamble of the Reserve Bank of India is ambiguous as it may include everything. In the second place, the authority has always twisted its meaning in such a way that the interests of the nation has always suffered.

The authorities have contended "that since it has been a Bankers Bank, in emergency it has to keep a large portion of its funds in hard cash and invest most of the remainder in readily realizable Government Securities and Treasury Bills, therefore, it is impossible for the Reserve Bank of India to lend to agriculturists direct or to advance large sums to co operative banks or indigenous bankers for being lent out to cultivators as a matter of course"<sup>1</sup>

Their contention is right because the Reserve Bank has certain limitations inherent in its constitution which stand in the way of creating a short-term agricultural credit. But we can't forget the conservativeness of the Reserve Bank of India in matters of developing co operative village banks and other Agricultural Credit Agencies.

The Reserve Bank, while admitting the necessity of building up primary credit agencies, followed the conservative principles of "Free Bankers" and holds that "credit agencies must build up their own business on their own resources and on lines which do not involve reliance, from day to day on an outside or even the central institution". Free Bankers would argue that "if commercial banks can always rely on the Central Bank helping them out of difficulties as the lender of the last resort .. ....they would lead more careless and bad banking"<sup>2</sup>. These charges hold no good in the 20th century when banking legislations are being passed and wide powers are being given to the Central Bank to regulate the whole banking system.

1 Reserve Bank of India, Agricultural Credit Department—Statutory Report (1937), p 34

2 Sayers—Modern Banking, p 223

The Reserve Bank shows its inability to act as the apex bank of the movement and it is apparent that co-operative banks must stand on their own legs like commercial banks

"The attitude of the Reserve Bank has given rise to some controversies in the country and the public is inclined to regard it as unduly conservative"<sup>1</sup>

Let us now examine the powers conferred by Sec 17 of the Reserve Bank of India Act, 1934, to lend to provincial co-operative banks and to carry on and transact businesses. We shall also study how far the Reserve Bank has utilized those powers to the furtherance of credit movement and to aid to the agricultural classes in general

"The terms on which the Reserve Bank is authorized to lend to provincial co-operative banks are already laid down in Subsections (2)(b), (4)(a), (4)(c) and (4)(d) of Section 17 of this Act"<sup>2</sup>

Sec 17(2)(b) —The Bank is authorized to carry on purchase, sale and rediscount of bills of exchanges and promissory notes (drawn and payable in India) and bearing two or more good signatures, one of which shall be that of a scheduled bank (or a provincial co-operative bank) and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and maturing within nine months from the date of such purchase or rediscount, exclusive of days of grace

(4) The making to states in India, local authorities, scheduled banks (provincial co-operative banks and the principal currency authority of Ceylon) of loans and advances, repayable on demand or on the expiry of fixed periods not exceeding ninety days against the security of

(a) Stocks, funds and securities (other than immovable property) in which a trustee is authorized to invest trust money by any Act of Parliament or by any law for the time being in force in British India

1 National Planning Committee—Rural Marketing and Finance, p. 183

2. See Statutory Report (Reserve Bank of India, Agr Credit Deptt), 1937, p. 36

- (c) Such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Bank.
- (d) Promissory notes of any scheduled bank (or provincial co-operative bank), supported by documents of title to goods which have been transferred, assigned or pledged to any such bank as security for a cash credit or overdraft granted for *bona fide* commercial or trade transactions, or for the purpose of financing seasonal agricultural operations, or the marketing of crops "1

The difficulty arises in Sec 17(4)(d) regarding "supported by documents of title to goods which have been transferred, assigned or pledged". The interpretation of the clause by the legal advisers of the Reserve Bank of India has been made like this "if institutions dispensing agricultural credit desire to hold security which can be negotiated with the Reserve Bank, they must have in their possession warehouse receipts or warrants issued against pledged goods in actual possession by a public body like a market committee or local sale societies or central financing agencies"2 But these institutions have their own godowns and "the receipts or warrants issued by them will not serve as security for credit to be granted under Sec 17(4)(d)"3

The present position of the warehousing is quite unsatisfactory and there is hardly any possibility of developing trade bills or agricultural bills, unless certain Sections of the R B I Act are suitably amended. There has been no attempt to start licensed warehouses and it will be unwise to wait for the growth of trade bills. There is a sufficient scope for developing trade bills within the present set up of the credit system. "It would be regrettable if an exaggeratedly rigid interpretation of the Reserve Bank of India Act were to stand in the way of exploiting whatever opportunities there may be for stimulating progress in this direction"4

Sec 17(2)(b) gives powers for carrying on the effective credit movement and aid to the agriculturists. If the bills of exchange arising from the operations of agricultural credit agencies were to be made

1 See Sec. 117 of the R B I Act of 1934 pp 13 14

2 & 3. See N P C —Rural Marketing and Finance, p 133.

4 " " " " " " " 134

negotiable with the Reserve Bank of India, the Indian cultivators would get the financial facilities "A canal would thus be cut joining the main spring of credit supply with the agriculture of the country"<sup>1</sup>

It seems that the Reserve Bank has deliberately or neglectfully acted to the detriment of the interests of agriculture by not using the powers given to it by the Sub-clauses of Sec 17. The Reserve Bank could have inundated at least some portions of agricultural sector with finance, but it did not. On the contrary, it issued circulars on June 12, 1939, to all provincial and central co-operative banks to come in line with the recommendations laid down therein, otherwise it would not offer financial accommodation. "It has laid down the conditions which co-operative banks will have to fulfil before they can be eligible for obtaining financial accommodation"<sup>2</sup>. Experience has shown that co-operative movement itself cannot go ahead without the guidance of the Reserve Bank of India. It is the duty and responsibility of the R B I. to bring about the necessary organisation for the co-operative movement. But the Reserve Bank of India's wait-and-see policy has left the movement far behind and disorganised.

In its Annual Report of 1939, it has been reported that "no co-operative or scheduled bank has so far approached the Reserve Bank for financial accommodation against agricultural paper". The very statement shows the neglectful duty of the Reserve Bank of India in matters of finance. It does not mean that co-operative banks or scheduled banks do not require such financial accommodation. Nobody would believe this. The negligence and "unhelpful attitude of the Reserve Bank of India have been primarily responsible for the fact that no institution dealing with agricultural credit has so far found it worth while to approach to it for financial accommodation against agricultural paper"<sup>3</sup>.

Now the Reserve Bank of India has been nationalised by the "Transfer to Public Ownership Act of 1948". It has assumed a greater importance in the post-war economic reconstruction of the country. But mere nationalisation will not help India in attaining the sole objective of

1 See N P C —Rural Marketing and Finance, p 134

2. " " " " " " p 137

3 " " " " " " p 138

"a stable level of good employment" If the interests of all classes of the agricultural community are to be safeguarded, and if the purchasing power of the agricultural sector of economy is to be increased, structural changes in Agricultural Credit Department are required to irrigate the whole agriculture with cheap money and easy credit

### **Work for the Future Suggestions to reorganise Indian Agriculture.**

"The synchronisation of plethora of funds in the bigger money markets and its scarcity in the rural areas is reflected in the very wide margin between the rates of interest prevailing in the two cases" <sup>1</sup> The present distribution of credit facilities is quite uneven Some sectors of our economy are flooded with credit facilities and others are equally dried for the want of credit facilities This excess of credit facilities in some sectors is quite analogous to flood-stricken areas and the dearth of credit facilities in Agricultural sector is analogous to regions suffering from scarcity of water So we need a better distribution of credit facilities and in the words of the National Planning Committee as "system for better financial irrigation" The advantages of war-time and post-war-period policy of cheap money have not at all percolated to the main sector of economy i.e., agriculture "Money has perhaps always been cheaper in bigger centres than in villages In our times there has, however, been an excessive concentration of funds in such money markets as Calcutta and Bombay" <sup>2</sup> Rural areas have so far derived little or no benefit of the cheap money campaign pursued by the Govt The divergence in the supply of cheap money and credit facilities between agricultural sector and the rest sectors of commerce and industry has become more pronounced during the post-war period The protagonists of cheap money-policy have called for the "Halt of cheap money-drive" We would like to say that "Halt of cheap money-policy" would not help India in emerging out of the fundamental economic crisis of the post-war period We would rather support the view of "Quick-march cheap money-policy" and that cheap money should be allowed to march quickly to the agri-

1 See N. P. C.—Rural Marketing and Finance, p. 125

2. " " " " " " " " p. 126.

cultural sector of our economy to fight the dacoit gangs consisting of money-lenders and Indian shroffs or indigenous bankers. "But the disorganised state of Indian agriculture, particularly the chaotic state of rural marketing and finance, has so far served as an effective deterrent to any improvement"<sup>1</sup> The best hope and the bright future of the Indian agriculturists lie in the reorientation of the village agricultural system, the abolition of the zamindari system and the present land-tenure system, and finally, in the reorganisation of the co-operative movement on the Nicholson lines along with the structural changes in the Agricultural Credit Department—"the apex of the co-operative movement" And on those lines we would like to make a few suggestions to ameliorate the village life

#### Suggestions —

(1) While welcoming whole-heartedly the policy of zamindari abolition by the National Govt, we suggest—(a) the compulsory merger of individual interests of land holdings into one common land or *shamlat*<sup>2</sup> land in every village,

(b) the control of the entire *shamlat* land thus shall pass into joint hands or collective ownership and all the proprietors shall merge their individual interests and hand over the affairs of the common land to an elected committee,

(c) each proprietor or individual tenant (or peasant) will receive a share containing the total bighas or acres of land owned by him, thus he will be a shareholder or common member of the collective farm or *shamlat* land of the village,

for example, if a farmer or a proprietor owns 10 bighas of land, he will get a share or document containing 10 bighas of land and he will be entitled to get a net return per bigha out of the total net output of the *shamlat* land after deducting all expenses and providing for depreciation and reserves and other funds,

(d) each *shamlat* land will possess its own rice or flour mill, electric power station, electric forge shops, carpentry machine shops and also workshops serving the everyday needs of the collective farms,

---

1 See N P C—Rural Marketing and Finance, pp. 128-29

2 See Reserve Bank of India, Agricultural Credit Department—Bulletin No. 4.

(e) out of the income in kind, i.e., out of the total quantity of grain, the *shamlat* land will provide for seeds and fodder, and will also make provision against bad harvests and calamities,

(f) distribution of incomes both in kind and cash among the members of the collective farm will be based on the number of bighas held in the form of share by each shareholder, as for example, the general meeting of members of *shamlat* land on the basis of its total annual income, decides to distribute for each bigha 10 maunds of grain and say Rs. 15 in cash, in this case, if a collective farmer has 10 bighas of land, he will receive 100 maunds of grain and Rs. 150/- in cash

(g) Besides what every member of the *shamlat* land receives from the commonly owned farming he also may have for his personal use a subsidiary husbandry on a small plot of household land i.e., *Bari*. He has his own house, a cow, small cattle, a garden, etc.

(2) Each *shamlat* land or collective farm shall start a co-operative bank of its own. Every member shall contribute a minimum share capital of the bank prescribed. The co-operative bank will attract deposits from the members both on short and long terms. It will lend money to the collective farm at cheap rates of interest in order to meet the agricultural needs and assist them in paying off the old debts borrowed at high rates of interest.

(3) The A C D of the Reserve Bank of India should formulate new principle for developing co-operative banks and help in all possible ways for the establishment and organisation of co-operative bank in each *shamlat* land. The functions and principles of organisation of a co-operative bank will be dealt later on.

With the aforesaid background of the Indian villages we suggest here for the structural changes in the A C D of the Reserve Bank of India in order to cut out a canal joining the main spring of credit supply with the *shamlat* land and its co-operative bank. We hope that the simplest and most effective method of bringing the advantages of cheap money-conditions to agricultural sector of economy would be to increase and broaden the powers and functions of the existing A C D of the Reserve Bank of India to participate actively in agricultural credit. In order to achieve this, close and continuous link should be made between the A C D on the one hand and all co-operative banks of all the *shamlat* lands on the other. A link should be established

between the A C D of the Reserve Bank of India and the co-operative banks of *shamlat* lands so that the liquid and cheap money might flow, percolate and irrigate the rural areas.

### **Suggestions —**

#### **1 Organisation and Management**

The A C D shall be put under a Departmental Manager, who will be appointed by the Central Government in consultation with the Governor of the Reserve Bank of India and will hold office for a period of five years but will be eligible for reappointment. The Departmental Manager will be assisted by a Board consisting of seven members. The members of the Board shall be appointed by the Governor of the Reserve Bank of India in consultation with the Departmental Manager and will hold office for a period of five years. The Departmental Manager must have a thorough knowledge of agriculture, rural finance and co-operative banking of European countries. He must be capable of developing and organising a sound co-operative banking.

#### **2 Capital and Resources :—**

As regards the resources of the bank it is essential that its capital should be fixed at a fairly high figure. It will be very difficult to lay down the exact amount of such capital as it can be settled with full justice only after a careful assessment of the responsibilities which the A C D is intended to undertake. Considering the requirements of Agricultural co-operative banks and the number of *shamlat* lands the amount for the capital should not be meagre.

One-fourth of the total capital should be raised by transfer from the general reserve fund of the Reserve Bank of India and the remaining capital by issuing bonds of smaller denominations to the public.

#### **Functions and Powers of the Agricultural Credit Department**

The functions of the A. C. D. may be as follows —

- 1 to provide finance for agricultural improvement and development of irrigation facilities through co-operative banks ,
2. to assist in the establishment and development of co-operative bank on each *shamlat* land ,

3. to make advice on the workings and operations of the *shamlat* land and co-operative banks with a view to promote the efficiency of the organisation

#### **Powers —**

The following powers may be given to the A C D —

- 1 powers of inspection of the co operative banks ,
- 2 control and regulation of loans and advances the A C D shall determine the loan-and-advance policy in general and in particular ,
- 3 it shall govern the purpose of loans, margins to be kept against loans, rate of interest to be charged thereon ,
- 4 each co operative bank shall submit weekly returns of assets and liabilities and any statements and informations required by the A C D ,
- 5 power to prohibit the co-operative bank from carrying on business if it thinks fit in the best interests of the *shamlat* land.
- 6 power to liquidate the co-operative bank if it runs against the principle of co-operative bank ,
- 7 power to issue licence and to cancel the licence granted to the co-operative bank , and
- 8 each co operative bank shall deposit with the A. C D. a certain percentage of total deposits

Thus a separate Co-operative Banking Act should be passed stating therein the full powers given to the A C D to regulate the co-operative banking system as a whole

#### **Relation with Co operative Banks**

Its relation with co-operative banks shall be clearly defined in the Co-operative Banking Act Generally speaking, the relation should be of developing and assisting the co-operative banks on sound lines and cautioning them from dangers and bad paths The relation should be like that of a parent organisation with its branches The accommodating spirit should be developed between the parent organisation and the co operative banks

In order to have close and continuous touch with the co-operative banks, the A C D. should maintain a Liaison Department consisting of expert officers having wide knowledge of agriculture and rural

finance and co-operative movement. Their main duty will be to travel all over the country from one *shamlat* land to another to contact with them and to educate them the co-operative principles by exhibiting the films, showing the workings and organisations of the collective farms. The A C D shall also maintain on its staff experts like agricultural engineer, irrigation engineer, mechanical engineer having wide knowledge of operating tractors and combined harvesters, cost accountants, chartered accountants, men with specialised knowledge of co-operative banking on Nicholson lines, legal experts, surveyors, statisticians to carry on designs of experiment in biology, and agricultural botanists and other scientists to smooth out the work while granting loans for bigger projects and schemes of irrigation and electricity, etc.

#### Methods of granting loans —

The principles of granting loans to *shamlat* land through its co-operative bank should be flexible and not rigid and must be based on the principles of co-operative bank as suggested by Nicholson. Financial assistance may be made in the following forms as best suited to the needs of a particular case (1) overdraft, (2) fixed loans (mortgage), (3) hire-purchase finance (for purchasing machinery), (4) cash credits, and (5) by such other means as may be appropriate to a particular case.

Accommodation may be made available by means of an ordinary overdraft method at a fine rate of interest.

Loans may be granted for a period not exceeding, from 5 to 10 years. A *shamlat* land should apply for loan to the A C D through its co-operative bank.

#### Methods of repayment of loans —

Repayment of loan should begin just after one year, since the completion of the project for which loan is granted. Repayment of loan may be insured by instalment system. Each co-operative bank and *shamlat* land shall allocate a certain percentage of the total income of the farm towards the Loan Repayment Fund and from that fund payment will be made to the A C D annually.

#### Relation with the I B R D.

Assistance offered by the I B R D for India's agricultural development should come through the A. C. D., as the A. C. D. is the

fittest organisation to decide in which way the funds so available will be utilized. The A C D will be made mainly responsible to the I R B D. for the repayment of such loans granted by the International Bank

### **The main functions of the Village Co-operative Bank**

"The banks which fulfil at once the requirements of thrift and credit while promoting in a high degree those qualities which are essential to high national character are the village co-operative banks. They are not formed by the capitalists seeking investments for their funds with the hope of earning dividends thereon, and therefore widening business regardless of the results to the borrower, but are small groups of men, all of the same neighbourhood or who unite their savings, attract capital by their thrift and prudence, and lend the proceeds to themselves on equitable terms for productive use"<sup>1</sup>

The co-operative movement has failed to keep high ideals. If the movement is to be reorientated, every village must become a common collective farm by uniting all the land holdings into one. And the village bank must be modified on new lines —(1) "Each bank will not take up more than one village within its ambit, (2) it should include everyone in the village, (3) there must be a greater adherence to essential co-operative principles, and (4) there must be continuous touch with the members"<sup>2</sup>

**Capital and Reserves** —Each bank must raise its own capital. The first co-operative principle is that credit must be based on the thrift and prudence. The soundness of the bank must be judged by its capacity to raise capital locally. "It must therefore endeavour to find its capital by collection of the idle hoards and the savings of the villagers before it approaches the A. C. D. of the Reserve Bank of India for loans"<sup>3</sup>. It may not be able to get locally all the finance that it requires. In that case it should approach to the A. C. D. of the Reserve Bank of India to get the initial capital

1 See Reserve Bank of India, A. C. D. —Bulletin No. 2, pp. 27-28

2 " " " " " " " " " " 29

3. " " " " " " " " " " 29

### Management by members

"The best education in co-operative principles is obtained by the management of the bank by the members themselves"<sup>1</sup> Bank's own committee may appoint paid staff if necessary Supervision and guidance may be given by the A. C. D. "A radical alteration in the system of work on these lines is not unpractical and will go a long way to ensure the understanding and observance of co operative principles

### Functions and Activities of the Bank.

1. Better farming the bank must evolve out new methods to assist the collective farm by limiting its expenditure and increasing its income

2 It should encourage and educate the mass for joint cultivation or collective cultivation as we have suggested before i e, the pooling together of their land by all members and its cultivation in one big farm This will make possible the use of modern machinery

3 It may help in organising co-operative marketing and in developing subsidiary occupations like, dairy-farming, poultry-breeding and bee-keeping, etc

### Banking functions

1 It shall attract deposits from the members of the collective farms.

2 It shall govern the use of credit and business habits of its members.

3 It shall create reserves and shall deposit with the A C D of the Reserve Bank of India.

4 It has to keep certain percentage of total deposits with the A C D of the Reserve Bank of India

5. "It shall gather property statements of members carefully prepared Transfer of land without the knowledge and permission of the village bank should be stopped"<sup>2</sup>

6 "The bank should have its own building at the earliest opportunity. This should be the centre of all social activities Till

<sup>1</sup> See R B I, A. C. D.—Bulletin No 2, p 37

<sup>2</sup> " " " " " " 59

a bank possesses its own building the village school may be used for the purpose. The keeping of the books of the bank with the president or secretary should not be permitted.

7 The bank must never lose touch with the members. Absence of such touch leads to indifference, default and disloyalty.<sup>1</sup>

8 It shall not grant loans to any single individual except the collective farm in common.

9 The village bank shall grant loans only for productive purposes.

## EXCHANGE CONTROL DEPARTMENT

### International Aspects of full-employment policies

"The Government of India do not have any specific employment programme though they have accepted certain commitments to provide full employment to the greatest possible extent. They are mindful of the necessity of utilizing all resources for the development of the country and for raising the standard of living of the people."<sup>2</sup> It is self-evident that India is heading towards the stable level of good employment. It is also clear that the objective of full employment must be approached primarily in the sphere of domestic or national action and by adopting various domestic measures namely, stabilization of the level of investments, and the aggregate demand, full-employment budgetary policy, etc. But the full-employment policy has also its international aspect. In its international aspect, India must achieve stability in international trade. "Stability in international trade cannot be maintained when the balances of payments of individual countries are in serious disequilibrium, and balances of payments equilibrium cannot be maintained if the demand or supply of individual countries for internationally traded goods is unstable."<sup>3</sup> Therefore, in order to achieve the stability in international trade we must strike at the root of the problem: i.e., problem of stabilizing

1 See Reserve Bank of India, Agricultural Credit Department—Bulletin No 2, p. 60.

2 See U. N. O.—Maintenance of Full Employment, p. 80.

3 See U. N. O.—National and International Measures for Full Employment, p. 49.

the demand and supply of individual countries for internationally traded goods. There are two approaches to this problem (1) "the *laissez-faire* case for free trade as a means of securing economic progress and prosperity through peaceful trade depended essentially on the belief that free competition could be relied upon to bring about an equitable, stable and effective use of the world's resources for the benefit of consumers all over the world"<sup>1</sup> But the case for international trade based on the grounds of competitive equity and efficiency must not hold good when we have different independent money markets and currency areas like Sterling area, Dollar area, etc. Disruption of the foreign trade balances as well as of the balances of payments deepened on the division of the world market into separate zones

"By 1933, four groups of currency systems were operating (1) the 'gold bloc'—France, Switzerland, the Netherlands, Italy (until 1934), Belgium and Luxemburg (until 1935), (2) countries maintaining an "artificial" parity or checking depreciation by means of exchange control and other restrictions (Germany, Italy and other Latin American countries), (3) countries with depreciated and controlled exchanges (most Latin American and some European countries such as Greece and Czechoslovakia), (4) countries with depreciated and free exchanges (altogether some 20 countries, by 1933, including the United States, the United Kingdom, the British Dominions, Sweden and Norway)"<sup>2</sup>

The multilateral trade, usually practised under capitalism has been replaced by trade between two countries, moreover, the countries are obliged to buy commodities not where they can obtain them at lower prices, but where they have the possibility to import commodities equal in value to their exports from the same country "The system of multilateral trade, already seriously affected, broke down with the collapse of the world monetary system. There ensued a general movement towards bilateralism—the endeavour by each country to achieve reciprocity in trade by reducing imports from countries with which its trade balance was passive"<sup>3</sup>

1 See I. L. O.—The Common Interest in International Ec. Or., p. 66

2 See L. N. O.—Commercial Policy in the Inter-war Period, p. 70

3 See L. N. O.—Commercial Policy in the Inter-war Period, p. 70.

Each bilateral agreement was designed to meet the individual trade requirements. After the post-war period of general economic dislocation, trade restrictions which had been imposed as temporary measures, were gradually relaxed and the old pattern of commercial relations were restored. "The planning" of foreign trade came to be more and more widely accepted as a normal function of the state and the weapons which had been forged as an emergency defence of prices, production or currency were not discarded, but tended to be pressed into service as permanent elements of trade regulation, dovetailed into programmes of national economic development"<sup>1</sup> But Professor Viner has pointed out the weaknesses of state trading monopolies and criticised by comparing them with an ideal functioning competitive world market. "With respect to Govt trade monopolies, as with respect to exchange control and the quota system, the case against them is strong only on the assumption that there is available as an alternative a smoothly working competitive market process, not subject to substantial interference by private monopolies and not restricted by tariff barriers more oppressive to trade and more discriminatory than the government monopolies themselves"<sup>2</sup> The case against state trading must be reconsidered as there is no ideal and smoothly functioning competitive world market. The case for state trading has assumed greater and special importance these days when we talk of the international aspects of "full employment programme". The demand and supply of individual countries for internationally traded goods will remain unstable until they are planned by the respective governments. And if the demand and supply are unstable, the equilibrium in the balances of payments cannot be achieved and if there is disequilibrium in the balances of payments, the stability in the international trade is bound to suffer from the inflationary and deflationary tendencies in one country or group of countries.

"The acute underlying disequilibrium in international transactions which has persisted throughout the post-war period, overshadows all

---

1. See L. N. O.—Commercial Policy in the Inter-war Period, pp. 71-72

2. See L. N. O.—Trade Relation between Free Market and Controlled Economies  
—By Jacob Viner (Geneva, 1943), pp. 82-83.

other international economic problems and remains by far the most disturbing feature of the current situation"<sup>1</sup>

The deficit countries are experiencing more deficits day by day due to the duality nature of the United States' export trade. The U S A is exporting goods in large quantities and importing a very little amount of goods. In the three post-war years (1946-48) exports of the U S A reached the value of 38,000 million dollars against 9,000 million dollars in 1936-38. Moreover, the United States imports in these post-war years did not exceed 18,000 million dollars. The duality in the exports trade of the U S. A may be explained by the fact that unlike other big exporting countries which export large quantities of manufactured goods and import much food and raw materials, the U S A is a big exporter of both manufactured goods and food. The result has been that all the West European countries, have adverse balances in their trade with the U S A. "The magnitude of this imbalance can be gauged from the fact that in 1948 current earnings paid for only 43 per cent of Europe's imports of goods and services from the U S A. and for only 90 per cent of her imports from other non European countries so that non European countries as a group paid for only 74 per cent of their imports from the U S A. by current earnings, finally that only 62 per cent of the current earnings of the U S A in foreign transactions was covered by imports of goods and services"<sup>2</sup> The elimination of this chronic disequilibrium will require large reduction in U S exports or a large increase in its imports and large increase in exports of European countries rather than a reduction in their imports. The U S A is primarily responsible for this persistent deficits in the balances of payments of all other countries and is ruining the economy in other capitalist countries not only by one-sided exports, but also by banning trade between Western Europe and Eastern Europe. "The size of the adjustments required in the structure of world trade in order to re establish world financial equilibrium is a sufficient indication that the solution of the problem requires a degree of international co-operation which would make it possible for countries to pursue policies of adjustments that are consistent with one another"<sup>3</sup> The experts of the

1 See U N O —National & International Measures for Full Employment, p 50

2 " " " " " " " " p 51.

3 " " " " " " " " p. 52.



imported from abroad In 1937 the imports of rubber, silk, vegetable oil and soya bean comprised nearly one-sixth of the total imports of the U S A —367 million dollars In 1948, when prices had doubled, the imports of these raw materials amounted to only 324 million dollars, not content with this, they began to export many commodities never exported by the U S A. before, as for example, coal, and cotton fabrics, which became important items of export in the post-war period "The main obligation of surplus countries is to take the internal measures necessary to ensure that any decrease in their exports or rise in their imports does not involve a reduction in their internal production and income and thereby generate again export surpluses in their own balances of payments The surplus countries should also take steps to facilitate the necessary adjustments in trading relationships by reducing or removing restrictions on imports, in so far as they contemplate an increase in imports, and by refraining from giving any direct or indirect encouragement to exports through governmental policies, in so far as they contemplate a reduction in exports"<sup>1</sup>

Thus we find that only the governments with their planning of foreign trade and complete exchange control under their respective central banks can help to establish the permanent and lasting stability in the equilibrium of balances of payments The experts of the U N O have rightly suggested that only the governments themselves, by acting together in agreement with one another, can take the steps necessary to eliminate conflicts between their national economic policies and thus lay the groundwork for a consistent and self-sustaining pattern of trading and financial relationships for the achievement of which all countries could work both individually and collectively

### India's Balance of Payments.

India emerged out of the Second World War as a creditor nation by sacrificing her 35 million sons of Bengal at the door of famine In the post-war period she had to endure the disturbing effects of partition In spite of these hardships, the general course of India's balance of payments up to 1948 cannot be considered as unsatisfactory This

---

<sup>1</sup> See U N O —National and International Measures for Full Employment pp 53 54

view was expressed in an article in the July issue of R. B. I.'s Bulletin, 1949

"The post-war demand for re-stocking and replacement pushed up the value of private imports by some 38 per cent in 1947 over the level in 1946" But this did not lead to any serious unbalance in India's foreign accounts. With the partition, the exports of the Indian Union in 1948 were naturally lower than the exports of undivided India in 1947, but the fall in the value of imports was even steeper. Thus private merchandise, as an item in the balance of payments, made a good show with a favourable balance which fell from Rs 55 crores in 1946 to Rs 23 crores in 1947, but rose again to Rs 81 crores in 1948. Much of the credit for this must go to the fact that the prices of India's chief exports went up much faster during these 3 post-war years than its import price. The article says, "India's current transactions with hard currency areas showed a net deficit of Rs 4.8 crores in 1946, Rs 85.8 crores in 1947 and Rs 49.6 crores in 1948"<sup>1</sup>

India's balance of payments has been growing adverse not only with the hard currency areas but also with other areas in general. We notice a rapid decline in her exports in the first quarter of 1949. "Such exports amounted to Rs 184 crores only during the period as against Rs 209 crores in the corresponding period of last year"<sup>2</sup>

The economic effects of "Partition" has totally altered the pattern of foreign trade of India. Undivided India's monopoly of jute exports could not continue after partition. Indian Union became the largest importer of raw jute. Jute manufactures and raw jute account for the decline in Indian Union's exports. Indian Union lost her position as exporters of jute, raw cotton, hides and skins due to partition.

India's imports increased tremendously due to large imports of food-stuffs from hard currency areas. In 1948 the Govt's imports of food-stuffs remained high at a level of Rs 100 crores. This single item of food is primarily responsible for the deficit in India's balances of payments.

The unspent-up margin of consumers' demand during war time for durable and essential consumers' goods and the needs of capital

---

1. See Reserve Bank of India's Bulletin, July, 1949, p. 450

2. See Dr S. K. Basu—Devaluation and the Dollar Problem, p. 15.

replacement and re-stocking also led to the widening of the gap in the balances of payments

The internal inflation has also led to the adverse balances of payments "Indian goods are being rapidly priced out of the dollar markets"<sup>1</sup>

Thus Dr S K Basu has summarised the main factors responsible for this widening gap in India's balances of payments "(1) Consequences of partition, (2) the back-log of deferred demand built up during the war, (3) the requirements of capital replacement and development, and (4) last but not least, inflation"

In reply to Question 12 of the U N O the Government of India says —"India has been suffering from the effects not only of internal inflation but of a very large increase in the price of its imports. The high prices of essential capital equipment most of which is obtainable only in the Atlantic countries, and of food (e.g., Argentine food-grains) have adversely affected India's balances of payments."<sup>2</sup>

### Foreign Trade Budget

Dr John Matthai, the then Finance Minister, told to a press conference that "there was no obvious improvement in India's existing foreign exchange position as a result of the Indo-U K sterling agreement, there is need for a very strict scrutiny and a very severe economy during the current year (1948-49) in respect of our foreign exchange expenditure"<sup>3</sup> He also emphasized the need for drawing up a Foreign Trade Budget "We have now to draw up a foreign exchange budget for the current year"

In the light of the above fundamental disequilibrium in India's balances of payments we suggest the following improvements in the working of the exchange control

(1) The Reserve Bank should open or create a permanent Exchange Control Department

1 See S K Basu—Devaluation and the Dollar Problem, p 17

2 See U N O —Maintenance of Full Employment, Appendix, p. 93.

3 See Amrit Bazar Patrika, August 5, 1949

(2) The functions of the said Exchange Control Department may be as under —

- (a) drawing up of the Foreign Exchange Budget in correlation with the Government's Foreign Trade Budget ,
- (b) complete control of exports and imports ,
- (c) fixing of "Targets" of each item in the Balance of Payments ,
- (d) preparation of Balance of Payments on the lines suggested by the U N O <sup>1</sup> determining the exchange rate in consultation with the I. M. F.
- (e) financing the entire foreign trade , (For a satisfactory conduct of India's foreign exchange business, it would be necessary that the entire foreign trade of the country with other countries should be financed through the Central National Bank —*K T Shah*.)
- (f) no further granting of licences to open new exchange banks ,
- (g) negotiation and keeping constant touch with the International agencies such as I M F and International Trade Organisation

(3) Nationalisation of all foreign exchange banks incorporated in India and complete abolition of foreign exchange banks incorporated outside Indian Union

(4) The Government of Indian Union should plan the foreign trade by means of a Foreign Trade Budget prepared in correlation with the Foreign Exchange Budget

(5) The present Foreign Exchange Regulation Act of 1947 is not a comprehensive one in the sense that it does not lay down the manner and degree of control. It has given wide powers to the Central Government and the Reserve Bank to control the movements of capital, export and import of bullion and currency notes. But it will be very difficult to control and regulate the movements of capital without an all-round exchange control of every item of exports and imports. It may be that capital may move out escaping the notice of the exchange authority in the garb of a current transaction. "It has been found by experience that it was impossible to control movement of capital unless control was exercised over all forms of foreign exchange

1 See U N. O.—Note on Balance of Payments Statistics

dealings, so that it was necessary to establish a system under which every item could be scrutinised so that a capital payment was not passed under the guise of a current transaction "1

Thus a separate Exchange Control Act should be passed giving wide powers to the E C D in order to implement the programme of planned foreign trade as a part of the general programme of full employment.

### **Organisation of Exchange Control Department.**

The Exchange Control Department should be placed under a departmental manager appointed by the Government of India in consultation with the Governor of the Reserve Bank of India. He will hold office for a period of 5 years and will be eligible for reappointment. He must possess the specialised knowledge of foreign exchange and foreign trade and must be capable of preparing a sound Foreign Exchange Budget. He should also possess the knowledge of statistics to estimate the balance of payments.

The E. C. D. must have experts on its staff such as statisticians, economists, accountants, lawyers, estimators, etc.

### **Procedure for applying for Foreign Exchange**

All applications for foreign exchanges shall be submitted in the prescribed form directly to the Exchange Control Department. The E. C. D. with its expert staff shall scrutinise all the applications and in correlation with the Foreign Exchange Budget and Foreign Trade Budget.

The scope of the E. C. D. will be wide enough to cover all items of exports and imports both visible and invisible.

The scheme recommended above provides a powerful and flexible weapon for offsetting the effects of disequilibrium in balance of payments on the economic activity and full employment in our country.

## **ISSUE DEPARTMENT**

### **Need for an Ideal Currency System and Stable Rupee.**

The present Indian currency is not at all stable and money circulation is experiencing one convulsion after another. Currency failures

1. See Article "A Note on the Foreign Exchange Regulation Act, 1947" in Reserve Bank of India's Bulletin, April, 1947, p. 214.

in countries having no sound economic planning are quite a natural phenomenon. Anarchy reigns in the economic development of our country. It inevitably leads to periodic financial crisis to the depreciation of the national currency and to disorder and chaos in international currency. A sound currency system must secure stability both in its external and internal purchasing power and elasticity. But to the utter disregard of internal stability, the Indian currency has always been attached to external stability : i.e., exchange stability.

### **Dislocation of currency**

The currency circulation is becoming more and more dislocated. The monetary reforms carried out after the war, such as Demonetisation of Notes of higher denominations, to find out the ill-gotten money, had not stabilized our currency. On the contrary, the emission of paper money is again swelling and its value is sinking, while prices soar immediately.

Great Britain devalued her pound sterling in September, 1949, in terms of dollar by 30 per cent. And the devaluation of pound brought in its wake the devaluation of the currency of 23 other countries including Indian Union. It clearly shows that Indian Rupee is not independent. It acts in chorus with the pound sterling. Indian Rupee has been devalued in sympathy with the mother country's pound sterling to the utter disregard of the internal stability. Since devaluation, cost of living index has risen enormously. It is doing more harm than good. The currency devaluation has completely betrayed the cause of the economic planning by raising the cost of imported capital goods and other essential goods.

### **Elasticity**

By elasticity we mean the capacity of the currency system to meet the changing needs and requirements of our trade, business and economic activity. No doubt, the adoption of the proportional reserve system has imparted elasticity to a great extent, but the use of elasticity and the timing of elasticity have never been to the best interests of the nation. This is clear from the fact that inflationary pressure is still persisting in more serious form. Excess of elasticity is bad and it may so happen that it will lead to

currency failures and breakdown of monetary system. The elasticity of the currency system must be regulated by conscious and progressive efforts to suit the requirements of trade, industry, commerce and agriculture. Elasticity in the true sense of the term knows no perturbations whatsoever. Just that is the secret of the stability and elasticity of the currency system.

The Rupee has miserably failed in creating confidence among the general mass of workers and peasants. Its purchasing power has gone very low to maintain the general standard of living of the total population. The Eastern European countries have already carried out their currency reforms, withdrew from circulation all excessive money and issued new full value of currencies. The purchasing power of these currencies has already doubled. There has been no conscious effort to reform the Indian currency during the post-war period.

We hear so much about planning and economic reconstruction. But our Central and Provincial Governments have set up many special departments for industrial planning. But nothing has been done so far regarding currency on which depends the success of all schemes of economic and social planning. A sound currency system with proper safeguards against inflation and speculative credit expansion will promote confidence and strength to the economic and social fabric of India.

### **Currency Reform Full Employment.**

To carry out the "Full-Employment Pledge" (which will be accepted by almost all the members of the U N O very soon) the Government of India should introduce far-reaching currency reform. We shall welcome any sort of currency reform which will eliminate the legacy of war-time inflation withdrawing excess money in circulation. We shall gladly accept the currency reform on the lines of East European countries such as Freezing of Notes and Deposits as an Anti-inflationary device. "The device of cancellation and blocking of notes and deposits has great value as creating a psychological atmosphere in which increases in wages can be kept within moderate limits as there will be a feeling of sacrifice all round and thereby imparting an anti-inflationary orientation to the whole economy. But the measure has to be

reinforced by other steps such as the balancing of budgets, Provincial and Central, increasing the rate of production introducing compulsory savings, etc."<sup>1</sup> This type of currency reform will help in the confiscation of ill-gotten money

### **How to ensure Stability**

Our money circulation should rest on a planned system of economy, based on social ownership of major and key industries and collective ownership of land. Money in the hands of the State should serve as an important weapon in carrying out the national economic plan.

The stability of the Indian rupee will be ensured if the circulation of the main mass of commodities in the country takes place according to the prices set by the Government, as the most important basis for the stability of the rupee and the increase in its purchasing power should be the steady growth of planned production.

The stability of the rupee should also be determined by the high rates of accumulation in the planned enterprises. The growth of this accumulation will ensure an expansion of planned production without taking foreign loans. This will again lead to an increase in the public wealth and national economic welfare.

The stability of Indian currency will be more strengthened by the existence of a state credit system namely, Agricultural Credit Department, Industrial Credit Department and Commercial Credit Department or Banking Department, and lastly, Exchange Control Department of the Reserve Bank of India.

### **How to ensure elasticity**

The present currency system derives its elasticity and strength from the proportional reserve system under which the reserve bears a certain proportion to the total note-issue, say 40-100. "The system has been incorporated in the constitution of the Reserve Bank of India which has to hold 40 per cent reserve of gold bullion, gold coin or sterling securities, the amount of gold coin and bullion being not less than 40 crores of rupees in value. To secure an emergent issue of currency, there is a provision for a reduction in the reserve ratio below

---

1. See S. K. Basu—Freezing of Notes and Deposits as an Anti-Inflationary Device, p. 5.

40 per cent with the sanction of the Governor General-in-Council and on payment of a graduated tax "1

"In practice, however, these provisions have little significance if any. The primary object of the required reserves was to maintain the public's confidence in the national currency. With any minimum ratio laid down by law as a norm any infringement of it, even if permitted by the statutes in exceptional circumstances, was liable to upset confidence and was therefore generally regarded as something to avoid "2

Truly speaking, these reserve requirements instead of inspiring much confidence imposed a limit on currency or monetary expansion which the central banks were authorised to create.

"Clearly the value of cover requirements as a means of preserving confidence depended largely on psychological factors and cannot be assessed in concrete terms "3. It is also remarkable to note that "so long as the world is not disturbed by wars or other disastrous events, the cover of bank notes is of very little concern to the public, whereas, in the event of such a disturbance, even a cover of 100 per cent would not be possessed of the power to preserve confidence "4

There is a growing tendency towards reducing the legal cover ratio to a minimum level. The legal cover ratio against note issue was lowered in Argentina from 100% to 40% in December, 1929, in Australia (temporarily) from 25% to 15% in June, 1930, in Denmark from 50% to 33½% in October, 1931. In Germany and Greece, the reserve requirements were suspended in July, 1931, and April, 1932 respectively. Later, the cover ratios were reduced in several other countries, such as Bulgaria from 33½% to 25%, Ecuador from 50% to 40%, Latvia from 50% to 30% and the Union of South Africa from 40% to 30%. During the last World War, as there was greater demand for gold and foreign exchange for making foreign payments, the legal reserve ratios of the central banks were either relaxed or abolished. It was suspended in Canada in 1949 and was relaxed in Roumania, Bulgaria and the Netherlands. In England the entire gold held by the Bank of

---

1. See D. K. Malhotra—History and Problem of Indian Currency, p. 236

2. See L. O. N.—International Currency Experience, p. 95

3. See L. O. N.—International Currency Experience, p. 96

4. See L. O. N.—Gold Delegation Selected Documents, p. 66

England was transferred to the Exchange Equalisation Account. Time may come when we should think of abolishing the legal cover ratio altogether. But Germany and Italy prior to 1939 abolished their reserve requirements.

The cover ratio can be reduced to a minimum without affecting the general confidence. The Gold Delegation Committee suggested that "legal minima could be reduced without in any way weakening the general credit structure and that it would be desirable to carry out such a reduction by common international agreement."<sup>1</sup> Today we have international organisation like I M F and it will be easier to reach on the common agreement.

The Macmillan Committee suggested that "just as the amount of gold held by the Bank should be settled independently of the volume of the note issue, so any precautionary limits which may be thought advisable to set to the Bank's power of note issue should be settled independently of the amount of gold which it is required to hold."<sup>2</sup> So we recommend that the Reserve Bank of India should also accept the above suggestion and its power of note issue should be settled independently of gold reserve but in correlation with the general economic planning and estimated total production of the country.

The Australian Banking Commission also suggested that "the statutory provisions which require the Commonwealth Bank to hold gold or sterling in proportion to the amount of Australian notes on issue should be repealed and note issue should be limited by law to a fixed maximum subject to the right of the Bank to exceed the maximum by a stated amount with the consent of the Treasury."<sup>3</sup>

Thus we find that the legal cover ratio has practically lost its prestige, and we suggest that Sections 33 and 37 of the Reserve Bank of India Act of 1934 should be repealed and new principle of note issue based on planned production and distribution of goods should be followed.

In the light of the above discussion our Issue Department should be reorganised on more scientific lines and we suggest the following measures

---

1 See L O N —International Currency Experiences, p 97.

2 See Report of the Committee on Finance and Industry, Paragraph 327

3. See Report of the Royal Commission to inquire into the Monetary and Banking Systems in Australia, Paragraph 580

1 Existing Issue Department should be continued

(a) Like all other departments the Issue Department should be placed under a departmental manager to be appointed by the Central Government. He should hold office for a period of not less than five years and will be eligible for reappointment.

## 2 Functions —

(a) Issuing of currency notes and coins according to the requirements of economic planning of the country

3 Transfer of all gold reserves to the Exchange Control Department (which will keep International currency reserve) to correct the disequilibrium in the balance of payments

4 Complete monopoly of note issue and coins of all denominations should be given to the Currency Department of the Reserve Bank of India

We hope these measures will go to enhance the prestige of Rupee to a great extent and we shall see that Indian Currency is the most stable in the world

## Banking Department of the Reserve Bank

### *Drawbacks of the Department*

A balance sheet of the Banking Department of the Reserve Bank of India reflects the conditions prevailing in the Indian money market. Since the beginning of the operation of the Reserve Bank, the Bank presents a sad contrast to its achievement in the organization of the Indian money market which is known for its lack of development and ill-organization. No doubt it has some control over the organized sector of the money market, but even today, the indigenous sector which constitutes fairly a big section of the market, falls outside the ambit of the Reserve Bank of India. Within the organized section of the Indian money market, non-scheduled banks receive no help whatsoever except guidance in matters of general banking principles from the Reserve Bank. Support given to scheduled banks is also very meagre. This will be evident from the Table given in page 160 of Chapter XV. Since the beginning of the operation of the Reserve Bank, the discounting policy of the Bank was conspicuously absent for a long time and from 1938 its operation was mainly directed in a limited

extent to discounting of Treasury Bills. Therefore, in examining the discounted bills held in the Banking Department, it is worth noting that the Reserve Bank rediscounted a small amount of commercial bills.

Although provisions have been made under Section 17 of the Reserve Bank Act to provide credit by the Reserve Bank by way of rediscount and loans and advances, the Bank was conservative in its outlook with regard to its lending and discounting policies as it became clear from its memorandum dated the 7th December, 1938. The observation of the Bank became crystal-clear with the failure of the Travancore National and Quillion Bank and with the subsequent banking crisis. The little help which the Bank gave by way of discount and loans and advances, was given only to a few banks included in the second schedule. A large number of joint-stock banks which are not included in the second schedule of the Reserve Bank Act still receive no accommodation facilities from the Reserve Bank. The indigenous sector of the Indian money market is also deprived of the financial facilities from it with the exception of granting remittance facilities to a few indigenous bankers. No doubt, in August, 1937, it drafted a scheme for bringing the indigenous bankers into the Reserve system. It suggested that the Reserve Bank would extend to the indigenous bankers financial facilities by way of discount and advances against Government securities and of remittance facilities subject to the conditions that they would maintain proper books of account which would be open to the Bank, and file periodical statements with it on the lines laid down for scheduled banks. But the Bank did not proceed further ahead with the scheme as the indigenous bankers did not show any anxiousness for the scheme to materialise.

Moreover, the *laissez-faire* policy of the Government in the matter of banking in India is partially responsible for the failure of the systematic development of banking in our country. Practically all the banking business in this country today is conducted on orthodox commercial principle, familiar chiefly in Britain. Indian Banks have no concern, directly, with the all-round economic development of the country, its productive capacity or distributive justice.

1. See—Report submitted to the Govt of India under Section 55(1) of the R. B. Act.

"That Banking is a Public Utility and a Social Service which, though not directly productive, can be an essential aid in producing new wealth, and so improving the general standard of living, seems scarcely realised in this country. The place of Banking, therefore, in the scheme of active development of the National Economy of a country like this is scarcely appreciated"<sup>1</sup>

There are not sufficient banks to meet the needs of a large country like India and its vast population. There is only one banking office for about two and a half lakhs of population as against one such office for five thousand persons in the United Kingdom<sup>2</sup> (By March 25, 1949, the total number of reporting scheduled banks were 94 and of non-scheduled banks 360 in 1948 in the Indian Union). This state of affairs cannot serve the needs of Indian trade and industry satisfactorily especially under Planned Economy. In India, Banks have developed in capital cities with a network of branches in all likely centres of commerce. Therefore, there is in this tendency a danger of lop-sided development of banking in our country.

Moreover, the recent banking crisis in Bengal in 1946-47 caused the greatest dislocation in the money market causing definite deservice to Bengal's economic development.

There cannot be two opinions that the predominant position of foreign exchange banks in the Indian money market is detrimental to the all-round economic development of our country. Not only do these banks make huge profits at the expense of India, but they discourage Indian enterprise in several directions. For instance, they help foreign Insurance companies, foreign merchants and brokers, etc at the cost of Indian merchants, etc. These banks do not co-operate with the Indian banks in the matter of foreign exchange business and inter-bank transactions.

#### **Full-Employment programme vis-a vis the Banking Department of the Reserve Bank of India**

Under planned economy, "the role of credit in facilitating the production of new wealth by anticipation would become more important.

<sup>1</sup> See N P C—Currency and Banking, p 61

<sup>2</sup> " " " " " p 71

The anticipation of new wealth would be facilitated automatically, especially if that machinery as well as the means of distribution are socialised"<sup>1</sup> "It is of the utmost importance, therefore, that all the instruments as well as institutions concerned with credit, its forms and applications, should be carefully recast and correlated so as to be assigned their proper place and function in the overall National Plan"<sup>2</sup>

(1) To carry out the "Full-Employment Pledge" the Banking Department of the Reserve Bank of India should be solely made responsible for directing credit along the desired channels. In order to direct credit in various sectors of our economy the Reserve Bank should be empowered to use rationing of credit as its general economic policy as rationing is regarded as a necessary accompaniment of a planned economy. For that purpose there should be financial plan which will run parallel to a production plan. Credit should be allowed to flow in various sectors of our economy namely, Industry, Agriculture, Trade and Commerce in accordance with the production plan. In other words, the Reserve Bank should, for the purpose of investment, allocate its funds among financially sound credit aspirants in accordance with a definite plan, and at times when the demand for credit exceeds the Reserve Bank's available resources, the Bank will divide these funds in some definite way among the enterprises which have need of them. If the flow of credit is adjusted in accordance with a definite production plan, it will be able to govern the relation between the banking system of our country and productive organization. Moreover, in course of time, the Reserve Bank will be able to check inflationary creation of credit by commercial banks.

(2) As the predominant position of the Imperial Bank of India in the Indian money market is a serious impediment to the establishment of credit control by the Reserve Bank and as the objective of the Reserve Bank is to attain "a stable level of good employment", there is no need of independent existence of the Imperial Bank. In order to assist the various sectors of our economy with necessary credit, the Imperial Bank should be amalgamated with the Reserve Bank as

---

1 See N P C.—Currency and Banking, p 65

2 See N P. C.—Currency and Banking, p 66

consequent on such amalgamation, the financial resources of the Reserve Bank will be strengthened. The Reserve Bank will, therefore, be able to flow credit in various economic sectors in accordance with the production plan through the existing network of branches of the Imperial Bank of India (which will be branches of the Reserve Bank after amalgamation)

(3) Moreover, in order to stimulate a rapid development of credit facilities over the length and breadth of the country, the other banks should be utilised by the Reserve Bank as apex banks for which the authority of the Bank with wide powers should be increased over the entire banking system of our country. We welcome the Banking Companies Act of 1949, as the Act makes provisions for extending the powers of the Reserve Bank with regard to regulation, supervision and general control over the Indian Joint stock Banks.

But the sad feature of the Banking Companies Act is that it excludes indigenous bankers from its purview. This policy of exclusion of the indigenous bankers has proved a constant source of weakness to the Reserve Bank of India in controlling credit in the past and may prove still more dangerous as they are like loose screws over the entire credit structure. The Reserve Bank of India should issue special licences to those indigenous bankers who are ready to carry on purely banking business. It should also prohibit those indigenous bankers who carry on banking business along with other multifarious businesses. A separate Act should be passed giving full powers to the Reserve Bank of India to exercise supervision, regulation and general control over the indigenous bankers.

(4) The next unhappy feature is that it still carries the age-long distinction between the scheduled banks and non-scheduled banks.

This distinction is, however, not scientific for the purpose of regulating the commercial banks. The original purpose of including the banks in the second schedule was to regulate a successful credit policy. By excluding a large number of banks having capital less than five lakhs of rupees, the Reserve Bank of India will not be able to extend the regulation and control to the same extent and in an uniform degree. Moreover, this distinction is meaningless as the Act lays down the minimum capital standard for each bank on the zonal and population basis. That is, "the banking company which has only one place

of business shall be required to have paid-up capital and reserves exceeding an aggregate value of fifty thousand rupees."

The Amendments under the Banking Companies Act, 1949, in Section 42 of the Reserve Bank of India Act, 1934, should be totally amended as under —

"The Bank shall, save as hereinafter provided by notification in the Gazette of India —

(a) direct the inclusion in the second schedule of any bank not already so included which carries on the business of banking in any province of India and which

(i) has a paid-up capital and reserves of an aggregate value of not less than fifty thousands of rupees (not five lakhs of rupees),

(b) direct the exclusion from that schedule of any scheduled bank—

(i) the aggregate value of whose paid-up capital and reserves becomes at any time less than fifty thousands of rupees (not five lakhs of rupees)

(ii) which goes provided that the Bank as the Bank considers reasonable to give the scheduled bank an opportunity of increasing the aggregate value of its paid-up capital and reserves to not less than fifty thousands of rupees (not five lakhs of rupees)

(5) As there are not sufficient number of banks to meet the needs of a large country like ours, and its vast population, it is desirable that the state and the Reserve Bank of India should formulate a general policy to encourage the growth of the banking business

(6) As the foreign exchange banks in India frustrated the policy initiated by the Reserve Bank of India and as they compete with the Indian Joint-stock Banks in financing the inland trade in India, it is desirable that their activities should be rigidly restricted and controlled. Foreign exchange banks desiring to open new branches in India should not be encouraged and a policy should be formulated for the gradual abolition of the existing foreign exchange banks

### **Need for a Central Co-ordinating Board**

In order to attain and maintain a stable level of good employment in our country by the Reserve Bank of India, we have suggested the creation of five separate departments namely, the Issue Department, the Banking Department, the Exchange Control Department, the Agricu-

tural Credit Department and the Industrial Credit Department. Mere creation of separate departments within the Reserve Bank of India may not achieve the objective of stable level of good employment, unless there is a central co-ordinating board for formulating the general policy for the successful working of each department

The Central Co-ordinating Board shall be designed to function as a central authority, a sort of "Capstone" in the structure of the Reserve Bank of India. The position of C C D vis-a-vis the various departments of the Reserve Bank of India may be regarded as the Sun round which the various departments cluster

### Organisation

The C C D shall consist of eight members (1) the Governor of the Reserve Bank of India, (2) the Head of the Treasury, (3) the Head of the Planning Department of the Govt of India and five departmental heads of the Reserve Bank of India. The head of the C C B will be the Governor of the Reserve Bank of India. The C C B will sit fortnightly to discuss the general policy of the Reserve Bank of India.

### Functions and Powers

It shall

- 1 integrate the credit policies of the various departments ,
  - 2 harmonize the monetary policy of the Reserve Bank of India and the general economic policy of the Govt of India ,
  - 3 determine the credit policy for each department ,
  - 4 determine the final quota of credit for each department in accordance with the Production Plan of the country ,
  - 5 formulate the policy for the Issue Department to maintain elasticity and security in note circulation ,
  - 6 guide the E C D in restoring and maintaining the equilibrium in the balance of payment , and
  - 7 make an annual report to the Central Government on the general trend and progress of the banking system in the country
-



## APPENDIX

### Special Powers of the Reserve Bank of India Under the Banking Companies Act, 1949

The popular demand for a separate Banking Act was long awaiting after the failure of the Travancore National and Quillon Bank in 1938 to safeguard the interests of bank depositors. The Draft Bank Bill was due to be introduced in the Indian Legislative Assembly in 1939, but only due to war it was postponed. Now the war is over and we have the full fledged Banking Companies Act, 1949. The chief objectives of the present Act are (i) the safety of the depositors and (ii) the liquidity of the banking system as a whole. "The question of the safety of the depositors is closely related with that of the liquidity of the banks and this question of liquidity, again, is inter-twined with that of the intermixture of banking functions."<sup>1</sup> Mr Sayers has given the true concept of liquidity. According to him there are two attributes of liquidity—"shiftability" and "risklessness". "The concept of shiftability finally resolves into "shiftability" on to a Central Bank. In the circumstances the liquidity of commercial banks is closely bound up with the liberality or otherwise of the eligibility canons of the central bank of the country in question."<sup>2</sup> Therefore special powers have been vested with the Reserve Bank of India to consolidate the whole banking system and to control "the powers of the commercial banks to create loanable funds which has been called the chief loose screw in our monetary and credit system because of the difficulties of subjecting it to effective control by the monetary authority".<sup>3</sup> The Banking Companies Act of 1949 has broadened the powers of the Reserve Bank to make the loose screw tight and to quell the monetary disturbances. The Act has given the full powers to control the powers of the commercial banks to create loanable funds.

1 See S K Basu—Recent Banking Developments, p 249.

2 See R Sayers—Modern Banking, pp 112-18

3 See Irving Fisher and associates in a mimeographed "Programme for Monetary Reform", 1939

## **1. Power of Reserve Bank to control advances by banking companies —**

Section 21 of the Act empowers the Reserve Bank to control the loans and advances made by banking companies. The Reserve Bank can dictate the policy of advances to be followed by banking companies in general and in particular in the best interests of the economic life of the nation. Not only that, it can govern the purposes for which advances may or may not be made. Thus the Reserve Bank has the power to control the loans and advances not only quantitatively but qualitatively too. It has the right to determine the margins to be kept in respect of secured loans and the rates of interest to be charged on advances. And each banking company shall be bound to obey and carry out the orders and wishes of the Reserve Bank. For reference see Section 21 given below.

"(1) Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy as so determined.

(2) Without prejudice to the generality of the power vested in the Reserve Bank under Sub-section (1), the Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances, and each banking company shall be bound to comply with any directions as so given."<sup>1</sup>

## **2 Power to grant and cancel the licence of banking companies —**

Sec 22 of the Act makes it compulsory for every banking company to apply in writing to the Reserve Bank for a licence under this section. Thus it has the power to stop the banking companies from carrying on

---

<sup>1</sup> See the Banking Companies Act of 1949, pp. 8 & 9

business unless they hold a licence granted by it. The Reserve Bank may require the banking companies to fulfil certain conditions as laid down by it before granting any such licence. The first condition is that the company must be in a position to pay its depositors in full. The second is that the affairs of the company are not being conducted to the detriment of the depositors' interest. The third is that a company incorporated elsewhere than in a Province of India must not discriminate in any way against banking companies registered in a Province of India and must comply with all the provisions of the Act. The Reserve Bank may cancel any licence granted if any of the above conditions are not fulfilled or it may after granting the licence under this section require that any of the said conditions shall be fulfilled within certain time as it may fix, and if the condition is not so fulfilled, cancel the licence. Of course, the banking companies may appeal to the central govt. and the decision on such appeal finally rests with the government.

"(1) Save as hereinafter provided, no company shall carry on banking business in any Province of India unless it holds a licence granted by the Reserve Bank in such behalf.

(2) Every banking company in existence on the commencement of this Act, before the expiry of six months from such commencement, and every other company before commencing banking business in any Province of India, shall apply in writing to the Reserve Bank for a licence under this section.

Provided that in the case of a banking company in existence on the commencement of this Act, nothing in Sub-section (1) shall be deemed to prohibit the company from carrying on banking business until it is granted a licence in pursuance of Sub-section (2) or is by notice in writing informed by the Reserve Bank that a licence cannot be granted to it.

Provided further that the Reserve Bank shall not give a notice as aforesaid to a banking company in existence on the commencement of this Act before the expiry of the three years referred to in Sub-section (1) of Section 11 or of such further period as the Reserve Bank may under that sub-section think fit to allow.

(3) Before granting any licence under this section, the Reserve Bank may require to be satisfied by an inspection of the books of the

company or otherwise that all or any of the following conditions are fulfilled, namely —

(a) that the company is in a position to pay its depositors in full as their claims accrue ,

(b) that the affairs of the company are not being conducted to the detriment of the interests of its depositors ,

(c) in the case of a company incorporated elsewhere than in a Province of India that the Government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in a Province of India, and that the company complies with all the provisions of this Act, applicable to banking companies incorporated outside the Provinces of India

(4) The Reserve Bank may—

(a) cancel any licence granted under this section where any of the conditions set out in Sub-section (3), on the fulfilment of which it required to be satisfied when granting the licence, ceases to be fulfilled or if the company ceases to carry on banking business in the Provinces of India or goes into liquidation ,

(b) at any time after granting a licence under this section require that any of the said conditions, on the fulfilment of which it did not require to be satisfied when granting the licence, shall be fulfilled to its satisfaction within such time as it may specify, and if the condition is not so fulfilled, cancel the licence

(5)\* Any banking company aggrieved by the cancellation of its licence under Sub-section (4) may appeal to the Central Government, and the decision of the Central Government on such appeal shall be final.”<sup>1</sup>

**2a. Power of restricting the opening of new, and transfer of existing, places of business —**

Under Sec 23 of the Banking Companies Act of 1949 as amended in 1950, the banking companies are required to obtain prior permission in writing from the Reserve Bank for opening of new offices and changing or transferring of the existing places of business not only in India but also elsewhere

[See Amendment of Sec. 23 of Act X of 1949...

---

1. See the Banking Companies Act of 1949, p. 9,

No banking company shall open a new place of business in any part of India or change, otherwise than within the same city, town or village, the location of an existing place of business situated in any part of India, and no banking company incorporated in India shall open a new place of business outside India or change, otherwise than within the same city, town or village in any country or area outside India, the location of an existing place of business situated in that country or area without first obtaining the prior permission in writing of the Reserve Bank]

### **3. Restrictions on Loans and Advances .—**

Sec 20(2) makes it compulsory for every banking company to submit to the Reserve Bank a return in the prescribed form giving full details of all unsecured loans and advances granted to companies in which it or its directors have interests

Sec 20(3) empowers the Reserve Bank to prohibit such banking companies which have granted loans and advances to the detriment of the depositors' interest from granting further loans and advances, and to direct such companies to secure repayment of such illegal loans or advances within a certain period as it may fix.

"(1) Notwithstanding anything to the contrary contained in Section 54A of the Indian Companies Act, 1913 (VII of 1913), no banking company shall make any loans or advances on the security of its own shares, or grant unsecured loans or advances to any of its directors or to firms or private companies in which it or any of its directors is interested as partner or managing agent or to any individuals, firms or private companies in cases where any of the directors is a guarantor

(2) Every banking company shall, before the close of the month succeeding that to which the return relates, submit to the Reserve Bank a return in the prescribed form and manner, showing all unsecured loans and advances granted by it to companies in which it or any of its directors is interested as director or managing agent or guarantor.

(3) If on examination of any return submitted under Sub-section (2) it appears to the Reserve Bank that any loans or advances referred to in that Sub-section are being granted to the detriment of

the interests of the depositors of the banking company, the Reserve Bank may, by order in writing, prohibit the banking company from granting any such further loans or advances or impose such restrictions on the grant thereof as it thinks fit, and may by like order direct the banking company to secure the repayment of any such loan or advance within such time as may be specified in the order."<sup>1</sup>

#### **4. Maintenance of Cash Reserve by every banking company —**

Sec. 18 makes it compulsory for every banking company not being a scheduled bank to maintain by way of cash reserves with the Reserve Bank or with itself a sum equivalent to 2% of its time liabilities and 5% of its demand liabilities and to submit to the Reserve Bank three copies of statement showing the details of time and demand liabilities on the prescribed date before the 15th day of every month

"Every banking company not being a scheduled bank shall maintain by way of cash reserve in cash with itself, or in an account opened with the Reserve Bank, or partly in cash with itself and partly in such account, a sum equivalent to at least two per cent of its time liabilities and five per cent of its demand liabilities and shall file with the Reserve Bank before the fifteenth day of every month three copies of a statement of the amount so held on Friday of each week of the preceding month with particulars of its time and demand liabilities on each Friday."<sup>2</sup>

#### **5. Power to call for other returns and information —**

Sec 27(2) empowers the Reserve Bank to demand from a banking company the statements and information relating to the business of such banking company and detailed statements giving the complete classification of advances and investments of banking companies in respect of industry, commerce and agriculture

"The Reserve Bank may, at any time, by notice in writing, require a banking company to furnish it within the time specified therein or such further time as the Reserve Bank may allow, with

---

1. See the Banking Companies Act of 1949, p. 8

2 " " " " " " P. 7.

statements and information relating to the business of such banking company, and without prejudice to the generality of the foregoing power, may call for information every half year regarding the classification of advances and investments of banking companies in respect of industry, commerce and agriculture"<sup>1</sup>

## 6 Power of Inspection —

Sec. 35 empowers the Reserve Bank to conduct an inspection by its officers of any banking company. Thus every banking company shall produce to inspecting officer all books, documents and accounts and furnish him with all statements and information as required by him relating to the banking company. The inspecting officer has the right to administer oath on the directors of the company. On inspections being made, the Reserve Bank shall report to the Central Government. And if the Central Govt. thinks that the affairs of the company are being conducted to the detriment of the interests of the depositors, may prohibit the banking company from receiving fresh deposits, and secondly, direct the Reserve Bank to wind up the company by applying Sec. 38. Of course, the Central Government has the right to pass or cancel or modify such order under Sec. 38.

"(1) Notwithstanding anything to the contrary contained in Section 138 of the Indian Companies Act, 1913 (VII of 1913), the Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts, and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.

(2) It shall be the duty of every director or other officer of the banking company to produce to any officer making an inspection under Sub-section (1) all such books, accounts and other documents in his custody or power and to furnish him with any statements and information relating to the affairs of the banking company as the said officer may require of him within such time as the said officer may specify.

(3) Any person making an inspection under Sub-section (1) may examine on oath any director or other officer of the banking company in relation to its business, and may administer an oath accordingly.

<sup>1</sup> See the Banking Companies Act of 1949, p. 11.

(4) The Reserve Bank shall, if it has been directed by the Central Government to cause an inspection to be made, and may, in any other case, report to the Central Government on any inspection made under this section, and the Central Government, if it is of opinion after considering the report that the affairs of the banking company are being conducted to the detriment of the interests of its depositors, may, after giving such opportunity to the banking company to make a representation in connection with the report as, in the opinion of the Central Government, seems reasonable, by order in writing—

(a) prohibit the banking company from receiving fresh deposits,

(b) direct the Reserve Bank to apply under Section 38 for the winding up of the banking company

Provided that the Central Government may defer, for such period as it may think fit, the passing of an order under this subsection, or cancel or modify any such order, upon such terms and conditions as it may think fit to impose

(5) The Central Government may, after giving reasonable notice to the banking company, publish the report submitted by the Reserve Bank or such portion thereof as may appear necessary "<sup>1</sup>

## **7 Further powers and functions of Reserve Bank —**

Sec 36 vests the powers in the hands of the Reserve Bank to give warning and prohibit banking companies in general from entering into any type of transactions. It can also prohibit a particular banking company for transaction. It has the right to advise banking companies on all important issues. For example, during the course, or after the completion, of any inspection the Reserve Bank may ask the company to call a meeting of its directors for considering the matters arising out of inspection and to discuss such matters with the inspecting officer. Further, it may ask the company to make necessary changes in its management

Sec 36(2) empowers the Reserve Bank to make an annual report to the Central Government on the general trend and progress of banking in the country.

---

<sup>1</sup> See the Banking Companies Act of 1949, p 13

"(1) The Reserve Bank may—

(a) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company .

(b) on a request by the companies concerned and subject to the provisions of Section 45, assist, as intermediary or otherwise, in proposals for the amalgamation of such banking companies ,

(c) give assistance to any banking company by means of the grant of a loan or advance to it under Clause (3) of Sub-section (1) of Section 18 of the Reserve Bank of India Act, 1934 (II of 1934) ,

(d) during the course, or after the completion, of any inspection of a banking company under Section 35, by order in writing, require the company—

(i) to call a meeting of its directors for the purpose of considering any matter arising in the course of or out of such inspection or of meeting an officer of the Reserve Bank to discuss any such matter ,

(ii) to make, within such time as may be specified in the order, such changes in its management as the Reserve Bank may consider necessary in consequence of the state of affairs disclosed during or by the inspection.

(2) The Reserve Bank shall make an annual report to the Central Government on the trend and progress of banking in the country, with particular reference to its activities under Clause (2) of Section 17 of the Reserve Bank of India Act, 1934, including in such report its suggestions, if any, for the strengthening of banking business throughout the country.

(3) The Reserve Bank may appoint such staff at such places as it considers necessary for the scrutiny of the returns, statements and information furnished by banking companies under this Act, and generally to ensure the efficient performance of its functions under this Act"<sup>1</sup>

---

1. See the Banking Companies Act of 1949, p. 14

## 8 Power of Direct Discount —

Sec. 36(1)(c) says — "Reserve Bank can give assistance to any banking company by means of the grant of a loan or advance to it under Clause (3) of Sub-section (1) of Section 18 of the Reserve Bank of India Act, 1934 (II of 1934) amended up to 1947 "

Thus Sec 18 of the Reserve Bank of India Act empowers the Reserve Bank to grant loans and advances directly to the banking companies in spite of the limitations put by Banking Companies Act, if a special occasion has arisen for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture <sup>1</sup>

## 9 Power to restrict amalgamation, etc —

Sec 45 restricts the court from sanctioning a compromise or arrangement between a banking company and its creditors without being certified by the Reserve Bank Here the Reserve Bank shall see that the arrangements are not detrimental to the interests of the depositors of such company This section further restricts the banking companies from entering into any kind of agreement for amalgamation with any other banking companies without the previous sanction in writing of the Reserve Bank of India

"Notwithstanding anything contained in any law for the time being in force,—

(a) no Court shall sanction a compromise or arrangement between a banking company and its creditors or any class of them or between such company and its members or any class of them, unless the compromise or arrangement is certified by the Reserve Bank as not being detrimental to the interests of the depositors of such company, and

(b) no banking company shall enter into any agreement or arrangement for, or be a party to, any scheme for the amalgamation of such company with any other banking company without the previous sanction in writing of the Reserve Bank "<sup>2</sup>

Sec 55 (Amendment of Act II of 1934) —

Sec 55 permits or orders that the Reserve Bank of India Act, 1934 (II of 1934), shall be amended to suit the purpose of giving special powers to the Reserve Bank of India to safeguard the depositors' interests.

1. See the Reserve Bank of India Act of 1934 amended up to 1947, p 17

2 See the Banking Companies Act of 1949 p 16.

## BIBLIOGRAPHY

### Books for general reference :—

- Allen, J S —World Monopoly and Peace (1947).  
Bay Kov, A —The Development of the Soviet  
Economic System (1947).  
Beveridge, W H.—Full Employment in a Free  
Society (1945)  
Burgess, W R.—The Reserve Banks and the Money  
Market (1936)  
Basu, S K —Recent Banking Development (1948)  
Basu, S K —Financing of Post-War Industry (1948).  
Basu, S K —Devaluation and the Dollar Problem (1949).  
Cole, G D H —Money, Its Present and Future (1944)  
Dobb, M —Soviet Economic Development since 1917(1948).  
Dunkman, W E —Qualitative Credit Control (1933).  
Dodwell, D W—Treasures and Central Banks (1934).  
Halm, G. N —Monetary Theory (1942)  
Hansen, A. H.—Fiscal Policy and the Business  
Cycles (1941).  
Hawtrey, R. G —The Art of Central Banking (1932)  
Hawtrey, R. G.—A Century of Bank Rate.  
Haberler, G —Prosperity and Depression (1941 )  
Keynes, J. M —General Theory of Employment,  
Interest and Wages (1936)  
Keynes, J. M —Treatise on Money, 2 Volumes (1930)  
Kock, De M H —Central Banking (1939 & 1945).  
Kisch, C B. and Elkin, W A —Central Banks (1932)  
League of Nations—Gold Delegation Selected  
Documents  
League of Nations—Money and Banking (1940-42).



**Wills and Beckhert**—Foreign Banking System  
**Young, A.**—The Federal Reserve System in War  
 Time (1945).

**Books relating to India —**

**Dadachanji, B. E.**—A Reserve Bank for India and  
 the Money Market  
**Basu, A. K.**—Fundamentals of Banking Theory  
 and Practice (1948)  
**Ghose, B. C.**—A Study of the Indian Money Market (1943).  
**Jather and Beri**—Indian Economics  
**Muranjan, S. K.**—Modern Banking in India (1948).  
**Malhotra, D. K.**—History and Problem of  
 Indian Currency.  
**Mitra, R. M.**—Post-War Banking in India (1946)  
**Raw, R. B.**—Present-Day Banking in India (1938).  
**Raw, R. B.**—Banks and Money Market (1933)  
**Raj, K. N.**—The Monetary Policy of the  
 Reserve Bank of India (1948)  
**Wadia, P. A. and Jhoshi, G. N.**—Money and the  
 Money Market in India.  
**The Reserve Bank of India**—Functions and Working.  
**National Planning Committee**—Rural Marketing  
 and Finance.  
**National Planning Committee**—Currency and Banking.

**Reports :—**

**Macmillan Committee Report.**  
**12th Annual Report of the B. I. S.**  
**Hilton Young Commission Report.**  
**The Indian Central Banking Enquiry Committee Report**  
**Report of the Commission of Enquiry into Banking**  
**Currency and Credit, Ireland (1938).**

- Report of the Royal Commission on Australian Banking  
and Currency Systems (1937).  
The Reserve Bank of India Reports on Currency and  
Finance  
The Reserve Bank of India, Agricultural Deptt  
—Statutory Report  
The Reserve Bank of India—Statistical Reports relating  
to Banks in India and Burma.  
The Reserve Bank of India—Reports of the Annual  
General Meetings of the shareholders  
The Reserve Bank of India Bulletin  
Federal Reserve Bulletin  
The Reserve Bank of India, Agricultural Credit Deptt  
—Bulletin Nos 2 and 4  
Reports submitted to the Govt of India under  
Section 55(1)(b) of the Reserve Bank Act  
Industrial Finance Corporation Act, 1948  
The Reserve Bank of India Act, 1934, as modified  
up to 1st August, 1947.  
The Banking Companies Act, 1949.

**Journals and Periodicals :—**

- The London Times  
The Banker's Magazine.  
Journal of the Indian Institute of Bankers.  
The Economist—London.  
The Commerce—Bombay  
The Capital—Calcutta.  
The Eastern Economist—New Delhi.  
Indian Finance—Calcutta.

## INDEX

### A

Act—The Banking Companies  
 Act of 1949, p. 129  
 The Banking Act of 1933,  
     U S A  
     " " of 1935,  
     " " U S A., pp 7,42,50  
 The Bank Charter Act of  
     1844, U K, pp 13,46  
 The Banking Act of 1945,  
     Australia, p 78  
 The Reserve Bank of India  
 Act, 1934, pp 107,113,123,143  
 (Third Amendment) Act, 1940,  
     pp 109,131  
 The Reserve Bank (Amend-  
     ment) Act of 1947, p 111  
 The Reserve Bank (Transfer  
 to Public Ownership) Act of  
     1948, pp 80-83,114  
 The Bank of England Act of  
     1946, pp 76,77,114  
 Accepting Houses  
 Agricultural Credit Department  
 (The Reserve Bank of India),  
     pp 192-203  
 Agricultural Bills, p 193  
 All India Industrial Corporation,  
     p 190  
 Archibald Rowlands, p 19  
 Argentine, pp. 48,120  
 Assets of the Banking Depart-  
     ment (The Reserve Bank of  
     India), p 147  
 Assets of the Issue Department,  
     p 145  
 Austria, p. 2  
 Australia, pp 16,43  
 Australian Trading Banks, p 43  
 Australian Monetary and  
     Banking Commission,  
     pp 14,59,71

Australian White-paper on Full-  
 Employment, p 60

### B

Bank of International Settle-  
     ment, p 67  
 " " Issue, pp 1,4  
 " " Batavia, p 14  
 " " Belgium, p 15  
 " " Sweden  
 " " France, pp 2,31,112,117  
 " " Italy, p 62  
 " " Netherlands, p 2  
 " " Norway, p 2  
 " " Japan, p 2  
 " " Greece, p 31  
 " " England, pp 1,2,13,32,  
     33,69,112  
 " " China, p 116  
 " " Canada, pp 61,66,112  
 " " Mexico, p 63  
 " " Finland, pp 31,61  
 " " Bolivia, p 62  
 " " Spain, p 14  
 Banco-de-Cuba, p 4  
 Basu, S K, pp 3,9,10,15,16,39,  
     70,71,75  
 Balance of Payments, p 10  
 Banking Principle, pp 13,116  
 Bank Rate, pp 21-32  
 " " in India, pp 155-166  
 Banking Commission in Belgium,  
     p 42  
 Bank Control Commission in  
     France, p 49  
 Banking Department, pp 116-117  
 Banking Companies (Inspection)  
     Ordinance, 1946, p 130  
 Bankers' Deposit, p 31  
 Bazar Rate—Calcutta, p 108  
 Bombay, pp 108,111  
 Beveridge, pp 73,83

Belgium, pp. 9,15  
 Beckhart, p 14  
 Belgium National Bank, p 15  
 Bills of Exchange  
 „ „ Treasury.  
 Boom, p 58  
 Board of Directors of the  
 Commonwealth Bank of  
 Australia  
 British White-paper on Employ-  
 ment Policy, p 60  
 Bretten Woods Conference, p 84  
 Brussels Conference, pp 2,3  
 Budget  
 „ Deficit  
 Business Cycles, pp 58-60  
 Bulgaria, p 2  
 Bullish Activities, p 179  
 Burgess  
 Burma Monetary Arrangement,  
 p 145

## C

Cash Reserve, p 7  
 „ Plan, p 47  
 „ Credits  
 Capital—Short-term  
 „ —Long-term,  
 „ —Working.  
 „ —Fixed  
 Canada, pp 2,5,7,10  
 Cawnpore  
 Calcutta, pp 109, 113  
 Call Money Rates, pp. 164-165  
 Central Banks  
 Central Assembly p 111  
 Central Board of Directors of the  
 Reserve Bank of India,  
 pp 113,114  
 Central Banking Enquiry  
 Committee, p 153  
 Central Government of India,  
 p 124  
 Central Co-ordinating Board,  
 pp 224,275  
 Chancellor of the Exchequer, p 78  
 Cheap Money

Chile, p. 10  
 China, p 2  
 Chicago, p 44  
 Commercial Banks,  
 Columbia, p 10  
 Commercial Bills.  
 Commonwealth of Australia, p 42  
 Commonwealth Bank of  
 Australia, pp 14,42  
 Conference—World Economic, p.3  
 Costa Rica, p 42  
 Cole, pp 58,76  
 Co-operative Societies Act,  
 Government of India.  
 Consumers' Instalment  
 Co operative Village Banks,  
 pp 200-201  
 Credit Control  
 Credit Plan, p 47  
 Croatia, p 3  
 Crisis of 1929—31  
 Currency Principle, pp. 13,116  
 Currency Ordinance No IV of  
 1940, p 145  
 Czechoslovakia, pp 10,49

## D

Dacca, p 113  
 Deutsche Noten Bank, p. 4  
 Deutsche Emission Und Giro  
 Bank, p 4  
 Dekock, pp 1,8,27,50,51,52,56,  
 89,92,116  
 Depression, p 56  
 Denmark, pp 7,15  
 Demonetization Ordinance, p 18  
 Deflation, p 24  
 Deficit Financing, pp 59,60  
 Delhi, pp 109,113  
 Deputy Governors, p 113  
 Departmental Manager, p 199  
 Defence Industries, p 19  
 Defence of India Rules—Rule 91  
 of Part XIV, p 139  
 Devaluation  
 Discount Rate, pp 27,28  
 Direct Action, pp. 50-57

Dollar, p 10  
 Dominion Parliament, p 81

## E

Ecuador, pp 10,42  
 Egypt, pp 2,15  
 Elkin, pp 2,20  
 Employment  
 England, pp 5,7  
 Europe, p 75  
 European Recovery Programme,  
 pp 103-104  
 Examination Department  
 Exchange Equilisation Account  
 Excess Profit Tax  
 Exports  
 External Capital Committee, p 179  
 Exchange Control Department  
 of the Reserve Bank of India,  
 pp 140-141

Exchange Banks

## F

Federal Reserve System,  
 pp 3,14,50,60,117  
 Federal Reserve Banks,  
 pp. 2,10,26,29,32,33,34  
 Federal Reserve Board, pp 29,117  
 Fiduciary System—Fixed, p 13 .  
 Maximum, p 14  
 Finland, p 15  
 Foreign Exchange, p 140  
 Foreign Exchange Reserve  
 System, p 15  
 Forward Exchange Market  
 Foreign Exchange Regulation  
 Act of 1947  
 Foreign Trade Budget, p 211  
 France, pp 6,10,17,18,19,29  
 Full Employment, pp. 73-83

## G

German Economic Commission,  
 p 4  
 Germany, pp 3,5,6,10,15  
 Gold Standard  
 Gold Delegation Committee,  
 p 217

Governor-General, p 113  
 Governor of the Reserve Bank  
 of India, p 113  
 Greece, p 16  
 Great War of 1914—18,  
 pp 2,6,9,61  
 Guatemalan Bank, pp. 49,71

## H

Halm, p 178  
 Hawtrey, pp 23,24  
 Henderson, p 68  
 Hilton Young Commission,  
 pp 14,107,117  
 Higher Purchase, p 179  
 Holland, pp 9,15  
 Hungary, p 10

## I

Imperial Bank of India, p 115,161  
 Import  
 India, pp 2,5,7,29  
 Indian National Congress, p 80  
 Indian Companies Act of 1913  
 as amended in 1936, p 137  
 India and Burma (Burma Mone-  
 tary Arrangements) Order, 1947,  
 p 123  
 Indian Rupee Securities  
 Indo-U K Financial  
 Arrangement, p 122  
 Industrial Finance Department  
 of the Commonwealth Bank  
 of Australia, p 48  
 Industrial Credit Department  
 of the Reserve Bank of India,  
 pp 180-191  
 Industrial Finance Corporation,  
 p. 129  
 Industrial Monetary Fund  
 International Bank for Recons-  
 truction and Development,  
 pp 67,73,97-106,201  
 International Gold Standard,  
 pp 90-91  
 International Trade  
 Organization, p 73

**International Labour**

Organization  
 International Monetary Fund,  
 pp 10,67,73,85-96,122  
 International Trade  
 Interim Government, p 108  
 Inflation  
 Interest Rates  
 Irish Central Bank, p 38  
 Iran, p 16  
 Issue Department of the Reserve  
 Bank of India, pp 117,118,  
 143,145

Italy, pp 9-10

**J**

James, S Allen, p 75  
 Japan, pp 9,15,20  
 Jacob Vinner, p 216  
 Joint stock Banks

**K**

Karachi, p 113  
 Key Industries, p 179  
 Keynes, pp 15,24,27,41,44,58  
 Kisch, p 2,20

**L**

Laissez Faire  
 Lahore, p 113  
 Lander Banks, p 3  
 Latvia, pp 22,120  
 League of Nations, pp 17,29,38  
 Legal Cover Ratio, pp 9,65  
 Legal Reserve Ratio, p 10  
 Legislative Assembly, p. 111  
 Liabilities of the Issue  
 Department of the Reserve  
 Bank of India, p 144  
 Liabilities of the Banking  
 Department of the Reserve  
 Bank of India, p 146  
 Liaison Department  
 Local Boards of the Reserve  
 Bank of India, p 113  
 London Money Market, pp 2,26  
 London Exchange Market, p 69  
 Luxembourg, p. 102

**M**

Maurice Dobb, p 47  
 Malhotra D K, p 217  
 Market Rate  
 Madras, pp 108,113  
 Member Banks  
 Mexico, pp 7,10,132  
 Metallic Reserves, p 9  
 Minimum Percentage System, p.15  
 Money Market  
 Money Income  
 Moral Suasion, p 51-52  
 Muranjan, S. K. p 17

**N**

National Bank of Costa Rica,  
 p 116  
 " " " Austria, p 2  
 " " " Belgium, pp 2,31  
 " " " Burma, p 4  
 " " " Egypt, p 80  
 " " " Bulgaria, p 60  
 " " " Hungary, p 67  
 " " " Yugoslavia,  
 pp 3,67  
 Nationalisation of Central Banks  
 Nationalisation of Banks  
 National Planning Committee,  
 pp 80,193,195  
 New Zealand, pp 7,12,43,132  
 Newyork, p 24  
 Neogy, K C, p 81  
 Nicholson, p 193  
 Note Issue  
 Non-scheduled Banks, pp 136,137  
 Norway, p 15  
 Netherlands, pp 16,120

**O**

Open-market Operations,  
 pp 32-41  
 " " in Great Britain, p. 35  
 " " in U S A, pp 33-34  
 " " in India, pp 166-175  
 Over Draft

**P**

Pakistan, pp. 4,108,123

Paris  
 Philippines, p. 41  
 Plumpire, p. 43  
 Public Works Administration  
 and National Planning  
 Board in U S A, p. 59  
 Publicity, pp. 52-53  
 Public Finance  
 Public Debts Provincial  
 Public Debts Central  
 Provincial Governments, p. 127  
 Proportional Reserve System,  
 pp. 14, 117  
 Provincial Autonomy, p. 127  
 Prosperity, p. 56  
 Promissory Note  
 Price Level—Internal  
 " " —External  
 Provincial Co-operative Banks,  
 pp. 156, 157, 175  
 Provincial Banking Enquiry  
 Committee, p. 180  
 Provincial Industrial Corporation,  
 p. 180  
 Provincial Debt, p. 128  
 Production Plan, p. 47

## R

Raj, K N, pp. 153, 154  
 Rangoon, pp. 108, 113  
 Rationing of Credit, pp. 46-49  
 " " " in the Soviet  
 Russia, pp. 46-48  
 Reserve Bank of India,  
 pp. 15, 29, 107—end  
 Revenue  
 Reserves—Cash  
 " —Metallie  
 " —Minimum  
 " —Foreign Exchange  
 Reich Bank, pp. 2, 61  
 Republic of South and Central  
 America, p. 2  
 Report on Currency & Finance,  
 pp. 3, 18, 19, 40-41, 45, 110,  
 118-128  
 Report of the Reserve Bank of

India of 13th and 14th  
 Annual General Meetings,  
 pp. 110-111  
 Report of the Central Board of  
 Directors, 30th June, 1949,  
 p. 111  
 Report—Macmillan Committee,  
 pp. 14, 42, 57, 117, 132  
 Robbins, pp. 27, 58  
 Royal Commission of the Com-  
 monwealth Bank of  
 Australia, p. 42  
 Russia, p. 46

## S

Selective Instruments of Credit  
 Control, pp. 70-71, 178  
 State Bank of Pakistan,  
 pp. 4, 124  
 State Bank of Russia, p. 47  
 State Bank of Sweden, p. 1  
 Sayers, pp. 23, 25, 27  
 Sansalvador, p. 23  
 State-owned Industries  
 Statutory Report of the Reserve  
 Bank of India, 1936  
 Securities, Gilt-edged  
 " Public, pp. 32-33  
 Scheduled Banks, pp. 131-136  
 Siberia, p. 3  
 Sir Basil Blackett, p. 107  
 Shanmukhan Chetty, p. 108  
 "Shamlat" Land, pp. 197, 198  
 Stock Exchange Market  
 Sterling  
 Slump  
 Social and Economic Planning  
 Council in South Africa, p. 60  
 Spain  
 Sweden, pp. 9, 12  
 Switzerland, p. 12

## T

Tamizuddin Khan, p. 108  
 Treasury, p. 69  
 Trade Cycle, pp. 56-60

Travancore National and Qui-  
 lion Bank  
 Turkey, pp. 2,157,220

**U**

United States of America,  
 pp 5,7,45  
 United Nations Organization,  
 p 85  
 U S S R, pp 47-48  
 Union Bank of Burma, p 4  
 Uruguay, p. 16

**V**

Variable Reserve Ratio,  
 pp 41-46, 176

**W**

Ways and-Means Advances,  
 pp 125,128  
 White-paper on Indian Consti-  
 tutional Reforms, p 108  
 World War No II,  
 pp 6,29,69,108,114  
 World Economic Conference  
 of 1933, p 10  
 Williams, p 92  
 Wills, p 14

**Y**

Youngman  
 Yugoslavia, pp 3,10,16

**ERRATA**

| Page   | Read          | instead of  |
|--------|---------------|-------------|
| 1      | Central       | Cental      |
| 3      | banking       | baking      |
| "      | R. M. 100     | 8 R. M. 100 |
| "      | of            | on          |
| 42     | volume II     | volume      |
| 47     | data          | datum       |
| 62     | of            | O           |
| 96     | exchange      | exchang     |
| 133    | non-scheduled | non sched d |
| "      | Reserve       | Rese e      |
| 145    | 118           | 148         |
| 156    | England       | england     |
| 190    | line          | time        |
| 183    | Halm          | Hatm        |
| 205    | L. O N.       | L N. O      |
| 206    | L O N.        | L N. O.     |
| [xiii] | B. R. Rau     | R B Raw     |





