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AN INTRODUCTION TO BANKING

By

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A. MUKHERJEE & CO. : : CALCUTTA

Published by
A. R. Mukherjee
2, College Square
Calcutta—12

Annas Eight only.

PART ONE
Printed by
S. C. Banerjee
H. S. Press
9, Sreekanta Chaudhury Lane,
Baranagore—Calcutta
PART TWO
Printed by
Subodh Kumar Paul
M. I. Printers & Publishers Ltd.
59C, Bechu Chatterjee Street
Calcutta—9

TO

MY BELOVED MOTHER

PREFACE :

This book is a Companion volume to my Introduction to money, and is intended for students and laymen. For the urgency of publication the manuscript was placed with two presses for printing and hence uniformity in printing could not be maintained. Every effort has been made to make the book uptodate.

123, Chittaranjan Avenue,
Calcutta, 7 April 1948.

K. L.

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AN INTRODUCTION TO BANKING

PART ONE

INTRODUCTION TO BANKING

CHAPTER I

MONEY MARKET

Importance of Money Market :

The money market of a country plays an important role in the national economy in so far as it helps the financing of all transactions, domestic and foreign. It is true that the financial operations are entrusted to the banking system but the latter in itself is a part of the money market and is being helped by it in so far as the banks are provided not only with the means in which they can invest their funds in liquid form but also with a reserve from which they can draw help in times of necessity. Not only that ; the money market helps the accumulation of capital, provides the government, both central and provincial, with long term loans and influences the determination of the rate of interest, which is so very vital in the determination of the volume of investment. From all these standpoints, therefore, the money market is an important organ in the national economy.

Definition :

A money market is a mechanism through which the short term funds are loaned and borrowed and through which the financial transactions of a country

are carried on. A money market may be conceived in a broad and a narrow sense. In a broad sense it includes the entire mechanism of the financing of business. But in a narrow sense it includes many things and is concerned only with a few standardised types of transactions.

Peculiarities of the Indian Money Market :

There are writers who have conceived the money market as a highly centralised organisation. But actually it is not so. Even in those countries where the central banking system is deeprooted in their economic structure and has considerable influence on the money market, "a money market is a loosely organised affair with a number of divisions and subdivisions, each devoted to a particular type of organisation and each constituting a separate market in itself." So far as the Indian money market is concerned, it is the most loosely organised affair and hence has nothing in common with money market in any other part of the world. The very first distinctive feature of the Indian money market that attracts the notice of any casual observer is that there is a sharp line of division between the indigenous part of the money market and the modern part characterised by the joint-stock banks, exchange banks, etc., and these two are functioning side by side more or less independently and on competitive basis. The second peculiarity of the Indian money market is the existence of an institution which till the

other day was entrusted with some of the central banking functions, but now has been deprived of most of them, I mean, the Imperial Bank of India. To-day it is the largest joint-stock bank; but it is something more than that and in those places where there is no branch or office of the Reserve Bank of India, the Imperial Bank works as its agent. This is an incongruous element and its favoured position, resulting in greater financial strength, has led to the creation of an unsympathetic attitude of the Indian joint-stock banks towards it. A third peculiarity of the Indian money market is the existence of foreign exchange banks, all owned and managed by foreigners and till recently having nothing to do with the financing of internal trade. This is the most incongruous element and although since the establishment of the Reserve Bank of India they have been subjected to a certain degree of control, yet in most other respects they are as free as before. Not only that; they have huge financial resources which they are now investing even in internal trade finance and have proved to be serious competitors with the Indian joint stock banks. The fourth peculiarity of the Indian money market is that even over the joint-stock banks the control of the newly established central banking institution is not enough. For, even among them, there are two categories—scheduled and non-scheduled, and the latter are practically outside the control of the Reserve Bank. Fifthly, the Reserve Bank of India lacks in many of the characteristics

of a central banking institution. Whatever degree of success it has achieved, it has done so as a Bank of Issue, but not as a Bankers' Bank. Hence it cannot be said that it has been able to fulfil its function and so falls far below the standard of central banking institution in any part of the world. Finally, Indian money market lacks in some of the very essential constituents like bill market, shipping and insurance market and even important commodities market.

Technical Organisation :

The technical organisation and function of different money markets differ in view of the fact that each has developed according to the economic needs of each particular region and hence it is not possible to lay down any hard and fast rules of technical organisation and function. Thus in London, before 1914, the acceptance market was the most important but gave way to short-term government security market in post-war years, particularly since the great depression. In European money markets, the first class trade bills have been the most important instrument in the money market. In New York, before 1914, the brokers' loan market and, to some extent, commercial paper market, were the most important but gave way to acceptance market after the first Great War. Further changes were introduced when treasury bills and certificates of indebtedness became the principal instruments of the money market.

The technical peculiarities of the Indian money markets may now be noted. The very first thing attracting our attention is the inelasticity and instability of the money market. In the busy season there is great demand for money for meeting the requirements of export trade. It is wellknown that a considerable part of our jute, cotton, rice, wheat and oilseed and other agricultural products are exported. Accordingly, in busy season when there is a movement of these crops from the upcountry centres to the ports, there is a heavy demand either for cash or for currency notes for facilitating these movements of crops. The result is that between the busy and slack seasons, there is a wide fluctuation in money market rates. Of course, since the depression of 1929, the fluctuation in the Imperial Bank Rate has not been much, although before this date, the Imperial Bank, being the sole agency for the control of credit, had, in order to protect its own cash reserves, to raise the bank rate to a high level. But owing to the slackening in the trade demand, the Imperial Bank rate remained stationary at 4 p. c. from 7th July, 1932, upto 15th February, 1933, and at 3½ p. c. from 16th February 1933 upto 3rd July, 1935. After the Reserve Bank of India had been established, it announced its rate at 3½ p. c. which was subsequently reduced to 3 p. c.

The seasonal monetary stringency in India was up to 1921 mainly due to the existence of the Reserve Treasuries. Under this system the Government main-

tained separate and independent District Treasuries and Sub-Treasuries, in which the funds received by them as revenue were locked up & hence were not available to the banking system "for the reconstruction of credit either in the long term market or short term market to the fullest possible extent." While the total volume of currency issued may have been sufficient, money available to the business community was small in view of its being detained in the Treasuries, and the Imperial Bank of India, though entrusted with the function of credit control, could do nothing in this respect, except raising its bank rate for maintaining its own reserve, and this increased the trouble of the money market all the more. In 1921, however, most of the Government balances were transferred to the Imperial Bank with the result that they could be available to the business community when these funds were lying idle. The Indian Paper Currency Act of 1923 empowering the Government of India to issue additional currency notes upto a maximum of Rs. 12 crores in the form of loans to the Imperial Bank against inland bills of exchange maturing within 90 days from the date of issue, the policy of purchasing sterling in India in order to remit to the Home Treasury and the re-introduction of the Treasury bills by the Government, all were aimed at a reduction of the seasonal stringency. The effect of the establishment of the Reserve Bank of India on the seasonal stringency in the money market is difficult to measure in view of the prevalence of easy money conditions in 1929, which

have not altered even during the years of the second Great War.

The second technical peculiarity of the Indian money market is to be found in what has been termed as "confusion and chaos" of money rates. This is to some extent due to the loose structure of the Indian money market, but mainly due to the lack of an organised bill market in this country. It was expected that the coming of the Reserve Bank of India will lead to the development of a bill market, as is the recent experience of central banking development in other countries and thereby it will reduce seasonal stringency and confusion and chaos in money rates. But so far as the development of a bill market is concerned, no important step seems to have been taken. Hence unlike in other money markets, it is extremely difficult to lay down specific relations between different money rates in this country.

As already said, all these troubles of the Indian money market are mainly to the lack of a bill market and this constitutes another peculiarity in technical organisation. This lack of a bill market is partly due to inadequate supply of bills but mainly it is due to the defective functioning of the money market which, if removed, the number of bills is bound to increase. Thus, e. g., before the coming of the Reserve Bank of India, there was no central bank in true sense and hence the joint-stock banks preferred loans from Imperial Bank against Government security to offering bills for rediscount to another

commercial bank which was competing with them. Even if the joint-stock banks could be made ready for rediscounting their bills with the Imperial Bank, the latter could not maintain the same impartial outlook as is demanded of a bankers' bank and hence in the absence of any standard for bills which may be acceptable to the Imperial Bank, the ordinary joint-stock banks could not be sure as to the acceptability of a particular instrument and had to depend on the discretion of the Bank authority. The bills are in themselves defective in view of the fact that there is hardly any document of title attached and hence it is difficult to know whether a particular bill is a genuine trade bill or a mere accommodation bill. It has been suggested that the Reserve Bank of India should be prepared to buy or discount at its published rate first class trade bills and promissory notes arising out of bonafide commercial transactions. Although the Reserve Bank has been functioning for more than a decade, it may be said that the Bank has not been able to stimulate the development of a bill market so far.

The following bills are in use in the Indian money market :—

(a) Government Treasury bills—Their influence on the Indian money market is negligible. Their distribution is unsatisfactory in view of the fact that at least half the volume of Treasury bills is purchased by the Imperial Bank and the remainder by other big banks, particularly exchange banks. At times this monopo-

listic domination goes so far that the Reserve Bank has to intervene by purchasing bills on its own account in order to ensure a successful placing of Treasury bills.

(b) Foreign Trade bills drawn in sterling—They are the monopoly of the exchange banks who transfer them to their London office for discount in open market, thereby making the Indian market subservient to the London money market.

(c) Agricultural credit bills which the Reserve Bank of India, under the Reserve Bank of India Act, has been authorised to purchase, sell and rediscount, provided they satisfy certain conditions. But the number of these bills has not increased because of the attitude taken by the Reserve Bank. The only thing that is being done at present is that the Provincial Co-operative Banks are utilised for giving advances to smaller co-operative organisations ; but this has nothing to do with the increasing use of bills. The bills of this type will not be popular with the banks unless sufficient arrangement is made for the establishment of licensed warehouses at the principal agricultural centres, of which none exists at present.

(d) Hundi—These are in use in indigenous transactions financed by shroffs.

(e) Inland Trade bills—They constitute a small proportion of the investment portfolio of the banks. In recent years, however, they have shown some increase.

This is the type of bill structure in our non-existent bill market. With this inadequate bill structure and

overcautious central bank, it is too much to expect that a bill market is visible in the near future. In the U. S. A., the establishment of a strong central banking organisation was followed by the development of a bill market. In India the rediscount facilities made available by the Reserve Bank of India are too meagre and the word "approved" bills and securities are often interpreted in an unresponsive manner. The nature of scrutiny by the Reserve Bank is also not looked with favour. "When accepting a bill the Reserve Bank will expect the scheduled bank concerned to supply the Reserve Bank with continuous information relating to the parties from whom it takes these bills, their credit standing, the line of business in which they are engaged and for which each bill is drawn, their own liabilities so far as known to the borrowing bank from time to time and other relevant data so as to enable the Reserve Bank to maintain a continuous check both as to the soundness of the security and the nature of the transaction to which it relates. The Reserve Bank reserves the right to make an independent investigation of the standing of the party and of the nature of the transaction through any agency available to it." This is really an unresponsive attitude. It is of course true that the Reserve Bank being the lender of the last resort cannot go very far in this respect; but it is equally true that the heavy responsibility of the establishment of a bill market is also placed on its shoulders, and if due to its overcautiousness the bill market does not develop, the Bank should be responsible

for that. We are living at such a stage of world economic development in which policy should be guided not by established principles but by exigencies of circumstances, and if circumstances demand greater responsiveness on the part of the Reserve Bank, it must come.

Institutional Organisation :—

In the above section we have studied the technical organisation of the money market. In the present section we shall study its institutional organisation on the basis of different types of financial institutions engaged in borrowing and lending short-term funds. In the group of lenders come the following : (a) The Reserve Bank of India, (b) the Imperial Bank of India, (c) exchange banks, (d) joint-stock banks, (e) business enterprises, (f) shroffs and money lenders, and (g) co-operative banks. In the list of borrowers we may mention (a) the Government of India, Provincial Governments, semi-government and public institutions, (b) industrialists, (c) agriculturists, (d) businessmen, (e) stock-exchange brokers, etc.

I Lenders—(a) The Reserve Bank of India—Under normal conditions, a central bank is to be regarded as the ultimate source of currency and credit ; but its actual position varies from country to country. Thus the Bank of England is free to do business with any one but it deals chiefly with bill-brokers and financial institutions. The joint-stock banks hardly borrow from the Bank of England. In the U. S. A., the Federal Reserve

Banks extend credit only to the member banks and to a few dealers in bankers' acceptances and government securities. In European countries, the central banks usually carry on business with the public as also with banks through their branch offices. So far as the Reserve Bank of India is concerned, it is a bankers' bank and hence cannot "engage in trade or otherwise have a direct interest in any commercial, industrial or other undertaking". The power of direct discount, in so far as it is given, is limited. Even as a bankers' bank, the sphere of action of the Reserve Bank is limited owing to the heterogenous composition of the Indian money market.

(b) The position of the Imperial Bank in the Indian money market is peculiar. Before the establishment of the Reserve Bank, it was semi-central bank ; since then its powers have been curtailed in some directions but extended in others and to-day it is the biggest of all joint-stock banks with certain privileges. As a lender, the Bank finances the internal trade to a great extent by discounting hundis from the approved shroffs. The Bank also gives short-term accommodation on promissory notes to a limited extent and at times on the personal security of some of the the shareholders. Loans are also granted on the security of produce stored in the godowns of the Bank. It was expected, after the establishment of the Reserve Bank of India, that the Imperial Bank being deprived of its central banking functions and being freed from some of its

restrictions would take to the financing of foreign trade; but unfortunately for the Indian joint-stock banks, the Imperial Bank did not follow the uncertain path of financing foreign trade but turned into a severe competitor to the Indian joint-stock banks.

(c) As lenders in the Indian money market, the exchange banks have twofold functions to perform—first, to finance India's foreign trade from Indian ports to the distributing centres in the interior or from the collecting centres in the interior to the Indian ports, and second, the financing of Indian foreign trade from the Indian ports to overseas markets or from foreign countries to Indian ports.

(d) Indian joint-stock banks—Generally, the commercial banks constitute the most important single class of lenders in the money market in all countries. But so far as the Indian money market is concerned, their position is not enviable in view of the existence of the Imperial Bank and the exchange banks on the one hand and indigenous bankers on the other. Even among the joint-stock banks, there are two categories, the scheduled banks and the non-scheduled banks, the former being in direct touch with the Reserve Bank and the latter being not.

The manner in which commercial banks place their funds at the disposal of the money market is not the same in different countries. In England the joint-stock banks put their funds at the disposal of the money market through the bill brokers and discount houses and also through the purchase of

Treasury bills and acceptances. In the U. S. A., before the first Great War, the brokers' loan market and, to a smaller extent, the commercial paper market were considered as the most important outlets for short-term funds. Since the first Great War, however, these markets have declined in improtance for the investment of short-term funds of the bankers and their place has been occupied by acceptance market and also by Treasury bills and certificates of indebtedness which in fact have become the most important outlets. In European countries the principal outlets for short-term funds are the stock exchange transactions and the purchase of trade bills. So far as the Indian commercial banks are concerned, they deal directly with traders by offering short term advances against easily realisable securities, discounting inland bills of exchange and opening cash credits. In bigger towns where there are stock exchanges, they advance large sums against the hypothecation of these securities. Elsewhere, they offer advances against the stocks of agricultural products, piecegoods, stock-in-trade or some other marketable security. The banks also finance the movement of goods to and from Indian ports, from and to upcountry centres, particularly in those places where the branches of exchange bank do not exist. The banks also to a small extent make advances against personal security or against hundis. This sort of direct operation has to be resorted to because there are no discount houses or bill brokers in India nor any public warehouses which

may make personal security or endorsement redundant. We have already seen that banks in England do not have resort to the Bank of England and hence the latter controls the money market through bill brokers. In the U. S. A., the member banks have direct approach to the Federal Reserve System. In India, however, the Reserve Bank, by law, is allowed to rediscount the commercial papers of the scheduled banks—not all papers, but only the approved ones—at the official rate. But their amount is not much. A greater part of the banking system remains outside the control of the Reserve Bank which is a very unsatisfactory position.

The nature of banking organisation also exercises influence on the relationship of commercial banks with money market. In Europe aud Great Britain, since banking resources are concentrated in a few institutions like the Big Five in Britain and the 'D' banks in Germany, which have covered the whole country by a network of branches, these may be shifted from one branch to another according to the requirements of different regions; this also strengthens the banking organisation and makes for an even distribution of the banking resources throughout the money market. The unit banking system in the U. S. A. presents an altogether different picture in view of the fact that the banking resources are scattered and hence while there may be plethora of funds in one part, there may be scarcity in another without any possible remedy. The banking organisation in India presents a different picture. The commercial banking resources in this country are small

in comparison to the total resources. The distribution of banking institutions is also uneven. Thus while Bengal, Bombay, Madras, U. P, and the Punjab are on the whole well-supplied with banks, other provinces and the native states are not so. Not only that ; some of the centres are already overbanked while others go without any. Indian banking structure upto recent times was one of unit banking type. In recent years the tendency is towards concentration of resources in few hands—not the concentration of old resources at the cost of existing institutions but that of new ones—and the Indian prototype of the Big Five has already come into existence. Besides, in recent years, a number of very big "commercial" banks have been started. Branch banking, rather indiscriminate branch banking, is a new feature in Indian banking structure.

The legal status of commercial banks also varies widely. In Britain the dictum that good banking depends on good bankers is true to the word. Every phase of banking activity here is governed by tradition and practice which have the force of law. In contrast, in the U. S. A., and Germany, almost every phase of banking activity is brought under governmental supervision and there are comprehensive legislations in this respect. But then there is nothing to select as between the one system and the other. It all depends on the habit of the bankers. If tradition and custom are enough to govern the banking system, law is a superfluity. Law is required only where tradition is not strong and bankers speculative. In organised banking in this

country, tradition is not very strong. This is due to the late coming of modern banks and is manifested in a number of bank failures from time to time. Upto this time there is no separate banking law in this country, banking business being governed by a few sections of the Indian Companies Act. Since the banking enquiry of 1929, the need for a separate banking law came to be recognised and the bank failure immediately preceding the second great war and also sometime back gave further stimulus. At present a Banking Bill is there before the Legislature.

The business carried on by commercial banks in different money markets differs. This difference is mainly due to the distinction between commercial banking and investment banking. In this respect, it should be noted that no country is following any hard and fast principle. Thus, e. g., in the U. S. A., till recently, the distinction between these two types of banking was almost non-existent and the commercial banks used to invest short term funds into long term business through the Security Affiliates. The evils of this system resulted in a banking crisis and the banking legislation provided for a separation between the two. The same is true of Belgium and Italy. In England and France, the commercial banks are typical commercial banking institutions and they follow the principle that short term deposits cannot be used for long term investment. But in recent years the tendency in England is for the commercial banks to take to long term investment, though not directly, at least indirectly, through the

Bankers' Industrial Development Company and Securities Management Trust. In Germany, before the first great war, line of distinction between the two types of banking was non-existent. In the years following the first great war the tendency was for a separation of these two types of banking. In India, the commercial banks are established on British lines and hence investment banking or even mixed banking is non-existent. Thus in the field of industrial finance a gap remains and the time has now come when under the leadership of the Reserve Bank, the big commercial banks may form an organisation like the Bankers' Industrial Development Company for filling up this gap.

(e) Business Enterprises—In this country the importance of business enterprises as lenders, with the exception of the managing agency system, is not very great. The managing agency system has, of course, played a very important part as lenders. But apart from this, the importance of corporations and insurance companies is almost negligible. Institutional saving is not very great in this country and whatever amount is thus accumulated is invested in the enterprise itself. So far as inter-company investment among concerns under the same managing agency firm is concerned, this has been prohibited under the Indian Companies Amendment Act of 1936. A greater part of the investment of funds of the insurance companies goes to government securities and the portion available to other fields of business is very

small. In other countries, however, the role of the business enterprises as lender has been considerable. Thus in England, the surplus funds of large corporations and insurance companies were used very often for the purchase of acceptances. In the years following the first great war, these acceptances declined in importance and their place came to be occupied by Treasury bills. Since the great depression, owing to the prevalence of easy money conditions, the return from investment in gilt-edged securities declined. Hence these business enterprises began to invest their funds in the form of loans to business concerns and to political bodies. In the U. S. A., the lending by business enterprises is no less great than that in England and was in part responsible for the stock market boom of 1928. These advances were given by business enterprises to bill-brokers and bill-dealers through the banks. But after the banking crisis the banks have refused to do this sort of business and subsequent legislation has prohibited it altogether.

(f) Shroffs and money lenders—They predominate in indigenous business transactions and their link with the organised part of the money market is negligible.

(g) Co-operative banks—whatever little inportance they have acquired, they have done in the field of agricultural finance. They are of little importance in our money market.

II. Borrowers—The types of borrowers in the Indian money market have been noted earlier, Leaving aside the government and semi-government

bodies, these borrowers consist of a number of enterprises and institutions as also individuals who operate with funds obtained from the money market. The types of borrowers differ from market to market. In London, the chief borrowers are the dealers in bankers' acceptances and Treasury bills and the discount houses. In the U. S. A., where speculative activity is more predominant, stock exchange brokers, investment houses and security and acceptance dealers predominate in the money market. Thus in London, bill brokers and discount houses need funds for financing the carrying of the portfolios of acceptances and Treasury bills. In New York they are needed for purchasing securities. In India, in big towns, a large proportion of advances are made against stock exchange securities. But where stock exchanges do not exist, funds are borrowed either against the security of goods, or against personal security or as cash credit against promissory notes and secured by commodities, shares or bonds.

A few words may now be said about government as borrower of short term funds. In England, the British Government raise short term funds by the issue of Treasury bills. In New York, however, short term Treasury bills and certificates of indebtedness did not play an important part upto 1930, after which their importance has increased considerably. The Treasury bills were first introduced in the money market in India during the first great war for meeting government's disbursements on behalf of the British

war office. Since then the device has come to be a permanent feature of our money market. Of course, the purpose of short term funds has not been the same. Thus in the years following the first great war, they were required for meeting huge budget deficits and in subsequent years for the repayment of old bills, for conversion of loans, and for current and capital expenditure. During the years of the second great war, they have been used again for the financing of war.

Rate structure :

The rate structure in a money market depends in part on the organisation of the money market and in part on the banking tradition. Unlike the money markets in western countries, the money market in India is extremely loose and divided into parts which are more or less independent. The central banking organisation being new, a well-coordinated rate structure is too much to expect in the Indian money market. In London the rate on loans at call or short notice stands in a definite relation with the Bank rate which is always higher than the former. Thus the entire money market is controlled by the Bank of England through its control over bill market which has a direct access to the Bank. In New York, it is, of course, true that there is no direct connection between rate on call loans and discount rate, but then the liquidity of the market is not hampered because of the fact that member banks have direct access to the Reseve Banks.

In Indian money market, different rates move in different directions. To take up the different rates prevalent and consider their relation inter se, it may be said that the call money rate should have a definite relation with the rate granted on demand deposits, for call money is repayable at the option of the borrower and the lender, and also with the Bank rate. In western countries, call money rate is lower than the Bank rate and is more or less the same as the rate on current account. But in the Indian market, call money rate has no such definite relation ; it all depends on the availability of funds. Thus in busy season, it may be as high as Bank rate, while in slack season, it may not be investible at any rate. The Bazar rates for discounting hundis or trade bills have no connection amongst themselves. They vary from market to market and even in different parts of the same market, according to the status of the indigenous banker, that of the holder of the bill and the nature of the transaction. A difference from 3 p. c. :to 10 p. c. is not a mean one. There are a few more peculiarities of the rate structure of the Indian money market. So far as the foreign trade bills are concerned, they have nothing to do with the rate of discount here ; for the export bills are discounted in London money market and the import bills are held till maturity. The banks' holdings of stock exchange securities are not huge in any sense and whatever investment is made in them is regarded as a definite investment. Hence these

CHAPTER II

COMMERCIAL BANKING THEORY.

Orthodox Commercial Banking Theory :

The orthodox view regarding commercial banking holds that the commercial banks should confine themselves to short term self-liquidating transactions. The principle underlying commercial banking is that the deposits received by commercial banks are mostly short term and hence they cannot give long term loans. As the British bankers genarally put it, "Our deposits are repayble on demand at short notice, our advances must be arranged on the same conditions".

The banks generally influence the economic situation by the way in which they invest their funds. The object of banking business being to make a profitable use of the deposits, the funds are variously invested in bills of exchange, government securities, etc., and according as they give preference to one type of paper to another, they influence economic activity. Thus sometimes they give preference to government securities, sometimes to trade bills and sometimes to industrial shares. Thus the initial form of the repercussion of the activity of the banks depends on particular classes of assets which they take in exchange for their deposits. Thus the views of those who hold that the banking system determines the total volume

of bank money in existence and that the public alone decide the actual use of bank money are not very scientific. It is of course true that the ultimate use of bank money is not fully within the control of banks; for, although initially invested in one use, it may be diverted to another use by the business public. But then if the banks find that their funds are being diverted to undesirable uses, they can at once impose restrictions on their investment policy.

Having established that the banks influence the general economic situation by the selection of papers on which they propose to invest their funds, it is to be seen on what grounds do they make this selection. In other words, what is the scale of preferences for the commercial banks for different classes of assets? The banks are usually guided by two factors, viz. liquidity and profitability. Liquidity is essential for the banks for the maintenance of public confidence, but then perfect liquidity will come into clash with profitability. To keep all the funds unused, in cash, is a perfectly liquid position for the banker, but then it will not bring any profit for the banks and hence they cannot pay interest to their depositors. On the other hand, perfect profitability would demand the investment of funds into long-term loans which is dangerous. For, in the first place, the banks must keep some money in cash for meeting the sudden demands of their depositors, and in the second place, they cannot block their short term deposits into long term loans, which, however profi-

table, is in itself dangerous. Hence some amount of imperfection in liquidity is essential for making room for profitability. The safest policy for the banks is therefore to strike a balance between the two and according as they are in a position to do so, they are successful in business.

Liquidity depends upon two factors, viz., shiftability and risklessness, and therefore even a long term paper may be regarded as liquid provided it is shiftable. Thus, take the case of long-term government sucurities. Although long-term, they are easily shiftable in so far as a good market exists for them and the risk involved is also not much in so far as under normal conditions, the face value at least can be obtained if not more. Or, take the case of the ordinary share of the Tata Iron and Steel Company. It is equally shiftable and involves little risk. But the same cannot be true of the shares of many smaller and newer concerns where risk is enormous and shiftability negligible. At any moment, however, the price of these securities or shares, otherwise however sound, may have gone down as a result of capital depreciation, and in this respect they cannot be regarded as perfectly liquid as cash money is. Besides, the banks have to transact businesses which however essential for them are not perfectly riskless. Thus loans on personal credit or even against goods hypothecated, secured loans to travellers, overdraft facilities, etc., fall into this category. The banker has confidence into the integrity of the firm ; the assets of the firm may

be sufficient to cover the amount of the loan sufficiently; and yet "the informality with which the loan has been arranged between banker and customer makes it shiftable only at more or less incovenience." However, the banker has to consider both these aspects of liquidity and at any moment of time the assets of a bank consist of so many different types of securities some of which satisfy both the attributes of liquidity while others do not at least involve the banker into losses.

Shiftability is a relative term, related to the eligibility rules of the central bank on the one hand and the nature of assets of other banks. So far as any particular bank is concerned, its assets may be readily shiftable and therefore it can safeguard its position. But in abnormal times of a depression or a crisis, the safety of a particular bank is not the safety of the entire banking system, and if there is a run, the whole system is affected. Therefore so far as shiftability is concerned the ultimate strength of the banking system depends upon the central banking institution of the country and the particular line of policy it adopts, and not on the strength or weakness of any member unit. Where the bankiug system is closely knit together, as in America through the correspondent system whereby one bank keeps deposits in another bank and so on, they can meet the situation by mutual transference of funds. Where however the banks are not so closely linked up but operate separately through their own branch connections, as in England and

many other countries, any serious disturbance of any one of these would not only affect the entire banking system but the economy as a whole. Herein arises the importance of central bank as the ultimate source of cash or the lender of the last resort. We have seen in the previous chapter that the method of the central bank operation is not the same. It depends in part on the relation of the central bank to the money market and in part on the customs and tradition established. But whatever the method, either direct as in the U. S. A. and Europe or indirect as in Britain, the central bank is the lender of the last resort and its help takes the form of lending against or discounting a certain class of papers acceptable to central bank. By necessary changes in their eligibility rules, the central banks can easily influence the lending operations of the commercial banks. It therefore provides for shiftability of assets of the banking system on the one hand, and for an effective instrument of control in the hand of central bank for guiding the operations of the money market on the other.

This is the orthodox commercial banking theory and England is the classical home for this where its application continued undisturbed at least upto the beginning of the first great war and to a considerable extent even now. In that country the banks provide current finance to industry in the form of overdraft or separate loan account but never put their capital for long term investment. The Indian banking system, based as it is on the British model, follows the orthodox commercial banking theory.

Mixed Banking in Germany & U. S. A. :

The German banks present a contrast to the British banking system in so far as the former represent mixed banking,—a mixture of commercial and investment bankings. The justification for this is to be found in the fact that the German banks were predominantly banks for financing industries, and that they carried on their business with their own capital, rather than with the deposits from the public, the latter being considered as only a side-line and not the principal item of commercial banking transaction. From the beginning of the present century the banks assumed a new role when they began to foster deposit business. But then their old preference for investment banking was never abandoned. Thus they combined both the functions—commercial banking with investment banking—and hence it is known as mixed banking system. The mixed banking system appeared in Germany only as a matter of necessity. The situation in Germany was quite different from that in England in so far as the pace of industrialisation was very rapid in case of Germany whereas there was no well-organised agency for the supply of industrial finance. The banking system adjusted itself to the circumstances. In the U. S. A. before 1837 commercial banks exercised some of the investment banking functions; but these were abandoned after the panic in that year and commercial banking was entirely separated from investment operations which were taken up by investment houses, investment trusts and savings banks. The tendency towards mixed

banking appeared in the U. S. A. after the passing of the Federal Reserve Act which allowed national banks to accept savings deposits and granted a limited permission to make mortgage loans. Later legislation, in particular the McFadden Banking Act of 1927, encouraged greater fusion of banking functions. The result was that the banks were encouraged to enter into the field of investment to a far greater extent and there was very soon a tremendons outburst of speculative activity among them. Not only that ; the banks had organised a number of security affiliates through which also they made long term investments. Thus although the German and American banks are structurally different, yet they represent mixed banking systems and hence suffered the necessary consequences in the years following the first Great War, and in particular, in post-depression period.

New Tendency towards Mixed Banking :

In the years following the first Great War, a new tendency towards mixed banking appeared even in countries which at one time were regarded as the traditional homes of orthodox commercial banking. This tendency affected England, France and some other countries. We have already said that England is the traditional home of commercial banking. In the years following the first Great War, a feeling was developing in England that the banking system was not doing all that it should do for the economic system. Accordingly, in 1916 the Board of Trade appointed a Committee on Financial

Facilities for Trade on the basis of whose recommendations the British Trade Corporation was formed in 1917. The Corporation was however short-lived. The question was revived in post-war years when the industry stood in need of rationalisation and reorganisation for which finance was the most crucial problem. Accordingly, the Macmillan Committee was formed to investigate, among other things, into the relation of British banks to industry. By this time the question had assumed great importance and the Government made arrangements with the banking system for rendering assistance to industries. Two important organisations, The Bankers' Industrial Development Company and the Securities' Management Trust were formed for the purpose. It should however be noted that although the British banking system came forward for helping industry, the participation was not of a direct type, as in case of Germany. Their orthodoxy remained unshaken so far as their own business was concerned, and the new development was taken up by the banks as something forced upon them by circumstances. Similar tendencies were visible in France as also in Japan. In France there are two types of banks, viz, banques de affairs and banques de depots, and their functions were quite distinct. But since the first Great War, the industry being largely in need of credit on a large scale, the line of demarcation between the two began to fade away and the banks began to invest their fixed deposits as also their own resources in the form of long term loans to industry either directly or through subsidiary companies.

Similarly in Japan, the ordinary commercial banks, under the leadership of the Industrial Bank of Japan, began to give assistance to industries.

Reasons for the New Tendency :

This new tendency towards mixed banking even in those countries which adhered to the orthodox banking principles is the result of twofold factors, viz., the depression in the years following the first Great War and also the change in the general economic situation. The depression was responsible for a number of interesting developments. For, a considerable part of the advances made by commercial banks to industry became frozen as a result of the depression and so if these industrial units were to be saved, it necessitated further investment of funds by the banks. This was one line of development. On the other hand, the war had stimulated industrial combination which in its turn encouraged institutional saving and so the channels for the investment of funds by commercial banks came to be restricted. The result was that while liquid funds were accumulating in the hands of the banks, they could not be used. The natural consequence was that the banks had no other alternative but to sacrifice safety and liquidity in favour of yield or profitability and to divert their funds towards long term investment.

This new tendency has induced some people to demand a change in the commercial banking theory. It is argued that the orthodox banking theory was formulated at a time when the general economic struc-

ture was entirely different. Now that the circumstances have changed and that the banking practice has undergone modification, the banking theory also should be similarly modified. It is argued that the orthodox theory of commercial banking was fomulated at a time when the stock exchanges had not come into existence and hence the liquidity factor had to be emphasized much. But now that the stock exchanges are functioning, all marketable securities, rationally selected, may be treated as liquid and safe. Thus at present a high-grade bond is as much liquid as a commercial paper. It may be pointed out that in times of depression there is the possibility of capital depreciation, but that is no more true of bonds than of any other short-dated paper. It is further pointed out that even in case of money at call or at short notice, it is not generally withdrawn by all, even though allowance must always be made for individual cases of withdrawal. Therefore beyond the safety line, the banks can make a profitable use of their funds and treat them as almost fixed. Besides, as already said, in those countries where institutional saving has come to play an important role, and where funds are raised by industry in capital market, which is mostly done, the banks are being deprived of an important part of their function and as substitute they cannot but take to investment banking. Under these circumstances, it is considered useless to pull on with the old theory.

Merits & Demerits of Mixed Banking :

This tendency towards mixed banking is not an un-

mixed evil. It has got some definite advantages for the industry. The greatest evidence of this is to be found in Germany where the rapid pace of industrialisation was to a considerable extent due to the close co-operation of banks with industry. German experience clearly indicates that mixed banking is not incompatible with sound banking, provided a considerable part of the deposits of the banks are true deposits and provided the banks maintain a good reserve to meet the demands of the public. It is also essential, for the sake of safety, that commercial and investment banking functions must be kept distinctly separate.

The greatest danger of mixed banking appears not in normal times but during the years of depression when the value of investment depreciates to a considerable extent. The banks find that the bonds in which they had invested funds had gone down in value to a considerable extent. Not only that, in times of boom, which precedes depression, the banking system in its investment policy is often carried beyond the safety limit, both as to the quality and the quantity of investment. Thus experience in America shows that the banks had invested in real estates and bonds which were beyond the eligibility rules of the central banks. Such illegalities and excesses were responsible for violent banking crisis which appeared in America during and after the depression.

Reaction against Mixed Banking :

While some form of mixed banking appeared as a necessity in the years following the first Great War,

the experience during depression resulted in a definite reaction against it. We have already said that in England the tendency was regarded as being due to the exigencies of circumstances and never obtained a permanent footing nor was it incorporated within the banking system. That is why the British banks could face the depression without being adversely affected. The worst results of mixed banking appeared in the U. S. A. where the intermixture of the two resulted in severe banking crisis. Hence the Banking Act of 1933 in the U. S. A. took a serious view of the speculative activities indulged in by the banks and the various security affiliates. Under the Act, the commercial banks must divest themselves of their interest in any investment affiliate and give up all issuing and underwriting activities. The Act also provided that no member bank might be affiliated with any institution engaged mainly in the issue, floatation, underwriting, sale or distribution of stocks, bonds, debentures and other securities, after one year of the passing of the Act. Short-term deposits to investment banks withdrawable by cheques or by any other evidence of debt at the request of the depositor were prohibited. Interlocking directorates as between member banks and investment banks were declared illegal. Further restrictions were imposed on mixed banking by the Act of 1935 which provided that the total amount of investment security of any one obligor held by a national bank must not exceed 10 p. c. of its capital and surplus.

Similar reactions against mixed banking were also visible in Germany, Belgium, Sweden, Norway and even in other countries. Thus under the German Credit Act of 1934, stocks other than permanent participations and bonds not admitted to the stock exchanges, that might be held by a bank were limited to a certain percentage of its liabilities. Real estate holdings or permanent participations were also similarly restricted. In Belgium the banks, accepting deposits at interest repayable within two years, are prohibited to hold shares in or to participate in any industrial enterprise under the Law of 1934.

Conclusion :

It will be seen from above discussion that mixed banking system however sucessful in Germany and some other countries cannot be relied upon during depression. In an economy in which we live trade cycle has become more or less a permanent feature and its appearance and reappearance give violent shock to the economic system. Under these circumstances, if the banking system is itself weak, it becomes an additional cause for anxiety. Much of the evils of the economic system are due to the speculative activities of the banks. Hence it is better that investment and commercial banking activities must be placed in entirely distinct hands. It is true that in some countries, as in India, the problem of industrial finance is very pressing. But then the more scientific solution would be the establishment of investment banks or similar other institutions rather than a mixture of the two

banking functions in the hands of the existing commercial banks,

CHAPTER—III.

Commercial Banking Structure.

A discussion on banking structure generally turns into a discussion on the nature and scope of the activities of each individual bank as also the relation between one bank and another. These two structural questions are not only distinct in themselves but also are different in different countries. The relation among the banks themselves depends in part upon banking tradition and in part upon the role played by the central banking institution of each country; whereas the nature and scope of the activities of each individual bank depends on whether the banking system represents unit banking or branch banking systems.

Unit vs. Branch Banking :

As the names indicate, unit banking represents a type of banking in which each banking institution is independent by itself and operating within a narrow area. The American banking system is a typical instance of unit banking, where the traditional fear against monopolisation and prevalent sentiment against money trust resulted in unit banking, though, of course, in a few cases banks were allowed to have

branches within strictly defined areas under the Acts of 1927 and 1933. In order to obvate the defects of unit banking, however, the American banks have devised what is known as the correspondent bank system. Under this system, a country bank deposits some of its cash reserves with a bank in a big city close by and the latter sends funds to still bigger financial centres like New York, Chicago, etc. This link facilitates the remittance of funds from one part of the country to another part through the correspondent banks, ie, "by transference of these funds in the great centres from the name of one country bank to that of another country bank." The British banking system represents the branch banking type, the institution being very large having a network of branches throughout the country and even outside. This system is more common and prevails practically in all the countries of the world, such as, Canada, South Africa, Australia, Germany, France, even India. In England the major portion of the banking business is done by five big banking institutions, popularly known as the 'Big five', viz., the Midland, the Westminster, Barclays, Lloyds and the National Provincial. Similarly, Germany has four big banks, viz., Deutsche, Disconto-Gesellschaft, Dresdner and Darmstaldter National; France has four, viz., Credit Lyonnais, Societe General, Comptoir National d'Escompte, and Credit Industrial et Commercial. Canada has four big chartered banks. These banks have got their branches throughout the country.

Amalgamation Movement in British Banking :

The development of British banking on the branch banking lines has an interesting history. It has two distinct phases, viz., amalgamation of existing banks and then the opening of branches by the banks which had amalgamated together. The history of the amalgamation movement falls into five distinct periods.

Before 1825 banking business was in the hands of private bankers and hence amalgamation in those days implied alliances between different families carrying on banking business. The second period from 1825 to 1843 is characterised by the steady development of joint stockism in the field of banking and these banking companies began to absorb many of the private bankers. The process was partly due to the fact that the newly created banking companies began to usurp the business of private bankers and partly due to the fact that many private bankers finding themselves unable to compete, resorted to voluntary amalgamation with joint-stock banks. The third period, from 1844 to 1861 is not very important from the stand-point of amalgamation movement excepting that the private banker, under the influence of the Act of 1844, began to set their own house in order either by alliance among themselves or by seeking to expand their business. The fourth period from 1862 to 1889 is however important from the stand-point of amalgamation movement. A number of factors were operating during this period favouring

amalgamation. The growth of cheque currency and the consequent decline in the use of notes, frequent legislation counteracting the effects of the Act of 1844, the failure of many private banks side by side with the growth of joint-stock banking, the recognition of the principle of limited liability under the Act of 1879, the failure of private bankers to publish accounts and to stick to their conservatism, the surrender of business by many private bankers in exchange of good prices, and the desire for the joint-stock banks to expand their business,—these and many other minor factors tended to strengthen the amalgamation movement during this period. With the termination of this period, the older movement, viz,, amalgamation of the private bankers with the joint-stock banks was mainly over, and the modern movement started from 1890 onwards. It was modern in so far as it was amalgamation among the joint-stock banks themselves. "This was influenced at the outset by the Baring difficulties. The acute shock given to commerce, after 24 years of comparative calm, directed public attention to banking and the resulting criticism added to the strong utterances of Viscount Goschen influenced some and caused other banks to seek amalgamation." At this time industry and trade were making very rapid developments, and in order to cope with the developments in these lines, the small local banks must amalgamate with big well-established units. The competition of the bigger banks also accentuated the process. Another interesting development took place at this

time. Owing to the decline in interest rates in London, the London banks began to open branches in the interiors for capturing business with a view to maintain their profits. On the other hand, the progressive provincial banks began to seek representation in London, and subsequently in other centres which were becoming commercially important. This effort at expanding business on the part of London banks into the interiors and on the part of the provincial concerns in London resulted in a keen competition in which there was no other alternative than to form defensive groupings among the provincial banks themselves.

This process continued even in the present century, with this much difference that the number and size of amalgamations increased at a rapid rate. The private banker had ceased to be important, though not altogether extinct. The banking units which survived at the beginning of the present century, either in London or in the interiors, were more or less equally strong, so that amalgamations in the present century took place not so much due to the intrinsic weakness of the amalgamating units as due to the realisation of the advantages of large scale operation. The units had become so much strong by the beginning of the present century that the period had not seen banking crisis as is usual with other countries of the world including our own.

The first Great War gave further stimulus to concentration movement in all parts of the economy, and banking had to keep pace. At the outset it was thought

that the War was not going to last for long and hence the banks gave up their competition and began to co-operate amongst themselves through mutual agreements for meeting the national demand. But soon it was realised that the end of the War was not in sight and hence in 1917 the London City and Midland Bank decided to extend to Ireland, an example which was soon taken up by others. This was followed by a strong wave of an amalgamation, the reasons generally advanced being "those of the necessity of keeping pace with banking developments abroad and of preparing for that magic period of 'reconstruction'." The business public naturally took alarm at this appearance of a money trust and it was a direct threat to the position of the Bank of England as a leader of the money market. The Big Five had already come into existence and hence a Treasury Committee was appointed in 1918 to investigate into the whole question and to suggest whether in case of further amalgamation, Government action was called for. The committee was of opinion that "the possible dangers resulting from further large amalgamations are material enough to out-weigh the arguments against Government interference and that in view of the exceptional extent to which the interests of the whole community depend on banking arrangements some measure of Government control is essential." Accordingly a bill was brought forward by the Government for controlling further amalgamation but was given up owing to the fact that an informal agreement had taken place among the banks and the Government

that no further amalgamation would take place without the previous approval of the Treasury.

What have been the effects of amalgamation in British Banking ? In the first place, amalgamation has resulted in the lowering of the ratio of capital to liabilities. There is justification for this. When there are a large number of independent banking units, each has to remain alert about its own position and has to maintain a proper relation between capital and liabilities. With the amalgamation only a few banking institutions have come to exist, each one with very large resources. What is important for them is to maintain the confidence of the public which can be done by keeping the balance sheet in more liquid condition. Secondly, while amalgamation has resulted in the disappearance of the independent banking units, there has been an enormous expansion in bank offices. Thirdly, amalgamation in banking has resulted in the growth of the use of cheque currency, equalisation of interest rates and loaning rates and charges, and increase in deposits. Fourthly, the method of banking transaction has changed owing to the disappearance of the private banker. The private banker was a member of the local community, coming in close contact with the people ; the same cannot take place under a system of branch banking. Under the old system the money of each locality remained within that locality and was available to local business. Under the new system money goes to the London money market where it is used for the financing of big business. Hence the

volume of money available to small businessmen has been restricted.

Unit & Branch Banking Compared :

"A comparison between unit banking and branch banking is essentially a comparison between small scale and large scale operation." In its origin each banking system is bound to be unit banking system. Only after a certain stage of development has been attained that there is amalgamation and the growth of branch banking. In America however the fear of money trust has always stood in the way of bank amalgamation and resulted in the imposition of restrictions in the way of expansion of a banking unit. To a certain extent the unit banks are at advantage. For, they come into close contact with the people of the locality and have a thorough knowledge about them. Hence their transactions become smooth and they can have a sympathetic understanding of the local needs. But so far as the advantages of large scale banking operation are concerned, they are beyond the reach of the unit banks. Besides, there are difficulties in the remittance of funds. Hence the correspondent bank system, of which we have already noted, has been introduced in the U. S. A.

The branch banking system enjoys the advantage of large scale operation. In the first place, they secure the economies of division of labour. Since the resources of the banks are enormous, they can secure the services of best men available and engage them for the particular task for which they are suited. Some of them, again, can be engaged to study the broader

problems of bank management, which are mostly beyond the ability of unit bank. Secondly, the giant institution with so many branches can make a better distribution of its assets. It can invest its resources in different occupations and thereby strike a better balance between safety and profitability. There is also economy in reserve in so far each branch is dependent not on its own reseve but on the total reserve of all branches, including the parent institution, and in times of need, it can draw upon the resources of other banks. In other words, each branch can maintain a lower reserve, and therefore the total reserve maintained by each bank with all its branches will be much less than if each of those branches had been an independent institution. In matters of remittance of funds, the branch banking system is at advantage in so far as the inter-office-indebtedness can be adjusted more easily. This defect of the unit banking system has been sought to be remedied by the correspondent bank system but then the cost involved in the latter is far in excess over the former. The branch banking system is able to spread risk geographically. All industries are not equally susceptible to business ups and downs. Some are more easily affected and others less. Thus during trade cycle the capital goods industries are affected in the first instance and only then the consumption goods industries. Since a big bank invests its funds in different industries in different localities, and since

these are not all going to be similarly affected by the prosperity and depression phases of the business cycle, the bank's position remains more secure. Not so in case of unit bank whose fortune fluctuates with the vicissitudes of business of the particular locality in which it is situated. "In so far as the declining industries are strongly localised, unit banks depending on those areas may incur severe losses and actual collapse may follow, whereas the losses incurred by branch banks in those areas may be offset by profits earned by branches of the same banks in the more prosperous areas. For example, the chronic depression of sections of American agriculture even before 1929 was one of the causes of the hundreds and hundreds of small bank failures which seemed so incompatible with the general prosperity of the United States at that time. In the same years the English branch banks were incurring heavy losses in the Lancashire cotton industry. But, thanks to their other business in more prosperous parts of the country, their cotton losses were not of sufficient weight to break the English banks."

While all is said, there is an optimum beyond which no institution can and should go. The bank is no exception to this rule. Whatever the resources and field of operation, management is after all a limiting factor for two reasons. In the first place, the ability of those entrusted with management, however great, is after all limited, and secondly, it is not possible for the central management to keep in touch with the needs and local habits and customs of different localities.

The element of personal contact is equally important. In these respects a big bank has some disadvantages. To encourage personal contact with the clients, the bank encourages its officials to mix with local people and to understand their requirements. Local people are also taken in on the board. Where the bank has overseas branches, they are more or less like subsidiary companies having the management in their own hands and maintaining only a nominal contact with the head office. In this way these giant institutions have been able to combine the merits of the two systems while avoiding the defects of the unit banking. Personal contact in unit banking is a strong point ; but it is also a weakness in so far as at times loans to undesirable parties cannot be refused. But in branch banking, while personal contact is being encouraged now-a-days, at the same time, the local manager can, if there is any occasion for refusing a loan, "thrust the unpleasant onus on to that remote abstraction 'Head Office' without running so much danger of terminating his social contacts with the client."

On balance, therefore, the advantages are predominantly on the side of branch banking and that is why it has developed in practically all the important countries of the world. U. S. A. is only an important exception to this. But then this is due to the legal restrictions rather than to the non-realisation of the defects of unit banking. This expansion in the size of banking unit is only a counterpart of an expansion in the size of business unit as also in the field of their operation.

Banking Trends in India :

So far as India is concerned, although there are five big banks, viz., the Central Bank of India, the Allahabad Bank, the Bank of India, the Punjab National Bank and the Bank of Baroda, like the Big Five in England, yet their development was not on the same lines as in the latter country. In England, the rise of the Big Five was the result of bank amalgamation and consequent concentration of resources in their hands, followed by the development of a network of branch banking. In India, however, the most notable feature is the concentration of resources to a large extent in the hands of the Big Five, side by side with the increase in the number of banks. The result has been that whereas in England, the amalgamation movement had swept away the inefficient concerns, in India however inspite of the concentration of resources in the hands of a few banks, the increase in the number of banks is going on and as a result of the war-time boom and liquidity in banking system, the development of banking, particularly branch banking, and its improper distribution, has gone so far that a period of depression would prove dangerous to banking business.

In the field of banking, amalgamation has taken place only in a few cases. Thus in 1923, the Central Bank of India absorbed the Tata Industrial Bank. The Lloyds Bank absorbed in 1923 the wellknown eastern business of Cox. & Co., and of Henry S. King & Co. The Allahabad Bank has been bought out

by the P. & O. Banking Corporation, which in its turn was purchased by the Chartered Bank of India, Australia & China. Leaving aside these three cases, there has been no amalgamation in this field worthy of name. It will thus be seen that the indigenous banks still hold out as a separate entity carrying on their own business. They are the prototype of private bankers in England. Even among joint-stock banks, there has been no amalgamation which may be called a movement. There are of course the five big banks ; but at the same time there are others with ample resources and many others working in the field of banking. The need for amalgamation, at least for co-operation, is very great among the joint-stock banks in this country. This is not only essential for the sound development of banking and for making preparation to meet any unforeseen crisis, but also for meeting the competition of exchange banks which are now in increasing measure taking to inland trade financing.

Two unhealthy trends have characterised Indian banking in recent years. In the first place,there has been no amalgamation in banking units with the result that many uneconomic units have come to exist, and secondly, there has been an indiscriminate expansion of branch banking in recent years not only on the part of sound banks but on the part of all and many of these branches being far away from the head offices have taken to doubtful or even risky operations. Many of these branches have again been opened at places where banking facilities are already available. Some of

these branches have failed to repay deposits and some have worked to the detriment of the interest of the depositors by involving heavy capitalised expenditure out of proportion to the resources of the bank, payment of high rates of interest on deposits, speculative activities to make up the higher cost, manipulation of accounts, employment of untrained and untrustworthy managers, etc. This expansion in branch banking can be seen from the following figures :

Number of Banking offices.

End of 1938—1471
" " 1942—2710
" " 1943—3143
" " 1944—4550
" " 1945—5266

This development is not on right lines and has weakened the banking structure as a whole. Even the newly started scheduled banks are not free from this defect. Thus about ⅓rd of the total number of branches of the scheduled banks was owned by banks which were floated during the War or which were included in the second schedule during the period. Be it noted that this expansion in branch banking has not increased the total banking facilities available in so far as these branches are not opened in the countryside but only in the towns which are already overbanked, thereby simply diverting business from one bank to another, and for that purpose even adopting doubtful devices. The situation had deteriorated so much that the State

could no longer remain indifferent, and hence immediate action was taken by giving effect to clause 18 (6) of the Banking Bill which is before the Central Legislature. The Banking Companies (Restriction of Branches) Act, as the Act is known, has been passed in November, 1946 and lays down that no banking company shall open a new branch or change the location of an existing branch without the previous permission of the Reserve Bank in writing. For the purpose of the Act a branch has been defined as "any sub-office, pay office, and any place of business of a banking company, at which deposits are received, cheques cashed and money lent." Before giving permission for the opening of a new branch or for changing the location of an existing branch, the Reserve Bank shall "take into consideration its financial condition and history, the general character of its management, the adequacy of its capital structure and earning prospects and the public interest to be served by the branch." If any banking company opens a branch or changes the location of an existing branch in contravention of sec. 3 of the Act, every director or other officer of the banking company who is knowingly and wilfully a party to the contravention shall be liable to a fine which may extend to one hundred rupees for every day during which that branch remains open for business or as the case may be the change in its location continues. The move was very timely. But as soon as the information that the Government was going to restrict the opening of branches leaked out, a number of banks have in hot haste

opened a number of branches without making necessary preparation. It is essential that the Reserve Bank should investigate their cases and consider how far their retention is an economic necessity. At the same time it must not be lost sight of that the amount of banking facilities available falls far short of the requirement of our country, particularly in the countryside, and that these restrictions should do nothing which may stifle the expansion of necessary banking facilities in this country.

CHAPTER IV

Commercial Banking Structure (Contd.)

British Banking Structure :

The British Banking structure consists of several types of institutions, which are as follows: Private Bankers, and Joint-stock Banks, and miscellaneous institutions, such as, Colonial and Dominion Banks, Anglo-foreign Banks and Foreign Banks. These may be studied in brief.

(1) Private Bankers—It has been noted in the previous chapter that the Private Bankers had to face the competition of the joint-stock banks when they appeared on the scene and ultimately gave way to amalgamation. But some of them survived and these have been fighting a defensive battle for the last one hundred years. In the field of domestic banking these

were defeated totally in the last quarter of the 19th century, and since then they have been functioning in the overseas markets.

There are two types of Private banks, viz., merchant banks and acceptance houses ; but the distinction is one of fiscal convenience rather than one of organic structure. Many of them owe their origin to foreign families, though outstanding examples of domestic origin are not altogether lacking. With the 19th century development of trade and finance of the world in which Britain played the leading-most part, these private bankers rose to the height of their power, prestige and prosperity. Before the first Great War, the functions of these private bankers were as follows :

(a) The short-term and long-term credit provided by London to foreign countries was sent through these private bankers who had established overseas connections.

(b) These bankers had developed international acceptance credit almost to perfection which helped the maintenance of stability of exchanges.

(c) They undertook new issues for overseas borrowers, granted short-term accommodations which were afterwards converted into long-term ones, commanded underwriting lists, and looked after the service of the loans issued by them.

(d) Some of the merchant banks specialised in foreign exchange business, which otherwise would have remained a monopoly of the London Agencies of foreign banks. The activities of these banks in the

field of foreign exchange facilitated international arbitrage in bullion and securities, which was highly profitable business for London.

In this new castle of foreign exchange business the private bankers were given a rude stock by the first Great War when the international edifice of gold standard had collapsed, and the position of London money market was considerably undermined by the appearance of new markets in other parts of the world. International trade had been crippled and international financial morality had declined. Many of these private bankers suffered losses for investments which they had already made. Hence they changed their lines of business after the War. They began to finance the work of reconstruction of Europe, which was very profitable. Once more in post-war years international acceptance business revived. "But much of this feverish activity was hollow and unhealthy. It was therefore a deadly malignant growth for these banks...The same was true to a large extent of new expansion of acceptance business. Much of it was not so much a reflection of the recovery of international trade as an indication of the abuse and perversion of acceptance credit. The large line of open credit facilities granted to some foreign banks had taken the place of genuine commercial documentary credit granted directly to the firm utilising its facilities. Thus short-term credit which should have been repaid and recreated every three or six months was, in fact, going into permanent capital. That abuse was fully revealed with the sequence of de-

faults, moratoria and standstill agreements that ran through Europe and South America in the early "thirties."

In post-depression period, therefore, the private bankers had to change the line of their activity once more. They diverted their attention to the domestic market and began to popularise domestic acceptance credit. Some of them began to establish important financial links with industrial concerns. The second Great War gave a fresh blow to their activity. The German standstill debts were completely frozen, and hence the Bank of England had to offer special help for their protection. The complete suspension of new issue business, both domestic and foreign and the control of foreign exchange market were additional impediments in the way of their activities. International acceptance business will not revive in the same way and to the same extent as in the past. Some of them may therefore be forced by circumstances either to liquidate or to amalgamate. But then they are "too typical and solid a product of British banking evolution to be 'sunk without trace'." So the most important of them will survive and continue to play important part which they have done in the past. Some of them will continue to establish a closer link with domestic industries which they have been doing since the depression. But for most of them, the scope of activity will remain overseas. "It may well be that the 'merchanting' part of their business will once more become dominant."

(2) Joint-Stock Banks—Regarding these institutions, their structure and functions, something has been said in earlier chapters. It has been pointed out that they strictly follow the commercial banking principles of the orthodox school of banking. Although in the years following the first Great War, they had started giving help to industry, yet so far as their own business was concerned, they had not departed even by an inch and hence, during depression, when all other banking systems faced crisis, the British banking system remained invulnerable. Regarding the structure of British banking it has already been seen that they represent the branch banking type and the stages of their evolution have been traced.

The deposit liabilities of British banks consist of two items, viz., deposits on current account and deposits on deposit account. The assets of the British banks consist of cash in hand and at Bank of England, money at call and short notice, bills discounted, advances and investments. These are so distributed as to provide for both safety and profitability. Cash in hand means the notes and coins in the hand of the banks and they are the most liquid but unprofitable part of the assets. These, along with cash at the Bank of England, which is nothing but a deposit in the books of the Bank in favour of joint-stock banks, constitute about 10 p. c. of the assets. In other words, these assets, coins excluded, constitute the liabilities of the Bank of England to the banking system. Money at call and at short notice are constituted of loans given to some

firms in the city, which are repayable on demand or at a week or two's notice. Bills discounted are the trade papers held by the banks, against whom the latter make payment to the drawer. They are payable on maturity. Advances are loans to various parties, which often take the form of overdraft facilities. Investments are long-term government securities, specially the securities of British Government and other Empire Govts. Of all these, loans and advances constitute the biggest item, being about 50 p. c. of the total asset of the banks.

The bills discounted by the banks constitute an important item in the bank's portfolio. When the banks have exhausted their funds in discounting the bills, and yet there are bills to be discounted, the banks usually take resort to the central bank for funds. In London, however, the practice is different owing to the existence of the discount market which is the most remarkable feature of the City and which has got no equivalent in any part of the world. The London discount market "forms a reservoir whose waterline registers the ebb and flow of monetary currents." In London the usual practice for the Bank is never to rediscount any of their holdings but to call in loans from the discount houses.

The discount market consists of houses who specialise in the practice of discounting bills and in this market "the offers and demands for bills are adjusted against the offers of and demands for money on day-to-day or short notice. They are the intermediaries through which the two markets, money market and

discount market, can communicate and complement one another." It should however be noted that the bills drawn by first class parties get immediate reception in the discount market. But the bills drawn by unknown parties fall into difficulty. Herein come the acceptance houses, regarding which we have already noted. These are firms having overseas transactions and therefore knowledge of parties working in different parts of the world. They charge a small commission and lend the use of their name on the bills drawn by such parties. With the name of one of these acceptance houses attached, the bills become acceptable in the discount market. This type of acceptance business has however declined partly owing to a decline in international trade and partly owing to the rise of money markets in different parts of the world which were previously financed by London.

The discount market consists of discount companies, bill brokers and running brokers. As early as 1810, the bill brokers gave no guarantee about the bills but yet they were employed by the banks in order to make sure that the selection of bills was a wise one. Similar brokers exist even now and are known as running brokers. They do not do any discounting on their own account but are mere agents bringing together buyers and sellers of bills and borrowers and lenders of money and in return earning a commission. The actual discounting then is done by a discount company or a bill broker. So far as their business is concerned, there is hardly

any fundamental difference between the two except that while the discount company gets some part of the funds from the public, over and above their own, on payment of interest, as in case of bank deposits, the bill-brokers depend on borrowings from the banks, over and above their own resources. Naturally, discount companies are much bigger institutions working with much bigger capital. The discount market gets money from the banks in the form of call money or day-to-day loans and money at short notice or "fixtures". The discount houses buy bills and short-term government securities on their own account and, in the first instance, with their own capital. Against these bills they get money from the banks, which is used for discounting further bills and so on and in this way "portfolios are built up whose value is 20 or 30 times that of the discount houses' own resources."

When the banks are in need of funds, they withdraw them from the discount market, and do not go to the central bank, as is the practice in other countries. When money is withdrawn by an individual banker, the bill-brokers take resort to those bankers who, in consequence of the withdrawal, are in possession of surplus funds. For this purpose the usual practice is for the broker to hand over bills in "parcel" as a guarantee to the bank in return for a cheque or banker's payment for the amount of the loan. The bills are dealt in in parcel in order to avoid the inconveniences in dealing with a few bills. As soon

as the bills are thus given, the bill broker ceases to have any interest in them, excepting that, having endorsed the bills, he remains liable in law to meet the bills on maturity, provided the party or parties mentioned in the bills fail to make payment. But when the entire banking system is in need of funds, this practice will not do and hence the discount market is forced to go to the Bank of England which gives assistance either by discounting their bills or by granting advances.

The great depression has introduced a lot of change in the discount market. The international trade has declined owing to the rise of economic nationalism. Even to the extent to which it exists, it is regulated by newer trade agreements and its financing has become different. The financing instruments are no longer the commercial bills of exchange but telegraphic transfers and world-wide branch banking. Hence the discount houses have come to rely upon another type of bills, viz., the Treasury bills. However safe the Treasury bills may be from the stand-point of safety, they are not ideal from the stand-point of profitability. The Treasury bills need no sorting nor are the guarantees of discount houses needed for a banker in holding Treasury bills. Besides, the banks have turned to be severe competitors with discount houses in matters of acquisition of Treasury bills. The survival of discount market therefore is not beyond question. It depends on how the market is able to secure profitable business for itself. This

depends in part upon how the market co-operates with the banks. So far as the banks are concerned, they have tried to help the discount market, sometimes by not tendering directly for Treasury bills and sometimes by not taking them until they have passed one month or so. Another line of operation for discount market lies in the revival of inland trade bills for which even the acceptance houses are trying. The future however is not very bright. Hence it is suggested by Sayers that "the Government should be prepared to be the strength and stay of as wide a market as can be supported on a diet of Treasury bills."

It has already been noted how the British banks changed to some extent under pressure of circumstances after the first Great War. Although the fundamental banking principles were not violated by them, yet they devised ways and means for providing long-term finance to industry. With the outbreak of the second Great War, British banking was faced with a new set of problems which were related to the questions of general credit policy as also to those of a more technical character arising from the phenomena of evacuation, decentralisation and departure of clearing from London. For the sake of "complete mobilisation and controlled canalisation of capital resources", the capital market had to be controlled by the imposition of ban on new issues and conversion of others, and the banking system had to adjust itself with the pattern of a rigidly controlled capital market. It is true that the British banks were concerned with the

provision of long-term capital; yet a control of short-term credit was essential for the success of the control over long-term capital. This was done not by Defence Regulations but by an informal approach to the banks who were requested to follow certain general precepts in their policy as to loans and advances. Thus the banks were requested to refuse demands for advances by trades of luxury and non-essential character and to recall, where possible, facilities which were alredy being used for similar purposes. The banks were also requested to give special considerations to requests for credit from firms engaged in government work or in activities of an essential character. When the first war loan was issued, the banks undertook to provide special short-term facilities to enable their clients to apply for the stock and spread their instalments over a lengthier period than that provided in the prospectus. The outbreak of the war was immediately followed by a decline in international trade and hence in commercial bills whose place was taken by Treasury bills. Another reason for the disappearance of commercial bills was the replacement of acceptance credit by confirmatory credit which produced no bills. So far as investment is concerned, there has been a gradual increase. The implication of new dominance of government securities in British bank balance-sheets are far-reaching. For, this will facilitate the submission of the banking system to government financial policy, which the banks had carefully avoided earlier.

More far-reaching, however, were the developments

of industrial finance in war time Britain. The earlier trends in British banking in this respect have already been noted and it has been seen how the Bank of England and the joint-stock banks were giving assistance to industries indirectly. These have, however, been termed as "an attempt to meet abnormal condition, to keep afloat waterlogged industrial units whose survial was a matter of national interest, or to launch equally important ventures for which it would have been impossible to find capital in open market." The Bankers' Industrial Development Company already referred to was one such institution and was never intended to be permanent. With its resources and prestige, it had been able to do important salvage and reconstruction work which otherwise would have been difficult. With the outbreak of the war it was thought that the Company has no longer any function to perform. Hence it repaid almost all paid-up capital and reduced its working capital from £6 million to £6000. The skeleton was, however, retained for use in post-war years. The other important instance of industrial banking in Britain before the war were the merchant-bankers whose other business having been lost, they were engaging themselves more and more to the financing of industry. This rather "negative record" of British banks in providing long-term finance to industries suffered a reversal with the out-break of the War. The pre-war capital market lost its importance owing to the imposition of Defence Regulations which prohibited all issues of capital in excess of

£ 10,000 and even that was allowed by the Capital Issues Advisory Committee only in a very few cases. These regulations aimed at canalising the flow of national savings into government issues and at ensuring that all demands for additional industrial capital were directly concerned with the war effort. Industries which were not considered essential were thus totally deprived of capital. In some cases, when a firm worked for some of the Supply Ministries, was supplied in kind by the Department with an "Embodiment Loan" under which the Department erected or extended the factories and provided and installed machineries and other permanent equipments.

(3) Miscellaneous institutions. In this category comes a number of institutions, such as Colonial and Dominion Banks, Anglo-Foreign Banks, and Foreign Banks. Among the Colonial and Dominion Banks, there are two categories, first, those having their head offices in London but carrying on business in some parts of the British Empire, and second, those having their head offices in some parts of the Empire but having offices in London. Their principal functions are to finance foreign trade and to act as agents for loans raised by their home countries in London money market. By their overseas links, they have come to assume an important place in the London money market. The Anglo-Foreign Banks are formed under the British law for facilitating international trade. The peculiarity of these banks lies in this that their field of operation is limited to each region, as the following names indicate :

the Anglo-South American group of banks, the Anglo-International Banks, Ltd., the Anglo-French Banking Corporation, the London and Eastern Trade Bank, the Imperial Bank of Iran, etc. The Foreign Banks, have their head offices outside the British Empire but operate in London. There are some other foreign banks which, though constituted under the English law, are owned and controlled by foreign share-holders. No restrictions are imposed on their working and they mainly finance the trade of their respective countries, and thereby bring a considerable volume of business to London.

American Banking Structure :

In 1912, there were in the U. S. A. about 30000 banking institutions. Whereas in point of number that country was the foremost in the field, the average size of each banking institution was much smaller than in other countries. These banks were mostly commercial banks pure and simple, and were owned by the residents of the places in which they were located. Their business was local in nature. These were called 'national' banks, but they were national only in name and not in their actual functioning. Apart from a very loose connection with clearing houses in principal cities, these banking units hardly cooperated with one another but worked at cross purposes as entirely independent units.

This decentralised unit banking system resulted in many inconveniences. The most serious feature of decentralisation was the scattering of reserves, a considerable part of which was practically not available. Thus a part of the reserve of each bank was kept as depo-

sit in another bank which the latter loaned out. Then there were the secondary reserves, i. e., funds invested in securities and call loans, which in times of panic could not easily be turned to liquid resources except at great sacrifice and financial loss. Thus the reserves were pyramided. The cash reserves of each bank had, therefore, to be maintained at a very high figure. The worst consequences of this decentralisation appeared in 1907 when, as a result of panic, even the largest supply of gold in the world, which the U. S. A. had, was not effective. Hence a number of disgraceful accompaniments were visible in America, such as, suspension of cash payments, currency premium, breakdown of domestic exchanges, illegal issue of millions of dollars of money substitutes, etc. The situation became worse still owing to the absence of any responsible leader of the banking system, like the Bank of England.

Another defect of the American banking system before 1912 was the inelasticity and perverse or inverse elasticity of bank credit. The national banks were authorised to issue notes by depositing with the government bonds which must be equal in par value to the notes issued. Thus the volume of notes depended not on the business requirement of the country but on the volume of bonds deposited with the Government. The volume of these bonds depended, in its turn, on the price of these bonds. When the price of bonds declined, the banks increased the supply of notes; and the reverse operation was resorted to when the price of bonds went up. Naturally, the price of bonds declined

at a time when business was slack and following this decline currency was unnecessarily expanded. On the other hand when business was active, the price of bonds went up and consequently the supply of notes contracted. Thus the volume of notes was not only inelastic, but it had inverse elasticity, in so far as the "bank note circulation frequently declined just at the time when business needs demanded an increase and increased when business situation called for a decline." Besides, it was not easy to obtain necessary bonds which often took considerable time to proceed. Similar inelasticity was to be found in case of loans and deposits. The legal minimum for bank reserve being laid down rigidly, it was not possible to expand loans and deposits in times of expanding business.

Thirdly, under the old system, exchange and transfer were equally defective. So far as domestic exchange was concerned, cheques were in circulation, but beyond a certain radius some of the clearing banks imposed a definite charge for their collection. The foreign trade of America was financed largely through London. This not only gave rise to additional foreign exchange operations but also gave the London banks the inside information regarding American foreign business. Remittance facilities were also not very quick and easy. Like the Indian money market American money market at that time was subject to large seasonal changes which resulted in large shipments of currency and before a shipment was received in one place it might be required in another

place. Finally, the absence of a Central banking institution resulted in making credit control impossible. Hence the American Banking system lacked in stability as was evinced by the crisis of 1907.

With the establishment of the Federal Reserve System, banking in America came to be established on more sound lines, and upto 1920, both the number of banks and the amount of bank resources began to show an upward trend. Another important change during the decade 1911-21 was that the number of state banks, especially state commercial banks, increased more than that of national banks. After 1921, however, the number of banks declined with the result that the average bank resources increased ; but this decline in the number of banks affected the state banks more severely than it affected the national banks.

The period from 1921 to 1932 is characterised by a number of bank failures, the largest number of failures taking place among the state banks. The causes of these failures were both specific and general. Among the specific causes mention may be made of the over-accumulation of doubtful, slow or past-due papers, heavy withdrawal of deposits, poor management, heavy depreciation of security values in which banks had invested money, large loans to officers and directors, defalcation or embezzlement, excessive loans to business in which the directors or officers of the bank were interested, and so on. Among the general causes of bank failure mention may be made of great social and economic changes of the time, such as,

improvement in transport, growing concentration of industry and commerce, improvements in technique of production and in methods of distribution etc., and consequent changes in the methods of business finance. A move towards big business had started in all countries during the years of the first Great War and although American opinion had all along been hostile to any sort of monopolisation, yet big business had come to stay, and this required big banks. This was another reason why the number of banks declined. A number of bank mergers and consolidations had come to stay throughout the country, particularly in case of large city banks. As already stated the principal cause promoting bank mergers was the growth in the size of business. Among other causes mention may also be made of the acquisition of branch banks, acquisition of trust company, acquisition of security business, desire for securing economies in working expenses, and to strengthen each unit against the possibility of future bank failures.

The above changes in American banking structure resulted in functional changes as well. In the first place, there were changes in the character of bank assets and consequent changes in the investment policy of the banks. The banks were giving increasing attention towards investing their capital in fixed assets of the industries. Thus while the funds of the banks were being blocked, the banks had no control over any of these industries. In other words, the banks were giving up commercial banking practice in favour of investment banking. The

broad effect of this was a decline in the liquidity of the assets of the banks whose funds were blocked either in securities or in real estates, and not in commercial loans or government securities. The result was that banks as a group grew more and more dependent on the stability of securities market and on an unswerving public confidence and hence more and more vulnerable to the vicissitudes of local, national and international economic and financial forces that mould and build public confidence." Secondly there was a change in the activity of the banks. We have already said that in the years following the first Great War, big business had come to stay and it was dependent, so far as its working capital was concerned, on institutional saving, which was mounting up rapidly in America. This enabled the industry and trade in America to obtain credit from the banks for long-term financial requirements without any direct responsibility to the banks themselves. Thirdly, the above changes affected the character of bank deposits. The increasing volume of deposits were mostly time deposits, and not demand deposits, and this provided a justification for keeping lower reserves, a factor, which all the more undermined the liquidity of the banking system.

The American Banking System received a rude shock as a result of the depression. It became very severe because of the fact that the banks were not maintaining liquidity. The tendency towards mixed banking in America has already been noted. This resulted in a severe banking crisis. The difficulties

that led to this crisis were more fundamental than mere structural weaknesses. There is no doubt that inspite of the failures and amalgamations of the earlier decade, the American banking structure was anything but strong. It is true that the number of banking institutions which had been 29211 in 1921 declined to 23972 in 1929 and less than 17000 in 1932 ; but yet this figure was too large and banks too scattered to be controlled efficiently by the central banking organisation of the country. But the most fundamental reasons were the functional changes, already noted, which undermined the liquidity and solvency of the banking system. A considerable part of investment by banks having taken place in industrial securities, it depreciated abruptly when the stock market collapsed. In this wrong investment policy, the banks were encouraged partly by the great influx of gold in the banking reserves during 1922-29 and partly by liberal rediscount policies pursued by the Federal Reserve Banks.

This period was,therefore, characterised by a number of important banking legislations in America whose aim was to protect the banking system from complete collapse. The first piece of legislation, the Reconstruction Finance Corporation Act of 1932, established a Reconstruction Finance Corporation whose primary function was to make sound loans to banks, etc. In a single year the corporation advanced loans to the extent of $ 850 million which checked bank failure for the time being. But late in 1932 once more the banks began to close their doors, so much so that

a bank holiday had to be declared in march 1933, to be followed by an Emergency Banking Act of 1933. The Federal Reserve System had all through been pursuing a courageous policy. Its hands were all the more strengthened by the passing of the Glass-Stegall Act of 1932 which provided that the member banks, either in groups of five or more or as individual banks, may borrow from Federal Reserve Banks upon securities which so far were not regarded as "eligible". This modification is to be applied only in case of banks who have no eligible papers in their portfolio and who, therefore, in ordinary way cannot approach the Federal Reserve System. The rate of interest to be charged on these loans will be one percent higher than the published discount rate. This measure was only a temporary one for individual banks ; but for joint borrowing by groups of 5 or more member banks, this new provision was made a permanent part of the Federal Reserve Act.

The above provisions were mere palliatives and did not aim at curing the disease from which the banking system was suffering. These provisions were included in the Banking Acts of 1933 and 1935. These legislations gave powers to the Federal Reserve System to determine whether any member bank was engaged in speculative and risky transactions and to withhold assistance to such banks. The Act of 1933 facilitated branch banking by national banks in the states. This aroused antagonism and hence it was changed later when it was provided that branch

banking by a National Bank may be state-wide only if it has not less than $ 500,000 in capital and if statutory law expressly authorises state banks to have state-wide branches. Under the Act, the security affiliates are required to be separated from the banks and more definite separation of deposit and investment banking is demanded. The regulations governing demand and time deposits have been tightened considerably and the payment of interest upon demand deposits totally prohibited.

The most important provision of the Banking Act of 1935 is the establishment of a Federal Deposit Insurance Corporation. It was done with twofold objectives. In the first place, it was thought that if the depositors could be prevented from withdrawing or transfering deposits during crisis as a result of lack of confidence, which can be done by deposit insurance, the banks will be adequately protected. Secondly, the deposit insurance will be able to maintain the volume of circulating medium in case of bank failure and thereby ensure the best functioning of the economy in general. The popular demand for deposit insurance rested on providing security to the deposits with the banks. Although the previous experience with deposit insurance in some of the states in U. S. A. was not very encouraging, yet the circumstances have now changed and a countrywide deposit insurance scheme had become essential. But the scheme that was adopted had many shortcomings. Thus the deposits of any one depositor are insured only upto $ 5000. Consequently

about 43 p. c. of the deposits of insured commercial banks are insured. In so far as the large depositors do not have their deposits insured, they possess as much power as ever for forcing the liquidation of the banking system. To be successful there must be 100 p. c. coverage. This is not only desirable but also financially possible. The corporation is supplied with funds from two sources, viz., $ 289 million from Congress and an annual payment of $\frac{1}{12}$th of 1 p. c. of the total deposits of the insured banks. All these arrangements are good and will succeed so long as the public confidence is maintained. But once the public confidence is shaken no scheme of insurance will be of any help. As the first annual report of the Federal Deposit Insurance Corporation admits, "Deposit insurance, however, is not a complete remedy for the ills of the banking system, nor for the unstable business conditions which in the past have culminated in periodic banking crises. The soundness of the banks is ultimately related to economic conditions ; and the solvency of the banks in the future, as in the past, while dependent in part upon the soundness of individual bank managements, will be controlled in large measure by general economic condition and monetary and credit developments." A more effective remedy will be to weed out the weak institutions or at least to merge them with strong ones, so that the banking structure may be strong. But this in itself will not be enough. As the American experience shows, the largest number of casualties have taken place among the insured banks while among the small banks, failures

have been considerably reduced. It indicates that the soundness of the American banking structure depends on the soundness of the general economic structure and it is the duty of the central banking structure of that country to concentrate on the single goal of stable economic progress.

Some of the important banking legislations in American during this period have been noted above. It has been pointed out that although the device of deposit insurance was commendable, it was in itself not enough particularly in times of waning public confidence. If immediately after the institution of the corporation, the number of bank failures was reduced, it was not due so much to the working of the corporation as to the increasing supply of credit and stagnation in its use. Deposits had been accumulating in the hands of the banks while loans and advances had practically disappeared. And while half the funds were lying idle in the banks, the other half were being used mostly in financing the deficit of the Federal Government. "The great increase in the banks' holdings of Government securities has the incidental effect of making them very dependent upon the course of bond market. Thus the American banking can be compared to a four-mastered schooner carrying an enormons spread of canvas but with not a breath stirring. In the circumstances, the man at the helm is powerless; there is no scope for credit control." This increase in banks' deposits is not due to an expansion of normal trade demand for credit but is

the result, in part, of the purchase of Government securities and in part, of the receipt of funds deposited with the Federal Reserve Banks. The latter was due, first, to devaluation, second, to sterilisation of some imports, and third, to the inflow of gold.

The outbreak of the war saw important changes in American banking. The most important factors affecting the banking situation were gold movement, continued federal deficits, and influences of the civil boom. The holdings of govt. securities by banks had been rising since 1930 and their loans and other investments remained at relatively depressed levels since then, until the middle of 1940, from which time a considerable expansion took place. With the inauguration of defence programme, special efforts were made to put the Government contractors in touch with banks and to give advice and assistance for the financing of contracts. In October, 1941, an Assignment of Claims Act was passed permitting bank-borrowings on the assignment of Government contracts. Thus defence loans were the most important during this period although commercial loans were also rising. The financing of defence programme resulted in an enormous expansion of bank credit and deposits, never previously experienced in the U. S. A. These developments were viewed as somewhat dangerous; for they might lead to inflation. Hence for checking the expansion of credit, the Federal Reserve Board issued regulations for the granting of instalment credit, which played an important part in

the retail sales in the U. S. A. and also raised the reserve balances of member banks to the maximum allowed by law.

French Banking Structure :

So far as France is concerned, it is not possible to speak of a banking system. The banks in France are a heterogeneous group consisting of a number of institutions each having some peculiarity of its own. The French banks are not closely tied to the central bank nor do they submit frequent reports to the latter. The widespread use of cash in business transactions and the prevalence of hoarding make it difficult to influence general business situation by the control of credit. There is not even a legal definition of a bank in France and even organisations like bucket shops often pass for a bank. Hence it is not possible to say how many banks are there in France. The whole system is so very loose that there are no restrictions regarding the functions of a bank, no legal reserve requirements and no provisions regarding note issue.

Next to the Bank of France, the central bank of that country, the most important financial institution of France is Caisse des Depots et Consignations. It was established in 1816, immediately after the Napoleonic Wars when the public confidence was badly shaken. It was the function of the Caisse to keep the funds belonging to individuals and the courts in safety. This original purpose has, however, receded to the background after the return of political stability and savings deposits with the institution have increased so much so that

they constitute the largest part of its liabilities. The Caisse being free from legal restrictions imposed upon private banks and having the support of the state, it attracted the largest amount of savings deposits. Besides, by a Law of 1837 deposits of private savings banks were transferred to Caisse and those of postal savings banks were entrusted to its management. Another source of funds of the Caisse are the social insurance funds. Under the various Social Insurance Acts the scope of state administered insurance has increased much more than that of private companies and the Caisse took full advantage of it. The Caisse with its enormous resources is concerned with investments of various types, —short, medium and long-term. A part of its funds are kept in cash, a part as deposit with the Bank of France and a part as deposit at the central fund of the Treasury, and the remaining portion of the short-term funds are invested in the notes of the French government or other governments or in loans given against the security of such notes. The Caisse being the largest holder of Treasury notes, it can influence the individuals against these notes and as the rate of interest charged by it is lower than that charged by the Bank of France, the banks approach the Caisse more often than they approach the Bank of France. Thus if the Caisse does not cooperate with the Bank at any time, the influence and leadership of the latter in the money market may be seriously impaired. The savings deposits of the Caisse are invested in the long-term loans. Before 1931, 90 p. c. of these deposits were by law invested in

government and semi-government securities. The law of 1931, however, allowed their investment in industrial shares as well, with the approval of the Minister of Finance.

The commercial banks of France, with network of branch offices, constitute the most important group of banks. The banking structure in France is in this respect similar to that of England and hence the banks in this country are much more powerful than the banks in the U. S. A. They provide short-term loans to the business public and also keep close contact with small investors who usually buy their securities over their counters and upon their advice. Many of these banks hold their customers' securities, collect coupons for them and perform any other services essential in connection with them. Of the commercial banks, three are the largest, viz., the Credit Lyonnais, the Society Generale and the Comptoir National d' Escompte. They are practically the leaders of the money market and their monthly reports indicate the banking conditions in France. Athough there are no legal requirements regarding cash reserves to be held against deposits, the large banks always maintain reserve either in the form of cash in their own hands or as deposits with the Bank of France. Before the first Great War, the percentage of reserves to deposits were less than 10 p. c. After the stabilisation of the franc, the reserves began to mount up and reached a high figure of 35 p. c. in 1931. Since then they have declined once more because of the withdrawal of funds by the depositors

who were frightened regarding the future of the franc and also owing to the situation created by the depression. But then they never came down to pre-war figures. The reasons for the maintenance of high reserve ratios were to be found in the uncertainty about the future of the banks and of the currency and the change in the liquidity of their portfolios owing to the tendency towards mixed banking which lessened the difference between commercial and investment banks.

Equally, or even more, important are the investment banks of France who not only are responsible for the accumulation of savings but also determine to a considerable extent the flow of these savings into various investment channels. Their functions consist in the floatation of government loans, underwriting of industrial loans, organisation of new and reorganisation of the old industries to a point where their shares become acceptable to the public. Their contact with the public is in part direct and in part established with the commercial banks and their branches. Their commercial banking functions are, however, carried on a very modest scale. Before the first World War the investment by these banks were of an international character. Thus they had invested in the Brazilian coffee, Canadian mortgages, U. S. railroads, etc. The war, however, restricted their activities mainly to the floatation of government loans and even in post-war years, their international investment could not be revived partly owing to the imposition of legal obstacles to the issue of foreign securities in France and partly to the

difficulties and risks involved in international credit. During this period, only those loans were granted abroad which served the interests of political aims of France in Eastern Europe. Otherwise these banks concentrated predominantly in supplying public credit needs. Another important change in the position of investment banks in the years following the first World War was that the banks began to encourage deposits from the general public for building up commercial banking business. This they had avoided before the war in order to do away with the necessity of maintaining a high level of liquidity in their portfolio. This change in policy after the war was encouraged by a reduction in investment opportunities of these banks.

The most highly specialised among the investment banks are the private banks or the institutions of haute banque, many of which belong to international banking families. They are not concerned with the general banking business. Their clients are confined to big industrialists and a considerable part of their activity is confined to the investment of their own and other funds in French Rentes or issues of other governments. Since they have got wide connections throughout the world, such as the Private Banks in London, they have played an inportant role in the financing of international trade. Since the first Great War, however, their influence has to some extent declined, partly owing to the structural weaknesses, in so far as these houses are hereditary in character, and partly owing

to the heavy depreciation of several foreign government securities which they used to hold.

The concentration of banking power in the hands of a few institutions and the close co-operation between the commercial and investment banks have, rightly speaking, resulted in the establishment of money trust in France which has resulted in inconveniences, at least to the small investors, who have no other alternative but to work through one of these big banks and submit to the terms dictated by them. One of the criticisms against the banking system often heard before the first World War was that the banks preferred foreign issues to the domestic ones. After the War, however, the situation had changed and the banks had to depend on the domestic market. But yet it is argued that the banks are interested solely in large affairs and that the small manufacturers and business men often find it difficult to obtain credit. In order to solve this problem, another type of banking institution, the local and regional banks, have come into existence. They have developed side by side with big banks and have not been absorbed, as in England, by the big banks. The area of operation of the local and regional banks is limited in so far as they operate in their own district and offer credit to smaller businessmen and industrialists according to their requirements. This personal knowledge about their clientele have enabled them to waive strict formalities associated with banking functions. They are mostly found in agricultural districts of France. After the first World

War, however, many of them failed ; for, they found it much more difficult than big banks to keep a diversified portfolio. As substitutes to these, People's Banks have been established since 1917. They are financed in part by the Treasury and in part by the Bank of France. These banks are concerned only with the provision of commercial credit to persons who cannot provide the necessary guarantee. These loans are given on cooperative security. On the whole, however, these banks have not been very successful, nor is their number adequate to supply the credit requirements of small business men.

Inspite of these diversified banking problems in France, the French banking structure was less affected by the depression than the American banking structure. There were reasons for that. In the first place, branch banking, however weak, is stronger than unit banking system, since it can arrange for a greater geographical and seasonal diversification of loans and hence pressure in any one area, season or industry may be counteracted by ease in others. Secondly, there has been a tendency towards consolidation, which has increased the number of branches in any one group. Many stronger banking units absorbed the weaker ones. This tendency has been accentuated all the more by the development of chain banking.

In France, the commercial credit instruments which are most prevalent are overdraft and trade acceptance. Overdraft in France is in very wide use and is particularly favoured for loans which are destined to

meet seasonal credit needs. Domestic trade acceptances also are in wide use in both big and small transanctions. Be it noted in contrast that in America while overdraft credit is prohibited by law, trade acceptances are very little in use. The overdraft credit increased further still after the first World War, especially during 1925-30. It became customary for the banks to endorse for each other the notes given by the customers who had obtained overdraft credit and the Bank of France, in order to relieve the stringency in the money market during 1925 and 1926 began to rediscount these notes, which virtually were three-named papers. This practice was, however, immediately restricted only to genuine commercial credit ; but yet the volume of overdrafts continued to increase. Since the depression, overdrafts appeared in a new role. Acceptances which could not be met at maturity owing to the depression were converted into overdraft account. Cheques are not in frequent use in France where the prejudice is in favour of cash transactions. The law governing the cheque is responsible for this ; for the holder has no protection in law and has to encash it within a few days. Crossed cheque has been legalised only since 1911. The banks also have done nothing to increase the cheque-using habit. In brief, the French banking system is characterised by "its conservatism, its inherent fear of credit inflation, and its preference for safety rather than for large profits.....The French banker is very slow in developing new business and is content to continue in the same routine that has prevailed for generations."

German Banking Structure :

The German banking structure represents mixed banking in the sense that both commercial and investment banking functions are combined in one and the same organisation. In this respect, therefore, the German banks stand in a category peculiar to themselves. But then this should not be taken to mean a lasting participation between banks and industries, as it has been interpreted in some quarters. Banks no doubt have participated in the floatation of industries and the rapid industrial expansion of Germany is in part due to this close co-operation of the banking system. But, it will be shown later, that in the years following the first World War, German banking has drifted more and more towards commercial banking.

In the first stage of their development between 1848-70 banks in Germany were predominantly investment banks giving long-term loans to industries. This type of business in Germany was not risky in so far as the banks carried on this business with their own share capital and not with deposits from the public. These banks, no doubt, received some deposits and granted short-term loans, but these were considered as only subsidiary the main business being the investment of their own funds in industries for earning as high a profit as possible for the shareholders of the banks. From the nineties of the last century the banks began to foster systematically their deposit business although the invest-

ment business was never given up nor even reduced. Henceforth they assumed the character of true mixed banks. But then the line of demarcation between short-term and long-term funds was never given up. Thus the short-term funds of the banks were used for granting short-term loans while for granting long-term loans, funds were raised by issuing shares and debentures which were sold to the public. When long-term capital was needed for a known period of time, it was raised by the issue of bonds redeemable by amortisation within a fixed period. Thus it was the practice with the German banks never to hold the shares and debentures for long ; although they were held by the banks in the first instance, ultimately they were disposed of among the members of the public.

The peculiarities of German economy were responsible for this state of affairs. German industries had to cover a wide ground in too short a period while financial assistance from the public was not adequately forthcoming nor were there other financial institutions in the country who were able to help the industries with requisite finances. Hence the only solution was to pool the small savings of the public through the German banks and divert them to industries.

During the years of the first World War, the German banks were concerned with financing the war programme of their government. They financed the government by floating its loans and the Govt.

took upon itself the task of financing industries. In fact, a number of regulations were imposed restricting the transactions of the banks in industrial securities. Henceforth the German banks began to develop as deposit banks. This tendency was accentuated in post-war years when the percentage of securities to total assets continued to decline. Under these circumstances, the banks became more and more unwilling to invest their funds in long-term loans and took to regular banking business. For financing the rationalisation programme in 1926-7, the banks once more revived their typical industrial activities, but this was short-lived, and the gulf that had been created between commercial and investment banking became wider day by day reaching its climax with the German Credit Act of 1934.

Another interesting feature of German banking has been the increasing intervention by the state in commercial banking, particularly during and after the depression when practically no country was free from government regulation of some sort. But even before the depression the German banking system was never perfectly free from state intervention. In the first place, the state controlled bank note issues. Secondly, state intervention was considered necessary in those matters which could not be performed by existing financial institutions. Thus in matters of promotion of savings in the interiors, where many private banks had been wiped out owing to the competition of big institutions which were concentrated in big centres, the governmet established

savings banks under the auspices of the Municipalities and Provincial Administrations. The deposits in these banks were guaranteed by the government and were exempted from taxes. In the field of mortgage credit also, state intervention became essential. Thus in 1770 the Silesian Land Bank was established for the purpose. In course of time a number of similar institutions cropped up and they dominated the field. Since 1912 the state intervened in the field of urban mortgage credit as well. During the war, the organisation of official credit institutions received fresh impetus which was continued in post-war years. The problems became complicated owing to the defeat of Germany which resulted in impoverishment of the people, currency chaos, weakening of the German banking system and widespread disorder of the German economy. Hence the state had to come forward once more. Banks were organised to assist in financing export, agriculture, housing development and in the stabilisation of German currency. Thus in practically all sectors of the economy state banks had come to stay. Some of these institutions took to general banking business and acted as correspondents for provincial and foreign banks. Even the savings banks which were organised for encouraging savings in the interiors began to enter into the field of short-term credit in post-war years. They allowed the establishment of clearing accounts, financed municipal credit needs and in general competed with large credit banks.

The liquidity crisis of 1931 which resulted in the

collapse of the German banking system paved the way for further state intervention. The election results of 1930 caused considerable apprehension abroad. The foreigners began to cancel credit and withdraw funds. These were all the more accelerated after the announcement of the proposed Austro-German Customs Union. These withdrawals assumed the character of a run in May, 1931, and the precarious position of the Austrian Credit Anstalt became widely known. About 2900 million Reichsmark were withdrawn and a considerable volume of foreign investments in Germany were sold out. There was a flight of German capital abroad. Tha Bank for International Settlement, the Federal Reserve System, the Bank of England and the Banque de France offered a 20-day credit of 100 million to the Reichsbank. But this, along with the credit granted to the Gold Discount Bank was exhausted very soon. The foreign withdrawals continued and confidence could not be restored by these measures. The collapse of the Nordwolle, the biggest German textile concern, dealt a severe blow to confidence in the stability of German business and there was run on other banking institutions in Germany. There was no further assistance available from the Bank for International Settlement and hence the Government decided to take drastic steps to prevent the complete collapse of credit machinery.

During the crisis of 1931, the state intervention took two forms : (1) direct support to the private banks, and (2) establishment of institutions which could render

indirect support to the financial and economic structure. Direct support was initiated by the government in 1931 when the Reich gave guarantee regarding the deposit with the Darmstaedter und Nazionalbank. This was followed quickly by the purchases of stocks in the Dresdner Bank, making the government the largest holder of stocks. The Reich and the Golddiskontbank purchased stocks in the various banks, the percentage of which was as follows :

Deutsche-Diskontbank.....35

Dresdner Bank, Danat Bank 90

Commerz Bank, Barmer Bank 70

Adca of Leipzig.....68

The Adca received help from the state of Saxony. Later the Reich effected the reorganisation of the Schroederbank. Another step towards reconstruction of the German banking system was the merging of the Darmstaedter und Nazionalbank with the Dresdner Bank in 1931 and of the Commerz und Privatebank with the Barmerbank Verein. Thus with the exception of the Berliner Handels—Gesellschaft, all the banks in Germany came under the influence of the government.

Indirect help for the reconstruction of the banking system was given by the establishment of various seperate institutions, among which the following were important :

(1) Die Akzeptbank—It was started for giving assistance to the Danat and Dresdner banks but very soon it began to give assistance to all institutions in need of liquid funds. The endorsement of the Acceptance Bank enabled the banks to rediscount two named papers held by them with the Reichsbank.

(2) A Diskont-Kompagnie was formed for rebuilding the discount market through the purchase and sale of trade bills.

(3) Die Deutsche Finag was established for making bank portfolios more liquid by taking over stocks and securities. In this way it prevented the losses which would be incurred as a result of depreciation in the volume of stocks and shares consequent upon the over-flooding of the stock market, if they were all sold too rapidly.

(4) Die Tilka was an amortisation institute intended to take over debts from small and medium sized banks which otherwise would have to be written off immediately. Banks were to deliver cash to this institute for writing off purposes amounting to 1½ p. c. of total debts taken over in each of the first four years and ½ p. c. per year thereafter of what remained of the debts. All debts must be liquidated within 25 years.

(5) For preventing the danger of heavy withdrawal of deposits, an organisation was set up whose function was similar to that of the clearing house associations in the U. S. A. Although the organisation was short-lived, it rendered very valuable service.

(6) Finally, since the government had been involved

in various banking institutions, partly by advancing money to, and partly by purchasing stocks in them, it became essential that the government interest should be safeguarded. For that purpose, a bank inspection service was organised.

By 1933, the Nazis had come into power and a totalitarian regime was established. This brought the entire banking system under government control. This was preceded by a searching enquiry, for the Germans felt resented at the banking crisis of 1931. The commission of enquiry prepared a plan for complete nationalisation of banking. Although the plan was not accepted and the banks remained under private management, they were subjected to severe control with a view to give effect to the economic policy of the Nazi Party. A comprehensive legistation, known as the Bank Law of 1934, was introduced for the purpose. This was amended in 1937 and 1939 for bringing the law into line with the economic policy of the state. The important provisions of the Bank Law of 1934 may be noted in brief.

(1) Liquidity provisions: Section 16 lays down the liquidity provisions. It stipulates that the total liabilities of a credit institution, less liquid assets of first and second class, must not exceed a certain percentage of capital. The ratio varies for different types of credit institutions, but all banks are permitted to maintain a ratio of five times the amount of their capital. The law defines "first class liquid assets or cash reserve" as cash on hand and deposits with the Reichsbank,

while liquid assets of second class are 90-day trade bills and securities acceptable as collateral by the Reichsbank. Balances due from banks are not consi dered as liquid assets. The cash reserve is not to fall below a stipulated percentage of total liabilities, except savings deposits. The percentage fixed by the Board may vary for different classes of banks but may not be fixed higher then 10 p. c. For comparison it may be noted that this percentage was 7.4 in 1913, 2.0 in 1930 and only 1. 8 in 1935. The secondary reserve is similarly fixed by the Board, but cannot be higher than 30 p. c. Sec. 17 lays down that holdings of stocks, except those representing permanent participation in a company and of bond not listed on German stock exchanges are limited to a certain percentage of liabilitities. The percentage is to be fixed by the Board but may not be fixed lower than 5 p.c. The total investments in real estate and permanent participations may not exceed the capital of the institutions.

(2) Credit limits : In pre-war days, German banks granted credit to all industrial institutions. These loans were often not only in proportion to the industry's capacity but also not in proportion to the capacity of the bank. They also gave short-term assistance against all securities. But circumstances in post-war period were changed. In post-war years, the banks borrowed money from foreign countries on short-term and lent it long and this resulted in the liquidity crisis of 1931. So section 12 of the Bank

Law of 1934 restricted the size of credit to be granted to customers and also the type of credit. Unsecured credits exceeding 5000 Reichsmark may be made only when the borrower reveals his financial condition, and credit granted to a single borrower must not exceed a certain percentage of the bank's capital. The percentage is fixed by the Board. The law considers all affiliated companies as a single borrower. When the total indebtedness of a borrower at one credit institution exceeds one million Reichsmark during a month, it is called Grosskredit or "Large credit", and must be reported monthly to the commissioner. When a borrower has obtained credit from several institutions, the commissioner may inform these institutions of the total indebtedness of the borrower and of the number of institutions involved.

(3) Credit Supervision Board: Supervision over the banks is exercised by the Credit Supervision Board consisting of seven members and the Reich commissioner for credit. This board replaced the Banking Board established in 1931. Apart from the specific duties and powers of the Board relating to capital structure, liquidity and clearing system, the Board has been given a blank authority over all banking affairs. Sec. 32 of the Act states that it is the duty of the Board to eliminate abuses in banking, to take proper measures when a bank is in difficulty and to require independent audit of yearly balance sheets of all credit institutions. The Board may issue basic rules governing the management of the banks and was given the authority

up to the end of 1935 to order cessation of certain or all operations by any credit institution whenever such action is deemed necessary for "a more purposeful organisation of the credit system."

(4) Sec. 20 of the Act provides for the submission of balance sheet, etc. to the Board. Section 1 has put a permanent stop against the misuse of the term 'Bank' and 'Savings Bank'.

(5) Savings Deposits—Sec. 22 defines Savings Deposits as deposits that are used for investment purposes. Withdrawals may be made only against presentation of the savings book, and withdrawals through the clearing system or by cheque are prohibited. Withdrawals without notice are limited to Rs. 300 per month per pass book. The Board is authorised to issue instructions regulating the investment of savings deposits. The object of all this was to prevent the reappearance of crisis and establish public confidence.

(6) The instruments of control in the hands of new Board were (a) licensing, (b) supervision of audit, (c) general right of information, and (d) several special rights. Sections 3 & 4 require a license to be issued by the Reich commissioner for the establishment of banks, branches and agencies and also clearing institutions. The existing credit institutions, excepting those established after June 30, 1934, need no permit. A license may, however, be refused (a) for the personal unfitness of the management, (b) when the resources are not available in Germany, and (c) when the general economic conditions do not justify the organisation of new banks.

The commission is given the power to close a bank when the information supplied with the application for a license is false, on the ground of insufficient reliability of management, for violation of public interest, and for insufficient guarantee of the safety of deposits and investments. Appeal against refusal or revocation of a licence and against an order for discontinuation of business may be taken to the Credit Supervision Board.

All domestic credit institutions, excepting the Reichsbank, the Gold Discount Bank, the Reichspost and institutions for financing housing, and also the branches of foreign credit institutions operating in Germany are subject to the provisions of the Bank Law of 1934. The Law was significant for more reasons than one. In the first place, the rigid provisions of the law as regards liquidity and the distribution of credits would lead to a uniformity of banking facilities. Secondly, henceforth there would be only one general ratio, legally flexible for all banks of the general commercial nature and it would thus not allow the banks to have much scope to adapt their credit policy to the requirements of individual customers. But one thing was sure. While private management was retained, the Act gave wide powers in the hands of the authorities and thus damped private initiative. In brief, the line of "development of German banking under this new law was in agreement with the whole trend of legislative measures decreed for the economic life of the National

Socialist state, all tending to foster the authoritarian influence of government."

With the outbreak of the second World War, the authorities were faced with double problems, viz, first, to finance the German War effort, and second, to organise banking in those territories which had come under German occupation. For solving the first problem, the government took pains to establish institutions for providing emergency credit facilities to concerns which were not in a position to get it. Many business concerns which were involved in difficulties owing to rationing and other measures were entitled to obtain credit facilities from a special institution, Oeffa. This institution, which existed before, was wound up in 1937, but revived since the outbreak of the war. It undertook to guarantee bills of essential war industries which thereby became eligible for rediscount at the Reichsbank. Then there were industries which were converted from a peace-time to a war-time basis for which huge capital was required. The government issued promissory notes which could be used for securing bank advances ; but these Promissory notes were not eligible for rediscount. For providing long-term finance to industries, the Government started a state bank, viz. the Deutsche Industrial Bank. For financing aircraft production, a public company, *the Luftahrtkontor*, was established.

But a more complicated problem was the control and management of banking in German Europe. The central banks in German occupied countries were

operating mostly whithout any appreciable gold stocks, which were already held abroad, particularly in the U. S. A. and consequently frozen. But they continued to show these stocks in their returns. They were issuing notes against their foreign exchange holdings which consisted of Reichsmark and the German Kreditkassenscheine, a type of emergency currency. These central banks had to issue considerable volumes of notes for financing the occupation of their countries by the Germans. In these territories, the Germans introduced a number of checks for cotrolling inflationary developments, such as, rationing of civilian goods, and rigid control of prices, wages and exchange rates. Germany's indirect control of the finances of the occupied countries was achieved by a central clearing system and the large exports to the Reich which forced the central banks in the occupied territories to accumutale Reichsmark against which notes were issued, was strengthened by the expansion of German commencial banks, specially in the South Eastern Europe. Commercial banking in these countries has developed on similar lines as that in Germany. In those territories which were absorbed in the Reich, the German system was introduced in toto. Thus emergency government financing to cover the suddenly increased outlay, partial moratoria, restrictions on the withdrawal of bank deposits and closing of stock exchanges were followed by the use of the German means of payment. When the occupation was complete German commissioners were appointed, the Kassens-

cheine was gradually withdrawn and local currencies introduced. The banks were opened, moratoria were lifted and stock exchanges started functioning. Strict exchange control was introduced for maintaning the external value of the currency.

CHAPTER V

Commercial Banking Structure (Continued)

The Indian banking structure is of the loosest type and finds no parralel elsewhere. Not only in the variety of institutions but also in the variety of banking practice, it is a type by itself. There is not only a combination of indigenous and modern, but also of native, foreign, semi-native and semi-foreign institutions. For long there was no central banking institution for guiding and controlling the money-market and the control of currency was vested in government, while credit control was entrusted to the Imperial Bank. For the last one decade we have got a central bank; but it is not so much a bankers' bank and a lender of the last resort as a banker to the government and a bank of issue.

Indigenous Banking Structure :

In our country, the indigenous banker is the most important link in the banking chain. In the indigenous credit stucture, there are, broadly speaking, two categories, viz., money lenders and indigenous bankers.

Money lenders again may be professional money lenders, either rural or urban, including itinerant money lenders, or non-professional money lenders, such as, landowners and agriculturists, merchants and traders, and other casual money lenders who pursue various occupations together with lending out their surplus money.

The indigenous banking practice will be noted in a subsequent chapter. Suffice it to say here that the indigenous banker is responsible for a considerable part —though not exactly about 90 p. c. as estimated sometime back—of our inland trade finance and provides a connecting link between the banks on the one hand and the vast trading community on the other. He buys hundis either directly from the traders or from smaller shroffs with his own money. It is only when he is short of funds, particularly in busy season, that he seeks the aid of organised banks by rediscounting those documents. This feature of our banking system led Keynes to remark that in busy season, the 'bazar' rate and the bank rate move in the same direction. But this is not very correct and the link between the two, the organised and the non-organised banking systems, is very slender and delicate, 'rudimentary and incomplete'. For the commercial banks do not take the hundis direct from small traders but insist upon endorsement from some well-known shroffs, whose number is limited. Hence the link is incomplete. Consequently while there may be plethora of funds in organised money market, the non-organised part may suffer for want of them. As regards

remittance facilities also, the indigenous bankers are given no special facilities which are accorded to the joint-stock banks but are treated on the same footing as the members of the public.

A few words may now be said about the linking of the indigenous bankers with the organised banking system. The need for coordination of the old with the new banking system is very great. It attracted a considerable part of the thought of the Central Banking Enquiry Committee which recommended that those indigenous bankers who are ready to drop out the non-banking part of business and to maintain proper accounts and abide by certain conditions should be included in a list of "Scheduled banks", to be distinguished from scheduled joint-stock banks. For so long as the vast portion of Indian's banking and credit machinery represented by indigenous bankers remains outside the organised part of the money market, it is impossible for the Reserve Bank to exercise full control over the money market and hence cannot be anything more than a mere central bank of issue. The Reserve Bank itself prepared two schemes respectively for effecting this coordination, the first providing for indirect link through the scheduled banks and imposing stringent conditions in case of direct link, and the second scheme being slightly lenient. But they have not found acceptance with the indigenous bankers ; for, while, on the one hand, the combination of trading with banking is the result of inadequate banking business, on the other, the suggestion regarding the taking of deposits and

giving wide publicity to accounts is not acceptable to them. It should be noted that while the Reserve Bank of India cannot sacrifice all the banking principles of safety in order to bring the indigenous bankers within its fold, yet at the same time it must be somewhat lenient in its attitude and adjust its working to the existing situation. In business there is nothing hard and fast; everything is to be modified by circumstances. For this purpose, if the indigenous bankers cannot but take to non-banking lines, the Reserve Bank should be satisfied if they agree to keep the two accounts separate. It should also be the duty of the Reserve Bank and other organised banks to see that the banking business of indigenous bankers increase so that they can neglect non-banking business. Thus they may be used as agents for the collection of bills and cheques, etc., by the Reserve Bank and joint-stock banks. It is too much to say that the speculative habits of indigenous bankers induce them to take to business; rather it is the insufficiency of business that is responsible for this state of affairs. And the more they are cornered by the organised agencies, the greater the tendency of separation. It should be realised by the Reserve Bank that indigenous bankers being what they are, the modern banking standards cannot be applied to them all on a sudden, and if they are to be brought within the fold of the Reserve Bank, a change in attitude, a relaxation in policy, a flexible outlook on the part of the leader of the banking system is called for.

Modern Banking Structure : Imperial Bank of India.

The Imperial Bank of India is a peculiar type of joint-stock bank and is the result of historical circumstances. Its origin is rather interesting. The European system of banking was first introduced at Calcutta by the Agency Houses who carried on banking business as a supplement to their general business and also as an aid to the latter. But owing to their speculative transactions, they had come to grief during the commercial crisis of 1929-32. Besides, with the expansion of trade of the East India Company, they found it inconvenient to use the services of the Agency Houses. Hence the Bank of Calcutta was established in 1806 with a capital of Rs. 50 lakhs of which $\frac{1}{6}$ of the capital was subscribed by the company who nominated 3 out of 9 directors. The notes of this bank were not legal tender and had a limited area of circulation. The Charter of 1839 allowed maximum note issue of Rs. 2 crores. The Bank of Bombay, another Presidency Bank, was started in 1840 but failed in 1868 owing to the participation of the bank in share speculation caused by the civil war and the cotton famine in the U. S. A. Another Bank of Bombay was started in the same year with a capital of Rs. 1 crore. The Bank of Madras was started in 1843 with a capital of Rs. 30 lakhs. In 1862, the Presidency Banks were deprived of the right of note issue which henceforth passed into the hands of the government. For compensating these Banks the government placed their

cash balances with them free of interest. The Presidency Banks Act of 1876 deprived them of their official character. Henceforth this Act regulated these Banks till the passing of the Imperial Bank Act of 1920.

The idea of amalgamating the Presidency Banks into one is as old as 1867; but provincial jealousies stood in the way of any such step being taken. During the first World War, they realised the advantages of cooperation, which was further strengthened by the rumours about the amalgamation of the Lloyds Bank and the National Bank. For, the latter amalgamation would reduce the position of the Bank of Calcutta. It was also realised that a central bank was essential for this country and that the amalgamation of the three Presidency Banks would provide the only practicable basis for the establishment of a central bank. It was felt that the Presidency Banks with vast business and wide experience and long association with government could not be neglected from any future central banking project. Above all came the pressure of public opinion which would force the government to establish a brand new central bank if the Presidency Banks did not amalgamate of their own accord. Hence the Imperial Bank was established under the Imperial Bank of India Act 1920 which was the result of amalgamation of the three Presidency Banks.

Until the establishment of the Reserve Bank of India the Imperial Bank was the sole banker to the government, custodian of government funds and did

the Treasury work of the government free of charge. It received government dues from the public and the government drew upon it for disbursements. It also managed the public debt of the government and provided the machinery for the issue of the government loans. This resulted in the abolition of the Government Reserve Treasuries and the fructification of government balances which could be used for helping the money market. The London office of the bank, which was started in 1921, took over a portion of the business of the government which was previously done by the Bank of England. The rates at which the Bank was to provide remittance facilities between its various branches to other banks and to the public were controlled by the government. In return the Bank was given the concession of transferring its funds from one place to another within India through the government Treasury Department free of charge. The government had a considerable amount of control over the management of the Bank. But then it was not a state bank nor a full-fledged central bank. Although it exercised a *de facto* control over credit, the issuing of notes, another very important function of the central bank was in the hands of the government.

When the question for the establishment of a central bank for this country came in for consideration, it was argued by some people that since, owing to the lack of a bill market, the newly created central bank as lender of the last resort, will not get sufficient bills for rediscount and since the

banks would prefer to rediscount their bills, whatever their quantity, in London money market, unless of course the rate of discount of the newly started central bank is less than that charged in London market, the establishment of a brand new central bank would be too risky a venture to be undertaken and hence the Imperial Bank should be converted into a central bank. Besides, if this is not done, an unnecessary competition might ensue between the new central bank and the Imperial Bank. But the majority of the members of the Hilton-Young Commission were of opinion that although the Imperial Bank had been performing some of the important central banking functions as the fiscal agent to the government and the *de facto* controller of credit, yet after all, the Imperial Bank was a private corporation frankly out to earn money. This was clear from the fact that at the time of the passing of the Reserve Bank Act the Bank had nearly 163 branches and that the Bank was a purely commercial bank in so far as it received deposits from the public and might equally be involved in a run in case the public confidence in the banking system was shaken. The assets of the central bank must have maximum liquidity which Imperial Bank would not be in a position to maintain in view of its huge deposit liabilities on which it has to pay interest to the depositors. The Bank cannot, therefore, neglect profit-making transactions altogether. And as a commercial bank it would enter into competition with other joint-stock banks. It was argued by some that the Issue and the Banking

Departments of the Bank should be separated and that the former should be entrusted with central banking and the latter with commercial banking functions; it was argued by others that the Bank should be totally deprived of commercial banking functions and concentrate entirely on the functions of a central bank. The former suggestion shows the knowledge of proper central banking function. As Mr. Kisch has rightly pointed out, the holder of the ultimate reserve of the country should not itself be the channel through which credit should be given to individuals and firms and that "the Issue Department is never made the handmaid of the Banking Department." The second argument if it was put into effect, would not only invite severe opposition from the share-holders who had been earning fat dividends but would also deprive the country of the services of a commercial bank with vast resources, wide experiences and extensive business connections. But at the same time it was felt that it was essential to free the Imperial Bank from the various restrictions imposed upon it under the Act of 1920, as it would enable the Imperial Bank to spread banking facilities freely throughout India. The argument that there would not be sufficient bills for the central bank to rediscount in the absence of a properly developed bill market does not in itself carry much weight; for, experience in other countries where central banks have recently been started shows that the development of a bill market follows, and does not, in fact, precede the establishment of a central bank. Moreover the fundamental consideration

for any central bank is not so much the earning of profits as the development of a sound banking structure in the country.

Hence when at long last it was decided to establish the Reserve Bank of India, the Imperial Bank of India Act had to be modified for freeing the Bank of the control exercised by the government and for removing some of the restrictions under which the Bank had been working so far. Henceforth the Bank ceased to be the banker to the government, although it still performs government work indirectly as an agent of the Reserve Bank in those places where the Reserve Bank has no branches of its own. The restrictions on its working have also been abolished in so far as it is now free to transact foreign exchange business, to open cash credits and to raise capital in foreign countries. The London branch of the Bank has also been freed from these restrictions. But it would be wrong to think that the Bank has been reduced to the status of an ordinary commercial bank. For under an agreement with the Reserve Bank, it is entrusted with some functions which are not performed by ordinary joint-stock banks. Thus it stands in a privileged position and is a type by itself. This agreement is valid for a period of 15 years and will remain in force even thereafter, and will only be terminated after 5 years' notice on either side, provided the Imperial Bank maintains a sound financial position. Under this agreement the Imperial Bank is to be the sole agent of the Reserve Bank at all places in British India where there is a branch of the Imperial Bank in existence at

the time when the Reserve Bank Act comes into operation and where there is no branch of the Banking Department of the Reserve Bank. The Imperial Bank will get a commission from the Reserve Bank. The Imperial Bank cannot open any branch in substitution for a branch existing at the time when this agreement comes into force, without the approval of the Reserve Bank.

Thus from its inception upto the coming of the Reserve Bank the Bank had been functioning as a controller of credit without the right of note issue. Even as a bankers' bank it was not above partiality and was competing with joint-stock banks. Nor was its bank rate a weapon for the control of credit. It was expected that with the removal of the restrictions under which the bank had been acting so long, it would enter, with its enormous resources and banking experience, into the field of foreign exchange business which has hitherto remained a monopoly with the exchange banks and would thus give a lead to the Indian joint-stock banks in that line. Instead of doing that, it has taken to the internal trade finance and with its enormous resources and privileged position has proved an undesirable competitor to the Indian joint-stock banks. Even in this field the Bank could have rendered yeoman's service to our banking structure provided it had the willinness. As Sir S. N. Pochkanawala pointed out, the Imperial Bank could offer a lead in matters of setting up an Association of Indian banks with the avowed object of providing a united platform for the discussion and solution of banking problems of

common interest and could promote better understanding and greater amity among all banks.

Exchange Banks :

The most incongruous element in our banking structure are the exchange banks which were started with the object of financing foreign trade. Gradually they obtained monopoly of this business and of late has even entered the field of financing the internal trade of the country. Hence the name, 'Exchange Banks' is not very accurate and it would be better to call them foreign banks in so far as they have their head offices, and some of them even their principal business, outside India and are dependent on them for their funds and are controlled therefrom. The profits in banking business have attracted the bankers from a number of countries having important trade relations with India to establish business here and in 1941 there were 17 such foreign banks. They are divided into two groups according as their principal business is in India or elsewhere. Banks doing a considerable portion of their business in India, i. e. having 25 p. c. or more of their deposits in India fall in the first category and banks which are merely agencies in India of large banks doing a major portion of their business abroad, i. e. having less than 25 p. c. of their deposits in India fall in the second category.

The main business of these banks is to finance the foreign trade of India. Until 1935 the Imperial Bank was prevented by law from dealing in bills of exchange.

The Indian joint-stock banks were not prevented by law from engaging in this business, and a few of them, now defunct, such as the Alliance Bank of Simla and the Tata Industrial Bank did engage in it. In recent years, of course, some of the big Indian banks have taken to this line of business, mostly indirectly through the foreign banks, but yet it remains a virtual monopoly with the foreign banks.

A few words may now be said about the method of foreign trade finance. The import trade of India is financed by 60 days' sight D/P Bills drawn on the Indian importer. The number of D/A bills was small previously, but is now on the increase. The import trade is also financed by bills drawn under London Bank's Acceptance Credit when money rate in London is substantially cheaper and both the importer and the exporter are parties having first class financial reputation. This facility is hardly available to the Indian importers ; for in this case the English exporter draws the bill not on importer but on a London banker and gets the bill accepted by him, though the goods are actually shipped to India. All these bills are drawn in sterling. In the former case, interest is payable from the date of the bill to the approximate date of the arrival of proceeds of the bill in London. Under London acceptance credit, however, the bill is discounted in the London market at the prevailing discount rate in London which is invariably lower than the rate of interest charged on 60 days' sight D/P bills. The D/P bills are never rediscounted. They are either

purchased or are advanced against from English exporter by the London office of the exchange bank and held by the Indian branches of the exchange banks for collection from Indian importers. In the export trade of India, when an Indian exporter sells to a foreign buyer, say, in England, credits are usually opened with London banks and finance houses and they are advanced to India through the medium of exchange banks. Under documentary credit, the foreign importer authorises the Indian branch of the exchange bank to discount bills which are drawn generally on a London bank or on a London Accepting House. Such bills are in all cases D/A bills. When goods are sent on consignment basis, the bills are generally not discounted but only advanced against, say, upto 60 p. c. of the invoice value of the consignment in question.

Besides financing the foreign trade, the exchange banks do every kind of banking business. They compete with the Imperial Bank and joint-stock banks by receiving deposits, making advances, negotiating bills and doing agency business in India. They finance internal trade in several up-country centres, such as the piecegoods trade in Delhi and Amritsar, the leather trade in Cawnpore and the jute trade in Bengal. They also finance the import of gold and silver bullion and act as references.

There has been a considerable amount of dissatisfaction with the working of the exchange banks. It is pointed out that their position and working in our

country have stood in the way of the development of our own banks. At the same time, because of their foreign origin, they are outside the control of the Reserve Bank of India. Thus they influence the Indian money market without being subjected to control of the latter. Besides, the policy of these banks has successfully kept the Indian firms outside the field of foreign trade of this country and encouraged the outflow of raw materials and inflow of finished products. The weak position of our joint-stock banks has all the more facilitated their functioning in that they have been able to attract deposits from the members of the public here which have been ulilised against our interest. This open-door policy came in for a good deal of criticism in the hands of the Central Banking Enquiry Committee. But not to speak of the more drastic measures suggested by the minority of the committee, even the most lenient steps recommended by the majority of the Committee for the control of the exchange banks in the interest of the country have not yet been adopted. The granting of commercial privilege should be based on the principle of reciprocity. Thus in the U. S. A., the foreign banks are debarred from receiving deposits within the country and the field of their activity is specially defined and limited. Even in England the foreign banks are not allowed rediscount facilities. India has, however, been following an open-door policy in this matter and our Reserve Bank has not any effictive control over these foreign

institutions which owe allegiance to their own respective central banks. Besides, these banks are entering into unjust and monopolistic competition with the Indian concerns aspiring to do foreign exchange business. Thus under the rules of the Exchange Banks' Association, Indian banks, desirous of selling on London through certified brokers, have mostly to pay a higher brokerage. It is high time that the activities of the exchange banks which are spreading even to the interiors should be restricted altogether and even in the field of foreign trade finance, restrictions should be imposed on them on the basis of reciprocity. In recent years, an increasing number of Indian concerns attempted to take part in the exchange business, but met with organised opposition. According to the information published in the *Eastern Economist* (4. 1. 46), "at the beginning of this year, about 20 Indian banks were on the list of the authorised dealers in foreign exchange, besides the exchange banks. Of the Indian banks few had direct agency agreements in New York and the majority of them were carrying on business through the Indian offices of the foreign exchange banks in India on the basis of a share in the commission on the exchange business and in some cases share in the earning of interest, the margin being large enough to allow the exchange banks liberal earnings. It is reported that the exchange banks wanted to cut out Indian banks from the field of foreign exchange and the Bombay Exchange Banks' Association passed a resolution that no member should

part with any portion of the commission and that there should be no rebates or repayments to the Indian banks and the agreement should be terminated." In the new Banking Bill there should have been provisions for the control of the activities of the exchange banks, but that field has been left untouched.

Joint-stock Banks :

The Indian joint-stock banks are those banks which are registered in India under the Indian Companies Act and whose head offices are in India. Although a number of joint-stock banks were established in the last century, yet they received great stimulus after the Swadeshi movement. In their enthusiasm, the business of many of these banks became unsafe and speculative in character and their cash reserves were so very slender in proportion to their liabilities that Keynes remarked that "in the case of the smaller banks, dealing as they are with clients to whom banking is a new field and in a country where hoarding is still dominant, the cash balances seem, from available indications, to be hopelessly inadequate ; and it is hard to doubt that in the next bad times they will go down like ninepins". The failure was confined to Indian banks, the first victim being the People's Bank. In 1913, 14 banks failed and in 1914 the failure amounted to 43. Even more serious than loss sustained by depositors was the shock to public confidence, set-back to habit of investment and a great injury to industrial and commercial development. The causes of failure of these banks were many. Thus

many of these banks sank too great a proportion of their funds in a single industry, and from time to time in a single concern. The deposits of these banks were short-term which they invested in long-term loans. This was dangerous in principle as well as in practice. Besides, there was no central bank in the country to help the banking system and the quasi-government banks failed to come in to their aid. Finally, a number of dangerous practices, such as fraudulent manipulation of accounts, advancing large sums of money to enterprises in which directors were interested, slender percentage of cash to deposit liabilities, unbusiness-like rates of interest offered to attract deposits, absence of proper proportion between authorised, subscribed and paid-up capital, ignorance of depositors who were duped by high figures of authorised capital, absence of sound and experienced personnel and a number of other factors had made the banks too weak to withstand a storm.

The structure of Indian banking has already been noted and their business practice will be discussed in a subsequent chapter. A few words may be said here about some of the characteristics of our joint-stock banks. As is wellknown, they are late comers in the field of commerce. Early attempts at the establishment of joint-stock banks were frustrated by the cotton boom of 1865 and the fall in the exchange value of the Rupee. The first impetus came during the days of the Swadeshi movement and the bank failures in subsequent years placed them for some time on uncertain grounds. The result of this has been that the part of the

banks in the financing of Indian trade and industry has remained confined to a limited field. Secondly, the joint-stock banks, being organised on British model, have kept aloof from providing long-term finance and have followed a very cautious policy. Thirdly, the exchange business is practically outside their control. For, the exchange banks are older institutions, and having the advantage of open-door policy they came and consolidated their position within this country without any difficulty. Fourthly, in the field of internal trade, they met with several competitors of which the indigenous banks were the most important. After the establishment of the Reserve Bank of India, even the Imperial Bank has turned its attention to this aspect, while the exchange banks are gradually coming into the field of internal trade finance. Fifthly, the organisation of the joint-stock banks is not a strong one. The weakness of internal organisation due to the existence of many uneconomic units as also to the tendency to excessive branch banking and the lack of any organisation among themselves had, till recently, made it difficult for them to face competition and unforeseen contingencies. Finally, the control of our central banking institution even over this part of the banking structure is not uniform, for, in the first place, while the Reserve Bank exercises direct control over the scheduled banks, it has practically no control over the non-scheduled ones, and its relation with them is only advisory in character. Further some of the scheduled banks have grown so big that in course of time they may even threaten the

Reserve Bank by their growing resources, as was the case in England in the years following the first World War when the possibility of further amalgamation seemed to imperil the position of the Bank of England.

Hardly had the banking system overcome the reverses when the great depression affecting the banking system in some of the important countries of the world threatened our banking system. Our banking system was not so much strong but yet it was not affected in the same way as the American and German banking systems. But the position was not very hopeful and the Central Banking Enquiry Committee had suggested the passing of a separate banking law for the control of banking. No such step was, however, taken. In 1936, however, the amendment of the Indian companies Act incorporated certain provisions to that end. Before we consider these provisions it will not be out of place if we take into consideration the salient features of commercial banking legislation in other countries in recent years.

Before the first World War, there were few countries where the full-fledged banking laws were to be found in practice. The earliest banking legislation was introduced in Denmark, which was followed by England where a similar law was passed in 1826. This was again followed by the Bank Charter Act of 1844. The next piece of legislation was introduced in Sweden in 1846 where a Royal Decree was issued in containing all the requirements of commercial banking regulation. In subsequent years banking legislation was

introduced in the U. S. A. in 1863, in Canada in 1871, and in Japan in 1872. Except these few cases, there is hardly any instance of banking legislation before 1914. During and after the first World War, banking legislation became very common in almost all countries of the world. This was due to unhealthy developments, particularly the trend towards mixed banking in the field of commercial banking. The economic difficulties of the post-war years were in part responsible for this state of affairs.

In fact, there is no apriori need for banking legislation. But that does not mean that there is no such need on empirical grounds even. For there are risks in any line of business, the more so in banking, where one has to deal with other people's money. In Britain, the dictum that has found greatest favour is that good banking depends on good bankers. But then, this dictum has been established by certain conditions, such as conservative traditions, development of branch banking, etc., which do not prevail elsewhere. Of course legislation in itself has certain difficulties. For banking business depends much on the discretion and judgement of the bankers and hence too detailed a regulation would hamper banking development. Moreover the division of responsibility between the banker and the state, which will be introduced as a result of legislation, would surely have undesirable consequences. Self-regulation is, therefore, the goal; legislation can only indicate the lines which must not be violated. Where legislation has been

introduced, it is concerned with the following items: capital reserve and surplus, cash reserves, restriction of assets, mixed banking, security for loans, interest on deposits, responsibility of the directors, formation of banks, opening of branches, amalgamation etc.

So far as capital is concerned, the aim of all banking legislation is to ensure the safety of the depositors. For that purpose adequate capitalisation has to be secured. and several methods have been followed. Thus some of the laws have made provision for fixed minimum capital. In Sweden minimum capital required is one million krona. Similar arrangements have been made in Belgium, Canada and Czechoslovakia. In India, the Indian Compaines (Amendment) Act of 1936 has prescribed Rs 50,000 as the minimum capital required of a banking company. Secondly, as in Switzerland and Argentine, the law may require that the bank should have proper ratio between capital and liabilities. This provision, however, operates more stringently over small banks than over big ones with many offices and branches. Thirdly, the statutory minimum capital may be made to depend upon the population of the locality in which the bank is situated. This is a feature of American banking legislation. In Spain, however, an altogether different method is followed whereby the capital of each banking institution is fixed by the particular circumstances in which it is. In some countries, again there has been a mixture of two or more of the above provisions. Thus in Germany

and Denmark there has been a mixture of the first and second provisions.

Turning next to reserve or surplus, in many countries, a mere provision of substantial minimum capital is not considered as adequate and hence banks are required to build up reserves, having a fixed ratio with capital. In some cases, the reserve is required to be as high as the paid-up capital. In the U. S. A. it required that a national bank before commencing business must have a paid-up surplus of 20 p.c. of its capital. Besides, each national bank, before it declares dividend, must set aside 10 p.c. of its profits till the reserve fund is equal to the paid-up capital. In India similar provisions have been made under sec. 277 (k) (1) (2)&(3) of the Indian Companies (Amendment) Act, 1936. The Act requires that every banking company shall maintain a reserve fund and that every banking company shall, out of the declared profits of each year and before any dividend is declared, transfer a sum equivalent to not less than 20 p. c. of such profits to the reserve fund until the amount of the said fund is equal to the paid-up capital.

But the strength of the guarantee does not depend so much on the maintenance of reserve as on its liquidity which in its turn depends upon how the reserve fund is invested. Curiously enough, there are very few banking legislations where the law has defined the manner in which the reserve is to be kept. The Indian law of 1936 is, however, very particular on this when it lays down that a banking company shall invest the

amount standing to the credit of its reserve fund in government securites or in securities mentioned or referred to in Sec. 20 of the Indian Trusts Act of 1882, or keep it deposited in a special account to be opened by the company for the purpose in a scheduled bank.

Apart from the reserve fund, every bank has to maintain a cash reserve against each of its liabilities. The conception of cash, however, is not the same. Some times it refers to the balances in the central bank and sometimes it refers to the quantity of notes and coins held by the bank and balances with the central bank. The older view regarding the cash reserve was that it helps the bank to maintain liquidity ; but this view does no longer hold good. For, a reserve of 5 p. c. and 2 p. c. is hardly enough to provide liquidity to banks in times of necessity. "The real purpose of these balances is not to guarantee the deposits of the public with banks ; for if this were so, a reserve of 5 p. c. against demand and 2 p. c. against time liabilities would hardly be adequate for the purpose. The primary purpose of these reserves is to enable the central bank to exercise some measure of control over the banking system." In practice, commercial banks in every country are required to maintain a statutory cash deposit with the central bank. In India, they are fixed at 5 p. c. of demand and 2 p. c. of time liabilities. In Germany two reserve ratios are enforced—cash to short-term libilities and secondary reserve to total liabilities excluding savings deposits. In many cases bank laws have fixed different

ratios for banks of different sizes. In the U. S. A. they are fixed according to the locality in which the bank is situated. The Indian law has not only provided for the statutory cash deposit but also has provided for penalty in case of default. Thus in the event of a bank failing to maintain the minimum balance, the Reserve Bank can charge the bank a penal interest at the rates prescribed in sec. 42(3). By the Reserve Bank of India (Third Amendment) Act, 1940, the penalty for default has been made even more stringent by empowering the Reserve Bank to prohibit defaulting banks from accepting fresh deposits during the continuance of this default and by penalising directors and other officers who are, knowingly and wilfully, parties to a default.

The restriction on banking assets has generally taken a negative character, viz., to prohibit certain types of assets being held by the banks. Detailed regulation in this respect is, however, undesirable because that would introduce unnecessary rigidity. A study of recent banking legislation shows that there is partial or wholesale restriction on the holding of real property. Although Britain does not possess any banking law, yet it is considered undesirable to invest in real property. In the U. S. A. billions of dollars were lost by banks during the speculative boom of 1929-31 because these were invested in real property. In Sweden banks are prohibited from acquiring real property except through foreclosure. In Denmark such investments are limited to 20 p. c. and in Germany they must not exceed

capital and reserves. The Macfadden Banking Act of 1927 in the U. S. A. liberalised the laws relating to investments of commercial banks in real estates. It extended the period from one to five years and raised the limit. After the Act of 1935 there was further liberalisation in this respect, a tendency out of harmony with banking legislations in other countries. Under this law, the investments were fixed at 60 p. c. of the appraised value of the property and the period was extended to 10 years. Restrictions have also been imposed on loans that may be allowed to a single customer. It is obviously dangerous to tie up all resources in one kind of investment or in one customer. Such restrictions are practically universal to-day. In some countries there are statutory provisions as to the margin that must be maintained against loans granted.

That the regulation of assets is important for the soundness of the banking system is undoubted. It is being recognised more and more that since losses result from the depreciation of assets, the magnitude of losses which a bank may incur is related directly to the quantity and quality of its assets, and not the volume of its deposits, and hence the traditional manner of regulation, viz, the fixation of some rotio of capital and reserves to deposits, is of little use. Hence under the Guatemala legislation passed recently, every bank must maintain an amount of paid-up capital and surplus equivalent at least to the sums of the following pecentages :

(1) 5 p. c. of its investments in securities issued or guaranteed by the government.

(2) 10 p. c. of its investments in other securities or loans ; and

(3) 50 p. c. of its investments in furniture, in real estate and other fixed assets. The principles underlying this provision are two :

(a) The larger the risk, the larger the percentage of funds which should be supplied by the share-holders ; and correspondingly, the smaller the shares which should be supplied by the depositors and other creditors ; and

(b) The capital requirements are increased in proportion to the risk involved.

We have already seen how mixed banking was coming more and more into existence in the years following the first World War. In some countries, as in Germany it had been prevalent even before 1914. Displacement of mixed banking, however, became a feature of the post-depression banking world. Even in countries which were the original homes of mixed banking, there was a definite reaction against it. We have already noted their reaction in Germany and America in connection with our discussion on mixed banking. Similar reaction was also visible elsewhere. Thus in Belgium, most complete separation has been brought about between commercial and investment banking by the Law of 1934. In Sweden, the Act of 1933 prohibits banks from acquiring shares and lending to industries. In Argentine the Law of 1935 attempted to bring about

separation between the two. In Norway and Italy special institutions were set up to take over investment banking functions from commercial banks.

Another type of regulation was concerned with the security for loans. Germany at one time was very much in favour of credit unsecured by tangible security. But the Act of 1934 has put a limit to the amount of unsecured credits. In Sweden unsecured credit is totally prohibited. In other countries, either there is a limit on unsecured loans or they are totally prohibited. Regulation of interest rate on deposits is another important feature of commercial banking legislation. India is one of the few countries where the joint-stock banks pay interest on current deposits. In the U. S. A., the Act of 1933 prohibited interest on demand deposits. In England no interest is paid on current account. In Argentine, interest paid on sight deposits must be less than the rediscount rate of the central bank. In Germany the rates of interest payable on different deposits are fixed by the Banking Commissioner. In India some of the small banks pay high rate of interest, and in order to make up the loss sustained thereby, they engage in undesirable forms of business. These should be regulated following the example of other countries.

The responsibilities of the directors of banks are also defined in certain legislations. Thus in the U. S. A. they are specifically prohibited from acting as directors of other banks. Limitation is also placed on the borrowings by the directors and managers from their

own banks, and in some cases borrowing is not permitted at all. In India, if a scheduled bank fails to maintain minimum balances with the Reserve Bank, the directors responsible for such failure will be penalised.

A feature of recent banking legislation is to control the formation of a bank, opening out branches and amalgamation of banks. We have already seen how, after formation of the Big Five in England, further amalgamation was stopped and it cannot take place any more without the sanction of the Treasury. In the U.S.A., amalgamation is restricted and in Norway and Sweden it requires official consent. Legislation restricting the opening out of branches aims at preventing over-banking. Thus in Germany since 1934, licensing has been provided for before a new bank can be opened. In the U. S. A., the controller of currency has considerable discretionary powers in matters of granting charter to new national banks. In Canada, a special Act of Parliament is required before a new bank can be opened. A recent feature of Indian banking legislation is the control of branch banking. Thus the Banking Companies (Restriction of Branches) Act of 1946 lays down that "no banking company shall open a new branch or change the location of an existing branch without obtaining prior permission in writing from the Reserve Bank."

Another feature of the Indian Companies (Amendment) Act, 1936, was the abolition of managing agency system with regard to a banking company.

The relevant provision was that no banking company shall, after the expiry of two years from the commencement of the Act, employ or be managed by a managing agent other than a banking company for the management of the company.

Immediately before the out-break of the second world war, there was a serious banking crisis in South India. The closure of the Travancore National and Quilon Bank created a certain amount of nervousness among the bank depositors in South India as regards the position of other local banks, though other centres were unaffected. Another very serious thing was that out of the total number of non-scheduled banks, only 45 p. c. were providing returns or maintaining cash balances required in the Indian Companies (Amendment) Act of 1936, and the claim of the others that they did not fall within the definition of the banking companies set out in the Act was upheld by the court. All these presented the need for safeguarding the interest of shareholders and depositors. So during 1939-40, the Reserve Bank gave detailed consideration to the question and framed a banking bill which was circulated by the Government of India for obtaining public opinion. The object of the bill was to ensure proper working and financial soundness of banking institutions and to enable the Reserve Bank to coordinate the credit structure of the country and more fully to utilise the powers of extending credit provided by the Reserve Bank of India Act. Owing to the outbreak of the war and the deterioration in war situation,

the consideration of the bill was dropped for the time being.

The effects of the war on Indian banking were varied. The first noticeable feature of war-time banking is the growth of banking institution. The process had started even three years before the war and continued thereafter. Not only the number of banks, but also that of branches increased during this period. This tendency in India stood in marked contrast with the tendency abroad where due to the scarcity in man-power a large number of institutions had to be closed down. India, however, saw a boom practically for the first time after the great depression. This, followed by an enormous increase in the volume of currency, assisted the process, and the deposits, particularly the demand deposits have gone up very high. This development is in line with that in other countries. The cash position of the banks has throughout the period remained favourable. This item—including both cash in hand and balances with the Reserve Bank—has of course witnessed seasonal variation; but, on the whole, the situation has remained satisfactory, and "with the exception of first nine months of war when there was some little decline in cash position, the proportion of cash and balances with the Reserve Bank to total deposits has always been above 12 p. c. while for the greater part of the war period it has been considerably above that." So far as the volume of advances and bills discounted are concerned, the tendency, inspite of seasonal ups and downs and various other dislocating

factors, has definitely been in the downward direction in proportion to the growth of the volume of deposits, though mostly it was above the pre-war figure. In England, however, it has definitely gone down, partly due to the reduction in the volume of exports and imports and the curtailed movement of produce and holding of stocks, and partly due to the entry of the government in the field of industrial and business finance. Among the banks' investments the premier rank came to be held by government securities. As in the first war, so also in the second, the banks have played a major role in war finance and "their deposits increased by the amount of their subscription of the government loans". Unlike in the first world war, the cash reserves of the banks suffered and lagged far behind the rapidly accumulating deposits. It was this fact and its repercussion on the future position of the banks that led to the amendment of the Companies Act as a result of which the capital structure and reserves of banks have to be maintained at a certain minimum proportion.

We have already pointed out that draft of the Banking Bill presented by the Reserve bank of India could not be taken up for consideration owing to the deterioration of the war situation. During the years of war, the banking system had developed in many desirable and undesirable lines and legistation to control some of these malpractices could not be deferred till the whole bill could be taken up for consideration. Immediately on the cessation of hostilities, therefore, steps had to

be taken to check some of these evils. Three pieces of legislation were passed. In the first place, the government of India issued the Banking Companies (Inspection) Ordinance, 1946, empowering the Reserve Bank to inspect the affairs of any banking company and to take corrective action if it was found that the banking company was working in a way which was detrimental to the interests of the depositors. The second step was taken when the Bearer Promssory Notes (Propibition of Issue) Ordinance, 1946, was promulgated. More about this will be discussed in a subsequent chapter. The third piece of legislation is the Banking Companies (Restriction of Branches) Act of 1946 which has already been considered in connection with our discussion on branch banking. Another important line of development has, as its object, the formation of two all India organisations—one relating to bank employees and the other to the banks themselves. The former, the Federation of Bank Employees' Unions, has been formed in Bombay and has assumed an all-India character. But more important has been the formation of the All India Bankers' Association, which was discussed much and considered so very essential for the last two decades. All the scheduled banks have assured co-operation to the Association which aims at serving 'as the common form of consultation among banks and shall foster healthy conventions and check malpractices'. It is, however, peculiar that the Imperial Bank of India which should have taken lead in the matter has refused co-operation to the Association.

Inspite of all these developments in the field of banking in the immediate post-war period, it cannot be said that all is well with the banking system. On the one hand, inefficient management and unsound banking policies and practices and, on the other, the difficulties created by the political and communal troubles have placed the banks in enormous difficulties. A large number of non-scheduled banks in Bengal and a number of scheduled banks in Bombay fell into this difficulty so much that the latter were either forced to suspend payments or were called upon by the Reserve Bank under the powers vested in them to refrain from accepting fresh deposits. Political and communal troubles apart, even in the practice and policies of the banks there are many elements which may be questioned and as the Governor of the Reserve Bank put it, "No Government as central bank can keep a complete watch over the day-to-day activities of banks if they are disposed to follow unsound practices and it is necessary to emphasize the truism that good banking would ultimatey depend on the good bankers and their sense of responsibility to the community as custodians of its savings." The difficulties with which the non-scheduled banks in Bengal were faced were due to the fact that many of them had given advances without any tangible assets as security which they could give to the Reserve Bank for obtaining accommodation during difficult times. Many of these banks did not possess actual titles to goods but were

the mere custodians. This sort of play with the assets without keeping them in a liquid form, is, however, dangerous. Secondly, the practice of declaring dividend from profits arising out of security transactions is undesirable. Properly speaking, this should go to strengthen the reserve. Thirdly, the practice of window-dressing of the balance sheets by the banks gives them a wrong notion about their position and is highly dangerous for banking business. The bankers should make it a point to submit statements outlining their actual condition clearly and avoid window-dressing by all means which is done by the British banks who have agreed no longer to to resort to window-dressing of cash in their monthly statements. Even the shareholders of the banks should insist on this. A system of inspection by the Reserve Bank may go a long way towards building up sound banking tradition in this country.

Now that the war is over, the need for a full-fledged banking legislation is being emphasized once more. In view of the changed circumstances due to the war, the original bill has been thoroughly revised. As already said, the ills of present day banking are mostly due to illiquid assets or to playing with them. Hence a considerable part of the revised bill is concerned with providing for liquidity of assets. This is sought to be secured by cash reserve (section 18), limitation of interest in subsidiary companies (section 19), restriction on loans and advances (section 20), maintenance of percentage of assets (sec. 23), assets in

British India (sec. 24) and disposal of non-banking assets. In part all other provisions regarding capital and reserve, restriction of business, regulation of branch banking, inspection, audit. etc., aim at securing liquidity of assets in broad sense. But in a restricted and conventional sense liquidity means the ability of the bank to meet calls on its funds and this has been sought to be secured by two ways, viz., first, the maintenance of cash reserve and second, the restrictions on assets. Section 18 of the bill requires all banks, scheduled and non-scheduled, to keep either with themselves or with Reserve Bank 2 p. c. of their time and 5 p. c. of their demand liabilities in the form of cash. The bill proposes to impose restrictions on loans and advances to directors or to firms and private companies in which they are interested as partners, directors or managing agents. Section 10 of the bill requires that any bank acquiring non-banking assets in the course of its banking business is required to dispose of those assets by the end of a maximum period of seven years. Section 23 requires that after the expiry of two years from the commencement of the Act every bank shall maintain in cash or in unencumbered approved securities valued at current market price not less than 20 p. c. of its time and demand liabilities in British India. Regarding subsidiary company, Section 19 of the bill lays down that a banking company shall not form any subsidiary company except for undertaking the administration of estates, for provision of safe deposit vaults or, with the

previous permission of the Reserve Bank, for such other purposes as are incidental to the business of banking and that no banking company shall hold shares in any company of an amount exceeding 20 p. c. of the paid-up capital of that company or 20 p. c. of its own paid-up capital and reserves, whichever is less. The bill aims at giving powers to the Reserve Bank whereby it may obtain full information and maintain intimate contact and render advice and guidance to banks. The Bank may warn all banks in general or any bank in particular against entering into particular transactions or types of transactions, advise a bank for amalgamation, give assistance by granting a loan or advance to it. The Bank is to submit an annual report to the Central Government containing its survey of the trend and progress of banking in India and suggesting the lines which it should follow. In other respects also, the powers of the Bank are increased. A more helpful improvement would have been to provide the Bank with powers of inspection by the creation of a separate inspectorate or a banking commission as prevails in some of the western countries, including the U. S. A.

The above bill, when passed into law and properly enforced, would undoubtedly help to improve banking business in India. But only a good piece of legislation is not enough. The term "Banking Reform" is very wide in its connotation. It includes at least four things, viz., reform of structure, of practice, of personnel and of law. So far as personnel is concerned,

very few trained and experienced hands are available and hence much reliance has to be placed on inexperienced hands or fresh comers. This in itself is a weakness that stands in the way of the development of good tradition. Since the banker depends on other people's money for his business, he must observe certain fundamental principles for the sake of safety. This necessity is often neglected and many banks, particularly the small ones are, on occasions, faced with troubles and difficulties on account of the absence of a generally acceptable code of conduct. These are enhanced by the fact that the smaller banks are mostly non-scheduled banks, outside the control of the Reserve Bank. Hence it is essential that before opening a new branch, the organisers must make sure that they entrust its management to a competent person.

The reform of banking law has been long over due and when the above-mentioned Banking Bill is passed, it will be a landmark, although much ground will yet remain to be covered. The consideration of banking practice will be taken up in a subsequent chapter. Suffice it to say here that in this respect we have to make a distinction between the indigenous and modern banking practices. It is well-known that the indigenous bankers occupy an important place in the economic structure of this country. In the words of the Bombay Banking Enquiry Committee,—"As a credit agency that has stood the test of centuries, notwithstanding political convulsions, revolutions and changes in dynasties, it occupies a unique position in

respect of the mangnitude of operations and their importance to society. Its development has naturally proceeded on the lines suited to the commercial and financial genius of their people, their local requirements, habits, customs and traditions." But these indigenous bankers at present require a good deal of modernisation and change in outlook. The Indian joint-stock banks are based on the British model and hence their operations have followed the rigid principles of banking, irrespective of the changes in the economic situation. They are concerned only with short-term finance. They deal directly with traders and merchants, by offering short-term advances against easily realisable securities, discounting inland bills of exchange and opening cash credit. In this respect they have not moved with the times and hence the gap in the field of long-term finance yet remains to be filled up.

Leaving aside the reform of banking law, practice and personnel, the most important reform is needed in banking structure. It is well-known that the Indian banking structure is a type by itself and the Indian money market has, therefore, become a loosely organised affair. In the first place, the indigenous banker, the the most important part of the banking system, still continues to be outside the organised part of the money market, and "until the vast portion of India's banking and credit machinery that is represented by the indigenous bankers is put into gear with the relatively small machine of the modernised money market with the Reserve Bank at its central control,

it will be impossible for the Reserve Bank to exercise full control over the currency and credit in India. The next incongruous element in the banking structure are the exchange banks which are all foreign institutions, monopolising Indian foreign trade finance and penetrating even in internal trade finance. This has been possible only because of the political dependence of the country and as yet these banks constitute an unabsorbable and uncontrollable part of the money market. The Imperial Bank is a hybrid institution trying painfully to combine incompatible functions." Even after the establishment of the Reserve Bank, it continues to be in a favourable position. It was expected that being relieved of some of the central banking functions, the Imperial Bank would take to foreign exchange business, thereby giving a lead to the Indian joint-stock banks, and would set up an Association of Indian banks with the avowed object of providing a united platform for the discussion and solution of banking problems of common interest. As already noted, in both these respects, the Imperial Bank has disappointed the expectations and has become a serious rival to the Indian banks. Even among the joint-stock banks there are two categories, the scheduled and the non-scheduled banks, the latter being outside the control of the Reserve Bank. Unless the banking structure becomes a closely co-ordinated one under the leadership of the central bank, it cannot be expected to do all that is expected of it in these days of planned economy.

CHAPTER—VI

Commercial Banking Practice.

Indigenous Banking Practice :

We have already seen that the indigenous bankers play an important part in our economy. There is no hard and fast rule governing indigenous banking practice. In fact, they differ from place to place and from community to community. Yet a general description of their activities and structure may be attempted here. In the indigenous banking structure, there are three elements; first, money lenders, both professional and non-professional, second, indigenous bankers in general; and third, modernised indigenous bankers. The last category of bankers work largely on modern lines and transact all kinds of business which ordinary joint-stock banks transact. Their only difference with joint-stock banks lies in this that they do not publish balance sheets and their management is entirely in the hands of private proprietors.

Before considering the indigenous banking practice the line of distinction between an ordinary money-lender and indigenous banker needs be clearly understood. In the case of indigenous banker, banking is of primary importance and not business. He generally uses his own capital, but he also uses borrowed money either in the form of deposits from the public or by drawing and discounting hundis.

It is not so in the case of money-lender. Other points of distinction have been noted by the Punjab Provincial Banking Enquiry Committee in the following words. "The indegenous banker ..... may also combine banking and business, but in his case banking is primary. This is largely a difference of degree and the other differences between the two are much the same in nature. The indigenous banker finances trade and industry rather than consumption ; the urban money-lender consumption rather than trade. Both banker and money-lender advance partly with and partly without security but the banker more often with than without, and the money lender probably more often without than with. The banker is generally particular about the objects for which money is required ; the money lender is careful. A further difference, and one no doubt arising from the last two, is that most of the bankers' clients repay punctually and many of the money lenders' have to be pressed."

The method of business as well as the system of accounts in case of professional money-lenders is simple but diverse, varying from place to place and community to community. Much again depends on the respective position and need of both money-lenders and borrowers. Loans may be offered on personal security, but where large amounts are involved or where an old loan is to be renewed, promissory notes are in use. In case of huge amounts or loans for long period, they are given on mortgages of land, houses and ornaments, and even cattle

in some cases. For current agricultural requirments, money is advanced on personal security; but in such cases, the understanding is that the crop will be sold to, or through the money-lender. It is interesting that the purpose of the loan is not the concern of the money-lender nor is the manner in which it is spent. The village money-lenders having nothing of the banking function do not receive deposits; they advance their own money to a limited group of persons. This is only one part of their business. Most of them are engaged in trade. In these respects there is no difference between rural and urban money-lender. The only defference lies in the fact that the urban money-lender carries on his business on a more extensive scale and performs some of the banking functions, viz, giving advances against Hundis.

Apart from the above professional money-lenders, there is another class who move in different parts and are to be found almost everywhere. People who have no credit elsewhere obtain loans from these itinerant money-lenders. Besides, there are various non-professional money-lenders, e. g., landowners and agriculturists, merchants and traders and miscellaneous groups who in some parts of India play an important role. They advance loans both in cash and kind and these are given either against the security of land or of crop. The enquiries made by the Provincial Banking Enquiry Committees reveal that all sorts of corrupt practices are connected with them. Some of the non-professional money-lenders being in a stronger

position can inflict greater torture on the debtors than could be done by the professional ones.

Unlike the practice of the organised joint-stock banks, there is no fixed period for which loans are granted. Generally they are to be repaid at harvest time or from the sale-proceeds of the crops. But they are very accommodating and in case of total or partial failure of crops very readily grant extension. In Bengal it was found that in case of mortgage by conditional sale, the period of loan is usually six years or more. In C. P., the period of intermediate loans does not extend beyond three years in ordinary circumstances while that for short-term loans extends to the time of the marketing of crops. In N. W. F. P., loans are given for an indefinite period. The degree of rigidity enforced for repayment of loans depends to a great extent on the personal characteristics of the lender.

The capital used by money-lenders is mostly personal. In some cases they resort to borrowing and, in rare cases, to receiving deposits. The urban money lenders, as they have larger volume of business, have very often to borrow from the indigenous bankers or from the joint-stock banks, particularly when they are themselves traders and merchants. It should, however, be noted that these money lenders, since they are not concerned with the purpose of the loan, do not distinguish between the short, intermediate and long terms with the consequence that "the capital of village money lender who is the mainstay of the agriculturists is becoming frozen from year to year".

The rates of interest charged by money-lenders are generally high and this is due to the various risks connected with the loans. The Central Banking Enquiry Committee has assigned the following reasons for high rates of interest charged by money lenders :

(1) The assets of the farmer consist of his land, cattle, crop, house-property and movable possessions including ornaments. Land is the only security for procuring long-term credit to the borrower and of other assets available as cover for short-term borrowings, the most valuable are ornaments. But ornaments in the case of a large proportion of the agricultural people are not worth speaking of. The other assets are generally of a very insignificant character. The money-lenders who are lending money in these circumstances are taking a risk which other organised credit agencies do not take. They have, therefore, to protect themselves against loss by charging high rates of interest.

(2) In many parts of India, money-lender is the only financing agency available to the agriculturist. At places where money-lender works side by side with other organised credit agencies, the latter do not touch all classes of population and do not even fully meet the requirements of the people they finance. On all these accounts the money-lender holds a semi-monopolistic position.

(3) The money-lender himself is suffering from paucity of capital. He rarely receives deposits and has generally no connection with the money market

with the result that competition among the borrowers drives up the rates.

(4) The lack of education and conservative habits of the people are also responsible for high rates of interest. The people have neither the ability nor the desire to enquire into possibilities of getting cheaper money from urban centres.

(5) Money lender's expenses of collection and management of loans given to innumerable small borrowers also account for the maximum limit of interest being fixed as high as 48 p. c. in the English Money Lenders Act of 1927 and 42 p. c. in the Uniform Small Loan Law in the U. S. A.

The grip of the money-lenders is fast getting loose under various provincial legislations.

The indigenous bankers, as distinguished from the money-lenders, are mostly bankers. According to the nature of the business performed, they may be placed into three classes :

(1) Those who do no business other than banking.

(2) Those who are both bankers and traders or commission agents ; and

(3) Those who are principally merchants or traders but who also employ their surplus funds in banking business. The largest number of indigenous bankers belong to the second category. In the words of the Central Banking Enquiry Committee, "It does not draw any distinction between *dealing in* other people's money and *dealing with* other people's money,

so that many an indigenous banker combines trading with banking".

In its organisation, the indigenous banking institution, with its resources, respectability and tradition, its hereditary relation and personal contact is a type by itself. The Bombay Banking Enquiry Committee has highly eulogized the institution. "As a credit agency that has stood the test of centuries, notwithstanding political convulsions, revolutions and changes in dynasties, it occupies a unique position in respect of the magnitude of operations, and their importance to society. Its development has naturally proceeded on the lines suited to the commercial and financial genius of their people, their local requirements, habits, customs and traditions."

As in the case of money-lenders, the operations of the indigenous banks are simple and not attended with delays and formalities common to a joint-stock bank. The cost of his establishment and staff is not high and his accounts are simple, economical, accurate and efficient. These bankers have little banking education, apart from what they have inherited by tradition and experience picked up in the course of business. These indigenous bankers belong to diverse castes and classes and, in certain large centres, they have their own associations and bazars. Each of these associations conducts its business on well-defined lines and helps the standardisation of banking practices. At the meetings of such associations, questions of common interest are discussed and disputes are settled. Thus

in Calcutta there is an association of shroffs. In Bombay Presidency, there are five big associations of indigenous bankers, viz., the Bombay Shroffs' Association, the Ahmedabad Shroffs' Association, The Marwari Chamber of Commerce, the Multani Shroffs' Association, and the Shikarpuri Shroffs' Association. But as yet no attempt has been made to co-ordinate the functions of these diverse associations. Their members may have business with one another; but there is no standard rule governing their transactions, and the money rates prevailing in these different bazars are, as shown earlier, entirely different and do not correspond to the bank rate. Inter-shroff advances are generally made at rates often lower than the bank rate.

The indigenous bankers generally invest their own capital which, in several cases, is supplemented by deposits, and, in busy season, even by borrowing. In Bombay they receive call money, short-term deposits and fixed deposits and keep current deposit accounts as well as fixed deposit accounts. At the height of the season, they replenish their resources by borrowing which generally takes place between shroff and shroff, and, if necessary, in big towns, they often resort to the organised banks wherefrom accommodation is obtained either from the demand promissory notes drawn by two approved shroffs or by discounting hundis endorsed by them. The period for which such accommodation is granted is usually 60 days. At up-country centres, the advances as a rule take the form of loans and cash credits, bills are discounted

and in some cases advances are made against produce. In Madras, the chettiars take deposits, both current and fixed, but they do not take much of the former as they do not keep fluid resources. The Multanies in Madras rely on their own resources and in case of need borrow from the members of their own community. They do not receive large sums in deposits, though at times they accept current deposits locally. Both the Chettiars and the Multanis borrow in case of need from the organised banks. The Marwari bankers in Madras do not obtain large funds by local deposits nor do they borrow on a large scale from the organised banks. In Bengal the organised bankers used to receive deposits. But as in Bihar and Orissa, so also in this province, this branch of their business is steadily dwindling. Deposits, in so far as they come, are received from the acquaintances of the shroffs or from those with whom they have business dealings. Very few indigenous bankers are able to attract deposits from the public. In the Punjab, funds are raised by deposits, by discounting hundis and by loans and cash credit against government securities or house-property. The personal capital of the indigenous banker is less than the borrowed money. In the N. W. F. P., a large part of the capital is received from deposits. In Assam the case is just the reverse. The indigenous bankers in that province do not invite deposits and some of them no not even accept them. Deposits, if any, are received on current account. Fixed deposits are also received by some firms.

The main business of indigenous bankers consists in financing trade and small industries. Their touch with agriculture, in so far as it exists, is only indirect, to the extent of financing the internal trade. Apart from these they do a good deal of banking business which is done by the joint-stock banks, such as, buying and selling of remittances, discounting of hundis, receiving deposits and advancing loans against stock-in-trade. Some of them issue cheque books; but these cheques are of limited circulation. Apart from the banking business, many of the bankers carry on trade proper in order to employ their idle funds. This combination of business with banking is unavoidable owing to a decline in their banking business brought about by the coming of joint-stock banks.

The indigenous bankers maintain touch with the organised banks, including Imperial Bank, either by taking loans from them or by discounting hundis. In this respect, therefore, the two are complementary. In some places, however, as in Bihar and Orissa, their relation is one of rivals. It is desirable that the organised banks should try to provide as much banking business as possible to indigenous bankers. Even in those provinces where accommodation is granted to indigenous bankers, the position is far from satisfactory. Thus it was complained before the Bombay Banking Enquiry Committee that the accommodation granted by organised banks "is grossly inadequate. Every shroff on the list of a bank is assigned a maximum limit of the amount which he can borrow

from the bank. The shroffs consider that the limits of credit assigned to them are very low." It was pointed out before the Bengal Banking Enquiry Committee that "in the mofussil it has been stated that the branches on the Imperial Bank evince a lack of sympathy in their attitude towards the indigenous bankers. Evidence has been received from two firms in Dacca that the local branch of the Imperial Bank refuses to rediscount hundis bearing the endorsements of even the firms of highest repute in Dacca town." The situation has not improved even after the establishment of the Reserve Bank which had so far followed a policy of indifference and non-interference to the indigenous bankers.

The clientele of shroffs is extensive. They deal principally with their brother shroffs, town and village money-lenders, artisans and traders. They also offer financial assistance to the promotors of many small and large industrial enterprises by subscribing to their shares or giving advances against them and by holding debentures. They also grant long-term accommodations against the whole or a part of the mill property, factory or goods. Sometimes they join the managing agencies of some concerns as financiers.

An idea of the variety of methods in which accommodation is granted by indigenous bankers to one another without security can be had from the following information collected by the Bombay Banking Enquiry Committee.

1. **Chalu khata**—This corresponds to current day-

to-day account. The debit and credit items are entered as in ordinary ledger account and the interest computed on the floating balance at a rate of interest previously fixed. The account includes both deposits and advances and is generally used for inter-shroff transactions. When a shroff receives temporary accommodation from another, it is a *chalu khata* transaction and is in the nature of a clean overdraft or call money. If he deposits surplus funds, it also goes to the same khata. The deposits as well as loans are liable to be repaid on demand and the borrowing shroff has also the option to return the money whenever he desires. The *Chalu khata* is also meant for keeping an account of such transactions with private customers.

2. **Khata Peta**—This account is the same as *chalu khata* except that in the case of *chalu khata* the amount of the loan is payable immediately on demand, whereas in case of *khata peta*, the borrower would not lose credit, if by consent he delayed payment for a little while.

Byaj Badla or Miyadi khata—Under this account money is borrowed or deposited by previous arrangement as regards the rate of interest and the period of the loan or deposit, the period varying from a fortnight to a year.

4. **Hath Udhar**—A temporary loan given free of interest for a day or two without taking any promissory note or receipt in writing. This is confined only to inter-shroff transactions.

5. **Promissory Note**—In Bombay, it is common with indigenous bankers because it is cheap. In

Bengal, however, it is mainly used for ordinary borrowing and is only sparingly used in commercial transactions. Because of the personal character of the obligation and the uncertainty about the use of the proceeds, this document "constitutes a less desirable instrument of credit than a draft.....It is an instrument more of a financial than commercial character".

6. Receipts—Sometimes the borrower is asked to pass a receipt acknowledging payment in lieu of a promissory note.

7. R/R or Railway Receipt (B/L or Bill of Lading in Bengal where there is arrangement for inland navigation)—Short credit is given against R/Rs (also B/Ls) for goods endorsed in favour of the shroff. R/Rs and B/Ls are extensively used in financing the movement of crops particularly from up-country centres to the big towns. When the merchant despatches goods to his agent or *aratdar* in big towns, he draws a hundi on the latter and discounts it with local banker, there by tendering the R/R or B/L to the latter. The agent of the banker at destination hands over the receipt to the drawee on payment. If the merchant has taken advance from the *aratdar* himself, he simply sends the receipt to the latter who tries to sell the R/R or B/L even before the arrival of goods. If the goods are sent against a contract, the *aratdar* simply hands over the receipt to the buyer after receiving payment as per stipulation. The receipt may change hands many times before the goods are taken delivery of.

8. Hundis—Short-term finance is also given by discounting hundis. Formerly, the hundis formed the stock-in-trade of the indigenous banker, but the stamp duty militated against their use. In January 1940, the central government reduced the duty chargeable on usance bills of exchange made or drawn in and payable in British India and having a usance not exceeding one year to two annas for every one thousand rupees or part thereof. Another defect from which usance bills or *muddati hundis* suffer is that on the face of the document it is difficult to know as to whether they are accommodation papers or genuine bills, with the result that when they are rediscounted by the banks, the latter count on the personal credit of the endorsing shroffs.

9. Short and long-term credits, the former for financing traders and the latter, usually given for a period not exceeding a year, against the security of bullion, jewellery, cotton, grain etc.

10. Mortgage of property—The shroffs do not generally advance money against mortgage of immovable property, but occasionally long-term finance is provided against such security.

The Bengal Banking Enquiry Committee mentions of two more credit iustruments, viz., **Purja** and **Hatchita.** A *Purja* is a written request addressed to the lender and signed by the borrower to pay the amount mentioned in the instrument. The rate of interest is always mentioned in the body of the *Purja* but the period for which loan is granted is not men-

tioned but is either understood or entered into a separate slip pinned to the *Purja*. It is not attested by any witness and is more in the nature of an acknowledgement of debt than a bond. It is used only for temporary loans for periods seldom exceeding three months. It is not a negotiable instrument. Sometimes the *Purja* is given as an acknowledgement by the borrower declaring that he has credited the amount borrowed in his own account books in favour of the creditor. A *Hatchita* is a sheet bound in the account book of the credit or/and entered in the form of a ledger bearing one-anna stamp and the signature of the borrower and all repayments and payments of interest on the credit side.

Organised Banking Practice

Relation between Banker and Customer—In order to understand the relation between the two, we must understand what precisely is understood by these two terms. Before the report of the Hilton Young Commission was published, no attempt at defining a bank in this country was made. The difficulties were also many-sided because of the existence of money lenders who are not compulsorily registered, of indigenous bankers who combine banking and business and of cooperative societies which neither accept money on current account nor allow cheques to be drawn upon them. The definition adopted by the Hilton Young Commission, very similar to that of Dr. Hart, was that "the term 'bank' or 'banker' should

be interpreted as meaning every person, firm or company using in its description or its title bank or banker or banking and every company accepting deposits of money subject to withdrawal by cheque, draft or order. In the Indian Companies Amendment Act of 1936, a banking company means "a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order, notwithstanding that it engages in addition in any one or more of the following forms of business....." The shortcoming of the above definition was that a large number of banking companies were enabled to claim that they were not banks within the meaning of the above definition. The Amendment of 1942, therefore, added the following proviso : "Provided that any company which used as part of the name under which it carries on business the word 'bank', 'banker', or 'banking' shall be deemed to be a banking company, notwithstanding that the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order, is, or is not shown to be the principal business of the company." The revised draft of the Banking Bill gives a detailed list of the business of banking and defines banking in more precise terms as the accepting of deposits repayable on demand and the banking company as any company which may be wound up under the Indian Companies Act of 1913 and which transacts the business of banking in British India.

A customer of a bank is to be known by his dealings. For this purpose, he must have a recognised course of dealing with the banker and the dealing must be of a banking nature, in the shape of having an account with the bank. The general relation between the two has been expressed as one of debtor and creditor. In the case of deposit account, the banker as debtor is liable to repay the debt on the expiry of the agreed period and the notice being properly given. In the case of current account, the payment will have to be made on demand. In any case, however, the basic relation remains unchanged. Here it may be noted that the earlier view that the banker is a depository of funds is too narrow. For, the banker is not only a safe custodian, but much more than that, a dealer in money, receiving it on the one hand in the form of deposits, and lending on the other, thereby earning his own profit. This relation is not altered in those cases where the banker does not pay interest to the customer on the latter's deposit. In any case his liability remains.

The above is a general statement of the relation between the two. The actual relation is governed by the state of account of the customer and by certain super-added obligations on each party arising out of the implied contract between them. For, if the current account is overdrawn, or if the customer has taken a loan, he naturally becomes a debtor and the banker becomes a creditor, having rights to repayment of principal, payment of interest and to the realisation of securities left with him in accordance

with the agreement. The banker has a number of obligations to his customers. Firstly, it is his duty to honour the cheques from the customers when they are in order, and this duty has to be performed so long as any one of the following incidents has not happened, viz., exhaustion of the customer's funds, receipt of the customer's countermand of payment for any particular cheque previously issued and not already paid, death of the customer, notice to the banker of an act of bankruptcy on the part of the customer, official declaration of the customer's lunacy and receipt from the court of an order garnishing the customer's account. Secondly, the banker is under obligation not to disclose any details concerning the account of his customer nor any other information that he may have obtained from some other source. At the same time the banker enjoys certain rights, e.g. a right to charge reasonable commission and interest on the customer's turnover or balance, a general lien on all securities which come into his hands in the ordinary course of business and so on. In certain cases, again, the banker is not a debtor, but an agent of the customer, e.g., when collecting the cheques or bills of his customers. Only when the value has been received and placed to the credit of the customer in the books of the bank does the latter become a debtor.

The above gives some idea of the different aspects of the relation between banker and customer. But the basic relation remains the same, and other

things remaining unaltered, the banker is a debtor to his customer. But then this debtor-creditor relationship differs from the relationship between ordinary debtors and creditors. In the latter case, it is the duty of the debtor to seek out the creditor and pay off the principal and interest on the expiry of the agreed period. But in the case of a bank, the debt is to be paid only when it is demanded in case of current account, and on demand on the expiry of the agreed period in deposit account. In any case the demand must come from the customer ; the banker will not take any initiative for repayment. If the banker does so, he may do it "without notice and possibly injure his customer's credit by dishonouring his cheques."

Different Aspects of a Bank—Bank as Borrower :

The banks may be borrowers in various ways of which some are of little or no importance. One of the methods is the issue of bank notes, which in early stages of banking was in the hands of joint stock banks. In India, before 1862 when the issue of currency notes went into the hands of the government the three Presidency Banks had the right of note issue, although these notes had limited popularity. With the coming of the Reserve Bank, this business has passed into its hands, and is, therefore, no longer a method of borrowing by joint-stock banks. Another method of borrowing is the issue of bonds, debentures and cash certificates a method which is popular in some of the continental countries like Germany, but unknown in England.

In this country this method of borrowing is recent and has not as yet assumed any great importance. But the most important method of borrowing money is the receiving of different types of deposits—current, fixed and savings bank deposits.

Before considering the various forms of deposits, it will be convenient to say a few words about the advantages of opening an account at all. They are clear enough. In brief, banking is the principal wheel of commerce and all advantages arise from this fact. In business, the businessman requires money, at times huge sums, from time to time. If he has an account with the banker, he can keep his money there and withdraw it from time to time according to his requirement, thereby being relieved of the need of keeping large sums of money with himself. Not only can he issue cheques against his deposits for effecting payments but he can also obtain advances from the bank by an overdraft or a loan against security and utilise the services of the bank for the collection of cheques and bills. The banks also render services towards making remittance and issue letters of credit to his customers. The bankers reply to the enquiries regarding credit-status from and about his customers. Some of the bankers again render miscellaneous services like buying and selling securities, advising about investments, collecting dividends, paying insurance premia, etc., on behalf of the customers. Because of these various services rendered by the banker, the opening of an account is essential.

A considerable change in the deposit structure of the banks has been seen to take place in India in the past few years. In the first place, the attitude of the public towards banks has changed remarkably. It was adversely affected by the instability in banking structure in the earlier period of its existence. Since the years of depression, owing to the prevalence of easy money conditions, the banking structure has gained strength and the attitude of the public has become a favourable one. Secondly, whatever amount of deposits was available to the banks was mainly fixed deposit, and not current deposit. In recent years the position has changed and the latter has acquired so much predominance that most of the banks do not allow any interest on current deposits, except when the amount involved is a huge one, say, a lakh of rupees or more. Although these deposits may be withdrawn at any time, yet the bankers generally insist that the customer should maintain a minimum balance with the bank, which becomes as good as fixed deposit, and may be used by the banker at his discretion.

If money deposited on current account earns very low or no interest, how is it that this type of deposit is growing enormously. The reasons for this are to be found in the advantages reaped by the customers. For, in the first place, the business funds of the customer may be lodged in a safe place. Secondly, he can utilise the services of the banker as agent for the collection of cheques, bills, etc. And finally, the customer can enjoy the facility of remitting by

cheques the amount he has to pay to his debtors. Thus here the main concern is not the earning of interest but of keeping money in safe place and utilise the various services rendered by the bank. If earning of interest is the principal objective, a fixed deposit account rather than a current account is preferable.

Current deposit places an enormous responsibility on the banker. For it is in connection with these deposits that the responsibility of the banker to honour the cheques arises and for this purpose he has to maintain a reserve. Besides, before opening a current account the banker has to be particularly careful regarding the party and a banker before opening a new account, is careful to obtain trustworthy information about the character and reputation of the prospective customer. If the party is not already known, it is required that he should be introduced by some one who is known to the banker or the customer must give references of responsible persons. For, the difficulty of allowing all applicants to open current account lies in the fact that dishonest persons would cheat the public by issuing cheques even when their account is exhausted and would thus affect the credit of the bank. When the preliminary enquiries are concluded and the banker satisfied about the bonafides of the customer the current account is opened. The name, address, and specimen signature of the customer are taken. In case of partnership, specimen signature of the firm's name as written by each partner, together with the full

name and other particulars of each member of the firm, are taken by the banker. For, in partnership business any partner is entitled to issue cheques, unless, of course, the power is entrusted to one or a few. Death or retirement of any one partner will cause the dissolution of the partnership and if the surviving partners decide to carry on the business, a fresh start with the bank is essential. In the case of a joint-stock company, if an account is to be opened, the banker will ask for a copy of the Memorandum and Articles of Association. These will enable the banker to acquaint himself with the borrowing limits of the company and also the activities which a company is entitled to carry on. For, any transaction of the company which was *ultra vires* will be void at law, and if the banker lends for any such transaction, he will do so at his own responsibility. It is also advisable for the banker to acquaint himself with the certificate of incorporation, and the certificate for the commencement of the company's business, so that the bank may not be cheated even before the start has been given. The banker would also require a signed copy of the directors' resolution providing for the opening of the bank account and instructing him how and by whom cheques, bills and other documents are to be signed, endorsed or accepted. When the banker agrees to open a current account, he supplies the customer with a pay-in-slip book, a cheque book and a pass book.

Where money lies at the bank on fixed deposit account, it cannot be withdrawn without notice and

before the expiry of a certain period which ordinarily varies from 3 months to 5 years, though in certain cases it may even be one month. The fixing of the period gives the banker a right to use those funds within that period without the danger of their being withdrawn. This enables the banker to employ these funds in business without having the necessity of keeping a reserve, and this is a cause for the popularity of this type of deposits. Interest is always allowed and when interest is paid on current account, the interest given on deposit account will of necessity be higher. Fixed deposits were popular in India, but in recent years current deposits have also increased enormously and this is partly due to the increasing use of cheques. The ratio between current deposits and fixed deposits is difficult to determine, for, all banks do not show separate figures for different kinds of deposits in their balance steet.

The popularity of fixed deposits in this country was mainly due to two reasons. In the first place, the bank may happen to have customers who do not make use of cheque currency. In their case, deposits with the bank are not exactly in the nature of business deposits but deposits for earning interest. And since interest on fixed deposit is high, this type of customers has greater attraction for this deposit. Secondly, some of the banks, e.g., district co-operaive banks, invest their funds in long-term securities and naturally accept fixed deposits. In recent years, however, the situation has changed owing to the growing use of

cheques and current deposits are increasing with great rapidity. Unless previously settled, these deposits cannot be withdrawn by cheques. The interest allowed on these deposits is not the same but varies according to the volume of deposits, period for which deposit has been entrusted to bank's custody, condition of the money market and the status of the banking institution.

A few words may now be said about savings bank deposits. The beginning of trustee savings banks in the presidency towns in India is traced to the period 1833-35 and they were transferred to Presidency Banks in 1863-64. In 1870, in certain selected Treasuries, district savings banks were opened. The post office savings banks came into existence in April, 1882. On the 1st April, 1886, district savings banks were abolished and the balances transferred to the post offices but the savings banks at Calcutta, Bombay and Madras were not transferred by Presidency Banks to government till 1st October, 1896. Indeed the story of post office savings banks is one of uninterrupted progress since its introduction.

Savings bank account is intended for persons having small savings and it may be opened by any person without formal introduction either in his own name or in the name of any member of the family. The importance of this type of deposit came gradually to be realised by commercial banks. The chief advantage of this expedient is that it encourages, on the one hand, small savings which are not negligible in a poor country like India, while, on the other, the banker has

to maintain a small reserve for meeting demands of the customers, for a depositor is not allowed to withdraw more than once a week. Besides, the maximum amount that can be withdrawn at a time without notice is also fixed. The rate of interest allowed is slightly higher than on current account and is given not on daily balance but on minimum monthly balance. The bankers, however, do not allow the use of cheques for withdrawing money from savings bank account; for they do not want to run risk in connection with the paying out of cheques. It has, however, been pointed out that the use of cheques for withdrawing money from savings bank account will be a step towards the popularisation of cheques, a measure which the bankers should consider seriously.

Sometime back the Reserve Bank of India organised a census of bank deposits in India. Only the figures for the scheduled banks have been available and the following results were obtained :

Table showing the ownership of Demand Deposits with scheduled Banks in India as on 31. 12. 45.

	Rs crores.	% to Total Deposits.
1. Business Demand Deposits....	259.00	43.90
(a) Manufacturing & Transport Companies...	66.96	11.35
Others....	10.19	1.73
Total (a)....	77.15	13.08

(b) Trading & Financial Companies...	58.16	9.86
Others....	123.69	20.96
Total (b)....	181.85	30.82
2. Personal Demand Deposit ...	234.62	39.77
3. Other Demand Deposit	80.88	13.71
4. Unclassified	15.46	2.62
5. Total „ ...	589.97	100.00

It will be seen from the above table that business deposits constitute about 44 p. c. of the total and personal deposits about 40 p. c., while in the U. K. and the U. S. A. there is a wide gap between the two. Thus in the United Kingdom, while business deposits are about 66. 8 p. c. of the total, the personal deposits are 33.2 p. c. only. In the U. S. A., similarly, there are 57.9 and 35.6 p. c. respectively. This correspondence between personal and business deposits in India is possible due to the fact that people do not so much draw a distinction between different forms of deposits and that personal business in India is still very important. This, indeed, accounts for the predominance of personal deposits. Another interesting feature of the enquiry was the analysis of the distribution of deposits among different types of business which was as follows: manufacturing and transport business 13.08 p. c. and trading and financial companies 30.82. In the former, again, joint-stock companies were more important, being 11.35 p. c. while in the latter, individuals and partnerships predominate.

being about 20. 96 p. c. The classification of deposits according to the size of the account is also highly interesting. Thus 38. 30 p. c. of the deposits are in the range of one lakh rupees and over 30. 59 p. c. in the group of more than Rs. 10,000 but less than one lakh rupees and only 31. 11 p. c. in the category of Rs. 10,000 or less.

Bank as Collector and Payer : If the cheques are in proper form and the customer's account is not exhausted, it is the duty of the bank to honour the cheques. In this matter, the position of the banker is not an enviable one. For, in the first place, the banker is to see whether the cheque is a crossed cheque or an open cheque. In the former case, the banker cannot pay the amount over the counter, but only to another bank through whom it is to be presented. If the banker pays for the crossed cheque over the counter, he does so at his own risk. Secondly the banker has to be cautious about the position of the customer's account while honouring the cheque. For, if the account is exhausted and the banker honours the cheque, it is he who shoulders the risk.

The banker also collects the cheques on behalf of his customer. It must be remembered that there is no legal obligation on the banker to collect the cheques. But this service is rendered by almost all banks and is one of their important functions. Now-a-days, a greater part of the work is settled through the clearing house organisation ; but even then the role of the banker is an important one. As already noted, the

banker, so long as the value of the cheque is not received, is a mere agent, and not a debtor to his customer, and therefore cannot assert any right of a holder for value. His title is no better than that of his customer. Here, the difference between the position of the paying banker and that of the collecting banker may be noted in brief. For, the legal liability of the two is entirely different, that of the collecting banker being more than that of the other one. The collecting banker is responsible for negligence, if any, and must take precaution regarding endorsements and the state of the customer's accounts. But since each bank is a paying bank as also a collecting bank, it does not make the position of the one bank better or worse than that of the other one.

As in the case of cheques, so also in the case of bills, the banker, although not legally bound, acts as agent in collecting the amount. But there is one point of difference. In case of cheques, the service is rendered for the convenience of the customer. The gain, if any, of the banker is an indirect one in so far as the banker can utilise the funds if they are retained with him by the customer. In the case of bills, however, the profit of the banker is a direct one in so far as the banker charges for the collection of bills. Besides, in the case of bills, the position of the collecting banker is more delicate. Not only should he be careful regarding negligence but also he must be careful in other matters. Thus without the consent of the customer the banker should not accept any qualified acceptance nor should he

accept the payment from the drawee by cheque and hand over the bill to him. For in that case the drawer, as also the endorser, if any, would be relieved of all responsibility and it will fall on the banker. Besides, when a bill is dishonoured by non-payment, he should return the bill immediately, if it is an inland bill and have it noted and protested if it is a foreign bill. Negligence on the part of the banker in above matter is dangerous. If the banker has already paid a part of the volume of the bill by discounting it, the banker's responsibility increases all the more in his own interest. The banker should immediately give notice of dishonour to the party or parties involved and to his customer who got the bill discounted, the latter bearing the immediate responsibility.

Bank as Business Concern—Banker's Assets :

The object of banking business is to earn profit by rendering financial services with the money of the depositors. Of course, the bank has to pay a certain rate of interest to the depositors to induce them to part with their money. But the banker lends this money at a higher rate, the difference constituting his profits. But then, the position of of the banker being what it is, the whole of the funds cannot be used profitably. A certain percentage has to be kept idle, while the profit earned from the rest is not uniform. For one part of the fund is invested in short-term self-liquidating securities while the other part may be invested in more permanent form e., g.,

in industry or trade, the rate of profit varying from one to another.

The nature of the banking business demands that a part of the funds of the banker should be kept as reserve so that the demands of the depositors may be met. The legal requirement in this respect is no indicator. Thus according to sec. 42 (1) of the Reserve Bank of India Act, the scheduled banks have to maintain a balance with the Reserve Bank which shall not, at the close of business on any day, be less than 5 p. c. of its demand and 2 p. c. of its time liabilities. And so far as the non-scheduled banks are concerned, sec. 277L of the Indian Companies Act of 1913, requires them to maintain by way of cash reserve in cash a sum equivalent to at least 1½ p. c. of its time and 5 p. c. of the demand liabilities. Actually, however, the banks have to maintain as reserve a much higher figure, which is determined by various considerations.

The determination of reserve is a very delicate question and the success of banking business depends on it to a great extent. For, while the maintenance of reserve is absolutely essential, the volume of this reserve should not be unnecessarily high so as to keep funds idle or it should not be too low so as to expose the banker to a run on it. The banker's success lies in striking a proper balance and for this purpose he has to note a number of factors, such as, (1) habits of the customers and business requirements, in the form of accommodations, of the locality, (2) experience

of the banker and banking customs of the locality, (3) requirement of cash depending on the cheque-using habits and existence of clearing house arrangement, (4) nature of account, whether fixed or fluctuating, as in the case of bullion dealers or share brokers, and size of average deposits, i. e., whether there are few large deposits or many small ones, the latter requiring smaller reserves, (5) nature of bill portfolio, viz, whether bills and securities are of short-term, gilt-edged, self-liquidating variety or of long-term one, and rediscount facilities available with the central bank, and (6) volume of reserves kept by other banks in that locality. Be it noted that the reserve requirements of our joint-stock banks have in recent years changed owing to the changed nature of deposits. The increasing importance of demand liabilities in recent years naturally calls for higher reserves. Besides, these reserves in India have been far from uniform not only for different categories but also for the same category of banks and have varied widely from year to year, as can be seen from the following table :

Table showing the percentage of cash to liabilities on Deposits of the several classes of banks in India on 31st December, each year :

(*Source* : *Tannan—Banking Law & Practice in India.*)

	1935	1937	1938	1940	1942	1943
Imperial Bank of India—	25	17	11	26	14	25
Exchange Banks :						
(a) Banks which are doing a considerable portion of their business in India—	15	19	13	17	10	12
(b) Banks which are merely agencies of large banking corporations, doing a major portion of their business abroad—	19	10	7	23	11	12
Indian Joint-Stock Banks :						
(a) Banks having capital and Reserve of Rs. 5 00,000 and over—	23	17	14	23	23	24
(b) Banks having capital and reserve between Rs. 1,00,000 and less than Rs. 5,00,000	16	16	15	20	29	32

Cash in hand or reserve constitutes a certain proportion of the deposits. The remainder of the funds are used for profitable investments. Among them mention may be made of money at call and short notice, investments in stock exchange securities, and loans and discount. Money at call and short notice constitutes the first line of defence with bankers in western countries. This money is advanced by bankers to the different elements in the money market, like bill-brokers, members of the stock exchange, etc. In India, however, this type of investment has not assumed a character of great importance as compared to that in other countries, though the volume of such investment, particularly in Treasury bills, has increased since the first world war, when the Treasury bills were introduced. In slack season when the Treasury bills are not floated, call money is practically idle, because there is hardly any demand for it from other elements in the money market.

The stock exchange securities are of various types and the degree of popularity of each kind with the banker is not same. In our country, bankers prefer government and semi-government securities, e. g. port trust, municipal and improvement trust securities and bonds, trustee securities, railway securities, and securities of public utility companies. The industrial securities, however, do not find favour with the bankers and, therefore, do not appear to any appreciable extent amongst securities held by banks. The problem of long-term industrial finance, therefore, remains unsolved.

To the limited extent that the bankers hold industrial securities, their first preference goes to debentures, next to preference shares, then to ordinary shares, and last to deferred shares, the degree of preference being influenced partly by the risk involved and partly by the nature and extent of the market available. In normal times investments in stock exchange securities are not very large.

The above-mentioned investments are neither very profitable nor very large and the banker has, therefore, to find more profitable avenues for the employment of their funds, such as granting of advances and discounts. Advances in our country are generally of three types—(1) clean advances against the personal security of the borrower, (2) clean advances against personal security but with a second signature to the pro-note, and (3) advances against tangible and marketable securities, lodged or pledged with the banker. Of these, the first type of loan is not much in favour in this country, though it is common in others. Bankers here insist on the signature of some prominent shroff or managing agency firm on the promissory note The same is done the case of *muddati hundis*. This may partly be due to the conservatism on the part of the bank but mainly it is due to a mere imitation of the practice followed by Presidency Banks, and subsequently by the Imperial Bank.

Banker's advances may take the form of cash credit, overdraft and loans. In cash credit the customer is allowed to borrow money up to a certain limit either against a bond with one or more surities or against

certain other securities. This form of advance is very popular in this country, because, while the customer need not borrow at once more than his immediate requirement, whatever the maximum limit, he can at the same time credit any surplus funds that may be lying idle in his hands in his account with the bank. The banker may, however, have to undergo certain loss. For, as in cash credit, so also in overdraft arrangement, if the actual drawings fall much below the approved maximum limit, the banker will not be able to earn interest, although he will have to keep funds in hands for meeting any sudden demand on the part of customers. For minimising this loss to the banker, the arrangement is that the "banker's cash credit agreement provides a 'half or quarter interest clause', according to which the customer has to pay interest or at least half or quarter of the amount of cash credit allowed to him, even when he does not use that amount." Whereas cash credit is opened for long periods, overdraft facility is only a temporary accommodation whereby the customer is allowed to overdraw his current account, generally against collateral security. But, as in the case of cash credit, so here also the rate is charged not on the full amount but on that actually used. The essential point of difference between the two is, therefore, one of periodicity. Loan is, however, entirely different from these two. In case of a loan the advance is given in a lumpsum for a particular period of time agreed upon, on the expiry of which the full amount is to be repaid. Unlike in case of cash credit and overdraft facilities, loan is not a

continuous process. If a loan is repaid and money is required once again, a fresh contract may be entered into with the bank, provided the latter agrees, upon fresh terms and conditions. In the case of loan transaction, the operating expenses are much lower, in view of the fact that interest is charged on the full amount and the banker need not maintain idle reserve as in the case of cash credit and overdrafts, and also because the number of operations are few, once at the time of granting loan and others at the time of payment of interest and repayment of the principal amount. In the case of cash credit and overdraft, the operations are going on almost incessantly.

Loans are of two types—secured and unsecured, and the Indian law demands that these two types of loans granted by a bank or any other registered company should separately be shown in the balance sheet. Of these two, secured loans granted against securities, bonds, immovable property or goods deposited either in the bank's godown or in the godown of the borrower under letter of hypothecation are more common than unsecured loans. The difficulty in granting an unsecured loan in our country is a real one, in view of the non-availability of correct information regarding the financial position of different parties and also due to their reluctance to supply any such information. In those cases, where such loans are granted, the banker has to depend entirely either on his personal knowledge of the party or on the reports of third parties who very often are known to exaggerate or underrate matters.

Hence, the only way out is to demand security. But banks in our country have been too much cautious, it must be admitted, and at times they have refused accommodation to parties of established reputation.

Unsecured loans, of which the commonest form is the discounting of clean bills, have not assumed any very great importance in this country. In England, however, the case is just the reverse, and the bill portfolio of the commercial banks is of great importance in the utilisation of their funds. In India this state of affairs is due to the operation of various factors. Thus the popularity of cash credit, side by side with the inadequate supply of trade bills, the importance, till recently, of fixed deposits, lack of bonded warehouses, diversity of customs governing hundi as also the difficulty of distinguishing genuine trade bills from kitelying, and several other factors explain this state of affairs. The government securities proved to be more attractive because of their high yield. The lack of a central banking institution, and consequent absence of the lender of the last resort and of rediscount facilities, were the crowning difficulties. Of course, in recent years, some of these difficulties have disappeared ; but even then the bill portfolio of the banks does not seem to have improved nor have they utilised the services of the Reserve Bank for rediscounting the bills.

Guarantor or surety is an important figure in case of an unsecured loan. For, when the loan is not secured by any tangible security, and when the

personal credit of the prospective borrower is weak, guarantee plays an important part. The Indian Contract Act has defined a Contract of Guarantee as "a contract to perform the promise, or discharge the liability, of a third person in case of his default." Thus the guarantor does not offer any tangible security; he simply agrees to make good the loss arising out of the default of the debtor. A guarantor may also be required in case of a secured loan, when the personal credit of the borrower is not sufficient and the value of the securities offered has depreciated, thereby exposing the loan to risk.

Secured loans may be of various types, depending upon the nature of the securities offered. In big cities, where stock exchanges are functioning—of course, such cities are few at present—loans may be taken against stock exchange securities. They finance not only the genuine investors, but also the speculators, the share-brokers, generally for a period of one month or less, intervening between two successive settlements. At times this is done in the form of *budli* transaction which implies the transfer from one settlement to another—"carrying over" as it is technically known. "When the buyer is unable to finance his purchases out of his own resources, resort has to be made to the banker who advances the money and takes delivery at the time of the settlement of the shares purchased by the share-broker on behalf of the client. At the same time the real purchaser of the shares undertakes to purchase them for the next

succeeding settlement or delivery about a month later, at a higher price than that at which the banker is asked to take delivery of the said shares. The difference between the purchase price and the sale price represents the interest on the money invested in the transaction. When the prices of shares are rising rapidly due to heavy speculation, *budli* rates yield from 6 to 12 p. c. interest. On the other hand, when the market is depressed, the *budli* rates also go down so low sometimes as to yield only 3 p. c. Banks ordinarily enter into such transactions with highly respectable parties and only in gilt-edged securities and first class shares, as in addition to the risk of the party's inability to pay for the shares at the time of the next settlement as a result of a fall in prices, there is the danger of defective title of the party delivering the shares". * In big industrial centres, accommodations are granted against the stocks of raw materials and finished products. In other centres which deal principally in agricultural produce, advances are offered against it.

The topic of banker's advances against goods is an important one from the stand-point of a businessman and, therefore, needs a brief consideration at this stage. The principal commodities against which the bankers may offer advances in this country are the agricultural produce of various sorts. But, in view of the absence of public warehouses, these accommoda-

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* Tannan.

tions are to be given against the produce itself rather than against the documents of title to goods. The task is rendered rather more difficult because of the lack of proper and standardised storage facility, and of the diversity of crops stored and differences in their valuation owing to the lack of standard grades. It is these difficulties that render it difficult for the bankers to enter into the field at present occupied by the indigenous bankers, nor will they be able to do so, so long as the above conditions are not standardised. A considerable part of the produce is brought to the towns or *mandis* where the *arhatiyas* operate. In these places goods are stored in pits, godowns, *Kothas*, or some other way under the *arhatiyas* who supply the finance to the villagers. It is only when they are in need of funds, they resort to the banks and obtain accommodation by pledging the goods. In such cases the integrity of the borrower, rather than the actual goods pledged, that constitutes the principal security. For, in some cases, it is found that goods are stored in *Kothas* where a rope is tied round and the seal of the bank is placed on it. This is considered enough by some banks for granting financial accommodation to their clients. Advances against stocks pledged are very common in the Punjab and some parts of the United Provinces. In others, however, the traditional conservatism of the merchants and the formalities attached with banking transactions have stood in the way of the establishment of a closer contact, parti-

cularly so where indigenous bankers or grain trade associations are ready to offer advances on competitive basis, and at times even at a cheaper rate along with greater facilities. In recent years, of course, this aversion is fast disappearing; but as the Report on Markets, Fairs and Produce Exchanges points out, "many instances were encountered...of merchants who financed their stocks of produce entirely from private source and who deprecated the idea of obtaining advances from a bank or any public institution as likely to lower their financial respectability in the eyes of their fellow traders." In the ports, however, the storage facilities are not so inadequate nor so primitive and un-standardised and hence no special difficulty is involved. Nowadays, the banks are having their own godowns or take godowns on rent and store the clients' goods in them. This is more secure from the banker's stand-point. For this type of advance there is no hard and fast rule about the documents to be used, each bank following its own way. But the most common document in use is the Demand Promissory Note. These advances may be seasonal in character in which no partial delivery is given or it may be in the nature of cash credit, when the Demand Promissory Note shows the sanctioned limit and not the actual amount taken. The Demand Promissory Note is accompanied by a Letter of Continuity, so that the account may not get exhausted. Before opening an account of this type, the banker, however, demands an applica-

tion for advance and a Letter of Pledge which gives the banker security in the court of law.

So long as the agricultural produce remains raw, it can be used as security and pledged with the banker for obtaining accommodation. But, when the raw produce has to undergo certain industrial process before it can be placed in the market, its possession cannot remain with the banker. It has to be placed in the hands of the mill or factory owner. Naturally, therefore, the risk involved seems at first sight to be very great, and this is the reason why money-lenders and indigenous bankers predominate in the field of financing these products. In recent years, however, the bankers are changing their attitude towards produce under hypothecation, and the verdict of a practical banker is that "experience.....has shown that though advances against hypothecation of goods are more risky than pledges, the percentage of loss through dishonesty of borrowers is very low". But even then, since the claim of the banker on produce under hypothecation is not accorded preferential treatment as against any other creditor, "vigilance on the part of banks is required".

When manufactured goods are offered as security the banker is faced with various considerations. For, these finished products have certain advantages as well as disadvantages over the raw produce as security. For, while a raw produce may have variety of uses, the use and consequently the market for the manufactured product are limited. But at the same time

manufactured products are standardised, durable and are forthcoming throughout the year. Besides, banking facilities are always available in big ports and industrial towns where such products are generally stored. Many of the products, again, have stable market.

Manufactured goods are of two types—those manufactured inside the country and those imported. In this country, the manufacturers have to give a number of facilities to the dealers, including financial assistance, storage and delivery of goods at stated intervals. Therefore, the dealers have to come to the bankers on a few occasions. For, if it is not possible for the dealers to sell out the previous consignment within the stipulated period, and are hence in need of funds to pay to the manufacturer, the dealers have to approach their bankers who grant accommodation against certificates issued by the manufacturers, working as warehousemen, in which they mention that particular goods are held on behalf of the bank and will only be delivered when order to that effect is received from the latter. The bankers do not refuse such accommodations against the certificates of the manufactures. It is convenient both to the dealer and the banker as also to the manufacturer. The manufacturer gets his funds on the expiry of stipulated period which he can re-invest. The dealer is relieved of the troubles about finance, storage and transport of goods while the banker's title to goods, in case of forced realisation, remains undisputed. Apart from this type, advances against goods manufactured in India are not very

common owing to the fact that neither the manufacturers nor the dealers are very particular about the invoices. The difficulty is enhanced in case of smaller businessmen who purchase from wholesale dealers in small lots, for, in their case, the manufacturer's invoices are not available at all. The invoices given by wholesalers for the small lots in which the goods are sold are not very accurate and hence not readily acceptable to the bankers. In such cases, whatever accommodation is available is on the personal credit of the borrower rather than on the invoices given by the manufacturer or wholesaler.

In the case of imported goods, however, manufacturers' invoices are always available and may be used for obtaining advances from the bank. In the case of direct imports, they may be kept in the warehouses at the ports either belonging to port authorities or private ones. In the former case, the certificates of port trust authorities are regarded as sufficient documents of title to goods and are acceptable to bankers. In the latter case the godown may be taken on rent either by the bank itself or by the party concerned and, after storing goods, transferred to the banker. Banks take godowns when a number of small consignments are to be stored, and charge proportionate rent. When, however, the shipment is a big one so as to cover the whole or most of the storing space, the godown may be taken by the importer or the banker and the rent may be paid as agreed on. In such cases, banks can easily advance against manufactured products under pledge.

Apart from the direct importers, a number of indent firms are also operating in our ports whose function is to arrange for imports on behalf of a number of small firms and who have got their own arrangements with manufacturers as regards the payment. The indent firms grant sufficient credit to their customers and offer warehouse services. The dealers, therefore, hardly take resort to the banker in such cases except when they fail to dispose of the goods within the stipulated period and have at the same time to take delivery of further consignments. Such cases are few, for the indent firms themselves compete with the banks in matters of providing banking services to their customers.

The above gives, in brief, an idea as to the bankers' advances against goods. It is clear that such advances are not only not much but also recent. It is true that advances against goods suffer from a number of drawbacks, particularly so when the goods are non-standardised, non-graded agricultural produce which is liable to deterioration and fraud as to quality and whose price fluctuates widely over the year. These are real drawbacks and need improvement before the bankers can safely employ their funds in these lines. But the greatest drawback is the absence of public warehouses. Warehousing is a specified function in western countries, with the recognition of law behind it, but it is conspicuous by its absence here. Under present circumstances, the bankers have to proceed with the existing primitive storage arrangements, of which the key is handed over to the banker granting accommodation.

Bankers in recent years have tried to come up to the situation and they offer all sorts of facilities to their customers, e. g., allowing them to show samples to customers, granting partial release against payment and even delivering goods at times against trust receipts, thereby allowing the borrower to despatch goods and repay the banker after negotiating the R/R or the B/L. In any case there are risks in these but yet they have to be undertaken under present handicaps.

The following documents of title to goods are in use in this country :—

(1) Bill of Lading (B/L)—This is the only document of title to goods which satisfies almost all characteristies of negotiable instruments. When goods are sent on consignment, banks advance a certain percentage of the invoice value. When the goods are sold out, the goods are delivered as soon as the branch or agent of the bank has received payment in proportion to the delivery. This type of advance runs the risk of fluctuation in price so long as the goods are not sold out and, hence, the retention of a sufficient margin would be a wise policy. When goods are sent to order, the B/L, accompanied by bill of exchange, is either purchased or discounted by the banker, and in the case of D/A bills, they are discounted in the foreign money market. When payment is received, accounts are settled. Another type of accommodation in use, though extremely restricted to first class parties only, is Shipping Lien Advance. This is granted to shippers to finance purchases of produce of various types from different

centres under a Letter of Hypothecation. When goods are so transported for the port of shipment, the R/R or the B/L is pledged with the bank. Weekly or fortnightly statements of account are to be submitted to the bank. Apparently this type of accommodation is risky and is, therefore, restricted. When the goods are shipped, the bills are discounted and the advances given by the bank paid off.

In import trade, accommodations required are few in view of the fact, that a considerable part of the import is effected through the indent firms. Only when goods are imported direct, the importer requires a letter of credit from the banker. When the documents arrive in this country, they are retired either by the payment in cash or by arranging for an advance against the goods from the banker. In the latter case, it is the banker who arranges for taking delivery of the goods and holding them in store, till they are taken delivery of, either whole or in part, by the client, on payment of the necessary amount.

In the coastal trade, advances from bankers are taken only in a few cases. These advances are given either as loans or a drawing limit is fixed in the current account up to which the customer can draw against the security of goods covered by the B/L. Such accommodations are taken only for a short period.

(2) Railway Receipt (R/R)—Another document of title to goods, which because of its increasing importance has in 1930 been included into the list

of documents of title to goods in the Sale of Goods Act, is the Railway Receipt. This document has assumed such an importance that it is today negotiated more or less like a B/L. This is due to the fact that in a vast country like India, a considerable volume of inland trade avails itself of the Railway services. For, the duration of transit in many cases is so long that the taking of advances against R/Rs becomes not a matter of choice but one of necessity. In any case, the security is provided by the goods in transit. Purchasers also at times require advances from their banker for retiring the bills when presented. Such accommodations are granted on the security of the R/R. The goods may then be taken delivery of by the banker or even by the purchaser in which case he is called upon to give a trust receipt for taking delivery and storing them in the godown of the bank.

(3) Miscellaneous Documents—In this group we may place the various documents like warehouse-keeper's certificate, dock-warrant, mate's receipt, wharfinger's receipt, etc. The common element in the above documents is that goods are held in the name of some person or firm and will be delivered to them or to their order. These documents are readily acceptable to the banker, in view of the fact that the title to goods, in case the bank provides accommodation, is undisputed. Once the document is endorsed in favour of the banker, it is as good as the goods lying in the hands of the banker. In India, however, these documents are not common,

because of the fact that private warehouses are almost non-existent and goods do not lie in the docks for any considerable length of time. Bonded warehouses are to be found in the ports and certificates issued by them are acceptable to the bankers. Thus to a limited extent the receipts of the Bengal Bonded Warehouses and also of Port Commissioners' warehouses are used as security for raising funds in Calcutta. These are used by persons who want to reship goods or to delay the payment of customs duty. On payment of a certain agreed margin, the banker retires the bill covering shipment; hence, the certificate of the bonded warehouse is issued in the name of the bank. Such advances by bankers are not given for more than a few months, except in exceptional cases. Delivery order is another such document; but it is not popular with the bankers. The characteristic feature of this document is that it is addressed to the owner of the warehouse, giving instructions regarding the delivery of goods stored there. But the defect in this document of title lies in the fact that until the banker takes possession of these goods, the ownership of the borrower remains and hence he may transfer it to some other party. Where such order is issued by persons having their own mills, the document is exposed to risk in so far as the goods may be non-existent or may have already been pledged. Only in case of respectable parties, where such orders are issued by third persons, are they acceptable to bankers. Even then it is better

that the banker should insist on having the goods transferred in his own name so that his title to goods may become free of risk. Another document which is in use in some centres to a limited extent is the certificate issued by baling presses of jute, cotton, yarn, etc, which are acceptable to the bankers. After these goods are pressed, they lie there awaiting despatch, during which period, their owners authorise the press to hold them in the name of the banker. In return, the press issues certificate, against which advances are freely obtained. Hessian delivery orders are an important class of documents in Calcutta.

Miscellaneous Services rendered by Bank :

The above discussion has given an idea as to the functions of a bank. Apart from the above main functions, the bank renders a number of subsidiary functions which may be noted in brief. The banks render a number of agency services which are of great advantage to the customers, and at the same time earn for the banker a small commission and goodwill of the customer. Among such services mention may be made of collection of promissory notes, coupons, dividends, salaries, pensions, etc., and also payment of premia, subscription, etc. The banker also purchases and sells shares on behalf of his customers. In this respect the position of the banker is that of a special agent working on behalf of the client in strict conformity with the instruction of the latter. The position of the banker is not, however, as safe as it is in some of the

western countries, where the banks themselves are the members of the local stock exchanges and exert a healthy influence on their operation. In our country, however, the banker has to operate through the broker and has, therefore, to shoulder greater responsibility in sending the instructions of the client to the broker as also in honouring the broker's cheques ; for, bothways, the responsibility is that of the banker, a state of affairs which may be avoided if the bankers themselves become the members of the stock exchange. The banker also serves as correspondent or representative of his customer and at times acts as trustee, executor. Some of the banks have opened separate subsidiary companies under them for specialising in some of these functions, e.g., the Central Executor & Trustee Co. Ltd. of the Central Bank of India, Ltd.

Apart from these agency services, the bankers also render a number of miscellaneous services, which though very important in other countries, have not assumed the same degree of influence in our country. In the first place, the bankers work as underwriters in the case of joint-stock concerns, as also they underwrite the issues of government loans and loans by local and municipal authorities. In India because of the existence of the managing agency system the underwriting of industrial securities is not common. Only in case of government debts, both central and provincial, the Reserve Bank is entrusted, under agreements concluded with each government, with the administration of public debt and the maintenance of accounts relating thereto. The duties

of the Reserve Bank comprise the issue of new rupee loans, collection and payment of interest and principal and consolidation, division, conversion, cancellation and and renewal of securities of the government and the keeping of all registers, books and accounts in connection therewith. The Bank is also the sole agent for investments by government either of government funds or of funds managed by the government. Secondly, the bankers deal in foreign exchange business, a line which in our country has remained a monopoly with the exchange banks. In the past, some of our own banks have tried to take to this line of business. But partly due to non-experience and partly due to the competition of exchange banks, these efforts have ended in failure. In recent years, however, both in the Calcutta and Bombay money markets, some of the banks are trying to push forward in these lines. It is essential that the government should assist them by imposing restrictions on exchange banks so that the competition may not be carried on unfair lines. Thirdly, the bank provides safe custody for the valuables of its customers, including bullion, ornaments, securities, deeds, etc. Finally, the issuing of bank drafts, of letters of credit, etc. falls within the category of miscellaneous services rendered by the bank. The bank drafts provide an easy and cheap means of remitting funds from one place to another. Letters of credit are of special importance to businessmen who do not have sufficient reputation or credit in the foreign market. This letter of credit is a document granted by the banker in which he

authorises some other banker in another place, acting as his agent or correspondent, to honour the drafts or cheques of the person named therein, upto the amount mentioned in it. These letters of credit may be clean or documentary, the latter being subject to the attachment of documents of title to goods, revocable and irrevocable letters of credit and circular letters of credit which are of importance to travellers. These are some of the miscellaneous services rendered by the bank.

CHAPTER VII

Commercial Banking Practice : Negotiable and other Instruments.

The meaning of the term 'Negotiability' may be made clear with the help of an illustration. If a bicycle or wrist watch is stolen, and if it is sold, the buyer, even though he pays for it, cannot retain it against true owner. But the same cannot be said about a currency note, a cheque or a bill of exchange, unless there is a definite indication to the contrary. Thus, in general, these are negotiable instruments and they are governed by the Negotiable Instruments Act, 1881. Before the passing of this Act, however, the negotiable instrument in India were governed, as in England, by the *law merchant* according to which no person could sue or be sued unless he

appeared as party by name or description on the face of the document. The present Indian law is founded on English law with minor changes to suit the particular circumstances. It should, however, be noted that the law is not a comprehensive one. For, after all, it governs a particular form of contract, the law of contract being a much wider statute. Therefore, the general provisions of the Indian Contract Act remain in force except in so far as the Act of 1881 has abrogated them. There is another limitation to this Act. The Act clearly mentions that it is concerned with bill of exchange, cheque and promissory note ; it does not refer to any other instrument, and even in the limited field, the Act does not deal with the transmission of rights in them by operation of law or by transfer *inter vivos*. In the case of other documents, they may be negotiable instruments if the transferee is a bonafide holder for value, capable of suing in the court of law in his own name and the document possessing the characteristic of transferability like cash by delivery by the custom of trade. Thus the debentures of the Bombay Improvement Trust are promissory notes within the meaning of the Act whereas share certificates, inspite of their passing from hand to hand with blank transfer deeds or a mate's receipt, are not negotiable instruments.

Negotiability is of three types—by custom, by statute and by estoppel. Custom is a sufficient factor ; but custom must be prevalent in the

country where the transaction has taken place, and must not be in vogue only in the country where the instrument may have originated. The strength or prevalence of custom is difficult to be stated in concrete terms ; hence it is enough that the custom prevails and is known to both the parties. Some documents like the bill of exchange, cheque, promissory note including currency note, though negotiable by custom originally, have now acquired negotiability under statute. Legal recognition by statute has been also accorded to a number of instruments which previously were negotiable by the custom of the trade. Certain instruments may again acquire negotiability by estoppel. An instrument which is not in its nature a negotiable instrument may acquire this quality by estoppel in the hands of the holder for value provided on its face that instrument purports to be transferable by delivery or by endorsement and delivery or provided that the former holder represented it to be such. This instrument is not negotiable in every case ; it is such only in those cases where the particular party has taken it as such. In the case of debentures, if the usage of stock exchange recognises them as negotiable instruments transferable by mere delivery, it will be treated as such and the court will recognise it. A few words may now be said about the different negotiable instruments in use in this country.

Cheque : According to the Negotiable Instruments Act of 1881, a "cheque is a bill of exchange drawn on a

specified banker and not expressed to be payable other than on demand." To be more clear, a cheque is a written order addressed to a banker by one of his customers and requiring the banker to pay on demand a stated sum of money to a person named or to bearer. (Cheque, however, is not legal tender and payment by cheque may be refused without prejudicing one's claim to be paid in legal form.) This is due to the fact that the element of confidence is the prime factor in the case of a cheque—confidence in the drawer having an account with the banker and that in the banker. (The two main characteristics of the cheque are that it is an unconditional order and that it is payable on demand.) If the payment on the document depends on the fulfilment of certain conditions, it cannot be regarded as a cheque. Payment on the cheque is to be made on demand, no matter whether the words 'on demand' actually occur on the cheque or not. The cheque again should contain a date which must be such as not to make the cheque stale, ante-dated or post-dated. At times for the sake of business convenience, the date is to be filled in by the payee, as also the amount, a practice which is not objected to by the banker. Other characteristics of a cheque are that it is drawn by a customer on specified banker, a feature which distinguishes it from a draft. The payee must be certain ; in other words, cheque must be payable to or to the order of a certain person or to bearer. In the case of a bearer cheque, it passes from hand

to hand without the endorsement of the payee or of any subsequent holder. In the case of an order cheque, however, the endorsement of the holder is required.

By endorsing the cheque, the payee becomes the endorser and the person in whose favour it is endorsed becomes the endorsee. In this way, by endorsements, it may pass from hand and hand. In the case of a bearer cheque, of course, endorsement of the payee is not required. But it is advisable to insist on it, as a condition for accepting the cheque ; for, it would be the evidence of his having been a party to the transaction. Whatever that may be, a payee should present a cheque for payment or collection to the bank as soon as he receives it or as early as possible. For, if it circulates too much, and is then presented to the banker, by that time, the account of the drawer may have been exhausted or some other contingency arisen.

Endorsement may be of various types. The most common form is blank endorsement which makes the cheque as good as a bearer cheque. It consists simply of the signature of the holder. In the case of special endorsement, however, the name of the endorsee must be given. In the case of restrictive endorsement, the further transferability of the cheque is prohibited and such a cheque cannot be treated as negotiable.

The endorsement must be in order. For this purpose the bankers have developed a number of rules

which must be followed by the customers. Some of these rules may be stated in brief. Thus the signature endorsed on an order cheque is to correspond to the name written on the face of the document. If a wrong spelling is given, the endorsement should be in the same way. The payee is, however, at liberty to add his correct name in bracket. Complimentary prefixes and suffixes and other courtsey titles as also titles, honours, ranks, etc., should not form a part of the endorsement. When the payee cannot write, thumb impression or marking of a cross is regarded as sufficient, though this form of endorsement is to be attested by a witness. Cheques made payable to more than one person must be endorsed by all, unless one of them is authorised duly to do so. Unmarried women are to endorse by writing their own name followed by surname. But when she is married and receives a cheque in her maiden name, she should write her name followed by her present surname, adding her previous surname at the end with the word '*nee*'. If, however, she is described by the name of her husband, she should endorse by writing her own name followed by her present surname and the words, "wife of so and so", or "widow of the late so and so". The above are some of the cases where the payee himself is endorsing. But cases may arise when one has to endorse on behalf of another person or concern which is more important in business, as in the case of a partnership or a joint-stock company. In the case of a partnership, since all partners have

equal rights any one of them can endorse on behalf of the partnership. This is not so in the case of a joint-stock company ; here only the person or persons duly authorised by the company can endorse in strict accordance with the instructions given by the directors, and they will have to add their designations. Even where private individuals are concerned cases may arise when one has to endorse on behalf of another. But in that case he must be duly authorised to do so and must indicate that he is endorsing on behalf of such and such person.

What is the position of the banker in case the endorsement is forged ? A banker is relieved of liability in case of forged or unauthorised endorsement provided he has paid amount in good faith and in ordinary course of business. The same is, however, not true in case the signature of the drawer is forged. For, it is required that the banker should know the signature of his customers and he is liable if he pays any amount countaining a forged signature of the drawer. Forging also takes place in the amount of the cheque by clever alteration and insertion of words and figures. Precaution should be taken against this in as many ways as possible, e. g., by using machines, by writing figures as closely as possible without leaving any gap in between, by marking across the cheque 'under Rs. ten' or as the case may be. But of all the precautions devised against forging, crossing is the most effective and largely in use.

A crossing consists of the name of a bank written

across the face of the cheque or of two parallel lines drawn across it with or without the words '& Co' between them. In case of a crossed cheque money is not to be paid over the counter but the bank must credit the amount to the credit of a customer or pay it to another bank which claims the amount on behalf of its own customer. The authority to cross a cheque is given either to the drawer or to the holder of the cheque and any holder may turn a general crossing into a special crossing. Crossing to two banks is not, however, allowed except when the cheque is crossed to one bank which cannot collect it himself but crosses it again to his collecting agent. The liability of the banker increases much more in the case of crossed cheque ; for here he has to act in strict accordance with the instructions given, any exception bringing liability on the banker.

As regards crossing, the Negotiable Instruments Act has been amended in April 1947 which makes the provisions in the law relating to the crossing of cheques applicable to bank drafts. Thus the Amendment has sought to regularise the growing practice of crossing bank drafts and it affords to bankers the same protection in respect of crossed bank drafts as is available to them under Sec. 131 of the Negotiable Instruments Act in respect of payments received in good faith for cheques crossed in their favour.

Crossing may be general and special. In the

case of general crossing, only two parallel lines with or without the words '& Co' will occur. In the case of special crossing however, the name of the bank to whom crossed is mentioned within or without parallel lines. Of the two, the latter is more safe and definite, for, here a person having no claim will find it difficult to obtain payment except through the bank mentioned therein and the bank will not collect the amount if the payee does not happen to be its customer. The transferability of a cheque is restricted if the words Account payee only are added to it.

What are the courses open to the holder of a cheque with regard to it and in what circumstance can a banker refuse to honour the cheque? He may, when it is an open cheque, carry it to the banker himself or send it through a bearer and receive the amount in cash. Or he may pass over the cheque to his creditor in settlement of a debt or sum due to the latter. Or he may deposit the cheque with his banker for collection, the amount being credited to his account. Of course, the most common form is the last one. For, a businessman would not like to receive cash and keep it idle with himself ; there is other inconvenience as well. For, when a cheque is received from a distant debtor on a bank having no branches here, it is difficult for him to go to the particular place simply for satisfying the intention of receiving money in cash. The settlement of a debt by a cheque received from abroad is also

not very common in view of the fact that the two amount will only rarely be in accord. Besides, there is risk in too much transference of a cheque and consequent delay ; for by the time the cheque is presented to the banker, the drawer may have exhaushed the account. Hence the deposit of a cheque with the banker is more convenient and less risky. In fact, the collection of the customers' cheques is a part of the ordinary business of the banks. For the sake of convenience in the collection of cheques, the clearing house organisation has been devised.

If the cheque is in proper order and the customer's account sufficient, the banker can have no objections in honouring the cheque. In certain cases, however, when the above general rule is not adhered to, the banker is authorised not to honour the cheque and to return it after indicating in brief the reason for such course. Some of these exceptions are as follows :

(1) Out of date—applies to stale cheques, when the drawee banker requires verification by drawer before payment is made.
(2) Refer to Drawer—when there is no fund or no sufficient fund or when the cheque is not provided for.
(3) Endorsement Irregular.
(4) Account closed.
(5) Cheque post-dated.
(6) Words and Figures differ.

(7) Alteration requires initials.
(8) Second endorsement required.
(9) Signature differs.
(10) Crossed two banks.
(11) No account at this bank.
(12) Effect not cleared—where cheques or other orders have been paid in by the drawer of the returned cheque but have not yet been collected.
(13) Instruction not to pay or payment stopped.
(14) Drawer Dead.
(15) Mutilated cheque—Distinction is, however, made between voluntary mutilation with a view to destroy the cheque and accidental mutilation or mutilation due to excessive handling. In case of doubt, the safe course is to refer the matter to the drawer.
(16) After notice of an act of bankruptcy on the part of the customer or on receipt of an order of the court garnisheeing his account.

The use of cheques in India was till recently almost negligible and although in recent years the use of cheques has increased to some extent, it does not compare favourably with its use in western countries. A number of reasons are responsibile for this. For some of them the banks, for others the customers and the government are responsible. Thus, till recently, the number of banking offices was inadequate and even now, though their number has increased, some areas are overbanked while others are suffering for want of

them, particularly in distant interiors. In England, it is not uncommon for banks to send a cashier and clerk to attend a country market for the day to receive and pay out cash. No exact counterpart of this practice has been met with in India. The drawing of the cheqne in a foreign language when most of our businessmen are ignorant of that has been another obstacle. In recent years some of the banks have agreed to honour cheques signed in Indian language provided the customer agreed to indemnify against any possible forgery. Only very few of them allow cheques to be drawn in Indian languages. This practice seems out of date when in the banks even the responsible posts are being held by Indians. The bankers can easily honour cheque drawn in Indian languages without demanding any indemnity from the customer. Another cause of unpopularity which no longer holds goods is that the people did not acquire for long the necessary confidence in the stability of the banks and realise the advantages of this form of currency. Facilities for the encashment of cheques were not very satisfactory and a lot of time was wasted to cash a cheque. Finally, the stamp duty on cheques acted as an obstacle upto 1927.

With a view to remove these unsatisfactory conditions and increase the cheque habit of the people, the Central Banking Enquiry Committee made a number of recommendations some of which remain to be fulfilled even to this day. The Committee writes, "Government can assist materially in spreading the cheque system in rural areas by accepting freely payment of land revenue

by cheque.....some of the Provincial Committees have suggested that local bodies should similarly encourage the use of cheques. We recommend that all municipalities and other local bodies should be asked to consider the feasibility of making and accepting payment by cheque on account of salaries to some of their employees and other items of receipts and disbursements. .....Merchants and traders should also be encouraged by banks to use cheques as far as possible instead of currency in the settlement of transactions in upcountry markets in connection with the movement of crops." The use of cheques should also be allowed in the case of savings bank deposits.

A few words may now be said about the clearing house organisation. The importance of a clearing house in the banking system does not need any emphasis. It is an essential part of the banking system. The principal clearing houses in India are situated at Calcutta, Bombay, Madras, Karachi, Cawnpore, Lahore and Delhi. The Imperial Bank, the Exchange Banks, most of the English banking agency firms and the more important local joint-stock banks, are on the list of members of the clearing house. In Bombay, clearing is effected in the premises of the Reserve Bank of India. In Calcutta, before the coming of the Reserve Bank, the premises of the Calcutta Clearing Banks Association were situated in the head office of the Imperial Bank building and final settlements were effected by means of cheques drawn upon the Imperial Bank. After the establishment of the Reserve

Bank the final settlements between clearing banks are effected through the Reserve Bank, but the premises continue to be located in the same place. In Madras also the Reserve Bank of India is in charge of clearing house arrangements. In the remaining places, it is the Imperial Bank who is in charge of it. The membership is restricted to the existing members and if any fresh member is to be enrolled, the approval of the existing members is to be taken. This conservative outlook has placed the smaller banks and even the newly started big banks into a difficult position, so far as the function of clearing is concerned. Their position became worse because of the attitude taken by the clearing banks. For, previously, these clearing banks used to collect cheques, drafts, etc., on non-clearing banks without charging any commission. But with the rapid increase in the number of banks, the work increased and so the clearing banks either refused to collect such cheques, drafts, etc., or charged a commission for this. In 1939, with a view to remove these difficulties and grievances, the Metropolitan Banking Association was formed. This is the only institution of its kind in India and from the information available it seems that the institution is making good progress. Similar difficulty, as in Calcutta, is being faced in the Bombay money market as well. Although no parallel institution has been organised till now yet pressure from various sources has forced the Bombay Clearing House to charge uniform rates for the collection of

cheques, drafts etc, on non-clearing banks, which was not a practice so far. In the interest of the banking system, a more rational attitude on the part of the clearing banks is essential.

Bill of Exchange : The Indian law has defined a Bill of Exchange as an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument. Thus like a cheque, a bill of exchange is an unconditional order in writing. But unlike a cheque it is addressed by one person to another, may be a banker, but generally on another businessman and may be either payable on demand or on the expiry of a particular period—in case of time bills, days of grace,—unless otherwise specified, are granted according to the custom prevailing ; not so in the case of cheques. Unlike a cheque or a demand bill, time bill needs acceptance of the party. The responsibility of the drawer of a cheque differs from that of a bill. For the drawer of a cheque is not discharged of his liability even if there is delay in presenting the cheque. In the case of the bill, however, if there is delay in presenting it, the responsibility falls on the banker. If a cheque is dishonoured, there is no need for a notice of protest being given ; for the liability of the drawer is first rate and in any case he must meet it. In the case of a bill however, if it is dishonoured by non-acceptance or by non-payment, this is to be noted and protested according to the procedure prescribed.

A bill of exchange may be either inland or foreign. An inland bill is one which is both drawn and payable within the country. A foreign bill may however be one which is drawn abroad and payable in this country or drawn in this country and payable abroad, or both drawn and payable abroad but negotiated in this country. Unless a bill is a demand bill, it is to be presented for acceptance which is nothing but the drawee's assent to the order contained in the bill. Before acceptance, the billl is technically known as a Draft. Acceptance may be of various types. In general acceptance the drawee gives his unqualified assent, and that is the one acceptable to the banker. If the assent given is a qualified one, qualified either by the imposition of any condition or as to the time, place and amount or qualified due to the acceptance by a few out of many drawees, in that case the holder may refuse to accept it and may treat the bill as if it has been dishonoured. If the banker takes a qualified bill, he does so on his own initiative and the drawer and the endorser, if any, previous to this acceptance, may renounce their liability. Time bills may be of various durations depending either on the understanding between the parties or on the custom in that trade In the case of time bills, three days of grace are generally added to the time granted for payment. If the last day of grace falls on some holiday, the bill becomes due on the previous business day.

As in the case of a cheque, so also in the case of a bill, the holder has several courses open to him. He may retain the bill till it matures and then present it

either himself or hand it over to the banker for collection, or he may part with the bill either by discounting it with the banker or by negotiating it with some private individual. Negotiation of a bill implies its transfer in such a way as to constitute the transferee the holder of the bill. A bill payable to the bearer is negotiated by mere delivery ; But a bill payable to order is negotiated by the endorsement of the existing holder. Endorsement may be in blank when it consists simply of the signature of the endorser. It is called a special endorsement when the name of the person in whose favour it is endorsed is given in it. The endorsement may be conditional i.e. subject to the fulfilment of certain conditions or partial as to the amount. If it is a restrictive endorsement, the further transferability of the bill is prohibited. When the endorser wants to limit or negative his liability, he may do so by giving a qualified endorsement in which he writes the words "Sans recours" or "without recourse to me." When the drawer or endorser wants to waive some or all of the duties of any future holder of a bill, say if he wants to waive the notice of dishonour so far as he is concerned, he can do so by giving a facultative endorsement. Finally, a few words may be said about accommodation bill. In this case the bill is drawn, accepted or endorsed without the value having been received or given for it. This is therefore a fictitious bill but is drawn merely for the purpose of lending the benefit of one's signature to the holder of the bill. Thus A may have helped B by giving his signature on the latter's bill as a result of which the

bill becomes acceptable to the banker which it was previously not. When the money falls due to the banker and the bill is presented to A for payment, A must pay the amount. But by this time, B must have put A in funds with which the latter will meet the demand of the bank. The advantage to B lies in the fact that in the mean time he can use the funds which on his own credit it would have been impossible for him to get. Since such bills are not genuinely trade bills, if the banker comes to know of them, they are not accepted for discount. But in fact there is nothing on the face of a bill which can enable the banker to distinguish accommodation bill from a genuine trade bill.

A bill is dishonoured either by non-acceptance or by non-payment. In such a case, unless the title of the holder is defective, he at once acquires a right to immediate payment by the drawer or by the endorser ; and the greater the number of the endorsers, the greater the safety of his position. But if the dishonour is due to any negligence on his part, i.e. if he fails to present a demand bill within reasonable time or if he fails to present a time bill duly, on the expiry of the stated period, the drawer and the endorsers can renounce their liability. The position of a banker in regard to a bill, as contrasted with that in case of a cheque, is therefore not an enviable one. When the bill is dishonoured, the banker would do well to have this fact noted by the notary public either upon the instrument itself or upon a slip of paper attached thereto. The banker may of course, without having it noted,

protest directly but it is better to have the fact noted and then proceed to protest ; for in the latter case the fact of dishonour is authenticated. The noting must be made within a reasonable time and must specify the reason. if any, of dishonour, the date and the signature of the Notary Public, an official appointed by the Government for the purpose. It is done by making a minute on the bill or on the paper attached therewith which contains the following details :—

(1) The fact of dishonour ;

(2) The date of dishonour ;

(3) The reasons, if any, given for such dishonour ;

(4) If the instrument is not expressly dishonoured the reason why the holder treats it as such ;

(5) Notary's charges ; and

(6) Notary's Initial.

Then the Notary takes the document to the drawee or acceptor for acceptance or payment as the case may be. If the drawer or acceptor persists in dishonouring it, the Notary prepares a minute specifying the particulars mentioned above. This minute is called Noting. But mere noting is not enough ; for it is no evidence of the presentment and dishonour of the bill unless the Notary gives evidence in support of it. This evidence is the Protest and is given either on the instrument itself or on a copy thereof if the original is not available. The protest contains :—

(1) The instrument itself or a literal transcript of the instrument and of everything written or printed upon it.

(2) Names of the persons for whom and against whom the instrument has been protested.

(3) A statement that payment or acceptance or better security as the case may be, has been demanded of such person by the notary public ; the terms of his answer, if any or a statement that he gave no answer or that he could not be found.

(4) When the note or bill has been dishonoured, the place and time of dishonour, and when better security has been refused, the place and time of refusal.

(5) The signature of the notary public making the protest ; and

(6) In the event of an acceptance for honour or of a payment for honour, the name of the person by whom, of the person for whom, and the manner in which, such acceptance or payment was offered and effected.

Protesting in case of foreign bills is of particular importance ; for if the matter is to come to the court of law, protest is essential. The law in many countries demands it and no other evidence of dishonour is admitted except the protest. Protest is however not essential in case of foreign promissory notes. In the case of inland bills, however, protest is not so very essential, though for authentic evidence of dishonour, it may be useful and so taken as an act of discretion. When a bill has been noted and protested for non-acceptance, and is not overdue, a person not already liable upon the bill may intervene and accept it for the honour of any party to the bill. In the same way, if the bill is

dishonoured by non-payment, a person may intervene and pay the bill for the honour of any party liable upon it. In any case, protest for non-acceptance must precede acceptance for honour and protest for non-payment must precede payment for honour. The object of this course of action is to save the credit of all or some of the parties liable on the bill and to prevent legal proceedings being taken against them. The intervenor for honour, after payment for the bill is made, has the right to recover the amount of the bill from the party for whose honour he has accepted and paid for the bill and all parties before him.

The Indian Stamp Act prescribes the duty that is to be paid on bills, both inland and foreign, and it varies according to the value of the bill. In case of demand bill in this country, however, as contrasted with that in England, no stamp duty is required.

If the acceptor of a bill finds it difficult to meet the bill on the expiry of the stipulated period, he may apply to the holder for the renewal of the bill, which he will accept. If the holder is satisfied in the credit of the acceptor, he may allow the renewal though he will be doing so at his own risk.

Promissory Note : A promissory note is an instrument in writing containing an unconditional undertaking signed by the maker, to pay a certain sum of money to, or to the order of, a certain person, or to the bearer of the instrument. Like a bill of exchange, a promissory note is also the result of credit transactions. When the oral promise to pay is not considered as

sufficient by the creditor, the promise of the debtor is converted into writing and is governed by the Negotiable Instruments Act.

The difference between a bill and a promissory note may be noted in brief. Unlike a bill, a promissory note is not drawn by the creditor but made by the debtor. Since the promissory note is never accepted, there is no acceptor and his place is taken by the maker, whose liability is the primary one. The maker of a promissory note stands in immediate relation with the payee but the drawer of an accepted bill stands in immediate relation to the acceptor. There is no other difference between bill and note as regards other parties. Secondly, the bill is an order to pay, whereas a note is a promise to pay. Thirdly, liabilities of parties to bill and note varies. The drawer of a bill when once it has been accepted, is liable only secondarily. But the maker of a note is the principal debtor and corresponds with the acceptor of a bill. Besides, when note is given by more than one maker, their liability may be joint or joint and several. In the case of bill, however, it is joint. Hence in the case of a note with joint and several liability, action, if necessary, may be taken against the makers either singly or in conjunction, simultaneously or one after another, till the full amount is recovered. Fourthly, the sections of the Act providing for presentment for acceptance, etc., which apply to a bill, do not apply to a note. Demand bills, however, are not accepted. Fifthly, a bill may be accepted conditionally but a promissory

note cannot be conditional. Sixthly, in case of dishonour of a bill, particularly foreign bill, it must be noted and protested. A promissory note, even if foreign, need not be protested. Finally, there is no stamp duty on bills payable on demand. In England, a two-penny stamp is essential in the case of demand bill. But all promissory notes require ad valorem stamps.

Thus we have seen that both bill and note are the outcome of credit transaction and we have also noted their similarities and differences. But then the bill possesses several advantanges over promissory note which makes the former more attractive to the trader. For, the bill is more secure an instrument than promissory note in so far as the former when accepted bears the signature of both drawer and acceptor. Even as negotiable instruments, bills have greater negotiablility and therefore command greater popularity. A promissory note is regarded more as acknowledgement of debt than a negotiable instrument.

In India however promissory notes are quite popular. At times even large amounts are raised by this device and is given preference to Hundis by smaller people. The main reason for this is to be found in the fact that because of limited negotiability, a promissory note ensures greater amount of secrecy, which is difficult to maintain either in the case of hundi or of a bill. The rules regarding payment, etc., are not very strict and hence those firms who can obtain advances on promissory notes will seldom use hundi. Only those shroffs who take advances from the bank do not accept

promissory note which is not accepted by bankers. They have to take hundi which is a two-named paper.

In May, 1946, the Bearer Promissory Notes (Prohibition of Issue) Ordinance was issued by the government which prohibited the banks from issuing promissory notes payble to bearer. These promissory notes did not contain the name of the original purchaser and passed from hand to hand as a negotiable instrument till maturity. Thus virtually they became notes so long as they circulated and hence constituted a violation of the principle laid down in Sec. 31 of the Reserve Bank Act under which the Bank is entrusted with the sole right of note issue. This section prohibits the issue of bills of exchange payable to bearer on demand. But since promissory notes are not mentioned therein, many new banks started the practice of issuing bearer promissory notes payable after a fixed period. Hence the ordinance was issued which lasted for six months. In November 1946, Sec. 31 of the Reserve Bank Act was amended as follows: "Notwithstanding any thing contained in the Negotiable Instruments Act, 1881, no person in British India, other than the Bank, or as expressly authorised by this Act, the central Government shall make or issue any promissory note expressed to be payable to the bearer of the instrument." The reaction of the business public to this was however unfavourable and the government action was regarded as unjustifiable and unwarranted.

In the case of small loans for short duration, even a promissory note is regarded as too complex an instru-

ment and hence the I. O. U. is devised. This also is an acknowledgement of debt but it contains no date on which money is to be paid back. Since it is not a promissory note, no stamp duty is required on it and hence is more economical. The I. O. U. is not a negotiable instrument. If the name of the creditor does not occur in it, it should *prima facie* be taken as an evidence of debt due to the person who possesses the document. If the maker of an I. O. U. does not pay the amount within a reasonable time, and if legal action is taken, the money is to be paid back on the date fixed by the court. Though it is not a promissory note and not a negotiable instrument, it is advantageous in case of small loans for short duration for which the expenses of stamp duty may be avoided.

Hundies :

The present chapter would remain incomplete if we do not consider Hundi, by far the most important instrument in use in this country. Hundi is also a bill of exchange but drawn in Indian language. This document has been in use since time immemorial and has developed a tradition behind it. But the usages and practices governing hundi are not the same nor is it a negotiable instrument within the definition of the Act. But where there is a conflict between the parties or where there is an express indication on the instrument to the effect that legal relations between the parties be governed by the Act, the Act shall apply.

A hundi is used to serve three purposes. In the first place, it is used for raising a loan and in this form

it corresponds to the finance bill. Secondly, hundi is used for the financing of trade. In that case it is very similar to a bill of exchange. But unlike the latter, the hundi is not accompanied by other documents of title. Thirdly, a hundi is used for the remittance of money, whether for purposes of trade or otherwise.

Broadly, hundies may be of two types—Darshani or Demand Draft and Muddati or Time Draft. Darshani hundi is used in the day-to-day business and in its popularity it may be compared to cheques in England and other western countries. Darshani hundis are generally payable on presentation but in some markets a few days of grace are allowed, which are however not uniform. Where the days of grace are allowed, even in case of darshani hundi, the acceptance of the payee is obtained soon after the draft is received. No stamp duty is payable on darshani hundi. The darshani hundi may be written on an ordinary paper; but the shroffs generally use printed forms for this purpose. Brokers play an important part in getting the hundis discounted, for which they charge a small brokerage which normally varies from 3 to 6 pies per hundred rupees and is payable by the buyer or by the individual or firm discounting the hundi. When hundi is used for the remittance of money or for realising a loan from the debtor, the shroff charges a fee varying from 6 pies to an anna per hundred rupees. Although not a negotiable instrument within the meaning of the Act, they have sufficient negotiability among the indigenous bankers and are even rediscounted by joint stock banks when presented by approved customers.

Muddati hundi is one of the most important instruments handled by the shroffs. Unlike the darshani hundi, it is payable after a specified period usually varying from 21 to 61 days. The period for which muddati hundi may be drawn is not fixed either by law or by custom ; but generally it does not exceed 11 months. The muddati hundi is written on a stamped paper, the stamp duty being annas two per Rs. 1000/- or any part thereof. Brokerage charged on muddati hundi is almost the same as in case of darshani hundi but in the case of weak and doubtful parties, whose credit is not sufficient, it may go as high as Rs 5/- per cent. The security against the muddati hundi is mainly personal, but at times the discounting broker may demand the signature of persons or firms of integrity, known to himself, in order to safeguard against any possible loss. Since muddati hundi is negotiable, though not within the meaning of the Act, it may be rediscounted for a number of times. Every time it is rediscounted, it is re-indorsed and this increases the safety of the instrument and makes it more readily acceptable. When the date for payment falls due, it is presented by the holder to the firm which originally executed it. The hundi is hardly, dishonoured ; for, the inability to honour one's hundi is considered as very serious ; it ruins his credit and is virtually taken as a declaration of insolvency. However, if it is dishonoured, the holder can claim the amount from any of the parties who have endorsed it.

The banks are nowadays beginning to take interest in

hundi transactions and therefore the business practice is also being modified. When goods are sent to some place, it is usually customary for the consignor to send R/R. accompanied by a darshani hundi drawn on the consignee through a bank or through another party known to the sender. The R/R is handed over to the consignee after he has honoured the darshani hundi. In other cases, where the value of goods is Rs. 100/- or less, the R/R is sent direct to the customer per V. P. P. When the business is of long standing, the R/R along with the hundi may be sent direct.

The premia and discounts on hundi depend on the nature and extent of demand for remittance on a particular market. When there is a heavy demand for making remittances to any particular market, hundis payble there often sell at a premium. When there is less or no demand, they sell at a discount. The limits of premium and discount are determined by the cost of making remittances by bank drafts in places where banking facilities are available. Where however no banking facilities are available, the limits are wide enough and may rise even to 1 p. c. Much again depends on the status of the drawer and endorser. When the drawer and endorsers are well known firms, they are discounted at favourable rates.

The reduction of stamp duty has been a step towards the increased use of muddati hundi. As it is, however, a number of reforms may yet be made which, if introduced, will be a step forward towards their greater popularisation. In the first place the rediscounting facilities

available to indigenous bankers in the organised money market in general and with the Reserve Bank in particular should be improved. The use of hundi should not remain restricted to the indigenous bankers. Even co-operative banks should be encouraged to deal in them. This step has been considered to be full of great possibilities and it is hoped in certain quarters that in this way "the distant parts of the province can in course of time be linked to the central money market. Besides, an arrangement should be made for revalidating the noting of dishonour and protest by recognised associations of bankers, merchants or shroffs, so that the holder may be saved of a lot of trouble and expenses.

The seasonal stringency in the money market arising out of the movement of crops has been too wellknown to need mention. Now, after the establishment of the Reserve Bank and the adoption of the proportional reserve system, the situation has been relieved to some extent. This is also partly due to the prevalence of the easy money conditions in recent years. But before 1930 the arrangement was most haphazard. The Government of India used to supply the deficiency in the money market by the issue of emergency currency against hundis held by the Imperial Bank. The Imperial Bank was however seldom able to tender a sufficient volume of bills against which the required amount of additional currency could be issued. Therefore, the Imperial Bank had to take resort to the doubtful expedient of getting cash-credits granted by it to its customers converted into hundi transactions with a view to being

put up as cover against the Bank's borrowings from Paper Currency Reserve. In order to remove this difficulty the Bombay Provincial Banking Enquiry Committee made a suggestion for the development of a discount market which does not seem to have exhausted its usefulness even to this day, and may be considered here not only for the popularisation of the hundi but also for improving the condition in the money market. In the words of the committee, "All these difficulties will be obviated, nay, the seasonal strain on currency itself will be greatly mitigated if proper inducement is offered to the people to draw hundis and accept hundis drawn on them and if in consequence a regular discount market comes into being. For the creation of a discount market for hundi in the mofussil, it will be necessary to open branches of banks at several places. Such branches will not however be paying propositions. We would therefore suggest that co-operative banks and the indigenous bankers should be encouraged to do hundi business at such centres, working, if it can be arranged, as agents of the Imperial Bank" (now Reserve Bank).

We have considered above two types of hundis. These two types however assume different character according as one or other condition is imposed. Thus in case of a Shah Jog Hundi, the instrument is drawn by one merchant or some other merchant asking the drawee not to pay the amount to any and every person but only to a shah or a respectable holder. This is as good as special crossing on a cheque and the liability

of the drawee in case of such hundis is practically the same as that of a paying banker in respect of crossed bearer cheques. This type of hundi passes freely from hand to hand and without endorsement. There have of course been cases of bogus *shahs* and the decisions of the court have held the drawee as liable for making payment to the unknown person in contravention of the instruction implied by the *Shah Jog* Hundi. The tendency in some money markets is towards removing these restrictions. Thus in Bombay Presidency, under the initiative taken by the Bombay Shroffs' Association, a new form of hundi has been introduced which is known as *Dekhadnar Jog* hundi or instrument payable to the bearer on presentation. This form is in use in Bombay and Gujerat.

Another form of hundi is the *Jokhmi* Hundi. This is an instrument which indicates how the Indian inventive genius had combined banking with insurance when risk was involved in transit. Therefore *Jokhmi* Hundi is in the nature of a policy of insurance, but the difference is that money is to be paid by the underwriter beforehand and will be recovered if the goods arrive safely. Naturally, therefore, there will be three parties to this instrument, the consignor, the underwriters and the consignee. The consignor despatches the goods, draws a hundi and sells it to the insurer for cash, depending on the value of the hundi minus insurance charges. The insurer sends the hundi to his branch at destination for collection. When the goods arrive safely, the hundi is presented to the

consignee who pays for it and takes it from the holder. Be it noted here that if the consignee refuses to pay, the holder has no other alternative but to take the goods himself and settle the matter with the consignor. The holder of the hundi cannot sue the consignee in the court of law in case of non-acceptance or non-payment. If the goods are lost in transit, it falls on the shoulders of the insurer and the hundi cannot be presented. But in the case of damage or partial loss, the holder has the right to receive the full amount, for he insured the goods against total loss, but not against partial loss or damage.

A *Namjog* Hundi is one which is payable to the party named in the bill or his order. If a *nam jog* hundi is accompanied by a descriptive roll of the party in whose favour it is granted, its transfer becomes restricted. When however it is not so accompanied, it may be transferred by endorsement.

In case of a *Jowabee* Hundi, the nature of the transaction is as follows. A person who is to remit money writes to the payee and delivers the letter to the banker who either endorses it on to any of his correspondents near the payee's place or negotiates its transfer. When the letter arrives, it is forwarded to the payee. The payee attends and gives his receipt in the form of an answer to the letter which is sent through the same channel to the drawer of the first documents.

Two other forms of hundi are *Dhani jog* and *Farman jog*, the former being payable to the holder and the latter to order. But these instruments are in little use.

A few words may now be said about *Ztckrichit.* A *Zickrichit* is a letter of protection given to the holder of the Hundi or any other negotiable instrument by any of the previous parties. This letter of protection is generally addressed to some resident at destination where the payment for hundi falls due and requests him to take the hundi in case it is dishonoured by the drawee.

Appendix on the effect of partition of India on Commercial Banking

Although the muslims, particularly in the west coast of India, had participated in the trade of this country, yet so far as banking is concerned, it was a monopoly of the Hindus, a state of affairs which has not changed even after the coming of the organised banking in this country. Thus at the time of partition, organised Indian banking as also indigenous banking was practically in the hands of the Hindus. Leaving aside the foreign exchange banks, the Indian banks may be divided into two types, viz., banks originating and principally functioning in the territories now constituting Pakistan and banks originating and principally functioning outside. But even the former banks which have their origin and principal function in the territories comprising Pakistan are owned, operated, manned and used principally by the Hindus. It is not possible to indicate the exact statistical position ; for, statistics on the communal lines have not so far been collected. But that the above assertion is true is beyond doubt.

For sometime before the partition there was a tendency for developing Muslim banks ; but they did not grow much in size and many of them dissappeared within a very short period of their appearance. Even those Muslim banks which exist have only very limited resources and limited fields of activity.

Turning next to the effects of partition on the banks which predominantly functioned in the territories comprising Pakistan , the effects were two-fold, viz., the transference of many of these banks from the Pakistan territories to the Indian Union and financial losses suffered by these banks. Some of the big banks had anticipated that big changes were imminent in the political field. This had in particular happened in the Punjab where the banks began to transfer their principal offices to East Punjab and Delhi, the lead having been taken by the Punjab National Bank which had transferred its principal office to Delhi. In Bengal, banks falling in Pakistan have either transferred their principal offices to Calcutta or have done so nominally, still continuing in Pakistan so far as the most important part of their business is concerned. In the Punjab, however, partition was followed by the worst type of civil commotion and hence although the banks had transferred their principal offices to East Punjab or Delhi it is not possible to remove everything and hence they have suffered considerable financial losses, the exact statistics for which, however, are not available, and their offices in Pakistan, in so far as they exist, have ceased functioning for lack of personnel, dislocation of trade

and commerce and lack of any security whatever. The matter has been rendered worse by the fact that the business records of the banks functioning in Pakistan have been blockaded and hence it is not possible to know their exact position, except only in the case of the Imperial Bank which had developed a system of maintaining a duplicate record in anticipation of the coming troubles.

So far as the Government is concerned, they have taken certain steps to meet the situation. Thus Section 17 of the Reserve Bank of India Act which had imposed restrictions on the lending powers of the Government and which therefore stood in the way of the Bank's being sufficiently helpful to the member banks in critical times has been repealed. Now the Bank is in a position to advance to any bank on any security which it considers fit, i. e., against the collateral against which the member banks have advanced their funds to the customers. An Ordinance, known as the East Punjab and Delhi Banking Ordinance has been promulgated by the government which has given power to the banks seeking aid under it to declare a moratorium which will run to three months, the withdrawals being restricted to a very small figure. A similar ordinance has been passed by the Pakistan Government for protecting the interests of the Pakistan branches of the banks which sought protection under it. The government of India has set aside a sum of Rs. one crore for the sake of the rehabilitation of the affected banks.

The distribution of Indian banks and Exchange Banks in Pakistan territories can be seen from the following table :

Indian Banks including Muslim banks			Exchange Banks		
West Punjab	...	251	Karachi	...	8
N. W. F. P.	...	25	Lahore	...	4
Baluchisthan	...	7	Peshawar	...	4
Sind	...	5	Quetta	...	1
East Bengal	...	122	Rawalpindi	...	1
			Chittgong	...	1
	Total	410		Total	19

The banking resources of Pakistan can be seen from the following table :

Sources : *Commerce Annual Review Number, 1947.*

(Value in Lakhs of Rupees)

	Demand Liabilities		Time Liabilities		Cash Balance		Advances.	
Week ended.	I.u. 1947	P.	I.u	P.	I.u.	P.	I.u.	P.
Agst. 22	62502	6547	30433	3946	3608	509	35947	4364
	(91)	(9)	(89)	(11)	(88)	(12)	(89)	(11)
Sept. 26	63419	6478	30792	3823	3540	440	35508	4327
	(91)	(9)	(89)	(11)	(89)	(11)	(89)	(11)
Oct. 31	65056	7004	31314	3112	3655	437	37092	3522
	(90)	(10)	(91)	(9)	(89)	(11)	(91)	(9)
Nov. 28	65442	7748	31136	3090	3551	482	36461	3859
	(89)	(11)	(91)	(9)	(88)	(12)	(90)	(10)
Dec. 5	65628	7834	31239	3025	3640	406	36506	3883
	(89)	(11)	(91)	(9)	(90)	(10)	(90)	(10)

I. U. Indian Union ; P. Pakistan.

The future of banking in Pakistan is difficult to predict. But inspite of all the assurances given by the Government, this much seems also evident that Indian banks with Hindu or Sikh personnel will not have good days in business in Pakistan owing to open restrictions or created disadvantages. Thus they will have practically to withdraw from the field and the gap thus created will naturally be taken advantage of by the foreign exchange banks which inspite of all troubles and inconveniences are still now able to function in the Pakistan territories. These banks which have a monopoly of foreign exchange business and were just pushing in the field of internal trade finance will come to assume an important place in the latter field even. It may be argued that the banking business will be developed by the Muslim banks provided the new state gives assistance which it will do. But then any businesss, banking being no exception, requires a long experience, tradition and goodwill which cannot be obtained or created in a single day, however strong may be the help rendered by the government. In the near future, therefore, the foreign exchange banks may be expected to continue to play an important role both in inland trade and foreign trade finances of Pakistan.

CHAPTER VIII

Investment Banking

Introduction: The underlying principles of investment banking have been enunciated in connection with our discussion on German banking. It has been seen that German banking started its career as shareholders' banks for providing long-term finance to industries. They hardly received any deposits and hence could take the risk underlying long-term investment which ordinary commercial banks cannot do. For, the latter have to deal with other people's money and so they cannot sacrifice the principle of 'safety first'. The investment banks are shareholders' banks wherein the shareholders put in their money for earning profit. Hence, profitability and not liquidity is the underlying feature of investment banking. That does not however mean that the bank injudiciously invests the money entrusted to it. In investment policy, it tries to avoid risk as far as practicable. That is to say, it does not shoulder unnecessary risk. But certain amount of risk-taking is unavoidable in this type of banking business. And so far as liquidity is concerned, that is not the principal concern of the investment bank, in so far as the money entrusted to it is not in the form of short-term deposits, but in the form of shareholding by its members. But

then, as already said, in the days where stock exchanges are functioning in all the principal cities, no paper, whether short-dated or long-dated is perfectly illiquid, in so far as it can be encashed in the stock exchange, may be at a discount or at a premium according as the particular paper stands in the market.

It should however be borne in mind that investment bank is not the same as investment trust. The underlying features of their organisation are entirely different. So far as investment trusts are concerned, it issues shares or bonds for sale among the prospective investors. With the proceeds that they get in this way, they purchase an assortment of securities in various companies, not for control, but only for investment. Out of the interest and dividends received, they pay interests and dividends on their own securiries. The success of an investment trust depends on whether the directorate consists of fully qualified men of undoubted standing and repute in the financial world or not. Not so in case of the investment banker. For, the invesment banker buys securities primarily for sale. If the selection is wrong, the investment banker suffers in good-will. For, the payment of dividend or otherwise will not go to the investment banker, but to the holder of the securities. As already said, the investment trust purchases securities not for transfer but for holding them, any profit or loss being borne by the trust organisation. All questions of purchase, transfer and sale of securities are to be decided by the directors, of course, sometimes within the prescribed limit. They have their discretion. It

is of course true that if the investment trust makes a profit, it will add not to the personal benefit of the directors but to that of the shareholders of the investment trust, but even then it must be admitted that the relation of shareholders is an indirect one, while that of the investment trust vis-a-vis the concerns in which it has invested is a direct one. Not so in case of investment banker. It follows as a corollary from this that while the investment banker is always on the alert to protect its own interests, the investment banker's interest being remote, he is less cautious and his sole interest lies in passing the securities over to somebody else.

It has already been pointed out that in the years following the first World War, the problem of the supply of long-term finance to industry became a complex one particularly in those countries, like England, where investment banking had been non-existent. To meet the situation, however, the existing commercial banks and even the central bank deviated from orthodox lines and began to make some arrangement for the supply of long-term finance to industries. In fact, a tendency towards mixed banking became visible in many countries ; and although in England the distinction between commercial and investment banking was not blurred over, yet the banking system organised some such institutions as the Bankers' Industrial Development Company for supplying, or for arranging the suppy of, long-term finance to industries. The problem was equally acute in the post-depression years. For, the depression had resulted in the decline of prices while

cost factors were rigid. Hence the advanced industrial nations launched on a programme of rationalisation and reorganisation which in its turn needed money. Hence the deviation of commercial banks from orthodox lines in the years following the first World War, though expected to be short-lived in the first instance, became more or less a permanent feature of banking practice.

Industrial Finance in Britain :—In this conection, a study of the supply of long-term finance to industry in Britain is interesting, in so far as this country was regarded as the traditional home of commercial banking. The developments in the post-war and post-depression periods have already been indicated. With the outbreak of the second World War the problem assumed a new appearance. The Banker's Industrial Development Company, which had about it it a half-apologetic air, and which had declared its intention of non-permanence even at the time of its inception, laid down its office by reducing its nominal capital from £ 6 millions to £ 6000, and repaid almost all its paid-up capital. The skeleton of the organisation has however been kept intact. Apart from this, however, there is hardly any evidence of industrial banking in Britain. In recent years, however, owing to the decline in their business, a number of merchant bankers acquired, either directly or through subsidiaries, participating interests in the capital of the concerns with which they were connected either by personal or by normal banking connections. This they have done by developing new-issue business and this in its turn

has created a more direct and permanent interest between the issuing houses and the industrial firms, particularly the smaller ones which do not have corporate reserve.

With the outbreak of the war, however, this "somewhat negative record of British banking in supplying long-term capital needs of industry" had been reversed. The free operation of the money market had been changed in favour of control. Thus the Defence Regulations forbade all capital issues over £ 10,000, and a Capital Issues Advisory Commitee was formed to work as a watchdog over the money market. The object of this control was to canalise the savings of the nation into Government issues and essential industrial activities. In case of essential industries, the Ministry of supply, the Admiralty and the Ministry of Aircraft Production would erect or extend the factories and instal machinery and other permanent equipments in the form of an "embodiment loan". All these measures became essential partly because of the fact that the purely war industries would not operate under private initiative only and partly because it was felt necessary to make the best possible use of available national capital under state supervision.

With the approach of post-war years it was felt that some organised agency for industrial finance should be provided for helping the industrial concerns in post-war years. Accordingly the Finance Corporation for Industry was started in January, 1945 with an authorised share capital of £ 25 million and an additional

borrowing power at £ 10 million. By March 1947 the paid-up capital of the Corporation was £ 500,000 and with £ 15,43,300 of advances from bankers, the total funds employed went up to £ 20,43,300. The actual amounts advanced to industry in the form of loans or share subscriptions were £ 1,862,051 and by the end of the year it had entered into definite commitments to the extent of £ 40,733,000 and documents for a further sum of £ 47,38,000 were in preparation. Thus the F. C. I. is now making satisfactory progress though in the first year of its working it incurred a loss of £ 16,085. This, it is said, was due to the time-lag between the conclusion of agreements and the utilisation of the facilities for which they provide, a lag which has further been accentuated owing to uncertainties and delays in obtaining the requisite materials and equipment for carrying out the approved project.

At the end of the war, the Industrial and Commercial Finance Corporation, another and a special institution created by the British Government, was started to help in the financing of industrial reconstruction. By september, 1947, on the completion of two years of its working, the advances and investments by I.C. F.C. amounted to £ 10,500,000, of which £ 57,16,000 had already been taken up. This clearly indicates that there is a considerable "credit gap" which cannot be filled in by the banks and other financing institutions, and hence this new institution, within a short period of its existence, has come to occupy a definite place in the capital market. For insuring against risk which is

inherent in industrial finance, a sum of £ 140,000 has been set aside. Practically all industrial areas in the country have sought accommodation, roughly in proportion to their employed population, the share of London being about 25 p. c.

Industrial Finance in India: The details of industrial finance in India have been considered in my *Indian Business—Volume One.* A few words may be said here about the role of banks in this matter. The assistance rendered by banks in matters of the supply of long-term finance to industries is extremely inadequate. This must however not be taken to mean that no efforts were made in this country to supply long-term finance; but these attempts were either localised or inadequate and based on unsound foundation, pursuing wrong financial policy. During the early days of the *swadeshi movement*, a number of banks supplying long-term finance cropped up, mostly in the Punjab, but most of them could not survive the bank failure in 1913-16. Once more during the post-war boom a number of industrial banks were registered. Whatever might have been the original objective with which these banks were started, the fact remains that within a few years of their inception, they were found to be carrying on commercial banking business, while one of them, the Tata Industrial Bank went into voluntary liquidation in 1923 and was amalgamated with the Central Bank of India. Thus as yet there is no organised institution on scientific lines to cater to the needs of big industries for long-term finance.

A few words may be said here about the proposed Industrial Finance Corporation regarding which a bill has been introduced in the Legislature. The purpose of establishing the I. F. C. has been described as "making medium and long term credits more readily available to industrial concerns in British India." The share capital of this Corporation will be Rs 5 crores divided into 2000 shares of Rs 25,000 each, being fully paid-up. Of this the Central Government and the Reserve Bank will each subscribe 400 shares each while as many as 800 shares will be allotted to the scheduled banks, the balance of 400 shares being available for distribution among insurance companies, investment trusts and other financial institutions in such manner as the Board may think fit having regard however to the desirability of distributing the shares and the voting rights attached thereto as widely as possible. The shares will be guaranteed by the Central Government, as to both the repayment of principal and the payment of dividend at a rate not exceeding $2\frac{1}{2}$ p.c. per annum. The Corporation will not be liable to pay incometax or supertax on its income and profits but the dividend paid by it to the shareholders will be liable to these taxes. The surplus profits of the Corporation, after payment of dividend not exceeding 5 p.c. and building up a reserve fund of Rs. 5 crores will be payable to the Central Government.

APPENDIX ON
INDUSTRIAL FINANCE CORPORATION

Since the above lines were written, the Bill for the establishment of an Industrial Finance Corporation has been passed. The Finance minister expressed the hope that "with the inauguration of this Corporation this gap will be filled and by the assistance and advice which this Corporation will be in a position to give we will see a large-scale expansion of industry in this country as speedily and rapidly as possible." The following important changes have been made in the Bill by the Select Committee :

(1) The services of the Corporation will be available not only to Indian Provinces but also the states which have acceded to India.

(2) The financial aid will be available only to public limited companies and co-operative societies.

(3) The capital structure has been raised to Rs. 10 crores, of which Rs. 5 crores would be immediateiy issued for subscription and the balance might be issued by the Corporation as and when found necessary with the previous consent of the Central Government.

(4) Among the classes of institutional investors, the Select Committee has also elected co-operative banks. The share capital should be confined to institutional investors and not to private individuals.

(5) The Central Government had undertaken to guarantee the return both of the capital and the payment

of a certain minimum dividend. In the Bill it was provided that the guaranteed dividend should not exceed 2½ p. c. The select committee has thought it fit to leave the matter to the central govt., who would determine the dividend according to the conditions in the money market at the time when the shares were issued. The govt. would guarantee only that minimum which was considered necessary to attract the necessary capital.

(6) The management of the Corporation would be entrusted to a board of 12, half of whom would be nominated by the central govt., and the Reserve Bank and the remaining half by the other shareholders. It has also been provided that the administration might appoint advisory committees.

(7) The borrowing powers of the Corporation would be five times the paid-up capital and reserve funds. The Corporation would accept fixed deposits from the public for a period of 5 years, instead of 10, as originally provided.

(8) The Corporation was empowered to make loans either in Indian currency or in any foreign currency, if it was thought appropriate. This provision was necessary because in the present state of affairs, industrial concerns in India would be requiring capital abroad for the purchase of plant and equipment, but may find it difficult to obtain necessary foreign exchange.

Agricultural Finance in India : Experience in all countries of agricultural importance shows that the supply of finance is the most crucial problem. The

nature of the agricultural occupation being what it is, the agriculturist has to go in for borrowing from the existing agencies, whatever they may be and however defective they may be. Even in the U. S. A., as in India at present, before the present Federal Farm Land Banks had come into existence, money lenders predominated along with all their defects and had to be tolerated as a dangerous necessity till the Land Banks came into existence.

The financial requirements of the cultivators are of two types, viz., short term and long term, the former being required for financing the process of cultivation while the latter for long run improvement of agriculture. In India, however the distinction fails because of the fact that loans are taken mostly for unproductive uses and hardly for effecting permanent improvement in agriculture. The loans taken being often consumed up and the paying capacity of the agriculturist being low, the short term loans are not paid even for a long period of time and hence in effect become long term loans without having the good aspect of it, viz, permanent improvement of agriculture as an occupation.

The most important agency of rural finance in India is the money lender. He not only finances the agricultural operations but also acts as the village trader assembling the products of the agriculturists and sending them to the town markets. The money lender therefore comes into close contact with the villagers. But the terms of lending are mostly unfavourable, the rate of interest being exorbitantly high. Besides,

another serious charge against the money lender is that once the agriculturist falls into his grip, there is no outlet for his escape, and he is exploited by the money lender to the utmost possible extent.

The charges are not wholly wrong. But under existing conditions when there is no organised system of agricultural finance, the money lender, however dangerous, and hence undesirable he may be, is still a necessity. Since the introduction of Provincial Autonomy, the tendency has been for all popular governments to control money lending. However desirable in themselves the various money lending legislations may be, it must be recognised that they have created a new problem without solving the existing one. Since there is no other organised agency of agricultural finance as yet, the agriculturist has no other alternative than to come to the money lenders.

Leaving aside the money lender who is the most important agency of agricultural finance, there are three other sources which, though not very important, need mention. They are : the government, the co-operative movement and the Reserve Bank of India. The problem of agricultural finance came to be recognised by the goverment in the last century and a number of Takavi Loans Acts were passed in 1871, 1876 and 1879. But these were not much effective. These were followed by the Land Improvement Loans Act of 1883 and and Agriculturists Loans Act of 1884 ; but loans given under these Acts were very scanty. Thus under the previous Act provision was made for distributing

Rs. 35 lakhs for the whole of India which was too inadequate in view of the intensity of the problem. The latter Act provided for short term finance but was hardly resorted to except in times of stress. Besides, these loans were not popular, partly because they often imperilled the credit of the agriculturist with the money lender and partly because the procedure for taking them being round-about and dilatory was unknown to many.

The next source of agricultural finance worth any mention is the co-operative movement. The ideal of self-help which is the very foundation of the movement is surely laudable, and the movement, as practised in Germany before the first World war, has achieved wonders. Of all the provinces Bombay is the most advanced so far as co-operative credit is concerned, and yet hardly 10 p. c. of the requirement is supplied by the co-operative sources, the remainder coming from the money lenders. The Bombay Banking Enquiry Committee pointed out even before the depression that the share of the co-operative societies in financing agriculture "is considerably smaller than that of the *Sowcar* and the *Quasi-Sowcar*." And the Assam Banking Enquiry Committee pointed out that "so far as we can see, the exploitation of cultivators by the village mahajans.....by village money lenders..... ex-tea garden coolies and others is on the increase." The progress of the co-operative movement during the last thirty years may be seen from the following table :

(Source : *Thirty years of co-operation in India.* Published by the Reserve Bank of India.

	1943-44			1944-45		
	Total Br India	Total Indian States	Grand Total	Total Br. India	Total Indian States	Grand Total
Population (millions)	303.5	59.1	362.6	306.3	60.2	366.5
Provincial and Central Bank and Unions.	483	128	611	480	133	613
Supervising & Guaranteeing Unions.	389	36	425	396	36	432
Land mortgage bar ks & other agricultural Societies	114004	21082	135086	114534	22113	136647
Non-Agricultural Societies	15674	3910	19584	17934	4007	21941
Total Number of Societies	130550	25156	155706	133344	26289	159633
Number of Societies per 1 lakh of population	43	42.6	42.9	43.5	43.7	43.6
(Value in thousands of rupees)						
Paid up Capital	147054	28341	175395	169253	32808	202061
Loans and Deposits from						
Members	120864	23364	144263	157085	28510	185595
Societies	84164	8399	92563	98417	9804	108221
Provincial & Central Banks	207124	17358	224482	219128	14618	233746
Government	10639	7541	18180	6950	7290	14240
Non-member & other Sourses	347204	37376	384580	379290	39814	419104
Borrowing of Land Mortgage Banks and Societies	61893	6079	67972	63734	6255	69989
Reserve fund	121481	19346	140827	128610	20989	149599
Other funds	63073	10812	73885	71755	12028	83783
TOTAL	1163406	158651	1322147	1204222	172116	1466338
Number of annas per head of population	61	43	58	67 6	458	640

It will be seen from the above table that after thirty years of working, the co-operative movement has made inadequate progress. The co-operative credit society can at most supply the short term finances ; but they are unsuited for supplying long term finances. At the same time the need for long term finance is very great not only for the payment of debts but also for the long run improvement of agriculture. With this end in view, a number of land mortgage banks have been established in different parts but so far their success has been negligible. Even in Madras where they have made the greatest progress, it has been suggested recently that the land mortgage banks should be abolished. The fact is that the land mortgage banks are proceeding on wrong lines so far. Owing to the almost exclusive attention that is being paid by them to the liquidation of ancestral debts, they are runnning the risk of finding their assets frozen. Experience shows that the security of loans proves more often an embarrassment than an asset when it has been realised. Hence they should look to the paying capacity of the debtor. As the Reserve Bank of India has suggested, "persons whose debts are to be paid by these banks should be made to serve a period of probation with a good primary credit society and even after the banks have advanced them loans they should continue to be the members of multipurpose society which will ensure regular repayment of their instalments by proper supervision of their activities. Further, land mortgage banks should pay increasing attention to the supply of finance for the improvement of land."

The Reserve Bank of India Act, 1934, contains certain provisions whose aim is to enable the Reserve Bank to provide short term finances for certain agricultural operations. Thus the Bank is permitted to purchase or discount bills or promissory notes bearing two good signatures, one of which has to be that of the Provincial Co-operative Bank and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops and maturing within 9 months or to make advances for a period not exceeding 90 days against such bills or promissory notes. The Bank is also permitted to make advances to provincial co-operative banks upto 90 days against Government and other approved trustee securities. But these provisions have remained practically inoperative owing to the lack of warehouses and documents of title to goods. The Reserve Bank has also prepared a scheme for extending financial accommodation to central co-operative banks through the Provincial Co-operative Banks for the purpose of financing seasonal agricultural operations or marketing of crops at specially reduced rates. Under the scheme contained in the Reserve Bank's circular of 14th May, 1938, a procedure was laid down to be followed by co-operative banks to get finance from the Reserve Bank of India. But only one provincial bank borrowed money under the scheme. In 1942 the Bank prepared another scheme. It offered to grant accommodation under sec. 17 (2) (B) and 17 (4) (C) for crop marketing at a concession rate (1 p. c. below the Bank Rate) provided

the concession was also given to the cultivators. The expectation was that the co-operative movement would derive utility from the scheme ; but it did not materialise and only one Provincial Co-operative Bank borrowed a small sum of money at 2 p. c. In November 1944, the Bank decided to extend the scheme of rebate to cover bills and promissory notes drawn for financing seasonal operations practically on the same terms and conditions as were laid down in the circular of May 18, 1938. The amount of loans and advances taken under the scheme by the Provincial Co-operative Banks was small, as is shown below :

Year	Amount in lakhs of rupees
1941-42	99.9
1942-43	295.25
1943-44	379.15

A special rebate of $1\frac{1}{2}$ p. c. was allowed to the United Provinces Provincial Co-operative Bank upto the end of March, 1946. Section 17 (4) (D) of the Reserve Bank Act has practically remained inoperative so far because of the lack of warehouse facilities. Hence in November, 1944, the Reserve Bank circulated a draft Bill for the establishment of licensed warehouses. It provided for the establishment of licensed warehouses where agricultural produce will be graded, stored and regularly inspected. When the proposal actually is given effect to, it will be possible to bring into operation section 17 (4) (D) of the Reserve Bank of India Act.

It may have been noticed that the above attempts of the Reserve Bank at providing cheap agricultural

finance through the medium of co-operative banks have not been so much of a success. For this the Bank has often been blamed. It is no doubt true that the orthodox lines on which the Reserve Bank is functioning in this country is in part responsible for the present state of affairs ; but then it cannot altogether violate the principles. As has been pointed out by K. Subba Rao in the Reserve Bank of India Bulletin that without warehouses and warehouse receipts the Bank cannot find any basis on which to provide accommodation and that the responsibility for the establishment of warehouses belongs to the Provincial Government who have so far done nothing in this respect. Hence, according to Mr. Rao, the Bank cannot go beyond what is demanded by the principle of safety. "The provisions of the Act impose certain limitations on the assistance that the Reserve Bank can render to agriculturists. In the first place, the Bank cannot make advances to agriculturists direct, but can extend accommodation only through scheduled banks or Provincial Co-operative Banks. Secondly, it is not authorised to supply the long term needs of agriculture and the kinds of agricultural bills which it may discount are limited to those drawn for seasonal agricultural operations or the marketing of crops. The maximum period for which it can make advances is limited to nine months so that it is authorised to lend only for short periods." It has already been seen how the Reserve Bank had prepared schemes for providing accommodation to agriculture through the Provincial Co-operative Banks but

the latter did not give sufficient response. The Reserve Bank also prepared similar schemes of providing finance through the money lenders and indigenous bankers which also have not been successful. Thus in January 1938, an effort was made by the Bank for providing finance for marketing agricultural produce through the money lender. The Bank offered to rediscount at concession rates through the scheduled banks the bill of approved money lenders drawn for making advances to agriculturists against the security of the produce provided the benefit of low rates were passed over to the agriculturists. The underlying feature of the scheme was that the scheduled banks would charge a rate not exceeding 2 p. c. over the Banks discount rate and the money lender was to pass on credit with a further margin of not more than 2 p. c. to the agriculturist. The Bank was ready to grant a rebate of 1 p. c. The proposal was however opposed by the scheduled banks on the ground that it would not be possible for them to dictate the rates of interest to the money lenders, and that under conditions of keen competition there would be little scope for the scheduled banks to rediscount produce bills with the Reserve Bank. In 1941, proposals were also made by the Reserve Bank to bring the indigenous bankers within its fold and the Bank enquired of the Bombay Shroffs' Association as to how many of its members would be ready to discard non-banking business within a period of time. The Association suggested a period of five years as necessary for effecting a legal segregation of banking and non-banking

business for approved indigenous bankers and agreed that accounts should be published and should be open to the depositors and the Bank, but it could not give any assurance as to the exact number of indigenous bankers who would be willing to join the scheme. The Association's suggestion was reasonable but the Bank insisted on immediate segregation of banking from non-banking business and on a certain number of shroffs or indigenous bankers immediately joining the scheme which were not acceptable to them. Thus this effort of the Bank also failed. Thus while the full blame cannot be placed on the Reserve Bank, it must be said that the Bank must share the blame with other institutions. Hence we can not see eye to eye with Mr. Rao when he says that "the Bank has all along adopted a nursing or fostering attitude towards the co-operative movement, but its attitude.....is not certainly that of an indulgent mother spoiling her child, but that of one anxious to bring up a sound and healthy offspring." In fact, while admitting the lack of warehouses and other difficulties, so far as the Bank is concerned, it must be said that it has proved to be too cautions a mother that has spoiled the offspring. A better course would be to persuade the offspring towards progress by being lenient rather than to turn its back towards it.

In recent years the question of agricultural finance has come to be reviewed by three committees, viz, the Gadgil Committee, the Co-operative Planning Committee and the Nanavati Committee. The failure of the co-operative movement in providing agricultural finance after

working for about half a century has evoked distrust in the minds of many regarding the future possibility of the movement. Some people have gone so far as to declare that the present position of the co-operative movement "is not such as to inspire much hope that it can be made to play a substantial part in financing agriculture, much less to become the sole supplier of such finance in the immediate future. Nor is it possible to depend on voluntary co-operation for achieving definite results within a specified field which planning involves." They have gone so far as to suggest direct state intervention in matters of agricultural finance. Thus the Gadgil Committee suggested the establishment of Agricultural Finance Corporation by the state "operating under general official supervision and direction, but whose day-to-day working and normal business transactions are largely conducted on an independent basis." Such corporations should be set up in all provinces except those where the Government feels that the co operative financial agencies are so strong and have such a large field of activity that they can make finance available to all credit-worthy borowers. The Corporation, if established, shall provide all types of agricultural credit. Its methods of business should be similar to those of any other institutional agency like a co-operative bank. In providing finance to a borrower, it should take into account the real assets owned by him as well as the nature of his business. The Corporation should deal with the more substantial cultivators directly. The smaller agriculturists

should be pursuaded to form themselves into co-operative societies or where this is not possible, into borrower groups. The corporation may finance co-operative organisations in two cases, viz, (1) where appropriate co-operative banking institutions do not exist, and (2) where, although co-operative banking institutions exist, they do not possess sufficient financial resources, care being taken in the latter case to give financial assistance only through the existing apex banks. The nature and extent of state intervention with the functioning of the Corporation is also definitely laid down by the Committee. Thus for making low rates of interest effective, it is suggested that state assistance will chiefly be in the form of not expecting substantial or any returns on the state capital and funds with the Corporation. For financing the less developed tracts the Corporation may require more substantial help from the state as the cost of administration and collection of loans as well as the risks connected with them will be large in those areas. The state may render the necessary assistance by such means as allowing free use of state funds or by directly subsidizing costs of administration, of supervision, etc. The Committee has also suggested the lines on which the co-operative movement should be reorganised so that it can play a more important role in agricultural finance. The Co-operative Planning Committee is in general agreement with these recommendations of the Gadgil Committee. It is however suggested by the Co-operative Planning Committee that to ensure their own

success, the co-operative credit societies should extend their activity beyond the field of credit, and that not only in some provinces where the co-operative movement has attained a high degree of development but also in other provinces and states where the Provincial Co-operative Bank or their central co-operative financing organisation can provide the agriculturist with all the facilities which are intended to be given by the Agricultural Credit Corporation, the same measure and type of aids as those recommended to be given to the Agricultural Credit Corporation should be given to the Provincial Co-operative Bank instead of starting separate such corporations. The Committee supported its arguments on the following grounds.

"In the first place, much time may be lost in preparing a scheme for the new Agricultureal Credit Corporation, in passing the necessary legislation and in setting up the detailed organisation required. On the other hand, the Provinciial Cooperative Banks and other central Cooperative financing organisations are already in existence and can, where necessary, be suitably reconstituted to shoulder the additional burdens which will be imposed on them. In the second place, the Agricultural credit corporation is intended to deal with the agriculturist also through the medium of cooperative organisations where they exist. A Provincial Coopertive Bank which has already acquired experience in dealing with these societies will, in our opinion, be better suited for the task. Thirdly, the anxiety of the Gadgil Committee for providing a larger number of

agriculturists with institutional credit as well as an alternative to money lenders credit will be met if the provincial governments adopt the targets fixed by us for the increase in the number of rural credit societies and the recommendations made by us for the expansion of their number and functions. Such a course will make the benefits of institutional credit available to many times the present number of members and the bulk of credit worthy agriculturists will be brought into rural cooperative credit societies. Fourthly, an Agricultural Credit Corporation which does not provide adequate representation in the management to those in need of credit is likely to be dominated by lenders."

The Agricultural Credit Organisation Committee, also known as the Nanavati Committee, has come to very similar conclusions as that arrived at by the Cooperative Planning Committtee when it points out that "the existing cooperative agencies can with suitable reorganisation and state aid, carry out the work of Agricultural Credit Corporation, and in view of this, it is not necessary to start an Agricultural Credit Corporation." Particulary in a province like Bombay where cooperative movement has made sufficient progress—there being 5000 rural credit societes and 140 branches of the Provincial and district Central banks, covering most of the *talukas*, with a working capital of Rs 3 crotes and a Provincial marketing society with 197 distric and *taluka* purchase and sale unions—and "was able to face the economic depression of the thirties, cannot be lightly disregarded and its potentialites for further improvement and extension have to be examined before we can think of an alternative agency." Regarding the backward areas in the Province the Committee suggests the formation of grain-cum-commodity depots, agricultural banks granting loans to individuals and societies and cooperative societies. The work of developing agricultural banks is to be entrusted to the Provincial Cooperative Bank.

Thus we have become acquainted with the view-points of three important Committees. It is obvious that in those provinces where cooperative movement has made some progress, it will be advisable to strengthen the existing orgainsation rather than start a new one which will take much time to develop. On the other hand, in those provinces where cooperative movement is in stagnant condition or even receding, it should be immediateiy replaced by direct state intervention without any loss of time. Time is the most important factor to-day. It may have been seen how Britain started two organisation during and immediately after, the war for providing finance to industries and they have by this time completed two years of their working and done important work in their respective fields. In our country, with so much scarcity of food and manufactured articles, the establishment of new institutions for providing agricultural and industrial finance and the reorganisation of the existing ones has not gone beyond the commission and committee stage. Now that there has been a considerable change in political condition the Government should expedite affairs. In this respect it will be advisable to institute a Ministry of Economic Affairs at the centre and also at the Provinces who should be advised by an expert body of economists with modern outlook Emergent action, and not paper planning or commissions and committees, is the need of the hour. The above suggestion if immediatly given effect will not only stop the unnecessary expenses on commissions and committees but also change the whole face of the economy.

END

AN INTRODUCTION TO BANKING

PART TWO

INTRODUCTION TO BANKING

PART II

CHAPTER I

CENTRAL BANKING PRINCIPLE

At present there is no country of economic importance which has not established a central bank of its own. For, it is being increasingly realised to-day that a central bank is absolutely essential for well-directed economic development of a country. Although the constitution and extent of powers enjoyed by the central bank are different in different countries, yet in their operation they show a remarkable uniformity all the world over. Whatever difference there may be is due to difference in economic structure and conditions of money markets. Extent of development is not the same in all money markets and this discrepancy calls for slightly different functioning on the part of different central banks. Thus the functioning of the central bank in an organised money market, as for instance, in London, cannot be identical with the operations of the central bank in a subsidiary money market, e. g., in Berlin or Paris or in an undeveloped money market, as in India or South Africa. But inspite of different conditions, the central bankers are guided more or less by the same outlook in all countries and show almost the same regard towards the central banking principles.

It is to be realised that central banking has become a separate category of banking altogether, although some of

them, at least the older ones, had evolved towards this position. Originally they had the same functions as other banks but, for some reason or other, came to be distinguished from other banks. In subsequent years, with the monopolisation of note-issue they assumed an entirely different character. Those central banks which, however, have come into existence in recent years have been established as such, and are not products of a long course of evolution. Their powers are, therefore, very clearly laid down Usually all central banks have the following functions, viz., monopoly of note issue, custody of cash reserves and metallic reserves, banker to the government, bankers' bank, lender of the last resort, credit control, maintenance of the currency standard, settlement of interbank balances through a clearing house and so on. In other words, their functions are entirely different from those of commercial banks. In recent years, however, it has come to be recognised that the success of a central bank depends upon the whole-hearted co-operation of the commercial banks. That is why the central bank does not do anything which may bring it into competition with the commercial banks. On the contrary, it always stands in readiness to help the commercial banks whenever there arises the need for it, particularly in times of difficulties. Thus it comes to acquire the leadership of the money market. Only in extreme cases or cases of national economic interest is the central bank found to be performing ordinary commercial banking transactions.

The functions of the central bank may be assumed by tradition or imposed by statute. In any case, as already

stated, they exhibit a remarkable degree of uniformity with only such differences as may be necessary, owing to the different stages of economic development of different economies. Economists have never been unanimous as to what should constitute the proper function of the central bank. Thus, according to Hawtrey, the central bank is the lender of the last resort. In the opinion of Vera Smith, "the primary definition of central banking is a banking system in which a single bank has either a complete or a residuary monopoly in note issue." The maintenance of the stability of the monetary standard is regarded as the essential function of central banking by Kisch & Elkin. In practice, however, it is extremely difficult to assign any particular function to the central bank. In this respect the views of the above writers are to be regarded as only partial. This is possibly due to the fact that each of them has viewed the central bank from his own standpoint. A real central bank should always be ready to perform any function which is essential for preserving the stability of the monetary and credit structures of the country. And for this purpose the guiding factor for the central bank should not be profit, but the larger economic interests of the community. In other words, as one writer has said, the central bank is an equilibrator or governor whose function it is to maintain the equilibrium or the balance of the community—balance between current production and current consumption, balance between current production of different goods, and between current and future production.

Central Bank of Issue :

A few words may now be said about the prevalent ideas on central banking. Prior to 1914, the central bank was a bank of issue, whose objective was to maintain both the external and, internal values of currency. The story of the development of the central bank as the bank of issue is rather interesting Originally the monopoly of note issue was not prevalent and notes could be issued by all joint-stock banks. Even, till the end of 18th century there was only one such central bank, viz ; the Bank of England, which had this privilege. Centralisation of note issue in the hands of central banks was an event of the 19 th century and hence theories concerning this right of central banks developed during this period. In 1802, the centralising role of the bank of issue was noted by Henry Thornton for the first time. This was the result of the crisis of 1793 and 1797 which forced the people to realise that it was not credit restriction as advocated by Adam Smith but the further issue of notes that alone could bring the crisis to an end. But this requires the centralisation of gold reserve in the hands of the central bank who can help other banks in crisis. In the words of Thornton, "The establishment of a great public bank has a tendency to promote the institution of private banks. The public bank, obliged to provide itself largely with money for its own payments, becomes a reservoir of gold to which private banks may resort with little difficulty, expense, or delay, for the supply of their several necessities." The effects of this are twofold. In the first place, the centralisation of note issue would

enable the public to get notes whenever they required; for it was the want of sufficient bank note that was "the chief evil". Secondly the establishment of a public or national bank of issue would result in the centralisation of note issue and would thus obviate the necessity of each and every private bank's maintaining its own reserve which could not be made effective in times of need. The Private banks would only keep bills on London or the Bank of England notes wherewith in times of need they might draw on London. Thus the whole responsibility for meeting these occasional demands for gold from private banks fell on the Bank of England which "has ordinarily to keep a quantity of gold equal to that of the notes liable to be extinguished, as well as a quantity which shall satisfy the other extraordinary demands which may be made at the same season of consternation either by banking houses or by individuals." And since London was the centre through which the trade of the whole world used to pass, it became the clearing house of the entire world, the trading metropolis of all the countries whom commerce brought together. This made it all the more necessary to strengthen the gold reserve of the Bank of England. That is why writers from Bagehot to Hartley Withers have all tried to make this idea current that the central bank is responsible for the maintenance of the country's gold reserve. This should not be taken to mean that Thornton wanted a total disappearance of the country bank of issue. For, that would mean an abrupt change which might not be liked, nay might be opposed by all private bankers. Hence what he

suggested was that in London, the national centre of the country's payments, there should be one single ban kof issue which should keep a strong cash reserve. He had no dispute with Smith regarding the use of discount rate for the control of credit or the credit restriction itself : what he was afraid of as a practical banker was rather that too mechanical a theory of credit restriction would, instead of curing the disease of the economic system, on the contrary, accentuate it.

The end of the Napoleanic Wars brought the crisis of the econonmic system also to an end, and the convertibilily of notes was resumed both in England and France. But even then, there was no total monopoly or centralisation of note issue in either country, though both were surely and steadily moving towards the same In England, the matter was finally settled by the Bank Charter Act of 1844, which laid down that the private banks were not to increase the number of their notes beyond the point reached at that time. Even before this two steps were taken, thus giving effect to Thornton's ideas. They were, in the first place, the granting of powers to the Bank of England to raise its discount rate above 5 p. c. for bills of less than 90 days which were generally sent for rediscount in times of crisis, and, in the second place, the giving of legal currency to the Bank of England notes, thereby protecting the Bank from internal drain of gold in times of crisis. The Act of 1844 had, however, created a certain amount of confusion regarding the distinction between notes and money and a doubt as regards the nature of the notes, which increased all the more when

gold bullion standard was introduced in 1925. In any case, the Act of 1844 marked a great advance in so far as it gave a practical monopoly of note issue to the Bank of England and thus confirmed the position of that bank as the central bank of that country. Similar ideas also developed in France. Thus the period, 1825 to 1870, saw the victory of monopoly regarding note issue and the formulation of a classical doctrine of central banking on this basis.

The development of the cheque currency from the middle of the last century introduced further changes in the conception of central banking. The idea that the gold reserve of the country should be centralised was also advocated. For, it was realised that if this was done, the reserve would be effective both for meeting internal crisis and making payment abroad. Bagehot was the most notable advocate of central reserve bank and he was carrying on the tradition of Thornton and Tooke in doing so. He seized the opportunity of the crisis of 1866 when the Bank Charter Act of 1844 had to be suspended for the protection of the London money market and pointed out that the Bank of England should be prepared to carry out the responsibility of a central bank imposed on it. But even then the authorities were not sufficiently alert. As late as 1907 when the crisis had started in the U. S. A. and the American banks, for lack of a central banking system in that country, had turned to London for assistance, it could not be given, for gold was not immediatety available. The Bank of England had, threfore, to raise the discount rate for attracting gold from Europe. This once again made the necessity of having a strong and centralised

gold reserve keenly felt, especially for the fact that London was no longer a money market for the U. K. alone but for the whole world. In fact, the gold reserve was essential not so much for domestic purposes as for meeting the international obligation which had increased at rapid strides since the days of Bagehot. It is, indeed, this fact that has led Hartley Withers once again to emphasize the need for a strong centralised reserve. The crisis was followed by the establistment of the Federal Reserve System in the U. S. A. which showed perfect appreciation of the idea that the central bank's main function is not so much the issue of notes as the maintenance of the country's gold reserve, for which the former is an aid. The whole development has been nicely summarised by Rist when he says that, "the concept of the central bank originating in the functioning of the Bank of England at the end of the 18th century, taken up by the Continent and for a time obscured in England by the disastrous ideas introduced by Ricardo, found its fulfilment in the U. S. in the early years of the 20th century."

In brief, the function of central bank before the first world war was quite simple viz, that it had to maintain the country's gold reserve both for the purpose of the convertibility of notes and for meeting international obligations by preserving stability in the values of currency. It is a well-known fact that the latter assumed greater importance in course of time. When there was a conflict between the two values of the currency, the internal and the external, the former had to be subordinated to the latter in the interest of maintaining the gold standard.

Current Concepts about Central Banking : After the first world war the concept of central banking underwent further changes. Stability in the external value of currency which had disappeared in the post-war years came to be regarded as a less important matter, the predominant position being taken over by the problem of stability of prices. Of course, discussions on the desirability of price stability had started even earlier. For, the maintenance of stable exchange rates was at times accompanied by violent fluctuations in internal prices. Hence it was considered by some economists that the stability of internal prices was essential for the solution of the problem of trade cycle. But the difficulties were enormous and the success of the policy necessitated international co-operation. With that end in view, Keynes emphasized the desirability of establishing a super-national bank.

Other ideas of central banking also developed at this time. One such idea is that the central bank is "a form of emergency relief or panic insurance". This function of central bank is closely connected with its position as a bankers' bank and the lender of the last resort. As a lender of the last resort, the central bank provides accommodation to the banking system in times of crisis which may occur either due to the acquisition of frozen assets or due to excessive expansion of credit, coupled with or followed by lack of confidence amongst the creditors of the banks. This may also be necessary for a widespread financial panic prevailing in the country either due to national or international factors. The aid may be

given either on the initiative of the central bank or on that of the banking system either directly in the form of loans of its own notes or by re-discounting the papers held by these institutions or even by guaranteeing their obligations. As a bankers' bank, it is incumbent on the central bank to assist in the remittance of funds and to provide accommodation to banks in times of need. In this respect the function of central bank is similar to the services rendered by the banking system to its clients. But the difference between these two services lies in the fact that while other banks compete amongst themselves for securing business from the public, the central bank deals only with member banks but never competes with them or tries to capture their business.

Yet another view regards the central bank as the banker to the Government, holding its deposits and funds. In some countries it even receives government revenues, and organises public loans. In recent years the relation between the state and the central bank has become even more intimate inasmuch as it functions in close co-operation with the Treasury in all matters affecting the national economic interests.

A more advanced view regarding central banking is that the bank should maintain the liquidity of the credit structure in the interest of the community. In this respect, it aims at establishing a market for pure credit and to deal with these evidences of credit and to maintain their convertibility. According to Willis, this function of a central bank has got three aspects, viz., that of analysing or testing credit, that of converting it into forms of current

payment and that of clearing such forms of current payment to the end that they may make as small a draft as possible upon the money stock of the country. "In this respect, its special and peculiar quality is found in the fact that when performing its characteristic service, it refuses to deal in anything but 'pure' credit, which is free of risk and payable without question." This Willis calls 'credit function'. This function is to be distinguished from 'emergency function', a fairly full account of which has already been given. But this function is rightly regarded as inadequate, unsound and injurious. For, "no central bank can, by the mere exercise of its credit-granting power, make something out of nothing or save other banks from disastrous consequences of their past policy. When a central bank does so, it merely tends to make bad matters worse." Lastly, it has got the clearing function. This "functional concept" of central banking is much more advanced than the concept of central bank as either a banker's bank or a lender of the last resort

Since the great depression of 1929 the concept of central banking has changed once again. The depression had made it clear that the greatest problem for the economic system lies in the phenomenon of the trade cycle and the central bank as the leader of the money market should come forward for stabilising the volume of employment at a certain level, more conveniently at the full employment level. The central bank can do so by preserving cheap money conditions in the country and can thereby create a psychological atmosphere favourable to the development of the volume of employment. The depression

was followed by the rise of economic nationalism and the introduction of economic planning in many countries. It is needless to point out that in this new set-up the importance of the central bank increased far more than it had been hitherto.

CHAPTER II

CENTRAL BANKING STRUCTURE

Classification of Central Banks : From the standpoint of the ownership of capital, central banks have been classified into seven types :

(1) By the state, as in Russia, Sweden, Finland, Denmark, Bulgaria, Latvia, Australia, New Zealand, Canada, China and some Latin American countries. Some of these were not originally state banks but were subsequently converted into state banks, as in New Zealand, Denmark and Paraguay in 1936 and in Canada in 1938.

(2) By private shareholders, as in England, France, India, Japan, Switzerland and several other countries.

(3) By commercial banks as in the U. S. A. The Bank of Italy under the Fascist regime became one such institution in 1936 though prior to that date it was a shareholders' bank. In that year a law was passed as a result of which the original capital and a part of the reserves were paid off to the shareholders and the new

capital was subscribed only by "public law" banks, credit institutions, savings banks, insurance companies and provident societies.

(4) Jointly by state and private shareholders, as in Estonia and Mexico. In Estonia the original capital was subscribed by the state and in 1929, one-third of it was sold to the public, and the state retained the major portion of the capital. In Mexico the share of the capital held by the state is 51 p. c. In some countries before the second world war, legislation had fixed the maximum amount of capital that might be in the hand of the state, e. g in Greece, Roumania, Yugoslavia and Czechoslovakia.

(5) By the state and commercial banks, as in Colombia, Chile and Peru.

(6) By the state, commercial banks and private shareholders together, as in Argentine.

(7) By commercial bank and private shareholders, as in South Africa and Salvador.

The central banks may also be classified from the standpoint of its relation with commercial banks and the members of the public. This aspect has been analysed in details in the first chapter. It has been seen that in this respect central banks all over the world do not maintain the same attitude. In England, although there is no legal restriction as to the persons and institutions with whom the Bank of England may or may not deal, yet in practice it does not deal with the public, not even directly with the joint-stock banks, but only with the bill brokers and discount houses. In America the member banks maintain balances with the Federal

Reserve Banks, and the percentage of these balances, however, varies with the location of the bank in question. This is provided by law ; for it was apprehended that unless this was done and the already well-established banking institutions were not legally brought under the Federal Reserve System, it would fail to stand on a solid foundation owing to the jealousy and opposition of the commercial banks. In Europe the relation of the central bank with the members of the public as also with the commercial banks is entirely different. Apart from their normal function as central banks, they have a substantial volume of private business which they carry on even in competition with the commercial banks. They maintain a number of branches throughout the country and accept deposits from, grant loans and extends discount facilities to, the customers. Thus they are, by all tokens, a mixed type of central banks as they curiously combine both the functions of the central and commercial banks.

State and Central Bank : We have already seen that in the case of some of the central banks, the state has got participating interest in them. This brings the question of the relation of the state to the central bank to the forefront. One of the fundamental principles of orthodox central banking theory is that central bank should be politically independent. This has been sought to be achieved by making the board of directors consist mainly or wholly of the representatives of the shareholders or commercial banks. Kisch and Elkin have advanced the following arguments in favour of the independence of the central bank from political affairs :

(1) The operation of the central bank must be continuous which cannot be assured if it is subject to the changing governments run by different political parties. If it is closely associated with the Government, every change of government would result in a corresponding change in the policy of the central bank which is harmful to the growth of economic organism.

(2) Secondly, the government in any country at present is the largest borrower in the money market. That being the case, if the administration of that market is also entrusted to the government or placed under its control, the short-sighted policy of the government would be likely to affect at times the broad and long-run economic interest of the country adversely. The government being run by parties, their outlook may be partial and for achieving their immediate objective, they may neglect the interest of the whole people.

(3) Thirdly, the direction of the central bank should be as much unbiassed as possible.

(4) Fourthly, if the central bank is closely associated with the state, in times of emergency, as during a war it will take recourse to the printing press and pursue an inflationary policy. This has been evident from the experiences of many countries of the world.

(5) Finally, there is something special about banking and monetary policy which needs must be distinguished from any other economic policy adopted by the state. State intervention in business, industry or commerce is to be viewed as resting on a different footing from state intervention in monetary policy ; for

itervention in the latter case affects the entire economic system.

The above arguments seem sufficiently reasonable and convincing at first sight; but it is proper to analyse and consider them. So far as the argument of continuity of policy is concerned, it is equally applicable to any department. A continuous change of policy with every change in the government will hamper the progress of any department of state activity. Hence in democratic countries, stability in the policy of the department has been sought to be achieved by the maintenance of the permanent civil service. The second and third arguments are also applicable to any department of state activity. For, the danger of the sacrifice of the long-run interest of the nation in favour of the short-run interest of the party is always there in a democratic government and can only be counteracted by an enlightened public opinion. For making the policy of the central bank as much unbiassed as possible, a strong board of directors is essential. Regarding the fourth argument, a distinction has always to be drawn between normal times and times of emergency. In times of emergency, when the interest of the nation is at stake, the state must have command over everything in the national interest, the central bank being no exception. Indeed this has often resulted in inflation which cannot be properly checked owing to prevalence of exceptional condition. If the government itself is overthrown, as it happened in Germany after the first world war, the effects are far-reaching and very drastic action has to

be taken under such chaotic condition as ordinary financial action becomes ineffective. As to the steps to be taken in normal times, however, opinions differ, some supporting freedom from vicissitudes of politics while others supporting a close co-operation. It is not possible to say anything either for or against these attitudes in a categorical way. In Canada, till the establishment of the central bank, the issue of currency was in the hands of the government and yet it was never abused. In India also currency was controlled by the government upto 1934. It had defects no doubt, but it had never reached the position which the Reichsmark experienced in the years following the first world war.

Some people have argued that the central bank has to come into touch with so many institutions and individuals at home and abroad that its relation with the government or the Treasury should not be too close. It should maintain the same impartial attitude to all it has to deal with. If it adopts a partisan attitude, or is closely associated with the government, none would entrust it with any confidential information. This argument, however, does not seem to carry much weight. For, in these days it is not exchange stability but price stabilitly and the maintenace of full employment that are the main objectives of central bank's policy and it is in particular the latter which cannot be achieved without the intervention of the state. Hence a close co-operation between the state and the central bank has become a matter of necessity, however strong the arguments from theoretical standpoint may be against it.

Recent Trend : Since the first world war, there has been a considerable change in the economic condition of different countries of the world and hence the relation of the state with the central bank has undergone a thorough change. Even many of the traditional principles of central banking which were closely followed by the central banks are not done so at present owing to the appearance of emergencies in the economic system. In other words, in order to cope with the situation, the central bank had to offer its helping hand to the state and in return the government relaxed the basic requirments of liquidity and responsibility demanded of a central bank.

It was expected during the first world war that the changed relation between the state and the central bank was a temporary one, being forced by changed circumstances and would disappear with their disappearance. But after the war one complicatian after another arose and this made the question of return to the pre-war central banking function practically impossible. "Partly as a result of the responsibility accepted by central banks in their capacity as fiscal agents for the proper placement of public debt and for its continuous refunding and reorganisation and partly owing to the efforts to re-establish a stable currency standard of some kind, the connection between various central banks and their respective governments has, if anything, been confirmed and in some countries has grown in closeness, while in others, after a struggle to bring about a restoration of the former separation, the central bank has slipped back into the position of a

branch of the Treasury or a fiscal department of its government." Thus once the governor of the Bank of England, the most independent central banking institution in the world, stated, "We must look largely to the Chancellor of the Exchequer and we assure him that in all matters his requests govern the conduct of our affairs." This closer relation between the state and the central bank has taken the form of close co-operation in matters of monetary and banking policy, of granting financial accommodation to the state, particularly since the great depression when, consequent upon the abandonment of the gold standard in many countries, the government finances had fallen into chaotic condition.

What were these new developments that led to the closer co-operation between the state and central bank? They were many. In the first place, after the conclusion of the first world war, the different countries of the world began to establish central banks of their own and the position of London as an international money market had declined. With this came the urgent bid for economic nationalism and along with it an attempt to develop the economies of different countries of the world, for which purpose also the central bank could not be kept aside. Even in such older economic structure of the world, as that of England, the central bank had to give up its traditional outlook and come forward to help economic reorganisation of the country. Thus during 1922-30, the Bank of England had become closely associated with a number of reorganisation schemes and in 1930 organised the Bankers' Industrial Development

Company. Similarly for providing greater assistance to the banking system in the U. S. A. even the conception of eligibility underwent a change and the Glass-Steagall Act of 1932 had added two new sections to the Federal Reserve Act under which member-banks singly or in groups of 5 or more could borrow from the Federal Reserve Bank on securities other than those which were acceptable so far. 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 institutions obligations maturing within 5 years, entered into for the purposes of advances to industrial and commercial enterprises. In exceptional cases, direct loans to private industries could also be given by the Federal Reserve System. Thus the whole conception of business emergencies was changing and with this the central banks had to adjust themselves in so far as this was regarded as obligatory on the part of the central bank to preserve business against all odds.

In matters of currency supply also, a closer co-operation between the state and the central bank has become visible. Before 1914 the function of the central bank in matters of currency was simple in so far as it was entrusted only with the function of maintaining the convertibility of currency by a proper administration of the gold reserve. The volume of currency available at this time depended on the volume of specie in the hands of the central bank. But after the first world war, the gold standard had broken down and hence the automatic checks

had disappeared. And in the emergencies that became more or less permanent, the currency policy of the central bank had to be made subservient to the requirements of the state in all countries. "A note issue automatically regulated in amount by the expansion or contraction of business and thus elastic in older sense, as well as liquid, hardly exists in the world today, while the practical recognition that the wishes of the state in regard to the enlargement or contraction of currency must be accepted by central bank authorities is well-nigh universal."

The business emergency already referred to manifested itself in another way, viz., panicky outflow of capital from some countries for seeking shelter in safer regions. Before the first world war whenever there was any flow of gold, it was the result of economic disequilibrium. In post-war years the flow of gold was the result of political factors. Even during the war, for the conservation of resources restrictions were imposed by central banks on the outflow of gold and other precious metals. In post-war years some countries tried to restore pre-war currency system and the free movement of gold in and out of a country, but these efforts were reversed mainly as a result of the complications created by the problems of war reparations. By 1933 about 40 countries had introduced, in one form or another, prohibition, regulation and direction of the movement of gold and other foreign exchange resources. This restriction was imposed either by the central bank or by central bank working in collaboration with the Treasury.

Nationalisation Trends : The closer relation between the state and the central bank reached its climax in nationalisation trend in many countries of the world. Thus the National Bank of Copenhagen, which was established as a state bank in 1813 and converted into shareholders' bank in 1818, and functioned as such for over a century, was nationalised in 1936. The Reserve Bank of NewZealand is an outstanding instance of nationalised central banking institution. The Bank of Canada was established as a shareholders' bank in 1935, but in 1936 the state assumed partial ownership by increasing its capital by the issue of 1,020,00 shares of class B at the par value of $ 50 each to the Minister of Finance. The Bank of Canada Amendment Act of 1938 nationalised the Bank. The Reichsbank was constitutionally a privately owned bank but this was operated and controlled by the government. This association with the government was done away with by a law of 1924. Once again the Bank was rendered subservient to the Government by the Law of 1937 under which the Directorium was placed directly under the Fuehrer and Chancellor. Even in those countries where no formal nationalisation of central bank had taken place or where the state had not acquired a participating interest in the capital of the bank, the state had come to interfere more and more, both directy and indirecty, in the administration of central banks.

It may now be asked, what led to this tendency towards nationalisation of central banks. Evidently this was due to the fact that in almost all countries the necessity of economic planning was coming to be realised after the great

depression with a view to fighting against trade cycle and establishing full employment within each economy. A planned economy must be subservient to the state. For, no plan can be successful unless it is carried on a national scale and a national plan to be effective requires the guidance from the state. And in any national plan, the central bank is of prime importance. Hence some people have gone so far as to suggest that the central bank should be a public corporation ; for if it is a shareholders' bank, run by a board of directors responsible to the shareholders, that institution cannot give that much of co-operation to the state as is required in a planned economy. For, the most important requisite of a planned economy is the maintenance of easy money conditions by expanding the cash basis of the banking system so that the latter may create deposits according to the requirements of the economic system ; and this is a duty of the central bank. This new tendency should not be regarded as something dangerous. For, the underlying feature of the relationship between the state and the central bank has undergone a change in planned economies. The rate of interest is to be maintained at a low level, not because the government is the principal borrower, but that the government is the controller of the central bank, and of the whole economic system.

Even after the outbreak of the second world war the tendency continued. Thus the Bank of Japan, the Nippon Ginko, was changed from a semi-official institution into an official state body. Under the new Statute the Bank assumed all tasks connected with circulation of notes,

regulation of money and the maintenance of the credit system in accordance with the policy of the state with a view to ensure the utilisation of the full economic potentials of the country. The activities of the Bank have also been extended. Thus in addition to ordinary credit operation, the Bank may grant advances to government without security, subscribe government loans or take them over directly ; it may provide direct financing for Japanese industry and make loans against securities or goods ; it may carry out all operations in open market, and undertake foreign exchange business in the widest sense. The business of the Bank may be even more widened beyond the limitations of the statute only on the permission given by the Finance Minister. The Finance Minister may also issue decrees permitting commercial banks to collaborate with the Bank of Japan and thus he is empowered to intervene in the entire banking and credit system of the country.

A number of central banks have been nationalised in recent years of which the most notable ones are the Bank of France and the Bank of England. In France, following the monetary chaos and confusion born of the war, the Constituent Assembly passed a law in January 1946 nationalising the Bank of France and four deposit banks. The measure was later extended to a few other banks and insurance companies. The Law also created the National Council of Credit consisting of members coming from principal economic associations, financial institutions and ministries of government and the governor of the Bank of France, and being consultative in character,

The Bank of England has been nationalised by the Bank of England Act of 1946. The nationalisation of the Bank of England had remained an article of faith with the Labour Party and an election pledge which was duly honoured. Among other countries which have nationalised the central banks mention may be made of Argentine and New Zealand. The statement of objectives of the nationalisation of the Bank of New Zealand contains the following items: facilitating post-war reconstruction. provision of reliable and economical banking services and promotion, in general, of the economic welfare of the community.

Question of Nationalisation of the Reserve Bank of India : For some time past the question of the nationalisation of the Reserve Bank of India has become important and has been engaging widespread attention. When the Reserve Bank of India came into existence, the government wanted to make it a shareholders' bank. As already noted, the case for making a central bank independent of the control of the state has been very strongly advocated in theoretical discussions. These made the case for the establishment of a private central bank very strong indeed. Since the establishment of the Reserve Bank, however, considerable change has taken place in economic situation of the world and also in the ideologies and hence collaboration between the state and central bank has come to be recognised as a matter of necessity. It is also argued that the developments during the last few years have resulted in a change in the nature of the Reserve Bank and as a result of excessive

concentration of shares in a few hands, and that too, belonging to a particular centre, it has lost its character as a shareholders' Bank and is controlled by a few. The original purpose is thus defeated. On this ground also the nationalisation of the Reserve Bank has been suggested.

It is further pointed out that the Reserve Bank, as a shareholders' Bank, has failed to achieve certain objectives which were expected of it as a Central Bank. Thus it has not been able to solve the problem of agricultural credit, or to link the indigenous bankers with the organised money market or to establish a bill market in this country. Even over the banking system as a whole, it has no perfect control. Finally, the Bank has failed to maintain its independence from the government interference, as is clearly shown from a number of recent incidents, such as inflation of currency, sale of gold, etc. Hence it is argued that the Reserve Bank should be nationalised and this should be a prelude to the nationalisation of the entire banking system in years to come.

Although apparently the case for the nationalisation of the Reserve Bank is very strong, yet on a closer analysis it will be found that it loses much of its strength under Indian conditions. Nationalisation of a concern is to be resorted to in the interest of the public when the concern is earning fabulous profits at the latter's cost. In such a case, particularly when the commodity provided is one of public utility, nationalisation becomes a necessity. So far as the Reserve Bank and its shareholders are concerned, it cannot be accused of any such charges. For from the very beginning, the dividend of the Reserve Bank has been

fixed by law and the surplus profit, if any, goes to the Treasury.

It has been argued that the central bank is the heart of the economic system and in these days of planned economy, the state must have control over and direction of the entire economy. In this respect also no charge can be levelled against the Reserve Bank. For, although it is a shareholders' bank, it has maintained close co-operation with the Government and, as the *'Eastern Economist'* points out, "from the point of view of public interest, the complaint would be not that the Reserve Bank did not co-operate with the Government, but that it co-operated so well and so completely with the bureaucratic administration...in its unsound monetary and economic policies, whereas it was an important part of the duty of an 'independent' central bank ..to have emphasized its own point of view in a more concrete manner than the Reserve Bank has perhaps done. It is well-known that during the years of war, the Bank, working in close collaboration with the Government, made matters worse. Thus unless the Government Departments, particulary the Treasury, attains a sufficient degree of efficiency, mere nationalisation of the Reserve Bank will not solve the problem.

It is true that the Reserve Bank has failed to perform some of the functions which it was expected it would ably do. Thus it has not been able to render effective help to small banks in times of difficulty. It has not been able to bring the indigenous bankers within the arena of its control. It has also not been able to develop a bill market in the country. But the fault does not lie

entirely with the Bank itself as with the rigid principles on which the Reserve Bank of India Act is based. These rigid principles have stood in the way of the Bank's fulfilling some of these functions. The Bank is an institution built on the British model, whereas the conditions in this country are different from those prevailing in Britain. "The character of foreign trade, the development of the country's economy, the saving and investment habits of the people, the manner in which internal trade is being conducted, the attitude of Indian bankers, the amount of confidence and trust needed between one another of a business deal—in all these India differs fundamentally from the U. S. A. and U. K."

Whether the central bank of a country is formally nationalised or not, the fact remains that no central bank at present can be perfectly free from the influence of the state. Some amount of co-operation between the two is inevitable in the interest of the economic regeneration of the country.

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* Since the above lines were written, the Government has announced its policy for the nationalisation of the Reserve Bank & the Imperial Bank of India, in the following words :

'It is the Government's intention to acquire the Reserve Bank's shares at their average monthly market value during the period March 1947 to Feb, 1948, taking the opening quotations for each month and to issue in lieu thereof to the shareholders 8.pc. long-dated stock of equivalent value and of appropriate maturity."

"In regard to the Imperial Bank of India, the Govt propose to adopt a similar basis for the acquisition of its share capital. The period for which the average of the market value of its shares is to be taken will be determined at the time of its nationalisation."

The step will be taken only after 30th Sept, 1948, when the Reserve Bank ceaseds to be a common banker for India and Pakistan under the terms of the Pakistan Monetary Arrangement Order, 1947.

CHAPTER III

CENTRAL BANKING OPERATION

Central Bank as a Bank of Issue : In a previous chapter we have traced the development of the theory of the bank of issue from the days of Thornton upto recent times. In the present chapter, we shall consider the central bank as a bank of issue. Among the functions that were entrusted to the central bank the first and foremost almost in all cases was the function of issuing notes : and this continues even to this day as one of their principal functions. In fact, until the beginning of the present century, and, in particular, upto the coming of the first world war, they were known as the banks of issue, other functions having developed after the war.

The issue of currency was regarded for long s a prerogative of the state. But while the state retained this prerogative in matters of the issue of matallic currency, the function of issuing notes was gradually entrusted to the banks. Where the banks had already started this function, this was given a legal recognition. Various reasons were responsible for the assignment of this function to the banks by the state. In some cases, it was considered that the issue of notes would be more appropriate in the hands of the banks, while in others this privilege was obtained by some bank for having granted a loan to the state in times of

necessity. In still others, the notes issued by the state had heavily depreciated and hence the public lost confidence in them. Hence fresh notes were issued by the banks, rather than the state.

Thus when this function passed into the hands of the banks, it was not centralised or monopolised by any one banking institution. The monopolisation of note issue was the result of long evolution. The greater part of the 18th century had passed in developing the bank note as a circulating medium and this was introduced only for securing economy in the use of precious metal. Only towards the end of that century the idea was gaining ground that the notes do not represent money but are in themselves only evidences of indebtedness of the issuing bank or an instrument of credit. As an embodiment of sound credit it came to be recognised only in the 19th century when the need for the regulation of its volume came to be recognised for the first time. And yet note-issue was not placed in a single hand. Such a step was taken only in 1844 in England and the process had not completed till recently when, in 1935, Canada introduced the monopoly of note issue in the hands of its central bank.

Thus when note issue was being made a monopoly of one bank, the others lost their note-issuing functions. It should not, however, be taken from this that the oldest joint-stock banks were always given this privilege. This was done only in a few cases, as in England and Sweden while, in many others, an entirely new central bank was created under special law or charter for securing uniformity in

the note-issue. Thus with the creation of monopoly of note-issue, other banks lost this function. These other banks were required by law either to redeem their notes as they were paid in or to withdraw them from circulation within a prescribed time limit, as in Sweden, or the central bank was called upon to take over the notes of other banks, subject to certain conditions as to their redemption, as in Japan, Italy, France and Spain. In England, although the Act of 1844 withdrew the note-issuing powers of other banks, yet the notes issued by them which were already in circulation were not withdrwn all at once. These notes were, however limited to the individual amounts outstanding at that time and provision was made that under certain circumstances they would lapse. The notes of other banks finally disappeared in in 1920. In Germany 33 banks issued their own notes in 1875. Of these all but four surrendered their right in favour of the Reichsbank, and in 1935 even these remaining four lost this privilege. Although in the U.S.A. and Canada, the central banks do not have a complete monopoly of note issue, yet they have a residuary monopoly. The issues of the national banks in the U. S. A. have lapsed in 1935-36. Some amount of Greenbacks and silver certificates representing government notes are still in circulation, but they represent only a small proportion of the total notes in circulation in the U. S. A., the notes of the Federal Reserve System being considered the most important. Thus "as more banks came to be established in each country and note currency came into greater use with rapid expansion of trade, the need for uniformity

in note-issue and for better supervision of note currency as well as the desire to secure for the state a share of profits of note-issue caused almost every country to grant one bank either complete monopoly of note issue, or a 'residuary monopoly'."

Free & Central Banking Controversy—Importance of Monopoly of Note Issue : From the foregoing discussion it may be clearly realised what a central bank is. But central banking is to be distinguished from free banking. Before we enter into the controversy, we should consider what free banking is. In the words of Vera Smith, "Free banking denotes a regime where note-issuing banks are allowed to set up in the same way as any other type of business enterprise, so long as they comply with general company law. The requirement for their establishment is not special conditional authorisation from a Government authority, but the abililty to raise sufficient capital and public confidence, to gain acceptance of their notes and ensure the profitability of the undertaking. Under such a system all banks would not only be allowed the same rights, but would also be subjected to the same responsibility as other business enterprises. If they failed to meet their obligations, they will be declared bankrupt and put into liquidation.....No bank would have the right to call on the government or on any other institution for special help in times of need. No bank would be able to give its notes forced currency by declaring them to be legal tender for all payments, and it is unlikely that the public would accept inconvertible notes of any such bank except at a discount varying with the prospect

of their again becoming convertible." This is the type of system free banking represents. Thus in such a system the gold reserve is not centralised but each bank keeps its own reserve and determines the volume of its notes. This lack of central control or co-ordination naturally creates disturbance in the economic system owing to the fluctuation in the total volume of notes. nor can the reserve be effiectively mobilised in times of need when it is distributed in the hands of all the banks. A multiple or free banking system suffers from the defect that while some of the banks may be run on sound lines, there will always be some who are the weak links. For want of a central institution guiding and controlling the operation of the banking system, these weaker and uneconomic institutions will always be a source of weakness for the entire economy. Further, when there is no central bank, there is every possibility of there being a credit inflation and constant lowering of interest rate which may ultimately bring about a collapse of the whole economy. This process is cumulative and even the more sound banks cannot withhold from this under pressure of circumstances

It is argued by the supporters of free banking that the above picture holds up an exaggerated apprehension and before the economic system comes down to such a low level, the process will be checked by the operation of the conservative banks. Thus if a bank goes on issuing notes incessantly, more and more of these will be presented for encashment through a system of bank clearing and hence the issuing bank will run the risk of

having its reserve depleted. "It is unlikely that all banks will decide in concert to decrease their reserve ratios and the bigger the conservative group, the stronger will be the check of these on the expansion of the other group. While admitting that circumstances may occur in which the majority of the banks are willing to allow some reduction in their reserve ratios, it is unlikely that they will ever risk fluctuations of dimensions anything like as great as those which are viewed with comparative equanimity by the central bank." The supporters of central bank, however, do not regard this argument as sufficiently strong. In full the arguments of free bankers are not correct. Their argument is that if one bank increases its issues by a given proportion, its business will increase in the same proportion, that the larger amount of loan repayment it will have to make, will give the bank the same number of claims on rival banks and that no differences, therefore, will arise in the clearings and no claims on reserves. For, the coincidence of the drain on reserve and the repayment is out of question and the time-lag between the two is dangerous to stability. Besides, in banking it is too much to presuppose that the attitude of conservative banks will be to maintain equilibrium. For, if there are no conservative banks and all move in step towards credit expansion, nothing can keep them in check. And even if there are a few conservative banks, they will be forced to join others. If they keep aloof, they connot keep in check the tendency to the instability created by other banks, since they do not command the prestige and position of the central bank of a country.

A monopoly of note issue is thus essential and the arguments in favour of free banking are very flimsy. Whatever the theoretical arguments may be, even in practice the monopoly of note issue has come to be regarded as an important constituent of central banking structure and has actually been entrusted to it. This is essential, partly because the notes of a central bank enjoy a prestige which cannot be enjoyed by notes issued by other banks and, partly because this privilege enables the central bank to control credit which is so very essential. It may be argued that even if the issue of notes is monopolised by the central bank, the objective of such a policy may be counteracted by the expansion of cheque currency, by increasing the velocity of circulation of notes and by encouraging the maintenance of larger current account balances. But these alternatives are not so very effective as a power to issue notes.

Banking & Currency Schools : Now that there is strong ground for the centralisation of note issue, the next question is whether the notes should have cent per cent cover or a partial cover only. This consideration has given rise to two schools of thought, viz, Currrency and Banking Schools. This controversy was the result of constant troubles regarding the currency during the latter part of 18th century and the opening of 19th century and the recurrence of bank failures and commercial crises. It was pointed out that all these troubles were due to the excessive issue of notes. Hence arose a controversy and two opposing schools of thought were born.

According to the supporters of the Currency School, notes are issued for economising the use of metal and hence their volume should be limited by the available supply of gold. In other words, there should be a cent per cent gold cover. The notes are not the instruments of credit but are economical substitutes for metallic money. The available supply of gold at any time is, therefore, the determinant of the volume of currency which will fluctuate with export and import of gold. The inflow and outflow of gold, in its turn, will, however, depend on trade conditions. The great defect of this method of note issue is that it lacks in elasticity. The theory was put forward at a time when industry and trade of England were rapidly expanding and if cheque currency had not come into existence, it would have created the greatest problem for British economy. The supporters of the Banking theory were in favour of leaving note-issue entirely to the discretion of the bankers. Thus they were of opinion that a cent per cent cover was unnecessary. For, at any particular moment all the notes are not presented for encashment. Only a certain proportion are so presented. According as the notes are encashed at any moment of time the bank should have a certain percentage of reserve against notes, to be determined by its experience of demand for conversion from the public. This will not only economise the reserve but also introduce elasticity in currency system which is so very essential for an expanding economy. The issuing bank, however, should have the responsibility of not only maintaining the convertiblity of notes but also

of controlling their volume according to the requirements of business community. If this is done, there will be neither currency inflation nor scarcity in the supply of currency. Those who had objected to the Banking Theory had behind their arguments the experiences of the past years and they contended that "bankers were not always in a position to judge the operations for which notes were required, neither were they always sufficiently prudent and careful, while to leave to them the control of note issues was to place too much power and responsibility in the hands of one class of business men." But it should be remembered that the past was not the same thing as future and the need of an expanding economy, which was the universal trend owing to the coming of Industrial Revolution, demanded an elastic currency. That explains why the Bank Charter Act of 1844 which had accepted the Currency Principle had to be suspended on many occasions in future and in fact the rigours of the Act partly removed owing to the increasing popularity of cheques. Most central banks that have since been established have accepted the Banking Principle.

Types of Currency Systems :

The test of a sound currency system is threefold, viz ; uniformity, elasticity and security. Considerations of uniformity necessitated the centralisation or monopolisation of note-issue in the hands of the central bank which cannot be done under a multiple banking system. Elasticity is the guiding principle of the banking theory

and has been adopted by most central banks. The need for security demands a cover against the note so that the confidence of the public may be maintained. Uniformity apart, there has, however, been a certain amount of clash between elasticity and security. Perfect security demands a cent per cent cover, which in its turn will make the currency inelastic. And if the currency is made perfectly elastic, and the question of security neglected altogether, there will always be the risk of inflation and loss of public confidence. Proper balancing of the two factors becomes, therfore, essential, and to achieve this, different countries have developed different currency syetems which are quite in keeing with their circumstances. A few types may be noted below in brief.

The British Type : It has alrady been said that the Currency Principle was embodied in the Bank Charter Act of 1844 which put a stop to the issue of notes by other banks. The underlying principles of the Act were as follows : In the first place, the Issue Department was authorised to issue notes against securities upto £ 14 million and all notes above that must have a cent per cent cover of gold and silver. Since the fiduciary issue, i. e., issue against securities, is fixed by law, this is called Fixed Fiduciary Principle. The silver content of the Reserve at any time must not exceed 1/4th of the gold held. The convertibility of notes into gold bullion was prescribed at £ 3. 17 s. 9 d. per ounce standard. After the passing of the Act if any bank ceased issuing notes, the Bank of England could obtain an Order-in-Council

under which it could increase its fiduciary issue by 2/3 rds of the lapsed issue. It was also laid down in the law that on bankruptcy, amalgamation or opening an office in London, any existing bank would forfeit its right of note issue and new bank of issue would be established in future. Thus the object of the Act was to ensure convertibility of note issue, particulary its fluctuating margin, with gold. Thus gold would always be available to redeem notes presented for conversion in normal circumstances. This also sought to control the volume of notes, above the fiduciary limit, with changes in the volume of precious metal available and unless the volume of gold and silver had increased at any time, no further expansion of note issue could be effected. This not only would curb out inflation but also tend to stabilise both external and internal values of currency. This system of note issue was prevalent, among other countries, in Japan, Norway, Sweden and also in Poland along with percentage system. The monopolisation of note issue in England was not perfected immediately but took a long time to reach the desired perfection. It was only achieved in 1921 when only the Bank of England notes were in circulation. Thus it took more than seventyfive years to perfect the centralisation of note issue in England and during this period, under the terms of the Act, viz., that the Bank could increase its fiduciary issue by two-thirds of the lapsed issue, the Bank's fiduciary issue was increased from its original figures of £ 14 millions to £ 19,750,000.

The system of note issue as established under the

Act of 1844 has come in for a good deal of criticism on the grounds that it had not been able to prevent financial crisis, that it lacked elasticity, that it had unnecessarily blocked too much gold and that it had exercised no control over the creation of bank credit. During the financial crises of 1847, 1857 and 1866, the Act had to be suspended and the Bank had to be given a free hand to handle the situation by increasing its fiduciary issue and by supplying currency to those who needed it and introducing thereby elasticity in the currency system. Thus in 1914 the Treasury authorised the Bank to increase its fiduciary issue against securities. Greater changes had to be introduced in the years following the first world war. Thus in 1928, it was provided that the Treasury could authorise the Bank to increase fiduciary issue above £ 360 millions to a specified amount for not more than 2 years. When there was a huge drain of gold in 1931, the fiduciary issue had to be increased for the first time to protect the credit base. But this expedient created further troubles. For it was interpreted in Europe as an inflationary development and all the more encouraged the outflow of gold from England. In the words of the *statist*, under this expedient "elasticity can only be obtained at the cost of a definite loss of confidence", inasmuch as it "attracts unnecessary attention when that attention is least desirable". The Macmillan Committee also stated that "an approach by the Bank of England to the Treasury for permission to increase the fiduciary issue would be interpreted as a sign of weakness, and

be the occasion of nervousness at a time when the opposite effect on sentiment was to be desired." In 1933 fiduciary issue was reduced to the original figure of £260 millions owing to the inflow of gold at that time and in December, 1936, it was reduced to £200 millions to compensate for the sale of gold to the Bank of England by the Exchange Equalisation Account. In 1937, it was again raised to £ 220 millions in order to protect the reserve against heavy seasonal expansion in note circulation due to Christmas demands and reduced again to £ 200 millions in January 1938. The Banking and Currency Act of 1939 freed the Bank of its reserve against notes in an indirect manner.

Inspite of all sorts of criticisms, the fixed fiduciary system is in force in England mainly as a matter of tradition. The rigidity had been sought to be removed by the frequent suspension of the Act of 1844 before 1914 and change in the fiduciary limit after that date. England is an industrial country and not one with agrilultural economy. Hence seasonal variations in the deemand for currency are not so prominent in England. And while the Act of 1844 had to be suspended on many occasions, its rigid provisions were helpful in other directions. Thus in the words of the Cunliffe Committee, "the stringent provisions of the Act have often had the effect of preventing dangerous developments; and the fact that they have had to be temporarily suspended on certain rare and exceptional occasions (and those limited to the earlier years of the Act's operations, when experience of working the system was still

immature) does not, in our opinion, invalidate this conclusion". The committee recommended the continuance of this method with some modifications which was done under the Currency and Bank Notes Act of 1914 which gave the Bank of England the right to issue notes "in excess of any legal limit" with the consent of the Treasury. Even Keynes had pointed out that this system may work successfully only if the fiduciary issue is fixed high enough so as to leave the central bank in unrestricted control over its gold reserves.

Other Types: Maximum Issue Principle—Under this system the central bank is given the fullest discretion over note issue. This system was adopted in France and was prevalent upto 1928. Under this system, there is no prescribed relation between note circulation and the amount of gold reserve. Whatever the volume of reserve at any moment of time, the maximum of note circulation was fixed which was generally much in excess of the expected note circulation in normal circumstances, and it was revised upwards from time to time according to the requirements. Thus the maximum originally fixed was 350 million francs, which was considerably raised during the Franco-Prussian War and the first world war. In this type, there is no legal restriction as to the form or amount of the reserve; but generally the central bank maintains a large reserve of gold and silver. The notes are undoubtedly convertible in gold and/or silver; but occasionally a premium is charged on the conversion of notes into gold in order to induce the people to accept silver.

This method has been praised by Keynes on the ground that it gives the central bank fullest discretion as to the volume of notes and as to the use of reserve in case of need. The method also found favour with the Macmillan Committee in England and Royal Commission on Monetary and Banking Systems in Australia. Curiously enough, the method was altogether given up by France in 1928, although the convertibility of notes was suspended since 1914. In 1928, however, the system was discarded in favour of a proportional reserve system under which a gold reserve of 35 p.c. was to be held against all notes issued.

Percentage or Proportional Reserve System—Under this system gold reserve shall not fall below a fixed percentage of note issue. The actual percentage of reserve in any country will, however, depend on a number of factors. The system was first adopted in Germany in 1875 and then in the U. S. A. in 1914. Thus in Germany the notes of the Reichsbank had a cover of 40 p.c. consisting of gold and some foreign currencies or foreign credits readily convertible into gold, in the proportion of 3 : 1. In emergencies, this reserve could be reduced subject to the imposition of a graduated tax on the difference and on the condition that the discount rate should be at least 5 p.c. which would rise as the reserve falls. During and after the first world war, all metallic coins were substituted by notes and this resulted in the severest inflation. The restrictions on note issue were altogether removed, the notes being issued against the Treasury

bills of the Government. The inflation had so much depreciated the value of German paper currency that even a billion Reichsmark could not purchase a loaf of bread. In 1923, the Rentenmark notes were issued by a new institution, the Rentenbank, and each rentenmark was made equal to the pre-war gold mark and one billion paper marks. In 1924, the Reichsbank was reorganised and the existing paper currency was replaced by a new currency based on the gold Reichsmark. Since 1931 the reserve of the Reichsbank has fallen much below the statutory requirements owing to the great drain of funds at this time. The reserve provisions had, therefore, to be suspended and the obligations of the bank to pay an emergency tax and to raise the Bank rate proportionatly had to be removed for the time being.

In the U. S. A., before the coming of the Federal Reserve System in 1913, most of the notes were issued by the National Banks against a cover of U. S. Government Bonds of nominal amount equal to the authorised issue, deposited at the U. S. Treasury. Each National Bank was, however, required to keep fixed proportion of gold to deposits and notes could only be increased against the holdings of bonds. The Federal Reserve Act of 1913 transferred the right of note issue to the Federal Reserve Banks. In persuance of the provision of the Act the notes of the National Banks have been replaced by bond-secured Federal Reserve Bank notes. Secondly, the Act has introduced Federal Reserve Notes issued by the Federal Reserve Board to the banks against the security of approved

securities, in addition to which the banks must keep a gold reserve of 40 p.c. In times of emergency this reserve can be reduced on payment of a steeply graduated tax. These notes constitute the main part of the American paper currency. These represent the obligation of the U. S. Treasury and are guaranteed by the Government. It is well-known that after the great depression, there was panicky outflow of gold from Europe and other parts of the world towards America, with the consequence that the gold reserves of the Federal Reserve Banks enormously increased and their notes came to have almost cent per cent coverage.

The system has been criticized by Keynes on the ground that it possesses no sound foundation either in logic or in common sense, and has the defects of all the systems. It is extravagant in keeping locked up so much gold, risky in encouraging credit expansion at the time of gold inflow and the central bank has to be definitely cautious in making a drastic curtailment of notes in emergencies when gold is going out. And in difficult times the reserve thus maintained is hardly sufficient to prevent the drain or to check the run. If a still larger reserve is maintained, that is still more extravagant.

Inspite of these theoretical arguments against the system, it has found favour in many countries of the world. Particularly in an expanding economy or an agricultural economy which is characterised by seasonal fluctuations in the demand for currency, as that of ours, the proportional reserve system is preferable to others which introduce rigidity in currency system. Its adoption

after the first world war was all the more necessitated owing to the prospective world shortage of gold, which made an economy in reserve highly indispensable.

A variant of the proportional reserve system as enumerated above is to be found in a system in which all or some part of the percentage reserve against note issue is held not in actual gold but in the form of bills or cash at some foreign banks. This may secure economy in the use of gold, but not always. For, if out of considerations of prestige, the country adopts this method not to exercise its option but to hold actual gold, the economy would be a false one. In fact, no first rate power would give its support to this system and Italy was the only country which adopted this system. The inefficacy and inexpediency of this method was further revealed particularly during the years of depression when many countries had suffered huge losses owing to the depreciation of sterling. No country can retain foreign exchanges without the prospects of heavy loss.

Gold Reserve: We have already seen how many countries in the years following the first world war came to adopt proportional reserve system. This raised the necessity of maintaining a gold reserve. A reserve is maintained by central bank for two purposes, viz., first, to provide cover against note issue and second, to meet discrepancies in the country's international balance of payments. The latter depending mainly on the range of fluctuations of the country's balance of payments.

After the first world war, the statutory minimum reserve requirements, instead of being relaxed, became

all the more rigorous. Thus in many cases the gold in reserve was raised from 33 p.c. to 40 p.c. Actually the reserves were much higher than the legal requirements, the highest being 91.3 p.c. in case of South Africa and the lowest 57.6 p.c. in case of Italy. The case of Great Britain with only a reserve of 34.1 p.c. was quite exceptional. This was regarded by Keynes as "a source of weakness to get the public into the habit of expecting the permanent and continuous maintenance of large free reserves." But in practice this was regarded as essential This was in the main due to the fact that prices had collapsed after the war and for meeting emergencies the central banks must have strong reserves.

Since the depression, however, a controversy started as to the desirability of having a gold reserve at all. For, gold production was showing a declining tendency and the price of gold was moving up. The Minority of the Gold Delegation as also Keynes, favoured total abolition of gold reserve. Prof. Sprague also pointed out that in view of decline in gold production, the universalisation of gold reserve ratios would be a serious obstacle. Though their arguments have strength, they are not irrefutable, for the decline in gold production can be counteracted by revaluation of gold reserve at existing higher prices and by the release of gold from hoards in many countries of the world. Hence the most sound argument in favour of time abolition of gold reserve was that of Prof. Cassel who made his case on the ground that since a reduction of legal reserve requirements would be impossible for

want of international agreement, its total abolition would be preferred. This need not mean an uncontrolled issue of notes which will have to be regulated at the discretion of the central bank in accordance with the requirements of national economy. Prof. Mlynarski suggested that the new regulating factor in place of gold should be "some relation between the total sum into the Treasury, i.e, the scale of taxation and note-issue." This is to be calculated in the following manner : The aggregate sum of all national and local government revenues as also of national income of the previous year have to be ascertained first. From this it will be possible to ascertain the percentage between the two. The issue quota should constitute such part of gross revenue of government as this gross revenue is of total national income.

Those who have opposed total abolition of gold in reserve have done so on psychological grounds of "human foibles and prejudices" and also on grounds of the requirements of international balance of payments. But a reduction in reserve was favoured. Thus the Monetary and Economic Conference held in London in 1933 recommended that in order to improve the working of a future gold standard, greater elasticity should be imparted to the legal cover provisions of central banks by reducing the percentage cover to a minimum ratio of not more than 25 p. c. This recommendation was given for increasing the free reserves of central banks with a view to strengthen their

of 1939, or as was done in America even earlier, in 1934. As a result of this, the gold reserve of the Bank of England which stood at £ 126.4 million on 22nd February, 1939 under the old prices, became £ 221 million. Similar measures have also been adopted in France. But the Reserve Bank failed to do this even and was accused of pursuing a deflationary policy. A reduction in reserve requirements and a revaluation of gold stock would have enabled the Reserve Bank to help the economic recovery of India.

After the outbreak of the war, the reserve stood at a very high level, being 92.70 p.c. in 1944-45 and 93.78 p c. in 1945-46. The gold coin and bullion held by the Reserve Bank at the end of December 1946 was Rs 44.41 crores at the statutory valuation of Rs 21/3/10 per fine tola, but slightly less than Rs. 100 crores if revalued at the price for gold fixed under the International Monetary Fund. Thus at the end of 1946, the gold and sterling holdings in the Issue Department of The Reserve Bank were Rs. 1190 crores, which were Rs 686 crores above the legal require- ments. Evidently this reserve will appear unnecessarily high. Even if the present volume of note issue be maintained—and it will have to be maintained not only for counteracting deflationary effects but also for promoting an expansionist economic programme—the existing reserve would indeed be regarded as very high. According to an estimate of the Reserve Bank of India itself, the foreign exchange reserve need only be £ 150 million or Rs 200 crores or about 16 p. c. of the existing note issue.

Indian Paper currency : In pre-British days the paper currency was unknown in this country. The early

European banks had introduced paper currency which had only a local circulation and was not recognised by the government. Most of these banks failed during the crisis of 1929-32. The notes issued by the three Presidency Banks had only a circulation within the Presidency towns.

In 1860 James Wilson suggested the introduction of the Proportional Reserve System in this country in which 1/3rd of the total amount of notes should be covered by metallic reserve and the remaining 2/3rd by government securities. But this suggestion was not accepted. For England had accepted Fixed Fiduciary Principle under the Bank Charter Act of 1844. The same Principle was adopted in our Paper Currency Act of 1861. For currency purposes India was at first divided into three circles which was subsequently raised to seven in 1910. Notes of the denomination of Rs 10, 20, 50, 100, 500, 1000, 10000 were issued, the five-rupee notes being issued later. Within their respective circles the notes became unlimited legal tender. When the note-issuing power of the Presidency Banks was thus lost, the Government agreed to keep as a compensation their balances with these banks, free of interest and without claiming any share in the profit of the Banks. The circle system was, however, disadvantageous in so far as it restricted the popularity and use of notes. Hence the process of universalisation of notes started in 1903 and by 1932 all notes upto the denomination of Rs 1000 were put into universal and unrestricted circulation. As already said, this Act had accepted Fixed Fiduciary Principle and accordingly the volume of notes that could be issued against government

securities was fixed at Rs 4 crores. This limit was raised in subsequent years and in 1911 the amount reached the maximum figure of Rs 14 crores. All notes above the fiduciary limit cwere overed by gold and silver coin and bullion. Three important features characterised Indian currency in the years preceding the first World War.

(1) Note issue was dissociated from banking, which was placed in the hands of Presidency Banks and note-issue was retained by Government.

(2) There was no central bank in the country with power to issue notes.

(3) The internal currency was absolutely inelastic and there was no provision for its temporary expansion except by importing funds from abroad either by the purchase of Council Bills or by the import of sovereign.

India being an agricultural country there are wide seasonal fluctuations in the demand for funds and since the currency became inelastic owing to the adoption of Fixed Fiduciary Principle in the Paper Currency Act of 1861, the monetary stringency became the greater, instead of being relieved. Hence a number of measures had to be taken for relieving monetary stringency. In the first place, the closing of the mint synchronised with an era of rapid trade expansion and consequent need for currency. So it were provided under the Currency Act of 1898 that the proceeds of the Secretary of State's sales of Council Bills was to be set aside in the Bank of England in the form of gold as part of Indian Paper Currency Reserve. The Government of India were to issue notes against this gold and

with these notes had to meet the Secretary of State's drafts. There was a drain on the stock of rupees with the Government and the latter was, therefore, forced to place gold coin in circulation. Secondly, in an attempt to popularise gold, the government introduced sovereigns into circulation in 1899-1900, and instructed the post offices, paper currency offices, district treasuries and railways to encourage receipts and payments in gold coins. This measure was, however, not successful. Thirdly, the Government resumed silver coinage on a large scale in 1900 and for this purpose silver was purchased in London, in exchange of gold kept for the Paper Currency Reserve. But these measures could not be an effective alternative to an elastic paper currency system.

During the first world war there was inflation of paper currency caused by the great demand for money which could not be met by fresh issue of rupees owing to the acute scarcity of silver. The demand for money inside the country had increased on account of three factors, viz., rise in the price of silver, government's need of finance for the eastern theatre of war, and abnormally favourable balance of trade. The fixed fiduciary limit was greatly increased up to Rs. 120 crores in 1919. A considerable portion of it was created against Treasury Bills while the metallic reserve came down to 35. 8 p.c. only. For economising silver one-rupee and two-half-rupee notes were put into circulation. The Government also abolished the extra-legal facilities for the conversion of notes. This

measure was supplemented by the prohibition of transport of rupees. The newly-issued one rupee and two-and-half rupee notes were running at a discount.

The war left the currency system unorganised and efforts were made to reorganise it on the lines suggested by the Chamberlain Commission immediately before the war and Babington-Smith Committee of 1920. Accordingly the Paper Currency Act of 1920 was passed which marked a departure from the old system. The Act had two parts, one containing the permanent provisions and the other containing temporary ones. The temporary provisions were regarded as essential pending the final attainment of the permanent provisions. For the time being the fixed fiduciary system was adopted under which it was laid down that the total amount of securities, exclusive of emergency currency issued against inland bills, should not exceed Rs. 85 crores. Subsequently this figure was raised to Rs. 100 crores of which not more than Rs. 50 crores were to be *ad hoc* securities. The permanent provisions of the Act, however, sought to introduce a proportional reserve system in which 50 p. c. of the reserve should consist of precious metals. The remaining 50 p. c. was to consist of securities of which only Rs. 20 crores worth of securities were to be kept in India and the rest in England in short term securities not exceeding a period of 12 months. For securing elasticity in currency supply provision was made for issuing emergency currency against genuine inland trade bills the amount of which was originally fixed at Rs. 5 crores, and subsequently raised to Rs. 12 crores by the Act of 1923.

The whole position was subjected to scrutiny by the Hilton-Young Commission who were influenced by the experiences of the Bank of England, the Federal Reserve System and the South African Banking System. Their main recommendations were as follows :

(1) The Commission pointed out that so long as the function of note-issue was separated from banking, elasticity of currency could not be secured and hence a Reserve Bank of India should be established with the sole right of note issue. These notes should be legal tender and guaranteed by Government at least for the first period of the Charter.

(2) There should be separate Issue and Banking Departments It was imitated from the Bank Charter Act of 1844. The idea behind this was that it would inspire more confidence. Of course, this practice does not make the notes more secure. But the commission were following the Banking Principle.

(3) Paper Currency Reserve and Gold Standard Reserve should be unified.

(4) The Commission recommended a proportional reserve system for India. India requires an expansion of currency in harvesting season and proportional reserve system would secure this, though, of course, it would make contraction difficult. The Commission recommended that 40 p. c. of the reserve should be in gold or gold securities provided that gold would be eventually 25 p. c. of the liabilities with a minimum of Rs. 30 crores in gold coin or bullion, at least half of which must be kept in England.

(5) The Commission suggested the suspension of minimum reserve requirements in the case of the notes on payment of a tax.

(6) The Commission wanted to dethrone the Rupee from its present position. The Reserve Bank notes should not be convertible in silver as in the past but will be convertible into gold in the form of bars of at least 400 ounces of gold.

Some of the above recommendations were given effect under the Reserve Bank of India Act of 1934. The following changes were introduced under the Act :

(1) From 1st April, 1935, the Governor-General-in-Council have ceased to issue notes. The Reserve Bank has the sole right to issue notes in British India. Of course, for the time being, the currency notes of the Government of India were supplied to the Bank by the Governor-General-in-Council. The Bank's own notes appeared from 1938.

(2) The Issue Department of the Bank is separated from the Banking Department.

(3) The notes issued by the Bank are legal tender at any place in British India and are guaranteed by Governor-General-in-Council.

(4) The Bank is authorised to hold as assets gold coins, gold bullion or silver of 40 p. c. value. The commission had, however, recommended only gold securities.

(5) The Commission had recommended that the total amount of gold coin or bullion in reserve should be Rs. 30 crores. But the Act provided for an amount of Rs. 40 crores. Of this 17/20th is to be retained in India.

(6) Should the reserve of gold and sterling in the Issue Department of the Reserve Bank fall below the minimum of 40 p c., the Bank shall pay to the Governor-General-in-Council a tax upon the amount by which such holding is reduced below the minimum of 40 p. c. at a rate not less than 6 p. c. per annum.

(7) Conversion of notes into silver rupees has been expressly retained under the Reserve Bank of India Act.

The most notable feature of Indian Paper Currency since the commencement of the Second World War has been an inflationary expansion of notes. This was, in the main, due to two factors—one external and the other internal. The external factor was the result of two phenomena, viz., repatriation of Sterling debt and increase in note circulation against sterling securities. A huge amount of sterling accumulated in India's favour since the outbreak of the war and this was the result of an excessive increase in exports, both of goods and services, and decline in imports. While the holders of sterling debts in London were paid off in sterling by the Reserve Bank, the Rupee counterparts of this debt were issued in India partly to the public and partly to Reserve Bank itself. Not only that ; a part of the sterling at the disposal of the Government of India in London was invested in sterling securities of the British Government and these were transferred form time to time to the Issue Department of the Reserve Bank. With these sterling securities as cover, the Reserve Bank of India, under the existing law, was able to issue corresponding amounts of notes in this country. In the first instance, these notes were transferred to the credit of the Government of India

who, with the help of this "artificial purchasing power", was able to acquire supplies in the market. The internal factor responsible for currency expansion in this country consists in the issue of notes against Treasury bills of the Government of India. For this purpose, the existing limit imposed by Section 33 (3) of the Reserve Bank Act on the size of Rupee Securities that could be held in the Issue Department was removed by an Ordinance issued in February, 1941.

Another interesting development immediately following upon the cessation of hostilities was the demonetisation of high denomination notes by the High Denomination Bank Notes Demonetisation Ordinance of January, 1946. This deprived the notes of the value of Rs 500/-, Rs 1000/- and Rs. 10,000/- of their character of legal tender. As Sir Archibaled Rowlands, the Finance Member, stated, the objects of the Ordinance were to strike at the black-marketeers, to rope in the tax-dodgers, to deprive public servants who had betrayed their trust of some of their ill-gotten games and to bring under control a potential threat to a sound monetary system. This Ordinance was immediately preceded by another ordinance known as the Bank Notes (Declaration of Holdings) Ordinance, whose aim was to help the Government to form an estimate of the amount of notes of denominations of Rs 100/- and above held by the banks relatively to the circulation. The question that was much discussed at the time was whether the demonetisation of high denomination notes would or would not be deflationary in its effect. The answer depended on a number of factors. These factors

were the proportion of high denomination notes which would not be offered for exchange, their proportion to total notes in circulation, their proportion to the aggregate liquid funds in the system, whether any further expansion of currency was taking place or not, whether the purchasing power embodied in the hoarded notes has been immobilised or not, and so on. According to the Finance Member, high denomination notes in circulation immediately before the promulgation of the ordinance amounted to Rs. 14,39, 700, 000 of which notes amounting to Rs. 11,75, 500, 000 or 81. 6. p. c. were presented for exchange upto 22nd. February 1946. On the other hand, during the same period, the total note issue of the Reserve Bank increased from Rs. 10,39,58 lakhs on January 12th to Rs 12,47,73 lakhs on January 25th. Thus, on the whole, it cannot be said that the effect of demonetisation ordinance has in any way been deflationary. Another proof of this is that during the same period, the deposits of the scheduled banks, both the demand and the time deposits, increased and did not show any sign of decline. "Any talk of deflation due to the demonetisation ordinances is ridiculous in the face of the enormous mass of liquid purchasing power now existing in the economy of the country which, it has been estimated, totals more than Rs. 2500 crores." (S. Basu.)

Effect of Partition on Currency. The partition of India has been followed by changes in the currency system, introduced under the Monetary System & Reserve Bank Order, 1947, issued under section 9 of the Indian Independence Act. Part I of the Order contains an introduction.

Parts II & III relate to the appointment of the Reserve Bank of India as bankers and note-issuing authority of the Federation of Pakistan. The provisions of part II will have the effect as part of the Law of Pakistan and those of part III as part of the Law of the Indian Union. The latter have taken the form of an amendment of the Reserve Bank of India Act, 1934, and will remain in force till 30th September, 1948. Part IV of the Order is concerned with the division of the profits of the Bank, of the reserves and other assets of the Bank.

Under the Order, the Bank is authorised to manage the curency of Pakistan and carry on the business of banking there for the Pakistan and provincial governments until 30th September, 1948, and manage public debt, issue new loans and carry on exchange operation until 31st March, 1948, until the Pakistan legislature otherwise decides, the standard monetary unit of Pakistan will be the Indian rupee. Until 30th September, the Indian notes will remain legal tender at any place in Pakistan in payment, or on account, of the amount expressed therein. On and after 1st April, 1948, the Bank may issue Pakistan bank notes which will be legal tender in Pakistan only. Indian rupee coins and subsidiary coins will have currency in Pakistan in the same manner as was in India before 15th august, 1947, for such period or periods, not expiring in the case of any coins sooner than one year from the introduction of corresponding pakistan coins as the Government of Pakistan may determine. One rupee notes will, however, cease to be legal tender in Pakistan after 30th September, 1948. As regards the supply of foreign exchange, the Reserve

Bank will, upto 31st march, 1948, sell or buy from any authorised person who makes a demand on that behalf at its office in Karachi foreign exchange at such rates of exchange and on such conditions as the Government of Pakistan, in consultation with the Government of India, may determine. The minimum amount for which the Bank will sell foreign exchange is Rs 2 lakhs.

The nature of control of the Reserve Bank over the scheduled banks in Pakistan will be the same as in India and they will have the same obligations to the Reserve Bank as any scheduled bank in India. In one respect, however, they are allowed certain concession, viz, that, in the case of any Pakistan scheduled bank, which finds it impracticable to submit weekly returns because of its geographical position, it will be sufficient if the Bank submits a monthly return. Further, the Banking Companies (Restriction of Branches) Act, 1946 and the Banking Companies (Inspection) Ordinance, 1946, will apply to whole of Pakistan until 30th September, 1948. Those banks which operate mainly in India but have branches in Pakistan need not be worried till a separate central bank for Pakistan comes into existence and demands separate cash reserves and returns of their affairs in Pakistan to be submitted to that bank.

CHAPTER IV

CENTRAL BANCING OPERATION

(Contd.)

Central Bank as a Controller of Credit : One of the principal functions of the Central Bank in all countries of the world is the control of credit. The objectives of credit control will be discussed in a subsequent chapter. In the present chapter we shall consider how far the central bank can control credit and what is the technique of credit control. In order to find out whether the central bank can control credit, we have to take note of the various types of credit and their uses and distribution. Credits are of various types, e.g., Bank Credit, Book Credit, Bill of Exchange, Promissory Note, Hundi, etc. Bank Credit apart, other forms of credit are beyond the control of central bank. And yet their volume is by no means negligible and they influence the level of prices in no mean degree. It is true that the central bank may come to acquire moral influence on the economic system ; but this is not true of most central banks particularly the new ones, and is not a thing which can be counted on particularly in emergencies when credit control becomes absolutely essential.

Turning next to bank credit, it is not possible to say that the central bank can exercise perfect and full control even over this field. For, this largely depends on how far the central bank has control over the banks. Thus, for example, all banks in the country may not have direct

relation with the central bank, as in the U. S. A. and India. This defect may, however, be removed by legislation. But if the banks do not spontaneously co-operate with the central bank, the control of credit cannot be made effective. This co-operation cannot be imposed by legislation but must develop spontaneously out of the relation between the central bank and other banks as it has developed in England. But even if the banks co-operate with the central bank, the ultimate distribution and use of bank credit are by no means within its control and, in fact, depend on the members of the public who use it. It is, of course, true that the banks can exercise some control over the immediate use of credit. They may not grant loans to stock exchange brokers, or for long-term industrial or agricultural finance. But once given, they cannot check its ultimate use, which may go against the policy of the banks and central bank. Besides, in recent years, the power of the central bank in this respect has considerably diminished and the actual volume of deposits is becoming more and more dependent on the public. In the words of the *Economist*, (7. 7. 45), "The real determinant of the rate of growth of deposits has been the form in which the public has elected to hold its savings." If the savings of the public are held by them in liquid form of bank deposit, the banks get a basis on which to expand credit. But if the public keep their money not in the form of liquid bank deposits but invest it in government loans, this will automatically impose check on the ability of the banking system to expand. Thus the possibility of expansion or contraction of bank deposits depends on the liquidity

habits of the people and not so much on the power of the central bank to control credit, a power which has lost its importance all the more since the adoption of easy money policy by all countries of the world for the last two decades.

Control of credit may be of two taypes, viz, quantitative and qualitative. Quantitative control of credit implies the control over the volume upto which credit may be expanded and the qualitative control implies the control of the distribution of credit. The difficulties in the way of instituting quantitative control of credit are so many. Thus in the first place, we must know how much credit is required which in its turn will depend on the level of prices, on the volume of money in circulation, on the velocity of circulation of both money and credit, on the volume of commercial activity in the country. It will be seen that many of these items are not accurately known and the central bank, therefore, must be absolutely careful in taking action. For, if the action of the central bank adversely affects the psychology of the people, that will engender greater fluctuation and do more harm to the economic system than good. Hence the central bank should proceed carefully and should be guided by customs and traditions and by its own experience and not by any hard and fast rule regarding credit control. No less difficult and delicate is the qualitative control of credit. In this respect also the central bank must not ordinarily move across the business psychology but proceed cautiously so that it can make its policy successful to a considerable extent.

Technique of Credit Control—Bank Rate : Now we pass over to the discussion of technique of credit

control. The technique includes : Bank Rate, Open Market Operations, Variable Reserve Ratio, Credit Rationing, Direct Action and Moral Persuasion. We shall take them up one after another.

Before the first world war, bank rate was regarded as the most important instrument for the control of credit. At times other methods of control were also applied but they were never regarded as the principal ones but mere subsidiary or complementary to the bank rate. Since the first world war, however, the importance of the bank rate as an instrument has considerably declined. We propose to trace here the evolution of discount rate both as a policy with the central bank and as a factor guiding the economic system as a whole one after another.

As a policy of the central bank, the bank rate was made effective in England first in 1839. Before this date, the rate varied between 4 and 5 p. c. and could not be raised further owing to the prevalence of usury law. Hence before 1839, only on occasions when the gold reserve of the Bank of England was threatened, the Bank had to protect it not by raising bank rate which could not be raised above 5 p. c., but by resorting to other methods, such as credit rationing, shortening of the currency of the bills eligible for discount, etc. After the passing of the Bank Charter Act of 1844, the Bank of England came to rely more and more on bank rate as an instrument of control. But even at the present time it cannot be said that the technique had reached perfection. The real test about its efficacy came during 1847 when this instrument was applied and the rate was raised to 8 p. c. The crisis was a great instructor. It brought home

the lesson that time is a great factor and if credit is to be restricted, it should be done just in time and with promptness. For, if the ball is set rolling once, if credit has been sufficiently expanded so as to stimulate excessive expansion, any action becomes ineffective till it precipitates a crisis. What is essential, therefore, is timely action. Even during the crises of 1857 and 1866 it was found that the Bank of England had not been able to take full advantage of the past experience. For, although the Bank responded promptly to external drain, its response to internal drain was insufficient. But then, this must be admitted that after 1844,—inspite of the fact that bank rate could not be made cent per cent effective,—the bank-rate had come to occupy a definite place as an instrument of control and was applied variously according to the currency and quality of the bills and was maintained at a rate above the market rate. In subsequent years, the practice came to be adopted in France and other countries.

The theory underlying bank rate policy as it was applied before the first world war is quite simple and brief. It means that a change in bank rate would bring about corresponding changes in market rates of interest and these changes in the market rates of interest, through their influence on the demand for and supply of money and on the flow of short term funds, would bring about adjustment in domestic prices, costs, production and trade and correct disequilibrium, if any, in the balance of payments. Thus, e.g., when gold goes out, it clearly indicates a maladjustment in the country's export-import position. Gold will go out from a country when the country is importing more and exporting

less and this it will do when prices in the country are not equilibrated with prices elsewhere but are higher and the country offers a profitable market for sale. More imports of goods and services mean export of gold. When gold goes out, the volume of money in the country decreases and this, according to the quantity theory of money, would reduce prices, bring pressure on factor-costs in downward direction, adjust home production, distribution and export-import position. The reverse drift would set in when gold flows in. But this is a dilatory process. A rise in the bank rate would bring about the adjustment more quickly and would stop the excessive outflow of gold. This would operate in the following way: When bank rate is raised above the interest rates current in other financial centres, it is a loss to send out gold and is more profitable to import it. So the exporters of gold would wait and would not import gold immediately. This also will bring about internal adjustment and would obviate the necessity of exporting gold. For, a rise in bank rate would be followed by a rise in the market rates of interest and if they continue for some time, they will bring pressure on cost-factors, reduce costs of production and hence prices. Thus when prices in the country have become low, not because of gold import, but because of the raising of interest rates, the country does no longer provide a profitable market for sale and hence imports come down to normal. As Robertson has said, "by one route and another, a rise in the rate of interest will have some effect in diverting the community's ready resources into avenues where they replace themselves more quickly, and will tend to restrain society from

investing for a distant return more than it can really at the moment afford." The lowering of the bank rate will have opposite consequences. If the corrective measures are continued for a sufficiently long time, they will not only stop the outflow of gold and bring adjustment in the economy, but will bring about the recovery of gold thus lost previously which would relieve credit stringency, reduce the rates of interest and revive business activity in general.

In order that a bank rate policy may be successful and effective, certain conditions must be fulfilled. In the first place, the bank rate must have close relation with market rates of interest and the market must respond to every gesture of the central bank. This requires a close co-operation between the two. Where co-operation is lacking, where the central banking institution is a new one, without long-standing tradition and influence, where the money market is badly organised, the bank rate cannot be made effective. This is true of many countries of the world, including India. Yet central banks in all these countries have adopted discount rate as a weapon whose significance in backward economies, according to De Kock, is threefold : (1) the bank rate is the rate at which the public can obtain accommodation from central bank on specified types of paper ; (2) the bank rate represents the basis of the rates at which commercial banks can obtain credit from central bank ; and (3) the bank rate has great psychological value which enhances the prestige of the central bank. Secondly, the economic system must be sufficiently elastic in order to

give effect to bank rate. We have already said that a rise or fall in bank rate is followed by adjustments in costs, prices, production and trade. But if these factors are not sufficiently flexible, the adjustment is rendered difficult and hence bank rate as an instrument of control fails. Finally, like the banking system, the business world also must respond to the gestures of the central bank. In order that they may be able to do so, they must be able to interpret the intentions behind the changes in bank rate, viz., whether these changes have been effected for correcting temporary maladjustment or for introducing permanent changes in the economic system. A wrong understanding of these intentions has often resulted in great harm ; for, as the Macmillan Committee pointed out, "even a change of bank rate of no great importance may cause undue alarm and have serious unfavourable psychological reaction on business confidence."

As already said, the bank rate as an weapon had declined after the first world war. There were several reasons responsible for this state of affairs. They were mostly connected with the disappearance of conditions prevalent before 1914. Before 1914, the importance of the London money market had increased not only because of the expansion of British trade but also because London was the money market for the whole world and all sorts of bills arising out of trade between various countries were discounted in London. After the war, however, the importance of the London money market had declined owing to the rise of money markets in different parts of the world and even the domestic bills had declined in

volume owing to the increasing use of bank overdraft and to the amalgamation of banks. The volume and value of international trade had declined in post-war years owing to currency difficulties and, in subsequent years, owing to the rise of economic nationalism. Other factors responsible for the decline of bank rate policy are the prevalence of easy money conditions in different countries of the world, the rigidities of the economic system, the fugitive move ment of funds which could not be checked by bank rate and the predominance of the influence of the state in the money market.

Regarding the bank rate as a factor in guiding the economic system, different writers have held different views. The older theories of bank rate regarded it as a means of regulating the quantity of bank money and as a means of protecting the gold reserve of the country. But they had never conceived of it as an instrument influencing saving and investment. This was done for the first time by Hawtrey who pointed out that changes in bank rate affect investment in liquid goods. Later on, Keynes also emphasized upon the importance of bank rate in influencing saving and investment but he differed from Hawtrey in this that while Hawtrey emphasized upon liquid goods, Keynes emphasized upon capital goods. Each has advanced strong arguments in support of his views ; but, on the whole, Keynes' point of view seems more correct. For the immediate effect of changes in the rate of interest is visible in investment goods industries where there is contraction of work, followed by unemployment in these industries, which in its turn leads to contraction of

consumption goods industries. The process works from investment goods industries to capital goods industries rather than the other way round. Hawtrey has also emphasized upon the stock of liquid goods. In this respect our statistical information is not very sufficient. But whatever statistics are available regarding bank advances they indicate that they have been unresponsive to changes in their costs and "have in fact generally been one of the last of the various economic series to turn up and down as trade has turned up and down."

Keynes derived inspiration from Knut Wicksell in the formulation of his theory. The natural rate of interest as developed by Wicksell in his *Interest & Prices* refers to a rate determined by demand for and supply of real capital and equal to the yield of capital instruments after deducting the remuneration of the entrepreneur. If the actual rate is lower than natural rate of interest, prices will have a rising tendency, and they will have a falling tendency if actual rate of interest exceeds it. So long as these two rates are equal, this will have no effect on prices. In his *Lectures*, Wicksell has slightly modified his views and connected them with the profits of the capitalists, which, in other words, is the same as profit rate—parallel to Fisher's 'rate of return over cost' and Keynes' 'marginal efficiency of capital'. But thus conceived, the natural rate of interest introduces greater complications. For the profit rate will be different in different industries and not uniform ; and hence it cannot influence total investment unless we take it to mean a rate

of interest at which the demand for and supply of capital in the capital market are in equilibrium.

Keynes uses the term 'bank rate' to mean the effective rate for lending and borrowing which prevails in the short period and builds up his theory of the *modus operandi* of the bank rate in the following words : A rise in the market rate of interest upsets the balance between the value of investment and saving, unless a corresponding rise in natural rate occurs at the same time. It may do this either by stimulating saving or by retarding investment. In the case of saving, the effect of a change in the rate of interest is direct and simple. A rise in the rate of interest will be followed by an increase in the rate of saving, and a decline in interest rate will be followed by a decline in saving. But its effect on investment is more complicated. The primary effects of a rise in bank rate will be a fall in the price level of fixed capital and therefore the price level of investment goods and an increase in savings. This will be followed by a decline in the output of such goods. An increase in savings will mean a contraction in the flow of income directed towards the purchase of liquid consumption goods and hence a decline in the prices of consumption goods. If, however, a rise in the rate of interest is followed by a proportionate decline in the volume of savings owing to the operation of other factors, the consequences will not follow. But under normal conditions such counter-forces are not expected to operate and hence prices of investment goods as also of consumption goods will decline. The ultimate effect of this will be a decline in the volume of investment which will go

on increasing if the prospects are not bright enough. And so long as there are prospects of losses, the natural rate of interest will fall below its normal level, thus widening tho gap between natural rate and market rate, and requiring a reduction of the latter, perhaps beyond what is practicable. The only solution of this state of affairs is a reduction in costs all round so that the economic system may be adjustjed at low prices. If this is not done, the entrepreneurs will be undergoing losses and will have to close their business. As Keynes has said, it is only when a reduction in the rate of efficiency earnings has been achieved that a true equilibrium will be established.

Althongh Keynes has developed his theory on the natural rate of interest as conceived by Wicksell, he is not sure about its efficacy, as he has indicated in volume two of the *Treatise*. In his later writings, Keynes still emphasized the importance of equilibrium between saving and investment but then he did not make it dependent on rate of interest, particularly because the rate of interest is ruling at a low level in all countries since the great depression ; but he had made this equilibrium dependent on state intervention, on comprehensive socialisation of investment, as he had called it.

Open Market Operations : Another instrument of credit control which came into greater use after the first world war was open market operation. That does not mean that this instrument was unknown before 1914. At times the London money market, which was the only important money market before 1914, became highly liquid and the Bank of England found it impossible to control it

with the device of bank rate. The Bank, therefore, withdrew the funds by means of selling consols spot and buying for the account and borrowing in the market from commercial banks and special depositors. But the device had not been perfected which is indicated from the fact that the Bank of England adopted diverse methods from time to time for the purpose and yet was not very happy about any one of them. The device was also adopted by the Reichsbank. The Bank of France had not, however, adopted this device but regarded it as an "Anglo Saxon Vice". When the Federal Reserve System came into existence in 1913, the Reserve Banks were authorised to buy and sell bonds and notes of the U. S. government and certain other papers. During the first world war and immediate post-war years, the device was used according to the requirements of war finance and post-war readjustment. In the post-war years, the importance of the device had increased and it was not used as a subsidiary or complementary means to bank rate but as a principal weapon. There were reasons for both. In pre-war years, the central bank was only a passive factor in the determination of the amount of credit and the dependence of the community on central bank was also much less owing to the fact that banking facilities were much more widely diffused. Besides, papers in which the central banks could deal were also less abundant at this time. In the post-war years, however, conditions have changed in favour of open market operations being adopted as a principal device. Thus in post-war years, the central banks, as also the Bank of England, gave up their attitudes of passivity and became more active and were co-operating with the

state and the entire economic system. Besides, as already said, the bank rate had declined in importance. Finally, at that time, the types of paper in which the central bank could deal increased both in volume and variety, particularly government securities and short term securities, such as treasury bills, and this increased the scope of open market operations.

In a wide sense, open market operation means the purchase or sale by the central bank in the open market of any kind of paper in which it deals. In a strict sense, however, it means only the purchase or sale of government securities by the central bank.

The significance of the open market operation lies in the fact that it tends to increase or decrease the volume of money in the economic system. Thus when the central bank purchases securities, it injects money in the economic system and when it sells, it withdraws money from the economic system. But the effect on the economic system is not direct. The immediate eflect of open market operations is on the deposits of commercial banks with central bank. The changes in cash reserves will proportionately increase or decrease the quantity of money and consequently bring about changes in money rates and credit conditions which in their turn will change the level of prices and bring about adjustment in general business activity.

From the above it will be seen that the effects of open market operations are rather complicated. For, a successful operation depends on a number of factors. In the first place, the cash reserves of commercial banks should increase or decrease in accordance with the nature and

extent of the open market operation. This does not always take place. For, the cash reserves of banks are not simply affected by the central bank's operations, but also affected by the flow of gold, return of notes from circulation or from hoards and other factors which may move in opposite direction and offset the purpose of open market operation. Secondly, the success of open market operation depends upon the banks' reacting favourably to changes in cash reserves i. e., they should increase or decrease their loans and investments in accordance with changes in their cash reserves. This also cannot always take place, because the functioning of the banking system is dependent on diverse factors, political and economic, monetary and psychological. The third assumption is that the demand for loans and advances will increase or decrease according to increase or decrease in credit base and decrease or increase in money rates. This assumption also cannot be fully effective. For if the period is charged with uncertainty, no amount of reduction in money rates will stimulate activity, while, on the other hand, when prospects are bright, high interest rates need not deter activity. Finally, it is assumed that the velocity of circulation of bank deposits is constant, which again is not true, nor is it controllable, but depends on business prospects, increasing during periods of rising business activity and falling during periods of declining business activity.

Besides these four, a number of other factors have to be taken into considertion. In the first place, there are a number of non-monetary factors, which working together with monetary factors, influence the economic system.

As already noted, even monetary factors cannot be fully adjusted by the action of central bank. And so far as non-monetary factors are concerned, they are clearly outside any control. To some extent the central bank may, by proper adjustment of credit, neutralise the effects of non-monetary factors, but a complete control over them is an impossibility. Secondly, the markets for short and long term government securities must be active and well-organised. But here also the trouble is one of price-differences—differences between the purchase and sale prices of securities which may bring loss to the central bank.

A few words may now be said about the use of this device in some countries. In Britain, although it was not unknown before 1914, after that date it has been used as the principal and independent instrument for serving the following objectives :

(1) to make bank rate effective ;

(2) to stabilise money market conditions by avoiding disturbances in the money market due to the movement of Government funds or seasonal movements ;

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

(4) to support Government credit in the money market for facilitating the issue of new loans or the conversion of the existing ones ; and

(5) to maintain cheap money conditions in the market for helping business recovery.

Since 1932, it has never been used to make bank rate effective. For maintaining the external value of currency, the Exchange Equalisation

Account had been instituted. The device was at times used as a supplement. For, the effects of gold and capital movement were offset through the E. E. A., generally, by the sale of an equivalent amount of Treasury bills when gold or exchange is purchased by E. E. A., and by purchase or redemption of bills in case of an outflow of gold or a sale of exchange. In 1938 when a substantial amount of French funds in London were repatriated, a new open market technique was adopted. At this time, the Bank of England, instead of seeking to offset the temporary contraction of bank cash by buying treasury bills, made it known that any dealer or broker finding himself short of funds would be able to sell bills to the Banks' broker instead of getting direct accommodation from the Bank at its official discount rate. As the *Economist* pointed out, this shifting of initiative from the Bank to the market was advantageous in so far as the size of these operations was automatically adjusted with greatest possible precision to the amount of help required by the market. Open market policy has also been of use in connection with the issue of new loans or the conversion of old ones. It also helped the maintenance of easy money conditions for helping business recovery, a function which was more successfully carried out in the U. S. A.

As already said, open market operation was adopted as a weapon in the hands of the Federal Reserve System when it came into existence in 1913. But before 1922 no effort at co-ordination of the open market operations between the 12 Reserve Banks was made. Each Reserve Bank purchased and sold Government securities and bankers'

bills according to its own requirements. This often resulted in competition among the Reserve Banks, raising prices of bills and securities against themselves and at times creating artificial market in government securities. As a step towards co-ordination, therefore, a committee was formed in 1922 for purchasing and selling government securities at the request of different Reserve Banks. This measure helped to abolish competition among the Reserve Banks. The committee was reconstituted in 1923 as an Open Market Investment Committee. Subsequently, a system of open market investment account was created under which it was required that open market investments should be governed with primary consideration to the needs of industry and commerce and of the general credit situation. The Banking Act of 1935 has further centralised the operation. For, it has abolished two bodies for the purpose, viz., the committee and the Reserve Board, in favour of a single committee consisting of 7 members of the Board of Governors and 5 elected representatives of the Reserve Banks. Henceforth the individual Reserve Banks have nothing to do but to follow the directions and regulations of the committee in respect of open market operations. The Act has prohibited direct purchase of securities from the Treasury which have to be purchased in the open market.

So much importance was given to the open market operation in the Federal Reserve System because the bank rate was not found suitable as an instrument of control. Besides, open market operation attracts less attention and hence is less distasteful in a

country where fluctuations in bank rate are not taken favourably. In the words of Governor Strong, open market operation could "be exercised without too great a red flag."

In the U. S. A. open market operation had the following objectives :

(1) To make bank rate effective or at least to prepare ground for it ;

(2) To influence member bank's indebtedness and money rates ;

(3) To influence business activity by relieving a stringency or averting excessive ease ;

(4) To protect gold supply ;

(5) To test the demand for credit by selling securities ; and

(6) To obtain control of a larger proportion of credit outstanding.

All these objectives were, however, not achieved. Thus, for instance, open market operation did not make bank rate effective ; rather, the bank rate was changed for making open market effective. The Reserve Banks have no complete control over member banks and their indebtedness cannot be controlled fully. The operation has hardly been used for the protection of gold supply which went on increasing owing to the panicky flow of gold to America.

On the whole, however, it cannot be said that open market operations in America have been very much successful. At the beginning, it was expected that open market operation will provide a means of

testing the real demand for credit; but very soon this point receded in the background. Keynes also enthusiastically approved this for the Federal Reserve System; but his approval also is hardly justifiable. He has been critical to such writers as Burgess, Strong and Chandler who have emphasized the theory that the open market operations are followed by inverse movements in rediscounts. In his view, the central bank is required to control the volume of bank money if member banks rediscount to the extent that they have been deprived of cash through open market operation. But he has missed the point that these offsetting movements themselves are an instrument of, not an obstacle to, control. In suggesting open market operation as an instrument for the F. R. S., Keynes' objective is to control the volume of bank money; but American experience is just the reverse. For, there the Reserve Banks have exercised little control over the volume of bank money. Hence in American experience also the scope for the use of open market operations as an instrument was very much restricted.

In backward economies the scope of open market operations is still more restricted, not because the securities cannot be bought and sold, but because their volume is so small that they cannot influence the credit policies of commercial banks. This is true of markets in Australia, Newzealand, South Africa, India, and other backward money markets. This is due mainly to the narrowness of the markets. Besides, in many cases the banks do not get local outlets for funds on short term or at call and hence their local cash proportions fluctuate widely over a period

of time. Thus in Australia open market operations have seldom been taken, the first instance being in 1935 when it was taken up with the object of checking a decline in security prices. So also in Newzealand, the narrowness of security market has made it difficult for the central bank to use open market operations. "The Bank's investments have remained modest and sedentary and it is difficult to detect in their movements any definite purpose or policy. When investments are undertaken, they are intended to facilitate government finance rather than to influence interest rates or credit structure of the country." The case of Canada stands in a different category because of the existence of New York money market nearby where the Canadian banks can keep large liquid resources, along with a fairly rigid cash proportion in Canada. That is why open market operation could be applied with some success in Canada in the first stages. But the increasing liquidity of the banks made the future of open market operations rather hazy.

Since the outbreak of the second world war, the objectives of open market opreations have changed. These objectives in most belligerent countries were, first, to preserve a pattern of interest rates, and second, to support the price of government securities. This was sought to be achieved by increasing the reserve balances of member banks with which they could purchase government securities. Thus the Bank of England began to purchase government securities with a view to preventing the cash reserves of commercial banks from being depleted owing to the demand made by the members of the public. In this

way it was possible for the British banks to maintain their cash ratio round about the traditional level of 10 p. c. In this way the Bank of England provided a basis of bank cash which was able to maintain the superstructure of bank credit. Similarly in America the Federal Reserve Banks purchased large amounts of government securities with a view to providing the commercial banks with an adequate amount of reserves with which they could build up deposits for the purchase of Goverment Securities and to maintaining market stability. In some countries these operations were aimed at absorbing the surplus liquid funds on the money and capital markets.

The war has not only changed the object, but also the technique, of open market operations in some countries. Before the war, the Bank of England had an indirect connection with joint-stock banks through the discount houses. This was substituted for a direct relationship between the two. When it was not possible for the discount houses to take the Treasury bills for which they have tendered, the Bank of England purchased short-dated bills from the banks so that they would be able to purchase long-dated bills from discount houses and thus relieve stringency in money market. The object of the open market operations of the Reserve Bank of India during the second world war was to maintain the values of government operations in the money market.

Variable Reserve Ratio : For long it was regarded that the primary purpose of legal reserves of member banks was to maintain liquidity. But this was a wrong

notion. For, if there is any run on the banking system, the legal reserve would hardly be sufficient to meet the situation. The liquidity of the banking system, really speaking, depends on the eligibility rules of the central bank. The purpose of the legal reserve is, therefore, to furnish the central bank with a means of control over the volume of credit. The real function of the legal reserve was first recognised in 1931 in the Report of the Federal Reserve Board's Committee on Bank Rererves. The Committee also recognised that apart from providing the banking system with a means of credit control, the legal reserves furnish resources to the Reserve Banks. A third purpose is to ensure the supply of gold and foreign exchange for foreign exchange operations. These three purposes have been kept in view in providing for legal reserves in newly enacted laws for the establishment of the central banks. Thus when the Reserve Bank of South Africa was established, the commercial banks were required to keep as deposit with the Bank 13 p.c. of demand liabilities (reduced to 10 p. c. during depression) and 3 p. c. of the time liabilities. These provided the Reserve Bank with gold supply, with a means for undertaking some amount of lending and investment operations and a means for controlling the banking system. In Canada the banks are required to keep 5 p. c. of the total deposit liabilities with the Bank of Canada, though customarily the bigger banks maintain a higher ratio of about 10 p. c. In India, under section 42(1) of the Reserve Bank of

India Act, every scheduled bank has to maintain with the Reserve Bank a balance of not less than 5 p. c. of the demand liabilities and 2 p. c. of its time liabilities. It has been recognised by the Reserve Bank of India that "the real purpose of these balances is not to guarantee the deposits of the public with banks; for, if this were so, a reserve of 5 p. c. against demand and 2 p. c. against time liabilities would hardly be adequate for the purpose. The primary purpose of these reserves is to enable the central bank to exercise some measure of control over the banking system."

Now it may be considered how the legal reserve ratio may be utilised by the central bank for the control of credit. This, it is suggested, can be done by variable reserve ratio. The idea originated in 1917 in the U. S. A. when the Federal Reserve Board made a proposal on these lines, but at that time it was too revolutionary to be accepted. The suggestion was approved by Keynes in his *Treatise* in the following words: "The possibility of an inadequacy of ammunition interfering in exceptional circumstances with the efficacy of open market operations makes it worth while to mention a further expedient which has never yet been put into practice, viz., a discretion to the central bank to vary with due notice and by small degrees the proportion of legal reserves which the member banks are required to hold." Regarding the efficacy of this new instrument of control, Keynes says, "It goes straight to the root of the matter,

instead of relying on the indirect and roundabout influences which our empirical systems of monetary management have evolved for themselves. If the member banks are lending too much and increasing cash balances without due regard to the requirements of their customers in existing equilibrium, or if, on the other hand, they are lending too little, the variation in their reserve proportions puts on them the direct possible pressure to move in the desired direction." The fact is that in a country where extensive open market operations by the central bank are not possible, the mere existence of the weapon of variable reserve ratio would add enormously to the influence of the central bank.

Those who have opposed against this weapon have done so on the following grounds. It is pointed out, in the first place, that a change in reserve ratio, particularly in upward direction, would obstruct the restoration of the previous level of loans and investments. Secondly, it was argued that when easy money policy is so very essential, as it was in particular after the great depression, any revision of the reserve ratio in upward direction would result in a contraction of the base on which the banking system could raise the super-structure of credit. And finally, a revision of reserve ratio, whether upwards or downwards, would introduce an element of uncertainty which would be harmful to the entire economic system. However strong these arguments may be, it must be admitted that the bluntness of the traditional weapons of credit control left no other alternative than to take resort to this new weapon.

At a time, of which we are speaking, viz., the years following the great depression, when the banks in the U.S.A. had huge excess reserves and hence discount rate would not be effective, even if applied. When the banks had such huge reserves in excess, the open market operations also would not be very successful and their effects would not be direct and immediate. For, they may withdraw some funds from the big banks but not from all banks. The variable reserve ratio would be immediate and direct in its effect, affect all the banks and change the base on which they were raising credit super-structure.

The method was first introduced in the U. S. A. in 1933 and later modified in 1935, when the Banking Act empowered the Board of Governors of the F. R. S. to change the member banks' reserve requirements by regulation "in order to prevent injurious credit expansion or contraction", the minimum reserve percentages not to be less than those existing at the time nor more than twice such percentages. This was made effective in 1936 when the reserve requirements were raised by one-half. This brought the reserves of the banks "within the scope of control through the system's open market portfolio". In 1937, further changes in the reserve requirements were made in two instalments upto the full amount permitted under the law. In 1938, however, as a part of the Governments' programme of encouraging business recovery, the minimum reserves were reduced by $12\frac{1}{2}$ p. c. from their high level.

In some of the less developed economics of the world, variable reserve ratio was found suitable as a means of

controlling credit and hence was adopted in countries like Sweden, Newzealand. Thus the author of the Midland Banks' Monthly Review wrote in 1937, "In many countries the facilities for open market operations by the central banks are relatively restricted ; the possibility of selling securities when cash supplies seem excessive is severely limited. In countries like this (viz., Newzealand) if minimum reserve ratios are thought necessary, the clearest case is to be found for flexibility in the minima—a much clearer case than, e. g., in the U. S., where a broad and active capital and money market is available as a field for central banking operations."

The device, however, is not suitable for all conditions, particularly in money markets which are very narrow and where the banks hold large foreign assets which they can dispose of, in view of any variation in reserve ratio and maintain their credit base. Thus, e. g., the markets in Australia, Newzealand, and to some extent in South Africa, are very narrow and hence the banks have to maintain considerably flexible reserve ratios which make the variable reserve ratio "a crude and insensitive weapon of credit control". The banks in these countries also maintain large balances in London, which in times of need they can dispose of and thereby maintain the credit base. This actually happened in Australia in 1936-37 when the cash ratios of the banks in Australia declined. In India also conditions are very similar in view of the narrowness of the money market, unstable ratios of the cash and balances with the Reserve Bank as percentage of total liabilities and also considerable external assets held by

banks. In the U. S. A., also, the availability of easy credit to the member banks at the Reserve Banks constituted a limitation to the successful functioning of the variable reserve ratio. A number of other limitations were placed on its successful functioning. Thus in the first place, while the reserves against demand deposits average about 10 p. c., those against time deposits are three per cent, the practice of mixing these together made it difficult to exercise control over the aggregate amount of deposits. Secondly, the legal reserve requirements being different according to the location of the banks, the transference of of funds from country banks to city banks by the depositors and vice versa affected the total reserves required for a given amount of demand deposits. Thirdly, the practice of small banks in depositing a considerable portion of their funds, during dull periods in Reserve Banks increases the amount of reserves which are required to support a given amount of individual bank deposits. These changes in the balances of inter-bank deposits affect the total amount of reserve which must be kept against a given volume of deposits. Thus as the law now stands, there are so many impediments in the way of the exercise of effective and accurate control over the volume of bank-credit. As Goodbar says, "The steering mechanism of control is powerful enough, but the front wheels have developed a disconcerting 'shimmy' and the dangers from this 'shimmy' in front wheels is directly proportional to the Boards' style of driving." Inspite of these limitations, this weapon has proved a useful addition to the system's mechanism of credit control. As Watkins puts it, "Reliance is placed

not merely on familiar rediscount rate and open market operations but on new weapons added by recent legislation, in particular, the power to increase the margins against brokers' loans. These new powers should aid the authorities in controlling speculative credit and assist in the avoidance of a repetition of conditions such as prevailed in 1929. But they promise to be more efficacious if they are employed or held ready at hand in conjunction with smaller excess reserves. In a sense, the variable ratio is an axe which may be used to hew down the abnormal reserve structure, leaving the planning and sand-papering to other more delicate instruments of control."

Credit Rationing : This was not adopted as a regular instrument for the control of credit but used for making discount rate effective. For this purpose it was adopted by the Bank of England towards the end of the 18th Century. The Bank placed a limit upon discount from any one discount house or rejected a proportion of each discount application whenever total demands exceeded the sum which it was prepared to discount on any one day. Since the passing of the Bank Charter Act of 1844 the practice has, however, been discontinued owing to the adoption of bank rate as a regular instrument. In the same way when other central banks came to adopt discount rate, the importance of credit rationing even for them declined, and it was adopted only under stress of war-time conditions.

Credit rationing may be both qualitative and quantitative. Qualitative credit rationing makes discrimination for certain types of bills and against others, whereas quantitative credit rationing limits the volume or amount upto

which credit may be granted. In combining the two, restrictions as to amount for particular types of paper and prohibition for others are imposed.

In the critical years following the first world war, credit rationing as an instrument of control assumed great importance, and it was adopted by central banks of several countries. According to Wagemann, credit rationing as an instrument was rather rediscovered than invented. Thus in Germany credit rationing had to be introduced when the currency, which was stabilised after the inflation by the introduction of the Rentenmark was endangered after the negotiations following the Young Plan had resulted in the withdrawal of foreign funds from Germany. The banking system of Germany had to bear the brunt of this impasse. In 1931 the Reichsbank used credit quotas for preventing the collapse of large banks. This strong attitude taken by the Reichsbank during these crises enabled the German economy to a considerable extent to recover soon.

In subsequent years, with the introduction of economic planning in many countries, credit rationing came to be adopted as a logical concomitant of national planning schemes. Thus it was adopted in France, Italy and Russia. Since it is a highly practical weapon, it is scarcely governed by theoretical principles. Its actual application has varied in accordance with the objectives in view, such as, integration of the banking system, organisation of money market, etc. The application will also vary according to the local conditions in each economy at a particular moment, the objectives of economic plan, etc.

Direct Action—Moral Suasion : Direct action as an instrument of control may be conceived in a broad as well as a narrrow sense. In a narrow sense, direct action includes those cases where the central bank is forced to take coercive measures against a member of the money market. In a broad sense, direct action includes not only coercive measures adopted by the central bank but also persuasive measures adopted in order to induce the banking system to do or not to do a certain thing. Thus conceived, direct action also includes moral suasion.

Direct action has assumed various forms depending upon circumstances. In some cases a central bank is found penalising other banks by charging penalty rates over and above the official discount rate. In some cases, again, the central bank may refuse to rediscount for banks whose credit policy is regarded as being inconsistent with the maintenance of sound credit conditions in the economy, while in others the central bank may altogether refuse to rediscount for banks who have already borrowed excessively from the central bank. Evidently the objective of direct action is to secure better qualitative distribution of credit in the economic system with a view to attaining certein objective. In practice, however, it has not operated very successfully and effectively. For, in the first place, direct action implies certain amount of coercion on the part of the central bank over the banking system, and coercion is obviously unpopular. Secondly, direct action may not result in the attainment of specific objectives. For, as we have already said, the ultimate use of credit depends not on the banking system but on the public and hence it cannot be

controlled. Thirdly, we know that central bank is the lender of the last resort. So in times of necessity when the banks stand in need of accommodation, it cannot refuse to grant the same, without, however, affecting its position as a central bank.

Direct action as an instrument of control was adopted by the Federal Reserve system and its experience cannot be said to be happy, nor can it be used as an alternative to bank rate policy. As Burgess points out, direct action is generally taken for dealing with a few banks obviously using the Federal Reserve credit for very long periods or in very large amounts, but to attempt to apply it more generally would involve endless controversy as to what constitutes "undue use of bank credit for the speculative carrying of, or trading in, securities, real estate or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions." The Banking Acts of 1933 and 1935, however, gave wide powers to the Board of Governors of the Federal Reserve System not only over the Reserve Banks but also over the lending operations of the member banks. If the Board feels that any bank has made undue use of bank credit, the bank may be suspended from the use of Federal Reserve credit facilities. The Board may also direct any member bank to refrain from the further increase of its loans under penalty of suspension of all rediscount facilities. Although the law has given such wide powers to the Board of Governors, yet its actual application is limited by factors indicated by Burgess which we have already noted. Besides, an enforcement of coercive action would result in a division

of responsibility between central bank and the banking system and this is often harmful in its consequence. For, the commercial banks would feel that the ultimate responsibility rests on the central bank and hence they would reduce their vigilance over credit creation or may even try to evade the regulations imposed by the central bank. "In such a highly specialised and complicated business as commercial banking, the division of responsibility between central bank and commercial banks for the soundness of lending operations of the latter and the confusion resulting from the evasion of regulations by some banks and their observance by others are fraught with grave dangers to the financial welfare of the community."

Moral suasion, as already noted, is a type of direct action and depends not on coercion but on persuasion, which, in its turn depends upon the prestige enjoyed by the central banking institution. It takes the same forms as direct action but its technique is different and the psychological reaction it may engender is less unfavourable in so far as it is not based on coercion. Thus it has greater possibility of becoming successful in so far as it can persuade the banks concerned to refrain from increasing their loans for speculative or non-essential activities or even to reduce their loans for such purposes. But then this instrument, as Burgess rightly points out, should be used with utmost discretion, and its effectiveness would depend upon the prestige and position of the central bank. Besides, if it is used too frequently, it is likely to prove blunt. Moreover, since it lacks administrative sanction, in times of utmost

necessity, it may prove ineffective. As Clark points out, the efficacy of warning as an instrument of control has been very slight, for while they have no doubt exerted a restraining influence at times the forces making for expansion have proved too powerful for warning without any teeth in them to be effective. For, without any "teeth", the efficacy of moral suasion depends on the co-operation from member banks which is not always forthcoming. Some may co-operate while others may not. Therefore, it becomes difficult to secure uniformity in policy and it discriminates against those banks who offer co-operation. In the U. S. A. the position was rendered all the more difficult because of the existence of independent unit banks and of the newness of the central banking structure, which therefore did not command the same prestige as that of the Bank of England.

In authoritarian states, however, these expedients have been applied with greater degree of success. Thus it was more effectively applied by the Reichsbank. The scope for moral suasion is great where the central bank commands prestige and position among the banks. In those economies, where other weapons of credit control are not successful, the central bank may try these ones, particularly moral suasion as far as possible. Moral suasion may also be used for removing malpractices from the banking system. Thus the Reserve Bank of India recently sought to utilise moral suasion for the purpose. It sent circular letters to the scheduled banks on two matters, viz, the habit of allowing the constituents to draw against undeclared cheques and the interest rates The former practice was

dangerous. Regarding the interest rates, the Reserve Bank advised the banks to introduce uniformity in interest rates by discontinuing interst on current deposits and reducing interest on fixed and savings deposits.

CHAPTER V

CENTRAL BANKING IN DIFFERENT COUNTRIES

Bank of England : The Bank of England was founded in 1694 to provide funds to the Government of William and Mary for prosecuting war against Louis XIV. Till the Bank was established, the crown relied, for its expenses, on the Royal Domains and special grants from Parliament. But since the income from Royal Domains had contracted and the crown was in conflict with Parliament, the stuarts attempted to raise funds by granting monopolies by appeal for loan to the Pope, the City of London and the king of Spain, by ship-money, by threatenting to debase coins, by seizing precious metals in transit on foreign account lying in the Tower of London. The last practice was shocking to the business community who henceforth used to keep gold not in the Tower of London but with goldsmiths, who became deposit bankers.

The war with France increased the difficulty of finance and hence the Bank of England was established by an Act of Parliament, since at this time there was no law governing a joint-stock company. The original capital of the Bank was £ 12,00,000 which was raised by public subscription, though in subsequent years it was raised by the same method till it reached £ 14 million sometime back. The whole of this sum was given to the government at 8 p. c., the government in return giving the bank the right of issuing notes upto an equivalent amount. Thus originally the bank was started not as a bank of issue nor as a bankers' bank, but only as a banker to the government, giving loan to the government. The Bank soon proved to be a success and in order to prevent the growth of rival institutions, the Act of 1708 forbade the issue of notes by other joint-stock banks except the Bank of England. But since the law was silent regarding note issue by private banks, their activities, as also numerical strength, increased considerably and they were unregulated and most often unfit to bear their responsibilities. The Act also gave the monopoly of joint-stock banking to the Bank. The Bank had, however, grown so much in importance in London that the influence of the private banks decreased and they found it more profitable to carry on banking business of receiving deposits and granting loans rather than that of issuing notes. In the interior, however, the private banks reigned supreme. The Bank of England was the only joint-stock bank for over a century after 1708 and under the influence of the state it grew in importance to a considerable extent.

During the Napoleanic Wars, the Bank was in particular faced with difficulty. The Government had to incur heavy expenses for financing the war and the gold reserve of the Bank was seriously depleted. When the rumour of French landing created a panic and heavy withdrawal of gold by the public had started, an Order-in-Council was issued in 1797 suspending all payments in cash. Further notes were issued to meet the situation; but these became depreciated notes. Hence gold totally disappeared from circulation and the market price of gold went up by leaps and bounds. Hence a Committee—the House of Commons Committee—was appointed in 1810 to consider the question of high price of precious metals. The Bullion Report of 1810 laid down a number of important principles regarding the issue of bank notes and the maintenance of the value of currency. These were very similar to the suggestions of Ricardo who wrote a number of articles on "the high price of bullion as proof of the depreciation of bank notes." Thus he wrote, "The remedy which I propose for all evils in our currency is that the Bank should gradually decrease the amount of their notes in circulation until they shall have rendered the remainder of equal value with the coin which they represent or in other words till the prices of gold and silver bullion should be brought down to their mint price." The Bullion Report suggested, among other things, that the rates of exchange with gold standard countries cannot go beyond or below the specie points for a considerable period of time, that the considerable variation in the chief exchange rate beyond these limits was due to the excessive

issue of the Bank of England notes which had depreciated considerably as compared with gold, that the market price of gold can never exceed the mint price. The Committee gave its opinion in favour of the revival of cash payment and restriction of the volume of notes to the extent to which cash payment is possible. The Committee however recognised that a sudden restriction of note-issue might cause a financial crisis and hence recommended a return to cash payment within two years. The recommendations were not however accepted by the House of Commons for party reasons ; but subsequent events proved their soundness. The Napoleanic Wars were followed by violent speculation in which hundreds of note-issuing banks had failed. This automatically reduced the volume of paper currency, reduced the price of gold and raised the exchanges above par. Specie payment was, therefore, resumed in 1816 but could not be continued owing to the rise in the price of gold. In 1821 however the bank note currency was establised on a convertible basis. Some people, however, argued that all troubles with paper currency were due to its concentration in the hands of the Bank of England and that they could be removed by allowing other banks to issue notes. Hence, in order to encourage note-issue by other banks, the Act of 1826 permitted the establishment of joint-stock banks of issue with unlimited liability outside 65 miles of London. Thus the Act facilitated the establishment of joint-stock banks in the interiors where till then banking had been a monopoly of the private banks. The Bank Act of 1833 removed the restriction and henceforth joint-stock banks could be

opened even in London, though they could not issue notes. The same Act made the notes of the Bank of England legal tender for all payments over £ 5. This provision added to the prestige of the bank to a considerable extent. The Act was followed by the establishment of a number of joint-stock banks in London. The subsequent developments, both in the matter of note-issue and credit control have already been noted in proper places.

The affairs of the Bank are directed by a Court consisting of a Governor, a Deputy Governor and 24 directors. The directors are all elected at the stock-holders' meeting, nominally for one year, though they may be re-elected and are actually re-elected for indefiinite number of time.

The Bank is divided into two Departments—the Issue Department and the Banking Department. The Issue Department consists of gold coin and bullion, notes issued, the government debt, other government securities and other securities, and silver coins. The notes issued represent the liability of the Bank's Banking Department. The Government debt consists of loans given to the Government from time to time including the original amount of the loan of £ 1,200,000. The assets of the Banking Department consist of Government securities and other securities. Government securities include investments in the British Government stocks and in Treasury Bills, Deficiency Bills, Ways and Means Advances. Other securities include Indian, Dominion and foreign securities, miscellaneous securities, commercial bills. The

discounts and advances of the Bank consists of Treasury bills and bills of exchange discounted with the Bank and advances to the discount market and other customers. The liabilities of the Banking Department consist of, the stocks held by the stockholders of the Bank, public deposits, other deposits and the rest. Other deposits include the deposits from other customers of the Bank. The balances of other domestic banks are shown as Bankers' Accounts. Other accounts include the Accounts of foreign central banks and Dominion and colonial banks as also the accounts of merchants banks, financial houses, Dominion and Colonial Governments and private customers. The rest is nothing but a general reserve of the Bank consisting of the undivided profits and the balance of Profit and Loss Account.

The fundamental business of the Bank is to act as a central bank i. e,, to control the commercial banks in such a way as to support the monetary policy of the state. With this end in view the bank controls note-issue, acts as bankers' bank and banker to the government, conducts a small amount of banking business and is the ultimate source of funds for the discount market. The operations of the bank are veiled with secrecy though the Acts of 1844 and 1928 made the publication of Bank Return compulsory.

Before the first world war, the Bank of England was not only a central bank for England but for the whole world, in view of the international importance of the London money market. In the words of Mr. Jones, "The Bank of England acted as a Central Bank for Great

Britain, but also as a sort of International Bank of economic settlements. In time of need, it was able to draw funds from other countries and to employ those funds at the place of need and in the manner dictated by that need. One of the outstanding features of the system was that, when any country was in distress, the Bank of England was able and ready to mobilise the reserves of the world and to rush to the rescue of that country..... .....If actual gold was needed, it was forthcoming, as in the case of the U. S. A., during the crisis of 1907 ; if a short term loan was needed, gold was not unnecessarily moved from one country to another.....The Bank of England adopted a more or less neutral attitude in the sense that it performed the essential functions of an International Bank and regarded the problem of monetary stability as international problem."

After the first world war, the situation had however changed. Central banks had emerged in most countries and London was no longer the money market for the world. This reduced the importance of the Bank in international field. But its importance in the domestic economy had increased in post-war years. We have already seen how the Bank helped the formation of the Bankers' Industrial Development Company for providing long-term finance to industry. After the depression the function of the Bank was reduced ; for, the functions of maintaining the external and internal values of currency were henceforth separated, the former being entrusted to the Exchange Equalisation Account and the latter to the Bank of England. The gold of

the Bank was transferred to the E.E.A. for the purpose. Thus the year 1932 marked a thorough change in the functioning of the Bank. In the words of F. G. Conolly, "the year 1932 divides two contrasting seven-year periods—in the first we had the gold standard, a freely moving Bank Rate, and a long-term yield frozen at a high level : in the second, managed currency, a freely moving long-term yield, and Bank Rate frozen at a low level." The Bank rate was lowered for making the cheap money policy of the government a success. There was close co-operation between the Bank, the E. E. A. and the government. As the Governor of the Bank said, "if they (Ministers) will make known to us through appropriate channels what it is they wish us to do in the furtherance of their policies, they will at all times find us willing with goodwill and loyalty to do what they direct us as though we were under legal compulsion. Under the Currency and Bank Notes Act of 1939, the fiduciary issue of the Bank was reduced from £400 million to £300million and the gold stock of £126 million was revalued at £ 221 million. With the outbreak of the war, the gold stock of the Bank was transferred to the E. E. A. and the fiduciary issue increased to £ 580 million. All through the war, the relation of the Bank with the Government was one of close co-operation. The money and capital markets were subjected to extensive regulations, as already noted. Foreign exchange was also controlled to suit the requirement of the Government. The termination of the war has been followed by a change in administration. The Labour Party has come into power and the Bank of

England has been nationalised under the Bank of England Act, 1946.

Bank of France : The Bank of France is the most important institution in the money market of France. From its beginning the Bank has been able to maintain its position in the market. But then like central banks in other countries of the world, the Bank of France has at no time claimed the management of currency or the control of credit nor has it been the leader of the money market. The Bank was established for increasing the available discount facilities and since its inception it has been granted the privilege of note-issue, their monopoly, etc, for enabling the Bank to render service to a wide area. At its inception, the Bank was a purely commercial bank granting credit to individual customers. And although in subsequent years it has developed into a bankers' bank, its relation with the public continued. Although a central bank, it has followed the lead of the money market, unlike other central banks. Besides, it has never taken resort to the open market operation which has all through been regarded by the Bank as an "Anglo-Saxon Vice."

The most important function of the Bank has been the issue of notes. It has already been seen that the French economists belonged to the Banking School. Hence they followed what has been called the maximum issue principle. Tha maximum was originally fixed at 350 million franc, which was raised in difficult times, as during the Franco-Prussian war and the first world war. The amount and form of the reserve were left entirely to the discretion of the Bank. Generally, it maintained a high reserve

and protected it by exceptional measures, e. g., charging a premium for conversion of notes into gold, thereby inducing the public to accept silver. Since the commencement of the first World war, the notes of the Bank were made inconvertible In 1928 when the gold standard was restored in France, the maximum issue principle was abolished and the proportional reserve system was adopted in which reserve of 35 p c. in gold had to be maintained. The maximum issue principle had functioned very successfully in France and was supported by many in England. The method has also been followed by Canada, most countries of Europe, and the U. S. A. "In a country like France where the chief need for credit arose from internal trade, and where there was relatively little danger of a foreign drain of specie, this principle was very suitable, especially in view of the slow development of the use of banking accounts." Although the monetary law of 1928 adopted the proportional reserve system, yet it did not abandon the principles of note-issue followed so far.

The Bank had taken no part in foreign exchange business until the outbreak of the first world war. During the war, however, the Bank had to undertake these transactions for stabilising market conditions. In the years following the first world war, the fluctuations in the rates of exchange became very frequent and increased in magnitude. Hence the Bank had to interfere in this business for counteracting the foreign speculation in franc. From 1928 onwards, the Bank began to convert its foreign holdings into gold. This caused great embarrassment to the Bank of England and so in 1931 the Bank of France

stopped converting its sterling into gold. The result was that when England went off gold and depreciated the sterling, the Bank of France suffered a huge loss. Since then the Bank converted its dollar-holdings into gold and thereby was saved from the disappointment which it would have suffered when in 1933 the U. S. A. depreciated the dollar.

The relation of the Bank with the banking system may now be noted in brief. Like other central banks, the Bank of France also developed into a bankers' bank. But as already said, the Bank also deals with private individuals and hence it offers discount facilities to all, both banks and the public. For the purpose, however, it requires that the paper must bear three signatures, be short-dated and arise from a genuine transaction. The discount rate has been uniformly maintained by the bank for all. The rise in commercial banking, however, led to a decline in the discount function of the Bank and its functions became more and more confined to rediscounting. In this way its commercial banking function declined and it began to emerge as a central bank. Even in the field of rediscounting the functions of the bank have remained limited. For, the big banks hardly approach the bank for rediscount facilities. They feel it beneath their dignity to do so. If they are in need of funds, they borrow from each other or borrow on their Treasury notes at the Bank. Hence the papers that are offered to the bank for rediscount bear the means of smaller banks and less wellknown merchants. The rate of interest prevalent in this part of the money market of France is generally higher than the rate of the

Bank of France. In this respect, the discount rate in France differs from the Bank of England rate.

Another important function of the bank is the collection of bills. Such bills are, however, considerable in number and volume, in view of the limited use of cheques. The branches of the bank give enormous facilities for the collection of the bills. Even the small banks, as a matter of custom, rediscount the country bills a short time before maturity.

As already said, the bank has never looked with favour at the open market operations. Although in 1928 the bank was granted the privilege of carrying on open market operations, it was never utilised, partly due to the opposition of banks and economists to interference by the bank in the market and partly "because such interference in other countries has usually operated in the direction of inflation."

In 1928, the bank was authorised to purchase or sell bills on account of other central banks. The Bank of France has done this type of function to a considerable extent for other central banks and for the Bank for International Settlements.

As already said, the Bank of France was not only a bankers' bank but also a banker to the members of the public, unlike other central banks. This was due to the fact that originally the Bank of France was a commercial bank, which function it has not been able to get rid of. For this purpose the bank has kept its discount rate stable over periods of time and has never been found making a discriminatory use of the same. Since the discount rate was not used for the protection of gold reserve, it could be

maintained at a low level, lower than the market rate, and this in itself is a sufficient indication that this technique was used not for controlling the money market but for rendering service to the public. The only exception to this was in 1853-66 when due to the Crimean War the stock of gold became reduced in making payments for war supplies. Apart from this, there was no other occasion upto 1914 when the protection of gold reserve of the bank became essential. This was due to the peculiar position of Paris as a money market which stood in a different category from London. London money market being an international money market was the abode of short-term funds from different countries. In Paris there were few foreign short-term balances and hence their withdrawal could not be a threat of considerable importance to the gold reserve of the bank. In fact, the reserves of the bank depended upon domestic policies and not on foreign short-term balances.

With the outbreak of the war, however, the policy of the bank underwent change under pressure of circumstances. The functioning of the bank became completely subservient to the needs of the government. During 1914-20, the discount rate of the bank remained at 5 p. c., when in 1920 it was raised to 6 p-c. In the meantime the external value of the franc was declining which made the revision of the discount rate in downward direction almost an impossibility. Rather, for preventing the flight from the franc, the rate had to be raised to 7½ p. c. in 1926. With the balancing of the Budget and the formation of the Caisse for the funding of the public debt, the rate

was reduced to 4 p. c. in 1927. During the years of depression, the stock of gold in France was sufficiently high and the discount rate stood at 2½ p. c. Even this was without any effect on the market. While the money market was suffering from plethora of funds, there was hardly any opportunity for their profitable investment. The volume of rediscounts was also small, since then the rate had been slightly raised in 1934 and 1935. Thus while other measures of credit control have not found much support in France, the discount rate also was not used very much, as it has been done in other countries. As it has been said, "Alternative measures to discount rate changes were no longer available since France had gone upon full gold standard ; nor would public opinion have tolerated different rates for different maturities of paper. On the other hand, changed conditions themselves made discount rate almost completely ineffective and there would have been little advantage in frequent and drastic changes."

Like all other central banks, the Bank of France has also been a banker to the government. Although a purely public institution, the bank was founded under government patronage and has been subjected to a certain amount of state control. In times of crisis the bank has given loyal support to the government while in normal times it has tried, and even struggled, for maintaining its independence.

The second world war created monetary chaos and confusion in France Hence the Constituent Assembly passed a law in 1946 nationalising the Bank of France and the four big deposit banks. The law also provided

for the creation of the National Council of Credit whose functions are of consultative character. The Banking Control Commission has been established for exercising supervision over banking.

Reichsbank : The Reichsbank is the heart of the German banking and credit system. The prestige of the Bank has been greatly enhanced owing to the serious lack of funds in the country and her dependence on foreign short-term credits for her economic development. The Bank also played an important part in the foreign exchange market.

The history of the Bank can be traced back to 1865 when Frederick the Great founded the Koeniglichebank in Berlin as a state institution. The Bank was subsequently converted into Preussischebank and turned at last into Reichsbank in 1875. The statutes of the Reichsbank have been amended from time to time, but the most characteristic change was made in 1924, when the Bank was completely reorganised in accordance with the requirements of the Dawes Plan. The statutes were further modified when the Young Plan was brought into operation in 1930. Since the commencement of the Nazi regime, it has been amended in 1933, 1937 and 1939 in order to bring the Bank into line with the general economic policy of the Nazis.

Upto 1875 the function of note-issue in Germany was in the hands of 33 private banks. When the Reserve Bank of Germany came into existence in 1875, this privilege of the private banks was greatly restricted. The Reichsbank was, however, given an elastic system of note-

issue. Henceforth the private banks began gradually to give up this function and in 1906, only 4 of them retained the privilege. The aggregate amount of their notes was fixed by a Law of August, 1924,. The Decrees of 1933 and 1935 altogether abolished the privilege of note-issue enjoyed by these banks so far.

As already said, in accordance with the Dawes Plan the Bank was reorganised by the Act of 1924. According to this new arrangement, 50p.c. of the seats in the General Council of the Bank were reserved for foreigners. It was, so to say, an international agreement for the control of the Bank and of the German economy. The Law of 1924 was considerably modified in the amendment of 1930 under the Young Plan which removed foreign control from the Bank. However, the proposals to change the provisions of the Law of 1924. as amended by the Hague Conference Agreement of 1930, must be submitted by German government to the Board of Directors of the B. I. S. This international agreement would remain in force until the Lausanne Agreement of 1932 was ratified. The B. I. S. approved the amendment of 1933. According to these amendments, the President of the Reich would appoint the President on the Bank on the suggestion of the directors of the Bank. The Reich President will also nominate the directors of the Bank proposed by the President of the Reichsbank. Under certain conditions, the Reich President could dismiss the President and directors of the Bank. By the Law of 1937 the Directorium of the Reichsbank was placed under the chancellor. The Law of June, 1939 brought the transformation of the

Reichsbank to a completion in conformation with the Nazi Plan. Some of the important provisions of the Law of 1939 were as follows: The Bank was made responsible directly to the Chancellor of the Reich. The Chancellor would appoint the President and other members of the managing Board of the Bank and would determine the duration of their term of office. For controlling the money market, the Bank was empowered to buy and sell fixed interest-bearing securities which were admitted to official trading on the stock exchanges, as well as treasury bills which were due only within one year from the date of purchase. The gold and foreign exchange holdings of the Reichsbank should be kept by the Bank at such a level as was deemed essential in order to settle balances with foreign countries and maintain the value of currency. The Fuehrer would alone determine the volume of treasury bills that might be held by the Reichsbank or on which it might make advances as well as the maximum amount of working credits which the Bank might grant to the state.

As a central bank, the Reichsbank was a type by itself. It was not exactly a bankers' bank, as the Federal Reserve Bank have been made in the U. S. A., nor was it as mush free as the Bank of England in transacting business, nor was it free to discount papers to any extent like the Bank of England or the Bank of France. The total amount of two-named papers that might be discounted with the Reichsbank could not exceed one-third of the total nominal amount of bills discounted with the Reichsbank. Bills bearing three signatures must always amount

to not less than 2/3 rds. of the total discounts of the Reichsbank.

Immediately after the first world war, the discount policy of the Reichsbank had been directed to the maintenance of stable exchanges and to the regulation of credit for controlling speculative activity. From the days of stabilisation of German currency till the banking crisis of 1931, the policy of the Bank was mainly determined by conditions prevailing in leading financial centres of the world. From internal economic standpoint, the policy was directed to the lowering of interest rates and to diverting the flow of short-term capital into capital market. Besides, the Banks directed the domestic and foreign capital to productive purposes, maintained the stability of internal prices and rates of interest and provided cheap money for agriculture and legitimate trade purposes. Other objectives of the Bank included the improvement of Treasury finance and of banking standards.

The Reichsbank used four methods of control, viz., discount rate, reduction in the purchase price of gold, credit restriction and credit rationing, and direct action. The last three measures have been resorted to in extreme cases, while discount rate was the most common instrument of control. Like the Bank of France, and unlike the Federal Reserve system, the Reichsbank did not use open market operations which were prohibited to it by statute. The Bank was not permitted to purchase government bonds and even treasury bills. The amendment of the Law in 1926 allowed the Bank to purchase treasury bills up to Rm. 400 millions ; but this was not

availed of by the Bank till 1928. Moreover, 400 million Reichsmark was too small an amount to be successful in controlling the money market.

The discount rate policy of the Bank was not very successful; for, one of the most important means of making it successful, viz., Open Market Operations, was lacking for long. We have seen that even in England where discount rate has been applied successfully before the war, its efficacy was reduced after the war, and before it could be effectively applied, the ground had to be prepared by open market operations. There were other reasons why discount rate policy of the Bank was not very successful. For at times, the discount rate policy of the Bank had to be subordinated to the gold and foreign exchange policy owing to the subordination of Germany. Besides, under German conditions, qualitative, rather than quantitative, control of credit was more essential, which could not be secured by discount rate policy.

During 1924-25, the market rates of interest in Germany were much higher than the discount rate. This increased the volume of borrowing from the Bank. But still the discount rate could not be raised; for it was apprehended that such a course would have adverse effect on the economic recuperation of Germany. Hence the discount rate was not raised but a policy of credit rationing was resorted to. Credit rationing was considerably relaxed in 1925 when the German money market began to feel the effects of the inflow of foreign funds, and it was totally abolished in 1926. From 1923 onwards the discount

rate was still further reduced owing to the influence of monetary conditions abroad.

The influence of the foreign funds on the discount rate policy was felt from the time of legal stabilisation of currency until august 1926. During this period the mark was pegged with dollar, which minimised exchange risk. The effect of this was a sharp decline in the discounting of domestic bills with the bank and a sharp increase in its holding of gold and foreign exchanges. This practice of pegging was discontinued in August, 1926, which in its turn increased the effectiveness of discount rate.

The election of 1930 was followed by a heavy outflow of funds. This forced the Bank to increase its discount rate. But this was not sufficient to stop the outflow. The discount rate was raised to 15 p. c. and the Government instituted the most rigid type of exchange control which prevented the collapse of the mark. When the crisis was over, the discount rate was again reduced. Henceforth the discount rate was determined not by the conditions prevailing in foreign centres but by domestic considerations.

As already said, when discount rate policy was not very successful, resort had to be taken to credit restriction and rationing. Under the Dawes Plan, Germany was subordinated to international control and German money merket was also influenced by money market conditions elsewhere. Thus when other countries had confidence in Germany and if the rate of interest in Berlin money market was higher, funds flowed in. But if the confidence was disturbed, funds flowed out. It was

under the latter circumstances that credit restriction and rationing were successfully applied. These were applied by the Reichsbank from April, 1924 to the end of 1925, in the spring of 1929 and in July 1931. On each of these occasions, both the foreigners and the Germans had lost confidence in German currency and the Reichsbank on each occasion had to lose a part of its gold holdings and foreign exchange resources. No amount of increase in discount rate would stop the flow.

It may be asked, how could credit rationing and restriction be successful under such conditions ? These were made effective in the following manner : the banks and corporations in Germany discounted a part of their portfolios with the Reichsbank and with the proceeds thereof purchased foreign exchange. Under credit rationing, the Bank granted to individual borrower only a fixed amount of credit ; hence for the rest of funds, the borrowers, who were predominantly the banks, had to seek accommodation elsewhere. Naturally the banks and business concerns in need of funds were forced to sell off their foreign exchange resources to the Reichsbank. In this way, the bank not only prevented its funds being used for the purpose of purchasing foreign exchange resources but obtained such resources from banks and corporations. This was an entirely new path taken up by the bank.

The policy of direct action became essential for checking stock exchange speculation which was financed chiefly by foreign short-term funds and for preventing rise in prices which would react adversely on exports, increase imports and would bring pressure on the foreign

exchange holdings of the Bank. Discount rate was of no use for the purpose. Even credit restriction and rationing would not be effective for checking speculation on the stock exchange so long as the Reichsbank was not the only source of credit in Germany but credit was forthcoming even from foreign financial centres so long as they had confidence in Germany.*

Federal Reserve System : Very few words need be said about the Federal Reserve System here. For, we have already seen the defects of American banking prior to the coming of the F. R. S. in 1913. We have also considered the methods of credit control and banking legislation in the U. S. A.

Central banking in the U. S. A. is a system of 12 banks working in different parts of the country. For banking purposes, the whole country has been divided into 12 regions. The system came into existence in 1913 ; but since then it has seen a lot of changes, particularly after the great depression. The capital of these Reserve

* Recently, a Bank of German states, empowered to issue new currency and fulfil most of the other functions formerly exercised by the Reichsbank has been established for the British and American zones. An Allied Bank Commission has been formed for exercising general supervision of the Bank and to issue specific directions to it. Other allied representatives from other zones may also join the Bank. The Bank will act as a federal reserve bank ensuring the solvency of its member banks and maximum uniformity in their banking policies. It will act as the sole clearing centre of its member banks. It will deal with foreign central banks in the usual way, buying and selling foreign exchange, gold, silver and platinum.

Banks was subscribed by the member banks in each region. The member banks are those banks in the U. S. A. which owing to legal obligations or other inducements have become members of the F. R. S. In fact, most of the banks in the U. S. A. are member banks. The control of the member banks over the F. R. S. is small, in so far as they elect some of the directors. Otherwise, the fundamental central banking operations are under the F. R. S. The Board of Governors consists of 7 members appointed by the President, subject to the approval by the Senate, and they serve for a period of 14 years. These include also the chairman and the vice-chairman. The Federal Reserve Board has effective control over all important business of the F. R. S,, including the appointment of officers of the different Reserve Banks. From administrative standpoint, the peculiarity of the American banking system lies in the fact that it is directed by men appointed by the government for fairly long period of time.

The profits of the banks are divided into three parts. A certain proportion of these is taken to the reserve fund. Of the remainder, 6 p.c. cumulative dividend per annum may be given to the stock-holder. The remainder goes to the Federal Treasury. The profits of the banks have, however, not fluctuated very widely because of the fact that the most uncertain element viz , gold reserve has remained outside their control. The gold reserve having been taken over by the Treasury, the effects of changes in the price of gold on the profits of the banks have been obviated.

Like other central banks, the Federal Reserve System also is the ultimate source of cash. Cash in America consists of two things, viz.. the deposits of the banks at the Federal Reserve Banks and bullion certificates. The F. R. S. controls their supply. It can add to the supply of cash by adding to its assets and contract cash reserves of the banking system by selling assets. The peculiarity of the F. R. S. lies in the fact that unlike the British system, the banks have a direct contact with the system. In other words, when the banks are in need of funds, they approach the F. R. S for accommodation. Another peculiarity of the American system lies in the fact that the ratio of cash to deposits in America is not something fixed but varies for different classes of deposits. It has already been seen that during the thirties, the reserve ratio was also varied by the F. R. S. for controlling the volume of credit. The system also has its weakness. For, the direct contact of the F. R. S. with the banking system may nullify the effect of credit control. The funds may be removed from the market by the F. R. S. by the open market operations for controlling credit; but immediately the banks may approach the F. R. S. for accommodation and thereby nullify the control. Hence in America there has been need for moral persuasion. For this purpose, "a tradition has developed in America that when member banks find themselves in debt to the Reserve Bank, they hasten to contract their loans. The working of the Reserve System's control has in practice depended very much on this distaste for borrowing from the Reserve Banks. And it is perhaps for that reason that the Reserve

System has during a greater part of its life discouraged prolonged or extensive borrowing on the part of any one member bank by moral pressure."

Reserve Bank of India : At present there is no country of commercial importance that has not established a central bank of its own. For, it is realised that a central banking institution under modern conditions is absolutely essential It is of course true that their constitution and range of statutory powers have varied from one country to another. But one thing is certain and it is this that central banking is a "new art" and its functions, whether developed by tradition or imposed by statute, are more or less the same.

The idea of central banking is not new in India. The earliest bank that performed some of the central banking functions in India was the "General Bank in Bengal and Behar" formed in 1773. The Bank was a private corporation under the patronage of the East India Company. The necessity was felt owing to the excessive shortage of funds in the northern districts of these two provinces which was due to the drain of current coins to the Public Treasuries of the city of Murshidabad. The Bank was established for remedying this shortage and also for ensuring the receipt by the Government of the full value of the rents paid and for obviating the costly necessity of conveying forwards and backwards, by the Government in the one case and the merchants in the other, of loads of cash under military escorts, travelling agents and the like. The bank was however short-lived ; for, its scheme was not approved by the Court of Directors of the Company. In 1808, a

General Bank scheme was prepared but this also did not receive approval. In 1836 a vast body of merchants submitted to the Court of Directors a project for the setting-up of a "Great Banking Establishment for British India". Since then the Presidency Banks were established; but yet the necessity for a single central bank was looming large. Hence some people suggested the amalgamation of the Presidency Banks with a view to establish a central bank for the whole country : but, as already seen, this was not possible owing to mutual jealousies. Since then schemes have been prepared from time to time for the establishment of a single central bank but none of them matured. (For details reference may be made to O. P. Gupta's *Central Banking in India* 1773—1934). At long last in 1920, the three Presidency Banks were amalgamated and the Imperial Bank of India came into existence. But as we have already seen, the Imperial Bank was not a full-fledged central bank in so far as the function of issuing notes was still outside its control. Hence the Hilton-Young Commission observed that India was perhaps the only country, among the great trading countries of the world, in which the Government exercised direct control over currency ,in general, and over note-issue in particular. The Commission gave its recommendations for the establishment of a central bank in this country. At long last, after much controversy for about 7 years, the Reserve Bank of India Act was passed in 1934.

The central banking structure has, in all countries, two aspects, *viz*, political and financial. One of the most accepted principles of central banking is that politically it

should be independent and this is sought to be maintained by the election of directors by private shareholders or by commercial banks. The arguments for and against this independence has so far been very strong. Nowadays, however, under planned economies, the hand of the Government is always there over the entire economy, of which the central bank is the heart. But then if the central bank becomes a department of the Government, there is every danger and likelihood of discontinuity of policy. For, every change in the administration will lead to change in the policy of the bank. Hence while political influence cannot altogether be eliminated under the changed circumstances of today, it is at least desirable that the directors should be the "representatives of, but not for, various sections of the community", and be appointed for fairly long terms. This will lead to a continuity of policy and maintain the dependence of the board as far as practicable. The Reserve Bank of India is a shareholders' bank ; but since the shares are scatterd throughout the country, and the rate of dividend limited under section 47 at 3½ p.c., it is uncommon to find the sharesholders taking any interest in the working of the Bank, even if they could do so. The Board of Directors consists of eight directors elected on behalf of shareholders on the various registers, and four directors nominated by Central Government. Besides the Governor, two Deputy Governors and one government official nominated by the Central Government will be on the Board. Apparently, therefore, the distribution of seats in the Board between shareholders and Central Government will be on fifty-fifty basis. Of the eight members

representing the Government, of course, six are voting directors. The Government seems to be over-represented. For, with one of the elected directors voting with the Government and the Governor exercising his casting vote the Government would come out victorious on every occasion. The powers of the Governor seem to be too much. For, unlike the meetings of the Board of Directors every week in the case of the Bank of England, in India the law requires a minimum of six meetings per year. Thus the elected members have fewer opportunities to influence the policy of the Governor and the next meeting may take place when a particular policy has been carried out. The Governor being a nominee of the Governor-General would hardly have any independence ; for the latter may both remove him from office or reappoint him as he pleases. This state of affairs while making the Governor a dictator over the Board places him as a mere tool in the hands of the Government. The independence of the bank is thus sacrificed. A large number of events in recent years, e. g., the expansion of currency according to the requirements of the Governmet, sale of gold on behalf of the Government, etc., indicate that in many matters the bank has to submit to the Government.

In its financial aspect a large number of items have been recognised as essential for central bank. The most important of them are as follows : (1) Full control over the currency system ; (2) Maintenance of proper relation of note and deposit liabilities to its gold and/or foreign exchange reserves ; (3) banker to the government ; (4)

bankers' bank ; (5) investment of its funds in short-term self-liquidating securities ; and (6) pursuit of accepted operations for the control of the money market.

To take up first the currency system, it may be noted that the Indian currency system is a type by itself and its total volume is more or less arbitrary. For internal circulation, we have got rupee notes and rupee coins, the latter being equally legal tender. Before the establishment of the Reserve Bank of India, the currency was controlled by the Government. But whereas there is a statutory limit as to the volume of note-issue. there is no such limit in case of rupee coins, the state having fullest discretion as to their volume. So long as the Mint was free, the public could influence the currency situation by taking resort to the Mint ; but that possibility does not exist after 1893. Not only that : the silver content of the rupee has also been changed from time to time according to the requirement of the government. In regulating the volume of currency, both notes and coins, the government has been influenced not so much by internal needs of trade or seasonal currency requirements as by the exchange position. This anomalous position continues even to this day. After the establishment of the Reserve Bank, the monopoly of note-issue has passed over to it, though one-rupee notes and rupee coins are even now issued by the Government, the coins requiring no reserve or cover nor there being any limit to their total volume. It is only through the Reserve Bank that they are issued to the public. The need for an elastic currency system in an agrarian economy like that of ours resulted in the

adoption of the proportional reserve system ; but its effect may be nullified if there is an equivalent contraction in rupee coins by the Government.

Based on the British model, the Issue and Banking Departments of the Bank are separated and the assets of the two Departments are kept distinct. The assets of the Issue Department consist of gold coin and bullion, sterling securities, rupee coins and rupee securities, of which not less than 40 p c, must under law consist of gold coin, gold bullion or sterling securities, provided that the amount of gold coin and bullion is not at any time less than Rs. 40 crores in value. With the previous sanction of the central government, however, the Bank may hold less than 40 p.c. of the assets for limited periods provided that it pays a specified tax on the deficiency. Some modification had to be introduced in the above for meeting the wartime requirements of the government. The Reserve Bank was also entrusted with certain exchange obligations with a view to maintain the stability of the external value of the Rupee. Under section 40, the Bank was obliged to sell sterling for immediate delivery in London at a rate not below 1 s. $5\frac{49}{64}$ d. for a Rupee. The Bank was similarly obliged to buy sterling at a rate not higher than 1 s. $6\frac{3}{16}$ d. for a Rupee. Moreover, the Bank had the obligation of meeting the exchange requirements of the government for which purpose it generally purchased sterling from scheduled banks. Even in this matter the hands of the Reserve Bank were tied under rhe Government of India Act, 1935. For, the rate at which the Reserve Bank was to purchase and sell sterling was already fixed, no

matter whatever was the natural rate. The Indian demand for the depreciation of the Rupee had long been neglected. Now, however, the Rupee has been de-linked from sterling and it has now become an independent currency and may be linked with the monetary unit of the International Monetary Fund. Hence the Reserve Bank of India Act has been amended with a view to enable the bank to buy and sell currencies of all countries which are members of the I. M. F. In place of sections 40 & 41 of the Reserve Bank Act, a new section has been substituted as follows : "The bank shall sell to or buy from any authorised person who make a demand in that behalf at its office in Bombay, Calcutta, Delhi or Madras, foreign exchange at such rates of exchange and on such conditions as the central government may from time to time by general or special order determine, having regard, so far as rates of exchange are concerned, to its obligations to the I. M F. provided that no person shall be entitled to demand, to buy or sell foreign exchange of a value less than two lakhs of rupees." Section 17 of the Act is also ammended so as to enable the Reserve Bank to buy and sell securities issued by the government of any country outside India which is a member of the I. M. F. The rate of exchange is no longer fixed by the Act but is left to the central government who is to determine the rate subject to such conditions as it might deem necessary consistent with the obligations under the I. M. F.

Turning next to the Banking Department of the Bank, on the liabilities' side, the principal items are capital, reserve funds and deposits from the government, banks

and others. Capital and reserve fund require no comment. The latter was provided by the government in the form of government securities in accordance with section 46. The deposits from the Governments have shown a large increase since 1938 because the provinces have undertaken to maintain certain minimum balances with the Reserve Bank in terms of the agreements entered into with them. The banker's deposits comprise mainly of the deposits lodged by the scheduled banks and undergo fluctuation with changes in money market conditions. On the assets side of the Banking Department, the most important items are notes and coins, bills purchased and discounted, balances held abroad, loans and advances mainly to government, and investments. Of all these, the most important single item is the "Balances held abroad" i e. held on account of the Reserve Bank by the Bank of England. Among the bills purchased and discounted, the only important one is the government treasury bills. Trade bills have not figured to any important extent because of the prevalence of easy money conditions. The investments of the Bank consist of rupee securities of the government of India and the U. K. securities and include those delivered to the Bank by the Central Government in respect of its reserve funds.

The Reserve Bank is also a banker to the Government. In accordance with section 21 (1) the Bank has entered into separate agreements with the central and each of the Provincial Governments, setting out the terms on which it has undertaken to transact their banking business. Since 1st. April, 1937, each of the Provincial Governments opened

separate account with the Reserve Bank. They agreed to maintain certain minimum cash balances with the Reserve Bank and to meet any temporary deficits in these balances either by obtaining ways and means advances from the Bank or by issuing their own treasury bills. Under tha new arrangement, subject to certain restrictions the Provincial Governments can borrow on the security of the revenue of the Provinces and several provinces have done so. The Report of the Reserve Bank on currency and finance gives details of these transactions.

The Reserve Bank is also a bankers' bank and hence a lender of the last resort. Before the establishment of the Reserve Bank. the position was extremely hopeless. The Imperial Bank was there, but it was neither a bankers' bank nor a lender of the last resort. The Reserve Bank has been established to fill up the gap. But after a decade of its working, it cannot be said that the Bank has attained any mentionable success. "It is still evolving its own organisation and it does not seem to have travelled far beyond the stage of establishing contacts" It has already been pointed out that the indigenous bankers who constitute the more important part of the money market have been left out of the control of the Reserve Bank. But even in the organised part of the money market, the Reserve Bank's control is not unifrom. The first line of demarcation is to be drawn between scheduled and non-scheduled banks. Of these the latter do not belong to the category of member banks and therefore have little to do with the Reserve Bank. The Reserve Bank is simply "expected to give guidance

to all the banks that make up the banking system, and does in fact readily give its advice to non-scheduled banks asking for it." The scheduled banks constitute a heterogeneous group and the Reserve Bank's relation with each one of them is not uniform. So fas as the Imperial Bank is concerned with its enormous resources and close association with the government, it is the agent of the Reserve Bank where the latter has got no branches. The exchange banks are all incorporated outside India and and hence though working in the Indian money market, they are practically outside its control. Even among the Indian scheduled banks, there are two categories, the Big Five and the rest, the difference depending on the volume of deposits and extent of branches.

The inclusion of a bank in a schedule depends on its attainment to the prescribed capital and reserve position. But the mere fact of inclusion of a bank in the schedule does not give any guarantee that it will continue to be sound or stable and "its fitness to be retained in the schedule is liable to be tested at Government's instance, should Government have reason to believe that its affairs have deteriorated to such an extent as to make it *prima facie* unfit for retention."

Once included in the schedule, the bank has certain rights and obligations. Thus every scheduled bank has to maintain with the Reserve Bank a balance not less than 5 p. c. of its demand and 2 p. c. of its time liabilities, the primary purpose being to enable the Reserve Bank to exercise some measure of control over the banking system. In some countries, as in the U. S. A., the experience

shows that the distinction between the two types of liabilities is often blurred over. But here the distinction has so far been maintained at least in accounting purposes. In return for this obligation, the scheduled banks would for the first time find a source providing currency in emergencies. Thus the Bank will provide financial accommodations in the shape of rediscount of eligible bills or loans and advances against eligible securities. This aspect of the function of the Reserve Bank has remained non-operative. Advances to member banks on the pledge of approved securities are little ; but the discounts by the bank are even less. This is due to the easy money conditions prevailing throughout this period. The real test for the Reserve Bank as a bankers' bank, a lender of the last resort, has not yet come. But the banking crisis that came in the middle of 1938 indicates that the reserve requirements for the member banks are not sufficient to enable the Reserve Bank to control the banking system and the relation between the Reserve Bank and the scheduled banks even is not a close one. The reserve requirement is ornamental, not effective.

Finally, the central bank must pursue accepted operations for the control of the money market. Accordingly, the Reserve Bank has been given the powers usually possessed by central banks for exercising control over the credit and banking systems of the country. Accordingly, the Reserve Bank publishes bank rate at which it will discount eligible papers and can undertake open market operations. In this respect, the position of the Reserve Bank has been explained in the following words, "The actual control is however

limited as the scheduled banks are not, as a rule, large borrowers from the Reserve Bank. Reserve Bank can exercise greater control when the banks approach it for financial assistance, as they may in that case be prepared to subject themselves to voluntary inspection. Such occasions, however, have been rare and as the inauguration of the Reserve Bank has coincided with an era of cheap money conditions, loans and advances to, and discounts for, scheduled banks have never reached a high figure. Among other methods by which the Bank can to some extent control the monetary and banking system may be mentioned appropriate changes in the amount of treasury bills offered, in the amount of sterling purchased and in the amount of money in circulation, but these methods are comparatively less effective and of limited applicablity. Thus although the Reserve Bank has been entrusted with most of the powers generally given to a central bank, its actual control is limited by the peculiar character of the Indian monetery and banking system." *(Functions and Working of the Reserve Bank of India.)*

The future success of the Reserve Bank depends partly on the money market conditions and partly on the attitude taken by the Reserve Bank itself. A rigid attitude on its part, a pursuit of traditional central banking principles without reference to the existing conditions inside the country, will never bring the leadership of the Indian money market to the Reserve Bank and unless the conditions in the money markets are brought under perfect control, any talk of economic planning is useless.

Therefore, not only for its own sake, but also for the sake of the entire economy, a more flexible attitude on the part of the Reserve Bank would be welcome.

CHAPTER VI
CENTRAL BANKING POLICY

The objectives of central banking policy have in part been noted in my *Introduction to Money*. We have seen how exchange stability was the most important objective before 1914, and how internal prices adjusted themselves with exchange rates. In the years following the first great war, it became impossible to maintain the stability of both prices and exchanges, so much had been the difference between the two, and price stability was given preference among the objectives of central banking policy.

After the great depression, the question of the mitigation of business cycle became important. It was realised that the trade cycle was the most severe problem for the economic system and it must be removed altogether. Apart from the jerk that the trade cycle gives to the economic system it creates so much of unemployment, loss of purchasing power and other problems which create a vicious circle.

Mitigation of Business Cycle: As said above, after the great depression, the mitigation of business cycle became the most important objective of central banking policy. But then it has got important limitations. For, it was proved beyond doubt after the great depression that

the trade cycle is not a purely monetary phenomenon but is the result of the conglomeration of monetary and non-monetary factors. And the central bank has no control over the non-monetary factors. Even among the monetary factors, we have already noted how the hands of the central bank are tied in matters of credit control. The available data in different countries of the world indicate that there is no close relationship between the volume of bank credit and the volume of production, trade and employment. The velocity of bank credit as also its ultimate distribution are beyond the control of the central bank. Even to the limited extent to which the central bank can control credit and thereby mitigate the trade cycle, the timeliness of taking action is an important factor. In this respect, statistical information should be the guide of the central banking policy. But then, as De-Kock rightly points out, though statistical data are of much use, there is something different about every business cycle due to changes in fashions, methods of production and distribution, changes in political ideologies and international relationship, etc. In other words, business cycle question should never be treated mechanically. Hence the necessity on the part of the central bankers to exercise personal judgement and discretion in deciding whether, and if so, to what extent, they should seek to bring about contraction or expansion of credit.

Full Employment: After the depression showed signs of recession, another problem assumed importance, viz, how to secure full employment in the economic system. For, apart from the years of the great depression

when vast masses of population became unemployed in every country, even in normal years a certain percentage of population remains unemployed and hence the problem. The attainment of full employment and its stabilisation at that level would not only solve the problem of unemployment but also would remove the trade cycle from the economic system. The central bank of a country can help the attainment of full employment in an economy by maintaining easy money conditions, i. e., by keeping the rate of interest at a low level so that it may provide sufficient stimulus to the expansion of the volume of investment.

Easy Money : Easy money is not a new thing but has been prevalent since the last economic depression. A policy of easy money was advocated not merely as an anti-depression measure but also as a measure of monetary reform and of reducing the great burden of public debt by conversion operations. During the great depression, owing to the cessation of private borrowing, large idle balances had accumulated in the hands of the banking system in every country. In many countries, again, this state of affairs was due to the repatriation of capital from foreign countries, particularly after the devaluation of their currencies which was followed by a decline in interest rates. Very soon it was realised that cheap money was essential not only for business recovery but also for taking the economic system to the level of full employment. Thus easy money conditions became a deliberate policy with many countries of the world. As the *Monetary Review* (1936-37)

published by the League of Nations puts it, "The remarkable recovery of productive activity which has taken place since 1932.....has not, on the whole, prevented the downward course of interest rates or their maintenance at an unusually low level. In several countries, indeed, interest rates have been deliberately forced down with a view to promoting industrial recovery."

The economists have, however, not been unanimous regarding the efficacy of cheap money as an instrument for bringing about economic recovery. According to Rogers, "it was the reduction in long-term interest rates, coupled with a revival of financing at those rates, more than any other single influence, that marked the beginning of recovery in the United States' Hawtrey on the other hand, opines that "perhaps the most notable of all the lessons to be derived from the years of depression is to be found in the prolonged failure of the accepted methods of credit regulation to induce revival." But most economists are of opinion that cheap money is helpful to a considerable extent in promoting economic recovery

After the economic recovery had started, and the depression was showing definite signs of recession, the question that assumed importance was, how far was it desirable and possible to continue the policy of cheap money ? The deflationists like Lionel Robbins and Grant have argued that further continuation of cheap money would lead to bad investment and that a rise in the rate of interest was absolutely essential to prevent the next boom. Edie argued not for tight money nor for raising interest rates, but for giving up the

extreme forms of easy money while keeping down the mortgage rates, and trying to bring about a greater geographical uniformity of rates. On the other hand, Keynes continued to emphasize the need for the continuance of easy money conditions, even after the war had broken out. He pointed out that for a successful financial policy in preparing for, and continuing, the war, a small difference of, say, 1 p. c. would mean a huge difference of, say, £ 500 millions in the governments' capacity to borrow. Keynes has refuted the assertion that a rise in interest rates is inevitable by pointing out that (a) in the absence of full employment, increased savings are provided for out of an increasing national income as employment expands ; (b) after full employment is attained, the diversion of resources for consumption could better be checked by taxation and control of consumption than by a rise in the rate of interest, and (c) the capital resources required for government purposes will necessarily be obtained by a system of priorities and by controlling the market for new issues. The disappearance of the old *laissez faire* market has made it unnecessary to use the clumsy and and expensive method of a punitive rate of interest payable by government equally with others. That easy money conditions are not only desirable but also possible to attain is emphasized by Keynes. He emphasized the immense strength of the Treasury as the principal borrower in the money market. This can be done by giving the market an increased amount of liquidity which it demands by appropriate banking policy, by waiting till the market is ready—following an unhurried programme framed with a view to continuous policy,

and by promoting confidence in the policy of borrowing which the treasury intends to follow.

An important and a peculiar feature of most money markets in different countries of the world has been the prevalence of easy money conditions even during the years of the second world war. This was in clear distinction with the conditions prevailing during the first world war when interest rates, both short-term and long-term, had gone up. In Europe, the continuance of easy money conditions, even in the face of general scarcity, rising commodity prices, and rapidly rising share values, is peculiar and is due to the immediate introduction of rationing and price control. As a result of the adoption of these measures, the monetary funds have to some extent become unusable except for the purchase of securities; and as the available supply of shares has been limited, there has been an overflow of funds from the market for securities into the market for debts. The result has been a fall in interest rates even though the supply of debts in the form of government securities has been rapidly increasing. In countries outside Europe, the decline in the expectation of profits and the prices of shares has influenced the interest rates in downward directions.

Cheap Money Policy in India: As already said, cheap money policy is the result of the great depression when it was adopted with a view to stimulate industrial activity. In India, however, it was not adopted as a matter of policy but money rates declined after the breakdown of the gold standard in 1931 which removed the deflationary spell which had been hard-pressing on the economic

system. Since then all money rates went down till 1936-37. Thus the Bank Rate came down from 7 p. c. in September, 1931 to 3 p. c. in December 1935 and continues at that level. The call money rates in Calcutta and Bombay declined from 4 p. c. and 5¼ p. c. respectively in 1931 to ¼ p. c. and ½ p. c. in 1936. The same was the condition of the yield on government paper. Among other factors facilitating the appearance of easy money conditions, mention may be made of the linking of the Rupee to 1s. 6d. sterling in place of 1s 6d gold, increase in the volume of currency, liquidity in the banking system, reduced demand for loans either on the part of the government or on that of the industrialists and businessmen. In other countries the governments launched on a public works programme for fighting against the depression and so loans to government in their case had not considerably declined. In our country, however, the government, both central and provincial, scaled down expenditure. All these factors brought about easy money conditions in our country.

Towards the end of 1936, however, money rates began to rise. Although the bank rate continued at the same level, viz., 3 p. c., the call money rates in Calcutta and Bombay went up to 2 and 2¾ p. c. by 1939. The Calcutta Bazar Bill Rate went up from 5 and 6p.c. in 1936 and 1937 to 7 and 8 p.c. in 1938. The Bombay Bazar Bill Rate went up from 3⅜ p c. to 5¼ p. c. The yield on 3½ p. c. government paper also went up. This rise in interest rates during this period was taking place inspite of the increase in the volume of currency in circulation

and in bank deposits. This was not due to any increase in governmental demand for funds ; for, during this period there was no important borrowing of funds by the government. Only some conversion operations were carried on. The demand for funds was therefore mainly private, consequent upon an increase in economic activity.

The outbreak of the war was followed by important developments in the Indian money market. Henceforth the cheap money policy was utilised to subserve the needs of government. As the governments of all the belligerent countries had to borrow large funds for financing the war, it was necessary to cheapen the cost of governments' borrowing. This was facilitated for them owing to scarcity of goods, rationed supplies and capital issues control, supplemented by the spirit of patriotism. On the outbreak of the war, for some time in India, the money market was disturbed and this caused a temporary dislocation in money market rates ; but the normal conditions were soon restored.

The money market in India evinced a firm tone in the beginning of April, 1939, when owing to seasonal demand for funds, the inter-bank call rate became $2\frac{3}{4}$ p.c. Thereafter with the coming of the slack season, the rate gradually receded to 2 p.c. in May. 1939. Monetary conditions were fairly easy in next three months during which the market was well-supplied with funds, particularly because of the return of money from the interior and the purchase of gold by the Reserve Bank. Towards the end of August, the Bank of England raised its discount

rate from 2 to 4 p.c. It was consequently feared that the monetary authorities in India also might take a similar action. Hence the lenders adopted a cautious attitude. This was followed by a slight rise in money rates. The war scare in September was followed by large current account withdrawals from banks and consequent rise in interest rates. This tendency was however short-lived and the stringency was soon relieved when the market received large sums of money by way of proceeds of the sales of sterling and gold to the Reserve Bank. In October, the Bank of England rate was reduced to 2 p.c. With the outbreak of the war, the demand for funds had no doubt increased but this was not sufficient to offset the effect of continued influx of money. With the approach of the export season, there was once again an iccrease in the demand for funds for financing the movement of crops and so the call rate went up to 2 p.c. in January, 1940. An important factor which contributed to the easiness of credit conditions in India was the large acquisition of sterling by the Reserve Bank by open market purchases, while the excess of treasury bill maturities over renewals also gave occasional relief to money market. The easy money conditions continued since then owing to an increase in currency and credit. Inflation of currency resulted in greater accumulation of funds in the hands of the rich who could not use them immediately owing to prevalent scarcity and control of capital issue.

Turning next to the long-term interest rates, the yield on 3½ p.c. government paper is a fair index of long-term interest rates. Under the circumstances prevailing during

1939-40, it was inevitable that there should be a rise in the yield on irredeemable securities ; the rise was however very small. After the declaration of war, there was á sharp fall in the price of government securities and the rate rose up. With the restoration of confidence and the continued firmness of the London securities market, however, the rate declined and soon reached the pre-war level. But the war time activity and governmental borrowing created a keen demand for funds. The Imperial Bank Hundi Rate was raised from 3 to 3½ p.c. in November, 1939, at which level it remained till January 1941. For a few months money rate ruled at high levels. After the fall of France in 1940, the markets became all the more easy. By 1941, markets became liquid and even seasonal stringency was removed to a considerable extent. As already noted, this was due, to a considerable extent, to currency inflation. The abundance of funds in the market, without any free use, enabled the government to improve on its terms of borrowing on each successive loan.

The climax of the cheap money policy was reached in 1946 when the 3½ p. c. paper was converted into 2¾ p. c. 1976 loan at 99 p. c. or 3 p. c. 1986 loan at par. This was very soon followed in August 1946 by the floatation of 2½ p. c. 1961 loan. The conversion and new floatation were successfully carried out. At this point some people in the market became confident that no further cheapening of money rates would be possible. This interpretation all the more received stimulus from a number of factors, viz, the gradual reduction in the Reserve Bank's buying rate for government securities, the permission given to the Bombay

Municipality to float 3¼ p c. 30 year loan at a discount of annas eight, the apparently indifferent outlook of the government towards the money and gilt-edged markets, etc. But they were mistaken in their interpretation. For, very soon the government floated 2½ p. c. 1954 loans. This time however the government was not successful. Possibly this was due to the fact that the limits of cheap money policy had already been reached and it was too much to expect response from the market, which is so very unorganised, at such a low rate. As it has been written in the *Commerce*, "Experience has shown that in recent years, the Indian money market unorganised and unco-ordinated as it is, has invariably functioned independent of the bank rate. The authorities must in all conscience be aware of this fact more than any one else. They should know that apart from imparting a momentary psychological effect on the financial markets, particularly the gilt-edged market, any reduction in the Bank rate will yield no material advantage. If the poor response to the new loan is any indication of the normal mood of the financial markets, it means that every new loan of the government will need some sort of artificial stimulus from the official side.

With the cessation of war, cheap money policy assumed new importance and it was felt in some quarters that the cheap money policy which was so long restricted to the organised money market should go to other sectors of the economy. For, it was rightly felt that since the governmental demand for funds would be considerably reduced, a restriction of the cheap money conditions in the organised part of the money market would only aggravate inflationary

tendencies. For, under existing conditions, the available capital equipments had reached the limit of full employment, partly owing to capital issues control and partly owing to the non-availability of fresh capital equipments. As the Governor of the Reserve Bank put it, "the benefits of cheap money have yet to percolate to the same extent to the other sectors of our economy, particularly agriculture... the continuance of cheap money unreleased by increased investment and enhanced production can only aggravate the inflationary potential in this country".

There were still other arguments against further cheapening of money rates and in favour of their stabilisation. It was argued that the special forces which prompted lending to the government, irrespective of yield considerations during the war years rapidly disappeared in the post-war years and profit motive began to assume greater importance. Finally, cheap money conditions in India were not broad-based but dependent mainly on the banking system and hence on a very uncertain foundation. For, as already said, monetary inflation in India was followed by further unequal distribution of wealth, and this money had mostly gone to such quarters wherefrom it was not spared for the government. There was undoubtedly an increase in wages and salaries, but this was not sufficient to constitute small savings after meeting the high cost of living. Therefore the government borrowing programme had mostly to depend on the banks. "This is a delicate support in that if and when the banks find that there are heavy calls on their deposits, or that they are able to earn a higher rate of interest in other spheres, they will naturally unload their

holdings of government securities which the government may have to absorb, if there are not sufficient buyers, in order to prevent a steep fall in the value of gilt-edged securities." Cheap money to be effective must be based on the real savings of the nation and should aim at providing cheap funds for investment at low rates of interest over a period of time. In fact, this is what is being attempted in the more advanced economies of the world. But even for such a policy, there are many obstacles. As the *Tata Quarterly* observes, "There is a special reason why, in India, a very cheap money policy by itself is not likely to be very effective in stimulating economic expansion. In India money and capital markets are not a well-integrated and organic whole but are split up in several parts, with little interchange of funds between them. A cheap money policy, as it is understood now, influences the only so-called organised money' market, of which the chief components are the banks ; but these touch only the fringe of the total investment processes of the country. An expansion of the resources available with the organised money market makes only a minute defference to the supply and cost of capital to the small manufacturer and trader and the agriculturist. Nor is this all. In India where orthodoxy in the ways of life and business is so much a habit with the people and where the average person engaged in trade or agriculture is so poor, the element of risk inherent in the supply of even medium-term capital enters into its cost in a much higher proportion than in other countries. This element which may be reduced by other means is left wholly aside by a cheap money policy."

If however the object of cheap money policy is not to increase the supply of investible funds but merely to make a saving of interest charges on public debt, there are, according to the *Tata Quarterly*, three objections to such a policy. In the first place, the "preoccupation with lowering the rates on government loans prevents the institution of what in fact would be the right policy now, viz., reducing the inflationary pressures coming from the side of money." Secondly, "the achievement of low rates gives the impression, whether government wills it or not that the government will be successfully defending the present low rates on, and the present high prices of, government securities later on The way of doing this, when business demand for funds revives and the banks are inclined to load off their security holdings is to ask ultimately the Reserve Bank to purchase securities in such amounts as, at the ruling high prices, no body wants. This looks like being far from the government's intention but that is indeed implicit in the cheap money policy as it is being worked out at present." And thirdly, "borrowing heavily from banks now and the consequent creation of new dead money twist the banking and monetary structure further out of shape. The time has come to induce banks to pay more attention to the part they will have to play in future in the financing of business but the present policy gives a misleading impression of the role of banks in this regard." In conclusion, it observes that "the art of monetary management consists however in avoiding too great an error even on the right side ; monetary expans on has to be halted before it becomes excessive. That is the need of the

moment in India and a suspension of the narrowly-defined 'cheap money' technique now should not imply abandoning a purposive monetary policy in the long run. If that is not done now, however, we face the serious risk of rendering money progressively 'cheap' in the sense of reducing its power to buy commodities and services."

Thus the above discussion makes it clear that a further cheapening of money is neither possible nor desirable and it should be stabilised at the point where it has already reached, and then it should be spread to all other sectors of our economy so that it may be possible to secure a balanced economic development. Upto now cheap money conditions were not the result of any particular policy of the government ; rather the advantage was taken of the prevalence of cheap money conditions by the government for reducing the burden of public debt. In future, our objective is a balanced economic development of the country for which cheap money policy should be instrumental. This can only be done by encouraging the movement of funds in different sectors of the economy by reducing risk premium which so far have formed a large element of total interest cost and hence prevented the full benefit of easy money conditions passing over to the other sectors except the gilt-edged market. In our country the scope for the expansion of investment is still considerable, in view of our vast unemployed resources, material, human and power, but it is limited as yet by the availability of capital equipment. In this respect therefore we must be very much careful so that expansion of credit may be in proportion to the availability of capital equipments and

not more than that which may bring about inflationary developments. At the same time, the propensity to consume will have to be increased, if not immediately, at least in future, for supporting a higher level of investment. That requires a policy pursued for reducing the existing inequalities in the distribution of income, and for increasing the purchasing power of different sections of the society. In other words, cheap money policy should be made subservient to our economic programme.

CHAPTER VII

CENTRAL BANKING CO-OPERATION.

The need for greater co-operation among central banks and the advantages to be derived therefrom have been emphasized at the Brussels conference in 1920, the Genoa Conference in 1922 and the World Economic Conference in 1933 and also by the Macmillan Committee and the Gold Delegation. The Financial Committee of the Genoa Conference, for example, adopted a resolution to the effect that measures of currency reform will be facilitated if the practice of continuous co-operation among central banks can be developed. The World Economic Conference suggested that the Bank for International Settlement should be regarded as an essential agency for central banking action designed to harmonise conflicting views and joint consultation. Central banking co-operation was also desired for their successful functioning in the home market,

and for improving their position in outside markets. It was also a condition for the stable working of international monetary standard.

Meaning of Central Banking Co-operation : For many central banking co-operation means the occasional financial assistance given to a particular central bank in need for the same. It reminds one of the extensive series of credits granted by banks of issue to other central banks at the time of the post-war restoration of the gold standard and also of the large advances extended at the time of international credit breakdown of 1931 to the National Banks of Austria and Hungary, the Reichsbank and the Bank of England. But these, though useful, do not indicate the real purpose behind central banking co-operation. The real central banking co-operation should manifest itself in continuous and day.to day practice and not in aid in times of emergency.

The functions of a central bank have already been noted. In brief, they are aimed at maintaining stability in the economic system by regulating the volume of currency and credit on the one hand and by maintaining fundamental equilibrium in the balance of payments on the other. The latter, in its turn, helps to preserve some degree of stability in the international value of national currency. These objectives can best be attained by central banking co-operation. As it has been said, "These may be best attained by working in recognised but independent union rather than in ignorant isolation or unconscious antagonism. Because the finacial fabric in one country quickly responds to events in others, and since economic booms and depressions

tend to be international in character,this sort of co-operation among central banks becomes desirable. Long range national advantage and international well-being usually coincide in the desideratum that the credit and currency policy of world's central banks be, as far as possible, uniform, and through co-operation, avoid being haphazard or mutually adverse." The following subjects for co-operation among different central banks have been indicated in a Report of the Bank for International Settlement :

(a) To evolve a common body of monetary doctrines and assure the widest possible measure of common agreement on monetary theory, problems and practice, including the agreement upon what the international standard is to be and how to maintain it.

(b) To comprehend by interchange of information and counsel the difficulties confronting one's neighbour as well as oneself.

(c) To learn how to avoid doing harm to one another specially when one central bank is operating in the market of a neighbour.

(d) To gather and exchange data and information of a monetary and economic character, domestic and foreign, thus helping to form a basis of judgment in guiding credit policy and deciding the proper course of conduct.

(e) To inprove inter-central-bank practice in technical matters.

(f) To be prepared to exchange technical counsel when needed with respect to the creation of new central banks or with regard to alteration in the statutes of existing central banks.

This list is by no means exhaustive and has to be modified from time to time according to circumstances. But two objectives are important, viz, the restoration and maintenance of a stable international currency system and the elimination of trade cycle. But then, too much cannot be expected from such co-operation ; for central banking co-operation is but a phase of international co-operation in all other matters. Henceif international co-operation is lacking, there cannot be any effective co-operation between central banks. Even when international relations are cordial, perfect co-operation is out of question because of the spirit of nationalism, the question of prestige, the tradition of secrecy and similar other matters. Finally, "co-operation to secure fundamental objectives is subject to the inherent difficulty which pertains to reaching common agreement on proper interpretation of world economic and financial situation."

The Bank for International Settlement : The Bank for International Settlement, the first of its kind, came into existence in 1929 on the basis of the Report on German Reparations by a body of experts under Mr. Owen Young. The primary purpose of this Bank was to facilitate the payment and transfer of inter-governmental debts arising out of the war, e.g., German Reparations, inter-allied debts, and payments due from European governments to the Government of the United States. This was only the immediate objective. The B. I. S. was however expected to perform much wider functions as is indicated below :

(1) The objects of the Bank are to promote the

co-operation of central banks and to provide additional facilities for international financial operations ; and to act as Trustee or Agent in regard to international financial settlements entrusted to it under agreements with the parties concerned.

(2) The operations of the Bank shall be in conformity with the monetary policy of the central banks of the countries concerned.

The new Bank had an authorised capital of 600,000,000 Swiss Gold francs. Its paid-up capital was 125,000,000 francs. Seven central banks—Belgium, England, France, Germany, Italy, Japan and the U. S. A.—were the founder-shareholders and the statutes laid down that they would retain their seats on the board even if they disposed of their shares. In subsequent years 18 other central banks from Europe became the members of the B. I. S. At the outset the B. I. S. encountered difficulty owing to the attitude of the U. S. Government who refused to permit the F. R. S. to hold stock or co-operate with the proposed institution. The difficulty was, however, overcome by distributing the American allotment of the stock among a group of large bankers. The major function of the B. I. S., viz., the administration of the reparations, considerably lost its importance after the Lausanne Conference of 1931 which reduced total amount of indebtedness resting upon Germany. In July 1932, the German Government announced a complete moratorium. Thus the business for which the Bank was mainly started had gone and the Bank was left with the task of finding new business for itself. Inspite of these limitations, the B. I. S., in its report

for 1931, declared that conditions had confirmed the belief in the "usefulness and use of the Bank for International Settlement as a centre for information, for counsel for joint financial action." In the third annual report, the tone became less confident ; but still it emphasized the growing interdependence of several nations in financial matters. "It becomes more and more evident with the passage of time that one of the useful roles the Bank would play in the international financial system is to serve as a central instrument of the banks of issue in assisting to co-ordinate the proper functioning of the gold standard." In its fourth report, the Bank described itself as "preparing for this function at the time when the principal currencies shall have been stabilised.....when tariffs shall have been finally established.....and when the international monetary standard shall have been restored."

But very soon the prospects of its functioning became gloomy. When the Gold Bloc countries also went off gold and totalitarianism obtained root in several countries of Europe, the prospects of a free flow of international trade became absolutely dark. International exchange of goods as also the external values of currencies were subjected to all sorts of restrictions and hence the scope for the functioning of the B. I. S. became extremely narrow. Even in the field of international finance its importance became reduced after the loans given by the B. I. S. in Central Europe became frozen.

With the outbreak of the second world war, the Bank's position became complicated ; but yet it "has constantly adhered to the principles of scrupulous neutrality laid down

for itself." This is clear from the fact that the National Bank of Czechoslovakia had deposited £ 6 million worth of gold with the B. I. S. and shortly after the entry of the Germans in that country, it instructed the B. I. S. to pay this gold which the latter did. By 1942 the share-holdings of the Bank were distributed among the Allied Powers and Axis Powers at 47,000 and 1,52,000 respectively. However, the shareholders lost control over the Bank which, as the report of the Bank for 1942 indicates, was still expecting to play an important part in restoring "collaboration in the field of economic and monetary relationship.....The public feels instinctively that a way can and must be found to establish effective co-operation without impairing the vital interests of individual countries." It was expected in some quarters that the B. I. S. would in future pave the way for greater economic collaboration. But recently it has been closed and a new World Bank has come into existence in its place.

World Bank : Like the International Monetary Fund, the International Bank for Reconstruction and Development has also come into existence after the second great war. Its aims have been enunciated by John Mc Cloy, its first President, in the following words :

"It is not to act simply as a lending agency in itself but rather it is to provide machinery for, and security of, long-term private capital investment in economically sound and productive projects in the international field.

"In the first place, capital funds of the Bank paid in, or to be paid in, by member governments amount to only 20 p. c. of the Bank's total subscribed capital or approxi-

mately 1550 million dollars ; the remaining 80 p. c. of the subscription of each member is subject to call only if needed to meet the obligation of the Bank. It is not available for lending purposes. It is there really only as an encouragement and an inducement to others to invest.

"In the second place, and this is most important, of this 1550 million dollars, only some 725 million dollars is represented by U. S. dollars : the remainder is represented by local currencies of various members other than the U. S. —pounds, francs, rupees,kroners, pesos and the like. Only relatively small portion of this other money, contributed by the few other countries which are today in a position of capital exporters is immediately available for lending purposes.

"Moreover, the need and desire of practically all potential borrowers is primarily for dollar. The Bank therefore looks for its lending funds partly to this 725 million dollars, but primarily to the sale of its securities in the private investment market, predominantly the U. S. market.

"Most of the Bank's loans, in other words, will be made out of funds contributed to it from private investors and not out of funds contributed by member governments. The Bank will have no hesitancy in lendidg its own funds. It has every intention of doing so for a number of reasons. But those who are responsible for the organisation of the Bank.....so arranged it that the Bank is forced to rely on private capital for its duly safeguarded major operations."

Justifying an institution of this type, the President argued, "in this transition period after the war, the needs of Europe and of the Far East to reconstruct productive

facilites ravaged in the war as well as the needs for developing the productive resources of underdeveloped areas of the world are so large that the necessary financing would simply not be available in the private market without some form of effective international guarantee such as that which the International Bank affords.

"Another element is the uncertain political factors which now pervade the world scene. I take it that the Bank should not hold back from granting loans until the whole political scene unfolds. By the influence which the availability of long term capital may have in stabilising economic conditions it is hoped that the Bank may play a part in helping to create a healthier political scene."

The first operation of the Bank was to grant loan to France, This loan which amounted to $ 250,000,000 has a total interest of 4¼ p. c., including 3% for interest, 1 p. c., for the Banks' Sinking Fund and one-quarter percent for the Bank's loan expenses. Since then the Bank has received applications for help from a number of countries.

The progress of the Bank has, however, not been very satisfactory. For, since the cessation of hostilities, the world economic conditions have changed for the worse, and hence the prospects of both the International Monetary Fund and the International Bank have become dark. As the Executive Director of the I. M. F. admitted, "Now, more than a year after the establishment of the Fund, the world is confronted with seriously unbalanced trade, with an urgent problem of financing international payments and with severe shortages of goods for reconstruction and even for maintaining the minimum consumption

standards in many countries. The Fund cannot solve these problems, but the role which the Fund will be able to play in the future must inevitably be determined in large measure by the way in which these problems are solved." The greatest factor impeding reconstruction was the lack of "an international political environment conducive to economic stability and progress,...Political uncertainties and disturbances have made it difficult for countries to devote their full resources to reconstruction." Besides, the magnitude of the task of reconstruction is far greater today than it was at the end of the war, while the available resources are too inadequate and, therefore, have rendered wellnigh impossible the realisation of the objectives of the I. M. F. and the International Bank.

Conclusion : It will thus be seen that the world economic co-operation, of which central banking co-operation is only a part, is not yet possible on a full scale. That is in part due to the attitude of the great powers among whom the basis of co-operation is almost always lacking. And when the big powers or the important central banks use their authority for narrow national interests, they influence the international situation for the worse. As Keynes has pointed out, "An international system works particularly badly if central banks which are strong enough to dominate for a time the general tempo and to set the pace for others, use this power to promote national policies which are out of keeping with the requirements of international position as a whole." The fact is that so long as national policies, are guided by national sentiments, it is too much to expect international

disinterestedness from central banks. Hence the central banks, particularly of the less developed economies, should always be careful in their policies. If co-operation is forthcoming from other central banks which is not harmful to their economic interests, they should stretch their hands out for co-operation. But if it is not forthcoming, they should at least be busy with their own economies. For, only when all the economics of the world are developed more or less to the same standard, when no country is a sort of pull-back influence, that will facilitate and pave the way for greater economic co-operation in future. Hence, for the present, "while too much must not be expected from central banking co-operation, if it be wholly absent too much cannot be feared."

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