CHAPTER IX

THE QUESTION OF STRUCTURAL EFFICIENCY

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Introductory :

Peter F. Drucker is said to have remarked that all our talk about labour participation in management will be loose and void of real content so long as managers have no stake in management. This is so for monetary policy also when all is said about making an efficient use of monetary instruments but without assuring oneself that the structural framework is such as to make policy measures effective in the sense of achieving the desired goals. Bagehot was cognizant of this requirement, though in a rudimentary way, when he said, "I venture to call this essay 'Lombard Street' and not the monetary management or any such phrase because I wish to deal and to show that I mean to deal with concrete realities".[1] John Law, on the other hand, having fully realised the concomitance of 'real' and 'financial' accumulation earned a bad name for all his banking reforms in France as he could not grasp the need for a structurally efficient banking system that would have been appropriate to the underdeveloped economy of the eighteenth century France.

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1. Walter Bagehot "The Lombard Street", Richard - Irwin (1962) P. 1.

In recent times, we owe it to H.G. Johnson to have reminded us that with the professionalisation of economics, problems of monetary management have come to be analysed more in terms of their - institutional and normative aspects and less in terms of their institutional and historical aspects.[1] On a general plane this would amount to applying the Pareto optimality criterion to the banking industry and define the structural efficiency of the system as one which meets with the need for holding a socially optimum money supply as Johnson has shown. When we think of an underdeveloped economy the issue could be tackled on a broader plane, as by its very nature such an economy is characterised by many gaps in its financial system. This would doubtless preclude reaching analytically simple and valid generalisations but approaching the problem in this manner surely puts monetary policy in its proper perspective and more so in an economy undergoing structural transformation of its financial system.

A reference to the structural efficiency of the banking system (or more broadly of the financial system) becomes necessary in order to gauge the effectiveness of monetary policy. Monetary policy

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1. This view has been stated earlier and incorporated into the goal function of the Central banks in the underdeveloped countries. Vide Chapter 3.

operating within an environment of an efficient banking (financial) system is more effective than one operating within an environment of an inefficient system.[1] Analysis of 'optimal policy making' is carried out in terms of the relation between targets and instruments[2] and it is presumed that the banking system, subject to forces of competition carries out its normal functions in an efficient manner. Banking institutions have however, been subjected to regulation in terms of size, adequacy of capital structure, location etc., and it is assumed that this regulation, born out of historical experience, is both a necessary and sufficient condition for effective working of monetary policy. Only in recent years problems such as (i) desirability of competition v/s regulation in banking (ii) whether banks are subject to increasing returns to scale, (iii) relationship between different types of financial intermediaries in terms of the degree of substitutability among their products and the resultant issue of regulation in the pricing of their products (iv) inter-sectoral and intra-sectoral allocation of financial resources of the community as conditioned by the working of these institutions etc., have

1. This aspect of the matter is inherent in the 'gap' concept of Hicks referred to in Chapter eight.

2. Ref~~f~~erred to earlier in Chapter three.

come to the fore. Earlier efforts by D.A. Alhadeff in the U.S.A. have led to proliferation of literature on the subject.[1]

Similar issues, though with some difference have been lying at the whole set of problems ranging from the long debated issue of integration of 'unorganised banking' with organised banking and 'social control' over to nationalisation of commercial banks as well as credit planning, deposit mobilization and so on, in India.

Confining the issue to commercial banks and carrying analysis at an abstract level Boris Pesek[2] has recently shown that although the use of traditional demand supply analysis in regard to banks suffers from two important limitations viz., (i) "determination of the equilibrium quantity of money and deposit monies is completely divorced from the determination of the equilibrium price (i.e.

1.(i) D.A. Alhadeff "Monopoly and Competition in Banking", Berkeley, University of California Press, 1954.

(ii) Dean Carson (Ed.) "Banking and Monetary studies", Irwin 1963.

(iii) For a review of the literature and further probing refer Federal Reserve Bulletins, November, 1964 and September, 1965.

(iv) Journal of Political economy, August, 1967 (Part II) Pp. 461-511.

2. Boris P. Pesek "Bank's supply function and the equilibrium quantity of money", The Canadian Journal of Economics, August, 1970. Pp. 357-83.

'purchasing power') of these two assets" and (ii) "determination of the equilibrium quantity of deposit money is completely divorced from the resource costs facing the banks and thus from the supply function of bank deposits", it is possible to derive the banking industry's equilibrium by defining the cost and price concepts (though complex in nature) in a suitable manner. Fixing attention on supply function of the banking industry in relation to its demand function opens important fields of enquiry. Pesek further contends that the "banker's task is monumental as is shown by the fact that the performance of it absorbs annually in the U.S. resources worth \$ 15 billion".[1]

Total resources absorbed by the scheduled banks in India, we may note, during the year 1966 amounted to Rs. 297 crores.[2] "The contribution of organised banking to the growth of income from commerce as an index rose from 100 in the base year 1952 to a fairly high level of 233 in 1964. The contributions to national income from railways and communications rose

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1. Ibid. P.361.

2. Vide "Statistical tables relating to banks in India" 1966 Pp. 20-21.

   National income during the year 1965-66 (current prices) was Rs. 20621 crores. So the resources absorbed were about 1.4 percent of national income. Co-operative and post-office savings banks are excluded together with the whole of 'unorganised banking'.

to peaks of only 155 and 150".[1]

The issue of structural effieiency in India:

As remarked earlier, the issue of structural efficiency in India to be tackled on a broader plane need concern itself with problems such as;

(A) Integration of the banking system;

(B) Efficiency aspect of commercial banks which will be related to (i) size (ii) costs and (iii) product i.e. efficiency in a static sense;

(C) Growth of commercial banking i.e. the dynamic aspect of structural efficiency.

(D) Growth of commercial banking vis-a-vis other financial intermediaries.

The Banking Commission constituted by Government of India in January, 1969 is currently addressing itself to these and other related questions.[2]

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1. S.S. Iyengar, "Economies of scale in banking" (mimeographed), Department of Economics, University of Bombay.

2. The terms of reference of the Commission, inter alia, are to :

   (i) enquire into the existing structure of the commercial banking system having particular regard to size, dispersion and area of operation and to make recommendations to improve the structure.

   (ii) make recommendations for extending the geographical and functional coverage of the commercial banking system.

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As may be seen from the 'terms of reference' what has been listed by us at (A) seems to be having a lower order priority in the terms of reference (item iv) of the Commission. Would it not be a more rational procedure to thrash out the issue of integration first and fit this with the 'emerging banking structure' as may be envisaged under the labours of the Commission as to (i) to (iii) ? The Commission would perhaps do well to approach both the issues in an integrated manner.

The issue of integration :-

The issue of integration at one remove, is that of bringing within the fold of organised banking, the whole set-up of business passing under the name of unorganised banking. At another remove it is one of bringing about co-ordination between the constituents of organised banking—commercial co-operative and post office savings banks. The policy hitherto has been,

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(iii) examine the cost and capital structure and review the adequacy of available surplus and reserves, having regard to the developmental needs of the banking system, and make recommendations in the light of the findings.

(iv) The Commission is also required to make recommendations with regard to the building up of a professional cadre of bank personnel, co-ordinated development of commercial and co-operative banks and the role of non-banking financial intermediaries including the indigenous banking agencies in the emerging banking structure.

on the one hand, one of masterly inaction based on the expectation that the unorganised agencies will die slow and natural death. On the other hand, the positive aspect of the policy has been to subsidise the growth and working of the co-operative system as a countervailing power. It is true that over the past few years, the co-operative system has entrenched itself into the field of rural finance[1] but the pace of penetration is tardy and uneven in addition to the cost of financial intermediation remaining heavy (funds provided by the Reserve Bank at a rate 2 per cent below the Bank Rate i.e. 2 per cent only till 1963 - percolated down to the farmer at the village level at about 10-12 per cent). There is as such the problem of efficient working of the whole network of co-operative financing. The Agricultural Credit Review Committee[2] looked upon the problem in terms of this efficiency aspect when it recommended vigorous expansion programme by commercial banks in

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1. The share of co-operatives in total agricultural finance which was 3.1 per cent in 1950-51 rose to 13.8 per cent in 1961-62. It may have reached a level of around 17-18 per cent in 1965-66.

2. Report of the All India Rural Credit Review Committee, Reserve Bank of India (1969).

the rural areas and introducing a sort of 'means test'[1] in provision of refinancing facilities by the Reserve Bank, together with structural and operational changes in the mode of financing - both in terms of differential interest rates on loans as well as deposits in addition to recommending measures to develop and strengthen intermediary non-financial development agencies for extending and rationalising the loan operations of the Co-operatives.

A similar problem has to be tackled in regard to the post office savings banks, which provide services as pure savings banks and are government dealers in - 'Small Savings Securities'. We saw in Chapter 4 that deposits held with these banks in 1965-66 were 22 per cent of deposits held with the scheduled banks. Taking an advantage of the nationalised set-up an arrangement could be thought of wherein while post offices may continue working as agents for small savings securities savings bank deposits from post offices in towns - where such offices exist but the scheduled bank does not have an office, could be transferred to the newly opening branch of the nationalised bank. It may well be argued that historically post office savings deposits have had an attractive for a class of savers who are risk-averters. However, this margin

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1. The term 'means test' as used by us here refers to the recommendation of the Commission that "the concessional rate of interest should not be made available automatically but should be made to depend upon the deposits mobilized by the central co-operative banks". The Commission has, in the light of this basic approach, recommended a scheme whereby targets would be set for each Central Co-operative bank for deposit mobilisation, fulfilment or shortfall in achievement of which, would entitle it to borrowing at higher or lower concessionary rates, respectively, from the Reserve Bank.

of preference would exist with nationalised banks also. It may then be enquired whether the whole of post office savings bank business could be transferred to nationalised banks. The question has - basically to be decided in terms of (i) extent of deposit accrual to new branches of nationalised banks, which can be known from data about distribution of post office savings bank deposits in the hitherto unbanked areas; (ii) relative cost of financial intermediation in holding deposits with the two types of banks, and other related issues. The problem is not gone into details here but the issue of - 'savings banks' in the entire banking set-up requires consideration.

A more formidable problem exists in regard to the integration of the 'unorganised money market' with the organised set-up. The term 'unorganised money market' may appear a misnomer for the very use of the term 'market' implies some structure or - organisation - whether it may be perfect, imperfect or monopoly type. The use of the term unorganised has been derived from the historical interpretation of the Indian monetary system which tended to recognise the peculiarity of the system in terms of one component (modern and organised) which carried on business with legalised homogenous and universally acceptable bills of exchange or other financial instruments and another component which did not either possess such instruments or was loath to create them, with the consequence that these widely divergent methods of raising deposits and effecting loan operations rendered the system less coherent than the organised banking component. The real issue is not about the system being unorganised but whether it worked with given norms of efficiency. The term 'unorganised' is co-terminus with exhorbitant and usurious rates of interest. U Tun Wai reported an 'authoritatively calculated world wide average interest rate of between 24 and 36 per cent for rural lending in underdeveloped countries".[1] The All-India Rural Credit Survey Committee had reported the upper limit at 50 per cent. The issue is about the economic factors underlying such high levels of rates. A. Bottomley pointed out that "in the more developed countries, loans which involve small amounts and comparatively high risks, such as for consumer credit, often carry interest charges which are close to those levied on rural lending in poorer countries and this is probably simply because the administration and risk charges are equally high in

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1. U Tun Wai 'Interest rate outside the organised money markets of underdeveloped countries'. I. M. F. Staff Papers - Vol. II (1957) P. 102.

both cases".[1] The high rates in the unorganised sector are thus an outcome of a variety of factors like costs of administering the loan, ignorance of the borrower, low productivity of the farmer, high risk premium, monopoly profits and so on.[2] It may be noted that the incidence of defaults in repayment of loans remaining high, the pure rate of interest, in the sense of the rate emerging when default free loans could be demanded and supplied, would not be that high. This is evidenced from the fact that the ratio of overdues to loans outstanding with the co-operative sector where finance is available atleast at about half the rate in the unorganised sector has also tended to remain high.[3] It may also be noted that the rates of interest in the unorganised sector do not play any part in the market for deposits since most of the funds are supplied by the money lender who acts mainly as a lender and much less as deposit - receiver.

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1. Anthony Bottomley "The cost of administering private loans in underdeveloped countries", Oxford economic papers (New series) March, 1963 P. 154.

2. Anthony Bottomley "Monopoly profit as a determinant of interest rates in underdeveloped areas" Oxford Economic papers (New series) November, 1964. Pp. 431-37.

3. Percentage loans overdue to loans outstanding with primary credit co-operative societies in India, which was 23 in 1963-64 rose to 29 in June, 1966 - vide "Renew of the co-operative movement in India" Reserve Bank of India, Bombay P. 50. (1964-66).

As per data collected by the All India Rural Debt and Investment Survey (1961-62) the combined share of government, commercial banks and co-operatives, in the total of cash loans borrowed by all rural households during 1961-62, was 16.8 percent, the remaining 83.2 percent having been provided by moneylenders, traders, relatives and so on. The former group of suppliers may be taken to represent the 'organised' and the latter as 'unorganised' sectors. The predominance of the unorganised sector, therefore, demands attention.

The unorganised system is better described as pockets of competing monopolists with gaps in the chain of substitution and the problem of structural efficiency has to be viewed in terms of closing these gaps. These gaps need to be removed through a rational interest rate policy and financial innovations. Offering rediscounting facilities to the 'bill' of the indigenous bankers or allowing these bankers to emerge as bill brokers on lines of 'Discount Houses' through a systematic revival and extension of the bill market scheme would constitute such innovations. More concerted efforts towards securing integration rather than a policy of 'quantitative injection of funds'[1] which has been the

1. As P.R. Brahmananda rightly observes "it would be incorrect to suppose that the problem of gaps may be primarily solved by quantitative injection of funds... the problem appears to be more that of optimum distribution". - "The role of banks in national life - a symposium, Syndicate Bank, Manipal (1968) P.52.

case with the co-operative system and which may easily become a policy measure with banks operating under public ownership would be the right course of action.

We need clarify one point at this stage. We have emphasised simultaneously the issue of integration as well as closing of gaps. The issue of integration embraces all the financial agencies operating in the rural sector and at the national level from co-operative banks to post office savings banks, commercial banks, moneylenders and so on. The emphasis is on putting these agencies in such behavioural relations as would ensure maximum efficiency. The emphasis then again is not elimination of some agencies but welding together of their working. Integration does not however, mean perpetuation of inefficient agancies but it takes an agnostic position as regards a particular agency being usurious or unjust.

An advocacy for closing of gaps on the other hand envisages expansion and entrenchment by the more efficient agency in the financial structure. This may entail elimination of inefficient agencies whether it be the money lending or the co-operative agency. To the extent these agencies perpetuate the method of 'self-finance' they should give way to other organisations or improve their working so as to resemble the 'debt-asset' method. It may be instructive to quote Gurley and Shaw in this regard, "Self finance is contralist....Degeneration in process of debt-asset finance reduces saving and investment but it can also direct funds into the channels of self-finance....Co-operative credit among say consumers or farmers has been at times a way of detaching relatively small homogenous groups (and this should apply to money lending agency also) from reliance on the broader security markets. The 'mujin' and 'kye' of the Far East are illustrations of co-operative saving-investment process that border on both self-finance and the debt-asset system."[1]

The issue of size of the banking unit :

One issue which is being intensively discussed in the U.S.A. (and U. K. also) is the advisability of regulation of entry in banking which has close bearing on the question of size of the banking unit. Sam Feltzman in his study of regulation of capital investment in banking and its relation to portfolio regulation in the U. S. A. has conclusively shown that restrictions on entry have reduced the number of new banks below what might have been expected if only economic factors had operated.[2] The policy in India, as we saw in Chapter 4 has been over the past years, to encourage smalgamations among commercial banks. In his study on Indian banking, Donald Hester found that small banks were

1. Gurley and Shaw "Financial structure and economic development", Economic Development and cultural change. April, 1967 P. 264.

2. "Research into banking structure and competition" Federal Reserve Bulletin, November, 1964. Pp. 1383-1394.

more efficient. He, therefore, concluded that "relationship between bank size and profitability suggest that amalgamations may achieve stability in the banking system only with some loss of efficiency. Extending this conclusion to the issue of nationalisation of banks in India he opined that since nationalisation will usher in a centralised set up and since small banks were found more efficient "bank nationalisation would be an unwise policy in India to-day."[1] With nationalisation of major banks in India, the conclusion is rendered less relevant now. Another study covering 44 banks (against 65 banks covered by Hester's study) and based on data of cost and output relationship for a period of two years has however, shown that there are economies of scale in banking in India and that, therefore, it "would be an economic use of resources to allow existing banks to expand than to start new unit banks."[2]

There is a general theoretical presumption that banks are subject to increasing returns to scale. H. G. Johnson thus observed that "there are significant economies of scale in the operation of the payments mechanism and on the lending and investing side of business - this may indicate the social desirability

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1. Donald D. Hester "Indian banks, their portfolios, profits and policy" University of Bombay (1963) P. 87.

2. S. S. Iyengar Ibid.

of operating banking business as a public utility."[1] Gurley and Shaw argued that the high degree of substitutability between bank deposits and loans on the one hand and financial assets and credit provided to spending units by non-bank sources on the other hand may be taken to mean that "banks are not in a position to take monopolistic advantage of its markets." Thus with relatively elastic demand functions for banking services and assuming that there are decreasing costs in banking, "there may be a rational basis for merger in the banking industry".[2]

It is then to be seen whether the nationalised set-up (a variant of the merger) in India "increases public welfare by economising on the costs of banking operations and by increasing the responsiveness of banks to monetary controls".[3]

This dynamic aspect of the efficiency of the banking system rather than concern with allocation of funds between private and public sectors or doling out funds at one end at as low a rate as 1 per cent and rationing them at as high a rate as 20 per cent

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1. H.G.Johnson "Efficiency in monetary management" Journal of political economy - September-October 1968, Pp. 971-89[esp. P. 975]

2. J. G. Gurley and E. S. Shaw "Money in a theory of finance" (196) Pp. 297-98.

3. Ibid.

(as is being currently debated under the differential interest rates proposition) are the real issues that need more attention.

The Indian banking system needs in an immediate context solution to the problem of integration and in a dynamic context both expansion of the system[1] and induction of financial innovations.[2] The findings of the Banking Commission and the policy stances emerging therefrom should obviously bear heavily on the course of monetary policy-making in India.

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1. The ratio of aggregate bank deposits (scheduled banks) to national income (at current prices) which was 9.2 in 1950-51 rose to 14.5 in 1965-66. The ratio was 67 per cent in Japan; 20 per cent in Phillipines and 16 per cent in Ceylon which speaks for low expansion of banking in India.

2. As A.L.Marty puts the issue "there are financial innovations that reduce the gap between lender's and borrower's rates (and act like a reduction in transportation costs), increase the degree of perfection of capital market, reduce lender's and borrower's risk premiums etc.... and these constitute real saving from society's point of view..... surely what is needed is a theory of financial innovations comparable to that on industrial innovations." (Vide Journal of Political economy August, 1967 (Part II) P. 507).