CHAPTER IV

THE INDIAN MONETARY SYSTEM - AN OVERVIEW

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This chapter has been interposed with a view to providing an overview of the general characteristics of the Indian Monetary system. The treatment is to give a factual account of the system in a very broad manner. The emphasis is on stating the structural rather than behavioural aspects.

Following are the constituents of the system :-

(1) The Reserve Bank of India

(2) Commercial Banks

(3) Co-operative Banks

(4) Post Office Savings Banks

(5) Financial Intermediaries other than those at 2, 3, 4. These comprise of statutory Financial Corporations: Insurance; hire purchase companies; Investment Trusts etc.

(6) Indigenous or traditional banking system.

1. The Reserve Bank of India :-

Proposals were afoot since 1926[1] for establishing a Central Bank in India but it was only with the passage of the 1934 Act that the Reserve Bank of India was established. It began functioning from 1st April, 1935. Established originally as a private shareholders' bank and later nationalised in 1948, the

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1. The Hilton Young Commission (1926) made the recommendation and a comprehensive enquiry was made by the Central Banking Enquiry Committee (1931.)

Bank carries out all the functions that normally devolve on a Central Bank. In addition, it was entrusted with the task of providing or making arrangements for provision of credit to the agricultural sector under the original 1934 Act. In the post-Independance period passage of the Banking Companies Act 1949 and subsequent amendments thereto have invested the Bank with vast powers so as to enable it to carry out the tasks of regulation and promotion of the banking system in particular and the financial system in general and with special concern for the general objective of economic development. According to the preamble of the Reserve Bank of India Act (1934) the main function of the Bank is " to regulate the issue of Bank notes and the keeping of reserves with a view to securing - monetary stability in India and generally to operate the currency and credit system of the country to its advantage[1]". With the proliferation of function enjoined on it after indepen -dence, the "Bank's responsibilities include, apart from purely regulatory functions, the institutionlisation of savings through promotion of the banking habit and the extension of the banking system territorially and functionally and/or by the establishment of promotion of new specialised financing agencies".[2]

Table 4(1) gives an account in absolute terms of the impact of the working of the Bank in regard to its various functions for some selected years.

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1. "Reserve Bank of India, Functions and Working", Reserve Bank of India, Bombay (1970) P.4.

2. Ibid P, 5,

TABLE 4(1)

Impact of the Reserve Bank of India

(Amount in crores of Rupees)

	Year					
	1924	1935	1945	1951	1961	1966
1. Notes issued (Outstanding at the end period)	-	193	1152	1292	1978	2891
2. Cheque clearances (annual)	1748	1885	6273	7878	12550	20956
3. Bills purchased and discounted	-	-	-	2	36	278
4. Loans and Advances (Government & others)	-	1	0.70	26	165	317
5. Investments (Government securities and others)	-	5	21	88	189	207

Source: Statistical tables relating to Banks in India for relevant years.

2. Commercial Banks:-

Development of the commercial banking system on western methods has a long and chequered history in India. The structure as it obtains at present is a highly differentiated one and has its roots in developments in the past. There are two broad categories namely 'scheduled' and 'non-scheduled' banks.[1]

1. The distinction is analogous to 'member' and 'non-member' banks in the U.S.A. with one distinction that whereas in the U.S.A. all banks have the access to the clearing system administered by the Federal Reserve System, in India ~~only~~ usually scheduled banks have access to this facility.

The scheduled banks are eligible for accomodation from the Reserve Bank and have to fulfil certain conditions one of which and rather important relates to such a bank having a paid up capital and reserves of an aggregate value of not less than Rs. five lakhs.

Scheduled Banks:-

The scheduled banks are further classified, as a legacy of the past and for legal and control purposes into (i) Indian Scheduled banks and (ii) Foreign Scheduled banks; the latter category of banks have been so called as they specialised in financing of foreign trade, were domiciled in foreign countries and enjoyed certain special facilities in the pre-Independence period.

The Indian scheduled banks are companies domiciled in India and there are two categories of them.

(i) Privately owned banks and

(ii) State Bank of India and its subsidiaries which are owned by the Government.

The State Bank of India so named is successor of the Imperial Bank of India nationalised in 1955. The Imperial Bank of India held a strategic position in the banking system after its emergence in 1921 by amalgation of the three presidency Banks established by the then British Government earlier to carry out its financial operations. Till 1935 the Imperial Bank combined in itself some functions of a Central Bank while remaining a commercial bank. The State Bank of India has thus remained a powerful competitor to other commercial banks, due first to its prestigious government-sponsored position and secondly due to the volume of banking resources under its control. As at the end of March, 1966 the State Bank and its subsidiaries held aggregate deposits worth Rs. 812 crores which were 27.5 per cent of aggregate deposits held by all scheduled banks in India.

Bank amalgamations and expansion (1951-66) :-

Indian Banks witnessed large scale failures during both the World wars. The Reserve Bank wielded powers enjoined on it under the Banking Companies Act, 1949 to strengthen the banking structure and became instrumental in amalgamation or merger of weak banks into bigger and sound banks[1] with the result that the number of banks has declined in the post-Independence period although number of bank offices and deposits have shown trends of continuous expansion. Table 4(2) gives a broad picture of these trends during the period 1951 through 1966.

1. There was a small wave of bank failures during the year 1960. To counteract repetition of such calamities, the Reserve Bank of India Act was amended in 1962; the Bank put more vigour in its programme of amalgamations and a more important consequence was establishment of the Deposit Insurance Corporation of India in January, 1962 to protect small depositers against such contingencies and ensure soundness of the system in general. Benefit of insurance which was available to a single depositor upto a limit of his deposit amount of - Rs. 1,500 was raised to Rs. 5,000 in January, 1968 so that the percentage of fully protected accounts to total number of accounts with insured banks increased approximately to 91. (Vide Trend and Progress of Bakking in India - 1967 - P. 30).

TABLE 4 (2)

		1951	1956	1961	1966
1.	Number of banks (all commercial banks)	566	423	292	99
2.	Number of Offices in India	4151	4067	5012	6595
3.	Number of branch offices per bank offices (2 ÷ 1)	7.3	9.6	17.1	66.5
4.	Population (Lakhs)	3610	3975	4427	4989
5.	Number of bank Offices per Lakh of population (2 ÷ 4)	1.15	1.04	1.13	1.32
		Rs. Crores			
6.	Paid-Up Capital and Reserves	75	72	76	99
7.	Total Deposits in India (December end)	908	1159	2012	3786
8.	Percentage ratio of 6 to 7	8.3	6.2	3.8	2.6
9.	Bank credit in India (December end)	627	824	1293	2565
10.	Percentage ratio of 9 to 7	69.1	71.1	64.3	67.7

Source: Statistical tables relating to banks in India for various years.

The table reveals that during the years number of bank offices increased from 4151 to 6595 (+ 58%)[1] while deposits increased from Rs. 908/- to 3786/- crores (an increase of 317%). Expansion in regard to both was much more marked however, during the period 1961-66. The number of bank offices per lakh of population however, showed a trend of more or less stagnation (Col.5). As mobilizers and allocators of the financial resources of the community, commercial banks made good progress but as agencies for monetisation and spread of banking habits, their achievement was not conspicuous.

Sectoral distribution of credit :

If we look to their functions as providers of credit to different sectors such as agriculture, industry, there are certain marked trends.

Commercial banks in India are urban-based institutions. Their lending operations are based on much larger use of 'cash credit' methods as against bill finance and term lending. For these and other reasons their lending operations have remained confined to industry and commerce with a tiny proportion going to agriculture.

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1. Number of banks decreased from 566 to 99 (a decline of 82%) through operation of economic forces and legal measures and voluntary agreements under the aegis of the Reserve Bank of India. This should have prima facie put the Reserve Bank in a more comfortable position to conduct monetary policy in an environment of a stable banking system.

Percentage share of bank credit to industry which was 34 in March, 1951 increased to 62.7 in March, 1966. The share of commerce which was almost same as that of industry (36%) in 1951 declined to 21.4. The share of agriculture which was 2.1% in March, 1951 remained steady at 2.4% in March, 1966.

Sectoral variations reveal the impact of growing industrialisation and point to a trend of stagnation in credit extended to the agricultural sector. For this and a host of other reasons there was a heated debate about the desirability of keeping commercial banks under private ownership with the consequent phenomenal policy decision to nationalise 14 big (having deposits of Rs.50/- crores and above) scheduled commercial banks in July, 1969.[1]

1. The structure of commercial banking as it obtained in India at the end of December, 1969 was as under:

Category	Number of Banks.	Aggregate deposits held (Rs. crores).	Percentage of total deposits with all banks
1. State-owned Banks			
A. State Bank of India.	1	1018	21
B. Subsidiary Banks of the State Bank of India	7	291	6
C. Other nationalised Banks	14	2735	56
TOTAL (A+B+C)	22	4044	83
2. Foreign Banks.	15	481	10
3. Other scheduled Banks	36	314	7
TOTAL (Scheduled Banks. (1 + 2 + 3)	73	4842	100
4. Non-scheduled Banks	14	23.48	

For analysing the working of monetary instruments covering the period 1951-1966 in the next three chapters this aspect of ownership of banks would be of little relevance. However, in view of the smallness of deposits held and the process of their amalgamation with scheduled banks being still under way, the non-scheduled banks will be kept out of consideration. Table 4(3) gives a comparative picture of both types of banks on selected dates.

Table 4(3)

Relative Position of Scheduled and Non Scheduled Banks.

(Amount in crores of Rupees)

Year (March end).	Scheduled Banks		Non-Scheduled Banks.		Percentage Ratio of (4) to(2)
	Number (1)	Aggregate Deposits. (2)	Number (3)	Aggregate Deposits. (4)	(5)
1950-51	93	880	331	137	4.2
1955-56	89	1043	378	67	6.4
1960-61	89	1746	256	143	2.5
1965-66	76	2950	33	24	0.8

(Source: Banking and Monetary Statistics of India (Supplement) and currency and Finance Reports).

3. Co-operative Banks :

For a variety of reasons rooted into the indebtedness of farmers, recurrent conditions of famines and the statutory obligations of the Reserve Bank in regard to agricultural credit, a myraid of co-operative financing system has evolved in India over the past more than half a century. State

Co-operative banks at the apex level; Central Co-operative banks in the middle and 'primary' societies at the bottom is the structure.

The Reserve Bank advances loans to State Co-operative Banks (the apex institute) at concessionary rates which then percolate down to the small farmer. In the post-Independence period the system has made rapid strides. Operations of the system are largely confined to the agricultural sector. Finances are being distinguished according to purpose and term of the loan, the purpose usually determining the term of the loan such as short term; medium term and long term. There are Land Mortgage banks which provide long term finance under support from the Reserve Bank. The Agricultural Refinance Corporation established in 1962 cater to the financial needs of agriculture on a broader base. The Corporation is controlled by the Reserve Bank.

State Co-operative Banks which are the apex institute and the vital link in the system are being heavily refinanced by the Reserve Bank. Table 4(4) gives an account of these banks in terms of some of their operations.

Table 4(4)

State Co-operative Banks maintaining accounts with the Reserve Bank of India.

(Amount in crores of Rupees)

Year (last Friday of March)	No.of reporting Banks. (1)	Aggregate Deposits. (2)	Borrowings from Reserve Bank. (3)	Bank Credit (4)	Ratio of 4 to 2 (percentage). (5)
1950-51	7	17.77	3.42 (12.41)	13.86	78.0
1955-56	17	28.49	13.20 (65.08)	25.35	89.0
1960-61	20	34.93	88.29 (94.53)	62.08	177.7
1965-66	18	62.28	166.78 (73.52)	267.86	430.1

Note: Figures in brackets (Col.3) show borrowings by Scheduled Commercial Banks.

Source: Currency and Finance Reports.

Whereas over the period 1951-66 the ratio of bank credit to deposits has varied within the range 69.1% to 67.7% in case of commercial banks (Table 4(2) it has shown wider variations between 78.0% to 430.1% in case of State Co-operative Banks which measures the extent of heavy support lent by the Reserve Bank. The tendency of bank credit to remain in excess of hundred per cent of deposits is to be noted. Further, these borrowings were made available at concessionary rates (the general rule being to provide accommodation at 2 per cent below Bank Rate). . In view of these pecularities and further in view of the total deposits held by these banks having been about 2 per cent of the total deposits of scheduled commercial banks,[1] we shall not take account of them while discussing the measures of monetary control in the next three chapters.

4. Post Office Savings Banks:-

These are savings mobilizing agencies and function as a part of the postal system of communications. The Rural Banking Enquiry Committee (1950) had recommended extension of branch work of post offices to meet the dual purpose of spread of communications and savings mobilization. The approach was more savings-minded and less finance-minded. Their superiority over other banking institutions is their low overhead costs.

TABLE 4(5)

Deposits with Post Office Savings Banks.

(Amount in Crorès of Rupees)

Year ending March.	Net receipts during the year	Amount outstanding
1950-51	16.69	187.28
1955-56	36.48	298.47
1960-61	45.10	440.78
1965-66	88.69	653.42

Source:- Currency and Finance Report 1966-67 P. S-100.

1. Figures in Table 4(4) above and the 2 per cent ratio understates the total of deposits with all co-operative banks. Our above figures relate to State Co-operative banks maintaining accounts with the Reserve Bank. For the entire system of co-operative banking (excluding Land Mortgage banks) the breakdown of figures will be as under:

	Deposits held as on 30th June, 1 9 6 6.
State co-operative banks	Rs. 141 crores
Central co-operative banks	Rs. 236 crores
Total	Rs. 377 crores

Their deposits (outstandings) in 1965-66 were 22 per cent of deposits of scheduled commercial banks. (Rs. 2,950 crores).

5. <u>Other financial intermediaries:-</u>

<u>Statutory financial Corporations:-</u>

The post-Independence years have seen proliferation of financial institutions to cater to needs of industrial finance. What is more, the Reserve Bank of India either in a direct manner or indirectly through provision of funds in equity or loan form or stake in management has been associated with these institutions. The Bank has thus been associated with the process of 'institutionalisation of savings and investment' by forging a link with institutions catering to the financial needs of the two main sectors of the economy viz. agriculture and industry.

The emergence of these institutions has made the Indian financial system sophisticated as compared to other underdeveloped countries. The structure again is variegated.

Among these institutions two main categories are (i) The Investment Trust and (ii) Specialised Financial Institutions. Although some private investment trust companies have operated in India, the volume of business handled by them has remained insignificant. The Unit Trust of India which came into being as a Public Sector institution in 1963 is a Savings mobilising agency which carries out a balanced investment programme for its 'Unit'-holders. On June 30, 1967 the Trust had investments worth Rs. 33.9 crores of which nearly 2/5 were in Equities, the other 2/5 in Debentures and the rest in other forms of investments.

The other category consists of specialised financial institutes[1] which meet with the requirements of long term finance by industries big or small and in the private or public sectors. Taken together they are multi-functional agencies carrying out functions ranging from granting of loans, refinancing, underwriting, equity participation, rediscounting of bills to rendering assistance for technical know-how and so on.

During the period 1948-65 these institutions (excluding Unit Trust of India) disbursed loans etc. worth Rs. 347 crores. The Reserve Bank extended support in terms of direct capital holding and otherwise to them till 1965-66 to the extent of Rs. 32 crores which comes to about 9.2 per cent of total amount disbursed.[2]

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1. These financial institutions are: (1) Industrial Finance Corporation (2) State Finance Corporations (3) Industrial Credit and Investment Corporation (4) Refinance Corporation (now merged with I.D.B.I.) (5) Industrial Development Bank of India (6) National Industrial Development Corporation.

2. The figures have been based on (i) Table VI. 1 in L.C. Gupta, "The Changing structure of Industrial Finance in India", Oxford University (1969) and (ii) Statement 30 in Currency and Finance Report 1969-70.

Emergence and growth of these 'Development Banks' in India is in keeping with the post-war trend of institutional financing witnessed elsewhere and invests the Reserve Bank with the further task of keeping the Indian financial System in a co-ordinated and structurally efficient form.

Non-banking financial companies :-

Prior to the emergence of the statutory financial corporations Indian industries resorted to the method of borrowing from the general public on a fixed term deposit basis, the method having remained in vogue thereafter also. There are also some other non-bank financial companies doing hire purchase business and accepting deposits. Both these compete with banks for funds. Consequently in 1965 the Reserve Bank carried out a survey of deposits held in these firms and imposed regulations in respect of them. The Bank classified such firms as Non-banking financian and Non-banking Non-financial companies.

At the end of March, 1966, 393 Financial and 1964 Non-financial companies were reported to be working. They together held deposits worth Rs. 283 crores.

Table 4(6) shows the dent made by these companies into the deposit mobilization business of scheduled banks during the years 1962 to 1966.

TABLE 4(6)

(Amount in crores of Rupees)

Year ending March	Number of Non-banking Companies.	Deposits with Non Banking companies	Number of reporting scheduled commercial banks.	Deposits with Scheduled Commercial Banks.	Ratio of 2 to 4 (percentage)
	1	2	3	4	5
1962	1542	135	83	1922	7.05
1963	1677	154	79	2042	7.54
1964	1789	186	78	2285	8.14
1965	1909	209	76	2583	8.10
1966	2357	283	76	2950	9.61

Source:- Reserve Bank of India Bulletin July, 1965, November, 1966 and April, 1968.

6. Indigenous banking system:-

Prior to the establishment of banking on western lines a vast network of money lenders and other indigenous bankers operated. They often are termed as constituting the 'unorganised' part of the Indian money market. Even as at present, they finance about 50 per cent of financing of trade and agriculture in India.[1]

We referred to the existence of this sector as a constraint on monetary policy in chapter three. The implication obviously is that to render policy more effective

1. H.V.R. Iengar, 'Monetary Policy and Economic Growth', Vora & Co. Bombay, 1962. P. 207. The Central Banking Enquiry Committee (1931) estimated the proportion as 90 per cent.

they have to be integrated with the remaining parts of the system. Important characteristics of this system are that they form a heterogenous group in regard to their methods of business and size (capital employed); they have larger impact on the rural sector as credit suppliers; they combine merchandise trade with banking and so on. According to the survey carried out by the Reserve Bank of India in 1952-53 nearly 2/3 of credit to agriculturists was provided by professional money lenders and agriculturists, the co-operative sector contributing about only 3 per cent. The share of co-operative sector having increased, nearly about 1/2 of total rural credit was provided by these sources in 1965-66. Rates of interest are high (varying between 10 to 30 per cent), show wide variations with individual borrowers; types of loan; region and so on.

Those of the indigenous bankers who operate on the urban side also have been largely trading in 'accomodation bills' and so it becomes difficult to distinguish whether such bills are trade bills or financial papers. The Shroff Committee (1954) made some suggestions to bring them under contact with the organised sector and control of the Reserve Bank but no scheme could be finalised in this regard. According to an estimate there were in 1964 "about 350 Multani banking firms operating all over the country with an annual turnover of Rs.150 crores covering about 4 lakhs of borrowers".[1]

1. "The role of the Indigenous Banker in India" - Journal of the Indian Institute of Bankers, Bombay (April 1964)P.118