SELECTED DOCUMENTS

This part contains a selection of documents from the Bank’s records. To enable the reader to relate these documents to the narrative, they are arranged in sections and subsections corresponding broadly to the sequence of chapters in the text, and chronologically within each subsection.

I. MONETARY POLICY
   A. Ad hocs: The 1955 Arrangement
   B. Other Selected Documents

II. FINANCING GOVERNMENTS
   A. State Loans
   B. Funding of Ad hocs
   C. Overdrafts of State Governments

III. RURAL CREDIT
   A. All-India Rural Credit Survey
   B. Controversies over Co-operation

IV. STATE BANKING
   A. State Bank of India
   B. State-associated Banks and Subsidiaries of SBI

V. BANKING
   A. Prudential Norms
   B. Regulating Co-operative Banks
   C. Non-scheduled Banks in West Bengal
   D. Consolidation and Licensing of Banks
   E. Banking Situation in Kerala
   F. Deposit Insurance

VI. EXTERNAL SECTOR

VII. THE BANK AND GOVERNMENTS
   A. Resignation of B. Rama Rau
   B. Aftermath of the Mundhra Affair
I. MONETARY POLICY

A. AD HOCS: THE 1955 ARRANGEMENT

CONFIDENTIAL

D.O.No.[...]
My dear Bala,

We notice that our cash balance has gone down below Rs 40 crores. As the working minimum balance, which we have been assuming, is about Rs 50 crores, we will be glad if you will kindly arrange to have ad hocs issued to the extent of Rs 10 crores and let us know the date on which you do this.

Yours sincerely,
H. S. NEGI

Shri G. Balasubramanian
Secretary
Reserve Bank of India
Central Office
Bombay

CONFIDENTIAL

D.O.No.[...]
My dear Balasubramanian,

I send you herewith the usual ways and means forecast for the months of January and February 1955. In order to maintain a minimum working balance of the Central Government with the Reserve Bank of India in the neighbourhood of Rs 50 crores at the end of every month it indicates creation of new special ad hocs by about Rs 30 crores in January 1955 and Rs 20 crores in February 1955. ‘A’

I would in this connection also invite your attention to my D.O. No.[...], dated the 8th January 1955.

Yours sincerely,
H. S. NEGI

For information with reference to ‘A’ above.
Payments to States during January and February 1955 have been estimated at Rs 61.07 crores.
(GB) 13/1/55
Secretary
DG (Ram Nath) 13/1/55
Governor 17/1/55
D.O.No.[...]

My dear Negi,

Will you please refer to your D.O. letter No.[...] dated the 8th January 1955? As per our telephonic conversation, ad hoc treasury bills for Rs 10 crores were created by us on the 7th idem, the proceeds of which have been credited to Government Account. As a result the Central Government’s cash balance on Friday amounted to Rs 50.53 crores.

2. In future we will create ad hoc treasury bills in suitable blocks to the extent necessary in order to maintain Central Government’s cash balance roundabout Rs 50 crores on Fridays.

Yours sincerely,

G. BALASUBRAMANIAN

CONFIDENTIAL

No.[...] of date

Copy forwarded for information to:

Shri D.D.Pai, Manager, Reserve Bank of India, Calcutta. If the balance of the Central Government on any Friday is less than Rs 50 crores he may please make a reference to the Secretary by IMPORTANT telegram or telephone before closing the books for the day.

An acknowledgement is requested.

The Chief Accountant, Reserve Bank of India, Central Office, Bombay.

SECRETARY

D.O.No.[...]

My dear Negi,

Will you please refer to your D.O. letter No.[...] dated the 14th May 1955 forwarding the ways and means forecast for the months of May and June 1955? It is observed that the closing balance for the month of June has been shown as Rs 43.75 crores as against the minimum working balance of Rs 50 crores which Government wish should be maintained with the Bank. As no credit has been assumed on account of the creation of new ‘ad hocs’, we shall be glad to know whether Government would prefer their balance to remain unadjusted even though it falls below Rs 50 crores.

Yours sincerely,

G. BALASUBRAMANIAN
CONFIDENTIAL

DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI

D.O.No.[...]
My dear Bala,

Will you please refer to your D.O.No.[...] dated the 21st May 1955 regarding the maintenance of our minimum working balance with the Reserve Bank?

2. We thought that it would be better to show in the ways and means forecast the overall deficit in Government transactions without allowing for ad hocs. The drop in the balance following the overall deficit was thus not intended to modify the arrangements settled last January, namely to maintain the balance at about Rs 50 crores on Fridays and to create the necessary ad hocs in lots of Rs 5 crores for that purpose. The Reserve Bank may, therefore, continue to create ad hocs so as to provide for a Central working balance of Rs 50 crores at the Bank.

Yours sincerely,
H. S. NEGI

For information
Secretary 28/5
DG(A) 30/5
Governor 30/5

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SECRET

RESERVE BANK OF INDIA
BOMBAY

D.O.No.[...]

Dear Shri Krishnamachari,

Ever since I came to the Reserve Bank, I have been exercised over the fact that under the arrangements in force for the last 5 years or thereabouts, currency is expanded against the creation of ad hoc Treasury Bills as a merely mechanical process depending on the weekly closing balance of the Central Government. There is no check against the volume of currency that could be so expanded. If Government want to go on increasing their expenditure without regard to the available resources, there would be nothing to stop them, so far as ways and means are concerned; the currency would be provided automatically. The process is in fact so mechanical that it is operated by my Calcutta Manager and I hear about this action subsequently.

I have, of course, no need to worry about the problem so long as you are Finance Minister, for I know that you are as concerned as anyone could possibly be about the stability of the currency. The reason I am exercised in my mind is that the present arrangement, as a standing arrangement, is defective. If there is a weak or careless Finance Minister in Delhi, which could conceivably happen after some years, the situation could easily get out of hand. It is, therefore, essential that proper conventions and safeguards are set up at the earliest possible stage.

The Reserve Bank, under the Statute, is charged with the responsibility of regulating “the issue of bank notes and the keeping of reserves with a view to securing monetary
stability in India.” (Please see the preamble to the Act.) As matters now stand, with an automatic expansion of currency at the will of Government, the Bank in my judgement, is not really in a position to discharge its responsibility.

I have initiated a study of possible methods by which, on the one hand, the Government of the day is not hampered in its activities by an obstreperous Bank and, on the other, the Bank has the opportunity of considering and advising, in conscious exercise of its prerogative and duty, on the degree to which currency could be expanded from time to time without damage to monetary stability. As you know, different countries have different arrangements. A somewhat striking arrangement is the one followed in France. The Bank of France, a nationalised institution, recently refused to grant a loan to the French Government except on certain conditions regarding raising the level of taxation. This it was entitled to do under established convention. I am not for a moment suggesting that we should follow the French example. I am mentioning it merely as an extreme example of the checks and balances which other countries have found it necessary to maintain in order to make it difficult for Governments to damage currency under the pressure of short term political difficulties.

When I have completed my study of the problem and have some concrete proposals to put forward, I shall write to you again. Meanwhile, I thought I ought to inform you of the fact that I am turning the problem over in my mind.

Yours sincerely,

H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister
New Delhi

FINANCE MINISTER
INDIA
SECRET NEW DELHI
D.O.No.[...]
July 27, 1957

My dear Iengar,

Please refer to your letter of the 5th of July on the subject of the creation of ad hoc Treasury Bills. While I appreciate your concern in this matter, I feel that it would be a mistake to lay down any rigid procedure such as is followed in France. That does not appear to have helped France in keeping away from difficulties. What to my mind is necessary is to ensure that Government policy is formulated in this respect after very full discussion with the Reserve Bank and that the latter is kept informed from time to time of any changes that Government feel called upon to make before they are made. Thus, it would be the duty of the Finance Ministry to formulate their proposals for borrowing as also for deficit financing in consultation with the Reserve Bank. These programmes of borrowing and deficit financing are incorporated in the Budget and placed before the Parliament for its approval. The subsequent creation of ad hoc Treasury Bills when the Government’s cash balances fall below a certain level is done within the limits thus prescribed. If in the course of the year it is found that these limits are likely to be exceeded, revised arrangements may become necessary
and these would certainly also be formulated in consultation with the Reserve Bank. The Reserve Bank thus would have every opportunity of discharging its responsibility of regulating the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India.

I believe Patel had discussed this matter with you and it seemed to him that generally you would be quite satisfied so long as such discussions took place in good time to enable the Reserve Bank to tender its advice for the consideration of the Government.

I look forward to any further suggestions or concrete proposals that you may wish to put forward though I hope that you would find working along lines indicated above to be sufficient for your purpose.

Yours sincerely,

T.T. KRISHNAMACHARI

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B. Other Selected Documents

Secret

Statutory Reserve Against Note Issue

[1-9-1955]

Given the likelihood that the volume of note circulation will increase considerably as the development programme proceeds and, at the same time, our holdings of foreign securities will decline, a change in Section 33(2) of the Reserve Bank of India Act, 1934\(^1\) may be necessary. The question, then, is, if a change in this Section has to be made, which of the alternatives available would be most suitable. The three broad alternatives available are as given in Shri [B.K.] Nehru's letter, viz., (1) to reduce the percentage of the statutory backing, (2) to adopt the system of a fiduciary issue and (3) to delete the sub-section altogether and have no statutory requirement for a currency reserve. As the Appendix to this note shows, the trend has latterly been towards the third alternative. This question has, however, to be considered primarily in the light of our own conditions, though with due regard to practices adopted by other central banks.

2. If an amendment has to be made in this Section, there appears to be a balance of considerations in favour of dropping this Section altogether. A consideration of the rationale of the statutory currency reserve and the altered conception of its essential function as well as the limited place which this requirement occupies in the overall obligation and responsibility of the Government and the Central Bank to ensure general economic and monetary stability point to this conclusion.

\(^1\) The Section reads as follows:

33. Assets of the Issue Department—

(2) Of the total amount of the assets, not less than two-fifths shall consist of gold coin, gold bullion or foreign securities:

Provided that the amount of gold coin and gold bullion shall not at any time be less than forty crores of rupees in value.
3. The function of foreign reserve is to be viewed not in terms of a backing for the note issue but as a reserve against the possibility of adverse movements in the balance of payments. The reserve has, therefore, little relation to public confidence in the currency which will be maintained or impaired by the overall fiscal and monetary policies of Government and the Reserve Bank. Given policies which ensure reasonable stability the absence of a statutory requirement in respect of the reserve will do no harm; in the absence of such policies, the statutory requirement could not stem a continuing decline in the value of money (or rise in prices). The fact that the statutory requirement may have to be modified periodically with substantial additions to the note issue only reinforces this point. With this altered conception of the function of a foreign reserve, it does not appear necessary or useful—once we depart from the present Section—to retain a lower ratio of statutory backing for the currency. On the other hand, too, if the fiduciary system were to be adopted, either the stages at which recourse to Parliamentary sanction will be required would be infrequent or frequent. If the former, Parliamentary sanction for exceeding the limit every time may, in effect, be little different from changing the proportion under the present Section; if frequent, Parliament and the public may get so used to it that, in effect, they will recognise that this provision is of small consequence for ensuring general economic and monetary stability.

4. It is this last point that is of particular importance in considering the question of an alternative to the present provision. After all, compliance with the requirements of a statutory provision in this regard does not safeguard against the possibility of a substantial inflationary movement or detract from the responsibility of Government or the Reserve Bank to ensure reasonable monetary stability. The fact that a provision—and now an altered provision—is being respected could not diminish the general responsibility or ensure its automatic fulfilment. This general responsibility requires more than fulfilling the requirement in respect of maintaining the backing against currency. It is currency and bank deposits together that constitutes money supply and with an altering relationship between currency and bank deposits, an inflationary movement could take place through an exceptionally large increase in deposits without corresponding increase in note circulation. In the making of adequate policies for fiscal and monetary control, the policies of interest rate, debt management, capital issues control, trade control, investment incentives and effective policies for economic development and increase in production, all play their part. Government has the overall responsibility and obligation to pursue policies in all these and related spheres, which make for the maximum rate of development consistent with stability. On the other hand, too, if Government decide that even reasonable stability is to be sacrificed and risks taken in the interest of a rapid rate of development, that issue will have to be resolved on overall general considerations of the precise combination of economic development and monetary stability that is supposed to serve the best interests of the economy and the country. In this context, the statutory ratio of the currency reserve has a small place; there is no risk that the absence of this ratio will lead Government to expand its expenditure programmes, because note circulation can be expanded without coming up against this particular wall; nor would it be a reasonable hope that Government will restrain the pace of expenditure when this limit is too near; it would
not do so because whatever new limit, whether in terms of a proportion (as in the proportional system) or in terms of absolute amount (as in the fiduciary system), is prescribed, there will be no clear rationale underlying any particular limit in either form (viz. as a ratio or an absolute amount). Since, logically, there is only a thin line of division between the proportional and the fiduciary systems, each being based upon an arbitrary level of limitation, it appears best to adopt the third alternative.

5. The levels of limitation would be regarded as arbitrary, because, given an adequate increase in general production in the economy, the level of note circulation may well go up substantially without necessarily resulting in serious inflation and, therefore, without need of a restraint on the increase in note circulation which, however, the statutory ratio may impose. For, if the national income expands at a greater rate than the volume of our international trade, the requirement of the foreign reserve, for what constitutes its proper purpose, may not increase, though in terms of an expanding monetary circulation internally a statutory ratio would continue to require an increase in the level of reserves. This points to the essential defect of the foreign reserve being related to the internal note circulation liability rather than to the possible magnitude of a foreign deficit. The fiduciary system would not be subject to this particular logical snag of establishing a relationship between the reserve and internal circulation, but does come up against the other difficulty that the volume of note circulation, by and of itself is, by no means, a satisfactory index of the discharge by the monetary authorities of their general responsibility to maintain monetary and economic stability in the country.

6. For the discharge of this general responsibility Government (and the Reserve Bank) are answerable to Parliament and the country. There is, therefore, no derogation from the authority of Parliament either, which is best exercised in terms of enforcing adequate discharge of the general responsibility of Government rather than only formal fulfilment of the provisions of a Section, the essential rationale of which has been greatly modified, as explained above.

7. There is, besides, the illogicality in the present provision that under the traditional and somewhat artificial division of the Bank into the Issue and Banking Departments—artificial at least from the point of view of a total picture of assets and liabilities of the institution—the statutory reserve provision applies only to the Issue Department, while the expansion of the free reserves of banks (viz: their deposits with the Reserve Bank) are an equally potent source of inflation. A proper proportional reserve system should include deposit liabilities as well as note liabilities. This question would arise, if a revised proportion were to be considered. It should arise even in terms of the logic of a fiduciary system, which applies equally to the base of credit expansion by banks, viz., their deposits with the Reserve Bank. In fact, it may become necessary for the Reserve Bank to explore and perfect other techniques of monetary and credit control, including maintenance of statutory reserve requirements by banks with the Reserve Bank, as part of its overall apparatus of monetary control. This only emphasises, however, the subordinate role of the present form of Section 33(2) in the whole mechanism of control.

8. A closer look at the fiduciary system as it is today in the U.K. reinforces the conclusion of the above paragraphs. An increase in the limit of fiduciary issue under the
system as at present is authorised by an Order of the Treasury. The Order, however, is subject to annulment on a resolution of either House of Parliament. Under the system as it worked before the War, Parliamentary approval was necessary if the excess over the statutory limit was continuously maintained for a period of two years. That was the fiduciary system as it is commonly known and understood. At present, Parliamentary approval is not necessary for the Treasury Order, though Parliament may pass a resolution annulling the Order, which is different. In practice, then, subject to the overriding right of Parliament to cancel the Treasury Order, the limit is left to be regulated by the Treasury in the light of the need for expansion of note issue from time to time. This is the only statutory limitation on the authority of the Bank of England.

9. Whether the fiduciary system operates in terms of specific Parliamentary approval, or in terms of the specified right of Parliament to annul a Treasury Order, the fiduciary system does not appear to offer a satisfactory alternative to the deletion of the cover provision, if a change has to be made now, for the following additional reason. Under the fiduciary system a limit of note issue is specified in absolute terms. We have at present a reserve equal to Rs 40 crores in gold, and Rs 622 crores in foreign securities (held in the Issue Department), exclusive of Rs 95 crores of balances held abroad in the Banking Department. Assuming that a certain amount of balances in the Banking Department would normally need to be held there, though they could be reduced, the foreign securities available for cover against note issue may, in round figures, be placed at Rs 660 crores, which with the available amount of gold would give Rs 700 crores, against which, under the present ratio, notes to the amount of Rs 1,750 crores can be issued. If gold were revalued, as is suggested in a later paragraph, an additional cover of Rs 78 crores would become available, enabling a further expansion to the tune of Rs 195 crores, say, to a total amount of Rs 1,950 crores. Under the fiduciary system, specific authority should presumably be required for note issue in excess of that for which gold cover is available: it follows that gold should be revalued to provide the maximum cover that is possible in terms of gold before the necessary limit of fiduciary issue is determined. The absolute limit of the capacity of the Bank to issue notes in terms of the present statutory cover provisions is of the order of Rs 2,075 crores (if all foreign balances were included and gold were revalued). If a shift to a fiduciary system were to be effected now, it would not be reasonable to ask for a lower limit than, say Rs 2,100 crores, in round figures, as compared to the actual circulation of Rs 1,300 crores. If this were to be done, it would confound public opinion more, and give a greater shock to confidence than the removal of the cover provision. In fact, it would be opposed to the rationale of the fiduciary issue system to ask for a limit of issue which is so much in excess of the current circulation. If the fiduciary issue system were preferred, it would be more in accord with its logic to make a shift when the need arises, and at that time give due explanations as to why the need arises.

10. The above description of the U.K. system indicates that under it the formal authority of Parliament is recognised, but in practice the system is little different from leaving the note issue to be determined (by the Treasury) without reference to any reserve in gold or foreign securities. In fact, there is no cover for the note issue in U.K. in terms of gold or foreign securities, these being kept in the Exchange
Equalisation Account. In U.K. the present system derives from the century-old history of the system during which it has been rendered progressively more elastic till it is completely elastic to-day. There is, therefore, no system of uniform stringency or elasticity which is identifiable under a name like the fiduciary issue. Under a system equivalent to the U.K.'s for specifying a limit of note issue we should probably require a limit only in respect of note issue in excess of the gold cover, though we could stipulate that specific authority would be required and the limit of issue would apply only for note issue in excess of gold and foreign securities, as in Finland (vide Appendix). Since, however, foreign securities will be declining, the rate at which the limit of issue will have to be raised will be greater than the rate of increase of note issue, to allow also for part of the existing note issue which will be deprived of foreign securities cover. It would, therefore, be better to leave the foreign securities out of account. On the other hand, it would be true that the foreign securities, together with gold, will provide a foreign reserve which might be normally adequate for our requirements in relation to the balance of payments situation. In the circumstances, it is possible that the publication from time to time of a limit of note issue in excess of gold cover—viz., under the fiduciary system—will mislead the (lay) public into believing that the amount of note issue without gold cover thus publicised from time to time is really without cover. From the psychological point of view, therefore, with ignorance in elementary financial matters to reckon with, the less public attention is directed to figures of statutory limits, the better. Deletion of the provision would cut the Gordian knot once and for all and subsequent assessment of the economic and monetary situation would be facilitated in terms of the total picture rather than of a figure the significance of which might be magnified out of proportion to its relevance.

11. The point might be made that the question should not be viewed from the short-term angle of the present Government in power, but should be viewed—in respect of a fundamental provision like this which concerns the basis of currency—from the long-term angle, and against the possibility of other Governments coming into power which might conceivably be less regardful of their general responsibility to maintain the stability of the economy. For one thing, as the above paragraphs indicate, the argument has hinged on the limited efficacy of the provision itself, rather than on the complexion of Government. For another thing, the point regarding the complexion of Government has only to be stated to appreciate that there is no ultimate safeguard against a Government unmindful of its responsibilities to the country and, in any case, a formal restraint of limited efficacy will not be of any use in the circumstances.

12. The above reasons indicate that if the provision has to be modified, it would be as well to delete it. The logic of the above argument would suggest the scrapping of the proviso to the sub-section, which provides for a minimum gold cover, together with the substantive part of the sub-section which relates to a 40 per cent cover in gold and foreign securities. It is for separate consideration whether it would be advisable to go to the logical conclusion and remove the statutory requirement in respect of a small amount of gold backing also. We could retain the proviso, by transferring it to subsection (1), with the amount of gold marked up in value as is suggested in a subsequent paragraph. If we did so, however, the contrast between treatment of gold and of
foreign securities would be obvious. It would be pointedly clear that we are removing foreign securities because we expect to find difficulty in complying with that requirement indefinitely, but we are retaining the provision regarding gold, because we do not anticipate any similar difficulty there. The validity of the reasoning in the above paragraphs applies equally both to gold and foreign securities and there would be no system or rationale about differentiation between gold and foreign securities. The gold backing should, therefore, remain as much a matter of actual fact rather than of formal provision, as foreign securities. It would be a more easily defensible position to treat both equally in form. In Australia and Canada, for example—countries which could easily fulfil a requirement—regarding gold cover, no such cover is prescribed.

13. The other changes in the Act will be as follows: Sub-Section (3) of Section 33 which will be renumbered as (2) will only describe the types of rupee securities, like Sub-Section (6) does in respect of foreign securities.

In Sub-Section (4) the basis of valuation of gold will be altered. Sub-Section (5) would stand as it is. The fact that it does will afford some assurance that the deletion of Sub-Section (2) is only a formal alteration which will make no change in fact so far as gold is concerned. Section 37 would also be deleted.

14. When would it be necessary to delete or amend Section 33(2)? If the balances in the Banking Department are assumed not to be available, and if the foreign securities in the Issue Department have to be drawn down at the rate of Rs 40 crores a year, and if gold has been revalued, the reserves will be able to provide cover for a note issue of Rs 1,850 crores now, Rs 1,750 crores a year hence, Rs 1,650 crores two years hence, and Rs 1,550 crores three years hence. The present note issue may be put at Rs 1,350 crores (peak issue), though it is in fact lower. Note circulation has expanded by about Rs 140 crores in the course of the last year. The limit—excluding Banking Department balances—may conceivably be reached in two years, taking the drawing down of balances into account. Without revaluation and without taking account of the Banking Department balances and with a draft on balances at Rs 40 crores a year—which are the most reasonable assumptions, since revaluation cannot be assumed unless it could be justified separately, in advance—these figures will be Rs 1,650 crores now, Rs 1,550 crores a year hence and Rs 1,450 crores two years hence. On this basis, there is not much more than a year, before some change in the cover provision should become obligatory.

15. Coincidently with the deletion with amendment of Section 33(2), gold may be revalued at the I.M.F. par of 2.88 grains of fine gold per rupee. The weekly statements of the Reserve Bank will continue to show (from week to week) the amount of gold holding together with the volume of foreign securities in fact available as part of our foreign reserves; the amount of ad hoc rupee securities will be reduced corresponding to the increase in the value of gold. We have another proposal under examination seeking to vest in the Reserve Bank power to vary statutory reserve requirements of banks. If this could be simultaneously put through, the deletion of the cover provision could, with some justification, be presented as the elimination of a somewhat outmoded provision in the context of the overall technique of monetary control. This other proposal about reserve requirements is being considered as part of the objective of perfecting the machinery of credit policy to deal with the problems of the Second Plan.
16. When deleting the sub-section, it appears important that Government should explain carefully the reasons as to why this provision is being deleted; at the same time Government may take the opportunity to reaffirm their awareness of the general responsibility to ensure economic and monetary stability consistent with development. It seems important to do this as the markets might interpret the step (viz., deletion of the provision) as the precursor of large-scale deficit financing and it is possible that an unhealthy boom in the stock exchange may be initiated by the announcement. This should, however, prove short-lived if the measure is presented in the right perspective, and if the public realise accordingly that the removal of the legal requirements makes no difference to the essential strength of the currency which depends on other fundamental factors. The fact that gold will be revalued simultaneously would serve to focus part of the public attention on what could rightly be represented as a change in the direction of more accurate presentation of the statement of affairs of the Bank. On the whole, to the inevitable criticism of such a step, there appears no better answer possible than that the action which is being taken is for the purpose of bringing the position in this respect in India in line with the latest thinking, which also conforms with the requirements of our economy, emphasising as it does the integral character of the general responsibility of Government and the Reserve Bank rather than place reliance on formal compliance with a provision of limited and partial efficacy.

B.K. Madan
1-9-1955

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TOP SECRET

No.[...]  
Memorandum to the Committee of the Central Board

RAISING THE BANK RATE

In a memorandum which I placed before the Central Board, at the meeting on 10th April 1957, on “The Financial Stringency in India”, I expressed the view that it is the duty of the Reserve Bank and Government to see that monetary expansion does not take place at a much faster rate than the capacity of the community to mobilise real resources for development. The economy had already been severely strained in the first year of the Second Plan and if adequate precautions were not taken the strain would go progressively worse. A policy of monetary ease, or general relief of financial stringency, by stimulating expansion of investment as well as consumption would run directly contrary to the necessity of restraint in the present situation. I accordingly suggested that in order to safeguard against more serious inflationary pressures, general restraint and discipline combined with selective response to specific financial needs of essential productive sectors was the best line of approach. The Board generally approved of these views; and this is the context in which the Committee has been considering, at its weekly meetings, the question of revising the Bank rate.
2. I consider that in view of the continuing strain on the economy caused by the inability of the savings in the community to keep pace with mounting expenditure, in both the public and private sectors, the time has come to make a special review of our Bank rate. Perhaps it would be appropriate if I prefaced my proposal with some brief general observations.

3. In the highly developed economies of the West the weapon of the Bank rate has been actively used during the last 6–7 years. It has been used, however, in conjunction with other instruments of fiscal and monetary policy, general as well as selective. Consequently, it is difficult to isolate the effectiveness of changes in the Bank rate alone in correcting external and domestic disequilibrium in these countries. The general view appears to be that while the Bank rate is an effective instrument for correcting balance of payments difficulties, especially through changes in the flow of foreign short-term funds, its role in restraining domestic inflationary pressures is less direct and powerful than was previously supposed. Within limits the Bank rate weapon can be of assistance in restraining inflationary forces. It has also been generally recognised that the indirect or what may be termed the psychological effects of changes in Bank rate are nearly as significant as the direct effects in terms of the cost of credit.

4. While, in the context of inflationary conditions, a rise in the Bank rate will prove beneficial, too sharp a rise or too frequent changes could ultimately defeat themselves insofar as they produce serious disturbances in the money and securities markets, raise the cost of Government borrowings and servicing the large and growing national debt, not to mention the enhanced strain to balance of payments of higher interest payments abroad on invested foreign funds. Further, in the present day general economic setting, with increasing public investment (which is by and large unresponsive to interest rate changes) increased share of Government in the total economy, high taxation and growing rigidities in the economic system, the effectiveness of the Bank rate weapon is even less potent than it was before the War.

5. These limitations of the Bank rate weapon are probably even more true in the case of under-developed economies with a significant non-monetised sector, narrow money markets as well as a low rate of investment activity, and with the public sector assuming a predominant role. Moreover, in India we have, under the Banking Companies Act, considerable powers of selective credit control, and we can directly regulate the volume of credit extended by the banking system. The Government has also wide powers under such statutes as the Capital Issues Control Act and the Industries (Regulation and Development) Act, to regulate directly investment in the private sector. These considerations, however, only indicate that the scope for wielding the interest rate weapon is comparatively limited; they do not by any means signify that the Bank rate weapon, operated in a flexible manner, has no place at all in our anti-inflationary arsenal.

6. On a review of the general economic situation in our country, I have come to the conclusion that a small increase in the Bank rate would be beneficial. It is scarcely necessary to add that in making this recommendation I am assuming that we shall effectively use, whenever we consider it appropriate to do so, all other means of monetary control that we possess.
7. I suggest that the Bank rate be revised forthwith from 3½ to 4 per cent. To a very large extent it may be stated that in doing so we shall only be giving formal recognition to a situation that has existed de facto for several weeks. The Committee will recall that the rate on advances under the Bill Market Scheme was raised last November to 3½ per cent and from February this year the stamp duty on usance bills was raised to ½ per cent making the effective rate of advances against Bills 4 per cent. Simultaneously the rate on advances against Government securities was also raised to 4 per cent. The markets have had time to adjust themselves to this rate and no dislocation need be feared by rationalising the lending rate structure of the Bank by raising the Bank rate itself. There would on the other hand, be certain advantages in doing so. In the first place, our lending rate to borrowers like State Governments and the Industrial Finance Corporation of India is the Bank rate itself. The impact of any policy to harden the interest rate structure should, by and large, apply to all borrowers. If this is not done, the borrowers would be disinclined to go to the market and pay the appropriate rates for raising funds; they would rather be inclined to lean more heavily on the Reserve Bank. Secondly, as regards the scheduled banks, our not raising the Bank rate de jure is stated to have led to some inconvenience to them in raising their lending rates which are customarily tied to Bank rate. The banks, of course, can raise their lending rate by giving special notice to their customers (and in fact they seem to have already done so). It would perhaps be more convenient to them if any change in the effective lending rate of the Reserve Bank could be so brought about as to facilitate an automatic increase in their own lending rates. The maintenance of Bank rate at 3½ per cent has also brought forth a grievance from one of the major industries, namely, the Electricity industry, which under the Electricity (Supply) Amendment Act of 1956 is allowed a standard rate of return of 2 per cent above Bank rate. The electricity industry considers that the maintenance of the Bank rate at 3½ per cent in the context of a rise in the general pattern of yields has the effect of denying the industry a legitimate return. There appears to be some force in this plea and the realignment of our Bank rate with the other rates would help to remove this grievance, although this is not by any means a major consideration in our policy decision.

8. If the Bank rate is raised to 4 per cent the cost of raising money under the Bill Market Scheme will be 4½ per cent (ignoring for the present the further cost arising out of the fact that banks do not draw fully against Bills lodged by them). I consider this is too high. I recommend that we propose to Government that the stamp duty be reduced from Re.1.25 to 0.50 naye paise per Rs 1,000, which means a reduction from ½ per cent to ½ per cent per annum.

9. If the Committee approves of the proposals, the following resolution may be passed:

RESOLVED
That (a) the Bank rate be raised to 4 per cent (b) Government be moved to reduce the stamp duty on usance bills from Re 1.25 per Rs 1,000/- to 0.50 naye paise per Rs 1,000/-.  

H.V.R. IENGAR
Governor

Reserve Bank of India
Central Office
Bombay
Dated May 15, 1957
My dear L.K.,

Thank you very much for your letter No.D.O.[...] dated the 7th December. As desired by you, I will have a note sent to you before the 13th on the question of bank amalgamations and I will also send, as soon as possible, a note on the lines you have suggested regarding the balance of payments position.

2. I am particularly grateful to you for having given me an account of what transpired at the meeting of the Consultative Committee. I was absolutely certain that the leakages in the press were unauthorised and inaccurate; nevertheless, I am afraid a certain amount of misunderstanding has been caused because the press has built up, sometimes with banner headlines, the story that the Minister has decided that there shall be no increase in the Bank rate at present. Mr. Murphy, the leader of the I.M.F. Mission, when he had a meeting with me two days ago, referred to these press reports and seemed clearly disturbed by them. I explained to him that the reports were unauthorised and that the position continues to be as it always has been, namely, that the authority for deciding changes in the Bank rate is the Reserve Bank and that the Bank, as a matter of policy, keeps in the closest touch with Government and would not make any changes except after consultation with them. I do not know whether Mr. Murphy will raise this point again in Delhi. It would be disturbing if international bodies like the I.M.F. felt that there was any conflict and confusion in India in regard to Bank rate policy.

Yours sincerely,
[H.V.R. IENGAR]

Shri L.K. Jha, I.C.S.

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My dear Iengar,

I am extremely sorry that at the last minute I had to cancel my trip to Calcutta to attend the Board meeting. I learnt on Saturday morning that there would be a general hartal in Calcutta on the 20th and knowing Calcutta as I do, I did not feel confident about being able to take the return flight for which I was booked. I tried in vain to have it changed to the 19th evening and as the World Bank team would be here from the 21st and I could not risk being delayed in Calcutta, I came to the conclusion that I had better postpone my journey to a later date.

2. In coming to this conclusion, I was encouraged by Rangachari who was also not proceeding to Calcutta and as there were a number of points of common interest to be discussed outside the Board room with you and Bhattacharyya, it would be perhaps best for me to come down for one of the Central Committee meetings—say, on the 4th
January if it suits all concerned. In fact, I tried to contact you over the phone on Saturday, but apparently you were not available at your house when I tried to get you.

3. I had two sessions with the I.M.F. team. The first one was when I was giving them a forecast of our balance of payments trends and explaining the statements which we had handed over to them. The second meeting was on Saturday when Murphy made a statement, giving an outline of the conclusions which he had reached to which I had to reply.

4. In his statement, he expressed considerable satisfaction about the improvements in our industrial and agricultural production and the progress reflected thereby. He expressed anxiety, however, on account of the fact that we were starting the Third Plan with a deficit arising on account of past commitments for repayment of credits and loans. He also expressed the view that inflationary forces were more in evidence and urged the importance of suitable monetary and fiscal policies to check them. In replying to him I dealt with the other points directly, but said that so far as monetary policy was concerned, the authoritative view on that matter would have been given to the Mission by the Governor of the Reserve Bank. I said that the policies being followed by the Reserve Bank were, of course, known to me, particularly as I was a Director of the Bank. I was prepared to philosophise on those policies, though not to expound them. I said that on a philosophic view of the situation, what you seemed to have really done is to raise lending rates to trade and industry without a technical change in the bank rate and, therefore, without raising the borrowing rate for Government. I also endorsed the thought you had expressed in Madras that it is wrong to think that monetary policy does not affect the Indian economy because of the preponderance and impact of deficit financing. Different sectors of the economy reacted to different forms of control and monetary policy had been particularly successful in certain selective fields where bank finance played an important role. Indeed, some of the pointers, e.g., the Stock Exchange, showed that the policy had been effective. A very much tougher fiscal policy was also clearly necessary to raise resources for the Plan and to divert goods from domestic consumption to export markets. At the same time, it should not be forgotten that a good sector of the Indian economy is not very responsive either to monetary or to fiscal policies and is, in the main, susceptible to supply and demand factors, affecting individual commodities.

5. Another point which the team raised with me, which I gather had been raised with Madan and then with you, was about the possibility of touching our gold reserves. The answer I gave was that we do not contemplate touching our gold reserves not because they are gold, but because such contingency would imply that our sterling balances had been fully exhausted. It was our firm policy not to treat the present level of sterling balances as available for further drawals as a long-term or permanent measure as distinct from short-term drawals. It was not, therefore, the sanctity of gold but the level of our total foreign exchange reserves which would cause grave anxiety if the Reserve Bank had to reduce its gold reserves.

Yours sincerely,

Shri H.V.R. Iengar
Governor
Reserve Bank of India
8, Council House Street
Calcutta

[LRK. JHA]
New Delhi
April 27, 1964

My dear Bhatta[charyya],

I hope to see you here on the 30th. In the meantime I am very uneasy with regard to our policy towards bank credit. It is no doubt true that any control of bank credit by itself does not touch even a moiety of the monetary problem.

2. While there is a great deal of justification for restricting credit for foodgrains, which we have done spasmodically and piecemeal, it does not seem such restriction has been confined to foodgrains only and has not extended to the legitimate demands of industry. At the same time one is not quite sure how much of the scheduled bank lending is directly to industry as such and how much of it goes to rediscounting of Multani hundies. If we could only get separate data from the scheduled banks as to how much of their advances are for rediscounting hundies, then the size of the problem and the needs of the industry will be somewhat clear. Can you get these details as quickly as possible?

3. There are many other matters which we might discuss. I am very uneasy how some of our big financial institutions, the State Bank, the Life Insurance Corporation, the [Industrial]Finance[Corporation] and so on seem to sway with personalities. We might discuss these when we meet.

Yours sincerely,

T.T. Krishnamachari

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CONFIDENTIAL

BOMBAY

D.O.No.[...]

June 18, 1964

Dear Shastriji,

As desired, I enclose herewith “A Note on the Present Economic Situation”. I trust that you will find it useful.

With regards,

Yours sincerely,

P.C. Bhattacharyya

Shri Lal Bahadur Shastri
Prime Minister
Government of India
New Delhi

CONFIDENTIAL

A NOTE ON THE PRESENT ECONOMIC SITUATION

I

The domestic economic situation demands urgent attention at this time in view of the slow progress of the Plan, the slow increase in the national income, and in particular the large and continuing rise in prices.
The most distinctive feature of the current economic situation and one that is cause for serious concern is the deterioration of the price situation. Wholesale prices in India are now at the highest level ever reached, and we are entering the difficult lean season when prices normally rise further. The general index at 144.5 on May 30, 1964 is 8.6 per cent above the level a year ago. Prices of foodgrains and other agricultural commodities in particular have risen sharply in the past year. Cereal prices have increased by 16.5 per cent and those of food articles by 13 per cent.

During the last year or more the rise in prices, particularly of foodgrains, has been the largest of all years since the beginning of planned development. The present rise has come on top of a continued increase in prices ever since the beginning of the Second Plan, the total increase in the last eight years being over 50 per cent.

The rise in prices imposes extreme hardship and inequity on large sections of the people and has serious implications for the steady progress of economic development. The upward pressure on prices, if it continues, is likely to build up higher wage demands all over the system, to affect industrial production by work stoppages and to jeopardise the investment programme itself through serious inflationary strain. The effects of inflation in raising costs of production would soon extend to the vital sector of exports and thus hamper the financing of development.

The basic element in the price situation is the failure on the supply side. Two successive harvests, those of 1961–62 and 1962–63, saw hardly any rise in availability of agricultural supplies. Though the 1963–64 harvest is believed to be better, the higher level of production has not been reflected in market arrivals. It is likely to have gone toward replenishing the depleted pipelines of supply, viz., the stocks with traders and producers. To some extent, in these conditions, the farmer and trader are likely to continue to withhold supplies from the market in the hope of realising better prices later on. A lot depends upon the course of the monsoon and good and well-distributed rains could yet change the outlook for the better. But the price trends so far have been rather ominous and it would not be prudent to bank on an improvement in the situation in the ordinary course.

The policy with regard to prices has to be considered both in its immediate short-term aspect and in terms of its longer-term strategy. The short-term measures should be so designed that they could be meshed into a long-term strategy. It would also be well to remember that any solutions should not be mechanistic and deal only with the symptoms of inflationary pressures such as hoarding, profiteering etc. but should seek to eliminate or at least to reduce the impact of the causes behind the price increase.

In the short-term, any real relief to the situation from the supply side can only come through quicker imports of the balance of quantities to be imported under P.L. 480 and through arrangement of additional imports as far as possible immediately and as part of a programme over the next few years. We have clearly not reached the stage of self-sufficiency. This has to be worked for through a consistent and carefully drawn up programme rather than be attained through a snap decision. In the meanwhile, even an announcement of arrangement of substantial imports both for supplementary consumption and buffer stocks should have a salutary effect on the price situation.

Measures such as the extension of State trading into the sphere of retail distribution should be decided on only after assessment of the magnitude of commitments that this
would entail and after arrangement has been made to provide for such extra commitments. The stocks with Government both at the Central and State level—are lower than last year and much lower than are necessary for undertaking any immediate obligations for large-scale retail distribution. The introduction of State trading for internal procurement has to be ruled out at this stage as this is bound to give a further push to prices.

The fixation of maximum prices may be of some help in the short-term although the relief that can be expected from such a measure would be no more than marginal. The fixation of maximum prices should however follow—and not precede—adequate arrangements to augment supply by import and for distribution of a minimum quantum of supplies through fair price shops organised in urban areas. The enforcement of any prescribed maximum prices would depend upon the capacity to make a minimum quantum of supplies available at the prices notified. In the absence of this, there is bound to be widespread evasion and the law will be brought into disrepute.

Any long-term solution would be the building up of buffer stocks through (1) the stepping up of procurement internally and through (2) conserving part of imported grains for building up such buffer stocks. But these methods of building up a buffer can be used effectively only during a good agricultural year. The experience hitherto, however, has been that when the crop is good and supply is adequate the urgency of the problem is not apparent and the opportunity has not been availed of for building up the buffer stocks. When, on the other hand, the crop is not good, and the need for a buffer stock is urgent, it is not feasible to build up such a buffer. Attempts to build up a stock under such conditions through internal procurement has led only to a further increase in prices in the past. The dilemma can be resolved only if a consistent long-term policy is pursued which is adapted to the agricultural cycle so that in good years the procurement both internally and by import is intensified and the stock built up and in bad years stocks are released. In our precarious food situation, the scope for open market sales is limited and release through fair price shops may be the main method of supplementing private stocks.

Apart from the supply side, namely, the failure of output to match rising demand, we have to recognise the factors making for an unusual increase in the level of aggregate demand which has been a major source of pressure and rise in prices. An index of the aggregate demand pressures in the economy is the expansion of money supply. Money supply expanded by nearly one-third in the first three years of the Third Plan as against a very small rise in real output. During the last twelve months money supply has risen by over Rs 450 crores as against Rs 300 crores last year. A part of this has transformed itself into unaccounted money and is exercising undue pressure on commodity prices.

The main impetus to monetary expansion in recent years has come from government budgetary operations. Deficit financing has been heavy and recently on the increase. The very considerable increase in the defence expenditure has been a source of additional pressure; also new rehabilitation demands have, to some extent, further intensified the burden on the economy. Defence and rehabilitation, however, have a certain priority, which throws the onus of adjustment on other sectors. At a time when
inflation threatens the basis of economic progress, a very strict scrutiny of Government expenditure with a view to drastic pruning down of non-essential expenditure and utmost economy in expenditure generally are necessary. It is essential that deficit financing is eliminated for the time being or at least, reduced considerably even if it means the slowing down of certain activities or developmental projects which are not of a basic character. The alternative would be a real deflation later—a course which would have very bad repercussions.

Ways and means of tightening the reins of credit extension without affecting the financing of expansion of production have also to be thought of in the private sector. Credit policy for the long-term has to be attuned to adequate financing of planned development, but the unusual pressure of development and other demands calls for the most effective mobilisation of genuine savings, failing which, here again, demands will have to remain unfulfilled.

The increased statutory requirement for investment in Government securities by banks would ease to some extent the problem of Governmental financing and limit availability of bank credit for private sector expansion. This would, in itself, act as a disinflationary source to some extent, if Government expenditure can be restrained. But if the latter does not happen, the restraint in the private sector expansion would be incapable of achievement as the two sectors are complementary to each other. If the private sector is restrained unilaterally, the result would be a lopsided development, apart from the fact that inflation would still continue.

When the need is to emphasise restraint in Government expenditure, it would not be wise to commit ourselves at this stage to figures of an unduly large Fourth Plan with all their implications of an expansionary—and inflationary—psychology. In the light of our current experience, our ability to finance a much larger investment effort has to be carefully appraised. Finalisation of the Fourth Plan should therefore wait for some time.

IV

A word about unaccounted money. This is one aspect of the problem of corruption at various levels in the economy. An approach to this latter problem cannot leave out of account an analysis of the sources, forms and extent of proliferation of unaccounted money throughout the system: it manifests itself in real estate, in bullion, in shares and other assets. By its very nature, however, this phenomenon is an elusive one and one which does not admit of any short or easy remedies.

Unaccounted money is symptomatic of the extreme pressure on the economy, for the most important source of unaccounted money is inflation which inflates most of all the unearned incomes and profits; the existence of various controls in the economy—fiscal controls such as high tax rates or import or investment controls—accentuates the problem. A policy aimed at correcting the basic inflationary situation would help in reducing the impact of this large volume of unaccounted money in the economy. This, again, points to the necessity, in our conditions, of trying to ensure the most effective utilisation of our limited real and financial resources, of the enhancement of production, of avoiding increases in expenditure which do not help in increased production and generally in limiting deficit financing.
CREDIT POLICY FOR THE ENSUING BUSY SEASON

The objective of credit policy for the ensuing busy season must clearly continue to be one of restraining credit expansion to levels warranted by the productive requirements of the economy. This is necessary in view of the current imbalance between aggregate monetary demand and overall supply as reflected in the continuing pressure on prices. Even if, as is likely, the onset of the harvest season (and the improvement in supplies) brings some relief to the price situation the need for continuing monetary restraint will not be the less.

2. Scheduled bank credit in the slack season so far has contracted (upto August 21) by Rs 125 crores which is in absolute amounts of about the same order as that of last year upto this point (Rs 122 crores). The inadequacy of the contraction is, however, evident in relation to the previous seasonal expansion. If the pattern of earlier years is to be repeated, it would seem that the major part of the credit contraction has already occurred. At most we might expect a further contraction of about Rs 90 crores by the end of the slack season. Consequently, the banking system would be starting the next busy season on a substantially larger credit base than last year. Aggregate deposit liabilities (excluding P.L.480 funds) have risen so far in the current slack season by Rs 160 crores. Though this pace of deposit accretion has been significantly higher than in the last slack season, this still would not leave much room for manoeuvre by banks for meeting seasonal credit demands from October onwards, in the light of the enhanced liquidity requirements that will be coming into force next month. Despite an addition of Rs 160 crores in the current slack season the investment/deposit ratio (excluding P.L.480 funds) is, at 30.7 per cent, still below the level of a year ago while the credit/deposit ratio at 69.6 per cent is 2.8 percentage points above the corresponding level of last year. On the assumption that credit contraction in the slack season would amount to Rs 180 crores and that deposits in the same period rise by about Rs 220 crores (both of them somewhat optimistic assumptions) the credit/deposit ratio at the commencement of the next busy season would be 66.3%; this is not much below that at the beginning of the last busy season (67.5%) though the enhanced liquidity requirements that would be needed would have suggested a lower level.

3. The higher credit base and the enhanced liquidity requirements in effect constitute built-in limits to the amount of credit expansion banks will be able to finance out of their own resources next season. The reliance on central bank credit to finance the seasonal needs would correspondingly be greater and perhaps be felt sooner than last year. The background to the operation of credit control will thus have to take into account the change in the frame-work of regulation reflected in the higher liquidity requirements. Banks would be feathering their holdings of government securities so as to not impair their liquidity ratios and would borrow in larger measure against bills under the Bill Market Scheme. In other words, banks would make use of central bank credit to sustain their liquidity ratios in a very direct sense. In fact, this was what

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1 The assumption here is that these higher liquidity requirements would be enforced and that neither a deferment nor an exemption [is] contemplated.
happened even in the last busy season when some banks ran up their credit/deposit ratios to not much less than 100 per cent while maintaining comfortable liquid assets ratio in terms of our legal definition largely by not encumbering their government security holdings but by borrowing from the Reserve Bank against bills, largely manufactured bills—under our Bill Market Scheme.

4. Our present mechanism of general credit control is through the operation of rediscount ceilings under the (in effect) three-tier system in terms of which borrowings by scheduled banks up to one half of their statutory reserves are available at the Bank rate at 4½ per cent, borrowings between 51–100 per cent of their statutory reserves are available at 6% and borrowings above their level of statutory reserves are charged a higher rate of 6½% and come under special accommodation. Special limits are granted taking into account the general conduct of its business by a bank, its pattern of assets and liabilities and in the light of needs of special sectors (such as defence production, exports etc.). This system which combines the principle of both a quantitative ceiling on central bank credit and a differential interest rate system irrespective of the type of eligible securities offered as collateral has been instrumental in regulating access to the Reserve Bank during a period of intense pressure in the market and has worked reasonably well in limiting the overall credit totals. In operating the system, the special needs of the export sector and of the small industries/co-operative sector and the collieries have been taken into account. Advances against rupee export bills are being made at the Bank rate by the fixation of an additional quota. Such an additional quota for lending at the Bank rate has also been provided for advances to small industries/co-operative sector. Also, advances under the Coal Industry Guarantee Scheme have been exempted from the ceiling. The total value of rupee export bills thus exempted did not amount to a very large figure last year (being Rs 7 crores at the peak) mainly because the scheme itself came into operation only in March 1963. Similarly, not much use has been made of the exemption with respect to Coal Industry Guarantee Scheme. In the case of small industries/co-operative advances, the total value of the additional quota amounted to about Rs 11 crores. In other words, with statutory reserves being roughly Rs 75 crores, the total of advances available from the Reserve Bank of India to the scheduled banks at Bank rate would (notionally) have amounted to Rs 55 crores; as against this, the actual level of advances obtained by the banks at Bank rate went up to as high a figure as Rs 60 crores at the peak of seasonal borrowings from the Reserve Bank of India.

5. The tier system has come in for criticism as being somewhat cumbersome in operation; it has also been suggested that under the system bond rates are comparatively insulated and that the private sector alone has been subjected to the discipline of higher rates. Nor does the system make any distinction between a bank whose credit totals are high in relation to its liabilities and one which is not so over-extended. Further, though in principle the tier system is designed to make credit not only dearer but also tighter, in actual operation credit has been made dearer and not particularly tighter as through the instrument of special accommodation the volume of central

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2 The aggregate figure of statutory reserves on the one hand and the actual borrowings are not strictly comparable as there would be quite a number of banks borrowing well above their ‘normal’ quota and equally banks borrowing well below it.
bank credit has not been unduly restricted. This is not mentioned here as a criticism; in fact the actual manner in which the policy operated was perhaps more suited to the situation. What is suggested is that if the objective was only to make credit dearer, the apparatus of a ceiling control was perhaps redundant. Simplification of the system would be desirable but this objective should be combined with ensuring continued central banking control on the overall level of credit expansion. Action on bank reserves does not appear appropriate during the busy season when the objective is not so much to reduce the quantum of credit but limit its expansion; further the attainment and subsequent maintenance by banks of the enhanced liquidity requirements will pose difficulties for many units in the system and raising reserve ratios would make their problem more difficult. Credit control should, therefore, seek to operate as it has done in the last 2 or 3 years on the access rights of the banks to the Reserve Bank. Whether this should take the form of fixation of rediscount ceiling or bringing about a limitation to the credit expansion by working primarily on the cost dimension would be a matter for decision. A stiff increase in the Bank rate of 1½ to 2 per cent would have a salutary effect by enforcing the discipline of higher rates on the entire market structure. For various reasons however—chiefly on grounds of budgetary interest cost considerations and because of the link of the Bank rate with other public sector and local authority operating rates—a certain rigidity has been imparted to the Bank rate as an instrument of monetary policy and such action might not be feasible. We have, therefore, to work within the confines of a policy which while effectively raising the rate structure (in effect for the private sector) would lead to only a slight upward adjustment in bond yields.

6. A variant of the present tier system which would emphasise the cost aspect is to adopt a system wherein no quotas as such would be set but differential interest rates would be prescribed to cover central bank lending against different types of eligible securities. Thus, we could think of one rate, namely, the basic Bank rate to cover central bank lending to commercial banks against the following securities, namely, (a) government securities, (b) export bills, (c) genuine (internal) bills of exchange including bills drawn by small industries/traders and a higher rate say ½% or 1% above the Bank rate to accommodate all other lending in effect against bills under the Bill Market Scheme. In view of the rather restricted volume of ‘free’ government securities (i.e. unencumbered government securities, above the level required for liquidity purposes), commercial bank borrowings would, as mentioned earlier, be increasingly against bills for most banks. The inclusion of export bills would continue the preferred sector treatment which we now accord to this class of bills. Similarly, by encouraging the use of ‘genuine’ bills as distinct from created bills we would be making sure that the transactions being financed were self-liquidating in character. The above change would not involve any necessity for legal amendments and would be covered within the four corners of the present statutes. However, such a classification

7 An interesting corroboration of this is that after the March 11, 1964 directive cutting the basic quotas back to 100% (instead of 150%) of statutory reserves, the Reserve Bank of India in nearly every case restored the original quotas through special accommodation. Also, in April and May 1964 the volume of fresh central bank credit exceeded Rs 100 crores in each month, which was not much less than during the relatively liberal phase upto March 11, 1964.
and the inclusion of government securities in a group of assets entitled to a lower rediscount rate is open in even stronger degree than at present to the charge that government securities are being shown undue preference. (Even if as proposed later the basic Bank rate were raised from its present level, the gravamen of this charge would remain.) Further, it would be possible for borrowers to adopt the bill as an instrument of finance to the extent necessary; borrowings from the Reserve Bank do not represent at the peak more than 7–8 per cent of credit extended by banks and a conversion of this part of credit into ‘genuine’ bills might be less convenient but no less possible than ‘creating’ bills as now. Thus the system would not ensure sufficient quantitative control of credit; again, even at the higher rediscount rate there is no absolute limit on the quantum of central bank assistance against ‘created’ bills as there is now.

7. Another alternative to the present tier system would be to operate a rediscount rate related to the actual level of credit extended by the commercial banks. In effect, if the intention is to limit credit expansion by a bank, the classical method of doing so is to operate via its liquidity base. The minimum statutory liquidity ratio in India is basically a measure of safety leverage rather than an instrument of credit control. There is, however, no reason why it should not serve the purpose of credit control not in the sense of constituting the base for credit expansion but by serving as a regulator for the cost of central bank rediscounting operations. This could be done by fixing a norm for the liquidity ratio and charging progressively higher rates as the proportion of the liquid assets falls below the norm.

8. In deciding on the norm an outside limit is set by the minimum liquid assets ratio of 28 per cent. No bank can go below this ratio without violating the statute. However, at present, in the calculation of the liquid assets ratio, borrowings from the Reserve Bank and/or State Bank of India are not taken into account in calculating the total of aggregate liabilities. Part of the justification for this is that to the extent that such borrowings are against government securities, the owned government securities of a bank become encumbered and hence do not qualify for inclusion in the total of liquid assets. However, as pointed out earlier in this note, it is conceivable and in fact it has even been our experience that some banks might be borrowing from the Reserve Bank but not against government securities. Thus while the denominator (i.e. the aggregate liabilities) is not increased, the numerator (i.e. legal assets total) also does not get reduced and these banks are able to extend credit without impairing their liquid assets position as defined by the law though in terms of banking criteria (as measured by the advances/deposits ratio) their credit levels might be high. It could, therefore, be suggested that while for purposes of Section 24, the ratio of 28 per cent will continue to be the minimum, for the purpose of credit control a norm of 28% may be fixed in respect of the net liquid assets position defined as the liquid assets in terms of Section 24 less borrowing from the Reserve Bank of India against bills. To the extent to which the net liquid assets ratio is 28% or above, the rate of lending could be at the Bank rate and for every one per cent drop in this ratio, the rate of lending ought to go up by say ½ or 1 per cent. Thus a bank with a ratio of 30% for gross liquid assets (i.e. as defined in Section 24) but with a net

4 Borrowing against government securities, in any case, will reduce the liquid assets position for Section 24 purposes.
liquid assets position of say 25% (as defined above) would have to pay 1½ or 3 per cent as the case may be above the basic Bank rate for the amount of Reserve Bank credit outstanding against its name for as long a period and to the extent to which the net liquid ratio is below 28%.

9. The implications of this proposal may briefly be considered. To the extent that a bank has liquid assets (as defined by the statute) above the level of 28% it makes no difference to it whether it borrows against government securities or bills as long as the total of such borrowings is equal to or below the excess over 28 per cent. Such borrowings would be at Bank rate. A bank might as well liquidate its holdings of government securities to the extent possible instead of approaching the Reserve Bank. This possibility is equally open under the present system. The difference arises only where a bank’s liquidity ratio (for Section 24 purposes) is near or at the waterline of 28 per cent, for then its borrowing would bring its net liquid assets below 28 per cent. As at this point banks cannot impair their government security holdings, such borrowings would have to be against bills. Thus, while a preferential rate is not charged for borrowing against government securities as such, it has to be recognised that a preference is shown for a bank whose holdings of government securities are in excess of the statutory requirements—a position that prevails even now in a sense. The defence for this is that to the extent that a bank has such an excess it is comparatively underlent in any case and its large holdings of government securities implies a certain sacrifice of earnings power, which merits some compensation. Should the increase in its credit totals be more than seasonal or sharp (in the season) it implies that the bank’s excess of holdings of liquid assets is diminished and possibly wiped out and this would naturally contract the volume of its borrowing at the Bank rate subsequently.

10. On the other hand, it will have to be admitted that relating it to the concept of liquid assets will not make this less cumbersome in operation than the present system. The calculation of the ratio and, in particular, arriving at the figure of ‘encumbered’ securities, will have to be done weekly and on a somewhat arbitrary basis viz. by adding 10 per cent to the figure of borrowing from the Reserve Bank and the State Bank of India (to take into account the maintenance of the margin against such borrowings). To make it less cumbersome, we could operate the system in such manner that when a bank approaches the Reserve Bank, a scrutiny is then made of its net liquid assets position and the corresponding rate charged for the actual amount of credit taken. This of course would mean that banks would not be in a position to ask for limits in advance but treat each borrowing from us as a separate transaction. The same effect could be more simply and more directly obtained by making the credit/deposit ratio the basis for regulation. Deposit liabilities, in any event, constitute the overwhelming proportion (roughly 90 per cent) of aggregate demand and time liabilities as defined for purpose of Section 24, the only additional items included in the latter being inter-bank deposits, inter-bank borrowings and other miscellaneous items. The credit/deposit ratio is thus effectively, though not exactly, the obverse of the liquidity ratio and constitutes as rational a basis for regulation as the latter, and has the further

5 The same argument could in fact be adduced in support of the previous alternative viz. a preferential rate for borrowing against government securities.
advantage of simplicity. It is true, of course, that in our legislation whether it be for purposes of statutory reserves or for liquidity ratios, we have used the concept of aggregate demand and time liabilities but this by itself need not preclude using deposit liabilities as the basis for regulation for credit control purposes. For the latter we could adopt whatever basis happens to be convenient, even though no specific reference to it is made in the Statute; an example of this is our present practice of fixation of rediscount quotas on the basis of statutory reserves. The eligibility criteria to govern lending by central banks in general lay down the type of securities and occasionally the purpose but the form or method by which such lending is undertaken is a matter for discretionary judgement based on institutional and structural aspects of the banking system. Further, relating credit to deposit liabilities indicates the emphasis on banks' efforts to increase their deposits and would also discourage banks obtaining funds through interbank borrowings to increase credit more than would be the case if credit to aggregate liabilities were taken as the guiding principle.

11. It could, therefore, be suggested that a norm be fixed for the advance deposit ratio of the commercial banks and that the basic Bank rate be charged for credit to a bank whose advances/deposits ratio is at or below this norm. This norm may be fixed at 70 per cent of deposits. The choice of this norm is suggested by the prescription of 28% as the minimum of liquid assets against aggregate liabilities excluding borrowing from the Reserve Bank and taking into account the difference in the base. For every 10 percentage point increase in the advance deposit ratio, the rate of lending would go up by 1 per cent. Thus a bank with an advance deposit ratio of 75 per cent would pay a rate equal to Bank rate plus ½% and a bank with an advance deposit ratio of 80 per cent would pay Bank rate plus 1% and one with an advance deposit ratio of 100% pay Bank rate plus 3% and so on. It may even be possible to think of further penal provisions for banks whose advances deposit ratio has exceeded 100 per cent.

(Statement 2 shows the ratios for the leading banks).

12. The operation of this system of a ‘floating’ or ‘sliding scale’ rediscount rate has the advantage of directly and without much complication linking the cost of central bank lending to the aggregate expansion of credit by a bank. It would also meet the objections of those who see in the present system or in the variants proposed earlier an attempt at extending either overtly or indirectly preference for borrowings against government securities. This system would not lead to showing any more preference for banks' investments in gilt-edged than is implicit in the present liquidity ratio prescription.

13. An implication of this is that if a bank should be permitted to bring in funds from abroad for meeting seasonal needs this would put up its credit/deposit ratio and penalise it when it comes to the Reserve Bank of India for borrowing.

14. This approach is consistent with the objective of limiting central bank credit by and large to the productive requirements of the economy; there need be no quantitative ceiling as such but by increasing progressively the cost of credit to the commercial banks, we would be inducing an economy in the use of rediscount facilities and, by implication, efficiency in resource use while the greater reliance on borrowing against

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6 Even if it should bring in funds from abroad subsequent to borrowing from the Reserve Bank of India, the higher rates will nonetheless apply.
bills would permit a degree of qualitative control. The emphasis is thus on dearer rather than on tighter credit, especially as emphasising the latter could lead (and has led) to some extent, to diversion to non-bank finance which is not merely a costlier source of finance (indicating incidentally the willingness of the borrower to pay higher rates) but weakens the area of effective central banking control.

15. The above discussion of the mechanism of control is independent of the level of the Bank rate. Any change in the apparatus of control should ensure that the average cost of borrowing from the Reserve Bank is at least as high as it is now, taking the banking system as a whole. In fact, consistent with our policy of a gradual hardening of rates the Bank rate may be put up for the present by \( \frac{1}{2} \) per cent to 5 per cent and place the main reliance (may be placed) on the higher effective cost of Reserve Bank credit to banks to limit credit totals. An increase in the Bank rate would also be consistent with the proposals regarding deposit rates made later in this note. To ensure the maximum effectiveness of the differential interest rate instrument, it is also suggested that the Reserve Bank in terms of Section 21 prescribe maximum interest rates for advances at 9 per cent. It is believed that the present marginal rate is 8–8½ per cent for the bigger banks though smaller banks charge more though even they would not find this maximum prescription unduly inhibiting as they would increase the rates in the intermediate levels of their lending. An increase of \( \frac{1}{2} \) per cent is consistent with the proposed increase in the Bank rate. This would mean that banks cannot afford to

7As the emphasis is on raising the cost of Reserve Bank credit rather than on restricting its volume, it would be interesting to compare (on the basis of the present Bank rate of 4½%) the effect of the adoption of these alternative systems. Taking the highest level of the ratio reached in the 1963–64 as the basis for comparison, the average rate of lending under the credit/deposits ratio system of 1% increase for every 10% rise in the ratio, the rate of lending works out to 5.61% (including the State Bank of India) and 5.95% (excluding the State Bank of India). For this purpose, the higher rate is calculated for the whole of the borrowing outstanding at the time and is not a weighted average which is more appropriate to a slab system. The calculations of the cost of borrowing from the Reserve Bank on the basis of net liquid assets is somewhat more complicated. If one were to apply the net liquid assets ratio last year (at the point the ratios were at the lowest) the rate of borrowing on the basis of a ½% increase for every drop of 1% in the net liquid assets ratio from a figure 28% works out to 5.70 for all banks including the State Bank and to 6.90% if the increase in the rate were 1% above the Bank rate for every one per cent drop from the level of 28%. This method, however, might not be quite appropriate as last year there was no requirement for 28% liquidity ratio and consequently the net liquid assets position could go down to 25.6% for all banks including the State Bank and 21.6% for all banks excluding the State Bank. Viewed at the difference between the gross ratio and net ratio, for all banks including the State Bank it was 1.7% of aggregate liabilities and for all banks excluding the State Bank 2.2%. If one were to assume banks would maintain the 28% liquidity ratio this time and treat only this gap as leading to their additional interest charge, the rates would be 6.2% including the State Bank and 6.7% excluding the State Bank on the basis of 1% increase for every 1% drop in the ratio. If the increase were only \( \frac{1}{2} \) per cent, the rate would be 5.3% and 5.6% respectively. As against this the weighted average rate under the present tier system touched a high point of 5.62%.

8By implication the rate charged to the co-operative sector will also be stepped up by \( \frac{1}{2} \) per cent while maintaining the present differential.
increase their marginal borrowing cost to above 8 per cent at the most (in other words would not allow their advances/deposits ratio to exceed 100 per cent or net liquid ratio to fall below 25% if the marginal borrowing rate is not to be penal in the full sense of the term).

16. The problem remains of dealing with the preferred sectors, namely, exports, small industries and collieries. The rationale for additions to the borrowing quota at a time when we are operating a system of quantitative ceilings on central bank credit is apparent but it would not be so when ceiling limits as such are not prescribed. To take the case of small industry, the problem here is one of availability of credit rather than its cost; the existence of this additional quota at the Bank rate has perhaps helped to make a larger volume of credit available to the small sector but not necessarily to lower its cost.9 The availability of finance for working capital purposes need not be impaired by the termination of the scheme as the problem before banks would be not the shortage of funds as such but the need for a quicker turnover of the credit they extend. This and the prescription of maximum rates for advances would meet the psychological objection that a concession now in force is being withdrawn.10 The case of exports under the Rupee Export Bill Scheme is somewhat different.

17. In this case, the cost of credit is a major consideration and the grant of concessional finance is linked with a ceiling on the discount rate charged by the Bank. The evidence of a self-liquidating transaction ensures that the funds made available by the Reserve Bank do in fact go to the exporter. Hence a continuance of this concession may be considered by excluding the finance made by the bank against Rupee Export Bills in computing net liquid assets position and/or the credit/deposits ratio as the case may be. With the expected full utilisation of the IBRD’s loan to the coal industry and on the basis of the limited use made of this concession so far, there is no reason to continue the preferred sector treatment to coal industry guaranteed advances. At the time of its inception itself, it was recognised that this was a temporary measure and its termination could now be considered.

18. The above proposals, as observed earlier, lay emphasis on the necessity for banks to augment their deposits with a view to meeting both the statutory liquidity requirements and the need for credit expansion. In this connection, the Reserve Bank has through its directive dated March 11, 1964 and in subsequent meetings with the representatives of banks indicated the need for stepping up term deposit rates. At present, the term structure of deposit rates does not provide for a wide enough spread between the short end and the long end of rates. At one extreme 3% is being paid for three day money i.e. call deposits and it is suspected that many current accounts are being classified as call deposits to earn this rate of interest. The Inter-Bank Interest Rate agreement does not permit the member banks to pay any interest on current accounts; the existence of 3% call deposits rate constitutes a circumvention of the spirit if not of the letter of the Agreement and it is something which one would expect

9 While this increase in credit refers to absolute amounts, in terms of proportion to total scheduled bank credit, the increase is from 3.3 in December 1961 to 3.7 in December 1963.

10 The present scheme, incidentally, is operated on the basis of the banks’ return to us and there are no ways (except through inspection) of verifying the accuracy of the data.
the banking community itself might wish to rectify. The attempts at reducing this rate (for example the recommendations of the Bhabha Committee) have not succeeded. The Reserve Bank has also an interest in this from the point of view of ensuring that the rate structure for short-term money is in alignment with the other market rates, including, in particular, the discount rate on treasury bills. From this point of view, it might be regarded that 3% for 31 days distorts the pattern of other short rates. On the one hand, the jump from 0 to 3% between the current account and the three day deposit is steep and on the other the spread between this rate and the other short-term rates is unnaturally narrow. Thus, two months deposits fetch only 3½% and deposits up to 90 days fetch only 3¾%. The narrowness of the spread tends to discourage the genuine saver and has possibly been a factor behind the growth in the placement of deposits with non-bank financial intermediaries and other companies. The payment of 3% on three day deposits had also tended to inflate the interest cost of banks and has limited their ability to offer more attractive rates on longer-term money. In the absence of agreement amongst the banks themselves to bring about the rationalisation of rates—the lukewarm response to even the marginal character of the Bhabha Committee recommendations is evidence of this—it may be necessary for the Reserve Bank to step in and in terms of Section 35(a) of the Banking Companies Act prescribe ceiling rates on short-term deposits. It is accordingly proposed that:

1. deposits up to 14 days be treated as on par with current accounts,
2. deposits between 15 days to 45 days be allowed a rate not more than 1.25% and
3. deposits between 45 days and 90 days be allowed a rate not more than 2.5%

At the same time, to provide for a reasonable spread and an upward revision of other short-term rates, we might also set a minimum of 4% for deposits of 91 days and over. The structure of deposits for terms above 91 days would be set through the State Bank of India setting a pattern of rates for varying terms. Though the State Bank is not a signatory to the Inter-Bank Agreement, its rates were, until the most recent change in Inter-Bank Agreement rates, in conformity with the latter. Announcement by the State Bank of a pattern of rates somewhat higher (by implication) for the longer-term deposits than what they are now will induce other banks to step up their rates to this level. The instrumentality of the deposit rate agreement need not be precluded; only the Agreement rates would then tend to follow the State Bank’s rates.

19. In any discussion of deposit rates, the relation between those rates and other money market rates will also have to be considered. The relationship between deposit rates and bank advances rates has always been close. Hitherto, banks have invariably followed an increase in the deposit rates by putting up lending rates on the ground that they have to maintain the spread between the cost at which they borrow funds and that at which they lend funds. Our experience has, however, shown that the reverse does not always occur. Thus, following the Bank rate increase in January 1963, though the banks put up their advances rate, there was no adjustment of their deposit rates despite the fact that the increase in Bank rate made only a marginal difference to the total cost at which banks raised funds (including in this not only the raising of funds from depositors but from the Reserve Bank as well). With the proposed increase in the Bank rate and the institution of higher interest rate application system
instead of only three tiers, the average cost of borrowing from the Reserve Bank and (by implication) the average cost of raising funds would be followed by an increase by banks in their minimum lending rates as well as in rates to the intermediate class of borrowers. The prescription of a maximum advance interest rate, however, will not affect the marginal borrower—generally the small industrialist/trader unduly.

20. The relationship of the deposit rate pattern with the Treasury bill rate is yet another aspect to be considered. The Treasury bill rate generally rules close to the deposit rate offered by banks for equivalent maturities. At present the Treasury bill rate is quoted at 2.4 per cent reflecting the seasonal easing of pressure on the banking system and the increase in demand from banks in view of the proximate increase in their liquidity requirements. It is in respect of non-bank demand for Treasury bills that the deposit rates offered by banks have significance and the fact that until recently the Treasury bill rate was quoted at 3% was partly because of the ability of depositors of ‘house money’ to obtain 3% from banks for three day deposits. With the return flow of funds into the banking system, though banks continue to pay 3% to their house money customers, they are able to obtain only 2.4% against Treasury bills.\(^{11}\) The prescription of ceiling rates for short-term deposits might in one sense add to the attractiveness of the Treasury bill as a short-term investment outlet both for banks and non-bank customers but such a ceiling prescription is to be regarded only as part of a larger package of measures, the other constituents of which such as the increase in the Bank rate and the stepping up of other term deposit rates would not fail to have repercussions on long-term bond yields and on the rates offered on small savings. The rise in such yields would be consistent with our policy of a gradual but definite hardening of the interest rate structure all along the line.

[Statements not reproduced] [M. NARASIMHAM]
31.8.1964

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TOP SECRET ECONOMIC SECRETARY
PERSONAL MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]
April 20, 1965

My dear Bhatta[charyya],

The upward trend of domestic assets of the Reserve Bank is so disquieting that we have decided today to draw another $25 million from the I.M.F. immediately. You will remember that our original decision to draw in the first week of May rather than in the last week of April was due to a desire to demonstrate that we were ourselves anxious to draw as little and as late as possible. There is now a considerable risk that before the 1st of May the domestic assets of the Reserve Bank may exceed the agreed ceiling of [Rs] 3044 crores. If this happens, we cannot draw at all without further consultation. Our foreign exchange position does not allow us to take this risk of a

\(^{11}\) The Treasury bill rate is Rs 2.5% and on the assumption that a holder rediscounts the bill after a week, his earning on a 7 day investment works out to 2.23% as against 3% for ‘house money’.
few weeks’ delay in further drawing. That is why I have sent a telegram today to Anjaria (copy enclosed [not reproduced]) asking him to ensure that the money is effectively transferred to the Reserve Bank on or before the 25th. I hope that by the 25th at least the ceiling of [Rs]3044[crores] will not have been burst. Anyway as a measure of precaution in this regard, and also to ensure that we shall be able to draw again a month later, I have asked Dehejia to reduce his indebtedness to the Reserve Bank by about [Rs]30 crores before the end of this month. I would however suggest, for reasons which you can guess, that our decision to go to the Fund immediately may be kept to yourself only for the time being.

Yours sincerely,
S. BHOOTHALINGAM

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FINANCE MINISTER
TOP SECRET
NEW DELHI
September 24, 1965

My dear Bhatta[charyya],

Our monetary policies have been partly framed with an eye to the promises that we gave to the I.M.F. The stringency of the market as such has been further accentuated by the withdrawal of unaccounted money which used to be inducted into business by bogus hundis. How much of unaccounted money has been taken out this way is very difficult to say, but one may say it is somewhere between [Rs]200 and 400 crores. The difference between the busy season and the slack season is narrowing down mainly because of the reason that the expansion of credit for agricultural purposes has not been of the same order as before because of the holding power of agriculturists. Nevertheless, increase in sugar production accounts for roughly a [Rs]100 crores of increased credit during the sugar crushing season which happens to coincide with the busy season. The beneficiary effect of monetary policies on prices is very very faint largely because there is a very large volume of unaccounted money still in operation and we have not been able to touch private credit; but the mal-effects of the credit squeeze are apparent: it has certainly stifled business to some extent, made money more costly which has the effect of dampening an already slack share market, increased the cost of deposits to banks causing thereby a general increase in interest rates. Conventional methods of monetary policy would not seem to apply with the same force in an economy such as ours and some measure of improvisation is necessary in order to achieve the ends we have in view.

May be, to a certain extent we have to maintain these policies because of the undertakings given to the I.M.F., but I think we should ask them to relax this stringency and allow us to adopt other means to make borrowing more costly which would otherwise not affect either the deposit rates or the interest rates to the same extent as the present monetary policies have done. I think from next year onwards we should have a tax on borrowings of at least 1.2 per cent per annum. This by itself would give us about [Rs]25 crores and more and at the same time enable us to reduce the bank rate by ½ per cent, decrease the cost of deposits to banks and also help us to borrow
money in the market at slightly lower rates, while to a person who does not have to borrow on shares, the possession of shares would perhaps give him a better return vis-a-vis the bank rate. I would like the Governor to have this matter examined so that next year we might make a change on the lines indicated above.

Yours sincerely,

T.T. Krishnamachari

TOP SECRET

Camp: CALCUTTA

D.O.No. [...]

December 23, 1965

Dear Shri Krishnamachari,

I must indeed apologise for not replying to your letter No. [...] dated September 24, 1965 earlier. I have been pondering over the points in your letter all this time as these require a very careful consideration from both the short- as well as the long-term point of view.

2. It seems to me that the present stringency in the market arises mainly from the fact that demand for bank credit from all quarters has been accelerating at such a pace that despite a substantially high rate of increase of bank deposits witnessed in the last two years, banks are finding it increasingly difficult to meet the demand on their own. In a developing economy where the production base goes on widening year after year an increasing trend for bank credit is only to be expected. This apart, a part of the increase in the demand for credit is, as you say, due to withdrawal of bogus hundis. But the main reasons for the present persistent high demand for bank credit seem to be three. Firstly, the continuing strong upward price trend experienced over the last two years. Secondly, because of the depression in the capital market, bank finance has had to fill in the gap caused by absence of equity capital from genuine investors. Thirdly, the level of stocks of sugar, foodgrains and textiles financed by bank credit lately was somewhat higher than last year. In the case of sugar and foodgrains, this is due to Government’s policy of releases and building up buffer stocks. As regards cotton textiles, as you know the whole position, I need not discuss it any further except to say that fortunately the position seems to be easing somewhat now.

3. To the extent bank finance replaces the resources of the unorganised money market, it is no doubt a useful development. Similarly, one has to accept that the policy of building up of buffer stocks of sugar and foodgrains with bank finance under Government control is inescapable in the present circumstances. But the trouble is that the money released thereby from trade and industry finds its way into other channels and does not come to the banking system.

4. The position has thus been reached where the banking system, if it has to meet all demands to the satisfaction of all its clients, has to be fed continually throughout the year by the Reserve Bank. This is an unhealthy development both from the point of view of the economy as a whole, as well as the banking system. The banking system, to be healthy, should provide all non-seasonal finance out of their own resources only, the Reserve Bank helping them to meet the pressure of seasonal funds when more money is needed to finance agricultural movements as well as increased trade...
movements during the winter. If the banking system were to be fed by Reserve Bank funds throughout the year, it would only add to the monetary pressure on the economy which is already suffering from the ill-effects of the heavy deficits incurred by the Government.

5. In view of the foregoing, I feel that it is necessary to continue with measures which, on the one hand, will increase deposit resources of the banking system and, on the other, ensure their economic utilisation. As regards the former objective, I agree of course that it is not necessary for banks to raise interest rates all along the line. What I have been trying to do is to hold rates on short-term deposits down and ask banks to pay higher rates on longer-term and savings deposits. You will recall that till directives were issued in this behalf banks were paying unreasonably high rates on short-term deposits and practically neglecting long-term ones. The cost of deposits to the banking system has increased somewhat. But it is not too onerous compared to the increase that is taking place in staff expenses owing to automatic increase in dearness allowance. A study of the volume of deposits at various rates of interest shows that on an average the cost of deposits to major banks has moved by less than 1 percentage point from about 2.4 per cent to 3¼ per cent. Perhaps some further reduction of rates on short-term deposits is called for. A substantial proportion of these deposits are for business purposes and have a fast turnover. There is no reason to require banks to pay high interest rates on these deposits. A reduction of the rates on these deposits should effect some economy from the point of view of the banks. I am considering this as well as the question of standardisation of the terms and conditions on which savings deposits are collected by the banks so that they represent genuine savings accounts and do not contain money that should go appropriately to current accounts. But I do not think reduction would be advisable at this stage for longer-term deposits. These deposits would represent savings of individuals and just as it is necessary that the banking system attracts as much of them as possible, it is also necessary to ensure that the public gets a feeling that they are having a reasonable return on their savings deposited with the banks. A reduction of interest rates paid by the banks at this point of time on genuine savings would merely drive them to the non-banking sector where extremely high rates are paid but where the depositor hardly gets any protection that is available when he puts his money in a bank. I do not think such a move would be in the long-term interest of the banking system or of the economy.

6. As regards the use of the resources of the banking system, as you know, we are trying to control this through both selective and overall controls. It is, however, a well-known fact that selective controls by themselves are not of much use if at the same time there is no control over the total volume of credit creation by the banking system. Further, there is the added complication of the non-banking sector in our economy. Here of course, we try to vary our strategy according to the requirements of the seasons. For, despite a popular feeling to the contrary, there is even now a very marked difference between the busy season and the slack season. This is so because besides agriculture there are certain important industries like textiles, sugar, coal etc. which experience seasonal fluctuations and the Government’s budgeting operations
also exert seasonal pressures on the banking system in the same direction as the pressures exerted by the rest of the economy.

7. In the present busy season, therefore, what I have done is (a) to ensure that banks do not expand credit for non-seasonal financing unreasonably beyond their own resources, (b) to ensure that if as a result of a bank’s past commitments it has to meet a large demand it gets the necessary resources temporarily from us but has an incentive in returning them as quickly as possible and (c) banks do not charge too high a rate to their borrowers. Thus, in the busy season Reserve Bank resources are not denied to the banking system; but they are available at a cost which increases if they are used disproportionately to the banks’ own resources so that their use is strictly temporary.

8. It is quite true that the beneficiary effect of the monetary policy on prices is very faint. The reasons, as you say, lie elsewhere. But I do not think this would justify either a cheapening of credit by reducing the Bank rate or by making other changes which would encourage banks to borrow freely from the Reserve Bank money which they will not be in a position to return in the slack season. The share market has adjusted itself to a yield pattern comparable to the returns from other types of investments but even if the return on bank deposits were reduced, I do not think the share market would be the beneficiary of the same.

9. I fully share your view that conventional methods of monetary policy do not apply with the same force in our economy as in the western ones and that some measure of improvisation is needed all the time in order to achieve the ends we have in view. It is for this reason that we have let it be publicly known that our policy is flexible and that we shall not allow production to suffer because of lack of finance. But I would strongly urge on you that this is not the time when credit should either be cheapened or made more freely available generally. We have to wait to see that the economy is geared to a condition where increased production possibilities are apparent before we make any change in the monetary policy.

10. Now, to turn to the proposed device like a tax on bank borrowings, I am doubtful if this can fit into the present situation in an appropriate manner. In the first place it is not desirable to use fiscal instruments in the monetary field. A fiscal instrument has a certain amount of rigidity and cannot be changed as flexibly as a monetary instrument. Thus when the time comes for a substantial change in interest rate policy it may be found that because of the revenue implications, the tax on borrowing cannot be changed so easily. Secondly, whereas an important objective of our policy is to penalise only those banks which expand credit out of proportion to their resources, the tax would not be able to discriminate in such a manner. Thirdly, a tax if it has to be followed by Bank rate reduction would reduce the profits of banks which follow a reasonable credit policy much more than that of the others. On the other hand, if it is not followed by a Bank rate reduction or any other change in policy, the burden on the customers would have to increase correspondingly. Fourthly, the effects of the tax would generally be regressive. Its impact would be higher on those paying low rates of interest. Finally, if a tax is to be levied on the borrowing from the organised sector, it has to be accompanied by a tax on all borrowings and taxing borrowing from the unorganised sector would raise great administrative problems. On the other hand, if this is not done, it would strengthen the tendency of companies to rely more and more
on the unorganised sector for its finance whereas our objective should be the precise opposite. In all the circumstances, I would very strongly urge on you that it would be inopportune to introduce such a tax even if it is to be levied on all borrowings. The situation would be much worse if it is to be levied only on bank borrowings.

With regards,

Yours sincerely,

P.C. BHATTACHARYYA

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SECRET
D.O.No.[...]
BOMBAY
May 21, 1966

Dear Finance Minister,

In the busy season that has just ended the expansion of money supply was as high as Rs 496 crores—as much as nearly Rs 100 crores more than in the preceding busy season. This occurred despite the fact that bank credit expansion in the same period at Rs 306 crores was little over Rs 100 crores less than in the earlier period. The divergent movement in almost equal measure of money supply and bank credit was entirely due to the growth in net bank credit to the government sector which increased in the 1965–66 busy season by as much Rs 387 crores as against Rs 160 crores in the 1964–65 season. This large expansion in the money supply, occurring as it has in a period marked by a severe shortfall of supply both domestic and imported has, not unnaturally, led to the building up of a considerable amount of liquidity in the economy.

2. As we enter the slack season which also is the lean season for agricultural supplies, this liquidity would in itself add to the seasonal pressure on prices. But on top of this liquidity that is already built in to the system, there is likely to be, as is usual, further addition to liquidity in the near future from the side of fiscal operations. I am aware that in the coming months there would be substantial sales of P.L.480 foodgrains. Despite this, on past experience and recent indications, the impact of fiscal operations on the money supply in the coming months is likely to be expansionary. One cannot view with equanimity such a situation. We estimate that the consequence of the expansionary impact of fiscal operations past and present would be to increase the deposit resources of the banks substantially. Our estimate of the order of deposit expansion in the lean season, based on the probable increase in net bank credit to Government and the impact of currency contraction, is that it is likely to be around Rs 200 crores. This expansion would obviously enable banks to create additional credit. Further, in the last busy season, credit against seasonal commodities rose by about Rs 170 crores. In view of the special circumstances relating to foodgrains and sugar advances, on a tentative assessment, it is considered that the contraction, in the slack season, of advances against seasonal commodities should be somewhere around Rs 135–150 crores as against which credit against non-seasonal items might ordinarily rise by anywhere between Rs 50–60 crores suggesting that the overall contraction in bank credit in the slack season should be within the range of Rs 75–100 crores. This money will also be available to banks for creation of additional credit if banks were left completely free to deploy their accruing resources during the lean season.
3. I am, therefore, convinced that, placed as we are, some restrictive action on the monetary side is called for to be operative during the lean season only. This will, however, affect only the private sector and poses for us a very difficult problem of public relations. You are aware that the Reserve Bank has been, off and on, criticised on the ground that its monetary action seeks to control expenditures in the private sector at a time when fiscal operations which are the main element in the monetary imbalance remain uncontrolled. It is also stated that such a situation leads to excessive restrictions inhibiting production in the private sector. We have, of course, on several occasions answered such criticism by making a reference to the emergence of private expenditures as a positive element in the monetary expansion and by stating that this makes it necessary to pursue an active monetary policy to regulate the operations of the private sector. None the less, you will agree that there is considerable force in the argument. It has to be admitted that if Government (and here I include the State Governments) were in a position to so order their affairs the recourse to deficit financing had been substantially smaller, the severity of action on the monetary side could, to that extent, be moderated.

4. A possible view may, therefore, be to let things go on without any intervention on our part. But if we were to take this view, we would be failing in our primary duty as the central banking authority. We have necessarily to take an overall view of credit operations and if Governmental operations continue to add to liquidity in the economy, we have to try to counteract the effect of this by restricting expansion in the private sector to the maximum extent possible, if we are to be true to our charter. As our measures are general in nature, it is not possible to guarantee that no productive efforts in the private sector will be hurt under such circumstances even when we take all possible precautions. If therefore we take action on the lines proposed later in this letter, I am afraid our action will be severely criticised by the private sector of business and industry and we shall need all the support that Government may give us.

5. I would add that our proposals have been framed with a view to limiting the secondary impact of the primary expansion of money as a result of fiscal operations, especially against the background of squeeze on supplies. I am aware of the possibility of augmentation of supply through larger availability of external assistance, especially maintenance imports. But on a realistic basis, I would presume that any such substantial supply is unlikely to flow before September or so whereas the problem of monetary imbalance would be at its most acute in the months before that. In fact, to be able to meet the need for credit when it is required (with more imports) action now to conserve bank resources for this eventuality would appear to be indicated.

6. The total resources that would accrue to the banking system may be set at Rs 300 crores made up, as indicated earlier, of about Rs 200 crores of deposits and Rs 100 crores or so of return flow of credit. Of this Rs 30 crores would be absorbed in the repayment by banks of their borrowings from the Reserve Bank while another Rs 60 crores would be preempted by the need to maintain statutory liquidity ratios.

7. The problem, as it seems to me, is therefore to attempt an immobilisation of Rs 200 crores or so which you will observe is also our tentative estimate of the likely volume of deposit expansion. Immobilisation of resources to this extent could be done through impounding of reserves and it is our proposal that this should be done. To take into
account the differential deposit outturn and portfolio behaviour of different banks, I propose the use of the instrument of incremental reserve requirements and call up the full 100% of increment to deposits in May. This is the maximum percentage of incremental reserves that can be called up under the law. The call up of reserves for June could be decided later in the light of Government's borrowing programme and other relevant factors. What we hope for is that the action that we propose to take for the May deposits will place the banking system on the alert. We would pay interest on such impounded reserves as permitted by the law and assure the banking system that the additional reserves would be released with the onset of the busy season or as and when the situation so demands including for instance banks' desire to subscribe to government loan issues.

8. I have also given thought to the question as to how the essential needs of additional credit during the lean season could be safeguarded along with the adoption of the restrictive measure outlined above. To achieve this, I propose to continue the refinance facilities which we now have in respect of food procurement, exports and defence supply bills even beyond June 30, 1966 when our usual Bill Market facilities are withdrawn. Further, it has been represented to us by banks in Eastern India that the requirements of those banks which purvey tea finance increase during the lean season as the requirements from the tea gardens are heavy during this period. There is some point in this. I therefore intend to keep the Bill Market facilities available in respect of tea garden financing also during the lean season in addition to the three refinancing schemes mentioned above. I propose, however, to limit this facility to the increase in banks advances to the tea industry over the level of June 30, 1966.

9. The advent of the lean season also justifies a review of the deposit rates structure, which we have helped to build in the banking system. For some time we have been thinking that in the case of deposits of less than 3 months which, in any event are largely institutional deposits, the maximum rates now prescribed could be lowered without any fear of this leading to a diversion of deposits or having adverse effects on savings which our intervention in the deposit rate structure was intended to promote. The present money market conditions would also justify such a move. Accordingly I propose to lower the maxima for rates on short-term deposits from 1.50% for 15 to 45 days to 1.25% and for 46 to 90 days from 3% to 2.50% per annum. This would also permit a lowering of our present 'administered' Treasury Bill rates to 3.00% which will be done. At the same time, I propose to modify our minimum rates directive somewhat. The banking system has by now got used to the new rate structure and the continuance of a minimum rate prescription does not seem to me to be necessary. I propose, therefore, to rescind our minimum rates directive insofar as it applies to three months' and six months' deposits and savings bank deposits. I do not expect that the abolition of minimum rates here will in fact be followed by a lowering of rates. But if it is done marginally, it will not be unwelcome to us. As a measure of abundant caution against any substantial reversal policy, I propose to leave the prescribed minimum rate for one year deposit undisturbed so that our objective for which the deposit rate intervention was resorted to, namely, widening of yield differential, still remains clearly apparent. I also propose to prescribe later on certain rules regarding savings bank deposits to emphasise the savings character of these deposits. Action,
however, in this regard will have to be co-ordinated with the rules in regard to Post Office Savings Bank and it is for this that I do not intend to take any immediate action.

10. I shall be glad to know if you have any other views in the matter. I would request an immediate reply as the proposed directives if they have to be issued, should be issued before the end of the month.

11. I have separately sent a copy of this letter to I.G. [Patel.]

Yours sincerely,

[P.C. BHATTACHARYYA]

Shri Sachindra Chaudhuri
Finance Minister
Government of India
New Delhi

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SECRET

June 21, 1966

My dear L.K.,

Various opinions are being given expression to in the Press and elsewhere regarding the proper credit policy to be followed after devaluation. This matter has now been studied in the Reserve Bank and I enclose herewith a copy of a note recorded on the subject. You will notice that the conclusion arrived at is that measures should be taken so as to conserve resources with the private banking sector for less essential purposes during the slack season so as to be available for meeting the larger and more essential demands from the private sector for the proximate future when non-project assistance starts flowing in.

I shall be grateful if this note is put up to the Prime Minister for her information. I am arranging to have these measures discussed in the Devaluation Committee of the Cabinet this morning.

Yours sincerely,

P.C. BHATTACHARYYA

Shri L.K. Jha, I.C.S.
Secretary to the Prime Minister
New Delhi

DEVALUATION AND MONETARY POLICY

Devaluation is primarily a corrective measure taken to meet a situation where internal prices have risen ahead of international prices. When internal prices rise faster than prices abroad, it leads to a situation of imbalance in external payments. This arises because on the one hand exports become uncompetitive while on the other strong demand is generated for imports. With a system of strict import control, this import demand tends to be satisfied through illegal channels. Though the external payments gap in our conditions is structural in character and related to the plan level of investment, we must, at the same time, keep the objective in view of
moving towards a position of balance in external payments so that our dependence on external aid is reduced. Devaluation helps to achieve this objective by making it attractive for the local producer to export his produce while at the same time it tends to discourage imports. It provides valuable time for the needed adjustments in the internal economy.

A situation where internal prices rise faster than world prices is a result of internal inflation. It is this inflation which is at the root of the problem. The immediate impact effect of Devaluation is, however, to raise prices of imports and consequently of articles with import content. There is also the possibility of prices of export commodities rising in view of some diversion from internal consumption. While this diversion is indeed one of the objectives of Devaluation, in a scarcity economy such as ours, this might have the effect of aggravating local shortages. In our situation, the import content of articles entering into the cost of living is low. Also, Government has decided not to raise the issue prices of foodgrains and other items of mass consumption such as kerosene. Further, the adjustments of import duties on the one hand and the fact that there was already a difference between landed cost and market prices in respect of a large range of imports would suggest that import prices need not rise to the full extent of Devaluation. Yet, some price rise must be regarded as inevitable. The measures now being contemplated such as the enlargement of the fair price shop network over a wider range of commodities and a wider area of operations, the various administrative measures to check prices etc. are necessary steps to correct the immediate price increase following Devaluation but it must also be noted that these form no more than a temporary holding operation.

The obvious and lasting solution to the problem is to tackle the inflation at the source. This calls for a sizeable increase in output of real goods and services on the one hand and the scaling down of expenditures both in the public and in the private sectors on the other.

The growth in aggregate output in our conditions is largely a resultant of the crop outturn. Given normal weather and with the emphasis on intensive farming in selected areas it is reasonable to expect that agricultural production in 1966–67 will more than recover to the levels of 1964–65. This should not only provide the needed relief to the food situation but also enlarge output in important agro-based industries such as cotton, jute, sugar, vegetable oils etc. These industries account for much the greater part of industrial production and some of them are also important from the point of view of exports. As regards other industries, the availability of substantial non-project assistance and the consequent fuller utilisation of capacity should lead to a perceptible increase in internal output. Even here, the major beneficiaries would be the engineering and chemical industries whose importance in the total industrial picture is still small but which are strategic for growth and which could generate a cumulative expansion over a wide range of industry. The outlook on the side of supply availability is thus reasonably hopeful but this cannot be expected to be realised before the end of 1966, whereas the problem of inflationary pressures following Devaluation would be at its most acute in the months immediately ahead. These months also coincide with the lean season for agricultural supplies and the pressure on prices would thus be aggravated. Immediately, therefore, the problem of inflation should be tackled from
the side of limiting expenditure in the public and private sectors. The growth of public expenditures ahead of an increase in resources had led to extensive recourse to credit from the banking system and particularly from the Reserve Bank. Deficit financing has been a major factor behind the present imbalance in the economy and the attendant economic strain and social tensions. Last year, for instance, the level of deficit financing was at a very high level and, against the background of a poor agricultural outturn, contributed significantly to the emergence of the present inflationary conditions in economy which have ultimately necessitated the drastic corrective measure of Devaluation. It is essential to keep deficit financing to the barest minimum if it is not possible to eliminate it over the year. Taking the Government sector as a whole, including both the Centre and the States, the objective should be to have a balanced budget. In concrete terms the Centre should aim at a surplus budget, while the States should once again be asked to review their financial position with a view to avoiding all postponable expenditure and limiting all non-development expenditures. In the private sector also expenditures have recently tended to run ahead of resources and the aim of credit policy has been to limit the recourse of the private sector via the commercial banks to the Reserve Bank and thus avoid deficit financing in this sector. Devaluation is not expected to add immediately to the strain on the liquidity in this sector. Rather, the banking system should acquire higher liquidity in the short run. Though the cost of financing imports would go up, so would export receipts. The private sector generally has a surplus in its external transactions and, to the extent that this is so, the rupee value of the surplus would be enhanced as a result of Devaluation. Further, a considerable amount of seasonal advances provided in the last busy season should return to the commercial banks in the immediately coming months. The problem will, however, arise for the private sector with regard to finding the rupee resources necessary for making use of the non-project assistance that is likely to become available in the country say, from October onwards. But if the private sector is to be financed in respect of this additional amount, in effect, by the Reserve Bank, it would be a case of deficit financing by the private sector which would be inflationary. It should be remembered that the rupee equivalent of this assistance would already have been taken credit for by Government to whom the loan is initially made. Obviously, rupee resources cannot be generated twice over in respect of a single addition to real resources without generating inflation.

The objective of monetary policy in the immediate future must therefore be to ensure that the present excess liquidity of the banking system is not used to finance non-essential expenditures in the private sector in the slack season. This is called for both from the point of view of reducing demand pressure now and to provide finance for the additional imports in the next busy season without aggravating inflationary pressures. Measures should accordingly be taken so as to conserve the resources of the banking sector from being used for less essential purposes for meeting the larger and more essential demand from the private sector in the proximate future when non-project assistance becomes available. Any measure to bring about a containment in private sector expenditures however justifiable on economic grounds is likely to be criticised by trade and industry merely on general considerations. It would be argued that it runs counter to the move towards allowing the private sector greater freedom
from controls. On the other hand, precisely because administrative controls are in the process of being liberalised, a restraint on the growth of demand in the economy has to be obtained through fiscal and monetary measures. Monetary controls are preeminently 'market' instruments of control. Another argument would be that when the private sector hopes to utilise larger non-project assistance, a reduction in the credit available to it will nullify the benefit of such assistance being made available. The answer to this line of reasoning is that such assistance may reasonably be expected to become available only from October, whereas the measures of control are intended to operate in the months before then so as to relieve the pressure on scarce supplies. The funds conserved are intended to finance essential seasonal and non-seasonal requirements after October. The proposed measures should however provide that if supplementary funds are needed for lending to industry even during the slack season, this would be made available by the Reserve Bank.
My dear Balasubramanian,

Please refer to your D.O.No.[...] dated the 2nd August 1951.

The Madras Government have considered the matter carefully in the light of the results of their previous issues, most of which were under-subscribed by the public and the underwriters had to take up a portion. They would prefer their entire loan upto about Rs 5 crores in the current year being underwritten in full. But, in case the Reserve Bank finds it impossible, in spite of its best efforts, to secure underwriting arrangements for State loans this year, the Madras Government will have no other alternative than the issue of a straight loan in the open market on terms that will attract investors adequately.

Yours sincerely,

T.A. VARGHESE

Shri G. Balasubramanian
Secretary
Reserve Bank of India
Central Office
Bombay

My dear Varghese,

Will you kindly refer to your D.O.No.[...] dated the 9th August 1951 regarding the projected Madras loan for the current year?

2. We fully appreciate your preference for the entire loan of about Rs 5 crores being underwritten in full, but so far as we can see, none of the underwriters in Bombay are prepared to accept such a risk. I do not know if you have considered the feasibility of the Hon’ble Finance Minister in Madras using his political influence to get sufficient support in Madras and the Governor would much like this possibility to be canvassed. In the absence of the loan being underwritten, you will have no other alternative than issue a straight loan in the open market but the Reserve Bank presume that by the expression “the terms should be such as would attract investors adequately”, the
Madras Government do not mean a rate of yield as might prejudice the pattern of other loans including the Government of India loans. We consider that 3½ per cent at par for 11 year money is a sufficiently attractive rate. We are pursuing further the possibility of underwriting your loan and will advise you of the final result in the course of the next ten days.

Yours sincerely,

G. BALASUBRAMANIAN

Shri T.A. Varghese, I.C.S.
Secretary to the Government
of Madras
Finance Department
Madras

CONFIDENTIAL

D.O.No.[...]
My dear Reddi,

Please refer to D.O.No.[...] dated August 18th 1951 to Varghese from Balasubramanian regarding the Madras loan for the current year, which I have seen after my return from Delhi yesterday.

2. I am afraid the expression “political influence” might be misunderstood, and I would like to explain that it was never my intention to suggest that you should exercise any illegitimate political pressure in order to get subscriptions to the loan. What I had in view was that you should make an appeal to local patriotism, especially as the loan is for development purposes. I had been to Calcutta last week in connection with the Bengal loan. The Chief Minister, Dr. B.C. Roy and the Finance Minister, Mr. N. R. Sarkar, appealed to the banks and insurance companies to support the loan and the entire loan has been subscribed by these institutions. It will not, therefore, be necessary to underwrite the Bengal loan, which will be on the same terms as the Madras loan. You might consider whether you should not make an oral appeal to the heads of the local banks and insurance companies to subscribe adequately to the provincial loan. As Balasubramanian has stated, we are also considering further the possibility of underwriting your loan.

3. I should be grateful if you could let me know, as early as possible, what the response of the Madras banks and insurance companies is to your appeal.

Yours sincerely,

B. RAMA RAU

The Hon. Mr. B. Gopala Reddi
Finance Minister
Fort St. George
Madras
My dear Rama Rau,

Many thanks for your letter No. [...] dated 21st. I am under no misapprehension about the nature of the appeal to be made to the financing agencies regarding the Madras loan. In fact, even last year, quite apart from the Manimuthar effort, I had informal talks with the agents of selected banks and insurance companies and there was indeed a satisfactory response. I had intended to do it again this year and shall let you know shortly the reactions. But, you would appreciate that as the head offices of the more substantial institutions are either in Bombay or Calcutta, my efforts might be effective, only to the extent local agents could influence their head offices. I am sure that you would also do your best at your end and let us hope that we can somehow pull through.

Yours sincerely,

GOPALA REDDI

Shri B. Rama Rau
Governor
Reserve Bank of India
Bombay

My dear Reddi,

Will you please refer to the correspondence resting with your D.O.No.[...] dated August 22nd, 1951 regarding your new loan?

1. I had informal discussions with the local underwriters yesterday afternoon and the general consensus of feeling was that in spite of their best efforts banks and brokers may not be able to canvass subscriptions for more than a crore of rupees for all the State Governments put together as against our estimated proposals of Rs 11 crores in the aggregate. The estimate may be unduly cautious, but it is evident all the same that the market is not favourably circumstanced to lend good support to a loan. In the circumstances, it is inevitable that we should abandon the idea of adopting the underwriting scheme for the State Governments’ loans and the only course will be for your Government to issue a straight loan in the market for the minimum possible amount, which in the case of your Government will be Rs 3 crores. To aim too high and achieve too low may jeopardise your credit, which it is important to maintain for the sake of future borrowings. For your confidential information we may add that the undernoted State Governments will be issuing loans to the extent indicated against each.

Bombay ... Rs 3 crores
Uttar Pradesh ... Rs 2 crores
West Bengal ... Rs 2 crores
Madhya Pradesh ... Rs 1 crore

3. In the light of the present trend of yields on Government loans and consistent with the general pattern of interest rates, I recommend that the loan should have a currency of 11 years, i.e. repayable in September 1962, carrying an interest of 3½% per annum, the interest being payable half yearly on the 17th March and 17th September. The issue price may be fixed at par or a little below par which can be decided when you send the notification for our approval. Brokerage will be paid at the usual rate of 18th per cent.

4. If the above proposal is agreeable to your Government, I suggest that the following programme may be followed subject to there being no untoward developments either in the domestic or international situation. Should such a situation arise, it may be necessary to abandon the idea of a loan.

State Government to communicate acceptance of the amount and terms of the loan and forward a draft notification with the number and date of issue inserted so as to reach us not later than 1st September 1951

Statement showing the financial position of the State Government to reach us not later than 4th September 1951

Loan notification to be issued on 10th September 1951

Lists will be opened and closed on 17th September 1951

5. In view of the present uncertain conditions we have tried to keep the date of issue of the loan as near as possible and the date 17th September has been chosen as it would enable the public to utilise the proceeds of the Government of India 3% Loan 1951-54 which will be repaid on the 15th September 1951 to invest in your loan.

6. Subscriptions will be received at the Reserve Bank of India offices at Bombay, Calcutta, Delhi and Madras and at the branches of the Imperial Bank of India and at District Treasuries within your State.

7. As all the loans will be issued simultaneously, our office will arrange for publication of a joint advertisement of the loans in newspapers and financial journals at Bombay, Calcutta, Delhi and Madras. You will, doubtless, make suitable arrangements for publicity of your Government’s loan within the State. The cost of joint advertisement by our offices will be distributed equally among the Governments concerned. A sum of Rs 3,000 may be provisionally allowed for this purpose.

8. Please let me know your views early to enable us to advise our offices.

Yours sincerely,

B. RAMA RAU

***
My dear Ambegaokar,

I have seen the two extracts sent with your confidential D.O. of the 10th September 1951 regarding State loans.

2. Before commenting on them, it would be advisable to give you some background information so that you may appreciate the position better. The so-called ‘busy season’ ends somewhere in June or July as the experience of recent years has shown. The Central Government has the first claim for borrowing on an easy money market as on its credit depends a good deal of public finance. So the Central Government naturally draws off the top cream. We allow some 3-4 weeks for the markets to adjust themselves after a Central Government loan before the States have a chance to dip into the market. By then, the money investible in Government loans has practically been absorbed. State Governments loans appeal to a limited clientele which concentrates on higher yield rather than on quick liquidity and State Governments bring some kind of pressure on small banks and insurance companies to help making a success of their loans. Till this year, these loans were underwritten, the underwriters parting with their six anna commission to their clientele. States loans are not popular with the big banks and the market for such loans is limited. The Reserve Bank has no portfolio of States loans and as you know any purchases of States loans by the Reserve Bank is like other purchases, inflationary. Such purchases tend to give a false impression regarding the popularity of States loans. Before the flotation of the Central Government’s loans, it is possible to prepare the market for the kind of loan it is proposed to be issued because of the wider field for the investment of Government of India securities. In the case of States loans, the field is limited and the interval between the flotation of Central and States loans is even more limited, not to forget the fact that the so called slack season is hardly three months in a year. Again the credit of each State Government is rated differently by the market as evidenced by the quotations and their popularity also varies. There is a lack of appreciation of relevant factors when one talks of nursing the market for States loans. What happens is that no sooner than the lists of States loans are closed, there begins a selling pressure from those who took the loans and as the field is limited and the amounts offered at times bear a larger proportion to the recent debt incurred, the result of a drop in quotations is naturally exaggerated.

3. From the foregoing, you will observe that the statement that the Reserve Bank does not “support” States loans in the open market is correct. The reason is obvious. In the first place, we do not hold, as I said above, a portfolio of States loans because of the composition of our reserves, though in exceptional times as in the difficult days of summer of 1947 we do buy in moderation such loans; and in the second place the loss resulting from open market operations will eventually have to be borne by the Bank, which will be passed on to the central revenues by a reduction of profits. I can take a safe bet, that once we start supporting States loans by buying them, the Reserve Bank will soon become an asylum for such securities and we shall be kidding ourselves by a lot of created money. Any limit we may impose on such purchases would hardly avail in these days of financial stringency. If sales of States’ Governments
securities are not indulged in, we should have no hesitation in accepting pledges of such securities for advances. So far my experience has been that no such proposal for pledging has been made. The “Commerce” apparently got some misinformation from some irresponsible broker which it put out in its issue of September 1. In the nature of things States loans have not that liquidity which the Central Government loans have and unless we formulate some scheme by which the States Governments would bear the losses resulting in the open market operations in their loans, nothing can be done further in the matter, unless the Centre is prepared to subsidise.

4. As regards Sri Vaikunth L. Mehta’s observations, I do not see how the Reserve Bank can in the existing state of affairs ‘nurse’ States issues beyond so timing the loans as to derive benefit from the payment of 1951–54 loan and by refraining from sucking the market of funds by sales of Government of India securities or the issue of treasury bills. Nursing of Central Government loans is done by buying or refraining from sales of appropriate securities and, as you know, what we do is really to go off the market in selling securities before we float a Central Government loan so as to create an attractive appetite for the new loan. This we cannot do for the States for reasons explained above. I have come to the conclusion that borrowing by multiple Governments is not on the whole conducive to orderly borrowing on any appreciable scale. Moreover, as things are at present, we cannot have different dates for borrowing by various States nor can we have different maturities without causing discrimination.

5. As I shall be in Delhi in the course of the next two days, we shall have an opportunity of discussing this matter.

Yours sincerely,

N. Sundaresan

Shri K.G. Ambegaokar, I.C.S.

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CONFIDENTIAL
CHIEF MINISTER OF MADRAS

Fort St. George
MADRAS

July 11, 1952

[My dear Rama Rau.]

You are no doubt aware of the difficult political situation that is obtaining in this State. The taxation proposals which are embodied in the budget are meeting with much resistance, as indeed, was to be expected, but I am not without hopes of retrieving the bulk of them. At this juncture, it is very desirable that Madras should face the money market boldly and could demonstrate that she commanded the confidence of the investing public all over the country. In this Government’s letter No.[...] dated 9-7-52, the Bank has been requested to assist this State to raise a loan of Rs 5 crores, including a conversion operation of the sum of Rs 219 lakhs, due for repayment this year. If you time the new loan suitably and offer reasonably attractive terms, it should be possible to do the conversion without hitch. In that case, the amount of fresh money that has to be tapped is less than Rs 3 crores, which is about the sum raised by this State during each of the last 2 years. I believe it
will have a very useful heartening effect on the morale of the country if we
could announce that Madras has successfully raised a loan of Rs 5 crores in
the open market. In sheer self-interest, if not on nobler impulses, some of the
money bags should hasten to strengthen my hands. You may kindly advise me
in time on this matter and also indicate the method of any special approach, if
you recommended such a course. I hope you will help.

Kind regards,

Yours sincerely

[C. RAJAGOPALACHARI]

SECRET

D.O.No.[...]

My dear Rajaji,

Your letter of July 11th, which I have just received, has crossed my letter dated
July 12th to Shri Subramaniam. I fully appreciate the very difficult circumstances
under which you have to carry on the administration and I need hardly repeat the
assurance I gave you personally in Madras that I will do my utmost to help you in
your financial difficulties, which I know have repercussions on the political situation,
though the Reserve Bank is not directly concerned with the political aspect.

2. This year I have introduced an important change in the loan procedure that we
hitherto followed. As you know, the Government of India invariably issued their
loans first and the States were obliged to go into the market later. There were good
reasons for this procedure, which I need not go into now. I have, however, persuaded
the Finance Minister to allow the States Governments this year to issue their loans
first, and you will observe from my letter to Shri Subramaniam that I have suggested
a rate of 4% for a 12 year loan, to be issued at a slight discount. This happens to be
the rate which you mentioned in the course of the interview I had with you.

3. The other departure I have made is in regard to the amount of the loan to be
issued. We have in the past given the States an estimate of what, in our opinion, the
money markets were likely to take. This estimate was based on the money available
in the market, the attitude of banks, insurance companies and other institutions, our
own open market operations etc. I am sure the Madras Government will recognise
that our estimates in the last two years were not pessimistic. The figures for Madras
are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Original Bank's Public proposal</th>
<th>recommendations</th>
<th>subscriptions</th>
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</thead>
<tbody>
<tr>
<td>1950: 3%</td>
<td>13/14 crores</td>
<td>3 crores</td>
<td>311 lakhs</td>
</tr>
<tr>
<td>Madras 1960</td>
<td>+ 1 crore by Tirunelveli ryots</td>
<td>taken by Government</td>
<td>128 lakhs</td>
</tr>
</tbody>
</table>
1951: 3 1/2% 5 crores 3 crores 1962
Madras Public 189 lakhs
issued Reserve 10 lakhs
at 99/12 Bank 50 lakhs
State Govt. 52 lakhs

Rs 301 lakhs

This year I am not asking the States to adhere to our estimates (the States were never under an obligation to accept our figures) and I am leaving it to the State Governments to determine what amounts they feel they can raise. In regard to development projects, there is a good reason for the States making their own decisions, for appeals to local patriotism and propaganda have a considerable influence on subscribers in the areas affected by the development schemes. You are in a far better position than we are to assess the results of an intensive campaign in the areas concerned. Even capitalists and other investors not directly concerned would undoubtedly be influenced by the possible political repercussions, if the loan should fail. If you feel that by your personal exertions, which I know will have a profound effect, you can raise Rs 5 crores, I will have no objection. You will, of course, appreciate that the Reserve Bank will have to be impartial in regard to their own subscriptions, if any, and it would not be possible to give any undue preference to any one State.

4. I may add for your information that when circumstances were not propitious for a successful loan last year in West Bengal, Dr. Bidhan Roy was able by private arrangements with insurance companies, banks and other big investors to get the entire amount subscribed before the date of issue. You will no doubt consider whether you should make a similar attempt to raise at least a portion of the loan in Madras. In any case, an intensive campaign will be necessary to mobilise public opinion in favour of the loan.

With kind regards,

Yours sincerely,

B. RAMA RAU

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My dear Rajaji,

Your telegram regarding the Madras loan. I have asked Sundaresan to explain the position to Varghese on the telephone. So I have not sent you a reply by telegram. When I made the suggestion about sale of Madras Government securities in lieu of cash payment, I was under the impression that you could sell the securities in your Cash Balance Investment Account. Varghese has just told us on the phone that these securities have been earmarked for some Fund. In the circumstances, the suggestion is not feasible.
2. We have explored all possibilities in regard to your suggestion that you should be allowed to retain the excess for ways and means purposes, but we cannot think of any expedient by which this can be done. As you know, with your approval, I issued a statement yesterday that applicants who had subscribed more than a lakh would receive partial allotment. Even if the suggestion was otherwise feasible, we cannot now say that no partial allotment will be made. It is well known that the loan has been heavily oversubscribed, and many of the applicants may insist on the return of the balance, especially as the new loan is now quoted at a discount.

3. I may also point out that according to the Madras loan notification, the proceeds of the loan will be utilised only for capital expenditure on electricity schemes and productive irrigation works. It would hardly be proper to use it for any other purpose, although there would, in practice, be no means of discovering how the loan has been utilised. I am very sorry that I cannot help you in regard to this matter, but you will appreciate that any departure from the authorised terms of the loan notification would provoke criticism and tend to destroy public confidence.

With kind regards,

Yours sincerely,

B. RAMA RAU

The Hon. Shri C. Rajagopalachari
Chief Minister
Madras

***

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI

D.O.No.[...]

December 12, 1952

My dear Bala,

I enclose a copy of the West Bengal Government’s letter No. [...] dated the 4th December, 1952 [not reproduced], in which they have asked for sanction to their raising a further loan of Rs 2 crores for financing their schemes for the development of salt production and for the Calcutta Sewage Gas. We are consulting the Planning Commission about the desirability of West Bengal launching the schemes which are outside the Plan and which, because of the limited financial resources which are likely to become available during the period of the Plan, may well jeopardise the schemes in the Plan. Meanwhile, on the question of the loan itself our line will presumably be that, if the West Bengal Government are reasonably certain that they can get this additional money, we need not raise any objection to a further issue of this year’s loan on the lines of the arrangements which have recently been accepted in the case of the U.P. Government. We will, however, be grateful for your comments both on the proposal and also the prospects of its success.

Yours sincerely,

H. S. NEGI
[For information: There could be no public issues of a loan. If the West Bengal Government are able to privately negotiate with any institution(s) for taking up a further sum of Rs 2 crores of their last loan a fresh issue may be created as in the case of U.P. Govt. It is, however, doubtful if the schemes, especially the development of salt production could be considered as so urgent as to be taken on Govt. Account and whether they will be able to find the balances of nearly Rs 5 crores in the next year or so in addition to the finance they will be requiring for the schemes already approved under the 5-year plan. If approved, we may reply on the above lines.]

G.B. 13/12/1952

CONFIDENTIAL

D.O.No. [...]  
My dear Negi,

Will you please refer to your D.O. letter No. [...] dated the 12th December 1952 regarding the proposal of the West Bengal Government for raising a further loan of Rs 2 crores for financing their schemes for the development of salt production and for the Calcutta Sewage Gas?

2. In our opinion, the tendency of State Governments to pursue their own paths would run contrary to the idea underlying the appointment of the Planning Commission. The object behind the setting up of the Commission is that all schemes should be approved or formulated by a central authority which should be able to decide upon the relative priorities and the allocation of resources. These objects cannot be achieved if State Governments are allowed to formulate their own schemes and use their influence with banks and insurance companies or other investors to raise the initial finance required for embarking upon these projects. Any funds that the State Governments may be able to raise by bringing pressure to bear upon insurance companies or other investors will necessarily entrench upon the resources available for the schemes approved under the Five Year Plan as the total of investible funds in the hands of institutions and others is limited.

3. It is doubtful if the schemes proposed by the West Bengal Government could be considered so urgent as to be taken upon Government account and whether the Government would be able to find the balance of nearly Rs 5 crores in the next year or so in addition to the finance that they would be requiring for the schemes already approved under the Five Year Plan.

4. One possible way out of the difficulty would be to lay down a requirement that if a State Government desires to embark upon a scheme, it may do so with its own resources, but if it wishes to raise funds from the market, whether by the issue of a public loan or by negotiation with private investors, it must obtain the approval of the Planning Commission for the project. This will ensure that only schemes which are considered desirable in an all-India perspective and in accordance with an approved order of priorities, are embarked upon and that resources are not frittered away in carrying out schemes, which may appear important to an individual State but may not be so having regard to the overall requirements of the economy. This proposal would
still leave the States free to pursue their own projects even though these may not be of sufficient importance to justify the expenditure of scarce resources. It would, however, tend to minimise the danger of uncoordinated planning and overlapping, which is inherent in the present position.

Yours sincerely,

G. BALASUBRAMANIAN

Shri H.S. Negi
Deputy Secretary to the
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

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SECRET

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]

My dear Subramaniam,

Will you kindly refer to para 2 of my D.O. letter No.[...] dated the 29th May, 1953, in which I had mentioned that I shall be writing to you after consulting the Reserve Bank, on certain points raised by you regarding the current year’s loan and the State agreement with the Reserve Bank? This has since been done and the position is as follows:

(a) On examination it does not seem to be a practicable proposition for the present Government to raise a loan from the market before the partition on the basis that subscriptions in the respective areas will be spent on works in that area. Under the constitution, the proceeds of any loan raised by the present Government will be credited to the Consolidated Fund of the State and will merge in its balances. Under the proposed legislation for the setting up of the Andhra State the balances of the present State on the date of the partition will be divided in a certain proportion between Madras, Andhra and Mysore. There is no means of securing that the sum raised by the market loan will, in fact, be available in the cash balances of the Government on the date of the partition. This is most unlikely in view of the fact that between now and the 1st October, 1953, the present Government will be in continuous deficit. Even if the amount were so available the proportion in which the cash balance, including this amount, will be divided may not reflect the subscriptions realised in the respective areas. It has also to be remembered that if the subscriptions are so earmarked there will be no money for repaying the maturing loan on the 15th September 1953, the burden of which will fall on the present State. In view of all these complications, I feel that the most prudent course is to float a loan in the ordinary course, without earmarking the proceeds for any specific area and use them for repaying the maturing loan and meeting the current capital requirements thereby reducing the overall ways and means accommodation from the Centre. The Reserve Bank are also of the same view.
(b) The Reserve Bank have to adopt a uniform policy in regard to accommodation given by them to the States and they are reluctant to agree to give ways and means advances in excess of the amount under their agreement without security. If a State Government do not have securities to pledge they will have to arrange for raising money by treasury bills or take loans from the Centre.

I trust that this makes the position clear.

Yours sincerely,
C.D. DESHMUKH

Shri C. Subramaniam
Finance Minister
Government of Madras
Madras

CHIEF MINISTER OF MADRAS

D.O.No.[...]
[My dear Rama Rau,]
The enclosed copy of the letter to Deshmukh will speak for itself. Please help.
Yours sincerely,
[C. RAJAGOPALACHARI]

[It seems sad to give back money which subscribers definitely want to give us for our ways and means. C.R.]

Copy of D.O. dated 20th July 1953 from the Chief Minister, the Government of Madras to Shri C.D. Deshmukh, Minister for Finance, Government of India, New Delhi.

1. Our loan was oversubscribed by Saturday to the extent of Rs 125 lakhs. As in last year, I am glad that agriculturists and other non-institutional investors supported us in large numbers. Banks and other institutional subscribers are holding out till the notified closing date. I have called off the drive in the districts of the Residuary State. The Andhra target of Rs 2 crores may be reached in two days and I shall call off the drive in those districts also.

2. Under the terms of the notification, the loan has to be kept open till the 31st of July. Since interest is payable in any case from 15-7-1953, a few institutional investors are holding back to the last notified date. The loan may therefore be very substantially oversubscribed by the closing date.

3. In making allotments, subscriptions of Rs 1 lakh and less have to be accepted in full and this will cover the agriculturists and small investors. Refunds will therefore be mostly to institutional investors. The terms of our loan are favourable and investors are by no means anxious to take refunds. Besides, they will lose interest from the 15th of July on the sums becoming due for refund. This may be an important consideration with many of them and they will be all the more anxious to get acceptance in full. You are well aware of our financial difficulties and the necessity for the two
new States to start with a fair opening cash balance. I hope it will be possible for you to find a way by which we can retain the full subscriptions, even if it may sound a bit unorthodox. The Reserve Bank may even now consult the larger investors, whose number may not be many, whether they would like full allotment or whether they would insist on partial allotment, as per the terms of the notification. Chances are that the large bulk of them may agree to full allotment and it may be possible that legal difficulty can be got over that way. Perhaps the Reserve Bank may be able to suggest an easier way of achieving the same result.

4. When our ways and means position is as difficult as it has been and will continue to be, it appears to me we must find some way of retaining money voluntarily offered by subscribers for this loan if we can at all do it properly and legally.

5. I am sending a copy of this letter to the Governor of the Reserve Bank in the hope that he will find a way out.

CONFIDENTIAL

D.O.No.[...]

RESERVE BANK OF INDIA
BOMBAY
July 21, 1953

My dear Deshmukh,

Rajaji has sent me a copy of his D.O. letter dated July 20, 1953, regarding the Madras loan, which as you know, has been heavily oversubscribed. The figures for Andhra and Residuary Madras last evening were as follows:-

<table>
<thead>
<tr>
<th>State</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra</td>
<td>Rs 163 lakhs</td>
</tr>
<tr>
<td></td>
<td>(includes Rs 63 lakhs conversion)</td>
</tr>
<tr>
<td>Residuary Madras</td>
<td>Rs 596 lakhs</td>
</tr>
<tr>
<td></td>
<td>(includes Rs 74 lakhs conversion)</td>
</tr>
<tr>
<td>Total</td>
<td>Rs 759 lakhs</td>
</tr>
</tbody>
</table>

2. Under the terms of the loan notification, the Madras Government are entitled to retain Rs 5 crores plus 10%, i.e., Rs 5½ crores. Subscribers of Rs 1 lakh and less have to be given full allotment, while those who have subscribed more than Rs 1 lakh will get partial allotment. Rajaji observes in his covering letter to me that “it seems sad to give back money which subscribers definitely want to give us”. There is considerable force in this statement, especially as Madras is badly in need of money. I would, therefore, suggest that persons and institutions who have subscribed more than Rs 1 lakh be given the option of receiving partial or full allotment. I enclose a draft notification, which could be issued by the Madras Government. Our legal officer states that this procedure would be quite legal, and subscribers can have no grievance, since they are given the option of receiving partial allotment.
3. I should be grateful if you would convey your approval on the phone tomorrow morning. West Bengal made a similar request, but we had already issued orders regarding partial allotment. If we allow Madras to keep the surplus, West Bengal will also have to be allowed to do so. I have asked our Calcutta branch not to make any partial allotment until further instructions.

Yours sincerely,

B. RAMA RAU

Shri Chintaman D. Deshmukh
Finance Minister, India
New Delhi

**DRAFT NOTIFICATION**

It is notified for the information of the subscribers to the 4% Madras Loan 1963 that the said loan has been heavily oversubscribed. Although paragraph 7 of the Madras Government Finance Department Notification [...] dated the 11th July 1953 provides for partial allotment to subscribers in cash for sums of over Rs 1 lakh, Government consider that applicants who desire to have the full amount of their applications should be permitted to do so. Applicants who, however, wish to have the excess amount refunded to them are requested to make an application in writing before the 31st of July 1953 to the office at which the original application was made. In the absence of any such application for refund, full allotment will be made on the assumption that no refund on partial allotment is claimed.

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GOVERNMENT OF MADRAS
FORT ST. GEORGE
MADRAS
September 27, 1956

D.O.No.[...]
My dear Ambegaokar,

You will recollect my representation on the phone immediately after the closure of the Madras Loan for the year that we had done intensive canvassing in the districts and this would result in some selling pressure till the securities found their way to more permanent resting places. You must have noticed from your office returns that there were over 25,000 subscribers to this year’s Madras Loan. Even granting that investment in Government bonds is becoming popular in the agricultural sector, not all the 25,000 could have been genuine investors. Whatever be the orthodox views on this form of salesmanship, we have to recognise the fact that the method has proved effective for hard-pressed States and will therefore be repeated. It is therefore prudent that we devise correctives to ensure that the bonds do not slump immediately after issue and thereby prevent avoidable loss to fugitive investors. The market quotation of
the Madras and Andhra issues are roundabout Rs 99-4-0 today and this is entirely due to the selling pressure by such of the agriculturists as had merely obliged district officials. I am sure the position will improve in a few months but you can expedite that process by some little concealed buying in the open market in Madras, Coimbatore, Madurai and Bezwada in Andhra. The amount you have to invest to make an impression on the market, may not be more than about Rs 50 lakhs and this is only a fraction of the sum you were willing to invest in case we had not reached our targets. The very fact that there is a buying enquiry in important centres, will immediately stabilise the position and the movement of the bonds from the unwilling investor to the willing one will be smooth and unnoticed. You may even be able to sell these bonds again after a time and make a small profit in the bargain. Perhaps it is not usual for the Reserve Bank to buy up State securities, but when the States do operate in the money market on as large a scale as at present, it is only prudent that the Bank gives them a measure of timely support in this way. We are ourselves buying in the local market to stabilise the price but the funds at our disposal are limited. Besides, we should normally go in for Central Bonds which alone would provide us cover for ways and means advances.

With regards,

Yours sincerely,

T.A. VARCHES

SECRET

RESERVE BANK OF INDIA

BOMBAY

D.O.No.[...]

October 1, 1956

My dear Varghese,

Will you please refer to your letter D.O.No.[...] dated 27th September 1956 suggesting that the Reserve Bank should make some purchases of your new loan which is quoting at a discount of 8 annas at Rs 99141/-? I remember that when you spoke to me on the phone about the closing of your loan you had mentioned the possibility of some support being required and pleaded that it should be given. We have been carefully studying the results of this year's State loan flotations and feel that it would be inadvisable for the Reserve Bank to buy any of these loans from the market for the following reasons.

2. What you have said about fugitive investors is not only true of Madras but of most of the States. Further it applies not only to individual investors but also institutional ones including banks. Your estimate that we may have to invest not more than Rs 50 lakhs is bound, therefore, to be considerably exceeded even for the Madras loan. The issues of other States, particularly Andhra, U.P. and Orissa, are also in the same position and they would also expect the same assistance from us so that if we agree in the case of Madras we shall have to be prepared to invest a very large sum indeed in the State loans. The floating stocks of all the State loans on the market are estimated at as high a figure as Rs 15 crores.

3. You have argued that we had agreed to take upto 10 per cent of your issues to enable the subscription list to be closed and that since we did not have to subscribe
anything initially we should now be prepared to use a portion of that money in making purchases from the market. I am afraid, the two situations are very different and not at all comparable. It is one thing for the Reserve Bank to agree to make a contribution for the purpose of insuring against the failure of the loan, particularly as the State Governments wanted to fix as large a target as possible and at the same time did not wish to risk a failure. To undertake to support the loan after it is issued in order that the investors may not suffer a loss is quite a different proposition. Such an undertaking would involve unlimited commitments and cannot be justified. It is not as if a few purchases by us would stop the selling pressure. What we are afraid of is that as the price goes up there will be more sales and if the price comes anywhere near the issue price even other investors like banks, who are holding back at present in order to avoid booking heavy losses, will start unloading. As it is, we seem to have financed a considerable portion of the loan subscriptions through our loans and advances to scheduled banks, which show an increase of Rs 36.7 crores during the three weeks ended September 21, 1956, the period during which the impact of the State loans was reflected in the financial position of the banks. Of this at least Rs 17 crores would seem to have been taken by banks against their purchases of the State loans. If we were now to start buying the loan, what was a temporary accommodation will become a long-term investment by us. You think that we should be able to sell out after a short while at a profit, but we cannot be so sure of this. Our experience of holding the 3½ per cent National Plan Loan of 1964 which was shared by the Central Government with the States shows that it is very difficult for the Reserve Bank to get rid of loans which have been forced on the market. In any case, it does not seem to us right that the Reserve Bank should be expected to take up loans for which it is claimed that they have helped to mop up surplus money from the mofussil. The whole object of the drive to secure the money from the countryside would be defeated if ultimately the loans are to come to rest with the Reserve Bank. In that event far from helping to keep down inflation they would be directly inflationary. It would also serve to conceal the real position and thus encourage the States to issue even larger loans in future without having to face the consequences of such action.

4. There must of course always be an element of fugitive investors, but their place must be taken by genuine investors and not the Reserve Bank. As other States also have adopted the Madras technique, the weight of the State loans on the market appears to have become too heavy to be supported by small purchases by the Reserve Bank. If you say that the Madras Government have to go in for Central bonds which alone provide cover for ways and means advances it is even more true that the Reserve Bank has to hold Central loans as a cover for the note issue. As you know, we cannot expand currency against State Government securities. Actually I find that against the maximum limit for grant of special ways and means advances of Rs 2 crores you already hold Rs 8.57 crores of Government of India securities so that it would seem that you have considerable scope for investing your funds in your loans. There is no reason why you should not invest the sinking fund contributions, prescribed for the loans issued by you from time to time, in your own issues. This is the advice we have recently given to Andhra and U.P. who have now agreed to put a part of their availabilities on this account in their new loans. Besides yourself the institution which
can make long-term investments is the Life Insurance Corporation and I understand that they have been making some purchases in the market. Provident Funds might also prefer the higher yield of State loans to those given by Central loans. I would suggest your canvassing help from these quarters instead of depending on the Reserve Bank to come to your rescue. It is not that we do not wish to help the State Governments, but we feel that purchases by the Reserve Bank will not be the correct course. I hope, therefore, you will appreciate our inability to comply with your request.

Yours sincerely,

K.G. AMBEGAOKAR

SECRET

CHIEF MINISTER
GOVERNMENT OF WEST BENGAL
CALCUTTA

D.O.No.[...]

March 20, 1957

My dear Iengar,

In September last we raised a loan of Rs 7 crores through and with the support of the Reserve Bank. The Finance Minister approved of such support. In November last the Bank advised that in view of great selling pressure in State loans we should place Rs 50 lakhs at the disposal of the Bank to purchase our own loans in the open market. We accordingly placed a sum of Rs 50 lakhs at the disposal of the Bank. In December the Bank again requested us to place a further sum of Rs 50 lakhs at the disposal of the Bank for the same purpose.

You will appreciate that the loan was raised for financing certain definite schemes in the Plan and it was the Planning Commission which insisted on our raising a loan of Rs 7 crores per year during the Plan period. We presumed that before making the estimate of the loans to be raised by this and other State Governments the Planning Commission consulted the Reserve Bank. In any case, if after raising the loan and starting implementing the schemes we have to buy back our own loans to the extent of Rs 150 lakhs in course of a few months, the position becomes really difficult. We are, however, authorising the Reserve Bank to make further purchases to the extent of Rs 50 lakhs as advised by the Bank; but it would not be possible for us to make any further allotment for this purpose. I hope if any further support is necessary this year or in future years, it will be possible for the Reserve Bank to give the support. In fact we are hoping that the Reserve Bank will be able to restore good conditions in the market so that it would be possible for it to sell back securities at good prices.

I am sending a copy of this letter to Sri T.T. Krishnamachari and also to Sri V.T. Krishnamachari.

Yours sincerely,

B.C. ROY
My dear Dr. Roy,

I am writing with reference to your D.O. letter No.[...] dated the 20th instant regarding the West Bengal loan of Rs 7 crores floated last year. As it appears that all the facts are not before you and there is also some misapprehension regarding the role of the Planning Commission in the matter of these loan issues, I am setting out the position of the Bank at some length.

2. I find from the papers that at the time of the flotation of the State loans last year, the Bank had emphasised in its communications, as well as in the discussions which Ambegaokar had with the representatives of the State Governments, that it would not be safe for the State Governments to base their expectation on the amount to be raised from the market on the basis of the experience during the previous year. The Bank had, on more than one occasion, drawn pointed attention to the monetary stringency and the fact that the capacity of the market to absorb the State loans had diminished considerably, as contributions from banks and insurance companies, who had all along been the principal supporters of the State loans, would be smaller than in the past. I would refer in this connection to Rama Rau's D.O. letter No.[...] dated 29th June 1956 and Ambegaokar's D.O. letter No.[...] dated 21st July 1956. In spite, however, of the advice given by the Bank, your Government decided not to make any reduction and adhered to the figure of Rs 7 crores. As was anticipated by the Bank, there was not sufficient response from the market in spite, we understand, of your own personal efforts and even after the Government had subscribed Rs 123 lakhs themselves, the Bank had to put in a tender on its own behalf for Rs 140 lakhs in order to close the loan and save the Government from an embarrassing situation. Although it was made clear in the Bank's letter dated 21st July 1956 that the maximum contribution by it, in the event of shortfall, would be limited to 10% of the subscriptions from the market, which in the case of your loan would have been about Rs 58 lakhs, the amount taken up was more than double this amount.

3. According to information available to us, several State Governments in their anxiety last year to make their issues a success, resorted to pressure on investors, both individual and institutional. It is, of course, perfectly proper to canvass for subscriptions and indeed not to do so would be a negligence. But in some of the States pressure was exercised to a point at which institutions and individuals subscribed to State loans far in excess of their available resources. Soon after, these unwilling holders started selling off; and it was mainly as a result of such sales that there was unusually heavy selling pressure in State loans with the onset of the busy season in October last. This pressure still persists even though large purchases have been made by the Bank on behalf of the State Governments and Administrators' funds. The recent debacle in prices of States loans, which led to a sympathetic fall even in the case of Central loans, was largely due to the fact that the State Governments had fixed their loan targets for 1956 too high and had borrowed amounts far in excess of the capacity of the market. While the Reserve Bank is at all times willing to assist the State Governments in their loan operations, we have always hoped that on their part the
State Governments would heed the advice of the Bank. If the State Governments do not accept the advice of the Bank, it seems only fair that they should be prepared to accept full responsibility for the consequences. Moreover, the assistance which the Bank can render to State Governments can only be for temporary periods and when the Bank buys State loans either out of the new issue or from the market there must be a reasonable prospect of the Bank being able to dispose of the purchases to the market in the near future, else it would amount to the Bank financing capital and development projects of State Governments with created money. This year for instance, such large amounts have been offered for sale that had the Bank purchased them on its own account, it would have been quite impossible for it to unload the purchases for a long time to come. It was, in these circumstances, that we had to advise the State Governments to make available their own funds to support the loans. In the case of your loan, having already taken as much as Rs 1.40 crores at the time of issue which it would not be possible for the Reserve Bank to dispose of for a long time, it would clearly not be desirable for us to lock up further funds in it. On the other hand, repurchase by the State Government would amount to recognition of the fact that you have not been actually able to raise the full amount of Rs 7 crores and it would seem better to adopt this course than to take the risk of depreciation which may create difficulties for future borrowing.

I entirely agree with you that every effort should be made to restore health to the securities market and as you must have noticed, this is exactly what we have been endeavouring to do. The steadiness of the gilt-edged market when the share market has collapsed and there is an acute stringency of money, is a testimony of our efforts. You have referred to the role of the Planning Commission in the matter of the loan issue of Rs 7 crores. It has never been the practice of the Commission to consult the Bank regarding public loans to be raised by State Governments. Indeed, it is not within their province to advise on the amounts which can be raised by State Governments in the market in any particular year. The competent authority in this matter is the Reserve Bank which is in close and intimate touch with the market.

Yours sincerely,
H.V.R. IENGAR

Dr. B.C. Roy
Chief Minister
Government of West Bengal
Calcutta

***

SECRET

RESERVE BANK OF INDIA
Camp: MADRAS
May 29, 1957

Dear Shri Krishnamachari,

You may remember that, after discussion with you, we wrote to the State Governments advising them not to float any loans in the market this year and adding that if in spite of our advice, they decided to do so, they must be quite clear in their
minds that they would not get any support from the Reserve Bank. In reply to this circular we have received letters from various State Governments to the effect that they do propose to float loans, totalling in all Rs 37 crores, the significant exception being West Bengal which has agreed to keep off the market.

2. I decided to discuss the subject with the Finance Ministers of Madras and of Mysore during my present tour in South India. The Mysore case is rather a special one as they have to repay a loan floated previously. The Madras case is very similar to that of other States in that it has a heavy development programme involving capital expenditure which it would be difficult for them to stop or slow down.

3. I do not like to burden this letter with a detailed exposition of all the arguments which were raised in the course of my discussions. Briefly, I pointed out that the securities market for State Government loans had got demoralised, more particularly because of the tremendous amount of official pressure that had been used last year in certain States, for example Madras, in collecting loan subscriptions. The bulk of the money supposed to have been subscribed by individuals in fact came from the banks; the individuals in many cases lost the money which they advanced from their own resources, usually 5 per cent. On their part, the banks have suffered on account of depreciation of the securities. The Madras 4½% 1968 has now dropped to Rs 96.40 and, even at that price, it is very difficult to sell. There are brokers who have told me that they find it difficult to sell even small amounts of Rs 10,000. I expressed the fear that if the Madras and Mysore Governments wanted to float loans this year, they could not possibly do so at less than 4½%. Even so, a great deal of official pressure would be required and a good part of the loan would rebound on the market and the prices would be depressed. There would be two consequences, both equally serious. If it was known that the State Government was coming on the market—and the market now realised that the State Governments could not do so at less than 4½% — the Central Government loan, if we wanted to issue it at possibly 4%, would become a flop. Secondly, the exercise of a great deal of pressure would result, as happened last year, in demoralisation of the market for State Government securities and that would result in a general aversion to Government paper, which would have serious consequences for the future. I explained that this was really the reason why we had advised the State Governments to keep off the market this year.

4. In both Mysore and Madras this point is appreciated but is met by the counter argument that they must have the money which they have budgeted for either directly through a loan operation conducted by themselves or through a further loan granted by the Central Government. In the case of Mysore, the loan required is about Rs 5 crores and in the case of Madras about Rs 10 crores. The Madras Finance Minister stated that, while small savings here and there may be possible, the schemes included in the Madras Plan were such that it would not be possible to stop them at this stage or slow them down without serious economic consequences. He said he could not possibly contemplate this. He was agreeable to one combined loan for both the Centre and the States being floated by the Central Government and the proceeds distributed on some rational basis. In other words, he was agreeable to the arrangement that we actually used in the year 1954. The Mysore Government put forward the same suggestion on their own.
5. In the course of discussion, we did contemplate the possibility that even a single issue may not result in getting from the market Rs 100 crores which is in the Central Budget plus Rs 57 crores which, I understand, is the figure of loan requirements of all the State Governments. In that event, the Plan may have to be cut down; but as that would be very difficult and contrary to the express intentions of the Government of India, the consequence would be that deficit financing would have to be increased in magnitude. That is likely to have serious inflationary consequences. The Madras Finance Minister told me quite frankly that as between facing a general disruption of the economy by increased deficit financing and getting a State loan through the use of pressure by the entire apparatus of the State Government, he would much rather prefer the latter. At worst, he said, this would have the same effect as a tax by the State Government. It might make the State Government unpopular but he would much rather have this than a general upward swing of inflationary forces in the country which might be the result of increased deficit financing.

6. These points obviously require further consideration. I think it would be very difficult to take the line that we advise the State Governments to keep off but if they do insist on coming into the market we wash our hands off them and they take the consequences. The trouble is that there will be serious consequences for the Central Government themselves because their own loan operations would be affected by the knowledge in the market that State Governments are also going to float loans. Moreover, as the local Finance Secretary, Varghese, pointed out to me, the Central Government cannot really wash their hands off this matter. If it comes to the worst, the State Governments will raid currency chests as has happened before and as is happening at present. We have now reached the situation in which the States and the Centre must take concerted action in the matter of raising loan resources.

7. After turning this matter over in my mind, I have come to the conclusion that the whole matter requires a little further consideration. I think it would be best if you could hold a conference with a few selected Finance Ministers and the Reserve Bank so that the matter could be thrashed out further. Apparently the National Development Council is not the right forum for this purpose, for few of the Chief Ministers who would be present, are also Finance Ministers of their States.

8. I am myself greatly concerned that the loan operations of the Central Government this year should be a success in the sense that we get all the money that we have planned for at as reduced rates as possible. I am also concerned that the demoralisation that has set in the securities market in the sense both of a depreciation of securities values as well as the difficulty of selling even small lots should be set right. On the other hand, the State Governments are oppressed by the problem that they must get on with the Plan and must find the resources for it, without adding to the inflationary pressure in the economy. I commend to you the proposal that a conference on the lines suggested above be held at the earliest possible opportunity. It could be held in Delhi; but if you would prefer to hold it in Bombay, I would, of course, be delighted to give all the required facilities in the Reserve Bank.

Yours sincerely,

H.V.R. IENGAR

***
D.O.No.[...]  
My dear Shri Reddi,

Will you please refer to the correspondence resting with my D.O. letter No.[...] dated 16th July 1958? A recent analysis of subscriptions to the State Government loans issued in 1958 prepared by our Department of Research and Statistics has revealed that among all the State Loans, the Andhra Loan alone had a disproportionately high contribution by individuals and the percentage of subscriptions from non-institutional investors in its case was as high as 45% followed by 16% for the Uttar Pradesh Loan, 15% for Rajasthan and much lower for other States. Though on the face of it, it may seem gratifying that there should have been such an outstanding response in Andhra by individuals, the information obtained by one of our senior officials who visited the districts indicates that severe official pressure was used in collecting subscriptions to the Andhra Loan in spite of the instructions issued by you to the Collectors as a result of my D.O. letter No.[...] 11th July 1958. It appears that each district was allotted a set target and the Revenue, Registration and Sales Tax officials who were called upon to complete the allotted quotas passed on the burden in turn to the lower officers of the Departments and considerable pressure was brought to bear on individuals to subscribe to the loan. In certain cases, the individuals who were not inclined to, or could not take, the allotted amount, were given the alternative of paying 10% of the amount without any return whatsoever. The amount so collected was used to induce well-to-do persons to purchase these bonds at a special discount of 10%. Certain revenue officials put pressure on tax-payers to purchase bonds equivalent to the land revenue or to pay 10% of it gratis. We need hardly reiterate that such pressure tactics would seriously affect the future borrowing operations of the State Government and would thus be self-defeating. What is, however, even more disquieting is that the same technique is being followed for the sale of National Plan Savings Certificates and you may be interested to read the following extract from a note recorded by one of our officers:

"Some of the capitalists who purchased the certificates paying only Rs 90/ for the certificates of face value of Rs 100/- wanted to cash them forgoing interest for the year but the petty officials are raising objections, being afraid of the reactions of their superiors on the large-scale repayments. Here the reputation of the Government is involved. Further the public specially those who are paying 10% gratis are exasperated at these demands year after year."

It is also reported that in some villages the collection of land revenue is at a standstill as the parties refuse to pay the extra 10% and the officials refuse to take land revenue unless National Savings Certificates of an equal amount are purchased or the 10% fee is paid. If your district officials are adopting these methods, they would make the National Savings Certificates extremely unpopular among the masses and nullify the constructive efforts that are being made by the various official and non-official bodies to increase the sales of Small Savings Certificates in order to reach the higher targets aimed at for raising resources for the Plan from this sector.

I have taken the liberty of bringing these reports to your notice, as we have no doubt that your Government will feel equally concerned about ensuring that misplaced
zeal and misdirected efforts should not jeopardise the success of loan flotations and collection from Small Savings and would want to take precautionary measures against such methods.

Yours sincerely,

K.G. AMBEGAOKAR

Shri K. Brahmananda Reddi
Finance Minister
Andhra Pradesh
Hyderabad (Dn.)

No.[... of date.

Copy forwarded for information to Shri H.S. Negi, Government of India, Ministry of Finance, Department of Economic Affairs, New Delhi.

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CONFIDENTIAL

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

D.O.No.[...

July 31, 1959

My dear Rangachari,

Mehta tells me that he had a telephone call from Shiv Naubh Singh regarding the publication of the details about the State loans in the "City Notes" column of the Times of India of the 28th instant, i.e. a day before the official announcement was made. I myself was surprised at this scoop and after the loans were publicly announced I made enquiries from one or two brokers as to how the Times could have obtained the information earlier. Their view was that the Press correspondents have a way of ferreting out such information and may have got at one of the several State Governments. I have no doubt that the information did not leak out from the Reserve Bank.

I have also made an attempt to get the truth out of the horse's mouth by sending for Hariharan, the Financial Editor of the Times. He would naturally not disclose the source of his information, but said that he had actually all the details much earlier and had purposely misquoted some of the States' figures to create the impression that he did not really have the exact information. According to him the various States had started canvassing long before the announcement by sending for the local Agents of banks who had sent on the particulars to their head offices. It was not, therefore, difficult to get the details of all the loans from one of these institutions. Some States had also sent instructions to their Collectors which also got known. His point was that newspapers were naturally anxious to publish such information for its news value as early as possible and he had in fact waited till a day before the formal official publication. He was quite unrepentant and even made the point that it was good for the States to get this kind of publicity for their loans.
As you know, we have to deal with several States and in order to enable them to decide the various issues put to them we have to give them particulars of the proposals of not only their own loan but also those of others. Under these circumstances it seems almost an impossible task to secure the same degree of secrecy for the State loans as we are able to achieve in the case of Central loan. At the most, we can make a further effort to secure the cooperation of the State Governments by pointing out to them that since we now allow three weeks between the date of announcement and the opening of subscription lists, this period is sufficient for them to do the canvassing and that they should, therefore, refrain from starting negotiations with banks and others for subscribing to their loans until the announcement is made. I doubt, however, whether this would have any effect. When I made this appeal recently to Dr. B.C. Roy in Calcutta, his reply was that in a previous year when he had waited in this manner, he found when he approached the banks that they had already made commitments to other State Governments, who had got at them earlier. Unless there is a gentleman’s agreement in this matter among all the States, it will be difficult to ensure secrecy. I am also inclined to think that since there is no speculation in the case of State loan issues little harm is done by premature leakage since nobody can make any big profits on the basis of this information. We on our part would, of course, continue to take all possible precautions.

Yours sincerely,

K. G. AMBEGAOKAR

Shri M.V. Rangachari
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

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B. FUNDING OF AD HOCS

SECRET

RESERVE BANK OF INDIA
BOMBAY

D.O.No.[...]

March 18, 1958

My dear Rangachari,

As we explained to you personally, the creation of ad hoc Treasury Bills in large quantities for the purpose of replenishing the Central Government balance is creating some difficulties for us, especially in regard to their accounting. Hitherto, it has been our practice to show all ad hocs under the head “Government of India Rupee Securities” in the Issue Department Statement and to issue notes thereagainst, if currency was required to replenish our cash balance; while if no expansion was necessary, dated Government of India securities of an equivalent value held in the Issue Department were transferred to the Banking Department under the head “Investments”, in order to equalise the assets of the Issue Department with the total note liability. Recently, however, due to the fact that Government balance was required to be replenished on a much higher scale than the demand for additional currency, we had to have recourse
largely to the second alternative of transferring dated securities from the Issue to the Banking Department, with the result that the balance of such securities in the former Department has been greatly depleted. Any further ad hocs created will, therefore, have to be taken directly in the Banking Department or set off against a corresponding transfer of Sterling securities to the Banking Department. The question of showing such ad hocs in the Banking Department was, on a previous occasion, discussed with our Auditors who considered that, since there was a separate head, viz., “Treasury Bills Purchased and Discounted Account” in the Banking Department Statement, such bills should appropriately be taken under that head. They, however, at the same time expressed a doubt whether it could be done so in view of the fact that, although the ad hocs were theoretically to be repaid in three months, it was very likely that they would be renewed from time to time and thus represented some sort of long-term investments, which should more properly find a place under the head “Investments”. The position, in their opinion, was, therefore, anomalous. As for Sterling securities, there was hitherto the restriction that interest on Sterling securities held in the Banking Department was not exempt from British income-tax and, although this limitation is now proposed to be removed according to a recent communication received from the Bank of England, it does not seem proper that a disproportionately large amount of Sterling should be held on the Banking side leaving almost the entire note issue to be shown against ad hocs except, of course, to the minimum extent represented by other forms of assets as laid down by the Act. It has, therefore, become necessary that a portion of the ad hocs should be converted into securities so that the Bank may be able to make their transfers from Issue to Banking Department without any difficulty and without infringing the provisions either of our Act or General Regulations.

2. We were at one time inclined to suggest to Government that the funding should be made into existing loans of various maturities; but on reconsideration we felt that additions to dated loans would not only make repayments in the respective years difficult, but would also have psychologically a depressing effect on gilt-edged prices. We also considered the alternative of issuing a special long-term loan with a specific date of maturity carrying the same rate of interest as obtainable on the Treasury Bills, but this proposal was also found not feasible for the reason that such a loan would not obviously be quoted on the market, a condition which will make the security ineligible for being held in the Issue Department [vide Section 33(4) of the Reserve Bank of India Act]. The obvious course open would, therefore, appear to be to create a further tranche of an existing loan quoted on the market but not repayable on any stated date of maturity.

3. We now hold about Rs 875 crores of ad hoc created for replenishing Government balance and it would seem sufficient if we converted for the present about one-third of this amount, viz., Rs 300 crores into the 3 per cent non-terminable loan 1986-97. The issue price may be at Rs 71 per cent which is almost the same as the current market rate of this security. This will, of course, result in the Bank getting a higher return on the funded portion of the Treasury Bills as compared to that on the unfunded balance, but in our opinion, this is a minor point, since any increase in the Bank’s profits resulting from this or any other cause would automatically accrue to Government. We have also to take into account the fact that the Bank has lost a
good deal of its income in the shape of higher yield on British Treasury Bills as a result of heavy depletion of its Sterling balances. In order that the creation and issue to the Bank of a large block of non-terminable paper may not have any untoward effect on the market, we should simultaneously with the funding operation make it known by means of a Press Note that the issue has been made purely to meet a special purpose and that an undertaking has been obtained from the Reserve Bank that no portion of it will be put on the market at any time. If this is done, there is no reason to fear that the funding of the ad hocs into an existing loan would have any harmful effect on security prices in general. On the other hand, the conversion of a part of the ad hocs held by the Reserve Bank, which are 3 months Treasury Bills, into a long-term loan will be a recognition of the realities of the situation, since it represents in fact a permanent debt of the Government which would not be repaid ordinarily.

4. The balance of dated securities held in the Issue Department now amounts to Rs 5 crores and we shall be glad if Government will take the necessary action as early as possible.

Yours sincerely,

K. G. AMBEGAOKAR

SECRET
SPECIAL SECRETARY

MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]
March 27, 1958

My dear Ambegaokar,

Will you kindly refer to your secret D.O. letter No.[...] dated the 18th instant about the replacement of a part of the ad hocs by the issue of a further tranche of the 3% non-terminable loan 1986–97? Ever since you mentioned this proposal when you were here for the last meeting of the Central Board I have been thinking over the consequences of implementing it and I think that the matter requires some further consideration. If we replace Rs 300 crores of ad hocs with you by the 3% loan 1986–97 at Rs 71 we shall have to create securities of the nominal value of Rs 422 crores and keep the difference in our books as a discount on this issue. Ordinarily, as you know, such a discount has to be written back to revenue over a period and I do not know if it will be possible to hold it unredeemed indefinitely in the debt section. In any case the creation of a block of Rs 422 crores will exaggerate the public debt. It will also involve an addition of Rs 5½ crores to the interest bill (the difference between 2½% on Rs 300 crores and 3% on Rs 422 crores) and while it is true that the bulk of it will come back to Government as surplus profits, I do not think that one can always bank on this, particularly if, as in the last few years the practice of agreeing the amount of surplus profits paid to Government from time to time in informal consultation between Government and the Bank continues. In view of all this I am wondering whether the idea with which both of us initially approached this problem, namely, the creation of a special issue at the rate of interest now paid on the ad hocs is not the really feasible one even if it involves some amendment to the Act. I feel we
FINANCING GOVERNMENTS

should talk this over once again before we make up our minds. I am planning to be there on the 7th April in connection with the Committee on interest rates, if the date is convenient to you and Madan. L.K. is going off to Europe and will not be available but I think we could cover some ground in his absence and conclude the discussions on his return in May. Unless I hear to the contrary from you I shall assume that the date is suitable.

Yours sincerely,
M. V. RANGACHARI

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C. OVERDRAFTS OF STATE GOVERNMENTS

I would like to see the papers regarding the "raiding" of the currency chests by the Madras Government and (more recently) by the Andhra Government. Are there any other sinners?

H.V.R. IENGAR

D. G. (A) K. G. Ambegaokar

Secy.
Please see note below.

As desired by the Governor, letters addressed by the Bank to the Madras Government and the Government of India in connection with the overdrafts of the Madras Government have been flagged[...]. Replies received from the State Government and important notings have also been put up. The account of the Madras Government was overdrawn from April 1951 to July 1953 except for brief periods when they were able to maintain a credit balance, very often as a result of purchases of securities made by us or by the Central Government, financial assistance granted by the Central Government or the proceeds of open market loans. The maximum overdraft was Rs 22.10 crores, with outstanding ways and means advances of Rs 80 lakhs, as on 21st March 1953. In recent years, the Madras Government have been maintaining a fairly satisfactory cash balance with us.

2. The Andhra Pradesh Government have been running an overdraft with us off and on since January 1955 and the highest debit balance was debit Rs 4.52 crores with normal ways and means advances of Rs 60 lakhs and special advances against Government of India securities for Rs 2 crores as on 18th January 1957. Their latest available balance (as on 15th inst.) is debit Rs 2.04 crores with ways and means advances of Rs 260 lakhs. We had called upon the State Government to repay in full the overdraft, as well as the ways and means advances, before the end of February 1957 in view of the provisions contained in the Agreement between the State Government and the Bank which requires a State Government to clear the ways and means advances not later than three months from the date of the initial advances in the series of outstanding advances. The Andhra Pradesh Government have not,
however, been able to square up their account. We have written to them on the 13th instant conveying Government of India’s offer to take over Government of India securities out of the State Government’s holdings to enable them to repay the borrowings from us and to maintain a reasonable working balance to meet normal disbursements.

3. The Government of Orissa have been defaulting in the maintenance of the balance since April 1956, their account being overdrawn on several occasions and for fairly long periods. The maximum overdraft was on the 18th May 1956 when their balance was **debit** Rs 2.28 crores with ways and means advances of Rs 99 lakhs inclusive of special advances for Rs 79 lakhs being maximum advance that could be made to them against their holdings of Government of India securities. Their balance on the 15th instant was **debit** Rs 1.35 crores with outstanding advances of Rs 98 lakhs. In terms of the Agreement with the Bank, the Orissa Government should have repaid the outstanding advances in full before the 28th February 1957. We had asked the State Government to repay their debt to us before that date and had also requested the Government of India to grant sufficient financial assistance to enable the Orissa Government to do so. The Orissa Government have failed to clear the overdraft and the advances and the Central Government have not so far advised us as to whether they propose to make any advances to the State Government.

4. The other State which has overdrawn its account very often during recent times is the Government of Bihar. They had to repay ways and means advances for Rs 240 lakhs before the 15th February 1957. It has not been possible for them to liquidate the advances and their balance has, in fact, become **minus** since 18th instant (**Debit** Rs 11 lakhs with ways and means advances of Rs 210 lakhs). We have sent a telegram on the 20th instant asking them to replenish their account urgently.

5. Governor may like to see in this connection the circular letter which was addressed by the Government of India to all States in February 1956 on the subject of overdrafts with the Reserve Bank [...] and the procedure which will be followed if a decision is taken by the Bank (with the prior concurrence of the Central Government) to stop payments of the State Governments [...]. The note at [...] of the same file describes the manner in which the Madras Government had overdrawn their account during 1951–1953.

M. K. Vijayakar
22/3/57

I would like to be kept in touch, from time to time, with the major developments of this case.

I expect that D.G.(V) has seen these papers some time or other. In any case I would like him to see them again and then discuss one aspect with me. I had hitherto been under the impression that these “raids” on the currency chests were facilitated by the fact that many of them are under the control of the State Government Officers. I see now that that is not primarily the point. The “raids” take place because State Governments live beyond their known means, even after taking account of the ways and means advances made by the Bank and exploiting the natural
reluctance of the Bank to dishonour State cheques. I see this stated explicitly in one of the notes on Madras.

The point I would like to discuss with D.G.(V) is whether we have not in our discussions on State-associated banks and on the necessity of taking them over as subsidiaries of the State Bank of India, made excessive use of the argument that such taking over is essential in order to prevent the misuse of currency chests.

H.V.R. IENGAR
28/3

D.G.(A)
I think the point we had in mind was slightly different from this kind of "raiding" that has so far taken place; we presumably want to avoid giving possession of currency chests which contain unused money, which might be put into circulation without our knowledge.

D.G.(V)
I have had a brief talk about this with the Governor and, insofar as State Governments on the one hand and State-associated banks on the other come into the picture, mentioned the following points. I should like D.B.D. to elaborate a little some of these points (e.g. by mentioning facts and figures or citing reasons given or views expressed by previous committees) for submission to the Governor:

1. There are sound reasons for banks, rather than treasury offices, managing the operations of currency chests. The more important of these grounds are connected, not with apprehensions concerning "misuse" by the State Government through its treasury staff, but with the ability of the custodian bank—as distinguished from the custodian treasury office—to offer larger remittance and allied facilities to other banks and to the general public, as also to Government itself, through the custody and operation of the currency chest.

2. Not all banks can be chosen as custodians of currency chests (which, incidentally, together hold an enormous volume of cash). There is ground for maintaining that, barring the State Bank, there is hardly any satisfactory agent bank available. Even the one or two State-associated banks so appointed have been required to obtain a guarantee from the State Government; further they have had to be brought under some form of control with which the Central Government and the Reserve Bank are associated. Even so, it has been thought proper that they should only be cautiously and gradually entrusted with currency chests. In many areas there is no "agent bank" at all. This has retarded what in many ways is an essential reform. Hence, for a very positive reason, the need to take over State-associated banks as subsidiaries of the State Bank. There is also (as mentioned above) a similar positive reason for transferring currency chests from treasury offices to "agent" banks, whether there be the State Bank or re-constituted State-associated banks.
3. The negative considerations connected with possible misuse by State Governments of their custody of currency chests can be seen in their proper perspective only if recognised as supplementing the positive grounds mentioned above. Apart from that, the relevant points here seem to be briefly these:

(a) Vis-a-vis State Governments, the currency chest system is in effect a form of decentralisation which permits practically unlimited local overdrafts, in cash, subject to the limits of the overall account with the Reserve Bank. The danger arises when the local overdrafts persistently add up to more than is permissible under the overall arrangement.

(b) The local overdrafts can legitimately occur whether the custodian is a bank or a treasury office.

(c) The distinction may turn out to be of real importance if and when the Reserve Bank, with the Central Government’s sanction behind it, chooses to instruct the custodian that no overdraft at all, or no overdraft beyond a specific limit, shall be given to a particular State Government from one or more currency chests or from any currency chest. An agent bank will find it easier to carry out such instructions than a State official who is subordinate to the State Government. (The real difficulty, however, will of course lie in taking the decision to deny an overdraft i.e. in the Central Government deciding beforehand to issue instructions for the contingent dishonouring of a pay order emanating from a State Government).

(d) Lastly, and perhaps only theoretically, there is the remote possibility of a State Government not merely “overdrawing” in a persistent fashion, but also ignoring all canons and rules in the use it makes of the currency chest. Entrustment of all chests to an agent bank, as distinguished from a treasury office, would of course be a complete safeguard against such a contingency.

4. It may be repeated that, so far as the proposal to reconstitute State-associated banks as subsidiaries of the State Bank is concerned, the considerations which have weighed are those set out in para 2 above rather than those mentioned in para 3.

B. Venkatappiah
29-3-1957

O.S.D., D.B.D.

This has been discussed in the past with Governor. His note on [...] and mine on [...] may be seen. The further noting elaborates some of the points.

B. Venkatappiah
31/7

Governor

No further action on these papers.

H.V.R. Iengar
5/8
I am attending the Finance Ministers’ Conference in Delhi on the 18th of this month. The Finance Minister has asked me to utilise the opportunity to speak to the Ministers on the undesirability of their raiding the currency chests.

I shall be glad if a self-contained note is prepared for my use before I leave for the Conference. The note should be historical beginning with the trouble we had with the Madras Government when C.R. was the Chief Minister. I remember to have read various letters of the Madras Government at that time to the effect that they had no option but to raid the currency chests because they had to incur development expenditure. This, of course, completely gives the case away and useful extracts from those letters may be included in the note.

H.V.R. IENGAR
11/11/1957

D.G.(A) Notes have already been prepared on the subject. This was dealt with by DCA(W) but he is away. C.A. should get a consolidated note prepared.

KGA
11/11/1957

C.A. As instructed, a note is placed below.

14/11

D.G.(A) Please see the separate note which I have placed below.

KGA
15/11

Governor
Thank you. I have detached the notes for taking to Delhi.

HVR
15/11

OVERDRAFTS OF STATE GOVERNMENTS

Section 17(5) of the Reserve Bank of India Act authorises the Bank to make to States Governments “advances repayable in each case not later than three months from the date of the making of the advance”. This provision in the Act for advances to States Governments has been embodied in the Agreement (Clause 6) the Bank has entered into with States Governments and is reproduced below:

"6. The Bank shall make ways and means advances to the Government if so required at such rate of interest not exceeding bank rate as may be fixed by the Bank from time to time, provided that the total
of such advances outstanding at any one time shall not exceed twice the amount of the minimum balance prescribed under Clause 5 and any subsidiary agreement provided under the Clause and provided further that the advances outstanding shall be fully paid off at intervals not exceeding three months, from the date of the initial advance.”

As will be seen, the Clause provides for grant of ways and means advances by the Bank to States Governments up to twice the amount of the minimum balance prescribed for the concerned State Government. The accommodation made available by the Reserve Bank to State Governments in terms of section 17(5) of the Reserve Bank of India Act, read with clause 6 of the Agreement, is intended to be of a short-term nature, the advances granted being for meeting temporary deficits on revenue account.

In connection with a reference made in 1942 by the Secretary of the State regarding the renewal of ways and means advances granted to the Government of Burma for a period beyond three months, the Legislative Department of the Government of India had examined the legal position and had expressed the view that “all what section 17(5) requires is that at the time of the making of the advance, there should be no stipulation for its repayment after more than three months”. There was in their opinion no objection to such advances being renewed by the Bank on the expiry of the three months period. Although from a strictly legal point of view the opinion of the Legislative Department is correct, the view taken by the Bank has been that it will not permit such renewals and the State Governments must repay the advances in full within three months. The original sub-clause (5) of Section 17 of the Reserve Bank of India Bill, 1933, read as follows:

“the making of advances to the Governor General in Council repayable in each case not later than three months after the close of the financial year in respect of which the advance has been made.”

The Joint Select Committee had made the following observations on the above Clause:

“We consider that the provision in its original form might lead to undue latitude. In an extreme case it would be permissible for Government to borrow in this way for a period of fifteen months. We consider that such advances should normally, as soon as possible be converted into treasury bills which should be offered on the open market even though the Reserve Bank may take them up. We have therefore limited the period to three months. We have enlarged the scope of this clause so as to include advances to such Local Governments as may have the custody and management of their own provincial revenues.”

The above views of the Joint Select Committee have been taken by the Bank as a clear directive as to the policy to be followed and we have been insisting upon all States Governments to clear off the ways and means advances after three months as expressly provided in clause 6 of the Agreement.

The minimum balances for the former Provinces were fixed in 1937 on the basis of distribution amongst the Central and Provincial Governments of the aggregate minimum balance prescribed for the pre-Provincial autonomy Central Government,
the balance for each Provincial Government being determined on the basis of the ratio the revenue of that Government bore to the total revenue and expenditure of the Government of India. When we took over subsequently the banking functions on behalf of Part 'B' States, the minimum balances were determined having regard to the minimum balances which were applicable in the case of Part 'A' States with comparable figures of revenue and expenditure. These minimum balances are intended to compensate the Bank for the out-of-pocket expenses incurred in connection with Government work. In October 1952, we wrote to the States Governments and pointed out that the minimum balances which had been fixed as early as 1937 were no longer appropriate and there was a case for an upward revision of the balances on the basis of the considerable increase in the turnover of Government transactions at the Reserve Bank and its agencies and the rise in the figures of their revenue and expenditure. The revised balances were made operative early in 1953. The minimum balance prescribed for an individual State also represented the extent up to which that State Government would be entitled to avail itself of ways and means advances from the Bank. With the increase in the minimum balance, we also agreed to grant to State Governments financial accommodation on a more liberal scale and the limit for advances was fixed at twice the amount of the minimum balance. A provision was also made for the grant of advances against cover of Government of India securities at the discretion of the Bank up to a uniform figure of Rs 2 crores, over and above the normal ways and means advances which were granted on a 'clean basis'. Whereas the interest charged on the normal ways and means advances has, except for a short period from 1st October '39 to 31st March '40, been one per cent below the Bank rate, the rate for such advances against Government of India securities varies according to the quantum of accommodation as under:

1) For advances upto Rs 50 lakhs (in excess of normal ways and means advances) — 3½% below the Bank rate.

2) For advances upto Rs 125 lakhs (in excess of normal ways and means advances) — ½% below the Bank rate.

3) For advances over Rs 125 lakhs (in excess of normal ways and means advances) — Bank rate.

It may be mentioned here that in Clause 6 of the Agreement, the Bank has agreed to make advances to States Governments at rates of interest fixed from time to time but not exceeding the Bank rate. Although we had in the past refused requests from States Governments for accommodation in excess of Rs 2 crores, against Government of India securities, we have relaxed the limit recently at the instance of the Union Finance Minister. In the case of the Government of Andhra Pradesh, for instance, we have sanctioned special advances upto Rs 9.90 crores. The limit for Bihar is Rs 3½ crores while that for Governments of Kerala, Madhya Pradesh and Madras is Rs 3 crores each.

Till 1948, the States Governments had been able to repay the outstanding ways and means advances within three months as provided in the Agreement, but thereafter there have been several instances where the States Governments were unable to repay the advances in time in spite of our having called upon them to do so. At present also
there are as many as 5 States against whom advances are outstanding for periods exceeding three months.

Overdrafts by States Governments have become more common and frequent since October 1950 and while in the beginning the main offenders in this respect were the Governments of Madras, Bihar and Orissa, a number of other States (Andhra, Madhya Pradesh and Kerala) are now running large overdrafts with us. During the period April '51 to July '53, the account of the Government of Madras was overdrawn almost continuously, the overdrafts being of a substantial order. For instance, the balance of the Government of Madras on the 21st March '53 was debit Rs 22.10 crores with ways and means advances of Rs 80 lakhs. To the innumerable communications sent by us on the subject of their chronic indebtedness to us, the usual reply given by the Madras Government was that the overdrafts were due to the large expenditure which was being incurred by them on development and irrigation projects which had been approved by the Planning Commission. It was further pointed out that the schemes had reached an advanced stage and if they were to be slowed down or abandoned altogether the considerable amounts which had already been spent on them would be wasted. (Extracts from some replies received by the Bank are reproduced [not printed]). The Government of Orissa have also adduced the same explanation for their present unsatisfactory ways and means position and a copy of their recent communication is also attached (Enclosure I1 [not printed]). There is no provision in the Reserve Bank of India Act for allowing such overdrafts but we have no alternative than to acquiesce in them. Under the present procedure, State Governments can draw upon us, the State Bank of India branches and treasuries, etc. without any limit and we or our agents cannot dishonour the cheques drawn by the States Governments. The receipts and payments made on account of the State Governments at our offices, the branches of the State Bank and other agency banks and the treasuries and sub-treasuries are adjusted at our Central Accounts Section, Calcutta who maintain the principal accounts for the various States and arrive at the day-to-day balance of individual States after taking into account all the advices received by them. An overdraft occurs if the total payments made on behalf of a State Government on any day are more than the receipts and the balance in their account. It is not possible for any of our offices or the agencies to know if a particular payment being made by them will result in an overdraft; this will be known only after the balance is struck at our Central Accounts Section, Calcutta. The balance of a State Government may also become overdrawn as a result of inter-Government debits. As has been pointed out by D.G.(A) in his note dated 13th July 1955, the relevant extract from which is appended, the overdrafts are due mainly to payments at the State Bank of India and Reserve Bank offices and not so much to drawings from the treasuries. It is not that the States are consciously or wilfully utilising the balances in currency chests but rather that the States are spending more than their resources. As compared to the Government disbursements at the branches of the State Bank of India (or the agency banks), withdrawals at currency chests for Government disbursements in the treasuries and sub-treasuries are insignificant. Some time ago, figures had been collected about the debits to the account of the Madras Government during the nine months ended 30th September 1952 and it was found that the net debits for Rs 12.32 crores
were due to payments at State Bank of India branches for Rs 25.69 crores and debits
for Rs 9.29 crores representing inter-Government adjustments.

Extracts from D.G.(A)’s note dated 13th July 1955:

“Governor wanted to know how exactly the Madras Government had overdrawn
large amounts during 1951–1953. As the above notes will show, the reasons for the
excess spending were

(i) capital expenditure on irrigation works which had reached an
   advanced stage and could not, therefore, be prevented;

(ii) large expenditure for famine relief, and

(iii) big amounts locked up in food grains.

The mechanism by which the Madras Government obtained the money was by getting
the payments made through their accounts in the usual course. It will be seen that the
excess debits were mainly at the Imperial Bank of India branches so that it cannot be
said that the Madras Government misused the currency chests under its own Treasury
Officers. Actually, the procedure followed by the Government was perfectly legal and
it was not as if they had helped themselves to the monies kept in their custody in the
form of currency chests. At the Imperial Bank of India offices the Agents of the Bank
are not, at any given moment, in a position to make out whether there has been an
excess of drawings by the Government. For the purpose of drawing cash from the
currency chests the Agents take into account their total requirements which include

(i) the payments to be made on account of the State Government;

(ii) the requirements for the Bank’s own purposes, and

(iii) amounts required for remittance on account of the public.

It will be clear from this that the mere restriction of operations on currency chests at
Treasuries other than those at District headquarters will not help to stop overdrawals
by State Governments. The only effective way by which the State Governments can
be made to restrict their expenditure within their own resources is to have limits
prescribed at each Treasury. Since the resources available to the State will depend not
merely on the rate of its expenditure, but the realisation of its estimates in regard to
revenue, it will be necessary to evolve an elaborate procedure in order to make sure
that the functioning of the Government is not brought to a standstill by any mechanical
application of the limits. This is the problem on which the Finance Ministry and the
Comptroller & Auditor General are engaged at present and until the separation of
audit and accounts is effected it will not be possible to introduce any new procedure.

As regards the apprehensions felt by the Finance Minister about the misuse of
currency chests by State Governments, Shri Rangachari pointed out that except for
the Madras experience in 1951/53 there has been no instance of State Governments
resorting to excessive deficits and even in the case of Madras the position was well
known to the Government of India, who could not at that time, in view of the political
circumstances, order the Madras Government to stop the development projects....

Recently and more particularly after the reorganisation of States in November
1956, the number of States which overdraw their accounts with us has increased and
as on the 11th November 1957, 7 out of 13 States were in debit, the total overdraft
being a little over Rs 22 crores. These Governments have been running overdrafts in
spite of our having granted them normal ways and means advances (i.e. on a clean
basis) to the maximum extent permissible in their cases and special advances (against Government of India securities) for Rs 23.31 crores.

FINANCE MINISTER
INDIA
NEW DELHI
June 3, 1957

My dear Iengar,

Thanks for your letter of the 29th May in regard to State loans particularly as it pertains to Madras and Mysore. The matter will come up today in the National Development Council meeting.

I have spoken to Subramaniam about this and told him that Varghese was not a very reliable guide in this matter but that if he wants to insist upon floating a loan of Rs 5 crores, it should be for ten years bearing 4½% interest, though the issue price might be Rs 98, and that in no case would I permit a loan to be floated bearing 4½% interest by the States.

I think some time you must explain this matter as also the question of State overdrafts to the Cabinet. I am going to ask the Prime Minister if he would like you to come and meet the Cabinet at one of its informal meetings and tell them about it.

With kind regards,

Yours sincerely,
T.T. KRISHNAMACHARI

On reading over again my note of 13th July 1955 which has been quoted in the office note, I feel that the essential point has perhaps not been clearly brought out in it. I would, therefore, like to restate the position as I understand it.

There is no doubt that the prevailing impression that the States manage to run up their overdraft against the Reserve Bank by raiding the currency chests in charge of their Treasurers is not correct. It is true that they can make use of the currency chests under their charge for the purpose of incurring their expenditure and pass on the debit to the Reserve Bank, but in actual practice the large overdrafts that occur are mainly due to cheques issued by them on the offices of the Reserve Bank and the State Bank. To the extent that these cheques are met by us or by withdrawing money from the currency chests in charge of the State Bank Agents, it is we who help them to get the money. Thus it is quite clear that what is essential is to stop the power of the State Governments to get money whether from us, the State Bank or the non-banking currency chests.

This does not mean that a State Government which has decided to defy the authority of the Central Government may not appropriate to itself all the money—and these amounts are very large—lying in the currency chests under their control. This, however, is a remote contingency and if and when it occurs it would mean almost a state of war. In such an eventuality even the treasury under the control of the Reserve
Bank or the State Bank will not be safe. Before, however, such a serious situation develops, the Central Government may be expected to take military or other measures that may be necessary. All the same it may also be conceded that currency chests which are not directly in charge of the State Government officers might be safer. The effort to establish more branches of the State Bank which would take over the currency chests in the area, which is being made for the purpose of improving banking facilities, will automatically help in this direction though, as pointed out in the previous notes, it will take a long time before all the chests are taken over in this manner.

I was at one time under the impression that the overdrawals by the State Governments occur because of the way in which the Central and the State accounts are mixed up and also because the Agents of the State Bank withdrew money from the currency chests whenever their cash balance was insufficient to meet not only the requirements of the State Governments, but also those of the Central Government and of the State Bank itself. While this may be true in the case of a casual overdrawal, it is quite clear that when the overdraft continues for a considerable time and is, in fact, being added to from week to week, there can be no doubt that the State Government has no balances with the Reserve Bank. It is not, therefore, a question of prescribing limits up to which a State Government can draw on particular treasuries, as I was inclined to think at one time, but of preventing a State Government from making any withdrawal whatsoever from the Reserve Bank when it is clearly established that the State Government has no funds left. It was for this reason that the procedure to give warnings to State Governments and then to put a complete ban on further payments was evolved. Though the Central Government had bravely issued a circular to all State Governments, they find they are unable to implement the threat when the actual contingency arises as is happening at present.

The real problem is not the raiding of the currency chests by the State Governments, but the way in which State Governments are living beyond their means without worrying the least bit about it because they have the facility of getting the funds from the Reserve Bank. Stopping that facility may seem at first sight to be the proper remedy, but in actual practice it cannot be applied for political reasons. But even if that is so, there is no reason why the Reserve Bank should be compelled in this manner to continue to finance the deficits of the State Governments without limit. The rules about the ways and means advances to be given by the Reserve Bank to the State Governments were laid down for the purpose of ensuring that they did not get credit for disproportionate amounts or for long periods. Not only are those rules being set at nought, but the States are even going further by helping themselves to overdrafts which are not even sanctioned. Since the Central Government will not allow the Reserve Bank to stop payments to the State Governments, it is for the Central Government to provide the necessary funds to the State Governments or compel the State Governments to reduce their expenditure. In my opinion, the real trouble arises because of the reluctance on the part of Central Government to force the State Governments to cut down their development plans for which the State Governments themselves are not making adequate efforts even to find resources which are available to them.

At the forthcoming conference of the State Finance Ministers we should take care not to be allowed to be diverted by the red herring of the State Governments’ raiding
the currency chests, but concentrate on getting the Central Government to bring every possible pressure on the State Governments to cut down their development outlays. We must also make it clear to the Central Government that if they cannot induce the State Governments to live within their means, the Central Government must undertake to provide the finance and not let the State Governments continue the forcible overdrafts. The way in which we are at present showing these overdrafts as advances to Governments, because we cannot show a debit balance for the State Governments, is extremely improper. In fact, if any bank under our control was indulging in such a practice we would have called it to account. Our auditors would be perfectly justified in making a special mention of this irregularity in the audit report. We must, therefore, make every possible effort to get the position rectified.

K.G. AMBEGAOKAR
15.11.1957

Governor

This matter was discussed in the Finance Ministers’ Conference at Delhi. The Prime Minister and the Home Minister as well as the Finance Minister impressed on the State Governments the imperative need of avoiding the overdrafts. I also spoke, pointing out that the continued recklessness of State Governments might affect the credit of the Indian Government.

The State Ministers nodded agreement but to what extent they will improve is an open question. The new grants that State Governments will get as a result of the Finance Commission’s recommendations will affect only their Revenue Budgets. The overdrafts are probably due largely to capital expenditure.

H.V.R. IENGAR
20.11.1957

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22-1-58

I would like to see the letters we have written to the Government of India in the last, say 12 months, on the subject of these unauthorised overdrafts by State Governments.

H.V.R. 22.1

As desired by the Governor, the undermentioned letters addressed to the Government of India, Ministry of Finance are flagged below:
1) No. [...] dated 25th July 1957; and
2) Cy.No.[...] dated 9th October 1957.

2. The Governor may also like to see in this connection the note dated 18th July 1957 in which a reference has inter alia been made to the conversation the Secretary (Shri K.N. Mehta) had with Shri H.S. Negi in the course of which the latter indicated that for political considerations the Central Government would not agree to the Reserve
Bank stopping payments on account of State Governments who overdraw their account. It will be recalled that overdrafts of the State Governments have already been brought to the notice of the Cabinet by the Governor at an informal meeting in September last (Please see Governor's remarks on Office Note dated 30th August 1957).

3. The note on overdrafts of the State Governments which was prepared for the Governor at the time of the Finance Ministers' Conference held in Delhi in November 1957 is at pages 342 to 352.

23/1/58

(A) We have also been writing to Govt. of India drawing their attention to any specific statements made by State Governments that timely and adequate help is not forthcoming from the Central Government.

(B) Further, whenever a State Government's account is overdrawn we call upon them to set right their account and forward a copy of our communication to the Government of India.

23/1

D.G.(A) Apart from the letters, I have also talked recently on two occasions with the Special Secretary at Delhi. He has undertaken to clear the overdrafts by 31st March. The Government of India have accepted the principle that States should not take such forced loans from us but do not want us to stop payments for political reasons.

K.G.A.

23/1

Governor

The Government of India may be informed that at the last meeting of the Committee, the Directors once again expressed serious concern at the continued unauthorised overdrafts by the State Governments and desired that the Govt. of India should be requested to examine whether the time had not come to take more drastic steps than hitherto even if politically unpalatable.

Please let me have a draft D.O.

H.V.R.

24/1

RESERVE BANK OF INDIA

CENTRAL OFFICE

BOMBAY

February 1, 1958

D.O.No.[...]

My dear Rangachari,

I expect you have seen the several communications which the Bank has addressed to Government regarding the heavy and continuous overdrafts of some of the State
Governments. I explained the gravity of the situation to several Ministers of the Cabinet at an informal meeting held in September 1957 in the Finance Minister's house. The Prime Minister himself took the trouble to speak about this in his address to the Finance Ministers when they met to consider the Finance Commission's report. Nevertheless, the situation shows no improvement, the latest figure of unauthorised overdrafts being Rs 10 crores. I do not have to tell you that this is a serious matter; apart from other consequences, a particular embarrassment to us arises from the fact that we have given an undertaking to our Auditors when we agreed in October 1957 to show the debit balance of State Governments in a particular manner, that the overdrafts were purely temporary and would be soon adjusted. It does not look as if we will be able to carry out this undertaking to our Auditors.

2. At two recent meetings of the Committee of the Central Board, the directors expressed serious concern at the continued unauthorised overdrafts by State Governments and desired that the Government of India should be requested to examine whether the time had not come to take more drastic steps than hitherto. The only step that I can think of, although this would be politically unpalatable, would be to put in force the procedure already evolved in consultation with the Finance Ministry for stopping payments on account of the States if they fail to clear their overdrafts after sufficient notice has been given by the Bank.

Yours sincerely,
H.V.R. IENGAR

Shri M.V. Rangachari

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My dear Iengar,

Will you kindly refer to your D.O.No.[...] dated the 1st February 1958 about the overdrafts of State Governments with the Reserve Bank? We have had the matter under continuous consideration and we hope it will be possible to clear the matter up satisfactorily before the end of the current financial year and make reasonable arrangements for the future. A large sum is still due to State Governments on account of grants and loans for development and will be paid to them in the course of this month and early next month. This should clear the outstandings of most.

Yours sincerely,
M.V. RANGACHARI

[Submitted as an informal item to the Central Board Committee at meeting held on 19.2.1958.]
CONFIDENTIAL

D.O.No.[...]

My dear Rangachari,

Will you please refer to your D.O. letter No.[...] dated the 16th February 1958? Although no overdrafts were outstanding as at the end of the financial year, several States started overdrawing their account almost immediately. As you must have seen from the daily position advices sent by our Central Accounts Section and the communications addressed by the Bank to States Governments, copies of which are endorsed to the Ministry of Finance, as many as five States are now in debit and the amount of the overdraft has also been steadily rising. According to the latest advice received from our Central Accounts Section, the total of the debit balances as on the 3rd instant was over Rs 22 crores in spite of our having granted ways and means advances for about Rs 25 crores. In your letter of the 16th February, you had mentioned that arrangements were being made to avoid the recurrence of overdrafts in future and we were hopeful that occasions on which States Governments would overdraw their accounts during the current financial year would, if at all, be rare; in any case, we had not anticipated that the overdrafts would be of the present magnitude. We shall be glad if you will kindly look into the matter and advise us as early as possible as to what action was being taken by Government.

2. The question of adjusting the debit balances is also of some urgency in view of the Bank’s annual closing of accounts. Our Auditors have approved of our showing the overdrafts under “Loans and Advances to Governments” only as a temporary expedient and it is imperative that the overdrafts are repaid in full before the 29th of the next month.

Yours sincerely,

K.G. AMBEGAOKAR

SPECIAL SECRETARY

D.O.No.[...]

My dear Ambegaokar,

Will you kindly refer to your D.O. No.[...] dated the 9th July 1958, about State overdrafts? I am marking the reply private and personal because not all of it is for the consumption of your Board.

2. As you know this problem is one of some years standing and you may recall grappling with it in the case of Madras some years ago. It has become wider and more intractable. I have been struggling with it ever since I came back last October. It is not easy to control the ways and means of fourteen States from the Centre but we have been doing the best we can to keep the State finance on an even keel.

3. The States’ difficulties largely stem from the fact that their plan outlay is not wholly covered by their resources plus the Central assistance promised to them. Some of them also have large commitments in respect of food grains and scarcity. We have been trying to clear each of these separately.
4. At our instance the Planning Commission are engaged in a reassessment of the States’ resources for the current year and may ask the States to readjust their plans on that basis. We are now releasing the Central assistance promised to the States in monthly instalments so as to keep pace with the State expenditure. Similarly, we are paying them their shares of revenue and grants either in advance or in monthly instalments. We are also considering whether the dislocation caused by a shortfall of their resources vis-a-vis the plan upto 31st March 1958 and reflected in their current balance position should be made good to them. The question of making separate arrangements for large food stocks is also under consideration. All this is bound to help and has helped but obviously one can never guarantee that the States may not once in a way find themselves in the red. Two things are clear to me. First, most of them have no adequate machinery for watching their ways and means and take no interest in it. Second, considering the magnitude of the transactions all of them would have to increase their minimum balances with the Bank. Something must be done to place both these matters on a satisfactory basis. A satisfactory long-term solution will take some time and I am sure you and your Board will appreciate this.

5. Today only two States are in the red, Bihar for a nominal amount and Madhya Pradesh for a substantial sum. I am writing to them offering a further ways and means accommodation to clear their overdrafts and keep an even balance with the Bank.

Yours sincerely,
M.V. RANGACHARI

[This is a very helpful reply and I would like to thank Mr. Rangachari for it. Governor may like to mention it first to the Committee.]

K.G. Ambegaokar 18.7.58

Governor 18.7.58

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Our Directors have been expressing deep concern from time to time at the manner in which some State Governments continue to have large unauthorised overdrafts. This was again voiced strongly at today’s Committee meeting. It was urged that we must not allow this state of affairs to continue. One way which was suggested was that there must be an arrangement by which any overdraft is cleared within a week by the Central Government making the necessary funds available to the State Government. Some of us pointed out that this would mean that the Central Government has to acquiesce in any expenditure incurred by the State Government and would result in the disappearance of all control and restraint on the State Governments. Failing any other remedy the Committee was of the view that we should at least not allow the State Governments to have such forced loans without paying any interest. We have in the past not been inclined to levy interest charges for fear that this would only mean regularising the unauthorised overdrafts and our policy has been not to give any countenance to such overdrafts. However, since there does not seem to be any other
way of checking this malpractice, the suggestion seems worth exploring, and I would like it to be examined so that I can discuss it with Government of India. We could have an increasing scale of penal interest, like what is prescribed in the case of Scheduled Bank’s balances and make it so steep for longer periods as to force the State Governments to take early action to regularise the position.

Rates of interest on overdrafts against State Governments

D.G.(A) has indicated that he would discuss this matter with the Ministry of Finance. If they agree, the penal rates may be made effective from 1st July 1959.

DG(A)

I have discussed with Mr. Rangachari today the question of continuing overdrafts of some of the State Governments. He said he had arranged to have the M.P. overdraft cleared—the M.P. Government having been given Rs 5 crores. Bihar also will be settled shortly.

As regards the proposal for a penal interest rate, he said this would be for the Bank to decide and he would not like to interfere with the Bank's discretion being exercised in accordance with banking principles. He pointed out however that the imposition of a penal rate would not have the intended effect of making the States avoid incurring overdrafts. The fact was that the plan expenditure made the position of the States so tight that they had no manoeuvrability left and with the smallest trouble in utilising their estimates of revenue, due to scarcity etc., they were bound to be in deficit. Some more fundamental remedy was needed to remedy this situation. Charging higher rates of interest would only make their position worse.

I shall discuss this further with FM tomorrow.

23/5/59

Discussed with FM and Mr. Rangachari yesterday. They both stated that all the overdrafts would be cleared by the six-monthly closing. We may also again write to all the States concerned that the overdrafts must be fully cleared by 30th June as we cannot show any minus balances.

As regards the penal rate of interest, FM also expressed the view that the States were helpless in view of their development programmes and because they had no such means of meeting deficits as the Central Government had. They both thought that charging higher interest would only increase the State Governments’ burden. As some kind of check, however, they had no objection to our introducing a slightly higher rate after the 30th June when the present overdrafts are cleared. I shall mention this to the Committee at the next meeting.

25/5/59

Secretary

Submitted as an informal item to the Central Board Committee at the meeting held on 27th May 1959.

DG(A) 28.5.59

The Committee’s reaction to the proposal for a penal rate was not very favourable.
One Director in particular was of the view that this would make no difference to the spending of the States. We may keep this matter pending till the Governor’s return.

Confidential

The folder containing notings in connection with the overdrafts against State Governments is resubmitted as directed by D.G.(A). The latest position of the State Governments who are having overdrafts with us is indicated below:

As on 6-6-1959 [Rs]

<table>
<thead>
<tr>
<th>State</th>
<th>Ways &amp; Means advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bihar</td>
<td>69,14,000 (Dr.)</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>1,14,97,000 (Dr.)</td>
</tr>
<tr>
<td>Kerala</td>
<td>3,31,38,000 (Dr.)</td>
</tr>
</tbody>
</table>

Government of Bihar: A credit of Rs 5 crores was received by them from the Central Government on 5-6-1959 which brought down the overdraft to Rs 34 lakhs (with ways and means advances of Rs 390 lakhs). The debit balance has again gone upto Rs 69 lakhs. Government of India have indicated that further assistance for Rs 2.26 crores will be given to the Bihar Government this month for Plan Schemes and the account of the State Government should be in credit on the 29th June although they will not be able to repay the ways and means advances in full.

Government of Rajasthan: The Rajasthan Government have advised us vide their letter dated 4th June 1959 that efforts will be made to keep their account in credit as on 29th June 1959. It may be mentioned that we have recently agreed to an increase in their cash credit arrangement with the State Bank of India from Rs 10.75 crores to Rs 11.30 crores against cover of securities and to an additional limit of Rs 3.75 crores against cover of stocks of foodgrains.

Government of Kerala: According to the reply dated 4-6-1959 of the State Government they have applied to Government of India for ways and means advance to clear the overdraft.

In view of the closing of the Bank’s annual accounts, we have already addressed the State Governments concerned on 1st June 1959 to take immediate steps to repay the outstanding overdrafts and to ensure that the balance of the Governments with the Bank is in credit as on 29th June 1959 (30th being a holiday). A copy of the letter has been endorsed to Government of India requesting them to grant sufficient financial accommodation to State Governments.

9/6/59

Secretary 9.6
CA 9.6
DG(A) 9.6

I think we may drop for the present the idea of charging a penal rate of interest on overdrafts. The suggestion originated from Mr. Tata at one of the meetings, but at a subsequent meeting, when he was not present, it was not favoured by Mr. Kasturbhai,
who thought it would make no difference to the behaviour of the States. We may consider it again if overdrafts start again after the 1st July.

Governor 9/6

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Memorandum by the Reserve Bank of India regarding unauthorised overdrafts of State Governments

The increasing extent to which State Governments are running unauthorised overdrafts with the Reserve Bank year after year is causing considerable concern. It is absolutely essential, if the economy is to remain stable, that deficit financing in the Public Sector is regulated.

2. Normally any deficit financing that can be reasonably incurred in the Public Sector is provided for through the Central Government’s annual budget. The Reserve Bank is constantly in touch with the budgeting operations of the Central Government and the extent of deficit financing provided in the Central Budget is an agreed figure which is considered as capable of being absorbed by the economy without any deleterious effect. Due to the unauthorised overdrafts created in the past years by the State Governments which had to be taken over by the Centre each year, the extent of deficit financing incurred by the Centre in these years had, however, exceeded considerably the safe limits of deficit financing each year and this has had extremely adverse effects on the economy of the country.

3. Apart from this overall consideration, any State Government running an unauthorised overdraft with the Reserve Bank does so in breach of the agreement under which the Reserve Bank has agreed to act as the banker to the State Government. This makes the position of the Reserve Bank untenable under the Act setting up the Bank and the Bank has been advised that it may be dragged into a court of law on this account.

4. The Bank has therefore no other option but to insist that a definite procedure must now be devised and given effect to immediately to ensure that the drawings of a State Government from the Bank in any year are limited to the amount of resources definitely expected to be credited to the account of the State during the year, leaving no scope for unauthorised overdrafts to appear.

5. At the same time, it is appreciated that the problem can only be tackled in stages. The first step proposed therefore is to control the flow of expenditure out of the Consolidated Fund so that this by itself does not lead to overdrafts. The following suggestions are made for securing this control.

6. As soon as the budget for the year is passed, the State Finance Department, in consultation with the Reserve Bank, will distribute the budgeted provisions among various drawing officers. This will be done for the year as a whole but in the first three months of the year the drawing officer will operate without any limit. For the purpose of these allocations, payments like loan repayments, interest payments, pension payments, charged expenditure, supplies received through Central Purchase Organisations like India Supply Mission, London and Washington, D.G.S.&D., Food, etc., book adjustments in respect of transactions originating in other States and payments
to gazetted officers, which are authorised by the Accountant-General, will be excluded. The allocations for each drawing officer would be intimated to them by the State Government under advice to the Treasury Officer and Sub-Treasury Officer with whom he is in account. The Reserve Bank of India will separately intimate the allocations to the branches of the State Bank of India and its subsidiaries conducting Treasury business with instructions that payments should be limited to the amounts intimated unless changes are subsequently notified by the Reserve Bank. In respect of payments in non-banking treasuries and sub-treasuries, the allocations settled in consultation with the Reserve Bank will be intimated to the Treasury Officer and Sub-Treasury Officer by the State Government with similar instructions. For the purpose of watching that the prescribed limits are not exceeded, it will be necessary for the branches of the State Bank of India and its subsidiaries to keep separate ledgers for each drawing officer for whom the limit has been prescribed. In the case of non-banking treasuries and sub-treasuries similar ledgers will have to be kept by the treasuries or sub-treasuries, as the case may be.

7. The allocation made in accordance with paragraph 6 above will deal only with expenditure met out of the Consolidated Fund.

8. If the State Government's budget, taking into account only the Consolidated Fund heads, provides for a deficit over the year, the initial allocations will be restricted to expenditure omitting the deficit which will be distributed over the heads and additional allocations will be made as and when ways and means have been found to cover the deficit. But if the budget as a whole is balanced i.e. any deficit in the Consolidated Fund is covered by a surplus in the Public Account, no adjustment will be made in the figures of expenditure in making the allocations. In determining the resources available to cover the expenditure to be authorised, resources which seem only reasonably certain would be taken into account.

9. The limits intimated to the drawing officers and treasuries and sub-treasuries, both banking or non-banking, will not be altered without prior consultation with the Reserve Bank. Alterations will be made only to the extent that additional resources appear to be definitely available during the course of the year.

10. Payments in one State on behalf of other States at banking treasuries and sub-treasuries will be taken against the balance of the State concerned and will not affect the balance of the State in which the payments are made. Payments on Central account in non-banking treasuries and sub-treasuries in a State and payment in such treasuries and sub-treasuries on behalf of other States will be cleared daily with the Accountant-General who will pass on the debit to the Accountant-General concerned.

11. States which have payments to make in other States should, as far as possible, arrange for payments by the issue of demand drafts.

12. If during the course of the year owing to a shortfall in resources or other reasons, the movement of balances indicates the likelihood of an overdraft, steps should be taken immediately by the State Government to arrange for accommodation to tide over the shortfall.

13. For the efficient working of the system the Reserve Bank will post in each State capital, one of its officers to work in close association with the State’s Finance Department. It will also arrange for a telegraphic instruction being sent to the States
of its daily balances by the Central Accounts Office. Efforts will be made to start the new system in the current year itself although it may not be possible to give effect to it till the 1st September i.e. the initial period during which the drawing officers will be acting without any limit will for this year be extended from 3 months to 5 months.

14. The normal ways and means of a State Government are frequently strained by large transactions on food purchases and procurement. Arrangements should be made that these are separately financed through Commercial Banks in all cases so that such purchases do not lead to overdrafts on the Reserve Bank.

15. The existing limits for ordinary ways and means advances under the various agreements of the State Governments have proved inadequate in the context of the large increases in the volume of the State transactions. Reserve Bank of India will take steps to examine this problem in consultation with the State Governments and fix adequate limits, not necessarily a multiple of the minimum balances as under the existing agreements, to meet the seasonal requirements of individual States with reference to the overall transactions in the last two or three years.

16. It is desirable that commencing with 1967–68 the local bodies, State Electricity Boards, State Transport Corporations and similar bodies which now bank with Government, should be allowed to bank with the State Bank of India and its subsidiaries or with any other scheduled bank which may be approved by Government. At present the balances of all such bodies, which represent banking liabilities, are used for financing expenditure of the States and the States may not be in a position to meet the demands from the various bodies when they arise, as few of them have comfortable cash balances or liquid assets. Once this system is started, the accumulated balances at the end of the current year at the credit of these bodies could be handed over to them in a phased manner over a period.

[Submitted to the Government of India in June 1966]

Governor, RBI

[16-7-1966]

This draft was discussed—It will be seen that Finance Ministry is not likely to press for the adoption of the Scheme sponsored by us. They would rather proceed on the old lines and tell CMs that once the normal ways and means limits are re-fixed any overdraft in excess of such revised limits will automatically result in stoppage of payment.

I am not sure how far they will succeed in this approach. The only amendments to the paper that I have suggested and are being adopted are as follows:

1) Once the ways and means advance limits are revised, we will not give any notice to the State to clear the overdraft. We will only intimate on the Friday in question by telegram that the States’ operations have resulted in an unauthorised overdraft.

2) We will then wait to see in the next week’s account whether the overdraft has been cleared. If it has not been cleared but the amount of overdraft has increased, we will immediately issue orders to stop further payments.
(3) If, on the other hand, the overdraft is reduced or remains stationary, we will wait for another week to see if it is being cleared completely. If not cleared by then, we will issue orders to stop further payments.

(4) There should be definitely understood arrangements between the Central Government and the States and we should not be asked to hold our hand in any case of deviation in the same.

The draft is being revised and will be submitted to Cabinet. Let us await developments.

[P.C.B.]

[22-7-66]

In the recent discussions in Delhi on the subject of overdrafts created by the State Governments the consensus of opinion was that the limits for normal ways and means advances permitted to State Governments needed a review. These limits were fixed last in 1953 and since then the size of the State Governments’ budgets has increased considerably.

The Government of India also took the view that rather than pursue the adoption by the States of the procedure suggested by us for detailed control of their drawings, it would be better to refix the limits of normal ways and means advances on a realistic basis and thereafter advise each State Government that if after that any State were to so conduct its operations as to result in the normal limit of overdraft being exceeded, the Reserve Bank of India will automatically issue instructions to stop all further payments on behalf of such State Government. I believe this position has been put to the Chief Ministers of the States and, as is to be expected, has provoked mixed feelings amongst them.

Pending a communication from the Government of India, I would like this question of limit of normal ways and means advances to State Governments being reviewed without any delay. I have spoken to the Economic Adviser about it. Secretary will please associate himself with the study that will be conducted in the Economic Division and I should like to have the considered views of all of them submitted to me at the earliest possible date.

P.C. BHATTACHARYYA

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(Ponts made by me [P.C. Bhattacharyya] in the CMs/FMs Conference on 11-4-67)

A.
1. Grateful to have the opportunity to offer some explanation on behalf of the Reserve Bank pertaining to some of the points discussed round the table.
2. The two points on which I would like to offer remarks are (a) Deficit financing in its overall aspect (b) unauthorised overdrafts of State Governments.
3. So far as (a) is concerned, the necessity for eschewing it has arisen out of the present price situation. The latter is the result of imbalances between demand and supply. The former is a function of money supply. The latter is a function of supply of real resources.
4. Deficit financing increases money supply. While when production is going up, a
regulated dose of deficit financing is required to keep money supplied for additional production, any further increase in money supply when production has gone down is bound to raise prices further.

5. What is therefore desired [is] that for some time deficit financing should be discontinued. Otherwise we will get into a stage of runaway inflation. The annual rate of price increase is all time high.

6. Once price situation is stabilised, and production is again on the increase, a second look at the situation could be justified.

B. 

1. So far as unauthorised overdrafts are concerned, the Centre has so far taken over these every year. But this has resulted in the planned deficit in the Central budget being converted into an unplanned deficit. If deficit is incurred through various points in an unregulated manner, it is not possible to secure monetary stability. It, in fact, amounts to each State and the Centre itself having a printing press of its own.

2. It is in this context, that the procedure of the notice by the R.B. has been devised. The R.B. is the creation of a Statute. Its authority is what the Governments have conferred on it. It is the moral responsibility of the Governments to adopt their financial operation in such a way that the Reserve Bank can discharge the statutory responsibility placed on it.

3. The procedure has been devised because the unauthorised overdrafts have become a means of financing the plan, whereas the law contemplates that the R.B. should only give overdrafts to meet temporary ways and means difficulties. The law prohibits the grant of overdrafts for more than 90 days at a time.

4. It is necessary that if there is shortage of plan finance, the resources for that should be secured by raising fresh resources. If the states are unable to raise the resources it is for the Central Government to consider whether they can raise it and pass it on to the States. The recourse of the State Governments should therefore be to the Central Government and not in creating unauthorised overdrafts on the R.B. If resources cannot be raised, the plan has to be cut.

5. The procedure provides for a notice of three weeks, to make it possible for the State Governments to have discussions with the Centre and clear up the overdraft with their assistance, if possible.

6. If on the other hand, it cannot be so cleared the Reserve Bank cannot continue to carry in its books an operation which is illegal under the Statute. Any tax payer can sue the R.B. for this neglect of duty. In such circumstances, therefore, there is no alternative to the R.B. taking steps that unauthorised overdraft is not allowed to increase. This can only be secured by stopping further drawals.

7. So far as temporary difficulties are concerned, if it is genuine, a special arrangement can be made with the Reserve Bank. Of course, the essential condition is that the Reserve Bank must satisfy itself that such a temporary arrangement will not last more than 90 days. A balanced state budget is an essential pre-condition for the Reserve Bank to agree to give a special line of credit.

[P.C. BHATTACHARYYA]

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I had a discussion with the Deputy Prime Minister yesterday regarding overdrafts of State Governments. He was quite clear that we must take firm action even if it ultimately meant stoppage of payments of cheques issued by the defaulting Governments.

2. In a subsequent meeting this morning in the Ministry with Shri Jagannathan and Shri Govindan Nair, it transpired that while the overdrafts had developed as a result of the States having paid their dues to the Centre in the beginning of October, they were going to receive payments from the Centre on account of their share of income tax as well as by way of Plan assistance in the middle of October and again in the beginning of November. It was further noted that two or three States had not received anything from the Centre when their overdrafts were made good by Central assistance at the end of the last financial year. The Ministry of Finance will be looking into these cases and I have left a copy of our note with them. Meanwhile, it was agreed that having regard to the special circumstances, it would be appropriate for us to call upon the defaulting States to clear their overdrafts by the end of November with the warning that otherwise we might have to stop the payment of their cheques.

3. E.D.(S) may now proceed to take action accordingly keeping the Ministry informed.

L.K. Jha

My dear Morarjibhai,

I mentioned to you as well as the Deputy Chairman, Planning Commission, the fact that once again State overdrafts have begun to worry us, the total amount overdrawn on 3rd November 1967 being over Rs 65 crores. This deterioration took place immediately after the beginning of October when most States had to make heavy payments to the Centre against their loans as some payments from the Centre to the States are due for disbursement in October-November each year, some improvement in the position can be expected. In fact, West Bengal and Punjab, which were originally overdrawn, are now, for the time being at least, in the clear. As regards Madras, Andhra Pradesh, Bihar, Madhya Pradesh, Rajasthan and Mysore, their accounts, even with this month’s payments, continue to be overdrawn. Their combined overdrafts as on 7th November were of the order of Rs 39 crores.

2. I think I can say that the firm tone which you adopted in dealing with this problem has had its effect on the States. Most of them are making efforts to avoid an overdraft. At the same time, we must also recognise that many of them have genuine difficulties. Their debt burden is heavy. The fact that repayment has to be made in one large lump makes the problem more difficult. Subscription to their loans has not been too satisfactory. There has been deterioration on other counts also for which they are not entirely to be blamed. In addition, political pressures and election pledges are having the effect of eroding their resources one way or another.
3. In this kind of a situation a simple three weeks’ notice of stoppage of payments will not, I feel, achieve the result. Even with the best efforts and will most of these States will not be able to muster enough resources within three weeks to clear their overdrafts. The stoppage of payments on their failure to do so will also have serious repercussions, some of a political nature but even more of the already dangerous law and order situation because if policemen do not get their salary, we cannot expect them to be on the side of law and order.

4. In these circumstances I feel that what is needed is a joint consideration of the States’ financial situation between representatives of the State Governments, the Finance Ministry and the Planning Commission. They may have to cut their plans. They may also have to agree to other cuts in expenditure or measures to mobilise additional resources and there may be a case for the Centre to give some relief to States whose difficulties are genuine either by staggering their debt payment liabilities or by additional loans or grants. I know that the resource position of the Centre is no better. However, a deficit at the State level is economically as bad as a deficit at the Centre and there are some advantages in not letting the States incur deficits in addition to what might be incurred at the Centre.

5. If after such a review a State does prove to be recalcitrant and if there is no other remedy left, the stoppage of payments may have to be a last resort remedy. However, to take this extreme step at this juncture on three weeks’ notice may not be the best method of dealing with the situation.

6. In order to pave the ground for such a meeting I have arranged for telegrams to be sent to the Finance Secretaries of all States concerned asking that they should take immediate steps to clear their overdrafts before the end of November 1967 and that they should send their representatives to the Reserve Bank to explain to us the action which they propose to take. It is possible that the States will refer to certain problems and difficulties which they have. We propose, in the light of these discussions, to send to Government an analysis of the problem as we see it. This would be helpful in the kind of tripartite discussions which I have suggested above.

7. I trust that what I have said above will have your approval. Further, since I gather that the N.D.C. is due to meet shortly, you might wish to call the State Finance Ministers a few days in advance so that when the N.D.C. meets, each State will be able to give a more realistic account of its own resource position, and both the Central Government and the Planning Commission will have a better picture of the kind of effort for resource mobilisation that the individual States are likely to put forth.

Yours sincerely,

L.K. JHA

Shri Morarji R. Desai
Deputy Prime Minister
Government of India
New Delhi

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My dear Deshmukh,

Would you kindly refer to your D.O. letter No. [...] dated 15th September 1954, in which you said that you presumed that the Government of India would be consulted before the actual publication of the Report on the Rural Credit Survey (Volume II, i.e. the “General Report”)? In that letter, as well as in our subsequent talks, you indicated your anxiety that early decisions should be taken on the main recommendations of the Report and that the decisions themselves should be followed by prompt action, legislative and other, to implement them. The proposals of the Committee are far-reaching and important and, as you know, I fully share your anxiety that there should be no avoidable delay in formulating and pursuing the further steps now necessary. In order that you may be put in early possession of the views of the Bank on these recommendations, I propose to convene a special meeting of the Central Board towards the end of January. The final printing of the Report is in progress and, by about the 21st of this month, it should be possible to have a sufficient number of copies for supply to the members of the Board as well as for general publication. For reasons I shall presently mention, it will not only facilitate publication but also greatly assist the Board in its deliberations, if, at the same time as the release of the Report to the public, the Government of India could announce and reaffirm their decision in general terms on one issue to which, from time to time they have already given consideration in the past. The particular issue I have in mind is connected on the one hand with the Imperial Bank of India in the different contexts in which its future has been considered by Government, and on the other hand (in the new context provided by the Report), with the establishment of a State Bank of India proposed by the Committee on the Rural Credit Survey.

2. I summarise below the various ministerial pronouncements on this question as well as my own views expressed at different stages to the Board of the Reserve Bank and to the Finance Ministry.

(a) On February 4th 1948, in reply to a short notice question in Parliament, the Finance Minister (Shri Shanmukham Chetty) stated as follows: “Government accept the policy of nationalising the Imperial Bank of India but as the Bank has branches outside India, Government propose to examine carefully the various technical questions that would arise in connection with the nationalisation of the Bank before the policy is implemented.”

On the basis on which compensation would have to be paid, he stated as follows: “As regards the Reserve Bank, Government’s intention is to acquire its share at the average of the monthly market value of the shares during the period March 1947 to February 1948 taking the opening quotations for each
month and to issue in lieu thereof to the shareholders 3% long dated stock of equivalent value of appropriate maturity. In regard to the Imperial Bank of India, Government propose to adopt a similar basis for the acquisition of its share capital. The period for which the average of the market value of the shares is to be taken will be determined at the time of nationalising the Bank."

(b) Subsequently on the 1st of February 1949, in answer to a question the Finance Minister Dr. John Matthai said that in the light of the examination of the technical questions referred to and in view also of the possible repercussions on the investment market and of the existing unsettled economic conditions in the country, Government considered that it was not feasible to proceed at the time with the nationalisation of the Imperial Bank of India.

(c) In connection with the debate on the Reserve Bank of India (Amendment) Bill 1950 on the 22nd November 1950, you, as Finance Minister, quoted the reply given by Dr. John Matthai on 1st of February 1949 and said “I may add that I am in complete agreement with this view and I am convinced that it is not in the best economic interests of the country to attempt any such measure.”

3. The Rural Banking Enquiry Committee which reported in 1950 recommended, among other measures, that the appointment of the Managing Director and the Deputy Managing Director of the Imperial Bank should be made subject to the approval of the Central Government or in the alternative the constitution of the bank should be changed and the general superintendence of the bank placed in charge of a Chairman whose appointment would be subject to the approval of the Central Government, the day-to-day internal working of the bank being entrusted to a General Manager.

In my memorandum to the Board of the Reserve Bank on this proposal, I described the fairly comprehensive powers of control which the Government and the Reserve Bank exercised over the Imperial Bank under the Banking Companies Act and the Imperial Bank Act, and stated that the Imperial Bank was definitely a State-controlled institution at present and that unless and until it was proved by experience that our powers were ineffective and that the Imperial Bank’s active co-operation in the planned development of industry and agriculture was not forthcoming, I would deprecate strongly any drastic changes in the constitution of the Bank. Nevertheless, I pointed out certain special features peculiar to this institution:

“It has to be recognised that the Imperial Bank has, partly on account of its long association with the Government and the special privileges it has enjoyed, attained a pre-eminent, if not dominant, position in the banking structure of the country. With a network of branches spread all over the country, it is still functioning as banker to Government at places where the Reserve Bank has no branches. It maintains currency chests and small coin depots and operates the remittance facilities scheme. It acts as a bankers’ bank by keeping their surplus cash and by granting them advances. It manages the clearing houses in many places. It is obvious that the Government cannot be disinterested in the working of a Bank, which has acquired such a dominant position in the credit structure of the country and is at present the biggest banking institution in Asia. It is immaterial from the point of view of national interests whether close association with the Government or sound management is the more important factor
which has contributed to this development. A Bank which has reached this position cannot justifiably claim to be treated like an ordinary commercial bank."

4. When the question of the appointment of the Managing Director and the Deputy Managing Director was raised again in August 1952, I observed in my letter to the Finance Ministry [...] dated August 26th, 1952 as follows:

“The time has arrived when we should consider the question of nationalisation or radical changes in the constitution of the Bank from the point of view of the planned development of the country. As you know, I suggested nearly three years ago, the transfer of all treasury work to the Imperial Bank, who would be required to extend their branches to all places where treasuries are functioning at present. The idea behind this was the planned integration of the banking structure. Commercial banking would be taken up to the taluk headquarters and as the Purshotamdas Committee have recommended, beyond this stage co-operative credit banks and other institutions would carry credit facilities to the rural areas. At present, considerations of possible losses arising from the rapid expansion of branches to semi-urban areas deter the bank from any such expansion on the lines suggested. This outlook influenced by the profit motive, is inevitable so long as the Directors and the Executive Officers, are responsible to the shareholders for the management of the Bank. If a partial nationalisation is to be undertaken for a rapid expansion of credit facilities, the proposal for the appointment of the Managing Director and the Deputy Managing Director by Government would not achieve the object, for these officers would still be responsible wholly or partly to the shareholders. Indeed, their position would become impossible if they have divided responsibilities to the Government and the shareholders. If control by Government is to be effective, the Government must hold, at any rate, a majority of the shares, if not all the shares.”

5. The Rural Credit Survey Committee’s main recommendations in regard to the Imperial Bank are briefly these:

(i) the amalgamation of the Imperial Bank of India with ten specified “State-associated” banks; (Bank of Mysore, Bank of Hyderabad, Bank of Baroda and others);

(ii) the expansion of the share capital of the amalgamated institution, in order that, among other things, it may initiate a large programme of branch expansion;

(iii) the allotment of this additional share capital (in the form of non-transferable and dividend-limited shares) exclusively to the Government of India and the Reserve Bank;

(iv) the assumption of major State control over the resultant institution (in which less than half the paid-up share capital would be private and more than half that of the State);

(v) the reconstitution of the Central and Local Boards of the Bank;

(a) the nomination of the majority of Directors on the Central Board by the Government and the Reserve Bank. The first Board would be wholly nominated by the Government for two years;

(b) appointment of the Chairman by the Government after consultation with the Board;

(c) the appointment of the Managing Director and Deputy Managing Director to be made by the Board with the approval of the Government.
(vi) subsidy from the State for that part of the branch expansion which is unremunerative but which, at the same time, is undertaken at the instance of the State for the benefit of the rural areas;

(vii) designation of the institution as the State Bank of India; and

(viii) provision for the State Bank later amalgamating with itself, as and where suitable, small banking units which happen to be complementary to its area of operations.

In general terms, the Committee describes the object of the recommendation as "the creation of one strong, integrated, State-sponsored, State-partnered commercial banking institution with an effective machinery of branches spread over the whole country, which, by further expansion (including further, but minor, amalgamation where necessary), can be put in a position to take over cash work from non-banking treasuries and sub-treasuries, provide vastly extended remittance facilities for cooperative and other banks, thus stimulating the further establishment of such banks, and, generally in their loan operations, insofar as they have a bearing on rural credit, follow a policy which, while not deviating from the canons of sound business, will be in effective consonance with national policies as expressed through the Central Government and the Reserve Bank".

6. The position has thus changed in important respects since the Ministerial pronouncements referred to in paragraph 2.

(a) In the first place, one of the important "technical questions" referred to in Shri Shanmukham Chetty's statement in 1948 arose from the fact that the Imperial Bank was then doing Government treasury work in Pakistan. The National Bank of Pakistan has since been established, and all the Government work done by the Imperial Bank of India in Pakistan has been taken over by the new institution. At present the Imperial Bank of India does not function as Government banker to any foreign Government outside India. The question of nationalisation of the Imperial Bank can now be considered on the merits.

(b) In the second place, the strongest objection raised by the Board of the Imperial Bank to the proposal that the appointments of the Managing Director and the Deputy Managing Director should be subject to the approval of the Government was that there was no justification for this discriminatory treatment, since the appointments of the higher executives of other scheduled banks would not be subject to such approval.

As a result of an amendment introduced in 1951 to the Indian Companies Act (Section 865) the appointment of a Managing Director or the appointment of a Director not liable to retire by rotation is void, unless approved by the Central Government. Their approval is also required in respect of any increase in the remuneration of a Managing Director. This section is applicable to all banking companies except the Imperial Bank, which is governed by a separate Act. The position has thus been reversed. If the Central Government's approval is required in the case of the appointment of the Managing Director of other banks, a fortiori, the appointment of the Managing Director or the Deputy Managing Director of a semi-public bank like the Imperial Bank is fully justified.

(c) In the third place, for the implementation of the far-reaching recommendations of the Committee on Rural Credit Survey, it is imperative that there should be
effective control over the policy and working of the Imperial Bank with a view to ensuring that the policy of the Imperial Bank, insofar as it has a bearing on rural credit, will be in consonance with the national policies as expressed through the Central Government and the Reserve Bank.

The difficulty of implementing this comprehensive scheme, which is of vital importance to the development of agriculture and small-scale industries, without a reconstitution of the Imperial Bank is strikingly illustrated by a very recent incident. The Shroff Committee, of which a senior executive of the Imperial Bank was a member, recommended that the Imperial Bank should aim at providing free remittance facilities to banks on all working days instead of on only one day in a week as at present; and that, as a first step, it should make provision for such remittances on two days of the week. The proposal was an extremely moderate one in that it obviously did not involve any large additional expense or trouble to the institution. Even so, it has been twice rejected by the Imperial Bank. This, of course, is merely one small instance cited as an illustration of the need for greater control over a commercial bank of such importance, which has grown up in association with the State, and on which the Reserve Bank has to depend for the translation into practice of many matters of policy.

7. I have no doubt whatever as to the essential soundness of the main recommendation of the Committee on the Rural Credit Survey regarding the Imperial Bank. For many valid reasons pertinent to the planned economic development of agricultural and industrial India—and such development will constitute the major aspect of governmental effort for many years and quinquennia to come—it is to my mind essential that, as an instrument of national policy, the nationalised Reserve Bank should be supplemented by a powerful commercial banking structure, which is under the effective control of the State and is positively aligned to its aims and objectives. This can and should be done without any lowering of the commercial banking standards of the State-associated bank which will thus come into being.

To the extent that such an idea may be applied to the Part 'A' and Part 'C' States, and therefore to the Imperial Bank which constitutes both the foundation and the framework of such a structure in those areas, it may be said that the essence of the suggestion has already found acceptance with Government, not now after the Committee has incorporated it in its recommendations, but for the last several years when the question of the future of the Imperial Bank came to be considered by Government from time to time.

I do not imply, of course, that Government are unequivocally committed to full nationalisation; indeed, as will be seen from some of the extracts, Government may be said to have been thinking of something which falls short of full nationalisation; however that be, what I am concerned with pointing out is that underlying all the pronouncements is the anxiety of Government that effective control should be assumed over the Imperial Bank.

Effective State control cannot be secured unless -
(a) the Government hold at least a majority of the shares;
(b) the majority of the Directors are appointed by Government; and
(c) the appointments of the Chairman and the two Chief Executives (the Managing
Director and the Deputy Managing Director) are subject to the approval of the Government.

The solution of the Committee is more or less on these lines. It is based on the vesting of a majority of the shares in Government and the Reserve Bank; the shares in question will largely consist of additional share capital, since, for one thing, it is postulated that existing shares are not to be disturbed; hence, while State control will be ensured, what will come into being is not a fully "nationalised", but a "State-partnered" banking institution in which there will be a mixed pattern of shareholding, private and State, with the State as the major partner.

8. As I have said, the reasons for State control over this important sector of commercial banking are of a fundamental nature in the present context of economic planning. Insofar as such reasons arise in connection with rural credit, certain considerations which are dealt with at length in the Report may here be very briefly indicated:

(i) Private credit, i.e. that of the moneylender, is most extortionate and the interest rates highest in those large tracts of the country which are subsistence food crop areas or which at any rate do not grow enough cash crops to come under the description of commercialised and monetised areas. This happens because there is no effective alternative to the moneylender. The alternative we want to see established here, as well as elsewhere is the co-operative society financed by the co-operative bank. But among the many difficulties in the way of establishing co-operative banks in these areas, one of the most important is the absence of facilities for the cheap and ready remittance of cash. Only the Imperial Bank (through the currency chests it gets from the Reserve Bank) can offer such facilities. By and large, however, neither the Imperial Bank nor of course other commercial banks are interested in relatively undeveloped areas including subsistence areas. The Imperial Bank must be made to expand to such areas on a much larger scale than at present and if necessary subsidised for the purpose. This cannot be done unless major ownership, and along with it effective control, are assumed in respect of the institution.

(ii) In Part 'A' and Part 'C' States alone, there are more than 90 district headquarter places to which the Imperial Bank has not yet extended and where the cash work of treasuries (along with the currency chests) is still managed by the State Governments. In addition, there are the "subdivisional" treasuries which continue to be managed by State Governments, because of the absence of a branch of the Imperial Bank; these are of course much larger in number; on the figures given by the Committee they number about 210 for Part 'A' and Part 'C' States. For many reasons, connected not only with the extension of commercial and co-operative banking to rural areas but also with the efficacy of the management of the Reserve Bank’s currency chests, it is a matter of great importance that these non-banking treasuries should be converted into banking treasuries over not too long a period. This, in turn, presumes a much more rapid expansion of the Imperial Bank than can be expected to be undertaken by an institution which belongs almost exclusively to private shareholders. Major State-ownership and control are again indicated.
(iii) The Committee has propounded an integrated scheme in which, *inter alia*, the
development of co-operative credit and the development of co-operative economic
activity (processing, marketing etc.) are proposed to be undertaken on a
countrywide scale through State-partnered co-operative institutions, i.e., through
co-operative banks, marketing societies, etc., to which finance in the form of
share capital, and other assistance in the form of trained technical personnel etc.,
will be provided in the fullest measure necessary by the State Governments. The
State Governments, for their part, will be helped by the Reserve Bank (in the
context of credit societies and banks) and by a Statutory Board under the
Agriculture Ministry (in the context of processing societies, marketing societies,
etc.). This extremely important scheme for the co-ordinated development of co-
operative credit and co-operative economic activity is in turn dependent (as
already indicated) on extended rural banking facilities such as can basically be
provided by the Imperial Bank alone in association with the Reserve Bank and
its currency chests. But that is not all. The Committee also envisages that if the
Imperial Bank (along with the other specified banks) could be converted into a
State bank responsive to national policies such a bank could also help in the
following directions:

(a) The establishment of branches of apex and central co-operative banks in
many of the relatively undeveloped States could take place in close co-
ordination with the branch expansion of the State Bank itself; for one thing,
the latter can provide accommodation and certain banking services to the
branch of the co-operative bank, thus reducing the expenses of the co-
operative institution as well as its requirements of trained personnel.

(b) Short-term loans to credit societies would be provided by the Reserve Bank
through the apex and central levels of the co-operative credit structure; but
there is the whole sector of co-operation represented by marketing and
processing societies, or societies engaged in some similar economic activity,
to which a State bank aligned to State policies could be expected, wherever
possible, to lend the requisite monies without any diminution of its own
business standards. This is extremely important from the point of view of a
programme which depends for its success on the effective and co-ordinated
development of both marketing and credit.

(c) The Committee further points out that much the same problems as confront
agricultural credit are also involved for small-scale and cottage industries in
the context of the credit which they require. A responsive, but not
unbusinesslike, State Bank of India would, the Committee indicates, make a
great deal of difference to the proper and adequate financing of this important
sector of planned industrial development.

9. The remarks I have so far made are with special reference to the Imperial Bank
vis-a-vis Part ‘A’ and Part ‘C’ States. Without entering into details and without
committing myself to particular items such as the list of the individual “State-
associated” banks specified by the Committee in connection with Part ‘B’ States (and
certain merged areas of Part ‘A’ States), I would endorse the Committee’s contention
that all the considerations mentioned above are equally valid in their application to
these other banks vis-a-vis the particular areas of former princely States in which the banks had been established as State-associated institutions of commercial credit. In other words, here also there is a need for a banking institution over which Government has control through major ownership of shares. It takes but one more step in this reasoning to arrive at the broad conclusion that an integrated State-controlled banking structure for the whole country—covering Part ‘A’, Part ‘B’ and Part ‘C’ States—should be the eventual aim of policy. In regard to the ultimate objective of integration, therefore, as distinguished from the detailed timing or manner of its achievement, as also from the detailed examination of the components which are to integrate, I find myself in substantial agreement with the Committee. The method, the time schedule etc. require much further consideration and I propose to advise Government on these matters after I have had an opportunity to consult the Central Board. The principle of eventual integration should apply not only to the Imperial Bank and suitable State-associated banks, but (as pointed out by the Committee) also at subsequent stages of the process of amalgamation to small banking units complementary to the area of operations of the State Bank.

10. At the same time, even as regards the method of integration, one thing seems to me clear, viz., that the integration of the Imperial Bank and the various State-associated banks cannot take place in one quick and comprehensive operation as the Committee appears to have envisaged. If only for practical reasons, it is necessary that the largest of these institutions, viz., the Imperial Bank, should first be taken up and major State ownership and control assumed in respect of it as soon as possible. Similar operations can then be undertaken with regard to such of the State-associated banks as may be selected for amalgamation with the State Bank of India which will thus have already come into existence through the transformation of the Imperial Bank into an institution over which the State has effective control. For this reason, it seems to me that, when examined from the practical angle, the Committee’s recommendations, like the background of previous consideration I have set out in earlier paragraphs lead to a common conclusion—one, moreover, to which Government may already be said to be committed—viz. that the next step to be taken is to assume effective control over the Imperial Bank of India, and that a minimum requirement, for the control to be effective, is the ownership by the State of not less than half of the paid-up share capital of the institution.

11. I would now reiterate certain considerations which I indicated at the outset:

(i) It is desirable that decisions should be taken and implementation commenced as early as possible. So far as the broad issues are concerned, it appears to me that Government is in a position to take immediate decisions since those issues are not materially different from questions which have received Government’s attention in the recent past. In particular, Government is already seized of the question of assumption of control over the Imperial Bank. A final enunciation of policy on this important question—which will in fact amount to a reaffirmation of the essence of previous decisions on this subject—will not only help to facilitate the speedy disposal of the detailed issues, but also be of considerable help to the Central Board of the Reserve Bank when they meet to consider some of these issues. Such decision or re-affirmation would of course
confine itself to broad principle; and its main aspects would consist in the following statements of intention which may form part of a communication to the Reserve Bank:

(a) Government proposes to assume effective control over the Imperial Bank;
(b) in doing so, it intends that the private shareholder should, if possible, be left in undisturbed possession of his existing shares or their equivalent; and
(c) as part of the scheme of control and through the allotment of additional shares made necessary by a large-scale programme of branch extension to rural areas or otherwise Government intends that not less than half the expanded share capital shall vest in the State (Central Government and/or the Reserve Bank).

The communication may add that Government has an open mind as to how these intentions may be embodied in concrete measures and that it will await the Reserve Bank's advice on this matter.

(ii) It is at the same time necessary to reaffirm the decision already taken by the Government of India regarding the broad lines on which compensation will be fixed for acquisition of Imperial Bank shares, should such acquisition become necessary at all. A suitable announcement at the time the Report is published will go far to allay the possible apprehensions of private shareholders. I would strongly urge, as a vital part of my suggestions, that the lines of compensation should be the same as those announced in the past by Shri Shanmukham Chetty. Similar considerations will apply where, instead of acquisition, there is exchange of Imperial Bank shares for State Bank shares.

12. Since the Government are committed as regards the basis on which the compensation for shares acquired by them will be calculated, it is hardly necessary to justify the Government decision. The following figures regarding the distribution of shares and the yield on the basis of the market value may, however, be of interest.

The total paid-up capital of the Bank amounting to Rs 5.26 crores was held on December 31st, 1953 by 10,472 shareholders in all. Out of these, as many as 7,256 shareholders constituting about 69% of the total number, held upto 10 shares only. The number of shareholders who held more than 100 shares was only 338 constituting, that is about 3% of the total number. More than half the share capital is thus held in the form of small- or medium-sized holdings. My information is that a fair proportion of the shareholders are persons of relatively small means, who have acquired these shares because of their steady yield. In the case of these shareholders income from their investment in the shares of the Imperial Bank is very important, and payment of compensation to them at anything less than the full market value will not only involve them in serious capital loss but would also result in a reduction in their current incomes.

I have also certain figures collected at your request some time ago of shares held continuously since 1921 and those acquired thereafter. Of the 75,000 fully paid-up shares of the Imperial Bank of India, only 2,991 shares have been continuously held by the respective shareholders, while 72,009 shares, or 96 per cent of the total, changed hands since 1921. Similarly, out of 1,50,000 partly paid-
up shares, only 3,979 shares were continuously held, while 1,46,021 shares, or 97.3 per cent of the total number, changed hands during the same period. The bulk of the holdings are thus at present held by persons who must have acquired the shares at a value higher than their face value. In a majority of these shareholders, therefore, there could not be a very large element of capital appreciation that could justify payment of compensation at anything less than the market value. Recently, at the request of Rajadhyaaksha we worked out certain figures of yield on the shares of certain selected banks, and we found that on the basis of the current market values, the Imperial Bank shares gave during the years 1949–54 an average yield of 4.32%. In the last 7–8 years, the price of fully paid-up shares of the Imperial Bank of India has varied between Rs 1,700 and Rs 3,300, whereas the paid-up capital is only Rs 500. This means that against a nominal rate of 14–16 per cent dividend, the effective yield on market value has varied from a little over 2 per cent to slightly under 5 per cent. The fully paid-up shares of the Imperial Bank of India are now hovering around Rs 1707.

I, therefore, feel strongly that, apart from the definite commitment of 1948, there is no justification on the merits for any departure from the undertaking in regard to the payment of compensation. Apart from being a breach of faith to the investor, such a course would have serious adverse repercussions on the general investment market.

13. The decisions on some of the points I have mentioned above could be announced through a statement by you in the Lok Sabha simultaneously with the publication of General Report of the All-India Rural Credit Survey. I enclose a draft statement. As I have already indicated, the publication of the note as well as the Report could be timed to take place about the 21st of this month. I need hardly add that this implies that Government will reach very early decisions on the broad issues mentioned in this letter.

Yours sincerely,

B. RAMA RAU

Sir Chintaman D. Deshmukh
Finance Minister
Government of India

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All-India Rural Credit Survey:
Report of the Committee of Direction

The Officer on Special Duty wished to have the remarks of the Agricultural Credit Department on the recommendations of the Committee of Direction of the All-India Rural Credit Survey. I have selected 5 major points and set down my views on them. They are matters of fundamental importance. They may be perused by E.D.(V[enkatappiah]). The points on which my views are submitted are:

(i) State Partnership in Co-operatives,
(ii) Partnership of Co-operative Financing Banks in Borrowing Institutions,
(iii) The Agricultural Credit (Stabilisation) Fund,
(iv) Open Membership in Agricultural Credit Societies, and
Large-sized Primary Co-operative Credit Societies.

O.S.D. wishes to have a copy of my notes today. May I send him an advance copy?

[J.C.R(YAN)]
29.12.1954

E.D.(V[enkatappiah])

I. STATE PARTNERSHIP IN CO-OPERATIVES

(Recommendations: 34, 54, 91, 113, 136, 140)

The central recommendation of the Committee of Direction of the All-India Rural Credit Survey concerning co-operatives is that the State should enter into partnership with co-operative institutions not only in administrative and technical matters but also by subscribing to their share capital. The principle that the State might take shares in co-operatives has already been recognised by statute. Thus, Section 31 of the Madras Co-operative Societies Act and Section 33A of the Bombay Co-operative Societies Act permit the State to become shareholders in co-operatives. In practice, several States, including Bombay, are already shareholders in co-operative institutions. While, therefore, there is no objection to the State subscribing to the shares of co-operatives, the point for consideration is at what levels it may do so. The Committee has recommended that the State might take shares in the apex co-operative bank (State level), in the central co-operative bank (district level) and in the primary society (level of the village or the town), albeit indirectly in the last two cases.

There can be no objection to the State taking shares in financing institutions (state co-operative banks and central co-operative banks). This will enable them to command adequate funds so as to make them available in the form of rural credit. But it is open to question whether it would be proper for the State to take shares in the primary co-operative societies to enable them to borrow funds from the financing bank. The Committee are of the opinion that the “State’s participation in Co-operation cannot stop at an intermediary stage but must be taken to its logical conclusion which is that of providing for a cultivator a strong and suitable superstructure.” The word “superstructure” would appear to restrict State partnership to the higher organisation of the co-operative structure but actually the recommendation made by the Committee is that the State should take shares even in the base of the co-operative structure, namely, the primary co-operative societies.

Firstly, is there a need for it? Share capital is needed to measure the borrowing power of the borrowing institution and is usually determined as a multiple of its owned capital. In the case of rural credit societies, most of which are based on unlimited liability, the borrowing power is not fixed at so many times the share capital. It is fixed with reference to the total net assets of the members of the society or with reference to the general solvency of the society. Thus, in Madras and some other States, the borrowing power is fixed at 1/8th of the total net assets of the members of the society. In some States it is fixed at so many times the land revenue paid by the members of the society. In Madras, a society having Rs 1,000 share...
capital is allowed a credit limit of say even Rs 25,000 reckoned on the net assets of its members whereas it will not be entitled to a credit limit of Rs 8,000 if the borrowing power is measured in terms of owned capital. This will show that increased share capital in primary society is not necessary for enhancing its borrowing limits. Nor is it necessary for attracting rural deposits. Rural savings do not flow into institutions on account of the size of their owned capital. They are to be hunted out and seized before they are spent away.

It might be contended that though there may not be so much need for large share capital in an unlimited liability credit society there would be such a need in a limited liability credit society. At present, the latter variety of societies is situated only in towns; but there is a tendency in some parts of the country to replace unlimited liability by limited liability even in villages. On account of this, it might be pressed that the State should subscribe to the shares of the least limited liability credit societies, the reason advanced being that the primary credit unit should be strong and that strength can only be imparted by adding to its owned capital. This argument would stand very well in the case of a joint stock banking institution which is a “union of capital”. It will not fit in with a co-operative institution which is a “union of individuals”.

The former is an association of lenders who lend chiefly to non-members; the latter is an association of borrowers who lend only to themselves. The former need capital to make it fructify, the latter need character to help themselves with the credit they need. The co-operative credit society claims to “capitalise honesty” and borrow on that security. Capital itself is of minor importance to it. It raises funds on the basis of thrift, namely, its members’ ability to save. It raises them on their ability to avoid improvident expenditure and utilise the credit obtained only for provident purposes. One of the most essential distinctions between co-operative banking and joint stock banking lies in this, viz., that the former is educative in character. It stresses the point that if one seeks a loan he should merit it. If facilities for borrowing are provided by increasing the share capital of primary societies with State subscriptions this educative character will gradually disappear. There will be less desire to save and rely on oneself and an increasing tendency to depend on the State. While, it is certainly necessary to extend rural credit, it is more important that the agricultural-borrower should be educated in self-help and thrift. We should endeavour to increase the number of agriculturists who rely on their own strength for the credit they need and who will put their savings in their society.

I, therefore, plead that, while we should facilitate the provision of rural credit by asking the State to be a shareholder in financing institutions, we should not allow rural credit to become facile credit by asking the State to take shares in primary credit societies as well.

It may be asked whether a distinction cannot be made in the case of a co-operative marketing society and whether the States may not be advised to take shares in it. Here again, the question is whether there is a need to do so. A marketing society with Rs 1,000 share capital does not have maximum borrowing power limited to Rs 8,000. It is allowed to borrow upto Rs 1 lakh provided what is borrowed in excess of Rs 8,000 is covered by the security of the agricultural produce of the members of
the marketing society kept under the safe custody of that society. Marketing societies have, therefore not complained of inadequate credit. Their problem lies in securing agricultural produce on the security of which loans could be given to their members. When marketing societies assist their members to sell their produce, they do so only on agency basis and for a commission. Few societies purchase their members’ produce on their own account and dispose of them on their own account. The latter variety of business is risky. It is, therefore, restricted to about twice or thrice the owned capital of the marketing society. If the State is to be advised to take shares in a marketing society to help in the outright purchase and sale business, an important question arises, viz., whether the State could take to trading business on a partnership basis. Considering the risks in trade it is natural to expect the State to embark on it without any partner. A third variety of business undertaken by marketing societies is storage and processing. The suggestion that the State should take shares in marketing societies to help them to erect warehouses or processing plants will not secure the end in view. A warehouse does not pay. Witness after witness who appeared before the Rural Banking Enquiry Committee asserted this, so that, that Committee considered that warehouses could be promoted only by giving a State grant to the extent of 25 per cent of the value of the warehouse and a State loan to the extent of another 25 per cent at a reduced rate of interest. To add to the share capital of the marketing society from the coffers of the State for this purpose is, therefore, an unsound business. Likewise, to provide additional shares from Government for erecting processing plants will not ensure the speedy execution of the object in view. What the society needs in this case (as also in the case of building warehouses) is facilities to acquire lands, to import machinery, and to erect them. When a grant and a loan are given by the State for erecting a processing plant, they can be given at the appropriate time and the execution of the work can be speeded up. The subscription of share capital by the State would be a wasteful investment. In the case of co-operative industrial enterprises, however, the State’s participation in primary societies is desirable. A co-operative spinning mill, or a co-operative sugar factory, or a co-operative handloom factory is an institution in which the State should take shares if such an enterprise is to be developed. The shares taken will be utilised for erecting the equipment necessary to start the factory, which is the first function of the society. Without State help in the form of shares the factories may not, in many cases, be established at all. But where the co-operative industrial enterprise is not conducted in a factory but is conducted in the homes of its members, as for instance, in the case of a handloom weavers society, the State need not take shares in the society because the yarn provided to the members is given to them as loans in kind just as in rural credit society loans are given in cash. Hence, in this case the member should merit the loan.

II. PARTNERSHIP OF CO-OPERATIVE FINANCING BANCS IN BORROWING INSTITUTIONS

(Recommendations: 68, 74, 102, 120, 136)

The Committee of Direction of the All-India Rural Credit Survey has advocated that the apex co-operative bank should take shares in the central co-operative bank
and that the latter should also take shares in the primary co-operative societies. Likewise, the Committee has recommended that the central land mortgage banks should take shares in the primary land mortgage banks. This recommendation has probably arisen from the fact that, in Bombay, the apex co-operative bank has taken shares in the central co-operative bank (albeit with State funds) and, in Madras central co-operative banks have taken shares in co-operative wholesale stores.

I am not sure that this procedure of the creditor becoming a partner in the affairs of the borrower is correct. Possibly, this point was not examined in Bombay. In Madras, central co-operative banks became shareholders in wholesale stores in a hurry as a matter of expediency to enable co-operative wholesale stores to undertake procurement business on behalf of Government. The procedure is now considered to be unhealthy there and steps are afoot to retrace the step taken. When a financing bank takes shares in an institution which is its borrower it amounts to saying this: “You hold a share capital of Rs 10,000; you can borrow only Rs 80,000; but you need a lakh and sixty thousand rupees; you should increase your owned capital to entitle you to a lakh and sixty thousand rupees; you are unable to do so; I shall give you a share capital of Rs 10,000; then you can have Rs 20,000 x 8 namely, a lakh and sixty thousand.” Looking at this line of thought critically we should say that it nullifies the principle that the borrowed capital of an institution should be related to its owned capital. When the State provides the extra Rs 10,000 as share capital instead of the creditor, the creditor has the shares of Government and those of the other Members of the institutions as its margin of security; but when the creditor himself takes the shares, the creditor has himself for his security. If he is anxious to lend the institution a lakh and sixty thousand rupees, the proper course for him would be to say that the borrower’s credit limit might be fixed not at 8 times the owned capital but at 16 times that. But the creditor knows that to lend up to 16 times the borrower’s owned capital is not sound banking. Yet he is anxious to lend. Therefore, he says: “I shall lend only 8 times your owned capital, but I shall contribute Rs 10,000 to your share capital.” Apart from the fact that this course is not a straightforward course, should the borrowing institution fail, the financing bank will lose not only a part of the money it has lent to the borrowing institution but it will lose the entire share capital it has invested in it. Hence, correct banking standards would require that a financing institution should not be a part-owner in the institution which borrows from it.

Applying the above canon, an apex co-operative bank need not be a shareholder of the central bank and the central bank need not be a shareholder in the primary credit society. In the case of a central land mortgage bank and a primary land mortgage bank the need for the former being a shareholder of the latter does not arise at all. Loans are given by the central land mortgage bank to the primary land mortgage bank on the security of immovable property mortgaged by the member. Where the immovable property is adequate each loan is sanctioned and disbursed to the member by the centre. If a restriction is placed that the loan should not exceed 20 times the share capital of the borrowing institution, the share capital is intended to strengthen the shares of the central land mortgage bank. The fact is that unlike the short-term banking structure, the land mortgage banking structure is a centralised structure in which money is raised by the centre and passed on to the units and the units have no
responsibility for raising funds. Debentures are issued by the centre and not by the units. The units, therefore, do not require large share capital. What they have, they pass on to the central land mortgage bank. Hence, the State's subscription to the share capital of the central land mortgage bank alone will suffice for strengthening land mortgage banking.

III. THE AGRICULTURAL CREDIT (STABILISATION) FUND

(Recommendations: 8, 63)

The Committee of Direction of the All-India Rural Credit Survey has recommended that the Reserve Bank should establish a National Agricultural Credit (Stabilisation) Fund and that each State Co-operative Bank and central co-operative bank should have an Agricultural Credit (Stabilisation) Fund. “The Stabilisation Fund in the hands of the Reserve Bank should be utilised for the purpose of granting medium-term loans to State Co-operative Banks etc. in circumstances in which it is satisfied that short-term loans of which repayment to it has become due by the State Co-operative Banks etc. cannot, without serious dislocation to the credit structure of the State’s co-operative system, be repaid in due time on account of famine, drought, etc. and consequently that repayment of such loans or part thereof, may justifiably be allowed to be deferred. In such a case, a book adjustment will be made between the Stabilisation Fund and the Banking Department of the Reserve Bank; the short-term loan will be technically treated as repaid to the Banking Department, but in effect converted into a medium-term loan from the Reserve Bank’s Stabilisation Fund. The Reserve Bank may make this facility conditional on the State Co-operative Bank concerned maintaining a similar Agricultural Credit Stabilisation Fund, the same applying to central co-operative banks, and where feasible, to the larger-sized primary societies; the Reserve Bank, in such cases, may further insist that part of the overdue liability should be met from such Stabilisation Funds kept within the co-operative credit structure itself.” Co-operative financing institutions are already having the system of granting extension of time for the repayment of loans which fall overdue owing to circumstances beyond the borrower’s control. But the extent to which such extensions are given is confined to the resources of the financing bank at the time and by ordinary business prudence. The present recommendation of the Survey Committee takes the matter a little beyond the pale of pure business; but what will be the consequences?

In Madras, the Government constituted a Revolving Fund of Rs 5 lakhs and placed it at the disposal of the Madras Central Land Mortgage Bank in order to relieve borrowers from the distress caused by famine. The primary land mortgage banks which were affected by famine were selected and borrowers who could not pay off the annual instalment due from them were told that the demand against them would be met from the Revolving Fund and that the amount so provided would be treated as a five-year loan payable by them on the expiry of the period of the original loan. About Rs 65,000 were disbursed out of the Revolving Fund according to this scheme. Thereafter investigations were made as to how the Revolving Fund was utilised with a view to making it a permanent feature. These investigations revealed
that although there were a few cases in which borrowers genuinely in distress had benefited, in a large number of cases borrowers who were not actually in need had been helped with the Revolving Fund. It was not that the scrutiny before the sanction of the loan was inadequate but it was a case of feigned distress in many cases which misled the loan sanctioning authorities. In some cases, evil advisers induced even borrowers who could pay their dues not to pay them but to avail themselves of the Revolving Fund. Ultimately, the Government of Madras scrapped the idea of the Revolving Fund and took back the undisbursed balance out of the Rs 5 lakhs.

The above experience reveals that the presence of a Stabilisation Fund makes the borrower less responsible than he should be. But such a Fund could make even the lender become less responsible. It is not unusual that the existence of a bad debt fund often encourages the managements of co-operative banks to write off loans against that fund even before every effort necessary to recover the loan is exhausted. The bad debt fund has also led the managements of some banks to sanction loans with greater ease relying upon that fund in the event of losses; when a Stabilisation Fund is established, worse results may follow. It cannot be ignored that the managements of co-operative central banks are entrusted in increasing measure in the hands of borrowers' representatives. It would be difficult for them to exercise their judgement in a judicial and independent manner, when help is sought for out of this Stabilisation Fund. Therefore, the proper thing to do is to entrust the Stabilisation Fund to an independent agency unconnected with the co-operative movement; for example, the Judiciary or the Revenue Department, or a Credit Stabilisation Board set up by the State under a special statute. Borrowers in distress may approach such a tribunal who may examine the merits of each application, grant extension of time to pay off the loan overdue and transfer equivalent funds out of the Stabilisation Fund to the creditor concerned. The removal of the Stabilisation Fund from the hands of the banks to an outside agency, which is not even the co-operative department will leave the banks intact as business institutions and avoid producing the impression that they are also agencies for relieving distress. So far as the Reserve Bank is concerned, the Stabilisation Fund with it may be administered by it. As no applications for help from the Stabilisation Fund will come to the Reserve Bank until and unless the tribunal set up in the districts approves help from the Stabilisation Fund to the central bank concerned, recourse to the Reserve Bank may be taken to be genuine in most cases. The administration of its part of the Stabilisation Fund by the Reserve Bank will serve as a check over the tribunal in the districts for each case will be examined on its merits a second time.

IV. OPEN MEMBERSHIP IN AGRICULTURAL CREDIT SOCIETIES

(Recommendations: 118, 55)

The Committee of Direction of the All-India Rural Credit Survey has recommended: "Membership of agricultural credit societies in general, larger-sized or small should be open to all persons residing in the areas of their operations. Further, as already mentioned a person who is refused admission to the society should have the right to appeal to the Registrar of Co-operative Societies."
This recommendation has emanated from a desire to provide rural credit to every credit-worthy borrower in the village; but it treats the agricultural credit society as a public body and takes away its autonomy as well. An agricultural co-operative credit society is not a public institution like a village panchayat or a municipality, where residence for a prescribed period within the limits of the local body, entitles one to vote. It is a private body like the Cricket Club or the Cosmopolitan Club. It has not come into being by an order of the Statute but has been brought into existence by a group of individuals getting together on a voluntary basis and having themselves registered as a co-operative society. These individuals have a right to say which of their fellow villagers can be permitted to associate with them and which should be kept out, in the same way as the Cosmopolitan Club can blackball any applicant for membership without assigning any reason. Indeed, the right to do so would be more justifiable in the case of the agricultural credit society than in the case of the Cosmopolitan Club; for, the members in the society have assumed unlimited liability and pledged all their worldly belongings as security for the loans taken by the society. If the society fails on account of a few bad members not paying off their loans, the rest of the members will have to make good the deficiency. It is, therefore, an inalienable right of those who assumed unlimited liability to say who can be admitted into their company and who cannot. There can and ought to be no appeal to any outside body like the Registrar on this matter; for, if unlimited liability happens to be enforced on account of the Registrar having forced the admission of an undesirable member into the society, the Registrar cannot prevent unlimited liability being enforced against the rest. Even if the agricultural credit societies are based on limited liability the danger is there, though it will be limited to the extent of the share capital of the members or a multiple thereof.

V. LARGE-SIZED PRIMARY CO-OPERATIVE CREDIT SOCIETIES

(Recommendation: 116)

The Committee of Direction of the All-India Rural Credit Survey has recommended that “The future line of development of co-operative credit at the level of the village should be unhesitatingly in the direction of bigger societies covering larger areas. Primary agricultural credit societies should hereafter be established, or wherever necessary, existing ones reorganised, so as to cover, according to local conditions, groups of villages with reasonably large membership and reasonably adequate share capital.”

The same suggestion was made before the Fifteenth Conference of the Registrars of Co-operative Societies held at Madras in 1947. It was sponsored by the then Registrar of Co-operative Societies, Madras, Mr. N.S. Arunachalam, I.C.S. He advocated the constitution of rural banks on limited liability basis, covering a wide area. It was claimed that such a large bank could command large business, could maintain an office of its own, could appoint competent paid staff and could even undertake such lines of business as the supply of provisions as well as the sale of agricultural produce. The suggestion was opposed by the late Mr. T.A. Ramalingam Chettiar who believed in “one village one society”, but he had no objection to
experiment with one or two rural banks in each district. The Chairman of the Conference, Sir Phiroz Kharegat, observed as follows:

"If I may take you back for one moment to our early days of co-operation, you will find that we started with the very idea that is now adumbrated by those who want a society for a group of villages. In 1904, all the societies that were started were not for each village but for a group of neighbouring villages. Every one of them was a failure, and had to be liquidated. Then, we experimented with the other idea, and that was to try and take all the people of one community of neighbouring villages and constitute them into one society. These were equally a failure although we expected that the caste feeling would be so strong as to supply a common bond of unity. It was after experimenting with all these types that our predecessors came to the conclusion that the ideal to be aimed at is one village one society. What I would suggest for the consideration of the Conference is that we might say that the area of operations of a primary multi-purpose society should ordinarily be the village. But the area of operation of the mandi trading society should cover all the villages from which produce is brought to the mandi. However, in tracts where villages are very small, or for other adequate reasons, there may be one primary society for more than one village. That would be a sort of general thing which would cover all conditions."

The suggestion of the Chairman was accepted and the following resolution was adopted by the Conference:

"This Conference considered the note submitted by the Government of Madras regarding the reorganisation of the primary credit unit as "Rural Bank" on limited liability basis and recommends (a) that the area of operations of a primary multi-purpose society should ordinarily be the village, (b) that in tracts where villages are very small there may be one primary society for more than one village, and (c) that the area of operations of a mandi trading society should cover all the villages from which produce is brought to the mandi."

The All-India Rural Credit Survey Report recommends large-sized credit societies for groups of villages. But these large-sized agricultural credit societies are open to the following objections:

(i) The present tendency of planners is to develop each village as a unit. A large-sized credit society will operate against this objective.

(ii) The anxiety of the Rural Credit Survey Report is that rural credit should be conveyed to as many agriculturists as possible. This can be done only if rural credit is not confined to propertied individuals but extended also to those who cannot provide movable or immovable properties as security for the loans taken. In the latter case, loans will have to be given to a member on the strength of his character assured by a surety of equally good character. Assessment of character over a large area would be difficult. A society with about 20 villages will, therefore, tend to confine itself to loans on the pledge of properties—immovable or movable and defeat the very object of the Rural Credit Survey Report. In this connection, it may be mentioned that the view of Sir Frederick Nicholson, the father of co-operation in India are worth considering. He writes in his Report as follows:
"That which is required jointly by both lender and borrower may be summed up in the word “proximity”. The great lesson of European credit is that without absolute proximity there is no such thing as credit on any reasonable terms for the small folk; hardly indeed is there credit at all. Until of late, only one form of credit satisfied this postulate, viz., that of the private moneylender; his credit satisfied the postulate of proximity, but not necessarily any other postulate.” Hence, the idea of large-sized agricultural credit societies need not be stressed.

[J.C.R(YAN)]
23.12.54

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B. CONTROVERSIES OVER CO-OPERATION

D.G.(V) has recently shown concern at the information that he has obtained that the Planning Commission is thinking of making a radical departure from the policy regarding co-operative credit which has been set out in the Agricultural Ministry’s letter of the 17th January 1957 addressed to State Governments. His concern is based partly on the ground that the policy itself, which has been adopted by the Government of India with the agreement of the State Governments and the Reserve Bank, is right and should not be amended, at any rate till we have given it a fair chance, and partly that, in any event, a ‘chop and change’ in matters like this at frequent intervals is ruinous to progress.

2. I was not able in Delhi to see the Deputy Chairman of the Planning Commission as he was away on tour, but I did speak to the Finance Minister. At first he said that he was in agreement with the Deputy Chairman. I got the impression, however, that he had not really appreciated the point of view of the Reserve Bank and I explained to him what was the experience of Bombay State in the matter of integrated rural credit and how the proposals which have now been accepted are merely an extension to the whole country of what has already been attempted successfully in Bombay. He seemed greatly interested. Apparently somebody has been talking to him about the dangers of so-called “collectivism”. I told him that the success of the integrated credit experiment in Bombay has been due to “co-operative” effort; and it is resulting in the elimination of the middleman. The Minister agreed that whether this is called co-operation or collectivism, it seemed to be a pretty good thing deserving of encouragement.

3. I also got a chance to explain to the Prime Minister how much I had been impressed by the smooth transition that has been taking place in some areas, for example, Broach District, where an integrated co-operative effort is bringing benefits to the cultivators without destroying the smoothness of the processing or distributive mechanism. He asked me whether we had any statistics about the movement for integrated co-operative credit.

4. I would be grateful if D.G.(V) would let me have a brief note explaining precisely what has been achieved and is being attempted in certain selected areas. I would like to send that note to the Prime Minister.

H.V.R. IENGAR
18.3.1957
D.G.(V) I have mentioned this to C.O., A.C.D. 18.3.1957
C.O., A.C.D.
Mr. Rao, we might send the note you are getting ready.

J.C. RYAN
18.3.1957

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Camp: MADRAS
29th May, 1957

[Dear Shri Krishnamachari,]

I notice from the papers that at the meeting of the Lok Sabha a couple of days ago, you announced your intention to promote legislation at the next session of Parliament for divesting the Reserve Bank of certain functions in connection with the handling of agricultural credit. According to the newspapers, you mentioned this point in the context of your enunciation of the future role of the Reserve Bank. We are all most grateful to you for having stated in such explicit terms the place you propose to attach to the Reserve Bank. I personally am particularly grateful that this statement should have been made by you after I became Governor. At the same time, I write to express the hope for the reasons stated below that you have not made up your mind finally with regard to the precise role of the Reserve Bank and the State Bank in the matter of agricultural credit.

2. In the first place, it seems to me necessary that the Boards of the two Banks should be consulted, more particularly as your proposal would involve an amendment of the Reserve Bank of India Act and the State Bank of India Act. It would be necessary to inform them in reasonably precise terms what exactly are the changes proposed and why, so that they can have an opportunity of expressing their views.

3. In the second place, it would seem to be necessary that leading co-operative institutions in the country should be consulted about the proposed changes. From the point of view of good public relations of the Central Government, I should consider such consultations obligatory. At the moment, they are completely at sea, having only vague reports in the press before them. As you are aware, some of these institutions are run by people who have dedicated themselves to the cause of co-operation and whose views it would be improper to bypass before a final decision is taken by Government.

4. In the meanwhile, also, as you are aware, there is an Ad Hoc Committee in the Reserve Bank consisting of Bhattacharyya, Prof. Gadgil and myself to examine this subject. We have already had a couple of meetings and are proposing to have another one early in June. I myself have, as you may have heard, been going round personally investigating this subject and during the course of my present trip, I have arranged a number of meetings with leading co-operative institutions. I am meeting, for instance, the directors of some co-operative land mortgage banks this afternoon and the directors of the State Co-operative Bank of Madras tomorrow. I am also arranging for some similar meetings in Bombay before the meeting of the Ad Hoc Committee. While
these consultations are useful from the point of view of the Ad Hoc Committee, they could not replace the more formal consultations with the co-operative movement which I have suggested above because of the status of the Committee, which is a purely Ad Hoc domestic committee of the Reserve Bank and the State Bank. Moreover, I am not able at this stage to tell the people I meet precisely what is the plan that the Government have in mind beyond that the State Bank should step into the shoes of the Reserve Bank. But this leaves certain questions in the air, such as, for instance, the precise role in the future set-up of the central co-operative banks and the State co-operative banks.

5. I had asked Dr. Madan, while he was in Australia, to study the practice of their Commonwealth Bank. As you are aware, there has been a great deal of discussion in Australia, most of it quite heated, about the role of the Commonwealth Bank in the matter of commercial and agricultural credit, and certain decisions have recently been taken as a result of which, while commercial banking is kept outside the purview of the Commonwealth Bank, agricultural credit will continue to be handled by the Bank. I have asked Dr. Madan to give me a note about this. What may be a correct decision in Australian conditions may not necessarily be appropriate for India, but it would be useful nevertheless to study the Australian debates before we reach a final decision.

6. After the next meeting of our Committee, when we have drafted our provisional conclusions, it might be useful if the Committee could meet you and have a personal discussion on the basis of our draft report. I hope you would agree to this.

Yours sincerely,

H.V.R. IENGAR

FINANCE MINISTER
INDIA

NEW DELHI

D.O. No.[...]
June 3, 1957

My dear Iengar,

Please refer to your letter of the 29th May, written from Madras, in connection with the statement that I made in Parliament on the subject of agricultural credit.

I have no intention of hustling you, but we have to get a move on. The ideas we have of agricultural credit itself is rather narrow and has to be expanded.

The position of bank advances against paddy and rice is not very happy. As you would have seen, twenty scheduled banks by themselves are holding as pledge about eight lakh tons of rice. We do not know what other scheduled and non-scheduled banks are doing. The increase in the advances to co-operative societies plus their own increased resources must account for a fair stock of rice pledged with them. An integrated credit policy is therefore necessary.

Besides, it seems reasonably certain that the National Warehousing Corporation has failed and a reorientation of our ideas in this connection must be thought of. The agency of the State Bank might be utilised in this connection as well. The pressure of circumstances now prevailing is so great that we have to move quickly. As I have said at the outset, I am quite prepared to wait until you have made up your mind in
this matter. But in the meantime I am increasingly of the view that the hasty implementation of the perfunctorily conceived recommendations contained in the Rural Credit Survey Report has done us a lot of harm.

With kind regards,

Yours sincerely,

T.T. Krishnamachari

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Organisation of large-sized agricultural credit societies
and expansion of the Agricultural Credit Department

The following papers relating to the question of organising large-sized agricultural credit societies are placed below for perusal, in connection with Governor's forthcoming visit to New Delhi.

i) Copy of Governor's letter to Shri A.P. Jain, Union Minister for Food and Agriculture dated 3 September 1958, together with a copy of the enclosed note.

ii) Copy of Governor's letter to Shri A.P. Jain dated 20 September 1958 (together with copy of circular letter).

iii) Copy of the D.O. of Chief Officer, A.C.D., dated 28 April 1958 to Shri A. Baksi, Joint Secretary to the Government of India, Ministry of Finance, together with a copy of the detailed note enclosed thereto, which had been prepared earlier in the A.C.D.

iv) Copy of D.G.(V)'s D.O. dated 10 June 1958 to Shri A. Baksi.

v) Copy of Shri Vaikunth L. Mehta's pamphlet on "Some aspects of Rural Credit Organisation".

vi) D.O. addressed to D.G.(V) by Shri G. Jagathpathi, Registrar of Co-operative Societies, Madhya Pradesh, together with the enclosures.

vii) A table showing the frequency distribution of villages with a population of less than 5,000, classified according to different population sizes, for 15 districts, selected on the basis of the criterion of the percentage area under irrigation out of the districts in which the All-India Rural Credit Survey was conducted.

27/9

A.C.O.(Das) - K.M.D. 29/9

D.G.(V) - B.V. 30/9

Governor—I have discussed this with the Finance Minister.

2. I am afraid he is wholly unsympathetic to our views. He is quite prepared for us to stop further expansion of Reserve Bank credit for agricultural production till what he calls the basic objective is achieved viz. of setting up co-operatives which can move on their own (people's) momentum, without official support or patronage. He thinks that the decisions taken on the basis of the Rural Credit Survey Committee Report were completely misconceived and that the sooner they are reversed the better. All he is prepared to do is not to break up large-sized societies that have (unfortunately) already been set up.
In view of Finance Minister’s attitude we must assume that Cabinet will approve of Planning Commission’s views. I think we must now reconsider the entire problem of R.B.’s policy and administrative arrangements.

H.V.R. IENGAR
6/10

D.G.(V) - C.O. wanted this (copy) to be put up for D.G.(V)’s orders on the last para.
K.M.D.
22/10

DCO(R) - I.S. Rao 22/10 - DG(R) wanted this to be raised.

The following points may be mentioned in connection with the reconsideration of the entire problem of the Reserve Bank’s policy and administrative arrangements in the sphere of rural credit and co-operation with special reference to the activities of the Agricultural Credit Department and the proposals for this expansion:
(1) The controversy with regard to the reorganisation of the co-operative credit structure is only in respect of the primary level, viz., that concerning large-sized societies. There is no difference of approach whatsoever with regard to the reorganisation at the higher levels of the credit structure, viz., central banks and State co-operative banks. There is unanimity of view that these higher levels need considerable reorganisation by State partnership, etc.
(2) A good part of the activities of the Agricultural Credit Department relate to the reorganisation at the higher levels of the co-operative credit structure. Thus, we inspect apex banks and central banks and central land mortgage banks. A large amount of work has yet to be done to ensure that the higher co-operative financing structure functions on sound lines. A good part of the expanded programme of activities of the Agricultural Credit Department in fact cover activities intended to reorganise the higher levels of the co-operative credit structure.
(3) Even as regards the basic level, the question is still an open one, and according to recent proposals, it is surmised that a high level committee would be set up to consider the various issues involved in the question of small vs. large-sized societies. Present indications, however, are that several of the Registrars are strongly of the view that the programme for organisation of large-sized societies should continue vigorously, at any rate, till the end of the Second Five Year Plan, according to the targets fixed in that Plan. They feel that the plans for the strengthening of the co-operative credit structure will receive a severe jolt if the instructions contained in the Government of India’s latest circular on large-sized societies are implemented. This applies both to Registrars in States where the movement is developed and also to the Registrars in States where the movement is undeveloped. At any rate, there are about 5,000 large-sized societies functioning in the country now and they will need considerable attention in the co-operative development plans. There is, besides, the enormous problem of existing small societies (many of which are not strong) through which the bulk of the Reserve Bank’s finance is now channelled to the co-operative credit structure. About 1,700 more large-sized societies are expected to be organised in 1958–9.
(4) The need for close liaison with the States, careful watching of credit development plans, giving technical assistance to State Governments and co-operative institutions,
remains in the same manner as before. Although the rate of expansion of credit may be slowed down a little, there will be no fundamental change in the scope and variety of our activities. It would thus appear that the general direction of our policy and administrative arrangements will remain largely unaffected.

I.S. Rao
23/10

The volume of loans drawn from the Reserve Bank by the co-operative movement as short-term agricultural credit, has risen from Rs 12.11 crores in 1951-2 to Rs 61.38 crores in 1957-8. It is not only likely that the increased volume of drawals will continue in the coming years but there is a prospect of that volume increasing further as the co-operative banking structure becomes stronger and stronger. The same is the position in regard to medium-term loans of which a sum of Rs 0.27 crore only was drawn from us in 1954-5 but which has risen to Rs 2.80 crores in 1957-8. The Reserve Bank is also making investments in debentures of central land mortgage banks, which stand at over Rs 1 crore today.

2. The supervision of the application of the loans taken from us for the purposes for which they are given and their recoveries on due dates, is becoming more and more important. There were defaults to us of a few days in Punjab and of nearly a month in West Bengal and the Agricultural Credit Department had to take suitable measures for recovering the overdues as well as for ensuring that similar defaults did not recur. Our responsibility for supervision over the State Co-operative Banks is bound to increase in the future and the need for tightening of supervision by the State Co-operative Banks over the central co-operative banks and the central co-operative banks over the primaries is looming large. Our advice and efforts to get the co-operative credit structure to recover its dues and discharge the duty of supervision satisfactorily, are likely to increase in the future.

3. Apart from this, the Agricultural Credit Department is entering the field of financing cottage and small-scale industries. Already the financing of the handloom industry has been taken up, and, during the year 1957-8 a sum of Rs 1.80 crores was sanctioned to State Co-operative Banks for the purpose. An increasing volume of credit will have to be given for this purpose in the present and coming years. Further, other cottage industries will also have to be taken up for financing. Already, the leather industry, the coir industry and the fisheries industry have been taken up for study and 6 more have been marked for investigation.

4. The inspection of State Co-operative Banks is to be done by the Agricultural Credit Department once a year, and the inspection of central co-operative banks has to be done once in two years. The inspection of central co-operative banks is in arrears for lack of adequate staff.

5. Apart from the above, the requests from State Governments for advice not only by correspondence but also by personal discussions, have increased and the Agricultural Credit Department has to keep in constant touch with the State Governments, the Registrars of Co-operative Societies and the non-official co-operators in every State.

6. Thus, it will be observed that even if the worst should take place and the organisation of the large-sized credit societies is ruled out altogether from 1st April
1959, the need for the expansion of the Agricultural Credit Department and the establishment of 4 more regional offices this year, will continue. May I, therefore, have orders:

(i) to continue the recruitment of the staff which has been sanctioned, and
(ii) to go ahead with the arrangements that have been initiated for providing the regional offices with office accommodation at Indore, Bangalore, Patna and Lucknow.

[J.C.R(YAN)]
23.10.58

D.G.(V)

I have assumed that the point raised by Governor concerns the future expansion of co-operative agricultural credit and R.B.I.'s part therein, and that accordingly we should review future administrative and other schemes of the R.B.I. from this point of view. We may discuss this after Governor’s return from tour.

As regards sanction already given I have told C.O. that, since these are related to the level of expansion already reviewed, we can proceed on the assumption that the proposed review does not affect these.

[B. V(ENKATAPPAN)]
25/10

[D.G. A(mbegaokar)]
27/10

Please take action accordingly and put up again after Governor’s return from tour.

[B.V.]
27/10

C.A. (for information) : On tour
C.O., A.C.D. Seen.

The papers are submitted for Governor’s perusal. 8/11/58

D.C.O.(R) I.S. Rao 8/11/58

Governor: I should like to discuss these papers with DG(V) and C.O. in the light of the decisions...taken at the meetings of the NDC in Delhi.

[H.V.R.]

DG(V)

D.G.(V) and I discussed the matter with the Governor this afternoon. The Governor drew attention to the decisions reached a few days ago by the National Development Council and inquired how this would affect the co-operative movement and the A.C.D. In particular, he desired to know (i) what effect this decision would have on the increasing credit given by the Reserve Bank to the co-operative movement and (ii) on the scheme of co-operative training looked after by the A.C.D.

2. I submitted that the National Development Council decision only affected the co-operative credit societies at the primary level. The effect would be that we might not have any more large-sized societies than the 5,000 societies which had so far been registered. The small-sized societies would continue to exist and more small-sized societies would be registered. The increase in our sanction of credits might not be so
RURAL CREDIT

much as in the past but there would still be an increase. The Governor drew attention
to the letter he had written to the Agriculture Minister saying that if 5,000 large-sized
credit societies were not registered increased credit to the tune of Rs 40 crores would
not be available for agricultural production, and enquired whether the N.D.C.'s decision
did not mean that the volume of credit supplied by us would be cut down. I indicated
that Rs 40 crores would not indeed be given through large-sized credit societies but
there would still be an increase in credit sanctioned in small-sized primary societies
and the large-sized credit societies already organised. In effect, the rate of increase in
future would be small but nevertheless there would be an increase.

3. I indicated that our programme for marketing societies, namely, 1,900 societies by
the end of Second Five Year Plan remained unaffected by the N.D.C.'s resolution.
Similarly, our plan for linking credit with marketing also remained undisturbed.

4. The Governor enquired whether State partnership in central co-operative banks and
state co-operative banks would not be interfered with. I indicated that nothing was
said on the subject in the N.D.C.'s resolution and added that so far there was no such
proposal. State partnership at the primary level had been disputed by the Planning
Commission, but it had acquiesced in state partnership at the central bank level and
the state co-operative bank level. They were aware that without state partnership in
cooparative financing banks, the volume of credit that might be supplied by the
Reserve Bank would be cut down and were not likely to disturb that principle at the
level of the financing banks.

5. As regards the training schemes, I represented that we were running five regional
co-operative training centres at Poona, Madras, Indore, Ranchi and Meerut as also
one Senior Officers' Training Course at Poona. All other training centres (block level
and junior officers) were financed by the Government. The junior schools might lose
for training the staff intended for 5,000 large-sized credit societies which were cut out
from the Plan; but the requirements of higher staff for other societies and departments
remained intact. The 5 training centres with which we are concerned require 250
candidates per year of the intermediate and the 6th centre requires about 90 candidates
of the superior grade per year. These candidates would be forthcoming in the rest of
the period of the Second Five Year Plan and even thereafter. The normal recruitment
of additional staff against casualties and leave vacancies would itself provide an
adequate number of students for being trained. D.G.(V) agreed that there was need
for the continuance of these training centres and added that the arrangements for
permanent abodes for Madras, Poona and Agra might be continued; but permanent
abodes for the rest might be deferred.

6. The Governor considered that it would be useful to call an informal meeting of
leading co-operators namely Prof. Gadgil, Prof. Karve and Shri V.L. Mehta, place
before them the N.D.C.'s resolution, and discuss with them the consequences thereof
and the steps that would have to be taken in the future regarding the relations of the
Reserve Bank with the co-operative movement.

7. D.G.(V) drew the attention of the Governor to the observations of the N.D.C.'s
resolution to the effect that agriculturists should be financed more freely even
disregarding the usual banking principles. He felt that this would be dangerous if
implemented; for the agriculturists who could not repay their loans could not be
provided with credit. The Governor observed that we had gone so far as providing credit for landless agriculturists who could repay out of their produce but could scarcely go beyond that.

8. D.G.(V) raised the question of our participating in the annual plans regarding Co-operation. He felt that invitations received from the Agriculture Ministry which were of a routine character need not be accepted. Those of an important nature might be responded to. But discussions initiated for the Plan by the Planning Commission might be avoided, if possible. This would save us from embarrassment resulting from participating in serious changes of policies. The Governor agreed with D.G.(V) though he felt that it would be difficult to avoid participating in the meetings; we could not refuse co-operation.

J.C. Ryan
13.11.58

D.G.(V) 14/11
A.C.D. 14/11

D.G.(V) desired that a letter may be addressed to Prof. Gadgil inviting him to the proposed informal discussion on the 24th. If approved, we may also send a similar letter to the other invitees, though they are at present away from Bombay. A draft letter of invitation is placed below for approval.

15/11

D.G.(V) has approved the draft.

A draft note for the informal meeting on the 24th is placed below for approval. We may send two copies of it to Delhi for D.C.O.(R)’s use.

A.C.O.(TSK) 17/11

D.G.(V) has returned the draft note, as approved by him. As desired by D.G.(V), this and the other material indicated have been sent to Prof. Gadgil, Shri Saraiya and Shri V.L. Mehta last night. A set of the notes will be handed over to P.A. to Prof. Karve to-day. He will hand them over to Shri Karve on his arrival.

2. It is presumed that the meeting will take place in the Board Room. D.G.(V) may indicate whether, apart from D.C.O.(R), A.C.O.(TSK) and R.C.O.(Shri Ramasubbu) who have been dealing with this subject should be present at the meeting.

3. Since it is an informal meeting no seating arrangements need be made.

4. A set of the notes is placed below for retention by D.G.(V). Another set has been sent to Governor.

D.G.(V) The meeting was held today. 24/11

Note by the Agricultural Credit Department [November 1958]

Scope of the future activities of the Agricultural Credit Department in the light of recent decisions on Co-operative Policy

This note seeks to analyse, from the point of view of the Reserve Bank, some of the implications of two recent developments pertaining to official policy in regard to the supply of agricultural credit through co-operatives. The first of these
developments is the issue of a directive by the Ministry of Food and Agriculture, Government of India, to the State Governments (vide its circular No.[...]) dated 1 September 1958) to the effect that no large-sized agricultural credit societies should be registered after the end of the year 1958–9, except in States where ten per cent of the villages have not been covered by that date and, even in such cases, that these societies should be organised mainly in backward and scarcity areas. The more important and recent development is the adoption of a resolution on co-operative policy by the National Development Council at its two-day session which concluded on 9 November 1958. This resolution lays down, inter alia, (i) that service co-operatives should be organised on the basis of the village community as the primary unit and should serve, as a rule, an area identical to that of a village panchayat, (ii) that suitable arrangements should be worked out in consultation with the Reserve Bank for meeting the credit requirements of the new agricultural programme, which are estimated to be larger than the sum of Rs 225 crores envisaged in the Second Five Year Plan, and (iii) that, in the provision of credit, special attention should be paid to facilities for the grant of crop loans and for assistance to those who could not hitherto obtain credit under the ordinary banking principles. The object of this note is to examine whether these decisions are such as to call for any major changes in the scope and level of the activities of the Agricultural Credit Department of the Reserve Bank of India.

2. The most direct consequence of these decisions relates to the provision of loans by the Reserve Bank to the State Governments, from the National Agricultural Credit (Long-term Operations) Fund, for contribution to the share capital of large-sized agricultural credit societies. It may be mentioned here that the provision of these funds by the Reserve Bank for this purpose figured in the estimates of co-operative development plans, though not specifically included in the outlay of the Central and State Governments, and that in pursuance of a decision of the Standing Advisory Committee, our practice has been to sanction a lump sum of Rs 10,000 as loan for contribution to the share capital of a large-sized society without going into the details of its lending programme, expected share capital contribution of members, etc. The decisions reflected in the circular of the Government of India and the resolution of the National Development Council virtually rule out the organisation of any large-sized societies beyond 1958–9 and, therefore, the sanction of any further loans for contribution to the share capital of large-sized societies, as part of the Plan programme, on the lines indicated above, will have to be treated as closed. At the same time, loans for State contribution to the share capital of primary credit societies need not perhaps be totally ruled out. Firstly, the future requirements of additional share capital contribution by Government in the case of large-sized societies already established and to be established before 1958–9 may be considered by us and met where justified. If on the other hand, it is decided to break up existing large-sized societies into smaller units, it may be necessary to withdraw the State contribution already made, and the State Governments may be permitted, if necessary, to use these funds for contributing to the share capital of the concerned central or State co-operative banks. Secondly, we may consider the sanction of loans to State Governments for share capital contribution to small-sized primary
agricultural credit societies, on merits, provided they satisfy certain conditions such as the following: (i) the society should be based on limited liability, (ii) the society should not be engaged in activities such as trading, farming, construction of public works etc. in a manner which may jeopardise its financial condition, (iii) the society is in a position to employ a paid secretary on its own, without a Government subsidy of the type provided so far to the large-sized society, (iv) the society satisfies certain criteria of viability, e.g., pertaining to volume of loan business, etc., which will have to be determined on the basis of a careful examination. These considerations, however, will not arise if all the State Governments decide not to make any share capital contribution whatsoever to co-operative institutions at the primary level.

3. As far as State contribution to share capital at other levels is concerned, it may be mentioned here that no objection has so far been taken to the principle of State partnership in the case of the district central co-operative banks and State co-operative banks. Loans from the National Agricultural Credit (Long-term Operations) Fund for this purpose will, therefore, have to continue to be given, on merits, though, here again, the provision made in the Plan estimates need not be taken into account by us in future as was done in the past, in view of the change in overall co-operative policy. One probable result of the proposed changes at the primary level is that the central co-operative banks may not be able to derive the share capital contribution which might have been expected earlier from the primary large-sized societies and the volume of State contribution needed to be made to the share capital of central banks, therefore, may be larger than earlier anticipated. The alternatives will, therefore, be the curtailment of the credit programme to the size permitted by the relatively small owned funds of the borrowing institutions, or additional contribution to the share capital of central co-operative banks by the State. In any case, any relaxation of the accepted principles of financial soundness will have to be resisted in view of the adverse effects this is bound to have on the strength of the structure as a whole. For example, the restriction of borrowing power to a reasonable multiple of owned funds will have to be insisted upon. The shift in policy now proposed is likely to affect the soundness of the structure at the primary level and this, in turn, may affect, in some measure, the position of the State and central co-operative banks on the strength of whose signatures the Reserve Bank's funds are provided for agricultural purposes. The Reserve Bank will, therefore, have not only to insist on a strict adherence to banking principles in the matter of provision of credit to (and borrowings by) these institutions but, further, ensure that proper arrangements are made for audit and supervision at the primary level. The programme of inspections of these institutions by the Reserve Bank will be of added importance in this context and will have to include a careful study of the working of the structure at the primary level as well which may perhaps involve an intensive examination of the working of the primaries in a compact area i.e. a firka or sub-taluk. It is only in step with such watchfulness and careful inspection of the working of the structure, that the Reserve Bank can proceed to provide increased loans to State Governments for participation in the share capital of central and apex banks.
4. The decision in regard to the expansion of agricultural credit beyond the target of Rs 225 crores and the supply of credit to those who could not obtain it under ordinary “banking principles” (subsequently clarified to mean “commercial banking principles”) have policy implications which call for careful examination. As those institutions at the primary level which were expected to command sizeable owned funds to provide a reasonable margin of security for the funds to be borrowed viz. large-size agricultural credit societies—are to be given up, as a rule, and at the same time the supply of credit is to be expanded, it may be suggested at some stage that the borrowing power of a co-operative need not be limited to a specified multiple of its owned funds. On this principle, the co-operative banks as well as the Reserve Bank will have to stand firm and uphold this prudent banking practice which compels the borrowings of institutions organised on a limited liability basis to bear a reasonable relationship to their owned funds. The owned funds form the margin of security for the lender and the banking system cannot work on sound lines and inspire public confidence if the volume of resources raised by institutions by way of borrowings is not carefully related to some stake of the borrowing institutions themselves and their members in their transactions. It will, therefore, be for those who are in favour of the small-sized societies, as a rule, to devise ways and means of enabling these institutions to acquire owned funds of sufficient magnitude to be able to provide credit of the order proposed. One possibility to be explored is that of State partnership at the primary level in those small-sized societies which satisfy certain criteria to be determined. Another line to be pursued will be that of obtaining a sizeable contribution of share capital from members whose ability to save is expected to be substantially promoted through village co-operatives. However, our experience of savings drives, promotion of thrift habits etc. has not been promising. Still another way of meeting the problem might be to provide loans to cultivators to enable them to take shares in co-operatives as has been done in the case of handloom weavers’ co-operatives. In the case of handloom societies, the State Government advances loans to members from out of amounts obtained from the Cess Fund, to enable them to invest that money in the shares of societies. If this is adopted the State Government must find necessary funds for the purpose. It is doubtful whether in the midst of various other commitments related to the execution of the Plan they could find funds themselves. While the pros and cons of alternative or complementary methods of providing the primary co-operatives with a sufficiently strong capital base will require to be examined, the need to preserve a proper link between owned funds and borrowings is inescapable.

5. In determining the quantum of credit which the co-operative banks (and ultimately the Reserve Bank) can provide to primary co-operatives, the banks will naturally have to take into account the nature and functions of the primary co-operative unit proposed to be organised. It is important to ensure that the non-credit functions with which the primary village co-operative is to be saddled will not be such or so numerous as to jeopardise its financial soundness. Where any supply functions are to be taken up, they should be undertaken on an agency basis and based on the indents placed by members and not on any account undertaken on a proprietary basis. It is also not known as to precisely what part these co-operatives will be required to play in the context of the socialisation of the wholesale trade in foodgrains which may involve
widespread procurement and distribution, though the Prime Minister is reported to have stated at a meeting of the Congress Parliamentary Party that the socialised wholesale trade in foodgrains would be successful only if village co-operatives are developed. Then again, it is not also clear how exactly the village co-operative will be required to undertake various special functions connected with actual agricultural production, rural welfare and development which are referred to in elaborate detail in the third paragraph of the resolution of the National Development Council. While certain non-credit functions with suitable safeguards could be taken up by large-sized societies which were likely to have sufficient financial and organisational strength necessary for the purpose, it is doubtful if the weaker small-sized societies can handle such additional functions with their negligible resources and turnover which will not enable them to employ adequate paid staff to attend to day-to-day business. Suitable safeguards will, therefore, have to be devised to protect the financial soundness of these primaries through which the funds provided by the banking system will have to flow.

6. Thus, on the one hand, the emphasis on small-sized societies with a village as the area of operations and the discontinuance of the organisation of large-sized societies are both developments which are likely to weaken the institutions at the primary level, especially from the point of view of their ability to borrow from the banks or otherwise raise financial resources; on the other hand, the village co-operative is likely to be burdened with functions which may impair its financial soundness and is to be required to provide loans to those who cannot obtain them on banking principles; both of these are likely to affect adversely the willingness of banks to finance the primary agricultural credit societies. For all these reasons, the flow of funds from the banks to primary co-operatives may actually decline, but the proposal is that the volume of agricultural credit supplied should be expanded beyond the Second Five Year Plan target of Rs 225 crores. Besides, the additional functions of the primaries are likely to add to their credit requirements. In this context, if the primaries are to be enabled to borrow on the scale required and if, at the same time, the soundness of the co-operative banking system is to be protected, the provision of Government guarantee at various levels—those of the central and state co-operative banks and the Reserve Bank—may become necessary in a manner comparable to the practice now obtaining in regard to the financing of industrial co-operatives. (In States like West Bengal, Assam and Bihar where the co-operative movement is weak, Government guarantee is already being given in respect of Reserve Bank finance for agricultural operations.) The Government may have to be persuaded to accept this responsibility in view of the urgent need for expanded agricultural credit, their preference for relatively uneconomic units at the base and their emphasis on radical changes in procedures for the registration of societies, grant of loans and management of co-operatives.

7. The changes in policy now announced will take time to be spelt out in practical terms and to be implemented on any significant scale. The co-operative banks are themselves likely to be watchful in regard to their interests and the Reserve Bank may have to take a firm stand against unsound expansion only if the co-operative banks fail to put forward this point of view and get it accepted by the authorities. As regards the credit to be provided by the Reserve Bank, there is not likely to be any contraction
of the present volume as, even today, the bulk of our funds is reaching the cultivators through the small-sized societies. At the same time there will undoubtedly be a substantial decline in what would otherwise have been achieved, e.g. through fulfilment during the next two years of the target of 10,400 large-sized societies, with the additional share capital at the primary level (together with the corresponding borrowing power) which these would have involved. Of course, the existing large-sized societies and those likely to be established up to the end of 1958–9—about 6,200 in all—will have sizeable borrowing power and their further progress will be attended with an increase in the supply of agricultural credit. This increase may even be quite appreciable. Besides, State participation in share capital in the central and state co-operative banks will continue. All these factors suggest that the agricultural credit structure will continue to draw (though at a much slower pace than at present) an increasing volume of accommodation from the Reserve Bank, notwithstanding the cut in the number of large-sized societies. As for the slower pace, this should not, in view of all the implications of the changed policy, be a matter of regret. It will be all the more necessary hereafter for the Reserve Bank to improve the quality of the working of the co-operative credit system through appropriate regulation, inspections, coordination etc. The Bank will have to emphasise at each stage the safeguards necessary for ensuring that, alongside the expansion of agricultural credit, there is also a strengthening of the structure in financial and organisational terms, through increases in owned funds, satisfactory arrangements for audit and supervision, the evolution of suitable procedures in respect of non-credit functions and the provision of appropriate guarantees from the State in respect of risks which the system is required to undertake for reasons of State policy, viz., those connected with increased agricultural production.

8. The other important aspect of the resolution of the National Development Council which concerns the Agricultural Credit Department relates to facilities for the training of co-operative staff. The emphasis placed by the Council on the training of village leaders, young men in rural areas who can serve as secretaries of village institutions and staff of co-operative departments only underlines the need for the retention and expansion of training facilities now being provided under the direction of the Central Committee for Co-operative Training. An important factor to be taken into account is, however, that the number of trained secretaries required for primary agricultural credit societies is likely to be reduced, consequent on the cut in the number of large-sized societies. It may be mentioned here that notwithstanding the general accent on deofficialisation, the need for a large number of properly trained departmental staff has been generally accepted on all sides.

9. In conclusion, it may be recalled that the functions of the Reserve Bank of India in the field of agricultural credit in practice consists of (a) the provision of financial accommodation for various purposes, (b) inspection of co-operative banks, (c) planning and co-ordination and the provision of advice to State Governments and co-operative banks, and (d) provision of training facilities for co-operative personnel. Except for the provision of loans to the State Governments for enabling them to contribute to the share capital of large-sized rural credit societies, it does not seem that the part to be played by the Bank in this sphere will in any way be smaller in future than it is today. While undoubtedly the rate of expansion of the
volume of agricultural credit provided by the Bank will be reduced in comparison with the target, which otherwise would have been possible, the Bank will have its hands full in ensuring the development of the agricultural credit structure on sound lines. This will be a difficult task in the context of the decisions now taken regarding the type of co-operative credit institutions to be built up at the primary level and in the light of the present eagerness to expand the supply of agricultural credit beyond the Plan target. If, as the central bank of the country, the Reserve Bank should see that these decisions do not result, in practice, in an impairment of the financial soundness of co-operative credit system, it will have to make active efforts in this direction, on the one hand, through the system of inspections of co-operative banks and, on the other, through such participation in policy-making in this regard as may still be open to it at the Central and State levels.

[6-12-1958]

Informal meeting to consider the National Development Council’s Resolution on Co-operative Policy

Governor had convened an informal meeting on 24 November 1958 at 11 a.m. to consider the implications of the Resolution dated 9-11-1958 of the National Development Council on Co-operative Policy from the point of view of the Agricultural Credit Department of the Reserve Bank of India. The following were present:

1. Governor
2. Deputy Governor (Shri Venkatappiah)
3. Shri M.R. Bhide
4. Shri V.L. Mehta
5. Shri R.G. Saraiya
6. Prof. D.G. Karve

Prof. D.R. Gadgil could not attend.

2. Governor indicated that he was surprised at the manner in which the Resolution involving such large-scale monetary implications should have been passed so casually and without consulting the Reserve Bank of India. He said that the question of co-operative policy was not on the Agenda of the National Development Council and, therefore, even State Governments had not had the opportunity of studying the full implications of the new policy. He felt, however, that nothing would be gained by conveying the Bank’s protest to the Government of India. He mentioned that the Government of India, Ministry of Food and Agriculture, had constituted a Working Group to consider the administrative and organisational arrangements required for implementing the Resolution on Co-operative Policy adopted by the National Development Council. Deputy Governor (Shri Venkatappiah) was a member of the Group which had so far met twice on 18 and 19 November and was expected to continue its deliberations. At these meetings Shri Venkatappiah had raised a number of points which would probably be taken into account before the Group came to any conclusions. He pointed out that although there was no estimate of the extent of agricultural credit which the Reserve Bank of India would be called upon to provide it
RURAL CREDIT

might be presumed that the Resolution envisaged a large volume of credit from the Bank for agricultural purposes. There were really two aspects of the question. One was whether the type of co-operative credit societies envisaged would be sound enough financially to command the necessary volume of credit, and secondly if that was the case, whether the Reserve Bank should agree to undertake provision of credit on a scale which would appreciably increase the supply of money in the country. The implications of both these aspects would have to be fully studied. He felt that since the Reserve Bank was already aware of the Resolution officially, an interim reply to the Government of India that the matter was receiving its attention should be sent immediately. He also proposed to refer the whole question to the next meeting of the Board of the Bank. He asked the invitees to indicate whether it would be advantageous to convene a conference of State co-operative banks in the country to discuss the matter.

3. Shri Bhide explained the circumstances under which the Resolution was passed. While discussing the food policy, the Prime Minister had felt that, in that context, the co-operative policy needed immediate change, and accordingly wanted a resolution on the subject to be drafted and passed in the meeting. The Planning Commission had not been happy about the experiment with large-sized credit societies, as in many States the area covered by such societies was too extensive. The controversy about large-sized credit societies was going on from January 1957 and certain decisions were reached from time to time culminating in the circular letter of September 1958 of the Government of India, directing State Governments to restrict the area of operations of a large-sized society to 4 or 5 villages, and to organise such societies in backward areas. Some members of the All-India Congress Committee, however, were not happy even with this formula and expressed their disapproval in the last meeting of the Committee. The Community Projects Administration, in the meanwhile, had not been able to create enough enthusiasm among people about agricultural production and co-operatives. The combined effect of these was the present Resolution of the National Development Council.

4. Prof. Karve said that the Reserve Bank could not be expected to lower its standards regarding the supply of agricultural credit. The omnibus character of the small credit society contemplated in the Resolution was not envisaged even for the large-sized credit society, which had better capital structure and better management. He felt that no useful purpose would be served by calling a meeting of State co-operative banks. Perhaps, the banks might take up the question with the Chief Ministers of their respective States who could take up the matter again before the National Development Council. Governor, however, did not expect any such move from the Chief Ministers in view of the strong feelings of the Prime Minister on the subject.

5. Shri Saraiya said that State co-operative banks would be prepared to undertake the programme, provided firstly that advances made by them to agricultural credit societies of the type envisaged were guaranteed by State Government and secondly that they were also provided with necessary financial resources. It was not enough to guarantee the advances made by the Reserve Bank to the State co-operative bank, because in that case, the money provided by the latter bank out of its own resources would not be adequately covered.

6. Shri Mehta also felt that a conference of State co-operative banks would not serve any useful purpose. He indicated that the type of society envisaged in the
Resolution was not to be found in any part of the world. Primary credit societies based on unlimited liability did not take up any functions other than the supply of credit and of certain commodities on an agency basis. Experience in the past was not encouraging about mutual knowledge and mutual co-operation which the Raiffeisen type of society was expected to promote. The Resolution of the Council seemed to ignore completely the experience of the past 4 decades of co-operation in this country. Partnership of the State gave status to institutions of small men and enabled them to expand their business. Government guarantee was not a substitute for State partnership. Emphasis should be on development of co-operative institutions as sound business organisations. The Council’s Resolution would not enable the institutions to build themselves up on sound financial lines. He felt that it was necessary for the Reserve Bank to make the position in this regard clear to the Government of India.

7. It was, therefore, decided by Governor to write immediately to the Minister for Food and Agriculture and to endorse a copy of the letter to the Finance Ministry. It was also decided that as the Council’s Resolution involved a fundamental change and had implications of a far-reaching nature, the matter should be placed before the next meeting of the Board of the Reserve Bank.

Dear Shri Jain,

I am writing with reference to the Resolution on co-operative policy adopted by the National Development Council at its meeting held on the 8th and 9th November 1958, a copy of which has been sent to me by Tarlok Singh. A representative of the Reserve Bank has since been invited to join the Working Group set up by your Ministry to consider the administrative and organisational arrangements required for implementing the Resolution. I imagine that, in due course, the Bank will be specifically consulted, as stated in the Resolution, on the arrangements for the expansion of agricultural credit.

2. It is these arrangements and more particularly the implications, in the field of credit policy, of the Resolution adopted by the National Development Council, that concerns the Reserve Bank. The changes proposed are far-reaching in character. The resolution contemplates a rapid multiplication of village co-operative societies which, though relatively small in size, will be expected to undertake a multiplicity of functions some of which involve substantial financial risks. The volume of credit to be provided to these societies will be of very large dimensions and may in fact, form, in size, much the largest part of the Bank’s activities. The risk involved will be correspondingly very large. In view of these far-reaching implications, I propose to place the subject before our Board at their next meeting which will be held in

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

D.O.No. [...]  
November 25, 1958

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I am writing with reference to the Resolution on co-operative policy adopted by the National Development Council at its meeting held on the 8th and 9th November 1958, a copy of which has been sent to me by Tarlok Singh. A representative of the Reserve Bank has since been invited to join the Working Group set up by your Ministry to consider the administrative and organisational arrangements required for implementing the Resolution. I imagine that, in due course, the Bank will be specifically consulted, as stated in the Resolution, on the arrangements for the expansion of agricultural credit.

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Calcutta on the 22nd of December 1958. I will thereafter communicate to you the considered views of the Bank insofar as the Resolution deals with the credit policy of the Bank.

With kind regards,

Yours sincerely,

H.V.R. IENGAR

Shri Ajit Prasad Jain
Minister for Food & Agriculture
Government of India

MINISTER FOR FOOD & AGRICULTURE
GOVERNMENT OF INDIA
NEW DELHI
December 3, 1958

My dear Iengar,

Please refer to your D.O.No.[...] dated the 25th November 1958. Originally it was intended that the Ministry of Food and Agriculture will set up a team for working out the scheme to implement the resolution on co-operative policy adopted by the National Development Council. Later on, however, at a meeting of the Planning Commission, it was decided that the team should be set up by the Planning Commission. My Ministry is fully associated with the team and is giving its full co-operation. I am sure that the Reserve Bank will be duly consulted in regard to the arrangements for expansion of agricultural credit.

It is true that the changes proposed are of far-reaching character. Naturally when big things are done, correspondingly large risks are involved. I can well appreciate that you are going to place this matter before the next meeting of the Board of Directors of the Reserve Bank. I shall await with interest the views of the Board.

When you come to Delhi next, please look me up. I would like to have a little chat with you.

Yours sincerely,

AJIT PRASAD JAIN

CO (JCR) 9/12
The following message was dictated over the trunk telephone by the Delhi Manager:

From Governor to Shri Venkatappiah—

"Prime Minister asked me whether some sort of federation of four or five Co-operative Societies could not be made to work. Last night the Home Minister developed the same idea at some length and hoped that some such scheme could be worked out which would meet both the basic conception of the N.D.C. and the Reserve Bank’s criticisms. There may be a meeting ground between this conception and your own suggestion to the working group."
Prime Minister has taken note of [my suggestion for] reinforcing the working group by inclusion of non-officials with real working knowledge of the Co-operative Movement. Meantime whatever the final answer may be, we must give serious thought to the conception suggested by the Prime Minister and the Home Minister and see whether we can give it practical shape. I would like to discuss this with you tomorrow.”

12.12.58

Secretary 12/12

D.G.(V) This has been discussed and notes are being prepared for informing Governor.

12/12

C.O., A.C.D. A draft note on the lines discussed is placed below for favour of approval. The note has been approved by DCO (R).

C.D.D.

15/12

D.G. (V) 15/12

Third Meeting of the Working Group on Co-operation (16.12.58)

Credit Unions

(Note by Shri B. Venkatappiah, Deputy Governor, Reserve Bank of India)

At the last meeting of the Working Group held on 8 December 1958, I outlined a proposal by which village societies could federate into unions which would deal with the credit requirements of the people for agricultural and other purposes, while the village societies themselves, as individual units, would devote themselves to as many aspects as practicable of the economic development of the village community as a whole. The federations may be called Credit Unions. It seems to me that this kind of arrangement has considerable advantages and that it gives practical expression, in an important sphere, to the National Development Council’s Resolution which states that “village societies should be federated through unions” while ensuring viability and strength of resources so important for providing adequate credit. In further elaboration of my tentative views I circulate this note in order to outline briefly (as I envisage them) the respective functions of the Unions and societies, their mutual relationship and the relationship between these and the institutions at the higher level of co-operative structure. I would emphasise that these views are personal and tentative.

2. Ordinarily, there will be a village society in each village. Where, however, the villages are too small, a society may be formed, with the consent of the people, for a group of villages, provided the total population covered by it does not exceed 1000. Every family in the village will be eligible for membership of the society through one or more of its adult members. Concerted effort will be made to bring all the families in the village or group of villages in the society. The general body of the society will
meet as often as necessary, but at least twice in a year, for the purpose of drawing up a production programme for the village community as a whole. Before the programme is placed before the general body, the managing committee will have gone into the production programmes of individual members, for it is on the basis of individual programmes that the programme for the entire village can be finally settled. The general body, after taking into account the various aspects of the question, will fix targets of production for the different varieties of crops grown in the village. Having fixed the targets for the village as a whole, the general body will first proceed to fix the responsibilities of individual members towards attainment of the targets.

3. Having thus decided upon the total and individual production programmes, it will be the responsibility of the village society to see that the resources and facilities required are mobilised in the village itself or from outside the village. There are certain programmes which can be carried out in the village itself without much outside help and the village society can easily promote them. One such is the multiplication of improved varieties of seed at the village level. The society can select a few enlightened cultivators from amongst its members and make them responsible for the maintenance of seed farms. The additional cost involved in this can easily be met out of the higher price the seed from this farm will fetch; and any technical assistance, advice, subsidy, etc. may be made available through the society by the agricultural department and other agencies. Popularising green manure preparation of compost and obtaining compost, fertilisers etc. can be done in a similar manner by the society. The society can further serve as a good medium for propagating amongst the cultivators knowledge of improved agricultural techniques.

4. There are, however, certain other programmes which cannot be implemented without substantial financial or technical assistance from an outside agency. These may fall into two broad categories, viz., programmes of individuals and programmes benefiting a group of individuals. In either case, financial assistance in the form of loans can come from the Credit Union and technical assistance can be provided by the concerned departments of the State Government. The manner in which the Credit Union will provide finance in the case of both individual and group programmes is indicated below.

5. It is stated in para 2 above that the village society will draw up production programmes for individual members; provision of credit will be based on this programme. Individual agriculturists will be advanced loans directly by the Credit Union on the strength of the recommendations made in this behalf by the village society. It follows, therefore, that individual agriculturists will be members of both the village society and the Credit Union. No loans will be advanced by the latter unless recommended by the village society. Nor will loans be given to anyone who is not a member of the village society. Ordinarily, a group of villages served by a village level worker may come within the jurisdiction of a Credit Union (although this may be flexible, and considered from the points of having an adequate turnover and ensuring accessibility to different parts of the area etc.), and all the societies organised in these villages should also be its members. Since loans will be made by the Union on the basis of a village society’s recommendations, responsibility for supervising the proper utilisation of the amounts will to some extent devolve on the
village community as a whole, i.e., as organised in the co-operative society. Thus the benefits of mutual knowledge and mutual supervision will be fully ensured because of the vital position assigned to the village society in the whole system. On the other hand, the Credit Union, with loan business extending to a sizeable number of families residing in a group of villages, can hope to develop within a reasonable period into a viable business unit capable of commanding confidence among depositors and financing agencies at higher levels. The Union will be in a position to employ trained staff and provide efficient service to its members. It would be possible for the State Government to strengthen the Union, where necessary, by contributing to its share capital. The stronger capital base of the Union will enable it to borrow larger funds than will otherwise be possible. The share capital to be collected from members will at the same time be kept at a low enough level, so that the credit programme may be commensurate with the village and individual production programmes drawn up by the village societies. In certain respects, where the village societies find it necessary to have common arrangements—e.g. maintaining a godown for storage or keeping a stock of fertilisers at a point fairly near the village—the Credit Union can be used for such purposes.

6. As regards programmes which are of direct or special concern to a certain number of individuals, and not necessarily to the whole village, such as (in some cases) contour-bundling, soil conservation, construction and maintenance of irrigation works, irrigation channels, etc. the executive responsibility may be undertaken by the village society as a whole or by a special committee appointed for the purpose. The finance required for such activities can be made available by the Credit Union as loans to individuals interested in the activities, who can, thereafter, pool their funds and undertake those activities. The financial responsibility will thus devolve on those who are directly interested in the activities. Technical assistance required will come from Government who may also subsidise partially the expenses incurred.

7. The credit required by individual agriculturists will be partly cash and partly in kind in the form of seeds and fertilisers. The supply of seeds can be arranged in the village itself by the village society from the seed farms as suggested in para 3 above, or from seed obtained from outside, and any payment necessary for the same can be made from loans granted by the Credit Union. The supply of fertilisers also can be arranged in the village itself by the village society by obtaining the necessary quantities from the Credit Union which will serve as sub-stockist of the marketing society, or directly from the marketing society itself. In making the fertilisers available the Credit Union will do so against cash payment by raising the necessary debits in the loan accounts of the individuals receiving fertilisers. In this manner, the tasks intended for the village society in the National Development Council’s Resolution, as per paragraph 3, can be performed by the village society in close co-operation with the Credit Union.

8. The village society will have to play yet another important function in recovering the loans advanced by the Credit Union. The managing committee of the society will see that the produce raised by its members is taken directly to the marketing society situated at the mandi centre where it will be sold. The Credit Union’s dues will be first realised out of the sale proceeds. In the scheme of linking credit with marketing,
it is envisaged that the services of an agent (e.g. the marketing panchayatdar) would be utilised at the village level for assembling the produce of members and for taking it to the marketing society. The president or secretary of the village society can perform that function and thus officially associate the society with the work of recovery of loans of the Credit Union. If the Union has a godown, the produce can be assembled in that godown before it is transferred for sale to the marketing society. The extent to which the village society makes a success of the link between credit and marketing will determine the extent of credit becoming available from the Credit Union.

9. The Credit Union will be affiliated to the central financing agency at the district level. Since the credit requirements of individual agriculturists will be met by the Union, the village societies may or may not be affiliated to the central financing agencies.

10. Thus the idea of a Credit Union serving a group of villages and confining itself to the supply of credit and of production requirements, and of a village society organised in each village drawing up production programmes, making arrangements for supply of seeds, fertilisers, manures, implements, etc. and undertaking on behalf of its members, such functions as contour-bunding, soil conservation etc. or any other economic activity which may be appropriately taken up by it, including joint-farming, can meet the basic conceptions in the National Development Council’s Resolution as well as the fundamental banking principle of separating from the purely credit function those other functions, such as trading and production, which involve appreciable financial risk as distinguished from the normal credit risk. It can, at the same time, ensure a free and adequate supply of credit, mobilise local resources and attract deposits, and ensure the full co-ordination of credit with village production programmes and marketing of produce, especially foodgrains. The centre of activity will thus be the village society and the Credit Union will be made to serve the needs of the village societies in its jurisdiction with the help of a nucleus of trained staff serving under its board of directors.

RESERVE BANK OF INDIA
BOMBAY
15.12.1958

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[Note by D.R. Gadgil]

It is difficult to comment on the report of the working group. This is because the reasons which led the National Development Council to adopt the particular resolution on co-operation are not clear to me. It does not appear that the reasons are clear to the members of the working group themselves. They are evidently doubtful regarding the proper and full meaning of the various parts of the resolution and also as to the definitive programme that is implied in the resolution. However, their attitude towards the resolution is that towards an oracular pronouncement which they diffidently try to interpret but whose possible inconsistencies, misdirection or ineffectiveness they dare not examine.
In the circumstances, I think it would be useful if, instead of commenting on the curious document produced by the working group, I offer brief, general observations upon what seems to be an impossible position into which policy relating to development of co-operation in India has got itself. In common with other matters of policy, attention is directed towards particular aspects of governmental socio-economic policy when difficulties are faced in implementation of existing policy or are created by any development of the situation. It is when problems and difficulties become acute and are identified that they are enquired into. An investigation or an analysis may suggest causes and explanation and also possible remedies. These remedies will usually be tentatively applied or tried on a small scale and when proved fruitful will be incorporated in principles and practices of general policy. None of these stages seem to have been gone through or even contemplated before the production of the N.D.C. resolution on co-operation.

The history of co-operative policy during the last 15 years may be said to begin with the appointment of two committees in 1944-5; one was the Co-operative Development Committee and the other, the Agricultural Finance Sub-Committee. Following the publication of the reports of these committees, steps were taken in many States in a variety of directions. The report of the Rural Credit Survey Committee, appointed by the Reserve Bank of India, contains a full account of most of these. That report, on the basis of one of the fullest factual enquiries ever undertaken in recent times in any country, embodies a generalised set of recommendations. These were considered by the Board of the Reserve Bank of India and submitted to Government. They were, in turn, the subject of many conferences, at official and non-official levels, in the States and at the Centre. As a result, a comprehensive policy relating to co-operation was formulated and has presumably been in operation throughout the country. It is expected of any policy however carefully thought out and implemented that it would, in practice, raise new difficulties and problems. Therefore, it was not unexpected that in subsequent years, complaints should be made and difficulties would arise. In these circumstances the proper procedure is to investigate the nature of difficulties and to ascertain whether they rose out of any defects of the policy itself or of its implementation or interpretation. This would have indicated directions in which modifications were required and not only would the proper remedies have suggested themselves, but also the reasons behind the changes would have been made clear to the public at large. Nothing of this sort appears to have been done, at least to my knowledge. The results of no enquiry, investigation, or analysis are available to the public in this behalf. If anything has happened, that has been in discussions at the Planning Commission or other closed circles and remains buried in official files. This development leads me to comment on another sinister aspect of recent developments.

Ever since the appointment of the MacLagan Commission, it was the practice of even the British government, in the sphere of co-operative policy, to appoint committees of enquiry which always had an important representation of non-official workers in co-operation. The Committees which shaped post-war policy were also appointed by the British Government and these consisted mainly of non-officials and had non-officials as Chairmen. On the State level, one may claim that in the Bombay State, for example, non-officials have participated even more than officials in co-operative
policy making in a history spreading over more than 20 years, say, from the Mehta-Bhansali Report to the Report of the Crop Evaluation Committee of the Bombay State Cooperative Bank published in 1958. The basic continuity, the analytical approach, the background of field experience and the importance attached to non-official workers and leadership, all are fully evident in this history. The working group, of which the report has been circulated, was, in contrast, a body consisting entirely of officials; and in discussions of co-operative policies subsequent to the formulation of policy on the Rural Credit Survey Report, no important representatives of non-official co-operators have been called in for consultation.

So much in relation to what appears to be the most alarming feature of the present situation; which is that co-operative policy is made not after rational, scientific study and full uninhibited participation of non-officials and officials in all States but by fits and starts through personal predilection or prejudice in Delhi. I may add some brief comments on what appear to be the main controversial points involved in the N.D.C. Resolution and the report of the working group. The first is a question of size, area and functions of the primary society. I cannot see how any dogmatic approach can cover the total situation in this regard. It appears clear to me, in the first instance, that co-operative societies must be looked at essentially as business organisations and must be primarily designed and constructed to carry out their particular businesses. They ought not to be confused with purely political or administrative organisations like Panchayats. It will happen, as often happens in all contexts, that the groups of people who lead the Panchayats and the co-operative organisations are the same; but this ought not to lead to confusion between legal and financial or other provisions under which a Panchayat acts and must act and the constitutional structure and business operations of a particular co-operative society. Secondly, even vaguely planning functions such as that of producing crop or production plans for the village, whatever that may mean in concrete terms, ought not to be confused with co-operative organisation. Here again, it may be good to have co-operative organisations represented on planning authorities at various levels; but this must not lead to mixing up the two organisations.

Coming to co-operative business proper, it is difficult to see how a single organisation can perform all functions or a rigid type of a single area organisation can satisfy all needs in every context. The co-operative business organisations have to carry out a large number of different functions. Co-operatives of producers have obviously to be formed in an entirely different way than the co-operatives for marketing or for credit. An artisan co-operative such as a co-operative for leather workers or weavers has to be composed of a number of artisans of the same type and may cover a number of contiguous villages or be confined to one, depending on the concentration of the workers. But if most of the lands in a village come within the fold of co-operative farming, it may be found desirable in the normal-sized village to form, say three or four co-operative farming societies rather than bringing all the lands into a single society. On the other hand, a processing society such as cotton pressing, ginning or rice milling must, to function efficiently, draw its supplies, from large enough areas to give it sufficient business throughout the year or the season. For the purpose, it must spread its membership over many
contiguous villages. In another context, a sales society can operate only where there is habitually a large congregation of traders. No doubt where there is an important element of assembling or grading and storing before transporting the produce to the market village, a village society may act as a useful subsidiary or supplement to the main sale society; but it could never function as the sale society in itself. Similar reasoning applies to purchases; purchases, say of fertilisers from Government cannot be made independently by a village society, but most of the larger village societies can act as distributive agents for an efficient purchasing organisation formed on the basis of a larger area. Credit, similarly, must be related to efficient handling of the credit business. This has two aspects; one is the processing and the scrutinising of applications, disbursement of funds or of materials in lieu of money, insistence on marketing through co-operative channels and recoveries. All this suggests an essentially local organisation in which knowledge of operations of individual operators assumes importance. At the same time, a certain turnover is essential before a primary credit society can operate efficiently. Therefore, unless there is going to be a perpetual subsidising of the secretaries of the societies, the size of a credit society must represent a certain minimum turnover.

All this again will not give a uniform answer regarding the area coverage required in each context. Where operations of agriculture are intense and heavy crops such as sugarcane predominate, even a hundred farmers may be able to sustain a credit society, i.e. in a small-sized village. On the other hand, where farming is largely insecure, non-monetised and subsistence farming the turnover per farmer would be very low. In extreme cases of this sort, no extension of area alone would serve the purpose and subsidisation may be necessary till considerable agricultural development takes place.

The whole question is further complicated by the possibility of combining a number of functions, at the village level. Credit operations may be combined with agency operations for sale societies and local distribution or consumer store business. With such combination, multi-purpose village societies may prove viable. It needs, however, to be remembered in this context that it is usually at a fair-sized village with a relatively central location that assumption of variety of functions becomes possible or profitable.

The upshot of all this is that it is impossible to lay down, it is in fact dangerous to lay down hard and fast rules. Large size is not an objective in itself but excepting in the poorest and most backward areas viability is or should be. The aim of combining everything in one society is impracticable. At the same time, at the primary level, a number of functions that can usefully be performed through one paid agency and one managing committee ought to be so combined. Therefore, policy should be defined in terms of broad objectives and desirable operations and the actual working out of details should be left to individual states being in fact adapted to the circumstances of agricultural business of each type of region.

Considerable controversy has also arisen in relation to government participation. The proper view in this regard is that government participation should be forthcoming where resources that can be raised by members of the societies themselves are inadequate in particular contexts. In a primary society, for example, the need may
arise in two different contexts. In a poor backward area people may be unable to raise funds initially required for even credit or multi-purpose societies in central villages. On the other hand, in developed areas the undertaking of important functions as that of processing or warehousing may require government subscription of share capital. At the same time, government participation by way of subscribing to the share capital of a society ought not to be confused with official domination of the movement. Even in British times the development in various provinces were not uniform in the latter regard. Today, there are a number of states where the resources of the credit movement are mainly derived from the Reserve Bank of India, where the distribution of funds by primary is largely through government or bank officials and where such development as appears to take place is through the pressure on community project or other administrative agencies. In many of such areas, there is no government participation but the movement is essentially officially guided and directed. On the other hand, in the Bombay State the entire co-operative banking structure has, during the last ten years, obtained large funds through subscription of share capital by government. The raising of the structure of sugarcane co-operative factories has also been possible only through government participation. However, in both these contexts, as I can vouch from personal experience, official dominance or interference is completely absent. Official assistance and technical help are always available but the main formulation of policy as well as the conduct of daily operations have been essentially in non-official hands.

It has been contended that the establishment of small village societies will lead to such a mobilisation of internal resources as will make external help unnecessary. This is an entirely illusory belief. In areas like South Gujarat, developments such as of co-operative cotton ginning and pressing have taken place gradually over decades without much external aid. These represent the exceptions. It is only where agriculture is secure and already well-developed and the grip of the moneylender-trader interest is relatively weak that external aid may not be required. Elsewhere rapid and planned development must be initiated with considerable external help. However, once development fructifies devices can be found to step up internal savings and dispense progressively with external aid. This has been the experience for example, of the older established co-operative sugar factories. To talk of depending on internal resources from the beginning is tantamount to condemning, as in the past, all the poorer and moneylender-dominated areas to permanent stagnation. Government participation is, thus, required for widening initially the owned resources base and to start developments. Whether this will lead to official domination or not, depends on the tradition and temper of local officialdom and the strength and quality of non-official workers. Where the latter is found inadequate, official dominance will exist even with little or no government assistance.

There is another vaguely formulated idea current, that a small all-purposes society will help stepping up agricultural production. Detailed analysis of the existing situation will show that this has no adequate basis. Agricultural production lags behind because of a number of reasons such as insecure tenure, unstable prices, an oppressive marketing and processing system, backward technique, failure of seed, fertilisers, etc., supply of inadequate resources which may mean inability to maintain irrigation sources,
implements and bullock power adequately and to purchase in time and sufficiently, needed materials or labour. All these and other defects have to be dealt with specifically and appropriately. An adequately articulated and integrated co-operative structure can alone provide for the total programme in this behalf. Atomistic, all-purposes village societies are not only no panaceas but will, in fact, prove a hindrance in the way of building up the proper remedial programme.

Conditions of underdevelopment, poverty, backwardness, all denote current inadequacy of resources both in finance and in personnel. That external assistance in both these respects, from those more fortunately situated, is urgently required by the underdeveloped is universal experience. The small-sized village in India represents inadequacy of resources in an extreme form and all programmes of its development must, therefore, seek to supply the needed assistance from outside and to integrate this weak unit meaningfully with the rest of the economy.

All this is not to deny that a large new programme of intensified co-operative activity is what the country needs most at this juncture. For the major part of the field of economic activity, co-operation must soon become the dominant form. In the context of this requirement existing developments are seen to be highly insufficient. But building up the new programme should not begin by throwing the baby out with the bath water. What is required is to utilise to the fullest what has been already achieved and what promises results and to think out clearly and step by step the variegated, multi-tiered and adjustable structure that alone can meet the needs of the situation. This is a task in which the participation of every co-operatively conscious element in the country, wherever located and in whatever position, must be invited and encouraged.

To sum up, as a result of a number of personal prejudices and preconceived notions, which have never been adequately discussed in public, co-operative policy in India finds itself in a sorry state. It is high time it was recognised (i) that future developments must take into account the achievements and experience of the past, (ii) that there is enormous variety in conditions and stages of development within the country; and that these rule out a rigid, uniform approach and call for regional adaptation and adjustment, and (iii) that no adequate policy can be formed, in any context in the absence of full public debate and of the co-operation of non-official workers.

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RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
March 31, 1959

D.O.No.[...]

My dear Bhide,

Please refer to your letter D.O.No.[...] dated the 23rd March 1959 in which you have invited the comments of the Reserve Bank of India on the Report of the Working Group on Co-operative Policy. This Report was considered by the Central Board of the Bank at its meeting held on 2nd March 1959 in New Delhi, and it is in the light of
the views expressed at this meeting that I communicate my comments. I hope Government will forgive me for being completely frank in my criticism of the Report of the Working Group. The matters at issue are so vital that not to do so would be an act of disservice to Government.

2. The criticisms which I have to make relate both to a vital matter of procedure as well as to substantive issues of policy but not, I would like to emphasise, to objectives. The Reserve Bank is in full agreement with the main objectives of the National Development Council’s Resolution on Co-operative Policy. In other words, it shares the desire to ensure that as large a section as practicable of the rural economy and, in particular, activities such as credit, marketing, processing and storage, are organised on a cooperative basis. The Reserve Bank also agrees that the maximum possible scope for initiative and growth should be retained at the primary level, that there should be the fullest co-ordination between Co-operation and Community Development, and that the development envisaged should be for the rural community as a whole, including the artisan and the landless labourer. But while agreeing with Government in the objectives stated in that Resolution, the Bank fears that some of the decisions likely to flow from the Report of the Working Group may retard rather than promote progress.

3. Procedure: It may be recalled that the present programme of co-operative development was decided upon after the most detailed data had been collected and the fullest discussions held with leading non-official co-operators, State Governments and the Reserve Bank. It is, in my opinion, a matter of regret that a major change in co-operative policy should have been formulated without similar examination of all available facts and the fullest exchange of views with all those concerned, including non-official co-operators, among whom, as you are aware, are persons of great eminence and experience. From this point of view, moreover, it cannot but be regarded as unfortunate that the Working Group appointed should have been wholly official in its composition. It is a matter for further regret that the proposed Conference where both State Ministers for Co-operation and leading non-officials who have worked in the co-operative field would have been present had to be postponed. The first point I would make, therefore, is that even at this late stage, the same procedure might be adopted as in the past and, before decisions are reached, the fullest provision made for consultations and discussions among all those concerned.

4. “One village, one society”: None of the considerations set out in para 2 justifies the very small unit—one village as a rule but, if this is departed from, not more than 200 families—which the Resolution envisages as the right size for a co-operative society. Nor, as pointed out by the Working Group, is there justification for the conclusion that all interests and all activities should be concentrated in this one society. Indeed, as the Working Group has been at pains to emphasise, it is essential that the credit function, for example, should not be combined with activities which involve substantial financial risk or sizeable long-term investment. For such activities, therefore, it will be necessary to organise separate societies, and some of these may well cover an area larger than a village. Similarly, where special interests have to be catered for or special needs met, as in the case of handloom weavers or other
artisans, it is often advisable to organise a separate society, covering a suitable area, for this class of persons. Briefly, the size of a co-operative as well as the range of its functions must be allowed to be determined by the wholly pragmatic consideration as to whether or not it will work. There should be no dogma such as "one village, one society", or "one society, all functions". Nor is there any reason why the Panchayat and the co-operative should invariably be made to cover the same area. Moreover, while it is important that these two bodies should work together, it is equally important that their functions and responsibilities should be defined and demarcated. The basis of the distinction is that which the Working Group itself has broadly indicated in its Report.

5. Large-sized credit societies: The large-sized society was conceived of as large enough to be viable while compact enough to be co-operative. The "size" was with reference to neither area nor population but to the turnover of business. But if viability, in any particular case, could not be secured without the area being too large or the membership too big, it was also contemplated that it would be the viability that would be sacrificed and not the compactness of the society. In other words, neither area nor membership would be permitted to exceed certain optimum limits. These principles have in general been well understood by State Governments. Any significant deviations therefrom, largely traceable to the newness of the experiment, have been confined to one or two State Governments; and, even there, steps were being initiated to rectify the position in the relatively few cases where that course was necessary. It was in this context, and with little or no attempt to ascertain the facts concerning the working and record of large-sized societies, that criticism was levelled against this form of organisation and attempts made to reverse the momentum which the programme had already gained. It is my duty to point out that much of the criticism was ill-informed. It has been hinted, for example, that the large-sized society perpetuates bureaucracy, whereas the small-sized society helps retain the initiative at the village level and is relatively free of officialdom. In most States, if not all, this is the exact reverse of what actually happens. The viable society has appreciable resources of its own and, in addition, a competent executive as its paid servant. The small society, on the other hand—as Shri V.L. Mehta and other experienced co-operators have repeatedly pointed out—is usually almost wholly dependent on the central co-operative bank, or the co-operative department, or both, for even the preparation of its credit statements and maintenance of its records, and is therefore in effect run by either or both of these outside authorities. The domination of the small society by the supervisors of the central bank or the officials of the co-operative department is all the greater in States which are co-operatively backward. This is only one illustration of the many misconceptions which have been generated concerning the functioning of large-sized societies. It is not my purpose to deal with each of these misapprehensions. I would leave that to a fact-finding enquiry which I hope will in due course be conducted. Meanwhile, I would emphasise that it is unfortunate that, without any attempt to ascertain facts and discuss conclusions, attempts should have been made to stop or curtail even the strictly limited programme of large-sized societies embodied in the Second Five Year Plan. Some of the State Governments have made available to us data which are summarised in the Annexure to this letter. (Information is awaited
from certain others.) On the facts set out, it appears to me that the only conclusion possible, albeit tentative, is that, from the point of view of the provision of adequate credit, this form of organisation is the most promising yet experimented upon in Indian conditions. Indeed, many of the societies appear to have succeeded not only in effecting a large increase in the quantum of loans available for agricultural purposes, but also in attracting deposits, effecting prompt recoveries and, above all, inspiring confidence and enthusiasm in the people. The Reserve Bank notes that a very vigorous programme of cooperative development—including marketing, processing, farming and other activities—is contemplated with almost immediate effect by the National Development Council. This is most welcome; but it should at the same time be realised that an adequate credit organisation is one of the essential pre-requisites of any such programme of co-operative development. It would, from this point of view, be unfortunate if no more large-sized societies were to be organised during the remaining two years of the present Plan. The Reserve Bank is, therefore, firmly of the view that the programme of large-sized societies should be neither stopped nor curtailed but should be proceeded with as laid down in the current Plan. A fact-finding enquiry should at the same time be initiated so that adequate data on the working of the credit societies at the primary level may be available in time for the formulation of an appropriate programme for the Third Five Year Plan.

6. Pattern No.1: As already emphasised, compromise has to be effected between viability and compactness where both cannot be secured. To restrict the size to a rigid 1,000, i.e. to 200 families (of whom in all likelihood only 120 to 150 would be farmers), is to abandon altogether the consideration of viability for a degree of compactness which surely no principle of co-operation can be said to require. Thus, if a single village with a population of 3,000 can be served by one multi-purpose society without violating co-operative principles, is there any reason why three close-by villages with the same total population should not be similarly served? There should be no rigid insistence on 1,000, which in any case is far too small. I would urge that, consistently with the principles of compactness of area, accessibility to all members and, last but not least, viability, the actual area of operations should be left to be determined according to local conditions by the State Governments themselves.

7. State contribution to share capital of village co-operatives: It is observed that, though the National Development Council’s Resolution is silent on the question of State partnership, the Working Group has ruled it out at the level of the primary village society, while providing for it at higher levels such as central and apex banks and marketing and processing societies. It is not clear why State partnership should be objectionable at the village level. In fact, as the examples of Andhra and Madras show, State partnership in the primary society has helped very appreciably in attracting deposits from the rural area. This is a phenomenon of great importance since it points a way of mobilising rural savings. I would suggest that wherever the State Government and the people themselves favour it, State partnership should be permissible in the village society.

8. Pattern No.2: This pattern has much to commend it in that it seeks to combine smallness and viability: i.e. the small single village society with the compact and viable credit union. If, for any reason, the choice has to be between pattern one and
pattern two, it is clear that only pattern two can bring about rehabilitation of the movement in many areas. This applies, for example, to large tracts in Bihar, Bengal and Mysore, where hundreds of villages have been burdened for years with an almost equal number of stagnant credit societies. But that is not all. From the point of view of larger agricultural production, which in turn implies adequate credit, it is clear that pattern two will be immeasurably more effective than pattern one in most parts of the country including areas which are co-operatively developed. The Working Group was, in my view, misguided in attempting to confine this pattern to sparsely populated tracts and economically and co-operatively backward areas. The State Governments and the people concerned should be at liberty to adopt pattern two wherever they want it. The idea that the Centre should dictate to the States on each occasion whether or not this pattern might be adopted appears to me to be both cumbersome and untenable.

9. As regards accommodation from the Reserve Bank, the Working Group have said, "We appreciate that the provision of larger funds by the Reserve Bank will depend a good deal, among other factors, on the strength of the co-operative credit structure, and the effectiveness with which credit and marketing are linked for ensuring prompt recovery of loans." I note that it is proposed to discuss this matter more fully with the Bank at a later stage.

10. Since your letter has reached me only a few days before the National Development Council is due to meet, I have confined my comments to a few of the major recommendations of the Working Group, especially those which deal with credit and the credit structure. These as well as other recommendations require further and careful examination and, above all, full and frank discussion with non-official co-operators, the State Governments, the Reserve Bank and others. I would, therefore, urge again that final decisions be deferred until there has been such an exchange of views.

Yours sincerely,

H.V.R. IENGAR

Shri M.R. Bhide, I.C.S.
Secretary to the Government of India
Ministry of Community Development and Co-operation
New Delhi

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I had a long talk in Delhi with the Minister for Co-operative Development, Shri S.K. Dey. I explained to him at some length the views of the Reserve Bank on the NDC Resolution and the Working Group’s Report. I told him I was unhappy at the way the whole problem was being dealt with in the Government of India and, in particular, the manner in which decisions were being attempted to be rushed without a proper consideration either of the issues involved or of the actual functioning of different types of co-operative organisations. The Minister told me that he did not
think that any final decision would be taken at the meeting of the NDC and that it was his clear intention to have a meeting, which he hoped would take place in July, with the Ministers in charge of Co-operation and leading non-officials who have worked in the movement. He told me also that he would want particularly to discuss with the Reserve Bank all the issues arising out of the NDC Resolution and not merely the problem of credit.

My discussion with the Minister was on the day before the NDC meeting. Whether the Minister was right in thinking that no firm decision would be taken or whether, in fact, contrary to his desire, the Government of India representatives at the meeting did take a final decision would only be known when we get the minutes of the meeting.

I notice that, in any case, a further discussion would be held with the Reserve Bank on the problem of credit. I had a talk with the Finance Minister about this yesterday. I told him that I was feeling apprehensive about the statement in the paper submitted by the Planning Commission that the problem of credit would have to be dealt with in a fundamental manner. This, together with newspaper accounts of what happened at the meeting, suggest that what the Planning Commission have in mind is that the Reserve Bank should give credit on a large scale to the new societies on a wholly different basis to that hitherto adopted, namely, on the basis of mere needs and not of a multiple of the share capital and reserves. I told the Minister that it would be a complete disaster to the financial reputation of India which, at present is very high, if the Reserve Bank had to show in its books sums as overdues from co-operative institutions. The Bank would have to take up a firm position with regard to the grant of credit to institutions beyond the limits of creditworthiness as assessed by the Bank. If the issue was forced by Government and it was decided finally that sums should be advanced against the Bank's considered judgement of the appropriate credit limits, I felt that it would be more appropriate if the problem were handled not by the Reserve Bank but by a separate institution to be set up for the purpose of handling agricultural credit. It would be open to Government to give such loans to this corporation as they might consider appropriate. Eventually, of course, the money would be advanced by the Reserve Bank, but channelling the funds through a separate corporation was desirable, partly to avoid the risk of the Reserve Bank having to show bad debts in its books and partly to indicate more clearly the nature of the transaction. I said that this was only a preliminary view. Many things could be said against it, but it may have to be resorted to as a lesser of the two evils. The Minister said that he would like to discuss this idea further with me on my return from my overseas trip.

[H.V.R. IENGAR]
7.4.1959

D.G.(V) 7.4
D.G.(A) 8.4
C.O.ACD 8.4
My dear Bhide,

One of the papers circulated to the National Development Council contains a summary of the views of different people and of the State Governments on the Report of the Working Group. The views of the Reserve Bank, as conveyed in the Governor's D.O. letter of 31 March 1959, are also summarised. It is unfortunate that the summary does not bring out adequately the Reserve Bank's comments on issues of substantive policy as distinguished from those of procedure. It will now be some time before the Conference of Ministers for Co-operation is held. Since there is an adequate interval, may I suggest that, for such conference, the replies not only of the Reserve Bank, but of the State Governments and others, be circulated in full? This will enable more informed discussion at a stage when that will be very important from the point of view of implementation of policy.

Yours sincerely,

B. Venkatappiah

Sub: Rural Credit—Revision of Policy

Letter to Deputy Chairman of the Planning Commission

I submit herewith a draft letter to Shri V.T. Krishnamachari on the lines advised by the Governor. I should like to make two observations:

1. I have refrained from making the suggestion that if a radical change in the co-operative structure is made, it may be that a separate central banking organisation will have to be established in the country. I am afraid that if this is said they may adopt the policy of establishing a separate central bank for financing the Co-operative Movement which may protect the Reserve Bank, but throw the Co-operative Movement as a whole in danger.

2. I have also extracted the Press interview of the Governor as reported in the Hindu. I have deliberately avoided quoting the official version because the Deputy Chairman should have what the public knows about the Governor's views.

[J.C.R(YAN)]
13.4.1959

Governor (HVR) 13/4/1959

D.O.No.[...]

April 13, 1959

Dear Shri Krishnamachari,

Yesterday I met Shri Jivraj Mehta, the Bombay Finance Minister, and he told me that you are under the impression that I am not happy about the Reserve Bank financing the Co-operative Movement. I was very greatly surprised by this; and I do not know how you gathered this impression. Actually I have been extremely happy...
over the progressive increase in the volume of credit provided by the Reserve Bank to the co-operative credit structure. The short-term funds provided by the Bank for seasonal agricultural operations and marketing of crops have been mounting up year after year; the sanctioned amount increased from Rs 16.32 crores during 1953–54 to Rs 48.24 crores during 1957–58. As these sanctions are in the nature of a recurring credit, during 1957–58 the Co-operative Movement drew from us Rs 61.38 crores. In a press interview which I gave at Bombay in September 1958, I drew the attention of the public to this fact and hoped that this progress would be steadily maintained with the result that the Agricultural Credit Department of the Reserve Bank would become one of its most important Departments. I extract below the Press report from the “Hindu” dated 5th September 1958.

"Mr. Iengar said that the activities of the Bank had been most striking in the sphere of rural finance, in the wake especially of the recommendations of the All-India Rural Credit Survey Committee. The Reserve Bank had done much to assist in the setting up of an integrated system of rural credit. The scale of financial assistance which the Bank had been providing to the rural sector, primarily through the agency of the State Co-operative Banks had been rising fast, the bulk of the advances being made at a concessional rate of two per cent below Bank Rate. The total of the outstanding advances of the Bank to the State Co-operative Banks, which was something like Rs 3 crores on the eve of the commencement of the First Plan now stood at a little below Rs 50 crores. By the end of the Second Five Year Plan it might go to Rs 100 crores. Besides, the Bank had made available a sum of about Rs 6 crores to State Governments to enable them to contribute to the share capital of co-operative institutions. Mr. Iengar visualised that the Rural Credit Department of the Bank would be one of the biggest institutions in the country in terms of money it handled. It might surpass some leading banking institutions in the country and that was only a ‘peep’ into the future, he added.”

I feel that if the present progress of financing the rural sector is maintained, the Co-operative Movement will be able to reach the target fixed under the Second Five Year Plan viz., Rs 150 crores of short-term credit of which a very large part will be provided by the Reserve Bank.

2. My anxiety about co-operative credit does not relate to what is happening at present. It concerns the plan for the future, which involves a radical change in the basic structure of the Co-operative Movement, viz. the primary credit society. This anxiety has been shared by the Board of Directors of the Reserve Bank who considered at length the recommendations made in this behalf by the National Development Council in November 1958 and the Report of the Working Group on Co-operative Policy appointed to work out methods of implementing those recommendations. I communicated the Bank’s views to the Co-operative Department at Delhi before the recent N.D.C. meeting, but it does not appear that they circulated a copy of my letter to anybody. I enclose a copy for your information in case you have not seen it. My real anxiety is that the Bank may be called upon in future to provide a large amount of credit to societies which are structurally weak and if that happened there may well be large unauthorised arrears. I consider that it would be wholly disastrous for the financial reputation of the country if the Reserve Bank had to show in its books a
volume of frozen advances. It is this I am worried about and not the current lending policy of the Bank.

Shri V.T. Krishnamachari
Deputy Chairman
Planning Commission
Government of India

My dear Iengar,

Many thanks for your letter No.[...] dated 13th April, on financial credit to agricultural co-operatives. Shri Morarji Desai mentioned to me in a general way the point you make in your letter.

2. I had intended to discuss this subject with you. I understand, however, that you are leaving for the U.S.A. on the 19th. As soon as you return, we shall arrange a meeting.

3. Like you, we in the Planning Commission are most anxious that the Reserve Bank should not get involved in unsound financial credits to the movement.

4. In the Second Five Year Plan and a series of letters issued in connection with it, there are two patterns of rural co-operative development envisaged:

(i) The ‘rural bank’ or the large-sized society recommended by the All-India Rural Credit Survey Committee’s Report:

The Plan set a target of about 10,000 societies covering approximately 50,000 villages. By the end of March, 1959, 6,300 societies have been formed covering 70,000 villages.

(ii) Revitalisation of village societies and forming new ones:

Targets for this have been indicated.

5. The National Development Council has laid down the policy to be followed in regard to the latter programme. The main point in this is the linking up of credit with an approved production programme of the village made up of family plans. The question to be considered now is how far the Reserve Bank should provide finance for this programme. Discussions on this are going to take place at official level with Venkatappiah and others. A final decision can be taken after you return and the Finance Minister and myself have discussed the whole question with you.

Yours sincerely,

V.T. KRISHNAMACHARI

June 20, 1959

Dear Shri Morarji Desai,

During the last week or two, I have been busy acquainting myself with some of the more important developments which have taken place while I was abroad. On one
of them I feel it my duty to write to you at once. It pertains to agricultural credit. I refer to the Rs 8 crore pilot scheme for establishing a “line of supplementary credit” from the Central Government to the cultivator through State Governments and co-operatives. The details are given in Circular Letter No.[...] of 16th May 1959 issued by the Ministry of Community Development and Co-operation. The connected papers show that the whole idea of a “supplementary credit line” has emanated from the Planning Commission.

If this had merely been a draft scheme for discussion, my comments would have been unnecessary. It is not. On the contrary, State Governments have been asked to take immediate action on it; and there has been no attempt to discuss beforehand either with them or the Reserve Bank certain features of the Scheme, and various assumptions on which they are based, which prima facie merited such a consultation. The point I am raising is not solely one of procedure, though even as a procedural matter it is one of considerable importance. For, firstly, the Reserve Bank is Government’s statutory adviser on agricultural credit. Secondly, it operates the very credit scheme to which the present one is supposed to be “supplementary”; and thirdly, it is far and away the largest lender to co-operatives and, in that capacity, is directly interested in the effect of any such scheme on the co-operative credit structure.

My main objection to the scheme, however, is based on substantive and not merely procedural grounds. I shall be doing less than justice to the importance of the subject if I am not completely frank. It is my considered opinion that in its present form the scheme is immature and ill-advised. In justification of this comment I shall draw your attention to three or four of those features—many more can be cited—which are likely in my opinion to render the scheme harmful in certain respects and ineffective in others:

(1) One of the strongest objections to the scheme is the effect it is likely to have on the conduct of business by primary societies. According to the letter, “Central co-operative banks will be sanctioning loans to the primary societies in the normal course. A supplementary loan over and above the normal credit limits for additional finance required by the primary society to finance its members on the fuller scale envisaged above will be given by the central bank. For this purpose, special credit limits may have to be sanctioned by the appropriate authority to the primary society as well as the central co-operative bank”. These additional limits will be derived from the supplementary line made available by Government and, obviously, will be specifically related to whatever is not “normal”, i.e. (a) loans to new members who would not otherwise have been admitted; (b) loans to existing members who would not ordinarily have been lent anything, and (c) in respect of a member who is a ‘normal’ borrower, such part of the new loan as is above the ‘normal’ level. All this is fairly complicated since not only notionally, but in actual practice, societies will have to distinguish between what is “normal” and what is “supplementary”. Moreover, the line between normal and supplementary is not static; it changes as the society grows in financial or organisational strength; it also changes if, for example, a good marketing society happens to be established in the area and a few more can be confidently given loans because there is a prospect of their being recovered through the marketing society. To introduce the idea of “normal” and “supplementary” in such circumstances,
with separate resources earmarked for the "supplementary", is in fact tantamount to inviting the society to adopt a double set of standards for its borrowers. Far from leading to progress, it is likely to result in confusion and retrogression. A conservative society will have every temptation to become even more conservative so far as its own risks are concerned, for it can readily relegate to the supplementary category all cases about which it has the slightest misgivings, including those which in normal circumstances it might well have considered favourably and lent from its own resources. There can be no better way of demoralising the co-operatives than to introduce double standards of this kind.

(2) It might be said, in answer to the foregoing objection, that the scheme does not in fact contemplate the bearing of any risk on the part of Government and that it is a basic assumption that all the [Rs] 8 crores together with the interest thereon will come back to the State Governments and through them to the Central Government. In the first place, the assumption is open to question. The supplementary money is Government money and even though it may be channelled through co-operatives every borrower will know it to be Government money; and if experience with tagai and "grow-more-food" loans is any guide, the prospects of full recovery cannot be said to be very bright. In fact the arrears are likely to be substantial. Secondly, if it is indeed true that Government has launched this scheme on the understanding that it will bear no part of the risk, it may be asked what there is in the project to impel central co-operative banks and primary societies to extend their lending programmes, and along with them their risks, so considerably.

(3) That brings me to the point that few, if any, State co-operative banks have exhausted the credit limits which the Reserve Bank has sanctioned them. The limits themselves are being increased from year to year, along with corresponding increases in the share capital etc. of the banks; and today, in 1958–59, the total of such limits sanctioned by the Reserve Bank, insofar as they are for the specific purpose of seasonal agricultural operations and the marketing of crops, amounts to as much as Rs 68.24 crores. (Incidentally, out of this only Rs 40.40 crores was outstanding on 22-5-1959, leaving a balance of Rs 27.84 crores which could still be drawn by the banks.) Indeed, the Ministry's own letter explicitly states: "Generally speaking, shortage of funds is at present not the main reason why central banks do not lend more to societies." It then goes on to propound a remedy of which the main feature is the putting of more funds at the disposal of central banks!

(4) The letter says, "The most effective way of increasing the borrowing capacity of the members is to link up credit with intensive production plans in which every family participates and also with the marketing of agricultural produce. If this is effectively done (emphasis mine), it will ensure not only prompt repayment of loans but also considerable increase in the share capital and reserves of the society. It will also attract local deposits and increase the membership". With this counsel of perfection there can be no dispute; nor even with the picture of all that will happen, once that counsel is translated into reality. But the Scheme is silent as to how all this will be "effectively done". There is no mention of more technical
staff for drawing up detailed production plans, nor of physical supplies (e.g. more fertiliser) for bringing about the production, nor of larger outlay on the establishment of marketing societies and godowns. In the absence of financial and other provision for simultaneous effort on all these fronts, the Scheme can have only one implication for the primary credit society, namely, that it alone among all the parties concerned is to act as if certain assumptions were true—e.g. that village production plans exist and marketing societies are effective—even though they are as yet (according to the letter itself) nowhere near reality. What is more, the society is to incur the financial risks involved in acting on these assumptions. Thus it may give a loan for production, but may find itself unable to recover it because effective marketing has not meanwhile been organised. It seems to me that, as a pilot scheme for production cum marketing cum credit, the project under discussion is wholly inadequate because it has no concrete proposals for either production or marketing.

(5) I am aware that officers of the Ministry, the Planning Commission and the Reserve Bank are engaged in further discussions on this Scheme both among themselves and with State Governments. In view of what I have pointed out, however, it appears to me very necessary that the Scheme be put in abeyance until such time as its harmful features are eliminated and suitable modifications introduced for making it more realistic and effective. I would, therefore, suggest that State Governments be informed that various points arising out of the circular are being considered by Government in consultation with the Reserve Bank and that, pending further communication, no action should be taken by them on the Scheme previously communicated to them.

I am sending a copy of this letter to Shri S.K. Dey, Minister for Community Development and Co-operation.

Yours sincerely,

H.V.R. IENGAR

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
August 4, 1959

Dear Shri Morarji Desai,

You may recall that I wrote to you some time ago expressing serious apprehensions about the pilot project scheme recommended by the Ministry for Community Development & Co-operation to State Governments. It was subsequently decided that I should discuss the matter further during the Conference of State Ministers of Co-operation at Mysore. I attended this Conference at the invitation of the Minister and am very glad indeed that I did so. For the first time in some years, there was full and frank discussion in which, besides the framers of policy in Delhi, those directly concerned with policy and implementation also participated. In addition to the State Ministers, these included eminent non-official co-operators from different parts of the country. The Conference gave me the opportunity to have some exceedingly useful discussions with the Deputy Chairman of the Planning Commission and his colleagues
and with the Minister, Shri S.K. Dey. As a result, certain misunderstandings have been mitigated, if not cleared, different points of view better appreciated and a definite course of action suggested in regard to the formulation of future policy and procedure.

2. In the Conference itself I made two or three points which seemed to me of importance from the angle of the Reserve Bank. My object in writing this letter is to let you know the position in regard to these matters.

3. I emphasised that one of the primary duties of the Reserve Bank was to ensure the monetary stability of the country; that this was a task on which it had been engaged with some degree of success over the years; and that any unrealistic expansion of agricultural credit on its part would not only be inconsistent with its charter but also give rise to inflation and injure the economic interests of the country. Briefly, any loans given by the Bank to the co-operative credit structure would have to fulfil three requirements: (a) they would have to be related to productive purposes; (b) they should in fact be utilised for such purposes; and (c) they should be fully recovered and returned in time. If these conditions were fulfilled, there was no reason why the Bank should not make a large-scale expansion of its credit to co-operative institutions. It was common knowledge that the Reserve Bank, on its own initiative, had conducted a most elaborate survey and helped to formulate policies on the basis of the results of that survey. Not only had the Bank taken a positive and constructive attitude in this matter, but, in the translation of those policies into practice, had actually stepped up its accommodation to the co-operative credit institutions from a mere 6 lakhs in 1946–47 to nearly Rs 65 crores in 1958–59. Indeed the latest figure of drawings from the Reserve Bank for agricultural credit was very nearly Rs 80 crores which was more than two-thirds of the total of the agricultural loans given by primary co-operative credit societies. The primary task (which, incidentally, the Prime Minister himself emphasised in his message to the Conference) was to make a sustained effort so that the conditions mentioned above could be fulfilled. I pointed out, however, that the mere fact of production, still less the mere formulation of plans of production, would not mean that every cultivator could be given a loan by a primary society. The society ought certainly to reassess a cultivator’s credit rating in the light of an effective production programme, but it would nevertheless happen that a certain number of marginal and sub-marginal cultivators would not stand the test of being able to repay. In other words, while a production programme might enhance individual income, and an effective marketing arrangement might enable the credit society to treat more people as ‘creditworthy’, there would still remain a number of farmers at the subsistence level or below for whom the real requirement would be not credit, but economic rehabilitation. Any pilot project meant to provide these with credit must perforce take into account the future solvency of the credit institution and therefore give adequate guarantees to the latter. In this connection, the position regarding amounts overdue to the primary societies was very pertinent. There was at least one State in which the percentage of overdue to outstandings was more than 50% and a few in which it was less than 20%. (In terms of percentage of overdues to demand, the picture would be even more alarming.) In the light of all this the Reserve Bank’s own credit policy,
while as progressive as circumstances permitted, could not depart from certain fundamental criteria; and as a practical matter it did not appear that the co-operatives could possibly advance credit to every single cultivator in the villages.

4. There was considerable discussion on the above points and I believe there was general understanding and appreciation of the attitude taken by the Reserve Bank. Indeed, I was gratified to note that both in his Presidential Address and his later speeches the Deputy Chairman repeatedly underlined the point that neither the credit society nor the Reserve Bank should be called upon to make unsound loans. In the result, it was decided to modify the original pilot project very considerably and put forward an alternative which in effect dealt only with the production aspects of the programme. In particular, it was agreed to omit from the previous pilot project at least two of the features to which I had objected, viz. the provision of Government finance (which you will recollect was to be of the order of Rs 8 crores) and the establishment of a supplementary line of credit at the level of the primary society. This was, I think, a very satisfactory result. All the States seemed to think so too.

5. The second main item I should like to bring to your notice concerns the form of organisation of the primary credit society. There has been, as you are aware, an unfortunate controversy regarding the relative merits of the large-sized and the small-sized societies. It was clear to me that conditions differed so widely in different areas that no one formula could be regarded as holding good everywhere. Most of the non-officials and many of the Ministers present at the Conference were unhappy that they had not been given a full opportunity of expressing their views before important policy changes were made. However that be, the Deputy Chairman of the Planning Commission and the Minister for Community Development & Co-operation were both agreed at the end of the discussions that the fullest possible opportunity should be given for both large-sized societies (i.e. those which had already been established) and the small-sized societies to stabilise themselves and make the maximum possible progress in their respective spheres. In particular, any impression that Government looked upon large-sized societies with disfavour was to be removed and each State asked to give immediate attention to the consolidation of such of these societies as had been hitherto registered on the lines which the Reserve Bank had had in mind. There was to be no question of their being broken up, and this was to be made clear to the States. Evaluation of both types of societies was to be undertaken in due course before any further changes in policy were attempted. But it was important that such evaluation should not be hasty or premature. Apart from size, the other aspects of organisation which claimed the attention of the Conference were those which had a bearing on the adequacy of the borrowing power of the primary society vis-a-vis the co-operative central bank and, through it, the apex bank and the Reserve Bank. It was the general view of the Conference that a committee should be asked to go into this matter. The terms of reference, it was felt, should be specific and detailed. These were drawn up and accepted by the Conference. I believe the personnel of the committee will be shortly decided upon by Government.
6. I believe the Conference fully justified itself. Shri Dey’s intention is to follow it up with closer consultations with the Reserve Bank and with non-official co-operative agencies. This, I think, is all to the good.

7. I am sending copies of this letter to Shri V.T. Krishnamachari and Shri S.K. Dey.

Yours sincerely,

H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
New Delhi

***
IV. STATE BANKING

A. STATE BANK OF INDIA

D.O.No.[...]

BOMBAY
August 26, 1952

My dear Deshmukh,

This is with reference to your discussion with me on T.T. Krishnamachari's letter No.[...] dated August 3rd, 1952 regarding the nationalisation of the Imperial Bank of India.

2. As you know the demand for nationalisation of the Bank was based primarily on three grounds:
   (a) The higher personnel of the Bank was overwhelmingly British and Indians were excluded from the higher posts.
   (b) In regard to advances there was discrimination in favour of European companies and this was facilitated by a majority of European Directors in the Board.
   (c) The Bank derived unfair advantages in regard to facilities for transfer of funds to currency chests and remittance of notes through treasuries and branches of the Bank.

In regard to Indianisation, the Imperial Bank has given an assurance to the Government that all senior appointments in the Bank will be Indianised by 1955 and the Purshotamdas Committee, which examined this issue, has stated that this assurance should be regarded as satisfactory. The process of Indianisation is going on according to schedule. It may now be taken for granted that consistently with the requirements of efficiency, everything will be done to Indianise the personnel of the Officer class within the shortest possible time.

As you know, a representative of Government now attends the weekly meetings of the Bank at which all the advances are reviewed and the general policy discussed. A.D. Gorwala, the Government representative, whom I have consulted, has assured me that there was no discrimination whatever against Indian companies. Whatever may have been the policy when the British were in charge of Government, it is extremely unlikely that under present conditions any discrimination will be exercised in favour of European companies. Europeans are no longer in a majority on the Board.

The question of unfair competition was examined by the Purshotamdas Committee, who made recommendations that other scheduled banks should share as far as possible the remittance and other facilities enjoyed by the Imperial Bank. These recommendations have been given effect to.

3. In view of these developments, there is no case for nationalisation on the basis of the old allegations made before India attained independence. There are, however, other factors which have to be considered very carefully before we arrive at a definite decision. You know the history of this problem, for you dealt with it as Governor of the Reserve Bank. In February 1948, Sir Shanmukham Chetty announced in the Assembly that it was the intention of the Government to nationalise the Reserve Bank of India and the Imperial Bank. In regard to the Imperial Bank, Dr. Matthai stated in
1948 that "in the light of the examination of the technical question and in view also of possible repercussions on the investment market and of the existing unsettled economic conditions in the country Government considered that it was not feasible to proceed at that time with the nationalisation of the Imperial Bank of India". Expressing your entire agreement with this statement, you stated in Parliament on November 22nd, 1950, that you were quite convinced that it was not in the best economic interests of the country to attempt nationalisation of the Bank.

4. There have, however, been certain fundamental changes in regard to the Imperial Bank and other scheduled banks since Sir Shanmukham Chetty made his announcement on nationalisation in 1948.

   Firstly, the Reserve Bank was nationalised in January 1949 and under Section 7 of the Act the Central Government has the power to give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest. The Directors of the Reserve Bank are now entirely nominated by the Government.

   Secondly, under the Banking Companies Act, which was passed in 1949, the Reserve Bank has been invested with very wide and effective powers of supervision and control over all scheduled banks, including the Imperial Bank of India. The more important of these powers are as follows:

   (a) Section 21: Where the Reserve Bank is satisfied that action is necessary in the public interest, it may determine the policy in relation to advances to be followed by banking companies in general or any particular banking company. The Reserve Bank has also been empowered to give directions to banking companies, either generally or individually, as to the purposes for which advances may be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances.

   (b) The Reserve Bank has also the power to inspect any banking company and its books and accounts. As you know we have now instituted a scheme of systematic inspection of all banks, including the Imperial Bank. Our expectation is that after next year every bank will be inspected at least once a year.

5. Apart from these general powers, which apply to all scheduled banks, the Imperial Bank Act contains provisions for the following additional powers of control and supervision by Government over this Bank.

   (a) The bye-laws of the Bank require the previous approval of the Government.

   (b) The regulations of the Bank and all amendments thereto require the specific sanction of the Central Legislature.

   (c) Under Regulation 59, the Government is authorised to appoint auditors to examine and report upon the accounts of the Bank.

   (d) Under the Clause 3 of the agreement with the Reserve Bank, the Imperial Bank is required to carry out all the orders and directions of the Reserve Bank in carrying out Government business and for the maintenance of the relevant accounts.

   (e) A Government representative now attends the weekly meetings of the Committee of the Central Board at which all advances are considered and decisions taken on questions of policy.
6. I have described these powers at length, since it is not generally recognised that wide and effective powers of control over the Imperial Bank of India are now vested in the Government of India and the Reserve Bank. As I stated in a memorandum to the Central Board of the Reserve Bank of India “it is definitely a State-controlled institution at present, and if the comprehensive statutory powers vested in the Government and the Reserve Bank are exercised when necessary, and certain minor organisational changes are made, the development of this Bank as a national institution can, in my opinion, be assured. In the next few years a vast extension of the credit machinery will be required to meet the requirements of the planned development of industry and agriculture. In this very difficult period, it is imperative that the Reserve Bank should have the willing co-operation of the largest banking institution in the country, which is functioning as its agent. Unless and until it is proved by experience that our powers are ineffective and the Imperial Bank’s active co-operation is not forthcoming, I would deprecate strongly any drastic changes in the constitution of the Bank.”

7. Nevertheless, (I am quoting again from my memorandum to the Board) “it has to be recognised that the Imperial Bank has, partly on account of its long association with the Government and the special privileges it has enjoyed, attained a pre-eminent, if not dominant, position in the banking structure of the country. With a network of branches spread all over the country, it is still functioning as banker to Government at places where the Reserve Bank has no branches. It maintains currency chests and small coin depots and operates the remittance facilities scheme. It acts as a banker’s bank by keeping their surplus cash and by granting them advances. It manages the clearing houses in many places. It is obvious that the Government cannot be disinterested in the working of a Bank, which has acquired such a dominant position in the credit structure of the country and is at present the biggest banking institution in Asia. It is immaterial from the point of view of national interests whether close association with the Government or sound management is the more important factor which has contributed to this development. A Bank which has reached this position cannot justifiably claim to be treated like an ordinary commercial bank.”

8. The time has arrived when we should consider the question of nationalisation or radical changes in the constitution of the Bank from the point of view of the planned development of the country. As you know, I suggested nearly three years ago, the transfer of all treasury work to the Imperial Bank, who would be required to extend their branches to all places where treasuries are functioning at present. The idea behind this was the planned integration of the banking structure. Commercial banking would be taken up to the taluk headquarters and as the Purshotamdas Committee have recommended, beyond this stage co-operative credit banks and other institutions would carry credit facilities to the rural areas. At present, considerations of possible losses arising from the rapid expansion of branches to semi-urban areas deter the banks from any such expansion on the lines suggested. This outlook, influenced by the profit motive, is inevitable so long as the Directors and the Executive Officers are responsible to shareholders for the management of the bank. If a partial nationalisation is to be undertaken for a rapid expansion of credit facilities, Krishnamachari’s proposal for the appointment of the Managing Director and the Deputy Managing Director by Government would not achieve the object, for these officers would still be responsible
wholly or partly to the shareholders. Indeed, their position would become impossible if they have divided responsibilities to the Government and the shareholders. If control by Government is to be effective, the Government must hold, at any rate, a majority of the shares, if not all the shares.

9. With reference to our discussion last week in Bombay, I will re-examine the whole question afresh from the point of view of development of banking and credit facilities after I have had the report of the Rural Credit Survey, which, as you know, is considering the question of the lines on which credit facilities should be extended to rural areas.

Yours sincerely,

B. RAMA RAU

11-3-1955

State Bank of India—Vesting of shares in the Reserve Bank of India—advantages

The Central Board of the Reserve Bank has strongly endorsed the Governor’s proposal that the major ownership of the share capital of the State Bank should vest in the Reserve Bank and not partly in the Reserve Bank and partly in Government as suggested by the Committee of Direction, All-India Rural Credit Survey. An attempt is made in this note to state the advantages of the proposal approved by the Board. These advantages principally flow from the basic assumption made in this note that there is some virtue in preserving the commercial character of a banking institution after the transference of control to Government; also that when a fundamental change is brought about in the economic field, it is always expedient to usher in the change in a manner which does not immediately cause much dislocation in the process of changeover or gravely disturb the confidence of the classes whose co-operation in the evolution of a new pattern is a considerable source of strength.

(1) Need for retaining flexibility of working:

For the successful and efficient working of a commercial bank, flexibility in working is of great importance, and it is necessary that it should not be hampered by the rigidity of Government rules and procedures. Although the managerial autonomy and operational flexibility of the State Bank may be achieved by constituting it into a separate corporation distinct from Government, it is believed that the vesting of its capital in an institution such as the Reserve Bank rather than in the Central Government would provide it greater flexibility, and eliminate delays and red tape. In other words, the Reserve Bank’s ownership of the capital of the State Bank will prevent the latter from turning, despite its separate corporate existence, into a Department of Government subject to its traditional and rigid restrictions.

(2) Greater public confidence:

Ownership by the Reserve Bank of the major share of the capital of the State Bank will inspire greater confidence in the public in its capacity to continue to provide quick, efficient and satisfactory banking service and to maintain its confidential relationship with the constituents. This would be viewed as earnest of the Government’s desire to implement the assurance given to the public that the Government’s association
with any bank will not result in impairing the credit and banking facilities generally enjoyed by commercial and other interests and the usual confidential relationship between the bank on one side and its clients and depositors on the other.

(3) Lesser political interference:

The Reserve Bank's ownership will be an assurance that, conversion of the Imperial Bank into the State Bank will not lead to interference by Government in the day-to-day working of the Bank. Direct holding of the capital by the State, it is feared by some, may lead to frequent interpolations in Parliament and political interference in the detailed working of the Bank, the effect of which would be injurious to the healthy development of the institution.

(4) Expert advice of the Reserve Bank:

The Reserve Bank is essentially an expert body in close touch with the working of commercial banks and fully alive to their needs and problems. It is, therefore, felt that the over-all supervision and control over the State Bank should be vested in that Bank. Such supervision and control will be more purposeful if the capital of the State Bank is vested in the Reserve Bank than in the Central Government.

(5) Freedom from Governmental Audit:

If the Government were to own the capital of the State Bank either in full or in part, the question of providing for audit by the Comptroller and Auditor-General would arise. (In this country, the extension of Government type of audit to institutions working on commercial lines is relatively a new phenomenon, and it is far from clear whether the enlargement of the sphere of such audit, intended largely to serve greater accountability of public funds to Parliament, so as to cover commercial banking institutions would necessarily advance public interest. In any case, it is desirable that the State Bank, at any rate in the early stages, should have freedom from the inhibitory effect and irksome restrictions of such an audit so as to retain for it its operational and financial initiative.)

(6) Consistency with the main purpose and objective:

The functions of the State Bank will include—

(a) the taking over of cash work from non-banking treasuries and sub-treasuries with charge of the Reserve Bank's currency chest;
(b) the provision of vastly extended and cheap remittance facilities;
(c) the spreading of banking facilities to rural areas; and more particularly to assist in fostering the development of commercial, and particularly co-operative, banking throughout the country.

In all these the Reserve Bank is vitally interested, while in some of them, the State Bank will be functioning more or less as the agent of the Reserve Bank. It appears logical therefore that the Government's partnership in the capital of the State Bank should be through the Reserve Bank. It is considered that such a relationship will, if anything, be more in accord with the aim of the Committee of Direction, which was to evolve a mixed pattern of shareholding.

2. The object of the Government to assume control over the Imperial Bank is principally to regulate effectively its policies. Since the Reserve Bank is a fully nationalised institution there can be no doubt as to effectiveness of Government control over the policies of the State Bank by the proposed device. It appears
therefore that the vesting of the capital of the State Bank in the Reserve Bank would
be a more desirable method of carrying out the reform the Government have in
mind. There is a precedent in Australia for the course suggested where the ownership
of the Government Trading Bank vests in the Commonwealth Bank and not in the
Central Government.

[N.D. NANGIA]

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[23-2-1955]

STATE BANK OF INDIA

The Department of Banking Operations have prepared a note containing their
observations in regard to the recommendation of the Committee of Direction, All-
India Rural Credit Survey, for the formation of a State Bank of India. The conclusion
reached by them is that it might be preferable to wait and watch the experiment of
nationalisation of the Imperial Bank before taking any steps either for the amalgamation
of the 10 other State-associated banks with the Imperial Bank or even for their
formation as subsidiaries for eventual amalgamation. Their suggestion is that a provision
may be made in the State Bank Act for voluntary amalgamation and that this course
may be pursued where the State Bank considers it desirable and the other banks also
agree. Before dealing with the reasons given by the Department of Banking Operations
for reaching this conclusion, it may be useful to describe the background against
which the Committee of Direction have recommended the formation of the State
Bank of India.

2. In July 1949, the Indian States Finances Enquiry Committee (under the Chairmanship
of Shri V.T.Krishnamachari) in its report on the financial integration of the Princely
States with the rest of India, emphasised the need for an early review of the question
of bringing the banking and treasury arrangements in Part 'B' States into line with
those obtaining in Part 'A' States as, in its opinion, the then existing arrangements in
some of the States were far from satisfactory. Later, in November 1949, the Government
of India appointed the Rural Banking Enquiry Committee which was asked, among
other things, to consider the measures that could be immediately adopted for the
extension of banking facilities in rural areas and also to make recommendations
regarding banks which were handling treasury work in Part 'B' States. The Committee,
after a detailed study of the subject, reached the following conclusions regarding Part
'B' States:

(i) The Hyderabad State Bank, in view of its origin and history and the functions
which it was already performing, should be appointed as agent of the Reserve
Bank in the State;

(ii) As regards the other States, the majority of the banks handling Government
work in them were not qualified for being appointed as agents of the Reserve
Bank. They had inadequate resources and were of insufficient standing. However,
in order to avoid damaging their position by depriving them of Government
work suddenly, the Committee recommended that they might continue to function
on the lines they were doing for a period of five years, at the end of which
period their position would have to be further reviewed.

3. The Committee's recommendations were examined by the Government of India in
consultation with the Reserve Bank. The Government of India decided that it would be a retrograde step to ask Part ‘B’ States to reverse the process and to assume treasury functions themselves. It was, therefore, decided to explore the possibility of appointing the State Banks as agents of the Reserve Bank and to entrust them with treasury work at appropriate centres subject to such safeguards as might be considered necessary in order to ensure the safety of Government monies, the balances of currency chests maintained by the Issue Department of the Reserve Bank, etc. In pursuance of this decision, the Hyderabad State Bank and the Bank of Mysore have been appointed as agents of the Reserve Bank in the respective States with effect from the 1st April 1953 and the 1st November 1953 respectively. It has also been announced that the Travancore Bank and the State Bank of Saurashtra will be considered for appointment as our agents. The safeguards taken are that the banks are required to accept the scheme of control in terms of which there is a nominee each of the Central Government and the Reserve Bank on the Boards of these banks. The Central Government have also power to issue instructions to the banks e.g. in circumstances involving contravention of the terms of the relative agreements between the State Banks and the Reserve Bank or in regard to the safety of balances in the currency chests. Over and above this, the State Government concerned is required to give a guarantee for losses occurring in the balances in the currency chests. It may be stated that these safeguards are of limited value. For instance, the scheme of control does not give an effective control to the Reserve Bank on the affairs of the banks. All important matters e.g. grant of advances, investments of the banks’ funds, etc., are decided by the Boards of the respective banks and although our nominees may tender advice, they have no power to overrule the Boards. The Boards can thus disregard the advice tendered by our nominees. The scheme of control is, therefore, not effective and so long as the banks are owned by private shareholders, no effective control can be acquired over them. The guarantee of the State Government, it may be mentioned, may be of no value in certain contingencies. Utmost caution has, therefore, to be exercised in establishing currency chests at offices of the State Banks.

The upshot of the foregoing historical background is that the rate of progress in converting non-banking treasuries into banking treasuries in Part ‘B’ States through the medium of the State Banks will be extremely slow if these banks continue to function as separate units and the Government or the Reserve Bank do not acquire control over them. As separate units and owned largely by private shareholders (except, of course, in the case of the Bank of Patiala and the State Bank of Saurashtra and also the Hyderabad State Bank), it would be impossible to secure an alignment of policies of these banks in consonance with national objectives. Further, none of the State-associated banks in Part ‘B’ States approaches anywhere near the Imperial Bank’s standards from the point of view of resources, experience and traditions, equipment and managerial efficiency. These are limitations which have to be recognised in the context of handing over currency chests to them and entrusting them with remittance and treasury functions on Reserve Bank’s behalf. The Committee of Direction, All-India Rural Credit Survey, took into account these limitations and the whole background of the State-associated banks and reached the conclusion that, in national interests, the next logical step to take would be to amalgamate them with the Imperial Bank.
4. Coming to the note of the Department of Banking Operations, the main points made by them and our comments thereon are given below:

(i) There will be an enormous rise in the establishment cost of the State Bank of India and its capacity to extend its activities by opening new branches will be severely curtailed. The argument “capacity to pay” will be difficult to sustain in the case of the State Bank of India.

The Department of Banking Operations have stated that the proposed nationalisation of the Imperial Bank and the 10 major State-associated banks has been hailed by the employees as a step in the right direction as they expect that their emoluments would considerably increase by such a step. The employees have perhaps supported the proposal because the control of the banks will pass from the respective managements to the Government or the Reserve Bank. This is perhaps because they think that they will receive a better treatment at the hands of the Government or the Reserve Bank than from the present managements. The answer to this point is that the employees of banks very well know that the employees in the commercial departments of Government such as Posts and Telegraphs Department, Railways, get much less emoluments than those prescribed in the award for banks. It is hardly likely that the employees would expect an increase in their emoluments as a result of nationalisation. As regards other State-associated banks, if, as stated in the Department of Banking Operations’ note, they are run as subsidiaries of the State Bank of India, they will be treated as separate units for purposes of labour awards and continue to be placed in the respective classes as prescribed in the awards. In this context, it may be stated that the Grindlays Bank is a subsidiary of the National Bank of India and yet the two banks are treated as separate units for purposes of labour disputes. Similarly, the Allahabad Bank is an affiliate of the Chartered Bank of India, Australia and China and yet both these banks are considered as separate entities for purposes of labour disputes. It cannot, therefore, be stated that the conversion of the Imperial Bank of India into the State Bank of India or the taking over of the State-associated banks as subsidiaries would involve an enormous increase in establishment costs. Nor is there any ground for the assumption that “the capacity to pay” would cease to be a valid consideration because of State control. The Railways, for example, are not paying their employees without regard to earnings and capacity to pay. For that matter, the pay scales of clerical and subordinate staff in the service of the Central and State Governments are not higher than those of Class `A’ banks. In fact, they are very much lower in the case of certain Governments e.g. Mysore.

(ii) The State Bank of India may have to undertake expansion of foreign exchange business. This will, however, depend partly upon the attitude adopted by the other countries towards the State Bank.

There are several State-owned banks engaged in commercial banking business which have branches outside the respective countries. Among Commonwealth countries, the Commonwealth Bank of Australia and the Bank of New Zealand are instances in point. Right in our midst in the city of Bombay, we have
branches of the Bank of China and Comptoir National D’Escompte de Paris, both of which mainly transact foreign exchange business. The first is a State-controlled bank (2/3rds of share capital vests in the Government of China) and the second is a fully nationalised institution. It would not be incorrect to assume that a State-owned bank may even have greater prestige abroad than a bank which is owned by private shareholders.

(iii) The advances granted by many of the State-associated or State-owned banks were, as a result of Reserve Bank inspection, found to be based on other than purely commercial banking practice and while some State-associated banks had gone into liquidation after the integration of the States, the financial position of many of the remaining banks is not quite satisfactory. This applies to banks owned by private shareholders also. The inspections of private-owned banks conducted by the Department of Banking Operations have revealed that there are instances of advances being granted on other than purely commercial banking practice. The number of State-associated banks, which have gone into liquidation, so far as we are aware, is not very large, and in any case, only smaller-sized institutions had to be taken into liquidation. The real or exchangeable value of the paid-up capital and reserves of the 10 State-associated banks, as estimated by the Department of Banking Operations, does not reveal that their financial position is not satisfactory. All of them appear to be solvent institutions and their position is no worse than that of many private-owned commercial banks. In fact, the entire case for amalgamation rests on the weaknesses (to the extent these exist) of the individual State-associated banks. By bringing them together with the Imperial Bank, a strong, well-integrated bank would result. This is the only way for us to get a stable and reliable agent in Part ‘B’ States. Of course, the case is different if the propositions were that banks which are not financially solvent (i.e. capable of meeting their liabilities in full) should be amalgamated. The Department of Banking Operations’ inspections of these banks have not, in the case of any of the 10 major banks, reached that conclusion. Amalgamation is merely the principle of achieving strength through unity. Indeed, certain provisions in the Banking Companies Act show that the Legislature has fully appreciated this position.

(iv) With variations in paid-up capital and reserves, earning capacity and the rate of interest and market quotations for shares, it will be difficult, if not impossible, to find any basis for compensation which will not lead to dissatisfaction, not without foundation, among the shareholders of the bank concerned. The question of devising a suitable basis for compensation may present some difficulties in certain cases. But it cannot be stated that the question is beyond solution. It should be possible to devise a machinery for ensuring that a fair basis of compensation is worked out in each case. In any case, this by itself, would not appear to be a reason for withholding the establishment of the State Bank of India.

(v) The rates of interest on deposits allowed by the Imperial Bank are lower than those of the other State-associated banks. If the amalgamation takes place, it is not unlikely that a fair portion of the deposits held at present by the State-associated banks will be transferred elsewhere.
In this connection, it may be stated that it is the common practice among banks to pay different rates of interest on deposits at different centres. Thus, for example, the Imperial Bank offers 1¼% on 6 months' deposits at Calcutta but the rate at Delhi is 2½%. The Bank of Baroda offers interest on Savings Bank deposits at various centres at rates varying from 1% in Ahmedabad and Bombay to 2% at Hyderabad and Madras. The State Bank of India could, therefore, pay slightly higher rates at centres in Part 'B' States, if necessary. In any case, if the State-associated banks are run as subsidiaries for some time, the question of lowering the rates of interest will not arise. There is nothing sacrosanct about rates of interest which are dictated purely by business considerations. There is no law which prescribes what the rates of interest given by banks on deposits (or those charged on advances) should be. Our assumption is that the State Bank of India should function as a business institution and at the same time, it should avoid the undesirable type of competition with other banks. It is a truism in banking that the bigger and stronger the bank, the lower is the rate it needs to pay to attract deposits. It may be that the State Bank of India would be able to retain the present level of deposits of the State-associated banks by offering lower rates. If, however, deposits show a tendency to get diverted to other banks in the area, the rates could be put up to the extent necessary to arrest such a process. A business concern knows best how to run; we may well leave this question to be tackled by the State Bank carefully and judiciously.

(vi) The amalgamation of the 10 State-associated banks with the Imperial Bank will lead to a concentration of the offices of the State Bank in the western parts of the country, leaving the eastern sector such as the tracts of Madhya Pradesh, Bihar, Orissa, West Bengal, Assam, etc., with relatively fewer offices of the State Bank. The objective of the Committee will be better achieved if the State Bank opens offices in the relatively undeveloped parts instead of taking over the State-associated banks.

In this connection, it may be stated that very great emphasis has been laid in the expansion programme of the Imperial Bank for opening branches in undeveloped areas such as Madhya Pradesh, Bihar, Orissa, Assam, etc. It is after great pressure exerted by the Reserve Bank that the Imperial Bank has agreed to open branches in these areas. So long as the bank is private-owned, it is bound to look at every proposition for opening new branches from the angle of earning potentiality. It is for this very reason that the Committee has recommended acquisition of control over the Imperial Bank and other State-associated banks, as otherwise they do not extend their activities to undeveloped areas. There would, of course, be rationalisation of branches of the Imperial Bank and other State-associated banks at certain centres. This will release trained staff, etc. for opening branches in undeveloped areas. The amalgamation will thus assist the bank in opening branches in undeveloped areas rather than impeding progress. The map given in the Report shows that the respective State-associated banks e.g. Hyderabad State Bank, Bank of Patiala, State Bank of Saurashtra, Bank of Mysore, Bank of Rajasthan, etc., have a considerable number of branches in the respective States. This is the reason why the Committee has suggested that the
amalgamation of the banks would provide a network of branches throughout the country to undertake treasury work, give remittance facilities and generally carry on and extend their operations in conformity with national interests. The Committee was well aware of overlapping at certain centres. This will have to be dealt with suitably when the State Bank of India is formed. The Committee, because of the vast field which exists for expansion, has pointed out that there would be no need for the retrenchment of surplus staff. In the Committee's appraisal of the situation, the need may well be for the recruitment of further staff e.g. by re-employment of retired personnel.

(vii) The offices of the State-associated banks are concentrated in a few districts. The institution of a currency chest at each of these centres would be an uneconomic proposition.

Currency chests will be established after careful investigation. At present, there are over 100 district centres and over 300 sub-divisional centres where currency chests do not exist.

Conclusion

The Government of India have already taken a decision on the conversion of the Imperial Bank of India into the State Bank of India. The question now for consideration is as to whether and if so in what manner the State-associated banks should be amalgamated with the Imperial Bank. If, as suggested, the State-associated banks are run as subsidiaries of the State Bank of India for some time, these banks will continue to be placed in the respective classes under the labour awards and there would not be any increase in establishment expenses. Such subsidiaries could also continue the rates of interest on deposits and advances according to local conditions and make adjustments gradually. Their administrative standards could also be improved during the interim period i.e. till they are integrated with the Imperial Bank. One of the essential conditions for extension of banking facilities in the country is the establishment of currency chests to facilitate the movement of cash from one centre to another. As already explained, a vigorous and co-ordinated programme for the establishment of currency chests cannot be carried out so long as these banks continue as separate, and relatively smaller units. So long as these banks continue to function as private-owned (except, of course, the Bank of Patiala and the State Bank of Saurashtra), these banks will be managed by the respective Boards and effective control over them cannot be exercised. In view of the smallness of their size, lack of premises and other arrangements comparable with those of the Imperial Bank and inadequately paid managerial staff, it would not be possible to entrust currency chests to them at many of the centres. Thus, remittance facilities cannot be provided until currency chests are established and currency chests on a large scale cannot be established so long as these banks continue to operate as smaller units. The guarantee of State Governments is not an effective safeguard, considering the changes in the political set-up which have taken place in certain States. It is true that the Banking Companies Act has conferred several powers on the Reserve Bank. It is also true that banks in Part 'B' States which are appointed our agents have to comply with our scheme of control. But, by the exercise of these powers, we cannot get over the limitations arising from the smallness
of size of these banks and the consequential lower standards of administration, particularly at branches, and generally of financial soundness and strength of these institutions as compared with the Imperial Bank. The presence of a Police force does not create good citizens. In the same way, weaker banks cannot be converted into stronger units by the exercise of certain powers. The case for integration of banks is the same as that on which the political and financial integration of Part ‘B’ States was based. The aim is to unify the banks and thus create the framework we want.

[T.K. RAMASUBRAMANIAM]  
23.2.1955

17th July 1957

Dear Shri Krishnamachari,

I got the impression, from what you told me on the telephone the other day, that you felt that the report of the Ad Hoc Committee on the State Bank’s role in agricultural credit had put you in difficulty vis-a-vis Parliament and the general public. I write this letter to elaborate the point I briefly made, viz., that, that impression would not be correct. While, of course, the Committee dealt with the proposals entirely on their merits, I was throughout conscious of the need of avoiding, as much as possible, any political or personal embarrassment so far as you are concerned; and, in the final analysis, the report, I think, has not been unsuccessful from this point of view.

2. According to the ‘Times of India’ of the 28th May 1957, while speaking in the Lok Sabha on the two Bills to amend the Reserve Bank and the State Bank Acts, you stated that the State Bank “should be not only a commercial bank but should also have a non-commercial or developmental side, taking over from the Reserve Bank the function of lending to co-operative institutions, to agriculture and to small-scale industries”. Referring to suggestions made by some members of Parliament, you observed that the “Reserve Bank must remain the topmost financial institution in the country controlling practically every movement in finance. But some of its present functions which were of a commercial nature, like affording agricultural co-operative credit, would be transferred to the State Bank.”

3. The Ad Hoc Committee’s recommendations fit in with this pronouncement. Let us first consider whether the State Bank would be taking on “a non-commercial or developmental side”. Credit to agricultural marketing and processing societies, which, according to the Committee’s recommendation, is to be the function of the State Bank in most of the States, is commercial in nature; at the same time, it is in furtherance of the co-operative movement at the primary level of villages and must be co-ordinated with the functioning of primary societies. It has, therefore, quite definitely a developmental aspect. No commercial bank would, in the ordinary course, give advances to such societies or be ever bothered with the tedious and unprofitable task of liaison with primary village societies; nor has the State Bank ever thought of doing so itself. In breaking this new ground, therefore, the State Bank will be taking on a commercial-cum-developmental activity to which the Second Five Year Plan attaches very great importance. As stated in the report, the quantum of assistance called for is immense and
I have, in fact, doubts in my mind as to whether the target can be reached. May I add here that this proposed development in the activities of the State Bank must be assessed in the context of other similar activities, e.g. the experiments in the field of small-scale industries? When I was in Madras, I went into this in some detail and I was very greatly struck by the potentialities of this new line. If the initial momentum in this field is kept up, the State Bank will be taking on a very big responsibility indeed. The combination of credit to marketing and processing societies and to small-scale industries will constitute a totality of developmental activity of tremendous size.

4. We may now consider your proposal that the Reserve Bank should divest itself of “functions of a commercial nature, like affording agricultural co-operative credit”. I would like to point out that the Reserve Bank does not provide funds to agriculturists direct, nor even to primary co-operative societies composed of agriculturists. It gives them to central co-operative banks for reimbursing the funds they have already lent to primary co-operative societies. This, as explained in the Committee’s report, is a central and not a commercial banking function. You are possibly aware that the Reserve Bank lends on the rediscount of agricultural bills at 2 per cent below the Bank rate. Quite apart from the nature of the transaction itself, no commercial bank would ever dream of giving a subsidy of this size.

5. I see no reason, therefore, for your feeling unduly defensive in case you accepted the Committee’s recommendation.

Yours sincerely,

H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister, India.

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B. STATE-ASSOCIATED BANKS AND SUBSIDIARIES OF SBI

Summary of the views expressed at the meeting of the Central Board of the Reserve Bank on the 28th February, 1955, on item No. 8 of the agenda, viz. “Integration of the State-associated banks with the State Bank of India”.

In his opening remarks, the Governor said that he would confine himself to some of the main points which would have to be borne in mind in the discussion of this subject. First of all, there would have to be certain criteria on which to decide whether or not it was desirable to amalgamate an individual “State-associated” bank with the State Bank of India. He suggested that there were two broad criteria, one relating to the utility of such amalgamation and the other to the degree of association with the State discernible in the present features of the bank. In other words, it would first have to be considered whether the amalgamation would serve one or more of the purposes intended, such as banking development generally and the provision of rural banking facilities in particular. Secondly, it would have to be examined whether, as of the present, the State Government concerned was intimately enough connected with the particular bank for the latter to be described as “State-associated”. In this
context, it would have to be remembered that the State Government's relationship with the bank could take one or more different forms. One of these was the degree of control, if any, exercised through appointment of directors, approval of the appointment of the Managing Director, sanction of bye-laws, etc. Another was the nature of the Government business, if any, e.g. cash work at the treasuries, entrusted to the bank. The third was financial partnership in the bank through ownership, wholly or in part, of the share capital of the bank. Fourthly, yet another connection with the bank might take the form of financial and other assistance, e.g. by way of maintaining Government funds in deposit with the bank. Bearing in mind the two broad criteria—utility and degree of association—one would also have to examine the practical difficulties which might arise in the process of integrating the individual bank with the State Bank of India, whether the integration takes the form of complete amalgamation or of owning and managing the bank as a "subsidiary". Thus, note would have to be taken of the fact that many of the State-associated banks pay much higher rates of interest on their deposits than does the Imperial Bank. The question of pay-scales (for officers, etc. as well as for staff governed by the Award), and the possibility of having to incur much larger cost through an upgrading of the pay-scales would be another point to be taken into consideration. The qualifications of the existing personnel, and the standards of work generally, differ for different banks; and this point too would need to be considered in the context of amalgamating particular banks with the State Bank of India. Another set of considerations arose in respect of the State Bank of Saurashtra, the Bank of Patiala and the Hyderabad State Bank. The State Governments were cent per cent owners of the Saurashtra and Patiala banks, while the major part of the share capital of the Hyderabad State Bank was held by the Hyderabad Government. From the constitutional point of view, the legality of this arrangement is itself open to question. In regard to these three banks, therefore, the case for their being taken over by the Central Government might be said to be on a different footing from that of the other banks. The Governor emphasised that he was merely analysing the considerations involved, and that it was for the members of the Board to express their views in order that the considered advice of the Central Board on this important matter might be duly conveyed to Government.

Prof. D.R. Gadgil stressed the following points:

The avowed object was the creation of a countrywide banking structure which would be effectively associated with the policies of the State and, for that purpose, also be effectively controlled by the State. It was a basic assumption that the existence and operation of this State-controlled banking institution in any particular area would confer certain important benefits on that area in the sphere of rural credit and other matters, whereas an ordinary commercial bank, which had all the time to look to its dividends, would not be able to confer such benefits. It followed that we could not think of such an institution in terms of Part 'A' States alone. The Imperial Bank was broadly confined to Part 'A' States. In Part 'B' States (and in one instance, i.e. Baroda, a merged area of a Part 'A' State) had grown up, under the active patronage of the former princely Governments, individual banks which were broadly comparable, in relation to those areas, to the Imperial Bank as it developed and spread in the former British Provinces. The amalgamation of these banks with the Imperial Bank,
and the establishment, as a result, of the State Bank of India was, therefore, prima facie a very valid proposition. It was only in this manner that, without damage to the existing State-associated banks, a countrywide institution could be formed which would confer benefits on all the areas concerned. Since no area could be denied the benefits envisaged, the only alternative to the amalgamation of the State-associated bank operating in that area would be the effective expansion of the State Bank of India itself into that area; but this alternative would be injurious to the bank concerned, whereas amalgamation would be a course which would give a definite place to that bank in the integrated banking structure. In this total context, which had been analysed and elaborated in the Rural Credit Survey Report, it was the whole history of development of individual banks, under the auspices of the former Governments concerned, that would be relevant, rather than any recent alternations in the long-standing basis of "State association". The real question before the Board would appear to be whether, in the solitary instance of the Bank of Baroda, the recent interruption in a long period of association with the State was in itself so significant a factor that this bank could not be classed with the rest for the purpose of the scheme of integration. In his opinion, the short interruption did not constitute a good reason for omitting the Bank of Baroda from the proposed banking structure. There was as good a case for integrating this bank with the proposed State Bank of India as there was for the remaining nine State-associated banks. It was not, of course, suggested that there should be outright amalgamation from the very beginning. As pointed out by the Governor, the ownership of each bank could first be taken over by Government and, for so long as necessary, the institution managed and run as a "subsidiary" of the State Bank. A programme of this kind would have to be pursued with determination, and delay—except such minimum unavoidable delay as may be necessitated by practical considerations—would be of no help. The alternative of voluntary amalgamation would not only cause interminable delay, but there was no assurance, even eventually, that it would result in the "countrywide" structure envisaged. Except in respect of the two or three banks which were already fully or substantially owned by the State Governments, voluntary amalgamation would, therefore, be no solution. The statute would, therefore, have to provide for compulsory acquisition.

Sir Purshotamdas Thakurdas wondered whether the largeness of the administrative effort needed and the question of availability of the trained personnel necessary had been taken into account by the Rural Credit Survey Committee while putting forward the suggestion that so huge a re-organisation of banking should be undertaken by Government. The nationalisation of the Imperial Bank was by itself a big enough task. He would caution Government to "hasten slowly", and not further enlarge and complicate the problem by seeking to tackle the State-associated banks as well. There was another aspect to which he would draw pointed attention. All these banks—he instanced the case of the State Bank of Saurashtra—were built up by local effort, served local needs and evoked local pride and sentiment. It had to be very seriously considered whether a programme of integration which involved the disappearance of these banks as individual entities would not do a great deal of harm not only to the local sentiment, but also to local usefulness, without any counter-balancing advantages from the point of view of national policy.
Sir Manilal B. Nanavati said that two main objectives seemed to underline the proposal that State Bank of India should be constituted. One of these was the wider provision of rural banking facilities, largely in the form of better and more extensive arrangements for the remittance of funds. He suggested that this objective could as well be secured by entering into an appropriate arrangement with each of the banks concerned. The other aim was the provision of agricultural credit through an adequate network of rural branches, such credit being largely based on produce in the custody of marketing societies, warehouses, etc. Most of the State-associated banks under consideration were already doing all they could in this respect; they had in most cases extended far enough into the rural areas; and when warehouses were built or marketing societies established, they would be able to expand their agricultural credit operations just as much as if they were parts of the State Bank of India. He, therefore, thought that the objectives postulated did not necessitate the amalgamation of these banks with the State Bank of India. He added that, if necessary, more control could be assumed by the State over each of these banks, if that was found to be necessary in the interests of rural credit; there was no need for absorbing the banks in the State Bank of India.

Shri C.R. Srinivasan agreed with Sir Purshotamdas Thakurdas that Government should “hasten slowly” in this matter and that the re-organisation of the Imperial Bank involved in its conversion into the State Bank of India was itself so big a task that it would be unwise to add to the administrative burden by taking on other banks as well. He agreed, however, that if and when a particular State-associated bank—e.g. Saurashtra or Patiala—was decided to be acquired, the first step should be that of constituting the bank into a subsidiary. Integration, in the sense of complete amalgamation, would come later. He added that the arguments for excluding the Bank of Baroda from the scheme of integration applied substantially to the Bank of Mysore as well; the State Government did not own any part of the share capital of this bank and it was only lately as a result of an agreement with the Reserve Bank, that the bank had come to be regularly entrusted with the cash work of certain Government treasuries in the State. The bank was essentially a commercial bank in the sense in which the Bank of Baroda could also validly be claimed to be a commercial bank as distinguished from a “State-associated” bank. For these reasons, while on the one hand the scheme of integration itself should be launched gradually and with due caution, the banks of Baroda and Mysore, on the other hand, should not be included in the scheme at all.

Shri Dhirendra Nath Mitra laid emphasis on the need to avoid any undue delay in the reaching of decisions; if “hastening slow” implied that the question would be kept open for a long time to come in respect of individual banks, then those banks would live under the shadow of nationalisation and not know whether to expand or not as normal commercial banks. It was, therefore, necessary that criteria for acquisition should be considered as soon as possible and decisions on individual banks arrived at without avoidable delay. He would make the tentative suggestion that State participation in share capital might be adopted as the main criterion; on the basis of such participation being appreciable, the banks to be acquired would be Saurashtra, Patiala, Hyderabad and, possibly, Travancore and Indore. For practical reasons, he would be in favour of each of the banks selected being first taken over as a “subsidiary” of the State Bank; he would postpone complete amalgamation to a later stage.
Shri B.M. Birla said that the State-associated banks were a great facility for the small business man who, in the area served by the bank, could approach it for loans, whereas a big institution like the Imperial Bank (or, hereafter, the State Bank) would hardly care to cater to his needs. If on the ground that the Saurashtra and Patiala banks were already State-owned it was proposed to merge them in the proposed State Bank, that was something to which no objection could perhaps be taken; but the nationalisation of the other State-associated banks would be an entirely different matter to which he felt bound to object. As regards these other banks, he did not see why their amalgamation with the State Bank should be sought even on a voluntary basis. In respect of them, therefore, he would go to the extent of saying that the State Bank of India Bill should not contain a provision which would enable negotiations for voluntary amalgamation.

Sir Shri Ram said that he would like it to be placed on record as his view that Government's decision in respect of the Imperial Bank, taken without consulting the Board, was not only unwarranted by the grounds adduced, but was definitely prejudicial to the private sector of industry, trade and commerce, whose confidence in Government's policies had already been badly shaken. He was of the view that none of the ten State-associated banks should be nationalised. He agreed with Sir Purshotamdas Thakurdas regarding the magnitude of the administrative and other difficulties involved and the consequent need for Government pursuing a slow and cautious policy in this matter.

Shri B.D.V. Ramaswamy Naidu was prepared to agree to the inclusion of Saurashtra and Patiala banks, but not any other. He generally agreed with Sir Purshotamdas Thakurdas and Sir Shri Ram regarding the undesirability of nationalising the State-associated banks.

Prof. Gorakhnath Sinha said that, as he understood the position, the conversion of the Imperial Bank into the State Bank would amount to its being reserved for the public sector on the one hand and for rural credit on the other. It was necessary that the private industrial sector should have its own sources of finance; he thought that if the State-associated banks were left as they were, they would serve the purpose of financing this sector. He was, therefore, against the amalgamation of these banks with the State Bank of India, or, as a first step, their conversion into subsidiaries.

Prof. D.R. Gadgil spoke again to point out that the discussion seemed to him divorced from the basis of policy already laid down in the Finance Minister's announcement. Since the Finance Minister had said that "the Government of India accept in principle the recommendation eventually to bring about the establishment of an integrated commercial banking institution covering the whole country with effective control vested in the State", the real question before the Board was not that of the principle itself, but the mode of implementation. In fact, it was about "the details of both the manner and the phasing of so important a measure of reform" that the Finance Minister had said in Parliament that careful examination was necessary and had gone on to add that "these will in due course be carefully examined by the Government after the receipt of the views of the Board of the Reserve Bank".

Shri H.M. Patel said that it would have been of greater help to the Government of India if the members of the Board, after making such reservation as they considered
necessary in regard to the broad policy itself, proceeded to make constructive suggestions in regard to the process of implementation; there were, for example, important issues such as the criteria for selection of individual banks for the purpose of integration on which Government were expecting advice from the Board of the Reserve Bank; and there was also the suggestion referred to by the Governor, that such banks as were included for integration should in the first instance be taken over as subsidiaries, and only at a later stage, if necessary, amalgamated with the State Bank. As regards the policy of integration itself, there was, in his opinion, no doubt regarding Government’s acceptance of it in principle. This was clear from the Finance Minister’s speech on economic policy as well as from the specific wording of the announcement. Shri Patel then referred to one of the ideas which had been put forward during the discussion, viz. that the State Bank of India in the form of a converted Imperial Bank should extend to Part ‘B’ States and, wherever necessary, establish branches which would be parallel to those of the State-associated banks, without however absorbing the banks themselves. He agreed with Prof. Gadgil that such an expansion on the part of the State Bank would be gravely prejudicial to the State-associated banks concerned. He added that it was for this, among other reasons, that Government had decided to accept in principle the broad scheme of integration. Summing up the discussion, the Governor said that, while obviously there was no unanimity, the Board appeared to be substantially of the following view:

(1) It is undesirable to provide in the statute for the compulsory acquisition of any of the ten State-associated banks;

(2) where necessary, amalgamation can take place on the basis of voluntary negotiation; and

(3) even so, there are only three banks which need be considered for amalgamation, viz. the State Bank of Saurashtra, the Bank of Patiala and the Hyderabad State Bank.

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At the meeting of the Central Board of the Reserve Bank on 28th February, one of the items considered was the integration of the State-associated banks with the State Bank of India. The ten State-associated banks considered were those mentioned in the Rural Credit Survey Committee Report, viz.

i) The State Bank of Saurashtra
ii) The Bank of Patiala
iii) The Bank of Bikaner
iv) The Bank of Jaipur
v) The Bank of Rajasthan
vi) The Bank of Indore
vii) The Bank of Baroda
viii) The Bank of Mysore
ix) The Hyderabad State Bank
x) The Travancore Bank

[2-3-1955]
While a few of the members did not see much objection to the State banks of Saurashtra, Patiala and Hyderabad being taken over for the purpose, many of them were of the view that no action at all should be taken beyond that which was rendered inevitable by the decision already announced by Government in respect of the Imperial Bank, viz. the conversion of that bank into the State Bank of India. In fact, Shri B. M. Birla was of the view that the State Bank of India Bill should not contain a provision for negotiating with other banks, at the instance of Government, for voluntary amalgamation. Sir Purshotamdas Thakurdas, Sir Manilal Nanavati and Sir Shri Ram, and one or two others emphasised that a certain amount of local sentiment was attached to most of these banks, and that a programme of integration would not only injure such sentiment but also impair the usefulness of individual banks. Sir Shri Ram cited with approval the view expressed in a communication addressed by Shri J. R. D. Tata to the Governor of the Reserve Bank which was to the effect that Government’s decision in respect of the Imperial Bank, taken without consulting the Board, was not only unwarranted by the grounds adduced, but was definitely prejudicial to the private sector of industry, trade and commerce whose confidence in Government’s policies had already been badly shaken. Shri Gorakhnath Sinha of Bihar appeared to argue on the assumption that the action proposed in respect of the Imperial Bank amounted to converting that bank into a financier, exclusively, of the public sector and of rural credit. He went on to suggest that the other State-associated banks should be left as they were in order to finance the private sector, including urban industry. Shri C. R. Srinivasan agreed with Sir Purshotamdas Thakurdas that Government should ‘hasten slowly’ and interpreted this to mean that the State-associated banks should be left out altogether. Shri Dhirendra Nath Mitra suggested that there was a clear case for integrating at least Patiala, Saurashtra and Hyderabad (and possibly also Travancore and Indore) banks and stressed the need for taking an immediate decision about these and other banks so that there might not be a long period of uncertainty as to which banks would be amalgamated with the State Bank and which would not. Shri B. D. V. Ramaswamy Naidu was prepared to agree to the inclusion of Saurashtra and Patiala banks but not any other. He generally agreed with Sir Purshotamdas Thakurdas and Sir Shri Ram regarding the undesirability of nationalising the State-associated banks.

With the exception of Shri Dhirendra Nath Mitra and Prof. D. R. Gadgil, the non-official members of the Board were therefore of the view that most, if not all, of the State-associated banks should be left out altogether and generally implied disagreement with Government’s policy of State control and integration of a certain defined sector of banks in terms of the Finance Minister’s announcement. Most of the discussion took place after Prof. Gadgil had briefly mentioned the reasons set out in the Report of the Rural Credit Survey Committee in support of assumption of control over the State-associated banks and their integration into a countrywide banking structure. Prof. Gadgil also intervened at an early stage of the discussion to emphasise that in view of the Finance Minister’s announcement that “the Government of India accept in principle the recommendation eventually to bring about the establishment of an integrated commercial banking institution covering the whole country with effective control vested in the State”, the real question before the Board was not that of the principle itself but the mode of implementation. In fact, it was about “the details of
both the manner and the phasing of so important a measure of reform” that the Finance Minister said in Parliament that careful examination was necessary and went on to add that “these will in due course be carefully examined by the Government after the receipt of the views of the Board of the Reserve Bank”.

On behalf of Government, I pointed out during the discussion that it would be much more useful if the members of the Board, after making such reservation as they considered necessary in regard to the broad policy itself, proceeded to make helpful and constructive suggestions in regard to the process of implementation; there were, for example, important issues such as the criteria for selection of individual banks for the purpose of integration on which Government were expecting advice from the Board of the Reserve Bank; and there was also the suggestion that such banks as were included for integration should in the first instance be taken over as subsidiaries, on which and connected points the views of the Reserve Bank would be of great help to Government. As regards the policy of integration itself, there could be no doubt whatever of government’s acceptance of it in principle. This was clear from the Finance Minister’s speech on economic policy as well as from the specific wording of the announcement. In regard to one of the ideas which had been canvassed, viz. that the State Bank of India in the form of a converted Imperial Bank should extend to Part ‘B’ States and wherever necessary establish branches which would be parallel to those of the State-associated banks, without however absorbing the banks themselves, I added that such an expansion on the part of the State Bank would not only be gravely prejudicial to the individual State-associated banks but would, in point of policy, be definitely contrary to the announced intentions of Government in regard to integration.

The position thus created was discussed with me by the Governor of the Reserve Bank after the Board meeting on the 28th February and again on the forenoon of the 1st March, when Shri Venkatappiah was also present. His general view appeared to be that we should proceed with the State Bank of India Bill on the assumption that it would for the time being be confined to the Imperial Bank, that another piece of legislation might later be introduced in respect of such State-associated banks as Government might eventually decide to include in the scheme and that, meanwhile, the views of the State Governments (and only incidentally the banks) concerned should be ascertained by means of a formal explanatory letter to each, followed by a visit of the officers of the Reserve Bank. Where there was willingness or, at any rate, little or no opposition from the State Governments concerned and the individual bank was on merit suitable for integration, a decision could be taken to include the particular bank in the scheme of integration; the integration itself, however, should be by stages, and in any case the substance of integration would be secured at the stage of acquiring the particular bank as a subsidiary of either the Reserve Bank or the State Bank. I said that I would report his views to the Finance Minister, but that I was myself by no means certain that the reaction of the State Government should be the main factor in deciding whether or not a bank should be integrated. The responsibility was that of the Union and, while informal consultations need not be ruled out, the decision would have to be related to the policies formulated. Whether or not there should be a separate piece of legislation, amending or other, in respect of the State-
associated banks would largely depend on the time factor. If decisions could not be reached early enough, it may, for that reason, become inevitable to confine the State Bank of India Bill to the Imperial Bank in the first instance. Even if there was to be a second bill, there could be no question of delaying it unduly, for it would be harmful from every point of view to postpone decision to a remote date. The Governor said that he contemplated very early action so far as consultation with the State Governments was concerned. I understand that he has since discussed this matter with the Finance Minister.

The Board of the Reserve Bank having reached the conclusions that it did, it is clear that as soon as the views of the Board are formally communicated to us, the whole matter will stand remitted to Government and that it will now be for Government to take decisions on all the broad issues arising from the policy already announced. It is unfortunate that these decisions have to be taken without the type of assistance, by way of formulation of criteria, modes of implementation etc., which, it was hoped could be obtained from the considered views, on all these points, of the Board of the Reserve Bank. I think the primary initiative and responsibility in respect of the consultations with State Government should now be assumed by the Finance Ministry. I think that the Finance Ministry, assisted by one or two officers of the Reserve Bank, can without much difficulty complete these consultations with the State Governments in the next two or three weeks. Apart from the issue of a sufficiently explanatory letter from the Ministry which can go to the State Governments concerned, which can be done in the next few days, my plan of action would be as follows:

The State banks of Saurashtra, Patiala and Hyderabad present a relatively simple problem. The first two are wholly State-owned; and apart from the State Government owning 51% of the share capital of the Hyderabad bank, the bank itself, by means of a resolution of the board, has recently welcomed the scheme of integration in relation to its own future as a State-associated bank. In each of these cases, the main points raised by the State Governments are likely to be concerned with the amount of compensation which the State Governments expect from the Government of India. I propose to ask Joint Secretary (Shri Barve) to visit the three States with either Shri Nangia or Shri Ramasubramaniam of the Reserve Bank. The programme will, of course, be settled in consultation with the Governor of the Reserve Bank. As regards the remaining banks, I propose, if F.M. agrees, to meet the Finance Ministers and Finance Secretaries of the States concerned as follows:

- **At Delhi:** Rajasthan and Madhya Bharat Governments (Banks of Bikaner, Jaipur, Rajasthan and Indore)
- **At Bombay:** Bombay Government (Bank of Baroda)
- **At Bangalore:** Mysore and Travancore-Cochin Govts. (Bank of Mysore and Travancore Bank)

In our communication to the State Government, we will suggest the advisability of their representatives being accompanied by one or two representatives (including the General Manager) of the banks concerned, so that their advice and assistance are available to the Finance Minister and Finance Secretary of the State concerned; formally, of course, our own talks will be with the State representatives, it being important to avoid giving the impression that we are conducting negotiations with the banks and are
thus departing from the procedure adopted vis-a-vis the Imperial Bank. Informally, however, this will give us an opportunity to ascertain the reactions of the banks themselves. Separate talks will be held in respect of each bank; in other words, no attempt will be made to hold a joint conference of the representatives of different Governments and banks. For these talks with the Governments of Rajasthan, Madhya Bharat, Bombay, Mysore and Travancore-Cochin, as well as with the banks concerned, I will request the Governor of the Reserve Bank for the assistance of Shri Venkatapthiah. If the programme is conveniently divided like this between J.S. and myself, I think the task can be completed reasonably early. In the letter to the State Governments as well as in the subsequent talks, every effort will be made to avoid giving the impression that the principle of integration itself is open to argument by the State Governments. The main point for discussion will be the applicability to the particular case, from the practical angle, of the general principle already accepted by the Central Government. Any special difficulties, including any special features of the banks relevant to the main issues, will be discussed, as also points connected with the manner and phasing of the programme of integration at a later stage whether any of the banks should eventually be dropped from the scheme and, if so, on what principles. The discussions will also be helpful in revealing any special features or points, of which we may not be now aware, but which, nevertheless, may have to be covered in drafting the final legislation.

If F.M. agrees, I will take further steps on the lines indicated above.

H.M. Patel
2-3-1955

FINANCE SECRETARY
GOVERNMENT OF INDIA
NEW DELHI
March 3, 1955

D.O.No.[...]
My dear Rama Rau,

This is with reference to your conversation with the Finance Minister and our subsequent talk regarding the desirability of holding informal meetings with the representatives of the State Governments concerned on various issues connected with the proposed integration of State-associated banks with the State Bank of India. As you know, the Finance Minister agrees with you that such discussions will be useful. He appreciates that it will not be possible to complete before the 11th a whole round of visits to six or seven States. He has, therefore, asked me to write and tell you that a later date, possibly towards the end of the month, will be fixed for your discussion with him. Meanwhile, he thinks that there will be considerable advantage if the Government of India is from the start associated with the talks with State Governments. The following suggestions are made in consultation with him. Barve will visit Saurashtra, Patiala and Hyderabad, and I trust you will find it possible to ask either Shri Ramasubramaniam or Shri Nangia of the Reserve Bank to accompany him to these States, and take part in the discussions. In each of these cases the main issue raised by the State Governments is likely to be that of the amount of compensation they expect to be paid for their shares by the Central Government. I hope to be able to
meet the representatives of the Rajasthan and Madhya Bharat Governments at either Jaipur or Delhi and discuss with them the cases of the four banks with which they are concerned, viz. Bikaner, Jaipur, Rajasthan and Indore Banks. The Finance Minister would like Venkatappiah to be associated with me in these discussions. Similarly, the two of us can see the representatives of the Mysore and Travancore-Cochin Governments at Bangalore and discuss the Bank of Mysore and the Travancore Bank. It is also proposed, at Bombay, to conduct informal talks with the State Government regarding the Bank of Baroda. Since this arrangement will facilitate early completion of the programme and help Government to reach final decisions without undue delay, I am confident you will find it acceptable. A detailed programme will be drawn up in a day or two and intimated to the Reserve Bank. I am consulting Venkatappiah, who is here, about the details of the programme.

I also propose shortly to write to the State Governments. It will be suggested in the letter that, if the State Governments consider it desirable, they may arrange for their representatives to be accompanied by one or two representatives (including the General Manager) of the banks concerned, so that informal talks can be had with the latter as well. Formally, of course, our discussions will be with the State representatives, it being important to avoid giving the impression that we are conducting negotiations with the banks and are thus departing from the procedure adopted vis-a-vis the Imperial Bank. Informally, however, this will give us an opportunity to ascertain the reactions of the banks themselves. Separate talks will be held in respect of each Bank; in other words, no attempt will be made to hold a joint conference of the representatives of different Governments and banks. The letter to the State Govts. will be so worded as to avoid giving the impression that the principle of integration itself is open to argument by the State Governments. The main point for discussion will be the applicability to the particular case, from a practical angle and from other relevant points of view, of the general principle of integration. Any special difficulties, including any special features of the banks connected with the main issues, will be discussed as also points concerning the manner and phasing of the programme of integration. These discussions, as you yourself have pointed out, will incidentally help us in deciding at a later stage whether any of the banks should eventually be dropped from the scheme and, if so, on what principles. Further they would be helpful in revealing any special features or points, of which we may not be now aware, but which, nevertheless, may have to be provided for in drafting the final legislation.

With kind regards,

Yours sincerely,

[H.M. Patel]

SECRET

BOMBAY

D.O.No.[...] March 8, 1955

My dear Patel,

Will you please refer to your D.O. letter No.[...] dated the 3rd March 1955, regarding the informal discussions proposed to be held with certain State
Governments on the subject of the State-associated banks with which they are individually concerned?
2. I agree that it would be an advantage if both the Finance Ministry and the Reserve Bank are represented at these discussions. I have asked the officers concerned to be ready for the visits you have proposed. I understand that you yourself will first visit Mysore and thereafter Rajasthan and Madhya Bharat. Venkatappiah and Nangia will accompany you to these States. I presume that a programme for Barve and Ramasubramaniam will be drawn up as soon as possible so that Saurashtra, Patiala and Hyderabad, and possibly Travancore-Cochin, are also covered during the next few weeks. As I mentioned at Delhi, it is important that the formal invitees should be the State Governments and not the banks. I see from your letter that this is what you intend, though opportunity will also be taken to ascertain informally the reactions of the banks.
3. You say that “the letter to the State Governments will be so worded as to avoid giving the impression that the principle of integration itself is open to argument by the State Governments”. I would emphasise that it is equally necessary to avoid giving the impression to the State Governments, either in your communication to them or in the subsequent discussions, that the “principle of integration” is something to which the Central Government are finally and irrevocably committed. As you know, it is theoretically open to the State Bank of India to extend to any one of the Part ‘B’ States concerned by either establishing its own branches in that area or by taking over the particular bank which is associated with the Government of the State. Moreover, the taking over can be in the form of either voluntary amalgamation or compulsory acquisition and, in either case, the bank can remain a distinct entity, e.g. as a “subsidiary” of the State Bank or the Reserve Bank, for such time as may be considered necessary. All these are alternative ways of establishing a countrywide State-controlled banking structure, and, so far as I know, it is to the principle of establishing such an institution, with the Imperial Bank as the nucleus, that the Finance Minister and the Government of India are committed and not to “integration” as the method of achieving the aim. Moreover, integration as a broad method covers all the different alternatives I have mentioned. One of these alternatives, viz. the compulsory acquisition of individual State-associated banks, has, as you are aware, been found unacceptable by the Central Board of the Reserve Bank. If the proposed talks with the State Governments are to be of real use, the discussions will have to cover the different alternatives involved, not excluding (1) the expansion of the State Bank to the particular area (as distinguished from amalgamation, either compulsory or voluntary), (2) the method of voluntary amalgamation (as distinguished from compulsory acquisition), and (3) in the event of amalgamation, the suggestion that the bank concerned should be converted into a subsidiary of either the State Bank or the Reserve Bank. The practical implications of all the alternatives will have to be ascertained from the point of view of the State Governments and incidentally, of the banks themselves, with a view to deciding final policy. I take it that this will be the object of the talks. The object cannot be achieved if the discussions take place on the basis that “integration”, in the sense of compulsory acquisition, is a settled principle on which no views are to be expressed by the State Governments.
4. I would add, as regards the specific case of the Bank of Baroda, with which the Government of Bombay are concerned, that even the holding of informal discussions with the State Government would be inexpedient at this stage. We are awaiting Counsel's opinion about the legality of classing this bank along with the other State-associated banks for the purpose of assuming State control and acquiring State ownership. Even apart from that, as I have emphasised before, the fact has to be taken into account that the Baroda bank is no longer associated with the business of the State; Okha is the only place at which it conducts treasury work, and this too it is doing on our request and at the specific instance of the Government of Bombay. Moreover, the Bank of Baroda is one of the “Big Five” among Indian commercial banks, and any impression given at this stage that Government are pursuing the idea of nationalising this bank is bound to cause nervousness among commercial banks generally. I am of the view, therefore, that a firm decision in principle should be reached by Government before any attempt is made to discuss this case even informally with the Bombay Government. I need hardly add that, even if the State Government is of the view that the Bank of Baroda should be included in the scheme of integration, that would not be a conclusive reason for holding that the bank should be nationalised.

Yours sincerely,

[B. Rama Rau]

Shri H.M. Patel, I.C.S.
Secretary to the Government of India
Ministry of Finance
New Delhi

State-associated banks—Proposals regarding the future of

Governor discussed this [note by B.Venkatappiah dated 17.1.1956—not reproduced here] with me and suggested that the points raised might be informally discussed with Shri H.M. Patel at Calcutta.

2. Governor’s first reactions are as follows:

I A. Immediate steps should be confined to Saurashtra, Patiala and Hyderabad banks.
B. The control and/or ownership of these banks may be vested in the State Bank, if willing and able; in any case, the State Bank should be consulted.
C. Governor would personally prefer the control and/or ownership to be vested in the Reserve Bank.

II A. As regards the other six banks, the need for action seems much less urgent.
B. One alternative would be to take steps for more effective control over these banks while retaining them as our agents, for the custody of currency chests etc., the details of such increased control could be worked out.
C. Another alternative would be to allow the State Bank to extend to district headquarters in the Part B areas concerned; the State-associated bank concerned can then exist as a more or less “Private” commercial banking institution with little or no special control by the State. It would however
still be complementary, in the matter of credit to rural and semi-urban areas, to the State Bank itself.

D. If, however, any positive steps for the assumption of statutory control and/or ownership of these banks are to be taken, it would be desirable to have the ownership etc. vested in the Reserve Bank rather than in the State Bank. This will of course mean that suitable administrative machinery will have to be set up in the Reserve Bank.

3. Governor emphasised that these are merely his tentative views and that he would like to consider the matter in greater detail after Mr. Patel's views are ascertained. Meanwhile, however, the question of assumption of greater control over the State-associated banks may be pursued by D.B.D. and D.B.O.

[21-1-1956

[B. V(ENKATAPPIAH)]

[Governor has seen the above and approved]
been dropped. All that had happened was that various enquiries had to be made and that was bound to take a certain amount of time. He assured the Standing Committee of the National Development Council that proposals would soon be made in respect of these banks in the near future. Thus, in a very real sense, the Finance Minister stands committed to announcing Government’s final views in regard to these banks. The reorganisation of the States which will take place within the next few months is another compelling reason for taking early action. Unlike the Governor, we feel that this is virtually the most important and compelling reason for taking immediate action. If we decide not to take over these banks and allow them to be converted into ordinary commercial banks, the State Bank will have to open branches in these areas and in particular at important centres at which these State-associated banks are functioning at present. The latter will thus have to meet severe competition which they will scarcely be in a position to meet and which might easily endanger their stability, the more so as most of them will lose Government funds and patronage. Incidentally, the necessity for opening branches in these areas would also throw considerable additional strain on the State Bank and might even reduce the pace of expansion of the branches as a whole.

3. I take it that you will now, after obtaining the orders of the Governor quickly, draw up the bill for introduction in the next session of Parliament. As you know, the parliamentary session begins on the 15th of February and if we are to have any reasonable chance of introducing the bill in Parliament, we must finalise the bill well before the 15th. That being so, if there are any points to be discussed in regard to this question, whether as to the details or as to the main question itself of how many banks will have to be taken over, I would suggest that we have an early discussion in Delhi. If you let me know what the Governor’s wishes are, I shall ascertain the date and time that may be convenient to the Finance Minister.

Yours sincerely,

H.M. Patel

July 22, 1957

My dear Patel,

I write this with reference to the recommendations of the Ad Hoc Committee on the taking over, as subsidiaries by the State Bank of India, certain State-associated banks. The last reference from Government on this subject was Baksi’s D.O.No.[...] dated the 2nd July 1957.

2. I called a special meeting of the Board on Friday, the 19th July, to discuss the Committee’s recommendations. At the meeting I stressed the following points:

(i) This was definitely not a prelude to the nationalisation of commercial banks in the country. In fact, the Finance Minister was, at one stage, averse to taking up this issue of the State-associated banks and changed his mind only for certain overriding reasons.

(ii) If the steps proposed were not taken, the State Bank would have to open branches in the areas now served by the State-associated banks and this process would
take some considerable time. When such branches were opened, the State-associated banks would suffer on account of the loss of certain privileges which are accorded to them by Government. The result would be considerable delay in the setting up, throughout the country, of a bank, which while maintaining its commercial character, would be responsive to the broader policies of Government in the field of co-operation, small-scale industries, etc.

(iii) Government are hesitating to open more currency chests in areas which are not served by a bank under their control. This delays the provision of remittance facilities in areas where they are not now available.

(iv) The handling of currency chests by State Governments is now giving rise to serious problems. Unauthorised raids on these chests are already considerable and it looks as if with deficit budgets, such raids may become larger and more frequent in future. This is potentially highly dangerous.

3. Opinion in the Board was sharply divided. I attach a copy of the decision recorded on this item. The six members, who voted against the taking over of the Bank of Jaipur, the Bank of Indore and the Travancore Bank, justified their stand on the ground that the step would be widely regarded as merely the thin end of the wedge towards nationalisation of banks. Their other argument was that a compulsory legislative process, such as the Committee had proposed, was “undemocratic”—whatever that means. They recommended that the shareholders should be approached and the change carried out only by negotiation. In this connection some of the members of the Board said that Government should buy up the shares of the State Governments and also blocs of shares from the private shareholders in the market so as to get 51% of the total shares. That, of course, under the Banking Companies Act would not give Government control in actual voting, but the holding would justify Government, without public criticism, in converting the banks into subsidiaries.

4. I do not think it would have been difficult for me to have got the Board to accept the proposals if I had brandished the big stick and said that the Government of India had virtually decided to go through with the scheme. A couple of members would then have changed their votes. But I deliberately did not pursue such tactics because I wanted the Board to express its views with complete frankness and freedom. As it is, with a sharp division in the Board and with the State Bank Board having agreed to the step, it would be quite open to the Government of India to go ahead with the proposal and submit the necessary legislation to Parliament. If it were a purely domestic matter, I would have strongly recommended the Government of India taking such a course because I do not think that the six members who voted against the idea of legislation in regard to the three banks in question are really, right. However, it seems to me necessary to consider what is likely to be the effect on foreign opinion in places like London, New York and Washington of our going ahead with the proposals at this stage. I imagine that foreign reaction in the centres mentioned will, to some extent, be dependent on domestic reaction in India. If some of our people said publicly that the Government’s step was unwise and was a prelude to nationalisation of commercial banks, the cry would be taken up in foreign centres and that, however misguided, would be most unfortunate from our point of
view. While, therefore, I am convinced that the majority of my Board were quite wrong and that the Government of India would be fully justified in going ahead with the proposed legislation, I would like the public reaction aspect mentioned above, to be very carefully considered before any decision is taken. If, as I understand is the case, there is not sufficient time during the present session of Parliament to get the proposed Bill through, that would be an added reason for suspending a decision before the Minister returns from Washington. This, in fact, is what I would now recommend. I would also suggest that the Life Insurance Corporation be meanwhile told to purchase the shares of the Banks of Jaipur and Indore and of the Travancore Bank in suitable lots (as and when they become available) at reasonable prices, and without undue publicity.

Yours sincerely,

H.V.R. IENGER

Shri H.M. Patel, I.C.S.

State-associated banks

When this matter [of the State Bank buying shares of state-associated banks from the market] was discussed at the Board meeting, the majority of the directors took the view that while they had no objection to the State Bank operating these banks as subsidiaries, the acquisition of interest in the banks should not be by compulsory process or legislation. They suggested that shares may be purchased by the State Bank and a controlling interest thus acquired. This, in their judgement, would enable us to achieve our objective without creating a public relations problem particularly in countries like the U.S.A. where we are seeking a massive amount of assistance.

I fear we did not examine this alternative in the past as carefully as we should have done. We allowed the matter to rest with Government writing to the Life Insurance Corporation suggesting the buying up of shares. It is clear, however, from the notes now prepared that the technique of buying shares is going to involve considerable loss of time and, even so, would not, in all cases necessarily give a controlling interest to the State Bank of India. On reflection, therefore, I have come to the conclusion that this proposal should be abandoned.

Two points are clear to me. The first is that we must not abandon the idea of the State Bank operating these banks as subsidiaries. That, I think, is desirable and in fact, necessary. The State Bank has begun to acquire a “new look” and is definitely taking interest in matters such as assistance to small-scale industries and provision of finance to the co-operative movement. We may expect progress in these directions to be more rapid in future. We could not possibly expect the other banks to organise their affairs in such a way as to support Government policy in regard either to the co-operative movement or small-scale industries. If progress is to be made, therefore, the State Bank would have to extend itself in the areas covered by these banks. That would be a very lengthy and difficult procedure and, therefore, I am driven to the conclusion that the State Bank must get control over the functioning of these banks. The only way in which it could do so would be to acquire a controlling interest in the share capital.

At the same time, it is clear to me that if it is possible to avoid compulsion, it is better to avoid it. It would be possible for us, as a matter of public relations, to
explain both in India and outside that the proposed legislation is not intended to be the beginning of a programme of nationalisation of commercial banks, and that it is confined to dealing only with a special category of banks. But the task will not be very easy and may not succeed in all the quarters where we want to make an impression. It would, therefore, be desirable to adopt another expedient which would absolve Government of the charge that they are compulsorily acquiring private banking institutions.

The alternative that could conceivably be tried is for us to negotiate with the banks and to get the shareholders, by a majority, to pass a resolution to the effect that they are agreeable to the banks being taken over and operated as subsidiaries by the State Bank of India. If such a resolution were passed, the question of compensation could then be decided either by agreement or, in default of the agreement, by a reference to a tribunal. In fact, such an arrangement could by itself form part of such a resolution. Should however any shareholder object and should there be a danger of the whole scheme falling through as a result of such objection, we could then, if necessary, legislate. At that stage, however, legislation will be on the basis of an agreement with the majority of the shareholders and would, therefore, cease to have the character of compulsion by Government. I would like this alternative to be examined quickly from the legal as well as the administrative points of view.

I have discussed this today with the Finance Minister and he is in general agreement.

Id/- [H.V.R.]
19-6-1958

D.G.(V) 20.6.1958
For information with connected papers.

D.G.(R)[Ram Nath] 7.7.58
It does not seem that if the banks are taken over one by one, the merger of the banks with the State Bank would involve greater administrative strain than the taking over of these banks as subsidiaries. I would, therefore, suggest that as a possible alternative to the taking over of these banks as subsidiaries under schemes of arrangement, the possibility of the banks being taken over by the State Bank under section 35 may also be considered.

[N.D. Nangia]
(14.7.1958)

D.G.(V)
I have mentioned this to the Governor. He was in favour of pursuing (at this stage) Shri Bhattacharyya’s suggestion that (i) shareholders be persuaded to pass a resolution favouring the constitution of each of the concerned banks, Jaipur, Bikaner, Rajasthan, Indore, Mysore, Saurashtra, as a subsidiary of the State Bank and (ii) legislation be passed constituting the bank as their subsidiary on the same lines as would in any
case have to be passed in respect of the banks of Hyderabad, Saurashtra and Patiala. The GOI is being addressed accordingly in another file.

We may revert to C.O.'s suggestion at a later stage, if necessary.

B.V.
16.7.58

[Dear Shri Morarji Desai,]

You will recall that when we last discussed the subject of State-associated banks I mentioned certain points which I said would have to be taken into account as constituting the background of this very important question. I shall briefly recapitulate the main considerations:

(i) Almost exactly three years have passed since the conversion of the Imperial Bank into the State Bank. During this period the State Bank has, in conformity with Government's policy,

(a) more than doubled the number of its branches (about 200 in 1955) and in the process, carried banking and remittance facilities—the latter as agent of the Reserve Bank—to areas hitherto ill-served in these vital aspects of a developing economy;

(b) started a drive for providing much-needed assistance, including short-term loans, to small-scale industries in co-ordination with other financial institutions; and

(c) initiated a programme for helping co-operative units especially those connected with processing and marketing, by the provision of finance for working capital.

(ii) If the State Bank is doing all this and can be expected to do much more in future, it is because of its very large resources, its unquestioned fitness to be the Reserve Bank's agent and custodian of its currency chests, its ability to meet the initial losses involved in e.g. a countrywide programme of branch expansion and several other features special to it as a State-partnered commercial banking institution.

By and large, however, the new developmental activities of the State Bank have been confined to those areas which had formed the former British provinces. This is because the Imperial Bank operated in those areas alone. If banking and remittance facilities, finance for small industries, assistance to co-operatives etc. are to be extended to the rest of India at the pace at which the State Bank is able to do this, it will be necessary to bring the State-associated banks into the picture. These banks were either promoted or encouraged by the rulers of the Indian States and were to those States what the Imperial Bank was to India. They cannot, however, function effectively (e.g. they cannot be entrusted with currency chests as agents of the Reserve Bank) unless they are brought under the control
of the State Bank of India. There is only one real alternative, namely, to let the State Bank itself expand to those areas; but that would take a good deal of time and not only be wasteful in the sense of involving duplication, but would entail a great deal of effort and expenditure on the part of the State Bank at a time when it is necessary to economise on both for the purpose of meeting the growing developmental demands on the bank.

(iii) The only way in which the State Bank could acquire adequate control over the State-associated banks would be by its obtaining a controlling interest in the share capital of each of the banks. So far as the Hyderabad, Saurashtra and Patiala banks are concerned, this would not present any difficulty since these are owned either by the Reserve Bank on the one hand or by the State Government on the other. Legislation can be passed to ensure that these banks become subsidiaries of the State Bank of India. The real problem is presented by the other banks. In regard to these, it would be desirable, if that was possible, to achieve the object without compulsion, since compulsion might be misunderstood abroad especially in America and, arguably, this would be inexpedient at a time when we are asking for substantial assistance.

(iv) It might, therefore, be worthwhile to negotiate with the banks concerned and, if possible, get the shareholders to pass resolutions to the effect that they would be agreeable to the banks being taken over and operated as subsidiaries of the State Bank of India. Such resolutions could indicate what compensation should be paid, the figure having been previously agreed upon by negotiation. Alternatively they could provide for future negotiation and agreement and, failing that reference to a tribunal.

2. I understood you to be broadly in agreement with this line of thinking. Accordingly, I had the suggestions examined by my Legal Division and they put forward a scheme of which the main features are as follows:

(a) The Hyderabad, Patiala and Saurashtra banks would be dealt with separately. Legislation would in any case be necessary in regard to them.

(b) As regards the other banks, viz. Jaipur, Bikaner, Rajasthan, Indore, Mysore and Travancore, the objective would be for the State Bank to acquire 75% of the shares in each instance and thereafter to run the banks as its subsidiaries.

(c) For this purpose, it would have to be arranged that each of the banks passes a special resolution in favour of a scheme of arrangement whereby 75% of the shares would be transferred to the State Bank. It would be necessary for the resolution to be supported by not less than 75% of the total votes available in respect of each bank.

(d) The compensation for the shares thus proposed to be transferred would be either specified in the scheme itself or left to mutual agreement or to arbitration in the absence of such agreement.

(e) There would be an application to the Court under Section 391 of the Indian Companies Act for calling a meeting of the shareholders to consider the scheme and for the sanction of the scheme if passed by the requisite majority. If the scheme was passed by three-fourth (in value) of the shareholders voting in person or by proxy, and if it was also sanctioned by the court, it would be
binding on the bank concerned as well as on all of its shareholders.

3. The suggestions of the Legal Division have since been examined by Bhattacharyya. I understand that he has also consulted his solicitors. I enclose a copy of his letter [not reproduced]. He regards the Legal Division’s scheme as impracticable for the reasons mentioned by him. I agree with him. He makes an alternative suggestion, viz. that informal efforts be made to get the six banks to pass resolutions at their shareholders’ meetings (by simple majority) indicating their acceptance of the proposal that the banks be formed into subsidiaries of the State Bank of India. These resolutions may then be regarded as constituting adequate moral support for promoting the requisite legislation. The legislation itself would be on the same lines as for the banks of Hyderabad, Saurashtra and Patiala.

4. It is clear that Government’s good offices would be required in a very large measure if the banks in question are to be persuaded to pass such resolutions. It would of course have to be pointed out to each bank that it can get (or retain) the agency of the Reserve Bank only as a subsidiary of the State Bank of India. If the bank did not agree to this, the State Bank of India would extend its operations to the area concerned and establish its own branches wherever required and, through them, conduct the treasury work of the State Governments and operate the currency chests of the Reserve Bank.

5. I commend Bhattacharyya’s proposal for Government’s consideration.

Yours sincerely,

H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
Government of India
New Delhi

***
V. BANKING

A. PRUDENTIAL NORMS

Proposals for (1) Strengthening Capital Funds of Banks and
(2) Raising Liquidity Requirements of banks

I

The draft letter to the Indian Banks’ Association, which is placed below, as desired by Governor, has been prepared on the lines generally agreed upon at the meeting which the Governor had with the representatives of the Association and subsequently confirmed by a letter from the Association.

2. In view of the keen desire on the part of the Association to have a voluntary agreement with us in the matter of strengthening their capital funds and raising their liquidity ratios, the following conventions are now sought to be achieved.

(i) all banks should transfer a minimum of 20 per cent of their declared profits (i.e., profits after providing for usual and necessary provisions and after making tax provisions) to their published reserves till such time as the paid-up capital and published reserves reach 6 per cent of their deposits, independent of the level of reserves in relation to the paid-up capital; and

(ii) all banks should maintain a minimum overall liquidity ratio of 25 per cent of their deposit liabilities as against the present legal minimum of 20 per cent.

3. As regards the question of relating the suggested liquidity ratio of 25 per cent to deposit liabilities, the following points may be noted. The Indian Banks’ Association seems to have misunderstood this issue. Our original proposal was to relate the overall liquidity ratio to deposits and not to deposit liabilities, and a figure of 27.5 per cent of deposits was suggested. In the Governor’s meeting with the bankers, the Chairman of the Indian Banks’ Association confirmed, in reply to a query from Dr. B.K. Madan, that the Association’s suggestion was that banks should raise their liquid assets ratio to 25 per cent in relation to their total liabilities. 25 per cent of total liabilities and 27.5 per cent of deposits are broadly the same and at the end of the meeting it was our impression that if we stipulate a ratio of 25 per cent of liabilities, the bankers would be willing to comply with it. It is, however, somewhat puzzling to see from the communication from the Indian Banks’ Association to the Governor that they want the liquidity ratio of banks to be fixed at 25 per cent of total deposits, which in effect would mean about 22.5 per cent of their liabilities or only 2.5 per cent more than the present minimum of 20 per cent of liabilities. In any case, since we are only setting up a convention, it has to be within the four corners of the existing legislation, which prescribes liquidity ratio only in terms of total liabilities. Hence the minimum to be observed at 25 per cent should be specifically related only to ‘total liabilities’.

4. In their letter, the Association has gone one step further and suggested that the items eligible for inclusion in the liquidity ratio of 25 per cent of deposits should be, not only cash, gold, and approved securities, but also remittances through notified banks. In the meeting, to the best of our knowledge, the representatives of the Association did not raise this issue. We have no estimates regarding the magnitude of
remittances through notified banks but unofficial enquiries with bankers reveal that it could fluctuate anywhere between 0.5 and 2.0 per cent of deposits. It will thus be seen that this suggestion of the Association, coming on top of their earlier one relating the 25 per cent ratio to deposits only, will practically result in maintaining the status quo in terms of Section 24 of the Banking Companies Act, namely around 20 per cent of total liabilities.

5. In the draft letter to the Association, we have not deviated from our earlier stand; we have suggested a ratio of 25 per cent of total liabilities without including “remittances through notified banks” as one of the items of liquid assets, as required by the Association.

6. Apart from the references to capital funds and liquidity ratios, the Indian Banks’ Association has also made a few other points which have no direct bearing on the letter which the Governor proposes to issue now. They seek a reduction in the burden of penalty for any shortfall in reserve requirement as well as liquidity requirement. But this is an independent issue which would involve amendment to the Banking Companies Act. This apart, the question of penalty for not complying with the new conventions which we seek to establish does not arise as we are resorting only to moral suasion. The Association has also suggested that transfers to reserves up to 10 per cent of taxable profit made in addition to that required for providing for bad and doubtful debts and making other necessary provisions should be exempt from income tax. This again is a separate issue which was examined in the memorandum submitted to the Governor on the eve of his meeting with the bankers. For reasons mentioned in the memorandum, it is not considered desirable to support tax incentives for this purpose at the moment.

II

7. The draft letter to the Exchange Banks’ Association deals only with liquidity requirements. In their reply to our letters on the draft proposals sent to them some time ago, the Bombay and Calcutta Exchange Banks’ Associations have asked for certain facilities in the event of our implementing the liquidity requirements. These Associations also would favour informal voluntary agreement. The Calcutta Exchange Banks’ Association has suggested that we should allow the exchange banks to deposit Sterling securities with the Reserve Bank, London, to the extent of 2½ per cent of their deposits towards the asset requirement of Section 24. The Bombay Exchange Banks’ Association, while supporting this, has also enquired whether we would permit exchange banks whose head offices are not in the U.K. to deposit acceptable securities from their respective countries which are marketable in London.

8. Being branches of international institutions, exchange banks stand on a special footing. Most of these banks, as a whole, do maintain high liquidity ratios. In the draft letter to the Exchange Banks’ Associations, these two requests have been accommodated. Lodgement of securities (U.K. Government and other trustee securities and in the case of banks whose head offices are outside the U.K. trustee securities of their respective countries and readily marketable in London) over and above the statutory minimum in terms of Section 11(2) may be allowed to count towards the new ratio up to 2 per cent of their aggregate liabilities (equivalent of 2½ per cent of deposits as suggested by the Association).
III

9. The draft letters have been prepared on the assumption that they will be addressed by the Governor to the Indian Banks’ Association Bombay and the Calcutta Exchange Banks’ Associations. But attention is drawn to the following points. Out of 66 Indian scheduled banks, excluding State Bank of India, only 37 are members of the Association. Although deposit-wise they account for over 90 per cent, since our proposals are mainly intended to strengthen the individual units of the system, the coverage in terms of numbers is important. It may also be noted that of the 26 Indian scheduled banks which now have a capital funds ratio of less than 5 per cent, six are non-members of the Association. As regards the liquidity ratios, in the case of most of the Indian scheduled banks¹ (members as well as non-members), it is no doubt true that the ratio has not as yet fallen below the standards now being set. However, in order to prevent a further deterioration in the liquidity standards in future it is desirable to impress upon all the individual banks the need to maintain a floor of at least 25 per cent of liabilities.

10. It is therefore suggested that instead of addressing the letter to the Association, we may issue this as a circular to all scheduled banks as well as non-scheduled banks just as we do in respect of directives.

11. Most of the foreign banks, however, maintained a liquidity ratio of less than 25 per cent of their deposit liabilities as of March 1961. A letter to the Exchange Banks’ Association will serve the purpose in this case. However, if we decide to issue a general circular in the case of Indian scheduled banks, it will be desirable to follow a uniform practice and issue a similar circular to exchange banks also on an individual basis.

IV

12. Finally, the question arises of what treatment is to be accorded to the State Bank. The position relating to their liquid assets ratio is brought out in the following table:

<table>
<thead>
<tr>
<th>As on the last Friday of March</th>
<th>Ratio of liquid assets to aggregate deposit liabilities (including P.L.480 funds)</th>
<th>Ratio of liquid assets to aggregate deposit liabilities (excluding P.L.480 funds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954</td>
<td>50.4</td>
<td></td>
</tr>
<tr>
<td>1955</td>
<td>53.9</td>
<td></td>
</tr>
<tr>
<td>1956</td>
<td>49.1</td>
<td></td>
</tr>
<tr>
<td>1957</td>
<td>38.6</td>
<td>27.2</td>
</tr>
<tr>
<td>1958</td>
<td>50.8</td>
<td>23.9</td>
</tr>
<tr>
<td>1959</td>
<td>58.3</td>
<td>23.5</td>
</tr>
<tr>
<td>1960</td>
<td>61.8</td>
<td>20.0</td>
</tr>
<tr>
<td>1961</td>
<td>50.0</td>
<td>20.5</td>
</tr>
</tbody>
</table>

It will be observed that the liquidity ratio of the State Bank (including P.L.480 funds) was below 25 per cent as of March 1961.

¹In the case of two member banks (Central and India) and four non-members, the ratio was below 25 per cent as of March 1961.
has all along been high. The ratio is no doubt lower than 25 per cent of their liabilities if we exclude P.L.480 funds, but for purpose of judging the adequacy of liquid assets standard, the ratio, inclusive of P.L.480 funds, is more realistic.

13. As regards the capital funds ratio, at the end of August 1961 the paid-up capital and published reserves of the Bank as a proportion of deposits stood at 4.1 per cent. The Bank’s transfers to published, reserves, as a percentage of their balance-sheet profit formed only 11 per cent in 1957, 15 per cent in 1958, 8 per cent in 1959 and 9 per cent in 1960. It appears that in view of our general circular to other banks asking them to transfer a minimum of 20 per cent of their balance-sheet profit to their published reserves, it will be necessary to suggest that the State Bank also should follow suit and transfer the required minimum to published reserves notwithstanding what it transfers to inner reserves. If this is not done, there will be criticism that the State Bank is being dealt with on a preferential basis.

14. It is, therefore, desirable, although the State Bank is already maintaining a high liquidity ratio, to issue the general circular to them also. The leadership of the State Bank in the matter of transfers to reserves will be of considerable assistance to us in establishing the conventions we have in view.

15. After E.A. has seen this, copies of the covering note together with the draft letters will be forwarded to the C.O., D.B.O., C.O., D.B.D. and the Legal Department for their urgent comments.

The draft reply may appear somewhat lengthy, but it seems unavoidable if we are to stress the arguments for the new convention we seek. They are being stated explicitly in public for the first time.

K.N.R. RAMANUJAM
19-12-61

MOST IMMEDIATE
CONFIDENTIAL

ECONOMIC DEPARTMENT

Proposals Relating to Capital Funds and Liquidity Ratios of Banks

The Governor desires to issue a letter to the Banks’ Associations impressing upon them to set up certain conventions in the matter of transfers to reserves and liquidity standards. A draft letter prepared in this connection and approved by E.A. is enclosed. For ready reference, copies of letters received from the Indian and the Exchange Banks’ Associations and the State Bank of India in reply to our earlier letters to them on our draft proposals in this regard are also appended.

2. We shall be glad to have the comments of the D.B.D. This may kindly be treated as very urgent.

K.N.R. RAMANUJAM
20-12-61

[draft letter not reproduced]

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Govr. What is happening about the proposals re:
capital funds of banks and liquidity? It is some time (over a month) since we
had a discussion with the Indian Banks’ Association and a fortnight since the Association wrote to us. The consideration of the case needs to be expedited.

HVR
20/12

ED (M) If the request to banks is on the basis of their agreement, the agreement seems to have been watered down in respect of liquidity requirements to almost no change from the present. In view of the limits of moral suasion in this sphere, particularly in respect of an appeal issued on the eve of the busy season, we may consider whether the letter may not be restricted to the capital funds problem.

24/12

Govr. I am inclined to think that for the present we may confine ourselves, as suggested by ED (M), to the problem of capital funds. The question of the liquidity ratio may be taken up towards the close of the busy season. The revised draft may issue. The question of having a standard form of balance-sheet need to be urgently pursued with the Assn.

26/12

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B. Regulating Co-operative Banks

SECRET

Bringing co-operative banks under the statutory control of the Reserve Bank of India

A meeting was held in the Governor’s room on 3 September 1963 at 3.30 p.m. to consider the note on the above subject circulated by the Agricultural Credit Department. Besides the Governor, the following were present:

1. Shri M.V. Rangachari, Deputy Governor
2. Prof. D.G. Karve, Deputy Governor
3. Shri C.S. Divekar, Deputy Governor
4. Shri D.R. Joshi, Executive Director
5. Shri B.N. Mehta, Legal Adviser
6. Shri M.S. Nadkarni, Chief Officer, Department of Banking Operations
7. Shri V.G. Pendharkar, Economic Adviser
8. Shri K.C. Cherian, Deputy Chief Officer, Agricultural Credit Department
9. Dr. C.D. Datey, Deputy Chief Officer, Agricultural Credit Department

The discussions started with the suggestion made towards the end of the note, viz., that the existing powers of the Registrar of Co-operative Societies for superseding the
board of management of a co-operative bank or for taking it into liquidation are sufficient for protecting the interests of the Deposit Insurance Corporation and that the Registrar might be relied upon to take necessary legislative action on the advice of the Reserve Bank of India. It was also suggested in the note that in order to ensure that the Registrar would take certain steps following any disciplinary action by the Reserve Bank against any co-operative bank, it might be worthwhile to take an undertaking in writing from the State Government that the advice of the Reserve Bank regarding a co-operative bank would generally be followed by the Registrar in taking legislative action against it for safeguarding the interests of depositors and, ultimately, of the Deposit Insurance Corporation. The consensus of opinion was, however, that it would not be appropriate to expect the Corporation to insure the deposits of co-operative banks knowing fully well that the Reserve Bank, in close association with which it worked for the success of the whole scheme of insurance of deposits of commercial banks, would not have powers for amalgamation or liquidation of a co-operative bank. The benefit of insurance accrued in the case of a commercial bank in the event of its amalgamation with another bank or of liquidation. Both these contingencies were under the control of Reserve Bank which had statutory powers to direct either amalgamation or liquidation of a commercial bank. Deputy Governor (R) was of the view that if the benefit of insurance to co-operative banks was to be extended without vesting similar powers in the Reserve Bank, the action might be questioned as discriminatory. It was, therefore, agreed that if reconstitution of the management of a bank or its liquidation could not be provided for by any central legislation, it would be necessary to have the required provisions made in the State Co-operative Societies Acts themselves. The Governor felt that in the case of State and Central co-operative banks we would have to think more in terms of reconstruction of management than of liquidation. The State laws therefore should be amended to make it compulsory on the Registrar of Co-operative Societies firstly to supersede the committee of a co-operative bank and appoint an administrator and, secondly, to take it into liquidation, if the Reserve Bank considered either or both of them necessary for protecting the interests of the Deposit Insurance Corporation. The benefit of insurance should be made available to co-operative banks only in those States which amended their Co-operative Societies Acts as above.

2. It was agreed that the various provisions of the Reserve Bank of India Act, 1934 and the Banking Companies Act, 1949, as indicated on pp. 7–14 of the note might be extended to co-operative banks. The Governor, however, observed that it should be examined further whether it would be possible for the Reserve Bank to exclude advances to State co-operative banks under the various sections indicated on p. 8 of the note for the purpose of correlation between the statutory cash reserve under Section 17 of the Reserve Bank of India Act. The exclusion should not be discriminatory and would have to apply also to commercial banks. As regards the extension of the Bank Guarantee Scheme, the Governor observed that the facility would have to be extended to selected apex co-operative banks only. The Governor also indicated that it would be necessary to define a co-operative bank and more particularly an urban bank. It was not intended to extend the Reserve Bank’s control to societies which did not conform to the definition of bank as given in the Banking Companies Act.
3. It was agreed that the proposals for bringing co-operative banks under the statutory control of the Reserve Bank for the purpose of regulation of credit and banking and for safeguarding the interests of the Deposit Insurance Corporation might be placed for consideration before the Standing Advisory Committee on Agricultural Credit. It was also felt that it would be better to explain the position to State Governments before the matter was referred to the Central Government for enactment of necessary laws.

4. It was decided that a note should be prepared indicating the amendments necessary to the various Acts as indicated below:
   i) Reserve Bank of India Act, 1934
   ii) Banking Companies Act, 1949
   iii) Co-operative Societies Acts of different States
   iv) Deposit Insurance Corporation Act, 1961

   This note will be further considered before the proposals are presented to the Standing Advisory Committee.

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SECRET

Bringing co-operative banks under the statutory control of the Reserve Bank of India

A meeting was held in the Governor's room on 19 September 1963 at 3 p.m. to consider the draft amendments, circulated by the Agricultural Credit Department, to the Reserve Bank of India Act, 1934, the Banking Companies Act, 1949, the Deposit Insurance Corporation Act, 1961 and the Co-operative Societies Acts of different States. Besides the Governor, the following were present:

1. Shri M.V. Rangachari, Deputy Governor
2. Prof. D.G. Karve, Deputy Governor
3. Shri D.R. Joshi, Executive Director
4. Shri B.N. Mehta, Legal Adviser
5. Shri M.S. Nadkarni, Chief Officer, Department of Banking Operations
6. Shri P.D. Kasbekar, Chief Officer, Agricultural Credit Department
7. Shri V.G. Pendharkar, Economic Adviser
8. Shri C.S. Venkat Rao, General Manager, Deposit Insurance Corporation
9. Shri K.C. Cherian, Deputy Chief Officer, Agricultural Credit Department
10. Dr. C.D. Datey, Deputy Chief Officer, Agricultural Credit Department

The following conclusions were reached:

I. Amendments to the Reserve Bank of India Act, 1934

The amendments proposed to Sections 2 and 42(6) and the deletion of Section 44 were approved. The proposed amendment to Section 18(1)(3) was intended to accord to all co-operative banks the status of banking companies for the purpose of emergency loans from the Reserve Bank. The Governor felt that this might go against the federal character of the co-operative banking structure under which an urban co-operative bank was expected to approach a Central co-operative bank first and a Central co-
operative bank to approach the State co-operative bank for any financial assistance in an emergency or otherwise. In keeping with this tradition, assistance to be given by the Reserve Bank to meet an emergency arising in any Central or Urban co-operative bank would have to be given to the State co-operative bank on behalf of those banks. He thought, therefore, that Section 18(1)(3) as proposed to be amended should include only the State co-operative banks and not the Central and Urban banks. DG(R) observed that the provisions of that Section were intended to give direct help to a bank in difficulties. The amendment as proposed by the Governor would mean that financial accommodation is to be provided to a State co-operative bank which itself might not be facing any critical situation on behalf of another bank which is in difficulty. In that case a separate sub-section under Section 18 would have to be incorporated. It was agreed that this should be done.

II. Amendments to the Banking Companies Act, 1949

Section 51 A

The Governor expressed his doubt about the legality of extending the Amending Act to co-operative banks in the different areas on different dates. He wanted the Legal Department to check up this point.

Section 24 (2A)

It was proposed in the draft amendment to Section 24 that co-operative banks might be required eventually to maintain liquidity at a total of 25 per cent of the deposit liabilities as against 28 per cent in the case of commercial banks. The consensus of opinion was against making any distinction between the commercial and co-operative banks in this regard. Considering, however, the prevalence at present of a different set of standards of fluid resources in the co-operative banks, it was agreed that powers should be given to the Reserve Bank to extend the period of transition by a further period of two years in individual cases beyond the two years already contemplated as from the coming into force of the Amending Act.

Section 35

The amendment as provided would have authorised the Reserve Bank to empower any person or agency to inspect a co-operative bank. The Governor said that the intention was to nominate only the State co-operative bank in a State, if need be, to conduct the inspections of urban co-operative banks in that State. It was, therefore, agreed that the amendment should be redrafted so as to authorise the Reserve Bank to nominate a State co-operative bank in a State for the inspections of Urban co-operative banks only in that State.

The amendments proposed to the other Sections were generally approved.

III. Deposit Insurance Corporation Act, 1961

Section 4

The proposal was to amend the section so as to increase the authorised and paid-up capital of the Corporation from Rs 1 crore to Rs 2 crores. The Governor felt that the present income from investments held in the General Fund should prove sufficient to cover the increased administrative expenditure, so long at least as the Corporation remained not liable to income-tax. The occasion to ask for an increase in the authorised and paid-up capital would perhaps arise only thereafter. It was, therefore, agreed that
the proposed amendment for raising the authorised and paid-up capital to Rs 2 crores was not necessary for the present.

**Supersession**

A suggestion was made in the note and also incorporated in the draft amendments that the Reserve Bank should have the power to direct the Registrar of Co-operative Societies to supersede the committee of a co-operative bank and appoint an administrator in its place. This power was considered necessary for the timely correction of the situation, particularly in respect of State and Central co-operative banks, in whose cases liquidation or cancellation of licence was likely to be impracticable for a variety of reasons. It was true that the Reserve Bank did not enjoy a similar power under the Banking Companies Act in regard to commercial banks. Under the Co-operative Societies Acts of the different States, however, the Registrar already enjoyed this power and it was intended that the Reserve Bank could use that power through him for the development of co-operative banks on sound lines. The Governor as well as DG(R) felt that the Reserve Bank could perhaps think of taking over this power in the interest of the Deposit Insurance Corporation only if the inspection of a bank revealed that its deposits had actually been eroded and that supersession of the management was necessary as a measure of stopping their further erosion. It would not be justifiable for the Bank to ask for this power merely on the ground that the bank was not properly managed or that there was fear of deposits being eroded by the continuance in office of the existing management. If it was considered necessary for the Reserve Bank to direct the Registrar to supersede the committee of a co-operative bank for proper regulation of co-operative banks, the proper place for it was not in the Deposit Insurance Corporation Act but in some other law governing the banks. If, however, it was not possible for the Central Government to legislate on this particular matter which concerned the constitution and management of societies, the alternative would be to persuade the State Governments, if that was considered absolutely necessary, to pass amendments to their Co-operative Societies laws on a voluntary basis. The Governor concluded that it would not be appropriate to include the power of supersession as one of the conditions for extending the benefit of the Deposit Insurance Corporation. He suggested, however, that the power could perhaps be taken as part of any scheme of reconstruction which the Reserve Bank might require or approve in regard to any co-operative bank. It was, therefore, agreed that the provisions relevant to supersession in the draft amendments to the Deposit Insurance Corporation Act should be deleted. The power to be given to the Reserve Bank for directing the Registrar to supersede the board of a co-operative bank might be included only as part of a scheme of reconstruction, if that was possible and considered necessary.

### IV. Amendments to State Co-operative Societies Acts

It was agreed that:

(i) no co-operative bank should be ordered to be wound up by the Registrar except with the prior approval of the Reserve Bank;

(ii) no scheme of compromise or arrangement for reconstruction or amalgamation of a co-operative bank shall be sanctioned except with the prior approval of the Reserve Bank;
(iii) the Registrar shall, if so required by the Reserve Bank by an order in writing, issue a final order directing a co-operative bank to be wound up;

(iv) the Registrar may prepare a scheme of reconstruction or amalgamation of a co-operative bank with the prior approval of the Reserve Bank.

The power of moratorium might be useful for facilitating the preparation of any scheme of reconstitution or reorganisation of a co-operative bank. Provisions similar to Section 45 of the Banking Companies Act would, therefore, be useful. It was, therefore, agreed that the Legal Department should examine as to whether a moratorium could be declared by the Central Government or the State Government, whether the provision therefor could be made in the Central Acts, and whether the Reserve Bank could order the Registrar to reconstitute or reconstruct a co-operative bank in a given manner or whether the Reserve Bank could only give assistance to the Registrar if he was preparing any such scheme.

It was decided that the draft amendments would be redrafted in the light of the above decisions. It was, therefore, decided that the whole scheme of amendments to the various Acts might be placed before the next meeting of the Standing Advisory Committee for its consideration before it was circularised among the State Governments for their opinion.

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C. NON-SCHEDULED BANKS IN WEST BENGAL

Office of Deputy Minister, Finance (G)

I have already handed over a note re: the banks in West Bengal. Apart from the banks which have already closed, there are 146 non-scheduled banks in West Bengal who have not been submitting any returns or report to the Registrar, Joint Stock Companies and have yet been continuing as banks. This is a scandalous state of affairs. This should be stopped at the earliest. It is no use citing legal and technical difficulties. We shall have to do something to remedy this state of affairs. I expect some effective suggestions to be made on this so as to stop this.

A.C. GUHA
15-6-1953

Extract from D.O. letter No. [...] dated the 13th June 1953 from Dr. B.C. Roy, Chief Minister, West Bengal, to Shri A.C. Guha, Deputy Minister, Finance, Government of India

I had sent for the Registrar of Joint-stock Companies and discussed this matter with L.R. and Finance Secretary also. It appears that under the present Act the Registrar has only the power to proceed against any person who does not follow the rules framed under the Act and prosecute him. But the Registrar says that in most cases he cannot trace the culprits. It also appears, that in many cases the Reserve Bank informs the non-scheduled banks people to give up banking and go to something
else. The result is that in many cases the party goes to the High Court, gets an order for altering the Articles and Memorandum of Association and start a new line, all the time cheating the depositors. On the other hand, the appointment of a Liquidation Officer would not help because the Liquidation Officer will not be able to trace these people once they have defaulted in observing the rules of the Companies Act. It is, therefore, suggested that the Reserve Bank should be asked to appoint Inspector to scrutinise the affairs of each bank and as soon as they find that a bank is not proceeding in the normal way, he should be given powers to prosecute even before the bank people are able to go up to the High Court to change their colour. Please consider this position.

Ministry of Finance
Department of Economic Affairs

This note was handed over to me by D.M.(G), Mr. Guha, after his return from Calcutta early this month.

2. A copy of this note should be sent over to the Reserve Bank for their remarks. Together with this a copy of the extract from the demi-official letter of the Chief Minister, West Bengal, to Mr. A.C. Guha dated the 13th June, 1953, with a copy of the D.M.(G)'s minute thereon should also go to the Reserve Bank. Very early remarks of the Reserve Bank may be invited.

S.G. BARVE
Joint Secretary
16-6-1953

Re: Non-scheduled banks in West Bengal [4-8-1953]

In connection with the U.O. reference received from the Ministry of Finance, Government of India, regarding the suggestions made by Shri A.C. Guha and Dr. B.C. Roy in relation to non-scheduled banks in West Bengal the Governor desired to know:

i) whether the rights of the depositors of a banking company would be affected if it ceases to do banking business but continues to carry on other business as a non-banking company and whether the depositors invariably get notice of such change of business of the company;

ii) the reasons why banks which find it onerous to comply with the provisions of the Banking Companies Act are being advised by us to convert themselves into non-banking companies.

2. As regards (i) above the Legal Division's note dated the 3rd August 1953 may please be seen at flag [...]. With regard to (ii) above, it may be stated that when the original proposals for an Indian Bank Act were circulated for eliciting public opinion, clause 7 relating to minimum capital requirements came in for severe criticism especially from the smaller institutions. Some of the replies indicated that smaller banks performed a useful function in the banking system and that trade and industry in rural India would suffer considerably by their disappearance. In this connection
the ex-Governor of the Reserve Bank, the late Sir James Taylor, stated in his memorandum dated the 24th September 1940 submitted to the Central Board that the aforesaid argument could not be taken seriously inasmuch as the banks which would go under, if the proposals were brought into force, represented less than 5% of the total banking deposits of the country. He also visualised that most of these banks would continue to exist for moneylending, etc. though they would not be permitted to call themselves banks. It was further stated in that memorandum that the proposals for compulsory reserves, liquidation by the Reserve Bank and the possibility of inspection were not designed to work and would not work with petty institutions. As will be seen from the memorandum dated the 28th March 1945 submitted to the Central Board, some of the bigger banks while expressing their views on the Banking Companies Bill, 1944, preferred that the weaker and inefficient banking companies should be left to be weeded out by natural economic forces and not by legislation. Such a policy was, however, considered to be out of tune with the modern concepts of the responsibilities of the State towards economic institutions. In the memorandum dated the 7th December 1945 submitted to the Central Board it was stated that it would be practically impossible for us to undertake the work of liquidation unless the number of licensed banks was drastically reduced and that no national interest would be served by the Reserve Bank taking over the work of liquidating petty banks with numerous branches all over the country whose assets had already been dissipated by mis-management. In view of the foregoing it was considered desirable that while advising banks to take steps to comply with the requirements of section 11 of the Banking Companies Act, we should also suggest to them that they should if they so desired consider the alternative course of ceasing to transact banking business as defined in section 5(1) (b) of the Act. The draft circular letter was approved by D.G.(R) and a reference to this circular letter was made in the note submitted to Governor regarding the policy to be followed in granting extensions under section 11 of the Act.

3. A banking company which finds it impossible to comply with the requirements of the Banking Companies Act has either to convert itself into a non-banking company or go into liquidation. As stated above, the late Sir James Taylor had visualised that a number of small banks would not disappear but would continue to exist for moneylending, etc. It would not also be desirable to force the smaller banks to go into liquidation as their assets are generally frozen and the liquidation charges may, in most cases, be more than the realisable value of assets of the banks concerned. Further, it would not be practicable to ask the bank to pay its depositors in full before it converts itself into banking company as its assets may be frozen and it may not have sufficient money to make such payments. This may also force the company to go into liquidation. As regards the interests of the depositors, the position of a banking company which converts itself into a non-banking company would be the same as that of the industrial and trading concerns in Maharashtra and elsewhere in the country accepting deposits. It has been considered undesirable to prohibit the industrial concerns from accepting deposits and these concerns are exempted from the provisions of the Banking Companies Act by the explanation to section 5(1)(c) of the Act. Even if industrial concerns accepting deposits are brought
within the purview of the Act with a view to protecting the interests of the depositors, there would be two categories of banks, viz., banks which do purely banking business and companies which accept deposits though acceptance of such deposits is not their main business. It would be difficult to control under the Banking Companies Act the activities of the industrial concerns in relation to the acceptance of the deposits as the business of a company cannot be segregated and the safety of the depositors' money will have to depend on the prospects of the industrial concern. It would, therefore, be undesirable for the Reserve Bank to undertake this responsibility.

C.O.
4.8.53

DG(R[amnath])

The above note states the position with respect to banking companies which are unable to comply with the capital standards prescribed in Section 11 or are otherwise unable to qualify for a licence. As will be observed from the memorandum circulated for public opinion when the proposals for banking legislation were first mooted it has all along been the intention—of which the public no less than the banks must be deemed to have been aware—that such banks will be weeded out. There is, however, no objection to their continuing as non-banking companies, in which case their position will be identical with that of industrial or trading concerns accepting deposits.

Apart from legal considerations which stem from the scheme of the Act itself, there is the practical difficulty of imposing any restrictions on banks which have ceased to be banks but continue as trading companies, as we cannot have two sets of banks, one licensed and the other unlicensed. Once we attempt to control banks which have become trading companies, we get drawn into the difficulty of controlling other trading and industrial concerns which accept deposits. We have recently examined the question whether any restrictions should be placed on such concerns and it has been decided that it would be undesirable to do so.

4.8.53

Governor

Banking Companies in the Eastern (Calcutta) Area

On the 30th April 1953 there were 25 scheduled banks having their principal offices in Calcutta. As regards non-scheduled banks, according to our records compiled mainly on the basis of information obtained from the Registrars of Joint Stock Companies, there were 194 non-scheduled banks having their registered offices in this area, i.e. West Bengal, Bihar, Assam and Orissa and some of the Part B and C States.

Scheduled Banks

Since the 1st January 1949, 7 Bengalee managed scheduled banks have been excluded from the Second Schedule. Five of these, viz., the Calcutta Commercial
Bank Ltd., Noakhali Union Bank Ltd., Pioneer Bank Ltd., Nath Bank Ltd., and the Bank of Commerce Ltd., are under liquidation while the remaining two viz. the Mahaluxmi Bank Ltd. and the Tripura Modern Bank Ltd. are working under Schemes of Arrangement. The total outside liabilities of the above five banks under liquidation and the two banks working under scheme at Rs 9.16 crores and Rs 1.50 crores respectively aggregate Rs 10.66 crores.

The existing scheduled banks include the undernoted Bengalee managed banks:

1. Metropolitan Bank Ltd.
2. Southern Bank Ltd.
3. United Bank of India Ltd.
4. United Industrial Bank Ltd.
5. Dinajpore Bank Ltd.
6. Calcutta National Bank Ltd.

A statement showing the position of the above six banks is given in Appendix I [not reproduced] to this note. Of the six banks, one viz. the Calcutta National Bank Ltd. which has deposit liabilities aggregating Rs 2.15 crores, has been ordered by the Calcutta High Court on the 30th April 1953 to be put into liquidation. An application for leave to prefer an appeal to the Supreme Court of India from the above judgement is pending before the Calcutta Appeal Court. Another scheduled bank, viz. the Dinajpore Bank Ltd., has deposit liabilities amounting to Rs 1.22 lakhs only, has been in a moribund condition for over a year. The remaining four scheduled banks, viz. the Metropolitan Bank Ltd., the Southern Bank Ltd., the United Bank of India Ltd., and the United Industrial Bank Ltd., appear to be functioning normally, their deposit liabilities aggregate Rs 23.56 crores of which the United Bank of India Ltd., accounts for Rs 21.46 crores.

Non-scheduled banks

Out of the 194 non-scheduled banks listed with us as on the 31st March 1953, 172 banks are in West Bengal. Of these 194 banks, only 42 are submitting returns to us under the Banking Companies Act regularly. A statement showing the State-wise distribution and aggregate paid-up capital, reserves, deposits and advances of these 42 banks is contained in Appendix II [not reproduced] to this note. It will be observed from the above statement that 26 of the reporting non-scheduled banks have their registered offices in West Bengal and their total deposit-liabilities aggregate Rs 3.10 crores. An inspection of these banks revealed that only about 16 of them having deposits of about Rs 1.86 crores may be in a position to pay their depositors in full. The remaining 10 banks whose deposits appear to have been affected on account of the depreciation in their assets have deposits aggregating Rs 1.24 crores. As regards the deposit liabilities of the 146 non-reporting banks in West Bengal, no information is available with us. We are in correspondence with the Registrar of Joint Stock Companies regarding the position of these banks which appear to be either defunct or untraceable. We are advised by the Registrar of Joint Stock Companies that some of these banks are being dealt with by him under Section 247 of the Indian Companies Act for the purpose of removing their names off the Register.
Banking Companies either under liquidation or working under schemes of arrangement

According to the information available from the Registrar of Joint Stock Companies and the liquidators of the banks concerned, as on the 30th September 1952 there were 90 banks in liquidation, both scheduled and non-scheduled, whose total outside liabilities aggregated Rs 19.75 crores. On the above date there were also 18 banking companies working under schemes of arrangement whose total outside liabilities as on the respective dates of sanction of their schemes of arrangement aggregated Rs 6.14 crores.

[10-8-1953]

Seen and returned.

2. Government have forwarded with these papers a copy of the note on 'Banking Companies in the Eastern (Calcutta) Area'. It may be explained that during his visit to Calcutta the Deputy Finance Minister asked Shri Desai, the Deputy Chief Officer (Department of Banking Operations) for a 'personal' note in regard to banks in West Bengal. Shri Ram Nath, Deputy Governor, who is immediately in charge of banking, happened to be in Calcutta during the Deputy Finance Minister's visit. The Deputy Finance Minister, however, did not discuss any of these issues with him. In fact, he did not even meet Shri Ram Nath during his visit, although he was working in the office in an adjoining room.

3. On the basis of the note handed over to him unofficially by the Deputy Chief Officer in Calcutta, Shri Guha has passed the following comments:

"I have already handed over a note regarding the banks in West Bengal. Apart from the banks which have already closed, there are 146 non-scheduled banks in West Bengal who have not been submitting any returns or report to the Registrar, Joint Stock Companies, and have yet been continuing as banks. This is a scandalous state of affairs. This should be stopped at the earliest. It is no use citing legal and technical difficulties. We shall have to do something to remedy this state of affairs.

I expect some effective suggestions to be made on this so as to stop this."

4. This 'so-called scandal' is not of recent growth. The question of enacting comprehensive banking legislation for protecting the interests of the depositors and for fostering the growth of banking in India on sound lines was investigated in detail by the Indian Banking Inquiry Committee (1929–31). The Committee after considering the evidence tendered by commercial bodies and the public on the subject, recommended the enactment of a comprehensive Bank Act. The Central Board of the Reserve Bank considered the problem in detail and submitted certain proposals to the Government of India in November 1939 in the form of a draft bank bill. This bill was circulated by Government for eliciting public opinion, but in view of the abnormal conditions created by the war and the lack of unanimity of opinion disclosed in the replies received from public bodies, Government decided not to undertake any comprehensive legislation during the war period. The special legislation for banking companies, viz., the Banking Companies Act, was ultimately enacted in 1949.

5. There was considerable criticism in regard to the position of banking in West Bengal and Shri Chintaman Deshmukh submitted an informal note to the Central
Board on January 31, 1949, explaining the whole position. The following is an extract from this note. "These banks own their existence mostly to loan companies, whose main business was to grant advances against mortgages. Advances against property, which are not generally looked upon with favour by commercial banks, find a very high place in the advances portfolio of these banks. Many of these banks offered very high rates of interest to attract deposits, spent lavishly on advertisements and opened numerous branches even in far off places, with the result that during the war when, due to inflationary conditions, the public had large surplus funds for investment, the banks showed remarkable progress. The deposits of non-scheduled banks in Bengal rose from Rs 4.87 crores in January 1940 to Rs 30.78 crores in August 1946. The deposits of Bengalee scheduled banks also rose from Rs 5.43 crores at the end of 1939 to Rs 69.85 crores at the end of 1946. The additional resources were not, however, wisely used. In the case of the non-scheduled banks, a scrutiny of their balance sheets, an examination of their financial position in connection with applications for capital issue or branch banking and inspections conducted by us under the Banking Companies (Inspection) Ordinance, 1946, disclosed that the financial position of many of these banks was very unsatisfactory."

Subsequent figures relating to these non-scheduled banks were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Number submitting deposits</th>
<th>Deposits (Rs crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1947</td>
<td>165</td>
<td>21.57</td>
</tr>
<tr>
<td>June 1948</td>
<td>104</td>
<td>7.68</td>
</tr>
<tr>
<td>December 1949</td>
<td>57</td>
<td>3.67</td>
</tr>
<tr>
<td>May 1953</td>
<td>19</td>
<td>1.45</td>
</tr>
</tbody>
</table>

6. Soon after the Banking Companies Act came into force the Reserve Bank instituted a system of regular periodical inspection of all banks in the country, scheduled as well as non-scheduled. It took some time to train the personnel and to organise these periodical inspections. All scheduled banks and such of the non-scheduled banks as could be traced in West Bengal have now been thoroughly inspected at least once. Many of the inspected banks have been under surveillance, since their methods of working were found to be unsatisfactory. These banks are required to submit periodical returns to show what progress has been made in regard to the removal of defects noticed in the course of inspection. On the 31st July 1953, the number of banks submitting monthly progress reports and quarterly progress reports was 22 and 244 respectively. If no improvement is shown and the position of the depositors is likely to be prejudiced, we take disciplinary action, such as descheduling the banks concerned or prohibiting the receipt of further deposits (e.g. Calcutta National Bank Ltd., Dinajpore Bank Ltd., Mahaluxmi Bank Ltd. and Tripura Modern Bank Ltd.). As the Finance Minister himself explained in Parliament recently, the Reserve Bank, through its system of inspection exercises as effective control over banks as is possible in any free democratic country.

7. As stated in the note handed over to the Deputy Finance Minister by the Deputy Chief Officer in Calcutta, there are however, 146 non-scheduled banks in West Bengal which are either "defunct or untraceable". We have sought the assistance of the Registrar of Joint Stock Companies in tracing these banks, but he has not been able to
help us so far except in a few cases. If the Registrar with the assistance of the administrative machinery of the Bengal Government cannot trace these banks, the Reserve Bank cannot obviously locate them. The Chief Minister of West Bengal has suggested that the Reserve Bank should appoint an Inspector to scrutinise the affairs of each bank. As has been explained above, there is already a very efficient system of inspection and it is our aim to inspect every bank at least once a year. It is obvious, however, that it is not possible to inspect banks which are either “defunct or untraceable”. We do not know of any remedy, legal or otherwise, by which we can resurrect for inspection and appropriate treatment a bank which has been dead for some time. Nor is a post-mortem examination possible until the corpse can be found.

8. Our difficulties may be illustrated by reference to the case of the Bishnupur Bank Ltd., Bishnupur (Bankura) about which a reference will be made shortly to the Government of India. This bank was inspected by us in June, 1950 for determining whether it would be eligible for a licence. The inspection revealed a number of serious defects, which were brought to the notice of the bank for rectification. The bank was asked to submit quarterly reports indicating the progress made by it in remedying the defects. It submitted its progress reports up to the quarter ended June 1952, but there were no subsequent reports in spite of several reminders. The Chairman has been guilty of malpractices, nepotism and dishonest transactions. The following is an extract from the second inspection report:

The bank appears to be in a moribund condition since the middle of 1952. The premises where its Head Office was situated, were disposed of by it in December 1952 and the books and records of the above office were transferred to the local residence of the Chairman of its Board of Directors. The name-board of the bank is not displayed at that place. Besides its Head Office at Bishnupur, the bank had two offices at Calcutta and one each at Purulia and Bankura. One of its offices at Calcutta and those at Purulia and Bankura were closed prior to the date of inspection while its other office at Calcutta was closed on the 6th April 1953 i.e., prior to the date of commencement of inspection. Most of the books and records of all the above offices which have since been closed have also been transferred to the residence of the Chairman.

The bank’s Chairman is apparently attempting to elude his creditors. A letter by us to the bank recently has been returned to us by the Dead Letter Office, Calcutta, although it was despatched correctly to the address furnished by the bank in terms of the Banking Companies Rules. The fact that in spite of such a state of affairs, none of the bank’s creditors or shareholders seem to have so far made any move for taking the bank into liquidation seems to indicate that either they have lost all interest in it or they do not consider it worthwhile to throw away good money after bad. Since it is necessary to see that the acts of misfeasance etc. on the part of the bank’s management, and in particular its Chairman, are thoroughly investigated by the Official Liquidator for such action as the Court may deem fit, we are addressing the Government for action against the bank under Section 35(4) (b) of the Banking Companies Act.

9. Dr. B.C. Roy has stated in his letter to Shri A.C. Guha that in many cases the Reserve Bank “informs the non-scheduled bank people to give up banking and go to something
else”. The possibility of conversion into a non-banking company as a result of banking legislation was recognised as early as 1939. In his memorandum dated September 24, 1940, submitted to the Central Board, Sir James Taylor stated that on the introduction of banking legislation on the lines suggested by him, many of the smaller banks would disappear or would continue to exist for moneylending etc., though they would not be permitted to describe themselves as banks. On October 20, 1942, the Reserve Bank sent a circular letter to all Registrars of Joint Stock Companies that under the amendments to the Indian Companies Act, which became operative from November 1, 1943, all companies which described themselves as banks but were not conforming to the provisions of the law relating to banks, should change their business or, with the approval of the Central Government, their designation. The provisions in regard to the requirement of minimum paid-up capital etc. in the Banking Companies Act are mandatory and if the banks are unable to comply with these requirements, they have to convert themselves into non-banking companies or go into liquidation, which is a much more costly process from the point of view of the depositors. It is obvious that the sponsors of the legislation were fully aware of the inevitable consequences of these provisions and the facts regarding the position of the banks in Bengal were known at the time. My predecessors who had initiated this legislation had no doubt satisfied themselves at the time that the interests of the depositors would not be prejudiced by the conversion of “banks” into moneylending institutions or ordinary companies subject to the Indian Companies Act. The advice given by the Reserve Bank in the cases referred to by Dr. Roy was based on the policy that had been formulated before and is implicit in the Act. I have, however, had the legal position re-examined, and I enclose herewith a copy of the note by the Legal Division [not reproduced], which states that except in regard to one minor procedural point the position of the depositors is not in any way affected by conversion into a non-banking company.

10. I must apologise for the length of this note, but it is not usual for a responsible member of the Government to use in relation to the working of a big institution like the Reserve Bank such expressions as “scandalous” on the basis of an unofficial note given to him, at his request, by the Deputy Chief Officer of one of our branches without an official request for fuller information from the Bank or prior discussion with the senior executives. I feel, therefore, a full explanation is necessary.

B. RAMA RAU
10-8-1953

D.M.(G)

I had a discussion with the FM. When I put that note, I had no idea of putting the blame on the Reserve Bank. A responsible officer of the Reserve Bank first drew this to my notice. Then I arranged to discuss the matter with him and the Registrar of Joint-Stock Companies. Both appeared to have been foiled by those people. The letter of the Chief Minister, W.Bengal also could not suggest any redress. When we are faced with such a state of affairs, I thought it my duty to take serious notice of that.

However, I hope the suggestions made by the Secretary (E.A.) in his note will be given effect to.

A.C. GUHA
16.8
My dear L.K.,

You will remember that at the meeting in the Finance Minister’s room on the 1st of this month, when the general banking situation was discussed, we promised to write to you after a review of the position of the various banks as disclosed by our inspections in 1957 and the latest inspections and the lines on which we feel that further action should be taken. We have since conducted the review and this letter contains our proposals in regard to future action.

2. You will recall that the point was explained at the discussions with the Minister that it would be easier to proceed with further amalgamations if the Deposit Insurance Scheme came into effect at an early date. We sent to Government a draft bill some time ago; but, apart from a news item in the press that legislation was likely to be introduced in the coming session of Parliament, we have not heard anything on the subject. I am assuming for purposes of this letter that the Insurance Scheme will come into force in the next two or three months.

3. The present position in respect of the commercial banks is broadly as follows. Excluding the banks which are in liquidation or have been refused a licence or have converted themselves into non-banking companies or are under moratoria pending amalgamation under Section 45 of the Banking Companies Act, we have at present 298 banking companies functioning in this country. Fifteen of these are foreign companies and the rest are indigenous. Sixty-five of them have been given a licence while 223 banks, including a foreign bank, have still to be licensed. Ten of the banks do not require any licence. The licensed banks together have a deposit of Rs 1,210 crores, unlicensed banks Rs 82 crores and the banks not requiring a licence Rs 651 crores. These are round figures and give the position in accordance with the latest returns available for 1961.

4. The bulk of the smaller banks fall in the category of unlicensed banks. Of the 223 unlicensed banks 22 are scheduled banks with a total deposit of Rs 43 crores. Fifty-three banks have a paid-up capital and reserves of Rs 1 lakh and less; many of them are no more than glorified moneylending institutions and their total deposits are of the order of Rs 1½ crores. One hundred and nineteen banks have a paid-up capital and reserves between Rs 1 lakh and 5 lakhs with a total deposit of Rs 15 crores. Twenty-eight banks have a paid-up capital and reserves of over Rs 5 lakhs and their total deposits aggregate Rs 20½ crores.

5. As you know, prior to the amendment of the Banking Companies Act, last year under which Government took power to place banks under moratoria and promote schemes for their amalgamation, the only power available to the Reserve Bank when
a bank was run inefficiently or its deposits were impaired was to put it under liquidation. The wide powers recently taken by Government were intended to facilitate the orderly elimination of the weaker units from the banking system and the building up of a strong and well co-ordinated banking structure. It was not at any time intended that small banks, as such, should be done away with or only big institutions encouraged. The idea was to build up, by a process of amalgamation, banking institutions all of which would be viable and reasonably efficient. Of the 35 banks which were placed under moratoria some of them had themselves asked for it while in the case of the others it was the considered judgement of the Reserve Bank that the methods of operation or the financial position of the institutions were such that either the interests of the depositors were in jeopardy or there was no prospect of the banks becoming viable institutions in the foreseeable future. The alternative to merging these banks with other banks was to let them linger along to ultimate disaster. As you know, in each of these cases the full reasons for the view taken by the Reserve Bank about the financial position and the prospects of the institution were placed before the Government.

6. At the meeting in the Minister’s room it was suggested that if, in the last two or three years, there had not been any worsening in the position of any bank there might be a case for going slow with it and giving it a chance to improve itself. The position of the various banks has been examined from this angle by comparing their financial position as disclosed by our inspection in 1957 with the position as disclosed by our latest inspection. The position has naturally varied from bank to bank; some have shown an improvement while others have shown a deterioration, but, on the whole there has not been any improvement. If we take the 298 banks functioning today, their position in 1957 was that the reserves of 183 banks had been affected but their capital and deposits were intact. In the case of about half of them the erosion was marginal or not very significant while in the case of the remaining the erosion was more substantial. Forty-seven had completely lost their reserves and had in addition lost upto roughly one half of their capital. Sixteen banks had lost their entire reserves and more than half their capital. Twenty-six banks had lost their entire capital and reserves and, in addition, a part of their deposits. The present position, taking the same banks into consideration, is that 175 are still in the position of having their reserves affected, 52 have completely lost their reserves and upto half the capital, seventeen have lost their reserves and the bulk of the capital and 23 have lost their reserves, capital and a part of the deposits. Individual banks may have improved or deteriorated but this is the broad picture taking them as a whole.

7. The banks which have only lost a part or whole of the reserves do not pose as urgent a problem as the banks which have lost their capital and deposits although every effort should be made through inspection, advice and, if necessary, directions to make these banks improve their position. Banks which have lost their capital and deposits have to be dealt with first to protect the depositors from further damage to their interests. Banks which have their deposits intact, but have only lost their capital may be dealt with a little later but before the deposits are affected. But action cannot be deferred any longer when the interests of the depositors are likely to be placed in jeopardy. Where damage has already been done or is likely to be done in the near
future, it is essential to take steps to get the banks amalgamated with other stronger units. It will be easier to do this once the Deposit Insurance scheme comes into operation although the burden on the Corporation would be somewhat heavier than if these institutions had been weeded out earlier.

8. In the light of the discussions at the meeting with the Minister I propose that our policy in regard to the future course of action should be:

(i) In the case of banks whose reserves only have been affected, efforts should be made to get them to improve their position over the next two or three years, but no action to merge them compulsorily with other banks should be taken except in case of gross mismanagement and repeated failure to carry out our directions or accept our advice.

(ii) In the case of banks which have lost their reserves but only less than half of their capital they should be nursed in the same way as banks which have only lost their reserves; action to merge them compulsorily with other banks should be taken only if they are grossly mismanaged and they fail to carry out our directions or accept our advice.

(iii) In the case of banks which have lost all their reserves and the bulk of their capital there is a danger of a further deterioration resulting in the erosion of deposits also. In the interest of the depositors these banks should be taken up for amalgamation with other stronger units as soon as practicable and well before the deposits are touched.

(iv) In the case of banks which have already lost part of the deposits after losing all their capital and reserves there is no justification for leaving them to function, as the chances of their rehabilitation are remote. These banks should be taken up for amalgamation with other banks, the programme being phased in such a way that it does not create any feeling of panic or insecurity in any part of the country.

9. The above proposals only cover the problem of dealing with the existing institutions which have, in one way or another, reached an unsatisfactory position. They do not deal with the larger question of rationalising the banking structure so as to do away with the distinction between scheduled and non-scheduled banks and licensed and unlicensed banks. I am convinced that these distinctions which are confusing to the public mind and are merely a historical relic should be done away with. With a scheme of deposit insurance in operation and all functioning banks coming within its cover, the distinction between licensed and unlicensed banks would largely lose its meaning as it is unlikely that an insured bank would be refused a licence. The distinction between scheduled and non-scheduled banks will disappear if all the smaller banks which, because of their very small capital and reserves or poor management, do not qualify for inclusion in the schedule could be amalgamated into a number of sizeable units. These units would be viable and well managed but still largely local and would qualify for inclusion in the schedule. In fact, at that stage, there would be no need for a schedule. I am convinced that this rationalisation should be effected in the interests of banking as a whole and should be kept in mind as our long-term policy. How long this process should take is for Government to decide. From the point of view of having a sound banking structure which can take on the increasing
pressures of the Third Plan, I would myself think that the less the delay in this programme or rationalisation the better it would be in the public interest.

10. I shall be glad if Government would kindly let me know their decision on the suggestions made in this letter. Meanwhile unless any bank comes forward with a proposal for a moratorium on its own to the Reserve Bank (as some of the Kerala banks did after the Palai crash) or a run develops on any bank which makes a moratorium inescapable we shall hold our hand. We shall go ahead with the schemes of amalgamation for the banks already under a moratorium but no further schemes will be formulated until Government have taken a decision on policy and the scheme of deposit insurance is introduced.

11. I have given in this letter statistics of the banks by categories. I have not deliberately given the names of the individual banks as it is not desirable that information about them should leak out.

Yours sincerely,

H.V.R. IENGA

Shri L.K. Jha, I.C.S.

***

CONFIDENTIAL

No.[...] Memorandum to the Central Board
Policy regarding the licensing of banks under section 22 of the Banking Companies Act, 1949

The policy of the Reserve Bank of India regarding the licensing of banks in terms of section 22 of the Banking Companies Act, 1949 was last considered by the Central Board at its meeting held on the 17th July 1958. The Board after considering the Deputy Governor's memorandum No.[...] dated the 5th July 1958 resolved that the policy regarding licensing outlined in the note attached to the memorandum be approved. Since the submission of that memorandum, there have been significant developments in the field of banking, particularly in regard to amalgamations and consolidation of the structure, which have accelerated the process of refusal of licences to banks. There have, however, been some adverse comments recently in the Financial Press in regard to the alleged slow progress in the matter of licensing of banks. In order that the Board may be kept apprised of the correct position in this regard, a note reviewing the progress so far made and the present position in regard to the licensing of banks is attached. If the Board is in agreement with the views contained therein, it may kindly pass the following resolution:

"RESOLVED
That the policy regarding the licensing of banks outlined in the note attached to the Deputy Governor's memorandum No.[...] dated the 30th July 1965 be approved."

RESERVE BANK OF INDIA
CENTRAL OFFICE
DEPARTMENT OF BANKING OPERATIONS
AND DEVELOPMENT
BOMBAY, dated July 30, 1965
Policy regarding the licensing of banks under section 22 of the Banking Companies Act, 1949

The policy followed by the Reserve Bank of India in regard to the licensing of banks under section 22 of the Banking Companies Act, 1949 was first considered by the Central Board at its meeting held on the 8th November 1954. Thereafter the policy was again reviewed by the Board at its meetings held on the 18th December 1957 and 17th July 1958. As over seven years have passed since the submission of the latter memorandum and dissatisfaction with the pace of licensing has been voiced in some quarters recently, it is proposed to review in this memorandum the Bank’s policy and progress in regard to the licensing of banks. The note attached to the memorandum submitted at the meeting held on the 17th July 1958 is appended for ready reference (vide Appendix [p. 1068]).

2. Present Policy

The policy of the Reserve Bank in regard to the licensing of banks is governed by the provisions of section 22 of the Banking Companies Act, 1949. The conditions to be fulfilled by a banking company to be eligible for the grant of a licence are:

(a) that it is in a position to pay its present or future depositors in full as their claims accrue;

(b) that its affairs are not being or are not likely to be conducted in a manner detrimental to the interests of the present or future depositors; and

(c) that in the case of a bank incorporated outside India, the Government or the law of the country in which it is incorporated, does not in any way discriminate against banks registered in India and it complies with all the provisions of the law.

While sub-section (1) of section 22 stipulates that no bank shall carry on banking business in India unless it holds a licence granted by the Reserve Bank, the first proviso to sub-section (2) provides that a banking company in existence on the commencement of the Act shall not be prohibited from carrying on business until it is informed by the Reserve Bank that a licence cannot be granted to it.

The basic objective underlying the provisions relating to licensing is thus to ensure that only those banks whose financial position and methods of operation are satisfactory, are given licences. In the case of foreign banks, there is an additional requirement that there is no discrimination against Indian banks in the foreign country concerned.

In judging the financial position of a bank for the purpose of granting a licence, the Reserve Bank takes into account, inter alia, the adequacy of the paid-up capital and whether the bank has been able to build up sufficient reserves commensurate with its age. The Reserve Bank also takes into consideration the quality of its advances and investment portfolios and earning capacity. It is not, however, the policy to refuse a licence to a bank—the effect of which is that it has to cease carrying on banking business—unless a reasonable chance is given to it to improve its financial position and methods of operation. In the case of a number of banks it is found that while the interests of depositors are not in immediate danger, their financial position and methods are such as do not justify the grant of a licence.
delay in the progress of licensing has been largely due to the existence of an appreciable number of such banks which have not yet been able to set their houses in order.

3. Progress in the licensing of banks

It was stated in the memorandum submitted at the meeting held on the 17th July 1958 that 58 banks (49 scheduled and 9 non-scheduled) had been granted licences upto the 16th June 1958, and that 4 banks did not require a licence, while licences had been refused to 117 banks. As on the above date, the total number of unlicensed banks was 345. The figures relating to the grant and refusal of licences since 1951 are given below for ready reference.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of banks granted licences</th>
<th>No. of banks refused licences</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Scheduled</td>
<td>Non-Scheduled</td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>1951</td>
<td>1</td>
<td>—</td>
</tr>
<tr>
<td>1952</td>
<td>21</td>
<td>1</td>
</tr>
<tr>
<td>1953</td>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td>1954</td>
<td>1</td>
<td>—</td>
</tr>
<tr>
<td>1955</td>
<td>12</td>
<td>—</td>
</tr>
<tr>
<td>1956</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>1957</td>
<td>3</td>
<td>—</td>
</tr>
<tr>
<td>1958</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>1959</td>
<td>—</td>
<td>7</td>
</tr>
<tr>
<td>1960</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>1961</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>1962</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>1963</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>1964</td>
<td>—</td>
<td>1</td>
</tr>
<tr>
<td>1965</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>(30 June)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>61</td>
<td>28</td>
</tr>
</tbody>
</table>

\(^1\)Includes 27 banks whose licences have since been cancelled/deemed to be cancelled on account of their merger with other banks, etc. Also includes 2 banks to whom licences have been granted to commence banking business in India subsequent to the date of last review.
It will be observed that the pace of refusal of licences has been appreciably accelerated since the beginning of 1964. The problem of licensing of banks is nearer solution now than at any time before as will be seen from the following table showing the number of licensed banks, banks not requiring a licence and banks which have not yet been granted a licence.

<table>
<thead>
<tr>
<th></th>
<th>Scheduled</th>
<th>Non-Scheduled</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>i) Licensed banks</td>
<td>51</td>
<td>11</td>
<td>62</td>
</tr>
<tr>
<td>ii) Banks not requiring a licence</td>
<td>8</td>
<td>—</td>
<td>8</td>
</tr>
<tr>
<td>iii) Banks which have not been granted a licence</td>
<td>17</td>
<td>47</td>
<td>64</td>
</tr>
<tr>
<td>Total</td>
<td>76</td>
<td>58</td>
<td>134</td>
</tr>
</tbody>
</table>

Of the 64 unlicensed banks, 39 banks are working under directions issued by us; the affairs of 27 of these banks are also under our formal/informal observation. All these banks have been inspected several times and we have been taking systematic and regular steps after each inspection for improving their working with the ultimate object of enabling them to qualify for a licence. Our observers have been playing a positive role and have not only prevented at source transactions of undesirable nature but where considered necessary have also given proper guidance to the banks. The banks are also required to obtain our prior approval for the declaration of dividend, a step that helps in the strengthening of their reserves. We also impress on the managements from time to time to take effective steps to improve their working and to attain our standards of eligibility for licence.

4. Developments in the banking field and their impact on the licensing of banks

It is necessary at this stage to explain the reduction in the number of functioning banks in recent years which has declined from 407 in June 1958 to 134 as on the 30th June 1965. During the last five years, particularly after the failure in 1960 of two scheduled banks, the Reserve Bank has been following an active policy of consolidation of the banking system through compulsory and voluntary amalgamations of banks. Certain other developments, which took place in the banking and economic fields at about this time, also lent impetus to this process. The main development which influenced the position, particularly of the smaller banks, was the promulgation of the Gold Control Order in November 1962. The impact of this Order adversely affected the position of banks which had confined their business largely to advances against gold ornaments. They were also faced with the problem of meeting increased expenses on staff as a result of the coming into effect of the Bank Award or the agitation of the employees in the case of non-Award banks for equivalent scales of pay. The impact of these factors was felt so severely by some banks that, although having no insignificant resources, they of their own accord decided to merge with other banks. Even a few banks which had been granted licences earlier resorted to this course. As a sequel to our study of the position of the various banks affected by these developments informal discussions were held by us with the managements of the banks and the advantages of their ceasing to have an independent existence and merging into stronger and viable units likely to qualify for a licence ultimately, were effectively brought
home to them. Thus, as many as 162 amalgamations and transfers of liabilities and assets have taken place during the period from 1961 to the 30th June 1965, of which 121 have been on a voluntary basis. During the same period, 43 other banks converted themselves into non-banking companies or went into voluntary liquidation or otherwise ceased to function.

5. Analysis of the position of unlicensed banks

Although the number of unlicensed banks is at present 64 as against 70 licensed banks, (including 8 banks not requiring a licence) the deposits of the licensed banks (including those which do not require a licence) aggregate as much as 97% of the total deposits of all banks in India. The corresponding percentages when the policy was considered by the Board in July 1958 and in June 1954 were 93.2 and 76.5 respectively.

On an assessment of all the relevant factors it is considered that 17 banks (10 scheduled and 7 non-scheduled) are likely to qualify for the grant of a licence in the next 5 years; their position vis-a-vis grant of licence is being reviewed from time to time. Out of the remaining 47 banks, 24 banks are either taking steps for their amalgamation with/transfer of liabilities and assets to other banks or have been advised by us to take such action in view of their unsatisfactory financial position/methods of operation. 10 other banks are taking steps to go into voluntary liquidation or for conversion into non-banking companies. The remaining 13 banks include a foreign bank. Apart from the usual considerations, the question of grant of licence to this bank will depend on its compliance with section 22(3)(c) of the Banking Companies Act, i.e. reciprocity. The viability of 3 banks is not free from doubt and we may have to persuade them for amalgamation/merger with suitable banks. The question of constituting one bank, in which a State Government has a considerable stake, as a subsidiary of the State Bank of India is engaging our attention. As regards the remaining 8 banks, they are mostly dominated by their Chairman/certain directors and have been functioning mainly to subserve their interests. The managements of these eight banks have not been responsive to the various measures suggested by us to make them viable units and have not made serious efforts for improving their working. Their future set-up is under our constant consideration.

6. Feasibility of fixing a time limit for unlicensed banks to satisfy the standards of eligibility for a licence

It has been suggested that the Reserve Bank should fix a time limit, say two years, for all the unlicensed banks to satisfy the standards of eligibility for licence and declare that banks which fail to do so will not be given licence and that the public will be informed of the decision. As already mentioned, the affairs of the unlicensed banks are receiving our constant attention. They have been unable to show appreciable progress in the rectification of some of the defects such as low reserves, realisation of sticky advances, etc., as these features, by their very nature, are difficult of rectification within a short period, in spite of the steps taken by the management. However, so long as there is no deterioration in a bank's financial position and its management continues to be keen in bringing the bank's working on sound lines and the depositors' interests are not put in jeopardy, it would be desirable to allow sufficient time and
afford it an opportunity to qualify for a licence. In this context it would be difficult to lay down a hard and fast time limit for the purpose.

7. Conclusion

It will be observed from the foregoing that the main purpose underlying our licensing policy is to ensure that only banks whose financial position and methods of operation are satisfactory and which will be in a position to function as viable units, are given a licence. The fact that the 64 unlicensed banks referred to above (out of 722 which originally applied for licence) have not yet qualified themselves for a licence, is merely indicative that they have been slow in taking necessary action to come up to our standards in this regard. However anxious we may be to hasten the process of licensing, unless the banks themselves take expeditious steps to improve their working and come up to the requisite standards, it may not be possible to show accelerated progress in the matter. At the same time, so long as the interests of their depositors are not in immediate danger, the balance of advantage would seem to lie in giving them time for improving their affairs and to endeavour to make them fit for the grant of licence either by bringing their working on approved lines or by merging them with stronger units. The present policy of consolidation-cum-licensing has yielded satisfactory results and it is expected that by the end of 1965 there will be about 100 functioning banks left in the country. In the circumstances, although some unlicensed banks may be with us for some more years, the policy outlined in the foregoing paragraphs may continue to be followed.

APPENDIX TO BOARD MEMORANDUM DATED 30 JULY 1965

Policy regarding licensing of banks under section 22 of the Banking Companies Act, 1949

The policy followed by the Reserve Bank in the licensing of banks under section 22 of the Banking Companies Act, 1949 was first considered by the Central Board at its meeting held on the 8th November 1954. At this meeting the Board approved of the policy as outlined in a note submitted by the Department of Banking Operations on the subject. Thereafter the policy was again reviewed by the Board at its meeting held on the 18th December 1957. The Board, while approving of the policy as outlined in the Deputy Governor’s Memorandum No.[...] dated the 6th December 1957, desired that the matter should be resubmitted to it after six months. Accordingly, the progress in regard to the licensing of banks and the developments during this period are reviewed in the following paragraphs. The note attached to the memorandum dated the 6th December 1957 is appended for ready reference (vide Appendix I [not reproduced]).

2. Present policy

The policy of the Reserve Bank in regard to licensing of banks is governed by the provisions of section 22 of the Banking Companies Act. Sub-section (1) of this section stipulates that no company shall carry on banking business in India unless it holds a licence granted by the Reserve Bank. The first proviso to sub-section (2) of the section, however, provides that a banking company in existence on the
commencement of the Act shall not be prohibited from carrying on business until it is informed by the Reserve Bank that a licence cannot be granted to it. Sub-section (3) of the section further provides that before granting a licence the Reserve Bank may require to be satisfied by an inspection or otherwise that the following conditions are fulfilled viz.,

a) that the bank is in a position to pay its depositors in full as their claims accrue;

b) that the affairs of the bank are not being conducted in a manner detrimental to the interests of its depositors.

In view of the provisions mentioned above and the fact that very little information was available to the Reserve Bank about the financial position and methods of operation of most of the banks, particularly the non-scheduled banks, it was decided to inspect every bank in order to ascertain whether it satisfied the criteria mentioned above. The inspections revealed that a very large number of banks were being operated under conditions under which, consistently with the provisions of the Act, a licence could not be given, and some of these were big banks with substantial deposits. This raised the question whether a licence should be refused straightaway in such cases. The policy adopted was that where the situation could possibly be retrieved and a bank made to work on sound lines, an opportunity should be given to enable it to do so and a licence refused only where the position was hopeless.

3. Progress in the licensing of banks

The figures relating to the grant and refusal of licences since the position was last reviewed are given below:

<table>
<thead>
<tr>
<th></th>
<th>No. of banks granted licences</th>
<th>No. of banks refused licences</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Scheduled</td>
<td>Non-Scheduled</td>
</tr>
<tr>
<td>Upto the 31st October 1957</td>
<td>47</td>
<td>5</td>
</tr>
<tr>
<td>From the 1st November 1957 to the 16th June 1958</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>49</td>
<td>9</td>
</tr>
</tbody>
</table>

It will be seen that since the progress was last reviewed by the Board, 2 scheduled and 4 non-scheduled banks have been granted a licence while 14 non-scheduled banks have been refused a licence. The total number of banks licensed so far is thus 58. At present the deposits of all licensed banks, together with those of the State Bank of India, the State Bank of Hyderabad, the Bank of Patiala and the State Bank of Saurashtra, which do not require a licence, aggregate 93.2 per cent of the total deposits of all banking companies in India. The corresponding percentage when the question was last considered by the Board in December 1957 was 92.4. It may be added that the percentage in June 1954 was 76.5. It will be observed from the foregoing that since the work relating to the grant and refusal of licences to the existing banks was taken up in 1952, fair progress commensurate with the policy adopted by us has been accomplished.
4. Present position of unlicensed banks

The total number of licensed banks as on the 16th June 1958 was 345. Of these 320 banks (Vide Appendix II [not reproduced]) are submitting periodical reports showing the progress made by them in the rectification of defects pointed out to them. No progress reports are being called for from the remaining 25 banks for various reasons. Some of these banks could not be traced or could be inspected only recently and in the case of certain others, a change in their set-up is under consideration. It will be observed from the statement indicating the progress of inspections/re-inspections etc. given in Appendix II that a large number of banks submitting progress reports has been re-inspected during the past three years. Since the last review, 101 banks have been re-inspected. It may be stated here that re-inspections in the case of 20 banks and a rapid scrutiny in the case of one bank were undertaken to assess the progress made by them in implementing fully the conditions imposed on them. 17 scheduled and 28 non-scheduled banks are at present working under conditions as against 10 scheduled and 32 non-scheduled banks as on the 31st October 1957. Under the new section 35A of the Banking Companies Act, 1949, such conditions have since been imposed by the issue of suitable directions to 3 scheduled banks and 1 non-scheduled bank. Of these, the affairs of 10 scheduled and 4 non-scheduled banks are under observation and an officer of the Reserve Bank is being deputed to attend their Board Meetings and to keep a watch on their day-to-day working.

In cases where the inspection reports on banks disclose serious defects, it is our usual practice to call the Chairman, the Chief Executive Officer and one or two directors of the bank concerned for a personal discussion in order to impress upon them the need for taking expeditious action to remove defects. In suitable cases, the banks are also advised to explore the possibilities of amalgamation with other banks. It may be mentioned in this context that during the last several months we sanctioned four schemes of amalgamation amongst banks.

Periodical inspections carried out by us together with the scrutiny of progress reports have revealed that in most cases steps are being taken by the banks to implement the advice tendered to them. The common undesirable features observed in the working of banks, the number of cases where they have been pointed out and the number of banks that have been able to rectify them either wholly or in part are given in Appendix III [not reproduced]. While several banks have been able to rectify the procedural and organisational defects within a reasonable time, few of them have been able to show appreciable progress in the correction of operational defects such as the realisation of sticky advances, the reduction of clean advances and advances against immovable property.

5. Refusal of licence to banks in Kerala

The position of banks in Kerala was reviewed by the committee of the Central Board at its meeting held on the 14th May 1958 and it appeared that the go-slow policy adopted last year has had a salutary effect on the banking structure in the State. While this was a welcome development, two measures of agrarian reform viz., the Kerala Indebted Agriculturists Relief Bill and the Kerala Agrarian Relations Bill introduced by the State Government at the end of last year seemed to have caused considerable nervousness in banking circles. The Deputy Governor visited Trivandrum...
in the middle of March this year and held discussions with the State Government and the representatives of the banks in regard to the prevailing banking situation and the problems facing banks in that area. Having regard to the discussions, the uneasiness created amongst banks by the above two Bills and the urge on their part to build up stronger units by way of merger or amalgamation, it was decided to continue the go-slow policy adopted last year for some time more.

6. Inclusion of banks in the Second Schedule to the Reserve Bank of India Act
Closely allied to the problem of licensing of banks is the question of their inclusion in the Second Schedule to the Reserve Bank of India Act, 1934. Since the position was last reviewed, 3 more banks have been so included. At present there are 50 banks the nominal value of whose paid-up capital and reserves is Rs 5 lakhs or above but which have not so far been included in the Second Schedule as their financial position and methods of operation are not satisfactory. Their position is, however, being examined from time to time simultaneously both for inclusion in the Second Schedule as well as for the grant of a licence under section 22 of the Banking Companies Act.

7. Accelerating the pace of inspections
In order to expedite the licensing of banks, it has been suggested that banks which are under our surveillance should be inspected more frequently. Even as it is, the maximum period allowed at a time for implementation of the conditions/directions is 12 months and invariably either a re-inspection or a rapid scrutiny is undertaken before the expiry of this period with a view to determining the future course of action. In the case of banks whose day-to-day affairs are under observations, the officer deputed to attend the meeting of the bank’s Board of Directors carries out simultaneously a rapid scrutiny of its current affairs. It has also been recently decided to accelerate the pace of inspections and make them an annual feature. With a view to expediting the disposal of all pending applications for licence, priority is given to the inspections of unlicensed banks. In view of these arrangements, it is expected that our surveillance would become more effective and yield better results.

8. Feasibility of fixing a time limit for the rectification of defects
It has also been suggested that a licence under section 22 of the Act should be refused to a bank if it does not show any appreciable improvement within a period of three years or so. As has already been observed, while some of the banks have been able to rectify the procedural or organisational defects in their working within a reasonable time, few of them have been able to show an appreciable progress in the correction of operational defects such as the realisation of sticky advances and the reduction of clean advances and advance against immovable property. These features, mostly a legacy of the past are by their very nature difficult of rectification within a short period. In several cases, in spite of the steps taken by the management, the progress made in the rectification of these features is slow. Initially, only a short period is allowed to banks for rectification of the defects and a re-inspection is undertaken at the end of the period with a view to deciding the future course of action. However, so long as there is no deterioration in the bank’s financial position and the management is keen on bringing the bank’s working on sound lines, it would be desirable to allow further time and afford it an opportunity to qualify itself for a
licensure. It would, therefore, be difficult to lay down a hard and fast time limit for this purpose.

9. **Analysis of the position of unlicensed banks**

With a view to assessing the prospects of completing the licensing process, the position of all the 345 unlicensed banks (39 scheduled and 306 non-scheduled) has been reviewed. It appears from the latest inspection reports, progress statements, and other information available with us that out of these banks, 5 scheduled and 20 non-scheduled banks broadly satisfy the requirements of section 22(3) and their working did not disclose any serious defects. The grant of licence in these cases has been held in abeyance pending rectification of a few unsatisfactory features observed in their working and it is expected that they would qualify for a licence within a year's time. The total deposits of these banks as on the 31st March 1958, aggregate Rs 1,165.31 lakhs. Of the remaining banks, it is observed that 26 scheduled and 196 non-scheduled banks do not satisfy one or other of the requirements laid down in section 22(3). Though their methods of operation cannot be considered as not detrimental to the interests of the depositors, the progress reports submitted by them reveal some improvement, and they seem to be taking steps to rectify the defects pointed out to them. The financial position of a large number of banks in this category cannot admittedly be considered as satisfactory, but given time for a few years more several of them may reach the standard of eligibility. The total deposits of banks falling under this category as on the 31st March 1958 amount to Rs 7,039.30 lakhs. Of the remaining banks, 36 non-scheduled banks with a total deposit liability of Rs 55.80 lakhs as on the 31st March 1958 do not satisfy the requirements of both section 22(3)(a) and (b) and their position is practically beyond repair. With the exception of 15 banks operating in Kerala State steps are being taken to proceed with the refusal of licence in the other cases. Though the financial position and methods of operation of the remaining banks, 8 scheduled and 54 non-scheduled, continue to be unsatisfactory, owing to various considerations such as the possibility of adverse repercussions on other banks etc., they have been granted time to improve their working. But from the past experience it appears that they may not be able to rebuild themselves into viable units. The total deposits of these banks amount to Rs 1,870.85 lakhs as on the 31st March 1958 and in most of these cases it may eventually be necessary to refuse a licence. Of the scheduled banks falling under this category four of them have sizeable deposits aggregating Rs 1,281.09 lakhs and although their deposits have been affected to a certain extent the question of taking adverse action against these banks has been deferred. In the meantime, they have been advised to make earnest efforts for exploring the possibility of either amalgamating with some other banks or alternatively arranging for the transfer of their liabilities and agreed assets to such banks or entering into a compromise with their creditors.

10. **Conclusion**

It will be observed from the foregoing review that although the working of a large number of unlicensed banks suffer from certain serious defects, given sufficient opportunity several of them may be able to retrieve their position. So long as the financial position of these banks does not show any deterioration and so long as they
endeavour to bring their working on approved lines, the balance of advantage would appear to lie in giving them more time for improving their affairs, as any adverse action at this stage would manifestly be detrimental to the interests of their existing depositors. The present policy has yielded satisfactory results and has contributed to the adoption of sounder methods by banks. Therefore, although completion of the process of licensing may take yet a few more years, no modification in the existing policy appears to be called for.

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E. Banking Situation in Kerala

My dear Iengar,

I have just seen Rangachari’s letter to Jha, regarding the action taken by the Reserve Bank of India under Section 38 of the Banking Companies Act, in relation to the Palai Central Bank. You had also informed me about it on the telephone before taking the action. Although there is nothing more to be done at the present stage, I am a little concerned at the way in which the affairs of this bank and also of the Laxmi Bank were allowed to drift, before the decision to wind them up was taken. 2. There has also been some criticism in Parliament to the effect that although the working of the Palai Central Bank was not quite satisfactory, when the bank was first inspected in 1951, its affairs were subsequently allowed to deteriorate very considerably, without any positive constructive action being taken. Because of this lapse of time, the attempts to strengthen the management and to change the methods of working, when they were actually made, proved to be too late. The general impression which this has created has been, I think, somewhat unfortunate.

3. I would like the Reserve Bank of India to consider, if possible, whether some more positive steps cannot be taken, on the basis of its inspection reports, as soon as there is an indication that the banks concerned have not been functioning properly. The Reserve Bank has now a wide range of powers under the Banking Companies Act, including the power to give directions relating to a number of matters. Perhaps, these powers might be more freely used.

4. The procedural details regarding the action to be taken against banks which are not conducting their affairs properly have necessarily to be left to your discretion, but I hope it will be possible for you to ensure that failures like those of the Palai Central Bank and the Laxmi Bank are, as far as possible, prevented in future.

Yours sincerely,

[MORARJI DESAI]
August 18, 1960

Dear Shri Morarji Desai,

Will you please refer to your D.O.No.[...] dated the 10th August regarding the Laxmi Bank and the Palai Central Bank and the general question of Reserve Bank policy in the matter of banks which are being run in a manner detrimental to the interests of the depositors?

2. I naturally share your concern about the banks which have failed. On the general question of Reserve Bank policy, I would draw your attention to the concluding part of the speech that I am delivering tonight at the Annual Meeting of the Institute of Bankers. I enclose a copy of the extract for ready reference. It is always a matter involving a rather delicate exercise of judgement as to when the stage has arrived for taking drastic action against a bank by refusing it a licence or applying to the court for the appointment of a liquidator. In view of the continued failure of banks in Kerala, we received a strong representation from the Kerala Bankers Association early in 1957 asking us to go slow in the matter of refusing licences to banks. This was also, broadly, the recommendation of the Travancore-Cochin Banking Enquiry Commission. In the situation that has been developing in Kerala in the last three years, my own view is that if we had taken, in any of the years 1957, 1958 and 1959, the action that we have taken now, the Reserve Bank would have been exposed to at least as great a criticism as now and, perhaps, even greater. This has been the considered judgement of my colleagues and myself in the Bank. I am quite prepared to accept the view that someone else could have exercised his judgement differently.

3. With regard to the Laxmi Bank, your reference to the affairs of this bank having been allowed “to drift” suggests that the full facts were not placed before you when you wrote to me. Undoubtedly there were several defects and irregularities in the running of this bank. But what precipitated a crisis was a clear fraud. The fraud was assisted by the fact that the Reserve Bank gave prior notice of its inspection. We have now changed our policy and have started surprise inspections of banks.

4. I am glad that you have raised the points that you did in your letter because it is essential that the policy, procedures and techniques of the Reserve Bank should be continuously reviewed with a view to their being improved. I am examining the whole question afresh with a view to seeing what we can do to tighten things up.

Yours sincerely,

Shri Morarji R. Desai

[Signature]

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September 28, 1960

Dear Shri Iengar,

I am sending by Nadkarni a note on my discussions with the bankers in Kerala. At the time Rangachari came here the atmosphere was heavily surcharged but I
was fortunate to find the majority of the bankers in a pensive mood. The idea of mergers and amalgamations was stated by them to have been well-received but there were also surprises. I was no doubt prepared for a lukewarm or even hostile reception to the idea of amalgamations from the representatives of the Travancore Forward Bank, but I did not expect that K.T. Varghese, who is the General Manager of the Catholic Syrian Bank Ltd. and also the Secretary of the Kerala Bankers Association, who saw me this morning, would even now not be thinking in terms of amalgamations. P.K. Koruth, Managing Director of the Martandam Commercial Bank, when he saw me alone on Monday gave his wholehearted support to the idea but he again came this morning with Chacko, one of his directors, to say that they were a well-managed bank, a strong unit, and, therefore, there would be no justification to include them in any scheme of merger. This, however, does not in any way disprove that the amalgamation idea has been favourably received.

2. I have written this at some length merely with a view to emphasising the difficulties that are likely to arise in our way. After my interview with the Chief Minister and talk with the Finance Secretary (the Finance Minister is out of Trivandrum), I feel confident of a good measure of support from the State Government. Bankers in general, however, in this area are a difficult lot. As I have said in the note they are strongly individualistic, well entrenched in their present positions and in the political life of the State, and with a vocal press at their command, are a dangerous fraternity. Juxtaposed, however, with the main idea behind the recent amendment of the Banking Companies Act, i.e., safeguarding the interest of the depositors, these difficulties, howsoever formidable they may be, have to be overcome, even if in the process we are subjected to all sorts of calumny.

3. We shall require an exhaustive amendment to the Banking Companies Act to bring in the State Bank and its Subsidiaries as also to provide for entrusting the liquidation of the unrealisable assets of the banks to a special officer in the liquidator's office. As I mentioned to you over the 'phone today the Advocate General of Kerala with whom I had a talk fully supports this proposal.

4. Urgent action on our part is required mainly because of the Kottayam Orient Bank who may not be able to stand the strain of withdrawals beyond another six weeks or so.

Yours sincerely,

C.S. DIVEKAR

SECRET

The present banking situation in Kerala and the steps necessary to meet it

I held discussions regarding the present banking situation in Kerala with the representatives of the banks which had approached the Reserve Bank for financial assistance following the closure of the Palai Central Bank. Some of them are also office-bearers of the 'Travancore-Cochin Bankers' Association. I also met representatives of bankers in other areas and had talks with the Finance Secretary and the Chief Minister. On the basis of these discussions and the statutory returns available to us so
far in respect of both the scheduled and the non-scheduled banks in this area, the main features of the present situation appear to be as follows:

(1) The first impact of the failure of the Palai Central Bank seems to have led to a general rush for withdrawals throughout the State. The monthly returns submitted so far under Form X (section 24) of the Banking Companies Act show that out of 97 reporting banks, 76 banks experienced net withdrawals of deposits in various degrees between the 5th August and the 26th August 1960 (vide Statement I appended to this report). The total decrease in the deposits of these banks during the period amounted to Rs 4.05 crores. As against this, only 21 banks (vide Statement II) led by the State Bank of Travancore show an increase in deposits aggregating Rs 28 lakhs. Even in the case of the State Bank of Travancore, the increase is in respect of demand deposits and the time deposits show a perceptible fall. The initial rush for withdrawals was very considerable in the case of the Travancore Forward bank, the Kottayam Orient Bank, the South Indian Bank, the Catholic Syrian Bank, the Trivandrum Permanent Bank, the Cochin Commercial Bank, the Federal Bank, the Martandam Commercial Bank and the Seasia Midland Bank. The banks in the area known as “Central Travancore”, i.e. those with the Headquarters at Kottayam, were the worst affected, firstly, because the Palai Central Bank had many of its branches here and secondly because this area in the State is relatively more important from the point of trade, commerce and industry. Comparatively the banks in the districts of Ernakulam and Trichur have not been subjected to very heavy withdrawals. The Calicut region in the north has been even less affected because there are a comparatively small number of indigenous banks in this area and the ubiquitous Marwari and Gujarati private bankers are said to play an important part in the credit structure.

(2) The pace of the withdrawals of deposits has somewhat slackened during the last two weeks. This is interpreted by some of the bankers as a sign of the revival of public confidence. The pressure of withdrawals is now confined more or less to the first two banks mentioned in (1) above. All the bankers, however, apprehend a recrudescence of withdrawals in case some action is not taken before the next balance sheets of the banks are published or should any large bank in the area in the meantime be forced to close its doors due to inability to meet the demands made on it. In the opinion of the bankers, the depositors now seem to be pinning their faith on the constitution of strong banking units through a process of amalgamations and insurance of at least a portion of their monies.

Statistics showing the present position of the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India, the Seasia Midland Bank and the Martandam Commercial Bank are given in Statement III.

(3) The money withdrawn from the five banks had, according to the bankers, found its way largely into the State Bank of India and its subsidiary, the State Bank of Travancore, other commercial banks with head offices outside Kerala and the Postal Savings Banks. A part of it was said to have been kept in hoards.
2. The representatives of the banks whom I met, with one solitary but important exception, seemed to have caught up the idea of amalgamation: indeed, some of them, on their own, made general suggestions for amalgamations. They seemed to have realised that for achieving stability and viability amalgamations were inevitable. The exception was the Travancore Forward Bank and here the reasons are mainly psychological. I pressed them for their constructive views for a long-term solution. After a good deal of whispering between themselves and hesitation they came out with half-hearted suggestions. In the opinion of these representatives, the two scheduled banks, namely, the Travancore Forward Bank and the Kottayam Orient Bank, being an “award” and a “non-award” bank respectively, should continue as separate units although each of them might take over some of the smaller banks belonging to its class. They thought that the Travancore Forward Bank, if granted a “provisional” licence might, over a period of a few years, be able to write off the losses in its capital from its future profits. They were clearly not helpful, were concerned with maintaining their own superior position and had no clear idea of how the situation was to be met if the withdrawals continued beyond a month or two. The representatives of the other banks were, however, in favour of amalgamations among the local scheduled and non-scheduled banks. In particular, the representatives of the Kottayam Orient Bank conveyed the impression that they would not be able to stand the pressure of withdrawals beyond a month or so. The consensus of opinion amongst the bankers appeared to be that the existing small units might be constituted into four or five big banks each having deposits of say Rs 8–10 crores. The amalgamations, in their opinion, could be brought about only by compulsion in terms of the latest amendments to the Banking Companies Act and not on a voluntary basis because of the likely opposition from the shareholders to write off losses from the capital and reserves and difficulties of reaching agreement on selection of directors and chief executive officers for the reconstituted units. One of the difficulties in the way of amalgamations, according to them, was that the grouping of the staff of the award and non-award banks would result in a substantial increase in the establishment cost of the units formed by amalgamation. At present there are only a few banks in the State which are governed by the award, the rest being non-award banks. The establishment costs of the award banks were stated to be 20 to 25 per cent higher per employee than those of the non-award banks. In the opinion of the bankers the employees of the non-award banks might, if persuaded, be prepared for a “truce” in respect of maintaining their existing scales of remuneration since the choice before them would be total loss of employment in case of closure of banks or continuing on their existing scales of pay in the amalgamated banks for a few years.

3. We have given thought to the question as to what would be the most feasible course of action in relation to the five banks mentioned above. Indeed this is the most pressing aspect of the banking problem in Kerala the solution of which will brook no delay. In my view an institution formed by the amalgamation of these banks would be a jerry-built structure with all the weaknesses of the component units, e.g. relatively large depreciation in assets and irrecoverable advances, low standards of efficiency and integrity of the existing management and of the staff. I also envisage a perpetual
conflict among the directors drawn from banks having affiliations with different religious denominations or groups, unless they are all imbued with a common sense of purpose as also a responsibility towards the interests of the depositors.

4. I do not also consider that the merger of the above five banks with any of the big banks incorporated outside the State would be a success. The managements of the two scheduled banks concerned seem to be strongly individualistic and may not fully co-operate in such an idea. Nor have we much time to devote to long-drawn negotiations or persuasion. Moreover the big banks have at present offices only at the more important centres in the State and it is unlikely that they would be willing to penetrate as far deep into the interior as some of the local banks have done. Secondly, the big banks would presumably not be willing to make advances say, against real estate, hypothecation of merchandise or on personal security to the same extent as local banks are doing. Thirdly they would not be able to serve the small traders. I have heard here that some of the local banks would advance even to the extent of Rs 10, say, against gold ornaments. It may not, therefore, be realistic to try to merge these banks with big banks from outside.

5. I have said above that the problem of these banks is pressing and considering all relevant factors it seems to me that the most practicable line of approach would be to merge these five banks with the State Bank of Travancore. This proposal may be criticised on the ground that it in effect means nationalisation of the banks through the backdoor. It seems to me that such a criticism could be effectively answered. Whatever be the grounds against nationalisation as a matter of policy, I have no doubt that the State Bank of Travancore will have a very much bigger role to play in this State. This was also the view of the Chief Minister but of that anon. The mergers with the State Bank of Travancore are to be effected on pragmatic and not ideological grounds. They have to be effected because of the difficulties of constituting viable units by amalgamating weak institutions and the impracticability of mergers with private outside commercial banks. The State Bank of Travancore is to enter upon a programme of branch expansion in the State; it may, by taking over the banks, get readymade premises, trained staff and some business from the commencement at certain centres. The State Bank of Travancore may take over good or near good assets of the banks against assumption of an equal amount of liabilities. The assets taken over may be valued by the State Bank in consultation with the Reserve Bank. After this operation is done, the banks in the attenuated form may be taken into liquidation and the Official Liquidator may be charged with the duty of recovering those assets and distributing the recoveries pro rata among the depositors and, if anything was left, among the shareholders. The whole process will mean that while the good business is transferred to the banking system the bad business is entrusted to the agency best suited to handle it because of the special powers it possesses under the provisions of the Banking Companies Act. It will, of course, be necessary to strengthen the organisation of the Official Liquidator in Kerala for the purpose by the appointment of a Special Liquidator for banking companies only. The course suggested above will, no doubt, provoke widespread criticism from the shareholders and depositors. If, however, steps are taken to explain to the depositors that this was in their best interests and any other course would have meant more loss to them, they may be
made to see light. I suggest that, in case the above proposals are accepted, the Legal Division may draw up the necessary draft legislation for transmission to Government. The legislation should empower the State Bank of India and its subsidiaries to take over assets and liabilities of banking companies on a compulsory basis, on the basis of valuation to be done in consultation with the Reserve Bank. On taking over the business of the five banks, the State Bank of Travancore may have to maintain offices at many small centres where these banks have offices at present. The State Bank of Travancore would not have in the normal course opened offices at many of those centres. There would hardly be any justification for raising the emoluments of the staff at the small centres soon after the mergers. The feasibility of making a provision in the amending law that the scales of pay and allowances of the staff at those centres would continue for a period of 3–5 years would, therefore, require to be examined. Also there should be provisions in respect of transfer of staff on the same lines as in the State Bank of India (Subsidiary Banks) Act. As stated earlier, the bankers have stressed the necessity of urgent action so that the whole process is over before the end of December 1960 when their balance sheets are drawn.

6. I found the Chief Minister during the interview to be very helpful. His personal opinion, he said, was that at least so far as Kerala is concerned there was a good case for nationalisation of banks. He emphasised, however, that he was also aware of the views held in New Delhi and deferred to them. He, therefore, suggested that the State Bank of Travancore should step in in a large way to fill the void created by the failure of the Palai Central Bank. He said, his Government’s concern was that the banks in the State were managed by people of integrity and he did not seem to hold in very high esteem the local directorates concerned with the various banks. He also said that the special features of banking in Kerala State such as small borrowers, etc. will require special attention in the new set-ups. I informed him that I had found that the idea of amalgamation was generally favourably received here and the Reserve Bank will bear in mind the points suggested by him and would also wherever possible respect local sentiments etc. The Chief Minister expressed his willingness to suggest suitable names, if required by us, to form directorates of the new units.

7. I have said above that the amalgamation of the five banks will not brook any further delay. This, however, is only from the point of view of priorities. The entire banking structure in this area calls for immediate reconstruction and we will have to take it in hand at a very early date. For this purpose it seems that it would be better to divide the banks in this State into three areas, namely, Travancore Central, Trichur and Calicut. In this connection the note submitted by Gogtay will be useful as the basis for deciding the further course of action to be adopted. In the light of our discussions here we have however, reduced the number of the proposed units to seven (vide Statement IV). It also seems that so far as the Calicut area is concerned, it may be worth our while trying to persuade banks in the Mysore area, such as the Canara Bank, Canara Industrial & Banking Syndicate, etc. to extend their activities to this part. As regards other areas, if it is not possible to form local viable units, we may make an informal approach to banks in Madras, such as the Indian Bank, Indian Overseas Bank, etc., if they would be interested to come into this State. All these, however, are tentative
ideas and will require closer examination once the decision to bring about bigger units is taken.

[Statements I–IV are not reproduced here]

C.S. DIVEKAR
28/9/1960

**Banking Situation in Kerala**

Attached is a detailed note [pp. 1075–80] on the banking situation in Kerala after the appointment of a Provisional Liquidator for the Palai Central Bank. It is a summary of the previous note submitted after the last visit to Trivandrum in September and also embodies the conclusions reached after discussions with bankers from Trichur and Calicut areas during this trip.

2. There is at present a lull in the feeling of nervousness that had overtaken this State following the crisis. The calm, is however, only on the surface and some of the bankers are exploiting this false sense of security for their personal and political ends. The rest of India and the Reserve Bank in particular have come in as the most handy scapegoats.

3. I, therefore, feel that we have now done enough of the preliminaries and the time has come for action. No further discussions, therefore, need be held to ascertain the views of bankers on amalgamations, reconstructions or mergers. The depositing public, barring those that are swayed by communal considerations and the like, are now said to have become critical of bank managements and appreciative of the Reserve Bank’s action in the case of the Palai Central Bank.

4. If we decide to take action, we shall have to adopt a definite strategy to ensure that the changeover is brought about as smoothly as possible. To this end, I have embodied some suggestions in the note. We shall have to assure the general public, the business community and the depositors that the new set-up of banks is going to be to their advantage, that banking facilities will thereby not be curtailed and may indeed grow, so that trade, commerce and industry are in no way adversely affected and the interests of the depositors if anything will be better safeguarded. We should also reduce to the minimum any possible impact of increased unemployment following the mergers.

5. There are some trouble-spots in the State with which we will have to deal both with firmness and understanding. In Trivandrum area, the Travancore Forward Bank and the Kottayam Orient Bank are said to be powerful elements with tendencies for mischief. Both, however, at present are in a bad way and, therefore, in a less recalcitrant mood. We should take immediate advantage of the situation and merge or reconstruct them with other banks. Of these, the Travancore Forward Bank is bigger and, I understand, willing to merge with the State Bank of Travancore. It is also an award bank and from that point of view, such a merger has much to recommend. Regarding the Kottayam Orient Bank, we will have to scale down their obligations and bring about a merger with some other units in the area. Proposals on these lines are contained in the note. Simultaneously we should reduce the emoluments of the higher executives of this unit and also move their headquarters to Trivandrum—away from Kottayam which is said to be a hot-bed of intrigue.
6. In the Trichur area, two units are likely to prove most troublesome, both unlicensed. They control the Chamber of Commerce as well as the Bankers' Association and are very powerful. They also seem to have an innate tendency to misinterpret and misconstrue others' intentions and actions. They will not accept any reform willingly and cooperatively and indeed can be depended upon to put obstacles in the way elsewhere. We shall, therefore, have to deal with them firmly, if necessary even changing their executives. Of the remaining banks, the Nayar group has expressed a desire to merge together, as also the other group managed by people from Palghat. In Calicut area the problem is simple.

7. We should also, to kill in the bud any possible charge of discrimination, first effect a few mergers in other States—we have already in hand one in Madras and are contemplating another in Bombay. It would be good if we bring a few units together both in Delhi and Calcutta also simultaneously.

C.S. D[IVEKAR]
16-10-1960

After the above note was finalised I went to meet the Chief Minister, the Deputy Chief Minister and the Finance Minister. The proposal made above that the time had come for us to take action found support from them, particularly from the Deputy Chief Minister, Shri Chacko, which in itself is an important fact. According to the Ministers the Reserve Bank should not now hesitate to proceed with the schemes of amalgamation bearing in mind the special features of the Kerala State. Shri Chacko said that he was of the opinion that the banks wanted to make a show of unwillingness or even of resistance so that later on they would be in a position to disown any responsibility for agreeing to the mergers.

A separate note on the discussions is being put up.

C.S. D[IVEKAR]
18.10.1960

Summary of discussions with the Chief Minister of Kerala

In Trivandrum I received a message that the Chief Minister desired to see me at 8.30 P.M. on Sunday the 16th instant. In confirmation a letter was received saying that the Deputy Chief Minister and the Finance Minister would also be present at the meeting. Accordingly I met the Ministers at the appointed time. The Ministers desired to have an idea of our assessment of the banking situation in Kerala following the closure of the Palai Central Bank. A reference was also made by them regarding the feasibility of the schemes of reconstruction submitted to the High Court.

2. I gave them a broad idea of our assessment of the banking situation in the State and the reactions of the bankers whom I had met in regard to the question of amalgamations, on the lines indicated in the note submitted separately. On behalf of the State Government it was stated that, in their opinion, it would be necessary to use compulsion in bringing about amalgamations. They indicated that some of the bankers might make a show of resistance before accepting amalgamations. They emphasised that, in effecting amalgamations, it was necessary to ensure that there was no curtailment of
banking facilities in any centre, howsoever small, and that the existing practices of the local banks of making advances for relatively small amounts against gold ornaments, landed property, etc. and for purposes of kuri business were continued. In other words, it was necessary to ensure that trade, commerce or industry in the State did not suffer as a result of the mergers. Another factor necessary to take care of was that unemployment was avoided. The units formed should be of an appropriate size—none too big—having regard to the existing pattern of growth of banking in the State. The Ministers also hoped that scaling down of deposits would be necessary only in a few cases so that there would not be much opposition from the depositors. Also action should be taken as early as possible.

3. The Chief Minister also desired to have an idea of the Reserve Bank’s reactions regarding the feasibility of the schemes of reconstruction filed in the High Court. I said that the Reserve Bank was always prepared to consider any schemes of reconstruction which were workable and were in the best interests of the depositors. The schemes submitted to the High Court were being examined and our views would be placed before the High Court on the 30th. Prima facie, however, the schemes appeared overoptimistic. I also mentioned that if the bank was revived on the basis of a substantial reduction in deposits, there was the risk of the depositors withdrawing their deposits soon after reformation. Thus, the reconstruction would, for all practical purposes, mean a voluntary liquidation. The Chief Minister agreed and observed that if the bank was reconstructed, say, on the basis of a payment of 50% of deposits, the depositors would most probably withdraw their deposits. The Deputy Chief Minister and the Finance Minister said that even on the basis of a payment of 60%, the position would be no better. The Chief Minister said that, if on examination, the schemes were not found feasible, the process of liquidation should be expedited by the appointment of someone who had banking experience and preferably also experience of liquidations. He said that the Court would certainly agree to the staff of the liquidator’s office being strengthened on request.

4. The Ministers also expressed the desire that Kerala Government be consulted or kept informed of any action proposed to be taken by us in regard to amalgamations of Banks.

C. S. D[ivekar]
18-10-1960

Governor

I think this note is a very useful one.

I suggest ED (Divekar) should have immediate discussion with Shri Bhattacharyya regarding the State Bank of Travancore taking over the Travancore Forward Bank. The deposits of this Bank are intact, so the question of putting bad, doubtful and sticky advances does not arise except perhaps in a very marginal way. Therefore no legislation will be necessary except perhaps bringing in State Bank within the purview of the recent legislation.

In the meanwhile I would like to forward a copy of the note to Finance Minister. Please let me have a draft on the lines suggested.

H.V.R.
20/10
Dear Shri Morarji Desai,

Banking Situation in Kerala

Soon after the passing of the Banking Companies (Second Amendment) Act, 1960, which gives wide powers to the Reserve Bank to prepare schemes for the reconstruction and amalgamation of banking companies, I deputed C.S. Divekar, Executive Director, to Kerala to study the local banking situation first-hand and formulate proposals for strengthening the banking structure. During his visit to Kerala, Divekar held discussions with the representatives of as many as 41 out of a total of 101 banks incorporated and functioning in the State. I enclose a copy of the report prepared by him on the 'Banking Situation in Kerala and the suggestions for meeting it', together with a copy of the relative covering note. He also met the Chief Minister of Kerala and a summary of his discussions with him is attached [for enclosures, see pp. 1075–82].

2. As a result of the discussions, Divekar has formulated certain proposals for amalgamations and mergers amongst banks in Kerala. We will pursue these proposals with the banks concerned and with Government in due course. The general sentiment in the State is in favour of amalgamations and mergers although a few of the bankers remain opposed to them. This section is very vocal, owns newspapers and has its representatives in the Central and the Local Legislature. The Ministers whom Divekar met are, however, strongly in favour of bank mergers and expressed a desire to be kept informed of the action proposed to be taken by us.

3. As will be seen from paragraph 6, page 12 of the report, the time has now come for urgent action to be taken in respect of the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India and the Seasia Midland Bank. It is proposed to constitute the last three banks into one unit, possibly with the addition of another small bank viz. the Venadu Bank. As regards the Travancore Forward Bank, which has lost deposits of over Rs 2.30 crores according to the latest available figures as on the 12th October 1960 and is still losing deposits, it seems that the most feasible course would be to ask the State Bank of Travancore to take over this bank. We are taking up the matter immediately with the Chairman of the State Bank and will let you know the result of our discussions at an early date.

4. The situation in Kerala requires urgent action in respect of some banks. Indeed, banks like the Travancore Forward Bank and the Kottayam Orient Bank are afraid to publish their latest statements of position which would show a heavy fall in their deposits and have urged the necessity for taking action before the 31st December 1960. While we are proceeding on the basis of the provisions of the Banking Companies (Second Amendment) Act, 1960 in formulating schemes of amalgamation, our detailed examination of the new provisions vis-a-vis the proposed schemes have revealed the necessity for certain further amendments to the Banking Companies Act. We are writing separately to Mathrani about this.

Yours sincerely,

H.V.R. INGAR
I paid a short visit to Kerala early last week. The visit was primarily to discuss with Shri K. M. Cherian the future of the Travancore Forward Bank about which there has been some correspondence with him. The Chairman of the State Bank of India, who was also at Trivandrum at that time, suggested that a meeting with Shri Cherian would be useful. The Chairman and I met Shri Cherian on the 29th November and had a long talk with him. Shri Cherian repeated the points he had already made in communications to us and the State Bank of India that the Travancore Forward Bank had turned the corner now and should be left alone. He appears to have received some encouragement for this position from the Joint Managing Director of the State Bank of India and possibly also Shri Vedamuthu. Both Shri Bhattacharyya and I pointed out that we could not agree that the bank was viable unless it could repay the amount outstanding from the Reserve Bank and there was some reasonable assurance that the bank could run with its reduced resources without erosion of deposits. The position at the moment was that the whole of the reserves and nearly the whole of the capital had been eaten up; the deposits still appeared to be intact. The bank had lost deposits of over Rs 2 crores and although the rapid outflow has considerably diminished, deposits have not started coming back and our feeling was that this was unlikely to happen for quite some time. In the larger interests of depositors we both thought that this was the appropriate time when the deposits were intact for a merger with the State Bank of Travancore.

2. Shri Cherian did not agree with this and talked of the adverse effect on the banking situation generally in Kerala if a moratorium is declared for a bank of this size. He said that there were many difficulties in his way but he hoped that with reasonable time he would be able to tide over them. So far as the merger with the State Bank of Travancore was concerned, the Chairman pointed out that the decision would be ultimately for the Reserve Bank to take but if at the time of the merger deposits still continued to be intact it would be possible to arrange for a voluntary merger without the inconvenience and psychological impact of a moratorium. But even if the bank's deposits at the moment were still intact the Reserve Bank will have to take a view of the immediate future and satisfy itself that the bank would be in a position to make enough profits and continue to function without any erosion of deposits. It was suggested that the appropriate course would be to get an agreed estimate of both the positions, the position at the present moment and the position as it is likely to be at the end of, say, six months or one year. This could be done quite informally by an officer each from the State Bank of Travancore, the Travancore Forward Bank and the Reserve Bank making the first assessment and an officer from the Reserve Bank and the Travancore Forward Bank making the second assessment. The second assessment would be on the basis that deposits would remain more or less at the present level and advances would have to be recalled and adjusted to enable the Travancore Forward Bank to pay the outstanding advances to the Reserve Bank and keep a sufficiently liquid position. After a considerable amount of hesitation Shri Cherian said that personally he saw no objection to our proposal but that he would informally consult his colleagues on the Board. Later, he sent a communication indicating that the proposal for the association of an Officer of the State Bank of
Travancore was not acceptable at present but that he would have no objection to the officer of the Reserve Bank conducting the scrutiny in regard to the future prospects of the bank on the lines suggested by us. The Chairman of the State Bank and I felt that while leaving the assessment of the present position for further discussion we should immediately accept the offer for an inspection by the Reserve Bank in regard to the future so that we could have some data on which we could take a final decision. Necessary instructions have been issued to our Deputy Chief Officer at Trivandrum.

3. The Chairman and I also took the opportunity of our visit to Kerala to meet the Chief Minister and the Finance Minister on the following day. Some pressure is being built up in Kerala against the merger of the Travancore Forward Bank with the State Bank of India. There is also considerable uneasiness, some of it artificially created, against any scheme for amalgamation of the smaller banks in the State. There is also agitation against any declaration of moratoria as it is alleged that this shakes the confidence in banking and might lead to runs on the sound banks as well. All these points were stressed to us in some detail by both the Chief Minister and the Finance Minister. We pointed out that ultimately the Reserve Bank has to take a view whether a bank already in difficulties or a damaged position could survive and there was no point in indefinitely keeping a bank which has already eaten up part of its deposits unless the position could ultimately be reversed in a reasonable period of time. We also explained that while voluntary mergers were possible when the deposits were intact without declaration of a moratorium, a moratorium will be necessary when the banks which have to be amalgamated have eroded the deposits, to facilitate the reconstruction of these banks before an amalgamation. We made it clear that it is not our intention to declare moratoria on a wide scale in a particular area in view of its damaging effect on confidence. It was the intention of the Reserve Bank to go about it reasonably slowly and arrange for amalgamations and mergers in an orderly way. We were heard quite patiently by both the Ministers but both of them again and again came back to the point that it may be best in all the circumstances to leave the situation as it is with the vigilance of the Reserve Bank securing that things do not go wrong any further. This attitude creates a somewhat difficult situation which would require careful handling.

For information.

M.V. Rangachari
5.12.1960

Governor—I would like to discuss this with D.G., E.D. & C.O.

H.V.R.
8/12

Discussed on 10.12.60. It was decided that the Travancore Forward Bank be left alone for the time being, but that we should go ahead with the proposed amalgamation of the Kottayam Orient Bank Ltd. with three other banks. As regards the general policy governing amalgamations, this has been dealt with
My dear Iengar,

I hope you had a pleasant journey to Cairo and I am looking forward to meeting you in Calcutta on the 19th when we can, as usual, exchange thoughts on various matters. I thought, however, of writing to you in between partly to bring you up-to-date on recent developments as we see them and partly to seek information on one or two points which are rather urgent.

2. The state of our Sterling balances continues to cause anxiety. Between October and December, we have continued to lose Sterling. The only improvement which we have had is due to the German credit and even this credit was offset partly by a deficit which we had on the rest of our payments during the week.

3. It seems to me that it would be worthwhile making a comparative study between the figures for October and November 1960 and the corresponding months in the two previous years. Is the unfavourable trend due to a failure of exports, or an upsurge in imports, or mainly on invisible account, or a combination of all three? Whatever may be the answer, it could usefully be analysed in some detail. If exports have declined, then we ought to know what are the main commodities involved. If imports have gone up, then we ought to know whether the increase is on account of pure maintenance, or on account of developmental imports which do not however, get identified as projects, e.g., components, or raw materials for the domestic production of capital goods, or of direct developmental expenditure abroad. Finally, on invisibles it would be worth examining to what extent we have been making increased payments for past debts, and to what extent other factors are operative. It seems to me that the Reserve Bank would be in the best position to undertake such a study and you might wish to initiate it.

4. The next point relates to credit policy. Yesterday quite a few questions were asked on the subject in the Informal Consultative Committee of the Parliament. You might have seen some reports in the Press on the subject. It is unfortunate that these discussions which are supposed to be confidential should leak out—in spite of the fact that I had intervened in the discussion to point out how unfortunate it would be if those present drew inferences from what was said in the meeting and the Press had access to such impressions. The main points which the Minister made at the meeting were that he stoutly denied that there were any differences of opinion or outlook on the subject of credit control and fiscal measures between the Government and the Reserve Bank. He further stated that all the steps taken by the Reserve Bank had the
fullest support of Government, that these measures were not intended to make money unavailable for productive purposes and the prime objective was to hit at speculation and hoarding. He then went on to say that on the question of dear money, there were two schools of thought. Some people outside India were strongly pressing for raising of interest rates. In Indian conditions, there were good reasons to depart from orthodoxy in this matter and selective controls as distinct from a general credit squeeze had much to commend themselves. At this point a member asked whether F.M. was against a dear money policy. F.M. replied that no such inference could be drawn from the exposition which he had given of the pros and cons of the situation. This incidentally was the point when I intervened in the sense indicated above.

5. There was a good deal of discussion on the banking system. Some members observed that they were aware of cases where under the Reserve Bank’s directive, banks had declined or cancelled credits which were for purely productive purposes. F.M. pointed out that the instructions on this subject had naturally to be in general terms and individual banks could on occasion interpret them in a manner which might not be wholly consistent with the objectives underlying the Reserve Bank’s instructions. When such a thing did happen, the matter could be brought to the notice of the Reserve Bank or the Government when it could be further considered whether in view of the facts of the case any change in the instructions to the banks either in general terms or in relation to the particular case was called for.

6. The discussion on the banking system once again displayed the familiar confusion on the subject of scheduled banks, licensed banks and unlicensed banks. F.M. explained the position in some detail. The main burden of the thoughts voiced by the M.P.’s was that the process of getting banks either licensed or, in cases where this was not possible, refusing them licences, should be greatly speeded up. A reference was made to the question of amalgamation. F.M. said that the task of the Government and the Reserve Bank would be greatly facilitated if the banks concerned themselves came forward with concrete proposals rather than leave it entirely to the Reserve Bank to bring about such amalgamations. About Kerala banks, many members spoke. In fact, only a day earlier, a special delegation had come out from Kerala to represent to F.M. that confidence in banks there was greatly shaken and something should be done urgently. F.M. told them, and rather firmly, that this constant talk of confidence having been shaken which responsible people indulged in, was itself contributing to the lack of confidence.

7. F.M. promised at the end of the Consultative Committee meeting to make an interim report on the steps which are being taken to strengthen the banking system and the progress achieved. This meeting is due on the 13th at 2.30 p.m. F.M. has asked me to write to you and I request you to let him have a report on the subject. Obviously, it will not be possible for F.M.—particularly in view of the leak in the Press—to take the Consultative Committee into confidence regarding any details of the operation or about the position of individual banks. It would, however, be most helpful if at this stage you were to get a note prepared and sent which would deal with the progress which has been made and perhaps also the problems which have to be resolved. In particular, is it at all possible to foresee the period of time over which the programme of amalgamations can be finalised?

8. A reference was made also to the Deposit Insurance Scheme. F.M. pointed out that
the Deposit Insurance Scheme would anyhow cover only small sums of money and could not cover the entire deposits of all banks. The timing for introducing such a scheme was an important matter for consideration. If the scheme was launched at a time when there were a large number of banks in a somewhat unhealthy state, there was some danger that the very existence of the scheme might precipitate a crisis. Also, in such a situation, the burden on the better banks would be greater. On the other hand, if the process of strengthening the banking system was carried yet another step or two, then the insurance scheme could well mean a great deal of added strength to the banking system as a whole. The whole scheme, however, was being examined by the Reserve Bank.

9. I am afraid this letter has turned out to be longer than I intended. The main points for action are the suggested comparative study of our balance of payments trends in recent months and secondly, a report on the steps being taken in regard to the strengthening of the banking system and the amalgamation of the smaller banks.

Yours sincerely,
L.K. JHA

Shri H.V.R. Iengar
Governor
Reserve Bank of India
Bombay

My dear Deva Rao,

Amalgamation/reconstruction of banks in Kerala under section 45 of the Banking Companies Act, 1949

Please refer to your D.O. letter No. [...] dated the 27th November 1960. The tentative suggestions for the reconstruction or amalgamation of banks in this area contained in the note enclosed with your letter have been examined by us in the light of the criteria set out therein, and a note embodying our comments is enclosed. Suitable comments have been given in cases where we have suggested any readjustment in the groups suggested by Central Office. A statement showing the revised groupings suggested by us is given in the Appendix to the note. Particulars relating to the banks in each of these groups, in the prescribed forms, are also enclosed.

2. The questions whether all the banks in a particular group should be amalgamated at one stroke and whether the amalgamations should be under section 45 or section 44A(1) of the Banking Companies Act, 1949, require very careful consideration.
We are of the definite opinion that the simultaneous grant of moratorium to a number of banks is likely to lead to avoidable inconvenience to the public and cause panic as in the case of the Travancore Forward Bank, the Kottayam Orient Bank and the Bank of New India (on account of rumours to that effect). The crisis caused by the liquidation of the Palai Central Bank Ltd. was in a way unavoidable when the decision to wind it up was taken. The same cannot be said about schemes of amalgamation and reconstruction which can be put through when the time is most suitable for them. There can be no two opinions on the point that there are far too many weak and inefficient units in Kerala and that the banking structure requires to be strengthened. The question, however, is one of timing and of procedure. Section 45 should, in our opinion, be regarded as an emergency provision to be used in cases where other means are not available. It may, for instance, be used in the case of banks whose position is irretrievable and is already known to the public. It may also be used in cases where deposits are fast dwindling and where there is no alternative to the grant of a moratorium in order to ensure, as far as possible, equal treatment to the depositors. In other cases, amalgamations should be under section 44A(1) of the Banking Companies Act, 1949, but under pressure from us. Most of the banks in Kerala are no doubt small in size, but with the exception of a dozen banks (vide Annexure I), they cannot be classified as banks whose position is irretrievable or which are experiencing any panicky withdrawals. We do not, therefore, think that section 45 should be invoked in all cases. Most of the amalgamations could be brought about under section 44A(1). A possible objection to the use of section 44A(1) may be that the interval between the publication of the scheme and its eventual sanction may be utilised by the public to withdraw their deposits. Past experience does not suggest this, and even if this happens, we can immediately invoke section 45. We, therefore, feel that the proper course would be to bring about amalgamations, as far as possible, under section 44A(1), but the initiative should be taken by us. We should call the representatives of the concerned banks (i.e. banks in the group finally decided upon) together and explain to them the lines on which the scheme should be drawn up. If they take up an unreasonable attitude, section 45 can be invoked. Even when this is done, it would be desirable to make the period of moratorium as short as possible.

3. Even if it is considered appropriate to use section 45 in preference to section 44A(1), we feel that the amalgamation of banks in a particular group should not be brought about at one stroke as considerable administrative difficulties may be experienced by the banks in bringing about the amalgamation. It would be better to take the banks one by one (or at the most two banks in a group at a time) and bring about the amalgamation by stages. It would also be desirable to issue a press note to ensure, to the extent it is possible, that the grant of moratorium does not cause a panic.

4. On the question of priority, we are inclined to the view that those banks whose position is not likely to improve even if they are given some time should be taken up first. This view is based on what has already been done in the case of banks in other areas, viz., the Indo-Commercial Bank, the New Citizen Bank, the Bank of Nagpur and the Prabhat Bank. On this basis, the order of priority, so far as individual banks
are concerned, would be as follows:
(i) Cochin Nayar Bank Ltd., Trichur
(ii) Catholic Bank of India Ltd., Changanacherry
(iii) Suburban Bank (Private) Ltd., Trichur
(iv) Anthraper Bank (Private) Ltd., Shertallay
(v) Cochin Commercial Bank Ltd., Cochin
(vi) Latin Christian Bank Ltd., Ernakulam
(vii) South Travancore Bank Ltd., Neyyoor
These banks are in different groups and it would be preferable to announce their amalgamation at a suitable interval of, say, two or three weeks. After effecting the amalgamation of these banks, we may take up the others. The minimum amount of paid-up capital and reserves required for a unit bank is Rs 0.50 lakh, and on the basis of a proportion of 1 to 10 between paid-up capital and reserves and deposits, we may consider banks having deposits below Rs 5 lakhs as those which are not likely to be able to work on a profitable basis. There are 36 banks in this category (vide Annexure II). The order of priority among these 36 banks may be decided, in the main, on the basis of their financial position, those whose position is comparatively worse being taken up first. In this case also, the procedure should be gradual as suggested in paragraph 3 above.

5. After the elimination of these small units, the question of amalgamating the remaining banks may be taken up. A statement showing the residual banks in each group is given in Annexure III. These banks have deposits of over Rs 5 lakhs each. In their case also, the procedure adopted for the amalgamation of the smaller banks may be followed, i.e., moratorium for only one or two banks at a time may be granted and the cases of comparatively better banks may be taken up later.

6. Please acknowledge receipt.

Yours sincerely,

[M.L. GOGTAY]

Shri K. Deva Rao
Deputy Chief Officer
Department of Banking Operations
Reserve Bank of India
Central Office
Bombay

[16-12-1960]

CONFIDENTIAL

The Chief Minister of Kerala, Shri Thanu Pillai, telephoned to me yesterday at 6 p.m. to say that he had been informed by his “banker friends” that a serious crisis had developed in the affairs of the Travancore Forward Bank and of two or three other banks, including the Kottayam Orient Bank. According to the information that he had received, the situation was so serious that an immediate moratorium was called for. The Chief Minister suggested that a moratorium should be declared immediately and also that the Reserve Bank should undertake a scheme of amalgamation and complete the process, if possible, in 4 or 5 days.
I told the Chief Minister that we have been placed in an impossible position by the Travancore Forward Bank. It had been our view that this bank should be merged with the State Bank of Travancore and this view had at one stage been concurred by the Chairman himself. Subsequently he went completely back on this proposal and wrote to us a letter making the most extravagant remarks about the soundness of the bank and its profitability, and now suddenly he has taken the view that there was a crisis. I told the Chief Minister that the deciding authority was the Government of India and that we can only make a recommendation to them. As regards the question of completing the scheme of amalgamation in a period of 4 or 5 days, I told him this was completely out of the question. A certain procedure had been laid down in the Act and this procedure will necessarily involve consultations with the institutions concerned, consideration of various matters in the Reserve Bank and subsequently also in the Government of India. I told him that I had received panicky messages but the facts were not clear to me and, therefore, I had asked the Executive Director, Shri Divekar, to fly to Travancore and let me have a report. Shri Divekar would be arriving in Travancore this morning and will be seeing the Chief Minister.

It is quite clear that the Chief Minister is not fully aware either of the legal position or even of the actual facts of the situation in Kerala. The Ministers themselves have been subject to as many swings of opinion as the banking community in Kerala. However, while this merely adds to our difficulty, it is clear that we have to take a decision on the best judgement that we ourselves can make.

I informed Shri Rangachari last night about my conversation with the Chief Minister and asked that the Government of India should be informed that we may have to call upon them to issue an order of moratorium at immediate notice. He told me he would take necessary steps for this purpose.

H.V.R.
16.12.1960

CONFIDENTIAL

E.D.(D) telephoned me yesterday and today regarding the banking situation in Kerala. I had requested the Private Secretary to the Governor to convey to him the gist of the message I had received from E.D.(D) yesterday. E.D.(D) would be speaking to the Governor today over the trunk telephone between 8 P.M. and 9 P.M. after a meeting with the Chief Minister of Kerala which is scheduled for 7 P.M. A summary of messages received from E.D.(D) indicating the reaction in Kerala of the recent moratorium granted to the Travancore Forward Bank and four other banks is given below.

2. Contrary to the expectations of some Jeremiahs, there has not been any sudden run on banks in Kerala as a result of the announcement regarding the grant of moratorium to the five banks. According to information available to E.D.(D), the only bank where there was a rush of withdrawals was the Cochin Nayar Bank Ltd., a bank whose financial position is not satisfactory and whose deposits have been eroded to a certain extent. The South Indian Bank, the only licensed scheduled bank in Kerala (apart from the State Bank of Travancore) was, however, reported to be feeding its branches with cash in anticipation of withdrawals. The Malayalam papers were stated to have
1092 DOCUMENTS

come out with leading articles saying that there was no cause for panic and that the moratorium had been granted in order to strengthen the banking system of the State. 3. E.D. also informed me today that he had personally visited the banking area in Trivandrum and did not see any sign of panicky withdrawals. There is, however, reported to be a general feeling that the period of moratorium is too long. There is also an undercurrent of nervousness amongst certain bankers who feel that holders of fixed deposits would withdraw them on maturity. E.D. further apprehends that when copies of the moratorium order are exhibited in each and every branch of the banks concerned, there may be some adverse reaction in the next few days and depositors might tend to withdraw their funds to the extent permissible.

4. Copies of the newspaper cuttings on the subject are also sent herewith.

Id/-
21.12.1960

Governor Id/- 23-12-1960

Record of talk with the Chief Minister and the Finance Secretary to the Government of Kerala on the position of banks in the Trichur area

Shri P.S. Padmanabhan, Finance Secretary to the Government of Kerala, rang me up at 8 O’clock this morning and informed me that Shri R. Shankar, the Deputy Chief Minister, who is also the Finance Minister, had received reports that the banks in the Trichur area were experiencing a heavy run and that the Trichur Agent of the State Bank of India had refused to grant accommodation against Government securities when he was approached by these banks, the Catholic Syrian Bank Ltd. being one of them. I informed Shri Padmanabhan that according to my information, which was based on the reports of one of our officers at Trichur and those of Shri M.V. John, General Manager of the South Indian Bank Ltd. (a licensed Scheduled bank), the situation in Trichur was more or less normal. Only the Kottapadi Bank (Private) Ltd., which is a small non-scheduled bank at Kottapadi which is about 20 or 25 miles away from Trichur, was in some difficulty. I, however, informed him that I would make enquiries from the Trichur Agent of the State Bank of India and also find out from the General Manager of the Catholic Syrian Bank Ltd. whether he had approached the State Bank of India for financial accommodation against Government securities and whether the State Bank of India had refused to grant such accommodation.

2. Within a few minutes, I also got a telephone call from the Chief Minister of Kerala State. He repeated what Shri Padmanabhan had stated and said that as a result of the action taken by the Reserve Bank of India against banks in Kerala, trade and industry was being brought to a standstill and that if the State Government had earlier visualised such a situation, it would not have minded spending a crore or two so as to obviate the need for a moratorium for Kerala banks and thus ensure that the trade and industry of Kerala did not suffer. He also said that, if necessary, he would speak to the Governor of the Reserve Bank to acquaint him with the situation and request him to devise suitable remedial measures. I informed the Chief Minister on the lines of what I had stated to Shri Padmanabhan and also promised him to find out immediately from the Catholic Syrian Bank Ltd. whether they had been refused financial
accommodation and also from the Agent of the State Bank of India at Trichur whether any
banks had approached him and whether he had refused financial assistance against
Government securities.
3. I immediately got into touch with the General Manager of the Catholic Syrian
Bank Ltd., Shri K.T. Varghese. He informed me that the situation in Trichur was
more or less normal. Some of the smaller banks had withdrawn their balances from
the bigger banks in order to improve their liquid position so as to be able to meet any
demands that may be made on them. But for this, the situation was normal. He said
that his bank had ample cash and that he did not foresee any difficulty in meeting the
demands that may be made on the bank. He, however, stated that there was a rumour
in Trichur that the Indian Bank Ltd., Madras, and the South Indian Bank Ltd., Trichur,
were to be placed under moratorium and that some 15 other banks were going to be
placed under moratorium. When I asked him who the author of the rumour was, he
said that Shri Manavalan, the Secretary of the Trichur Chamber of Commerce, might
have made some reports to the Finance Minister. I, therefore, requested him to ask
Shri Manavalan to speak to me on the telephone.
4. Shri Manavalan told me that when the banks in Trichur had approached the State
Bank of India for accommodation against Government securities, the latter had insisted
on a Board resolution, Memorandum and Articles of Association, etc. and was not
giving accommodation promptly. I informed Shri Manavalan that these were normal
formalities which would have to be complied with by any joint stock concern and if
the banks were not prepared to comply even with these formalities, they were
themselves to blame. I also asked him whether he could give me any specific instances
where banks had approached the State Bank of India and had been refused assistance.
He said that he had none to give. I, therefore, told him that it was no use making
vague generalisations and that the Reserve Bank could not investigate any complaint
unless concrete instances had been furnished to it. I also told him that the Chamber
should play a helpful role and not create difficulties by spreading baseless rumours
and engendering a sense of panic. Shri Manavalan then said that the rumours are
probably being spread by the Communist Party and that the Chamber of Commerce
did not want to create any difficulties or cause panic. I thereafter told him that if any
bank was in difficulty, the proper course for it was to approach me so that I could see
what could be done in a particular case.
5. In the meanwhile, Shri K. Raman Nambiar, the local Agent of the State Bank of
India, had got in touch with his counterpart at Trichur and he informed me that the
allegation against the Trichur Agent was altogether baseless. The Catholic Syrian
Bank Ltd. had lodged some bonds with him and he had sent them to the Public Debt
Office of the Reserve Bank at Madras for the usual examination and had informed the
bank that if in the meanwhile it needed any accommodation, he would be prepared to
grant it. The same procedure was being adopted in the case of those banks which had
approached him.
6. Having thus satisfied myself that there was no truth in the reports received by the
Finance Minister, I spoke to the Chief Minister and gave him all the information
which I had been able to collect. He seemed satisfied and said that in view of what I
had stated, it was not necessary for him to trouble the Governor of the Reserve Bank.
He said that he was himself going to Trichur and would be able to find out the position. I requested him that in case anybody complained to him, it would be better to get concrete instances so that the Reserve Bank could look into them. It was difficult for the Reserve Bank to make an investigation on the basis of vague generalisations. The Chief Minister is expected to return to Trivandrum on the 29th December 1960.

7. The information collected by me was also conveyed to Shri Padmanabhan who said that he would pass it on to the Deputy Chief Minister.

8. The gist of this was conveyed by me to Shri C.S. Divekar over the telephone on Sunday afternoon. As desired by him, I shall try to get in touch with the Deputy Chief Minister and find out from him the sources which have complained to him. A further report will be made after I have spoken to him.

M.L. GoTAY
25/12/1960

BANK FINANCE FOR PLANTATION INDUSTRY IN KERALA

I was asked to make on-the-spot enquiries at Kottayam regarding the extent to which the plantation industry, particularly the rubber and pepper industry in Kerala has suffered in the matter of obtaining bank finance on account of the grant of moratorium to some banks in Kerala. Besides obtaining certain information from the Kottayam Orient Bank, the Travancore Forward Bank and the Chairman of the Seasia Midland Bank, who is residing at Kottayam, I also interviewed the Chairman of the Rubber Board, the Secretary of the Association of Planters of Kerala and Agents of certain other comparatively large-sized banks having branches in Kottayam. It may be stated that while rubber and tea crops are grown on a plantation scale, pepper is generally grown in compounds of houses. In some cases rubber is also grown on a small-scale basis.

(i) Kottayam Orient Bank Ltd.

In the analysis of advances as on the 17th December 1960 furnished by the Bank at the time of the last inspection, the advances secured by the hypothecation of crops have been shown at Rs 18.45 lakhs. The Head Office of the bank has not consolidated the figures regarding advances made on the security of tea, pepper, rubber and rubber products given by the branches in the individual statements in Form No. 7 submitted by them directly to our Department of Research and Statistics at Bombay. The Kottayam Orient Bank Ltd. has furnished me with a long list of advances to planters at its various branches; the total of such advances as on the 17th December 1960 amounted to Rs 31.20 lakhs (vide Annexure I). Another list of advances aggregating Rs 5.49 lakhs granted to dealers in plantation products was also furnished (vide Annexure II). The various types of deposits kept with the bank by the planters are shown in a separate list (not enclosed). It is seen therefrom that the current account deposits as on the 17th December 1960 amounted to Rs 2.07 lakhs. It was stated by Sarvashri Mathew and Iype, the senior executives of the bank, that the main difficulty experienced by the planters and the dealers in plantation products is the absence of
banking facilities at the various plantation centres where the Travancore Forward Bank Ltd., Kottayam Orient Bank Ltd. and, to a lesser extent, the Bank of New India Ltd., were functioning. The only other local banks which have offices in the plantation area are the Chalapuram Bank Ltd. the Perumbavur Bank Ltd. and the Federal Bank Ltd. and these have branches only in a few places. There is, therefore difficulty in purchase and collection of cheques and bills, remittance of funds and retirement of bills.

(ii) **Travancore Forward Bank Ltd.**

Shri M.M. Mathew, the Deputy Secretary of the Travancore Forward Bank Ltd., agreed with the views that the temporary cessation of banking facilities at the interior centres has been the cause of the difficulties of the planters in their day-to-day operations. He also mentioned that the Travancore Forward Bank Ltd. was extending direct credit facilities to the planters on a smaller scale, while indirect facilities extended by it by purchase of cheques, etc. were considerably large. He estimated that the total facilities extended by the bank amounted to about Rs 50 lakhs. Although the limits sanctioned to the borrowers were substantially reduced in many cases during the period of large-scale withdrawals of deposits the facilities extended by the bank to planters and dealers in plantation products may now amount to Rs 30 lakhs. A list of advances granted to planters and dealers showing the balance in the accounts as on the 17th December 1960 furnished to me indicates the aggregate advances at Rs 29.21 lakhs (vide Annexure III). It was stated that it was not possible for the Head Office to furnish a statement showing the current deposits in the names of planters. It is, therefore, not possible to say to what extent those who had deposits with the bank have been inconvenienced as a result of the inability to use their own money kept with the bank as deposits.

(iii) **Seasia Midland Bank Ltd.**

The bank has its Head Office at Alleppey but the Chairman resides in Kottayam. He informed me that the bank is not directly accommodating the planters but some bills purchase limits have been fixed for dealers in plantation products at the Kottayam and Kothamangalam branches. The extent of these facilities is stated to be within Rs 1 lakh.

(iv) **Discussion with the Chairman of the Rubber Board**

During the course of discussion, the Chairman of the Rubber Board, Shri K. B. Warrier, mentioned that he had received a number of complaints from planters, especially small holders as also from the dealers in plantation products that they are experiencing difficulties in the day-to-day operations on account of the moratorium granted to the banks in Kottayam which had a network of branches in or near about the plantation areas. The Rubber Board is stated to be experiencing difficulty in realising the cess from the rubber growers. The rubber planters are stated to have been handicapped in implementing the expansion programme. The Chairman stated that he had already discussed the matter with the Managing Director of the Kerala State Financial Corporation so that the question of extending facilities to rubber growers for planting new areas may be considered by that agency.
(v) Discussion with the Secretary of the Association of Planters of Kerala

I contacted Shri O.C. Mathew, the Secretary of the Association of Planters of Kerala, and enquired whether he had received any complaints that the planters are handicapped on account of the moratorium granted to a few banks. He stated that he has received some complaints that the want of banking facilities at some of the interior centres near the estates has been causing difficulties to the planters. This also applies to the bigger plantations managed by Indians who have accounts with the local banks, although it is possible for them to make alternate arrangements. Bigger plantations which are being managed by foreigners, e.g., Aspinwall & Co., Pierce Leslie & Co. and Harrisons Crosfield are not reported to be experiencing difficulties as they have been banking with bigger banks like the State Bank of India, Chartered Bank and National and Grindlays Bank. He also showed me a letter received by him from the Tea Board asking him to furnish the list of tea estates which are experiencing difficulties and the extent of finance which would be required by them for the 1961-62 season. Shri Mathew’s view was that it will be difficult to estimate the extent of bank finance obtained by the estates and there may also be some reluctance on their part to disclose to the Association the exact amount of the borrowings from banks.

(vi) Discussion with some of the Agents of the bigger banks at Kottayam

I met the Agents of some of the bigger banks having their branches at Kottayam, such as the Central Bank of India Ltd., the Indian Bank Ltd. and the Indian Overseas Bank Ltd. The Agents of Central Bank and Indian Bank stated that the Travancore Forward Bank and the Kottayam Orient Bank had a number of branches in the plantation area and the temporary cessation of facilities due to the moratorium granted to them has caused difficulties to the planters even in the matter of retiring the bills on them. The bills received in Kottayam have to be retired by the parties by coming over to that place for the purpose. It is stated that these two banks do not generally entertain proposals for advances against real estate and also against hypothecation of stocks of rubber etc. They have confined themselves to granting key loans before the produce is sent to the marketing centres. The Agent of the Indian Overseas Bank agreed with the view that the withdrawal of facilities at the plantation centres has led to some difficulties, but a few proposals received from first class parties are being considered by the bank for granting advances to them.

Conclusion

The enquiries have revealed that the grant of moratorium to the Kottayam Orient Bank Ltd. and the Travancore Forward Bank Ltd. has resulted in the temporary cessation of banking facilities for the day-to-day working extended directly or indirectly to the plantation industry, especially for rubber, pepper, tea, cardamom, etc. which are the main crops in these areas. The representatives of the Kottayam Orient Bank and the Travancore Forward Bank stated that the limits made available to the planters were more or less the same as in the last season although some reduction was made at the time of large-scale withdrawal of deposits prior to the grant of moratorium. In the case of the Travancore Forward Bank Ltd., the limits were stated to have been curtailed by about Rs 20 lakhs. In many places in the plantation area, there is no other bank to fill the void created by the temporary withdrawal of banking facilities and
one or two local banks still functioning in a few places are cautious not to increase
the advances portfolio on account of the uncertain conditions.

G.S. ANNASWAMI

Reserve Bank of India
Department of Banking Operations
Trivandrum
Dated the 24th January 1961

[Annexures not reproduced]

Banks in Kerala—Effects of the moratorium orders on trade
and commerce in the State

A news item regarding the above subject has appeared in The Hindu dated the
18th January 1961. Certain other press reports of a similar nature which had appeared
in the various local dailies received from our Trivandrum Office have been flagged at
[...]. In this connection the letter dated the 3rd January 1961 addressed by the Indian
Chamber of Commerce to the Governor may also be seen [not reproduced].

2. The more important points made in the various press reports/representations may
be summarised as follows:

(i) In view of the failure of the Palai Central Bank and the moratoria granted to
certain banks in Kerala, business has come almost to a standstill in many
places; smaller rubber planters have been hard hit and the merchants,
industrialists and farmers find it difficult to meet their day-to-day monetary
obligations.

(ii) The period of moratorium granted to the banks should be reduced to the minimum;
three months’ time is too long a period.

(iii) The reconstruction proposals should be implemented as early as possible so that
the uncertainty and dislocation in the banking and trading circles will be set at
rest soon. The process of reorganisation should be carried out without causing
any disturbance of trade and industry in the State.

(iv) Since no more financial assistance can be expected from the banks under
moratoria, trade in rubber and hill produce may go into the hands of the North-
Indian traders or the few Keralites having dealings with branches of North
Indian banks.

19.1.61

The moratorium had to be declared at the instance of the banks themselves.

C.O.

19.1.61

E.D.(D) Has spoken.

19.1.61

Govr. Did we get a reply from our Trivandrum Office re: the difficulties of
rubber growers to which advances had been made by the five banks
under moratorium in Kerala?

Governor

27.1.61
E.D. (D) Shri Gogtay’s letter enclosing a report from Shri Annaswami has been sent to the Governor.

30.1.61

REPORT ON THE DISCUSSION HELD WITH THE DEPUTY CHIEF MINISTER ON THE 4TH FEBRUARY 1961 REGARDING THE BANKING SITUATION IN KERALA

The discussion centred round the suggestions made by the Committee appointed by the Kerala Congress Parliamentary Party and the Citizens’ Committee in the memoranda submitted by them to the State Government regarding the banking situation in Kerala. Copies of these memoranda are enclosed for Central Office information. The topics discussed are dealt with below.

1. Palai Central Bank Ltd.

The Deputy Chief Minister stated that the main cause of the present banking crisis was the chain reaction caused by the closure of the Palai Central Bank Ltd. which has resulted in the loss of public confidence in the other banking institutions of the State. The economy of the State has been considerably affected and the new unit proposed to be formed by the amalgamation of four banks may also be subjected to withdrawal of deposits. The Deputy Chief Minister expressed the hope that this does not happen. He, however, stated that if, unfortunately, this fear materialised, it would shatter the economy of Kerala and completely upset its Third Five Year Plan. This would also adversely affect the chances of the survival of the present Ministry. The State Government, therefore, desired to do whatever was possible to restore the confidence of the public in the banks. He felt that the absorption of the Palai Central Bank Ltd. by some bank, after suitable reconstruction, would go a long way in restoring confidence. He stated that now that the stand taken by the Reserve Bank in regard to the Palai Central Bank Ltd. had been upheld by the Kerala High Court, it could afford to be generous and it should take the initiative in drawing up the scheme. I told him that this was a matter of policy and added that only a very big bank, like the State Bank of India, would be in a position to shoulder the burden, and that this proposal, which has already been considered by the higher authorities of the Reserve Bank, has not been found practicable. Further, there was already much public criticism against the directors of the bank for their failure to repay the dues and it may be possible to take effective steps against them only in liquidation proceedings. Shri Shankar felt that nothing would be lost in making a fresh attempt. I then informed him that those who had made the suggestion did not appear to have considered the practical aspects of the case as it would not be possible to get any bank to consider the absorption of the Palai Central Bank Ltd. The Deputy Chief Minister agreed that it was not easy to suggest the bank which would be prepared to consider the absorption of the Palai Central Bank Ltd. and said that he would find out from the more prominent members of the Committee/s whether they could get some bank to absorb the Palai Central Bank Ltd. and put forward a practicable scheme. He also stated that some decision will have to be taken early, before the Liquidator commences repayment of preferential
liabilities to small depositors, because the merger of the institution with another bank may not be feasible after that stage, as a considerable portion of the readily realisable assets would have been utilised to pay off the small depositors, and no institution will be interested in taking over the remaining assets. Although he did not say so, the Deputy Chief Minister may perhaps approach the Finance Minister, Government of India, in the matter.

2. Proposed unit to be formed by the amalgamation of three banks with the Kottayam Orient Bank Ltd.

(a) Appointment of the Chief Executive Officer

The Deputy Chief Minister stated that one of the points raised in the memoranda was that an outsider should not be appointed as the Chief Executive Officer of the new unit and that the post should go to one of the top officials of the amalgamating units. I told him that the Reserve Bank did not consider any of the top officials of the amalgamating units as suitable as they had failed to exercise proper vigilance over the working of the banks and conduct the affairs of the banks in the interests of the depositors. I also told him that the Reserve Bank considered it essential to have as the Chief Executive Officer of the new unit an experienced and efficient person of high integrity who would rise above parochial considerations. The Deputy Chief Minister then enquired whether it would not be possible to appoint any of the present Chief Executive Officers to the next important post. I informed him that it is not our intention to completely break off from the past and that it is our desire to retain the present Chief Executive Officers in lower posts on reduced salaries, if they are agreeable.

(b) Transfer of Head Office to Trivandrum

The Deputy Chief Minister stated that representations have been made against the proposed move to shift the Head Office to Trivandrum. I explained to him the considerations that weighed with us. The proposed unit would have a much better chance in a different atmosphere, and it would be easier for the new Chief Executive Officer to work in Trivandrum than in Kottayam. It was also difficult to get a person who would be willing to go to Kottayam. Trivandrum is the capital of the State: there would be better liaison between the bank and the Reserve Bank and the Government. Although Shri Shankar appreciated our point of view, he stated that it would be politic on the part of the Reserve Bank to concede either this or the earlier demand regarding the Chief Executive Officer, as such a concession might placate the opponents of the scheme and make them feel satisfied that at least one of the two demands has been allowed.

(c) Board of Directors

The Deputy Chief Minister stated that there was also some objection to the Board as proposed to be nominated by us and that representations have been made to the effect that the directors of the new unit should be appointed by selection from the existing directors and by nomination of one or two directors by the State Government. I then showed him the list of persons proposed to be nominated by us as directors. I informed him that six of the persons have already accepted our offer, while Shri K. Sankaran, the retired Chief Justice, has declined it. Shri N. Krishna Iyer has gone to New Delhi and is expected to return to Kottayam on the 5th. The Deputy Chief
Minister himself then contacted Shri Sankaran but was not able to persuade him to accept the directorship. I then told him that we proposed to nominate Shri G. Kumara Pillai. The Deputy Chief Minister, however, remarked that as the list stood at present, all communities, viz., Christians, Nairs, Ezhavas, Brahmans and Muslims, were represented on the Board and it would be preferable to substitute Shri K. Sankaran, who is an Ezhava, by another person of the same community, which is the commercial community. He suggested the inclusion of Shri K. Padmanabhan, retired District Judge, (vide our D.O. letter [...] dated the 6th January 1961) and also stated that we might consider having Sarvashri Kumara Pillai and Padmanabhan on the Board instead of Shri Sankaran, who has declined, and Shri Joshua, to whose nomination there was general opposition. Incidentally, it may be stated that we have obtained a confidential report on Shri Joshua from the Kottayam branch of the State Bank of Travancore, according to which he is a person of high business integrity with means of over Rs 5 lakhs.

(d) Steps to be taken to ensure confidence in the new unit

The Deputy Chief Minister stated that apprehensions were entertained that the new unit might continue to face large-scale withdrawal of deposits after re-opening. He wanted to know whether we had in mind any specific steps to restore confidence. I told him that as the new unit would start with the status of a licensed scheduled bank and have a powerful Board and an efficient Chief Executive Officer, it was expected to inspire the necessary confidence. If required, financial assistance would be given by the Reserve Bank. The Deputy Chief Minister then informed me that it has been suggested to him that the State Government should contribute to the share capital of the new unit and also deposit funds with a view to restoring public confidence. He stated that the State Government might not be averse to taking such a step if absolutely necessary, but it would be in a position to contribute only a nominal amount, as a gesture of goodwill, say, Rs 4 to Rs 5 lakhs towards share capital and Rs 10 lakhs in the form of deposits. He also stated that, if considered necessary, the Government would have one of its nominees on the Board with a view to inspiring confidence.

(e) Reducing the period of moratorium

When the Deputy Chief Minister opened this topic, I told him that the Reserve Bank of India is doing whatever is possible to expedite the lifting of the moratorium.

3. Forcible amalgamation of small banks

The Deputy Chief Minister asked whether it was the intention of the Reserve Bank of India to bring about compulsory amalgamation of small banking companies, and if so, whether it could be achieved without granting a moratorium to them. I told him that as the law stood at present, amalgamation under section 45 of the Banking Companies Act, 1949, was possible only after the grant of moratorium. I added that as many of the banks in the State are small and cannot be considered as viable, they may have to be amalgamated into bigger units. I, however, made it clear that it is the policy of the Reserve Bank to encourage voluntary amalgamation.

M.L. GOGTAY
5.2.1961
D.O.No.[...]
My dear Shri Iengar,

A few days back, Divekar sent me certain notes relating to the tentative scheme for the insurance of bank deposits as prepared in the Reserve Bank. The subject is an important one and is to some extent controversial. Certain aspects of this problem also seem to require more detailed examination and consideration.

2. As you are aware, we have not yet obtained the Finance Minister's orders on this scheme and I am not also sure whether the minutes of the meeting with the bankers held on the 16th September, 1960 as recorded, fully represent his views regarding this question. My impression is that while he was prepared to have the scheme considered further he did not finally commit himself to its introduction.

3. The scheme of deposit insurance is likely, according to some of its critics, to promote an attitude of irresponsibility on the part of some banks. As it does not appear to have been tried on any large scale outside the United States, and as it is also likely to encounter some opposition in our own country, for example, from the bigger banks which may feel that they are called upon to subsidise the weaker institutions, or from co-operative banks which might think that they will be exposed to much greater competition from the insured banks, a final view cannot be taken regarding the desirability or practicability of introducing the scheme, until the question has been much more fully discussed.

4. Even if it were to be decided ultimately that the scheme should be introduced, various other points connected with the proposal, e.g. the demand for a separate autonomous corporation, the conditions on which capital may be found or advanced initially, the extent to which the fund or the corporation, as the case may be, will be responsible for the liquidation of the banks or for the realisation of the amounts which may be recoverable for liquidation, the coverage of the institutions and the deposits, and the form of the rebate, if any, will have to be discussed further. The implications of any decisions which may be taken regarding these matters will have to be examined carefully by Government in consultation with the Reserve Bank. The Central Board of the Reserve Bank is meeting on the 11th of this month. I do not know whether it is proposed to take a conclusive view on the matter at that meeting. I thought, however, that you would not mind if I mentioned the above points at this stage, to you.

5. The Finance Minister is returning on the 10th October. We shall then put up the matter to him and obtain his preliminary reactions to the scheme, including the major points of principle referred to in this letter.

Yours sincerely,
K.P. Mathrani
volume of frozen advances. It is this I am worried about and not the current lending policy of the Bank.

Yours sincerely,

H.V.R. IENGAR

Shri V.T. Krishnamachari
Deputy Chairman
Planning Commission
Government of India

PLANNING COMMISSION
NEW DELHI
April 16, 1959

My dear Iengar,

Many thanks for your letter No.[...], dated 13th April, on financial credit to agricultural co-operatives. Shri Morarji Desai mentioned to me in a general way the point you make in your letter.

2. I had intended to discuss this subject with you. I understand, however, that you are leaving for the U.S.A. on the 19th. As soon as you return, we shall arrange a meeting.

3. Like you, we in the Planning Commission are most anxious that the Reserve Bank should not get involved in unsound financial credits to the movement.

4. In the Second Five Year Plan and a series of letters issued in connection with it, there are two patterns of rural co-operative development envisaged:

(i) The ‘rural bank’ or the large-sized society recommended by the All-India Rural Credit Survey Committee’s Report:

The Plan set a target of about 10,000 societies covering approximately 50,000 villages. By the end of March, 1959, 6,300 societies have been formed covering 70,000 villages.

(ii) Revitalisation of village societies and forming new ones:

Targets for this have been indicated.

5. The National Development Council has laid down the policy to be followed in regard to the latter programme. The main point in this is the linking up of credit with an approved production programme of the village made up of family plans. The question to be considered now is how far the Reserve Bank should provide finance for this programme. Discussions on this are going to take place at official level with Venkatappiah and others. A final decision can be taken after you return and the Finance Minister and myself have discussed the whole question with you.

Yours sincerely,

V.T. KRISHNAMACHARI

June 20, 1959

Dear Shri Morarji Desai,

During the last week or two, I have been busy acquainting myself with some of the more important developments which have taken place while I was abroad. On one
of them I feel it my duty to write to you at once. It pertains to agricultural credit. I refer to the Rs 8 crore pilot scheme for establishing a “line of supplementary credit” from the Central Government to the cultivator through State Governments and co-operatives. The details are given in Circular Letter No.[...] of 16th May 1959 issued by the Ministry of Community Development and Co-operation. The connected papers show that the whole idea of a “supplementary credit line” has emanated from the Planning Commission.

If this had merely been a draft scheme for discussion, my comments would have been unnecessary. It is not. On the contrary, State Governments have been asked to take immediate action on it; and there has been no attempt to discuss beforehand either with them or the Reserve Bank certain features of the Scheme, and various assumptions on which they are based, which prima facie merited such a consultation. The point I am raising is not solely one of procedure, though even as a procedural matter it is one of considerable importance. For, firstly, the Reserve Bank is Government’s statutory adviser on agricultural credit. Secondly, it operates the very credit scheme to which the present one is supposed to be “supplementary”; and thirdly, it is far and away the largest lender to co-operatives and, in that capacity, is directly interested in the effect of any such scheme on the co-operative credit structure.

My main objection to the scheme, however, is based on substantive and not merely procedural grounds. I shall be doing less than justice to the importance of the subject if I am not completely frank. It is my considered opinion that in its present form the scheme is immature and ill-advised. In justification of this comment I shall draw your attention to three or four of those features—many more can be cited—which are likely in my opinion to render the scheme harmful in certain respects and ineffective in others:

(1) One of the strongest objections to the scheme is the effect it is likely to have on the conduct of business by primary societies. According to the letter, “Central co-operative banks will be sanctioning loans to the primary societies in the normal course. A supplementary loan over and above the normal credit limits for additional finance required by the primary society to finance its members on the fuller scale envisaged above will be given by the central bank. For this purpose, special credit limits may have to be sanctioned by the appropriate authority to the primary society as well as the central co-operative bank”. These additional limits will be derived from the supplementary line made available by Government and, obviously, will be specifically related to whatever is not “normal”, i.e. (a) loans to new members who would not otherwise have been admitted, (b) loans to existing members who would not ordinarily have been lent anything, and (c) in respect of a member who is a ‘normal’ borrower, such part of the new loan as is above the ‘normal’ level. All this is fairly complicated since not only notionally, but in actual practice, societies will have to distinguish between what is “normal” and what is “supplementary”. Moreover, the line between normal and supplementary is not static; it changes as the society grows in financial or organisational strength; it also changes if, for example, a good marketing society happens to be established in the area and a few more can be confidently given loans because there is a prospect of their being recovered through the marketing society. To introduce the idea of “normal” and “supplementary” in such circumstances,
the Department of Economic Affairs informed about the progress of the developments,
from time to time.

With kindest regards,

Yours sincerely,

K.P. MATHRANI

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Insurance of bank deposits

Placed below is a letter dated the 6th October 1960 [p. 1101] received from Shri Mathrani in regard to the tentative scheme for insurance of bank deposits prepared by us. He has stated that as the subject is an important one and to some extent controversial, it would require a more detailed examination and consideration. He is doubtful whether the minutes of the Finance Minister’s meeting with the bankers on the 16th September 1960 prepared by us fully represent the former’s views on this question and feels that the Finance Minister did not commit himself to its introduction. Although the Finance Minister did not himself raise this issue at the meeting with the bankers, some of them wanted an assurance that their Associations would be consulted before the scheme is put into operation. The Finance Minister thereupon stated that even though Government and the Reserve Bank might not see their way to accept some of the suggestions of the bankers in this connection, full opportunity will be given to the Associations to express their views on the subject. In view of the situation created by the closure of the Palai Central Bank, some of the bankers themselves have felt the need and urgency of the scheme and written to us in this connection. There have also been some questions in Parliament recently when Government stated after consulting us that the matter is under our active consideration. In view of these developments, it will not be desirable to defer consideration of the subject or postpone its introduction indefinitely.

Most of the objections mentioned by Shri Mathrani are covered by the points raised by the Indian Banks’ Association and these have been separately examined. One important aspect mentioned in his letter is that co-operative banks might think that they will be exposed to much greater competition from the insured banks. Co-operative banks account for a small portion of the total bank deposits and in view of the close association of the State Governments with their working, the introduction of the scheme of deposit insurance is not likely to have any adverse effect on them. However, a copy of the draft outline of the scheme will be sent to the Agricultural Credit Department for their comments on this point.

As Shri Mathrani has stated in his letter that the proposals made by us will have to be examined carefully by Government before any final decision is taken, it is for consideration whether the matter should be discussed with the representatives of the Ministry of Finance in the light of the comments received from the Banks’ Associations and our observations thereon.

29-10-1960
Insurance of bank deposits

The comments of the Indian Banks’ Association and the Exchange Banks’ Association on the draft outline of the scheme of deposit insurance forwarded to them have been examined and a statement giving our remarks on the main points raised by them is placed below.

I. The Indian Banks’ Association does not generally seem to be in favour of any scheme for insurance of bank deposits. While admitting that the basic principle of insurance of bank deposits is wholesome, it has stated that such a measure is in operation only in the U.S.A. and it would not be helpful to make a comparison between our country and the U.S.A. in this respect. Its contention is that there were widespread bank failures in the U.S.A. 25 years ago when the scheme was introduced and such is not the case in India at present. We have made the need and urgency of the scheme clear in the draft outline forwarded to the two Associations. Apart from its utility in ensuring guaranteed repayment of deposits up to a certain extent in the event of a failure of a bank, its role in inspiring confidence in the banking system facilitating the mobilisation of a larger volume of deposits, particularly in the rural areas, is of equal importance. The recent failure of two scheduled banks, one of which is an institution with sizeable deposits, has shown that the closure of even a small or medium-sized bank could have serious repercussions on the confidence of the depositing public to a far greater extent than is warranted by its size, standing or reputation. Thus, in the present context, banking conditions in this country cannot be said to be very dissimilar to those that prevailed in the U.S.A. at the time of the introduction of deposit insurance.

The next point raised by the Association is that the protection to the depositors is only partial and even though the scheme may avoid bank failures brought about by the spread of panic, it cannot prevent bank failures resulting from unsound management. The Association feels that the scheme places the well-managed and mismanaged banks on the same footing and this will encourage unsound banking practices. It has suggested that if licences cannot be granted to all the unlicensed banks, the scheme should not be started until it is found possible to amalgamate them inter se or with some other better managed banks. The fears of the Association appear to be unfounded, as it is not intended that deposit insurance should be a substitute for vigilance in regulating the banking system. On the other hand, it has been decided that the Reserve Bank should devote greater and more detailed attention to the working of banks and improve the quality of their management. As for the problem of sub-standard banks, we do not propose to include banks whose financial position is considered irretrievable or whose deposits have been eroded. Reconstruction and/or amalgamation of the banks falling under the latter category as well as those which have lost a substantial portion of their paid-up capital has been taken in hand in terms of the new provisions of the Banking Companies Act and it is expected that this process will be completed by the time the insurance scheme is put into operation. In the case of the majority of the unlicensed banks, their deposits as well as a substantial portion of paid-up capital are intact and the inclusion of these banks in the scheme will not impose any undue risk on the insurance fund.
If at all a scheme of deposit insurance is to be introduced, the strongest objection of the Association is for its administration by the Reserve Bank. It has conveyed as the opinion of most of its members that the scheme should be operated by an independent statutory corporation. In this context, it has cast certain aspersions on the inspecting officers of the Reserve Bank which are wholly unwarranted. The Association apprehends that the preconceived ideas of some of the officers of the Reserve Bank as embodied in their inspection reports on banks would interfere with the functioning of the insurance organisation as an independent insurer and cause undue hardship to some of the banks. The implication seems to be that even after the introduction of the deposit insurance, the Reserve Bank will continue to refuse licences to banks on the recommendations of the inspecting officers and such action would create liabilities for the insurance fund in an unjustified manner. Another argument advanced in this connection is that if any of the insured banks fail, it will be necessary for the insurance organisation to take over their entire assets and this can be best done by a separate Corporation. When the insurance organisation is the responsibility of the Reserve Bank, it will obviously not take any action even if recommended by an inspecting officer which would be prejudicial or onerous to the insurance fund. We have made it clear in our communication to the Associations that most of the functions and powers necessary for administering a scheme of insurance of bank deposits are already vested in the Reserve Bank and even if an independent statutory corporation is constituted, it will not be possible to associate with its management commercial bankers in view of the close supervisory role which the Corporation will be required to exercise over the banking system. As for taking over the assets of insured banks that may fail, it will be open to the Reserve Bank to entrust their realisation to any other member bank or the Official Liquidator and a separate Corporation is not necessary for this purpose.

Two other points urged by the Association are that the Reserve Bank should pay outright half of the resources of the scheme and the rate of premium payable by banks should be 1/40th of 1% instead of 1/10th of 1%. The statutory deposits maintained by the scheduled banks with the Reserve Bank which do not bear any interest have been mentioned in justification of the first suggestion. It may be pointed out in this connection that the statutory deposits are intended to serve as a measure of control of the cash base of banks, which is an accepted Central Banking practice. This being so, the Reserve Bank cannot be said to be utilising the funds of commercial banks for profit and the argument advanced by the Association is fallacious. The insurance scheme is expected to result in a larger volume of deposits of banks and the cost thereof will have necessarily to be borne by them. As for the incidence of premium, we have made it clear to the Associations that if the accumulations in the fund over a period of time are considered sufficiently large in relation to insurance commitments, the question of rebate would be considered at the appropriate time. In view of this provision, the contention of the Association that the rate of premium is too onerous loses its significance.

In continuation of their letter forwarding the comments on the scheme, the Association has invited our attention to Governor’s speech at the Second Indian Conference on Research in National Income wherein he mentioned that “the overwhelming proportion of the deposits, well over 90%, are held in banks which
are soundly run and although there are a few weak spots, the Indian banking system, taken as a whole, from the point of view of safety of deposits is sound and vigorous”.

II. The Bombay Exchange Banks’ Association has agreed in principle with the desirability of introducing a scheme for insurance of bank deposits but has urged that the rate of premium should be based not on total deposits but on insurable deposits. They have contended that the calculation of insurable deposits does not present any difficulty and if the premium is related to the total deposits, it would weigh heavily in favour of the smaller banks and against the bigger banks. Although the calculation of the average insurable deposits may not present any insuperable difficulty, it will not be possible for the insurance organisation to verify the figures furnished by the banks. If the rate is to be based on insurable deposits, it will have to be much higher than 1/10th of 1% and the working of the medium-sized and smaller banks might become unremunerative if they are compelled to meet this heavy incidence. In any scheme of insurance the good risk always compensates for the bad one and the rate of premium on total deposits suggested by us would not cause any undue hardship to the bigger banks. The Association has also stated that although the lending rates of banks have been raised, the penal rates of interest recently prescribed on borrowings from the Reserve Bank would nullify the benefit of the increased lending rates. The penal rates on borrowings will apply only if the borrowings of a bank are in excess of the quota fixed and so long as they are kept within these limits, the banks will derive the full benefit from the higher lending rates.

While agreeing that the Reserve Bank of India is best qualified to ensure the effective operation of the scheme, the Association has indicated that it would be desirable to provide for some representation of the commercial banks on the managing body. The Working Group has suggested the formation of a high-powered Standing Advisory Committee consisting, among others, of the Chairman or Vice Chairman of the Indian Banks’ Association and acceptance of this recommendation will meet the point made out by the Association.

III. The draft outline of the scheme forwarded to the Associations was considered by the Central Board in the last meeting held at Madras and the Board, while generally approving the proposals made by us, desired that if on any major point the Associations are not in agreement, such issues may be referred to the Committee of the Central Board. Although the Chairman of the Indian Banks’ Association and the Exchange Banks’ Association had informally signified their broad acceptance of the proposals made by us to the Governor, the consensus of opinion among the bigger banks seems to be in favour of the following:

1. The scheme should be administered by a separate statutory Corporation with the representatives of the commercial banks on the managing body.
2. The rate of premium should be based on insurable deposits and if it is related to total deposits, it should be much smaller than 1/10th of 1%.
3. Banks with an unsatisfactory financial position should not be included in the scheme and if this is not feasible, the scheme should be brought into operation only after they are amalgamated inter se or with some better managed banks by utilising the powers recently given to the Reserve Bank.
For the reasons stated in this note as also in the appended statement [not reproduced], it does not appear to be practicable to accept the viewpoint of the banks on the three major issues indicated above. Government also seem to be somewhat doubtful of the desirability of going ahead with our proposals without the concurrence of banks and a letter received from Shri Mathrani in this behalf is being put up separately. In view of the observations of Shri Mathrani and the points of view expressed by the Associations, it is suggested that we may first of all discuss the essential features of the scheme with the Ministry of Finance and then have a full-fledged discussion with the representatives not only of the Associations but also of the big, medium-sized and small banks before finally coming to a decision on the various aspects of the scheme. No reply to the Associations is considered necessary at this stage.

29-10-1960

CONFIDENTIAL

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI

D.O.No.[...]

My dear Venkatappiah,

In his letter No.[...] dated the 20th September, 1960 Divekar sent his tentative proposals of the Scheme for Insurance of Bank Deposits which is being sponsored by the Reserve Bank of India. I have communicated to Shri H.V.R. Iengar the initial reactions of the Finance Minister to the Scheme and I am enclosing herewith a copy of my letter dated the 24th October, 1960 to Shri Iengar in this behalf. One point which has been worrying us here in regard to this Scheme is its possible repercussions on the Co-operative Banks. Since Co-operative Banks, which provide the bulk of rural credit, will be left out of the Scheme, they might find themselves at a disadvantage in competing with commercial banks whose deposits will be guaranteed up to a separate amount. A fear is expressed here that the repercussions of the Deposit Insurance Scheme on Co-operative Banks may not be inappreciable. You, probably, have already considered this aspect of the matter while examining the proposals for the introduction of the Deposit Insurance Scheme. I should be grateful if you could advise us how far the fears expressed above are justified, and if they are, whether the Scheme needs any modification.

2. I have not mentioned this point in my letter to Shri Iengar because I felt that it would be desirable to have the benefit of your advice on the point before we take a definite view on it.

With kindest regards,

Yours sincerely,

K.P. MATHRANI

Shri B. Venkatappiah
Deputy Governor
Reserve Bank of India
Central Office
Bombay
Discussed with Shri Mathrani.

I said that the question of deposit insurance for co-operative banks raises issues which are quite different from that for commercial banks and that a scheme for the latter need not be held up because of the former. He agrees. He said he would record a note accordingly on his file. No reply, he said, was necessary to his letter of October 29.

[B.Venkatappaiah]
8.11.1960

Deposit Insurance Scheme

Further to his letter of the 6th October 1960 [p.1101] which has been separately put up, Shri Mathrani has indicated the reactions of the Finance Minister to our proposals in regard to the Deposit Insurance Scheme in his letter dated the 24th October, a copy of which is placed below.

2. The first point raised is that as the scheme has not been tried in any other country except the U.S.A., we should proceed somewhat cautiously in the matter. This point is already being borne in mind and our proposals for insuring deposits up to Rs 1,000/- each and for keeping the premium rate fairly high in the initial stages were formulated against this background. Independently of the experience of the U.S.A. where the scheme has been a success, it is felt that with a large number of small banks in the banking system, some of them playing a useful role, and the attendant risk of bank failures, a scheme of deposit insurance will go a long way in inspiring confidence in the banking system and facilitating the mobilisation of a larger volume of deposits particularly in the rural areas.

3. It is stated that although the Finance Minister has no objection to the scheme being pursued by the Reserve Bank, it should consider more fully two important aspects of the matter namely, the timing and the manner of introduction of the scheme. As regards the timing, the Finance Minister feels that it would be desirable if the programme of reconstruction and amalgamation of the banks that are not likely to qualify for a licence in the near future is initiated first. We have already taken up this task on hand and it is expected that the future set-up of at least such of the banks as have lost a portion of their deposits or a sizeable portion of their paid-up capital will be settled before the formalities required for the introduction of the scheme are completed. At the same time it may not be necessary to wait until all the contemplated amalgamations are completed, as the process of consolidation of deposits or capital in some cases, might initially generate an adverse effect on the confidence of the depositing public in the banking system as a whole. As for the manner of introducing the scheme, the Finance Minister is of the opinion that it would be desirable to take the banks into confidence and obtain their views. This has already been done and the comments of the Indian Banks’ Association and the Exchange Banks’ Association on the draft scheme have been examined and put up separately.

4. In regard to the nature of the organisation required for the administration of the scheme, the Finance Minister has some doubt whether the Reserve Bank should undertake direct responsibility for the operation of the scheme and would like the question to be further examined to see whether a separate autonomous or semi-
autonomous body functioning under the control of the Reserve Bank could not be set up. It is primarily in view of the need for the expeditious introduction of the scheme involving minimum legislative changes that the suggestion for administering the scheme departmentally was made. Another consideration against the formation of a separate Corporation was that it would lead to unnecessary duplication of inspection work. Shri Mathrani has stated that as participation in the scheme would be obligatory on all banks, it might not be necessary for the insurance organisation to have a separate inspecting machinery. In the U.S.A. the Federal Deposit Insurance Corporation is vested with the power to make examination and to require information and reports from insured banks and can also act as Receiver. In practice the corporation regularly examines the insured state non-member banks only but reviews reports of examination of other insured banks made by the Federal Banking agencies. An insured bank normally examined by another federal supervisory agency may be examined by the Corporation when such action is deemed advisable by the Board of Directors to determine its condition for insurance purposes. It would appear from the above that although the Corporation has independent powers of inspection, it frequently makes use of the examination reports of the Federal or the State supervisory authorities and avails itself of the use of information, services and facilities provided for by them. Thus, if a separate Corporation is constituted for administering the scheme, even though it might utilise largely the inspection reports of the Reserve Bank, it will have to be vested with concurrent powers of inspection and calling for information. The inspection machinery need not be elaborate but a skeleton staff may have to be provided for undertaking special investigations and inspections whenever considered necessary. Although there is much to be gained if at the outset the scheme is operated by a department of the Reserve Bank, as the banks seem to be generally of the opinion that the work should be handled by a separate institution, this alternative organisational set-up may be further considered at this stage. In any case, direct representation of the commercial banks on the Deposit Insurance body seems to be inappropriate. In this context it may be mentioned that in the U.S.A., the management of the F.D.I.C. is vested in a Board of Directors consisting of three members, one being the Controller of Currency and the other two, one of whom being the Chairman, appointed by the President with the advice and consent of the Senate. The members of the Board are not eligible to hold any office, position or employment in any insured bank. They are also not entitled to hold the shares of such banks.

5. On the question of resources for the scheme, the Finance Minister is of the opinion that it should be run on a purely commercial basis and should not be subsidised in any way either by the Reserve Bank or by Government. As against our suggestion that an initial amount of Rs 5 crores may be advanced by the Reserve Bank, the Indian Banks’ Association has suggested that the Reserve Bank should pay outright half the resources of the scheme. Until such time as the fund accumulates a sufficient amount by way of premia, it should have some resources and the provision of an initial contribution by us may not amount to a subsidy by the Reserve Bank. If the Reserve Bank is not to make any initial contribution, the only alternative is to levy a capital contribution on the banks to which they are not at all likely to agree.

6. If, in the light of the reactions of the Finance Minister and the views expressed by
the Banks’ Associations, it is felt that the Reserve Bank should not undertake direct responsibility for the operation of the scheme, a separate statutory Corporation may be constituted for the purpose. This will be a semi-autonomous body functioning under the control of the Central Government and the Reserve Bank. The management of such a Corporation may be vested in a Board consisting of 4 members nominated by the Central Government in consultation with the Reserve Bank. Two of the members will be officials, namely, a Deputy Governor or Executive Director from the Reserve Bank and a Joint Secretary from the Ministry of Finance. The other two may be non-officials but they should not be connected with any banking institution. As in the United States, no particular requirements of eligibility for membership need be laid down insofar as the non-officials are concerned and one of them may be nominated as Chairman. In the U.S.A. the term of office of the two members appointed by the President is fixed at 6 years. As this period is a little too long and as the non-official members are expected to represent the interests of the depositors in general, a term of three years for the non-official members may be fixed in our case. The chief executive and the other members of the staff will be provided by the Reserve Bank. This need not, however, be large as the Corporation will utilise the inspection staff of the Reserve Bank as well as all the information available in the Department of Banking Operations in regard to the working of the insured banks. However, as some special inspections and investigations might become necessary in due course, one or two inspecting officers may be included in the initial staff of the Corporation. If the Corporation is to undertake liquidation work whenever considered necessary, it will have to build up a suitable organisation for this purpose in course of time. In order to enable the Reserve Bank to have the necessary control over the insurance organisation, a power to issue directions to the Corporation in consultation with the Central Government may be provided in the statute. The proposed set-up is somewhat on the lines of the arrangements made by the Refinance Corporation for Industry (Private) Ltd. but as the work involved will be much heavier, separate staff will have to be earmarked exclusively for the purpose. If a policy decision in regard to the organisational set-up of the scheme is taken, the other details including the necessary legislative changes will be submitted for consideration.

4-11-1960

Governor

I have been put into a very false position in regard to the Deposit Insurance Scheme by the letter which Mr. Mathrani wrote to me a few days ago. I thought, in the first place, that the letter was extraordinary because it assumed that I did not know the pros and cons of the insurance scheme and had to be taught the elements of it by the Finance Ministry. Apart from this, it is curious that all the arguments used by Mr. Mathrani are identical with those used by the Indian Banks’ Association; the only difference is in the language. Mr. Mathrani’s letter is polite whereas the Indian Banks’ Association’s letter is offensive in its reference to the officers of the Reserve Bank. Mr. Mathrani has made things worse by saying that he has taken the instructions of the Minister. I feel wedged between the Finance Ministry on the one side and the Indian Banks’ Association on the other, and feel I ought to let the Minister know about my feelings on this subject.
2. So far as the Indian Banks’ Association itself is concerned, I am not at all sure to what extent it is representative of the opinion of the Indian scheduled banks. Quite a few of the bankers I have met have told me that they are in favour of the Deposit Insurance Scheme but the official letter of the Association takes a contrary line. I am inclined to think that on matters of this sort in future we ought to write directly to the banks by-passing the Association which seems to be consisting merely of a clique of bankers in Bombay who pretend to speak for the banking community in general. I am also inclined to think that in spite of the letter from the Association, we should even now do so.

3. As a basis of discussion, I place below a draft letter to the Finance Minister and would like to discuss it with D.G.(R) in Bombay. In the meanwhile, could it be ascertained informally by what process the Indian Banks’ Association came to their conclusion? Was it merely a committee meeting at which they discussed the letter, or was it circulated to their constituent members and, if so, was the opinion of the constituent members unanimous or near unanimous? I have no objection to whoever is making the enquiry saying that it is being made at my instance and under my instructions.

H.V.R.
3.11.1960

D.G.(R)

I understand that the constituent members were not specifically invited to give an opinion and that the matter was decided at a meeting of the Managing Committee. This particular meeting appears to have been attended by the representatives of the Central Bank, the Bank of India, the Bank of Baroda, the Punjab National Bank, the United Commercial Bank, the United Bank of India, the Indian Bank, the Dena Bank and the Bank of Jaipur. All the bigger banks seem to have opposed the proposal except the United Bank of India which was in favour of the scheme and the United Commercial which gave hesitant support. The Jaipur Bank expressed no opinion. The smaller banks were nowhere in the picture. Sir Homi Mody spearheaded the opposition but I understand that Shri C.H. Bhabha stood by the support he had given to the proposal in the discussions with us.

M. V. RANGACHARI
5-11-1960

Governor

CONFIDENTIAL
URGENT

Deposit Insurance Scheme

A copy of the draft outline of the scheme for insurance of bank deposits of commercial banks which has been sent to the Indian Banks’ Association and the Exchange Banks’ Association, is attached [not reproduced]. The Agricultural Credit Department is requested to let us have their views thereon with particular reference to
the possible effects that such a scheme might have on the working of co-operative banks at an early date.

K. VARANASY
3.12.1960

Seen and returned.
2. We have to offer comments only on the effects of the scheme of deposit insurance on the working of co-operative banks.
3. The scheme of insurance of deposits of commercial banks will create a shift of deposits from co-operative banks to commercial banks. It may be mentioned that co-operative banks are already complaining that they are unable to attract enough deposits owing to competition from commercial banks and from Government. A shift of deposits occurring at this stage may create an obstacle in the growth of the co-operative movement which should, for its healthy development, depend more and more on its own resources than on borrowings from the Reserve Bank as it does today. If deposit insurance protects individuals in commercial banks alone, there will be little hope of increasing public deposits in co-operative banks. Expansion of co-operative credit, without a parallel increase in deposits, will mean expansion of Reserve Bank credit, which we want to avoid as far as possible.
4. A good part of the surplus funds of co-operative societies is kept in central co-operative banks and State co-operative banks, but surplus funds (e.g. Reserve Funds) are under the orders of the Registrars kept with co-operative Central banks and State banks. If the deposits in these banks are not insured while deposits in commercial banks are, such compulsory deposits and there are many such below Rs 1,000/- will tend to go into commercial banks which have insured their deposits. The Section of the Co-operative Societies Act which requires the Registrar’s previous approval for investment in commercial banks is rarely enforced even now in many States and will be more honoured in the breach than in the observance when commercial banks get their deposits insured. There will even be a clamour from the co-operators to get that Section deleted. I, therefore, apprehend that the integrity of the co-operative structure will be adversely affected and capital formation within the co-operative movement will be retarded if the deposit insurance scheme is restricted to commercial banks.
5. It is, therefore, felt that the State co-operative banks and Central co-operative banks may also be included in the scheme. In case all these banks are not included in the scheme in the initial stages, a selection of these banks may be made for inclusion, which will give us an additional lever to improve their working. The limit for insurable deposit for these banks may also be the same as suggested for commercial banks viz., Rs 1,000/- or whatever figure is finally decided upon.
6. Urban co-operative banks in particular, contribute voluntarily in large measure to the deposits of State co-operative banks and Central co-operative banks. The urban deposits in urban banks thus help co-operative financing banks to finance agriculture in the country. If the deposit insurance scheme is not extended to urban banks, not only will their own deposits go down but also the deposits of apex and central co-operative banks will fall. Therefore, urban banks also may have to be admitted to the deposit insurance scheme, though, of course, on a selective basis. Co-operative banks
may have no cause for complaint when they are on a par with commercial banks. Co-operative banking is, or at least ought to be, as much deposit banking as commercial banking is.

7. We have to point out, therefore, that as the Indian Banks' Association and the Exchange Bank's Association have been consulted on the scheme, the State co-operative banks and a few selected Central co-operative banks having a large business turnover may also be consulted likewise and their views ascertained. If the Department of Banking Operations has no objection, we shall write to them in the matter.

J.C. RYAN
29.12.60

D.O.No.[...] December 28, 1960
My dear L.K.[Jha],

We have given consideration in the Reserve Bank, in consultation with the Indian Banks' Association and the Exchange Banks' Association, to the question of introducing a scheme of deposit insurance for commercial banks. We have now reached a stage when we can get down to preparing details including the outlines of the necessary legislation. Before we do so however it seems necessary to ascertain from Government whether in their view, as a matter of policy, such a scheme is necessary at all at this stage.

2. As you know, the idea of deposit insurance was not a hasty afterthought following the crash of the Palai Bank. It had actually been suggested some years ago by the Shroff Committee and was shelved largely on account of the opposition of the bigger banks to any such scheme. The widespread public criticism following the failure of the Palai Bank about the hardship caused to the smaller depositors by bank failures revived our interest in the scheme. We had, as you know, drawn up a very tentative scheme on insurance of deposits in commercial banks upto Rs 1,000, to be managed by the Reserve Bank and circulated it to the two Associations of banks. I enclose for your information a copy of the communications from both the Associations containing their comments.

3. After a careful consideration of the matter in all its aspects, I am convinced that in the interests of the public and the long-term interests of the banking industry itself, it is desirable to have some form of insurance and to introduce it as early as possible. The question of the extent to which the deposits should be insured, the rate of premium to be charged, the method of computing this payment, the authority which would run the scheme are all matters of detail which could be thrashed out once the principle of having a scheme of insurance is accepted. I propose to deal in this letter only with the larger objections to and criticisms of any scheme of insurance leaving the points raised about the detailed matters which I have just mentioned for consideration at a later stage.

4. The first objection to a scheme of insurance is that no country other than the United States has one in operation, that conditions in this country are not similar to those in the United States when a countrywide scheme of deposit insurance was introduced in the early thirties and that, if for example in countries like the U.K., France and Italy there is no insurance of deposits it is not necessary to have it here.
This line of criticism seems somewhat misconceived. Conditions in a large country like ours are really comparable to those in the United States and not to those in the U.K., Italy or France. In U.K., the bulk of commercial banking is in the hands of a small number of highly organised institutions and the traditions of conservative banking which has been built up over the years and the large hidden reserves banks there carry have made insurance unnecessary there; in France and Italy banking has been largely nationalised. If (as I think) it is our policy not to concentrate too much of the banking business in a small number of larger institutions but to encourage the growth of a number of medium banks of reasonable size in which the smaller people could safely deposit their savings it is necessary to have some form of assurance to the smaller depositors that their money is safe; this is particularly important to encourage the growth of the investment habit and mobilisation of resources through the network of branches of banks in the countryside. While it is true that we do not now have a banking crisis as there was in the U.S. in the early thirties (during the period of the Great Depression), it is not correct to say that everything is all right with our banking system particularly at the level of the medium and smaller banks.

5. A second line of criticism is that any scheme of insurance would benefit only the sub-standard banks and that the money for this would be largely contributed by the bigger banks deposits in which are quite safe. This overlooks the basic principle of insurance that the larger and healthier units have to share the losses of the smaller and less healthy ones. The recent experience of the Punjab National Bank and the Indian Bank has shown that even the bigger banks are not as invulnerable as is generally claimed. Once some rumour starts about the position of a bank the smaller depositors get panicky and attempt to withdraw their money and when large queues of small people form before a bank it has a snowball effect on loss of confidence which spreads to other banks. A scheme of insurance would prevent such panic developing and enable a bank to survive any temporary run in a much more orderly way. It would thus enable us to proceed with the process of reorganisation of some of the marginal banks without needless scare affecting parts of the banking system from time to time.

6. A third criticism is that a scheme of insurance which does not cover all the deposits is not worth having. The problem is not one of protecting all the depositors but of protecting the smaller ones where numbers are much larger and to whom a bank failure is a much more severe blow than to the big depositors. It is true that insurance limited to a small sum would cover a large number of accounts but only a relatively small proportion of the total amount of deposits. An insurance covering all the deposits would, no doubt, be ideal but it is likely to be impracticable and in any case too costly. I have had certain rough figures worked out showing the cover that will be provided both in terms of accounts and in terms of the value of deposits if we had insurance limited to Rs 1,000, Rs 2,500 and Rs 5,000 and a statement containing these is enclosed [not reproduced]. It will be seen from it that a very substantial number of accounts will be covered by insurance at any of these figures. It will have a healthy effect on the public if, say, 70% or more of the depositors had the assurance that their deposits were safe whatever happened to a bank.

7. There has been some misgiving in regard to the effect of a scheme of insurance
for commercial banks on deposits in the co-operative sector. The total volume of deposits in the commercial sector excluding P.L.480 deposits is in the order of Rs 2,000 crores, while the corresponding figure in the case of the Co-operative sector, taking State Co-operative Banks, Central Co-operative Banks and agricultural credit societies, is of the order of Rs 150 crores. I do not myself expect that there will be any large diversion of deposits from the co-operative sector to the commercial sector if we had a scheme of insurance only for the latter. Theoretically, it is possible to provide for co-operative institutions also participating in the insurance scheme although I would not personally recommend it. The co-operative movement is developing under so much of State guidance and supervision that a scheme of insurance may be unnecessary for it. But this is a matter in which we need not take a final view just now; we may watch the effect of any scheme of insurance over a period and make up our minds later.

8. A point has been raised about the position of the State Bank of India and its subsidiaries in a scheme of insurance. It has been suggested that it will be inappropriate for a State-owned institution like the State Bank to participate in a limited scheme of insurance. There has also been some talk about the deposits in these institutions being in some way guaranteed by Government. I am afraid that there is some confusion in regard to this. I do not think it is correct to say that the deposits in these institutions have been guaranteed by Government. It is true that the State Bank and its subsidiaries cannot be put into liquidation except with the approval of the Central Government and it is very unlikely that these banks would share the fate of the Palai Bank or the Punjab National Bank, or even have a run on them as the Punjab National Bank and the Indian Bank recently experienced. But it is not the same thing as saying that the Government of India have guaranteed the deposits in these banks. There is no legal provision for this comparable to that in Section 37 of the Life Insurance Corporation Act under which Government has specifically guaranteed the policies issued by the Corporation. So long as the State Bank of India and its subsidiaries function as commercial banks I see no reason why they should not participate in a scheme of insurance just as other commercial banks merely because their capital is very largely owned by Government through the Reserve Bank or why they should consider it as detracting from their dignity to do so.

9. I have dealt at some length with the various objections which have been raised in principle to the introduction of a scheme of insurance. As mentioned earlier, I have not gone into criticisms on matters of detail. My main purpose in writing this letter is to get a decision in principle. If Government agree that we should have a scheme of deposit insurance, we can get down to the formulation of one with due regard to conditions in this country and the criticisms which have been raised on matters of detail. On these details I have not got views myself and I am sure that once the principle is accepted we shall be able to thrash out a scheme fair and equitable to the banks and the depositors on which legislation could be based.

Yours sincerely,

Shri L.K. Jha, I.C.S.
Secretary
Ministry of Finance
Government of India
January 31, 1961

My dear L.K.,

I have been looking again at my D.O. letter to you No. [...] dated the 28th December [p.1114] on the proposed scheme of insurance for bank deposits. It seems to me that although the arguments in favour of such a scheme have been mentioned, that has been done extremely briefly; the letter is concerned basically with defending the scheme against arguments made in criticism of it. This imbalance in the letter was due to the previous D.O. correspondence which had pointed out a number of difficulties. I think it is desirable now to set out more clearly one or two arguments which, to my mind, reinforce the case for expeditious action to set up a scheme of deposit insurance.

2. Ever since the failure of the Palai Bank and the occasional flurries in one part of the banking system or the other affecting now a big bank, now a medium bank, and all the time many of the smaller banks, a steady erosion of deposits from the banking system has been taking place. Although this is the time of the year when bank deposits are never too buoyant owing to busy season demands for conversion of deposits into currency, the behaviour of bank deposits during the last six months betrays distinct traces of after-effects of the shocks to confidence in the system administered by the alarms and excursions following the Palai crash. Since the end of July to January 20, 1961 the entire growth in money supply has been accounted for by currency expansion; indeed, an expansion in currency circulation of Rs 129 crores has been associated with a decline in bank deposits of Rs 40 crores (after allowing for the decline due to fall in P.L.480 deposits); this compares with an increase in currency of Rs 102 crores and Rs 81 crores during the corresponding periods of the previous two years, which was accompanied by an increase in bank deposits of Rs 69 crores and Rs 9 crores respectively. The detailed analysis of the trends in deposits on a regional and bankwise basis supports the view that bank deposits are stagnant owing to persistence of a sub-stratum of apprehensiveness among a number of small depositors as a reaction to recent experiences of bank failures and moratoria. This is particularly unfortunate at a time when monetary stringency is acute and banks are depending to a somewhat alarming extent on accommodation from the Reserve Bank. Quite clearly in my judgement, the essential aim of policy must be to stimulate the flow of savings into the banking sector. This is the first major argument in favour of introducing a scheme of deposit insurance at this stage.

3. The second major reason arises out of the need for giving a fair start to the scheme of amalgamations. We have received warning from people who claim to be in touch with the state of public feeling on this matter in Kerala, that it is quite on the cards that when we do set up new units there amalgamating some older units, the new institutions may have to face a run as soon as the moratorium is over and hardly before their lease of life had started! In other words, mere amalgamation of weak units into what we consider viable units would not, having regard to the prevailing state of nervousness, necessarily prevent further runs. We have received specific warning of this possibility in the case of the four banks under moratorium in the Travancore region. I am, therefore, more than ever convinced that the steps we are taking to try and tone up the banking system do not by any means reduce the need for...
expeditious action to extend the cover of insurance over it so as to eliminate the possibility of runs, with long queues of small depositors tending to undermine confidence in the whole system and posing a danger to its general stability. Indeed, the fact that we are taking action to amalgamate and reorganise a number of small and medium banks makes it all the more urgent that we enlist the aid and protection afforded by an insurance scheme to enable us to carry through the process of reorganisation in a smooth and orderly manner. The new units once set up will, in their initial stages, have to be nurtured for a period into confident and autonomous growth; and the fact that we expect to have many such units brought into existence makes it necessary that these vulnerable sections of the banking system are protected against unreasoned fits of nervousness on the part of the depositing public to which it has become more susceptible of late.

Yours sincerely,
H.V.R. IENGAR

SECRET

ECONOMIC SECRETARY
MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]
February 4, 1961

[My dear Iengar,]

I am writing to you with reference to your two letters dated the 28th December and 31st January relating to the proposed scheme of insurance for bank deposits.

2. In principle and on general considerations, Government view the scheme with sympathy. The positive points which you have made in your latter letter in favour of an early introduction of the scheme are weighty ones.

3. Before such a scheme can be implemented, however, a number of points of detail to which you have referred in para 3 of your earlier letter as well as some others will need to be considered. Some of these points, if they cannot be satisfactorily settled, may well create insurmountable difficulties in the implementation of the scheme. I would, accordingly, suggest that, in the light of what I have stated in the preceding paragraph, the Reserve Bank may prepare a detailed scheme which can then be further discussed. I hope to send you separately a brief memorandum covering some of the difficulties which should be taken care of while formulating a detailed scheme.

Yours sincerely,
L.K. JHA

ECONOMIC SECRETARY
MINISTRY OF FINANCE
NEW DELHI

D.O.No.[...]
February 17, 1961

My dear Iengar,

Madan reminded me that you were expecting a memorandum from us regarding the bank deposit insurance scheme. I am sorry it has been delayed, but as you can
amalgamation of the banks would provide a network of branches throughout the
country to undertake treasury work, give remittance facilities and generally carry
on and extend their operations in conformity with national interests. The
Committee was well aware of overlapping at certain centres. This will have to be
dealt with suitably when the State Bank of India is formed. The Committee,
because of the vast field which exists for expansion, has pointed out that there
would be no need for the retrenchment of surplus staff. In the Committee’s
appraisal of the situation, the need may well be for the recruitment of further
staff e.g. by re-employment of retired personnel.

(vii) The offices of the State-associdated banks are concentrated in a few districts. The
institution of a currency chest at each of these centres would be an uneconomic
proposition.

Currency chests will be established after careful investigation. At present, there
are over 100 district centres and over 300 sub-divisional centres where currency
chests do not exist.

Conclusion

The Government of India have already taken a decision on the conversion of the
Imperial Bank of India into the State Bank of India. The question now for consideration
is as to whether and if so in what manner the State-associated banks should be
amalgamated with the Imperial Bank. If, as suggested, the State-associated banks are
run as subsidiaries of the State Bank of India for some time, these banks will continue
to be placed in the respective classes under the labour awards and there would not be
any increase in establishment expenses. Such subsidiaries could also continue the
rates of interest on deposits and advances according to local conditions and make
adjustments gradually. Their administrative standards could also be improved during
the interim period i.e. till they are integrated with the Imperial Bank. One of the
essential conditions for extension of banking facilities in the country is the establishment
of currency chests to facilitate the movement of cash from one centre to another. As
already explained, a vigorous and co-ordinated programme for the establishment of
currency chests cannot be carried out so long as these banks continue as separate, and
relatively smaller units. So long as these banks continue to function as private-owned
(except, of course, the Bank of Patiala and the State Bank of Saurashtra), these banks
will be managed by the respective Boards and effective control over them cannot be
exercised. In view of the smallness of their size, lack of premises and other
arrangements comparable with those of the Imperial Bank and inadequately paid
managerial staff, it would not be possible to entrust currency chests to them at many
of the centres. Thus, remittance facilities cannot be provided until currency chests are
established and currency chests on a large scale cannot be established so long as these
banks continue to operate as smaller units. The guarantee of State Governments is not
an effective safeguard, considering the changes in the political set-up which have
taken place in certain States. It is true that the Banking Companies Act has conferred
several powers on the Reserve Bank. It is also true that banks in Part ‘B’ States which
are appointed our agents have to comply with our scheme of control. But, by the
exercise of these powers, we cannot get over the limitations arising from the smallness
do give us wide powers to direct the day-to-day working of commercial banks on approved lines. In the case of the co-operative banks even the inspection reports prepared by our inspectors are sent to the Registrars of Co-operative Societies and we have no direct statutory contact with the co-operative banks. So far as the Insurance Corporation is concerned, it may well make use of our inspection machinery for the purpose of commercial banks but the position so far as co-operative banks would be somewhat different. The large number of Urban Co-operative Banks spread over almost all the talukas and district places would also pose new problems so far as the supervision over their activities for the purpose of insurance is concerned. Besides, the relations which the depositor of a co-operative bank has with his bank are usually different from those which a depositor has with a commercial bank. In a co-operative bank the depositor may also be a shareholder of the bank in view of the restricted area of operation. In this view and having regard to the close contact which the depositor may have with a bank run on co-operative lines the possibility of a shift of deposits from co-operative to commercial banks as a result of the insurance of the deposits of commercial banks seems rather far-fetched. Even assuming that it is decided to make applicable the insurance scheme to the co-operative banks also, the selection of a few of them for insured status at once presents a number of practical difficulties and may even charge the Reserve Bank with discriminatory treatment. The selection of a few banks out of the large number of small units which forms the co-operative movement, itself may be the point of disintegration for that movement. In balance, it does not appear feasible to extend the Scheme of Deposit Insurance to co-operative banks especially when the insurance scheme as and when introduced will be more or less on an experimental basis covering deposits up to Rs 1,000/- only.

8.3.1961

***
Dear Shri Krishnamachari,

Some time ago, I had asked the Research Division to make a statistical computation on the basis of which we could estimate to what extent the policy of the Government of India, in the international and particularly the economic field, had appealed or failed to appeal to the foreign investor. In our present position, with the possibility of serious jeopardy to the Plan if we fail to get a fairly massive degree of support from other countries, such a study is particularly important.

2. You will recall that after some initial nervousness in 1947-48 immediately after independence, the foreign investor seemed to regard India as a reasonably good risk. Between 1948 and 1953, there was a net investment in our country of [Rs] 132 crores of which the U.K. share was 137 crores and that of the U.S.A. 13 crores. (Disinvestment of 18 crores by other countries.) Part of this investment consisted of fresh capital brought into the country and part of the ploughing back of profits in existing concerns. Although, in relation to the general level of overseas investments of the U.S.A. and the U.K. this figure does not sound very impressive, we have to take note of two facts: (a) that this fresh investment was made during a period of intensive rehabilitation of domestic industry in the U.K., and (b) that the increase was a substantial addition to the total volume of foreign investment in India which, at the close of 1948 was 288 crores.

3. The study which has since been completed shows that in the two years between 1953 and 1955 the net increase in foreign investment was 62 crores of which 27 crores was investment by oil companies. Of the balance of 35 crores, there is some doubt as to the precise significance of the figure of 'investment' in tea companies of 15.8 crores. Since these companies are known to have made sizeable remittances out of their retained profits during the period, the increase seems to be fictitious; it appears that the increase is due to revaluation at the high prices prevailing in 1955 of their assets—which would largely be stocks. If this is so, then the foreign investment during the two years—apart from oil refineries and distribution—has been only 19 crores. Even this figure needs to be interpreted with caution since it contains an 'investment' in banking of 4 crores; this would mostly be attributable to the movement of short-term funds.

4. I am afraid it is difficult to escape the conclusion that since 1953 the foreign investor is taking a much poorer view of India than between 1948 and 1953.

5. I think it is necessary that we should ponder over this fact and decide to what extent and in what direction it would be necessary for Government either to reorient its policy or shift emphasis in the various facets of policy. Quite obviously we cannot, merely to attract foreign capital, break away from or distort certain fundamentals which are necessitated by our social conditions and political principle. But there are
points which are not fundamentals; and in dealing with them, as I think I have told you in discussion more than once, it would seem necessary to keep foreign reaction in mind and to allow for it even if we do not always consider it particularly reasonable. The figures I have mentioned in this letter seem to suggest that we have not perhaps always attached adequate importance to this point.

Yours sincerely,

H.V.R. IENGAR

Shri T.T. Krishnamachari
Finance Minister, India
New Delhi

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SECRET

D.O.No.[...]

RESERVE BANK OF INDIA

BOMBAY

August 6, 1957

My dear Patel,

As I informed the Minister and yourself in Delhi, I am placing before my Board at the meeting to be held on the 21st of this month a paper on the Foreign Exchange situation and the amendments that would be necessary in the currency reserve provisions of the Reserve Bank of India Act. In the meanwhile I took the opportunity to discuss the subject at the Committee meeting this morning. The Committee’s views were quite clear on both the points that I put before them. They felt that rather than allow the situation to slide and then face the country with an Ordinance very suddenly when our balances looked like going down below [Rs] 300 crores, it would, in every way, be desirable to put the matter before Parliament in the form of an amending bill during the current session. You will remember my telephoning to you in Delhi shortly before I left saying that in the course of my discussion with the American Ambassador, this question as a purely tactical problem of public relations arose and the Ambassador was emphatically of the view that it would be better for us to legislate now before the Minister went to Washington rather than to do so either while he was there or immediately thereafter. The second question discussed with the Committee was the actual content of the legislation. The Committee was emphatically of the opinion that it would be a serious mistake to do away altogether with the provision requiring a currency reserve in the form of foreign securities. The Committee’s view was that such a change would be regarded as evidence that we had failed in our efforts to stabilise our situation and that the position had in fact become desperate. Foreign reaction to such legislation would be wholly adverse and internal reaction would also be bad. The Committee accepted the view which I discussed with you and B.K. Nehru in Delhi that we should even at this stage maintain a minimum reserve in foreign securities. What the reserve should be is a point which I will discuss at the Board meeting. In the meanwhile, I thought I should inform you of the feelings of my
Committee which, I have little doubt, accurately represent the views of the whole Board.

2. I am sure you will show this letter to the Minister.

Yours sincerely,

H.V.R. IENGAR

Shri H.M. Patel, I.C.S.
Finance Ministry
Government of India

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[18-2-1958]

AIDE-MEMOIRE ON JACOBSSON’S DISCUSSIONS

During his stay in Bombay Mr. Jacobsson had a series of discussions with various authorities in the Reserve Bank and the Bombay Government as well as with individual businessmen. He also gave several talks. A list of these discussions is given in the Appendix [not reproduced]. The ground covered in the course of discussions in the Reserve Bank of India and his public lectures can be divided broadly into three sectors:

(1) the present international economic situation,
(2) the current Indian economic situation, and
(3) the role of the Fund vis-a-vis (1) and (2).

(1) As far as the first sector is concerned, Mr. Jacobsson was inclined to take a somewhat more optimistic view than many of the foreign economic commentators both in the U.S.A. as well as outside it. The basis for his optimism appeared to lie in the fact that whereas in previous recessions the U.S.A. had shown strongly protectionist and also anti-foreign-aid tendencies, in the present situation the President had actually recommended measures such as continuation of Reciprocal Trade Act for a long period and increased foreign aid. Mr. Jacobsson realised, however, that the main source of difficulty for the President was his own party and not the Opposition. This change in emphasis together with increased awareness of the necessity to do something to avoid recession both on the merits of the case and on political grounds and the increased defence expenditure necessary in the present international climate were sufficient to justify the view that the recession would not be a major problem. Because of this stand Mr. Jacobsson would not say specifically what the Fund would do to help countries getting into balance of payments difficulties. He did say, though, at one of the discussions that at present the Fund had enough resources to meet contingencies foreseen now; but that if the situation became more serious the Fund would have to think of increasing its resources.

Discussing the international economic situation over a long period and in a wider context, Jacobsson made the following points:

(i) The world as a whole was getting tired of inflation. Hence the return to ‘sound’ money policies.

(ii) Therefore, a number of countries have had to cut down their investment plans. So long as America indulged in inflationary finance, the rest of the world could
afford to have an investment boom. However, with the Americans themselves checking this situation, the rest of the world would find it very difficult to continue its investment plans unaltered.

(iii) Unless investment were financed out of genuine savings it was his belief that countries would find themselves in a serious balance of payments situation and loss of reserves. Mere import restrictions were unable to meet the situation as the problem would then crop up in the form of diversion of resources from exports to import substitutes.

(iv) The present position of Germany and Italy owes very much to the policies of monetary stability pursued by their respective governments.

(v) Jacobsson frequently brought up the case of France as the most recent example of a country which has followed his prescription.

(2) Coming to the discussion of India's economic problems, Jacobsson laid great emphasis on the implications of deficit financing particularly for reserves. The framework of ideas within which he works is as follows:

(i) In his view the concept of deficit financing as used in India was equivalent to inflationary finance. He himself would use the term in a somewhat different manner. His idea was that the term deficit finance should be used to denote borrowing from the public necessary to finance government deficits; whereas it appeared to him that what we meant by deficit financing was central bank extension of credit to government.

(ii) He did not think that such a method of financing could give the government substantial additional resources for investment purposes. On the contrary, he felt that this would lead to increased demand for consumption, a rise in prices followed by a rise in wage rates. All these would finally lead to a serious loss of reserves.

(iii) He felt his theories were fully confirmed by the fact that during the year ending January 31, 1958 there was an increase of rupee securities held by the Reserve Bank of the order of Rs 405 crores, while at the same time the foreign assets held by the Reserve Bank of India declined by Rs 223 crores and in addition the country had to draw on the standby of Rs 34 crores. He thought this indicated abundantly the immediate and important (according to him) connection between Reserve Bank's extension of credit to government and loss of monetary reserves.

(iv) He realised that India had several valuable assets in the form of a stable government, a sound banking system, good administration, the people's faith in their currency and so on. He also realised the necessity of having a developmental plan of sufficiently large magnitude and the vigour with which it was being carried out. As between development and stability, however, he appeared to prefer the latter.

During the course of discussions, it was repeatedly emphasised from our side that in the first place the concept of deficit financing and its impact on money supply in relation to India's Plan was quite different from what Jacobsson appeared to think. For instance, Rs 200 crores of the deficit financing of Rs 1,200 crores was to be set off by the drawing down of Sterling balances. In other words, to that extent the increase in money supply would be reduced. Next, it was also pointed out that with the increase in the monetisation of the economy, there would be need for increase in money supply to finance the growing volume of transactions being conducted with the help of money. Then, again, with the increase in national income and standard of
living there should be an increase in the demand for cash. This would lead to a certain amount of absorption of money. Taking all these three factors together the inflationary potential of the deficit finance would be considerably reduced. Moreover, the Reserve Bank, by its policies relating to selective credit control and lending to commercial banks, can exercise the appropriate checks on the monetary and credit situation.

With reference to the current situation it was argued that, in the first place, a part of the borrowing from the Reserve Bank was due to the peculiar financing arrangements in relation to PL 480 imports. The Government of India has had to pay the Government of U.S.A. the cost of commodities purchased under PL 480 in rupees and this has been done by borrowing from the Reserve Bank and placing the amount to the credit of the U.S. Government. In the second place, it was observed that the rather large loss of reserves was attributable to two factors: (1) the rapid pace at which the private sector proceeded with its investment plans, and (2) the difficulties in arranging external assistance on a large scale within a short time. Since the Plan started with a very high level of reserves, it was found feasible to make a heavy drawing on them while all these arrangements took shape. Thirdly, it was pointed out that the balance of payments deficit was a planned deficit in the sense that it was used as the mechanism to bring the necessary resources such as capital goods, raw materials etc. into the economy from outside for the purpose of development. It was not something which arose out of consumer goods imports or out of strong price resistance to India’s exports. In fact, it was pointed out that India had not experienced during the last year any such price resistance. On the contrary, India’s exports were rather larger than those allowed for in the Plan. Fourthly, the balance of payments deficit provided the necessary corrective to the increase in money supply from government’s budgetary operations.

It seemed that at the beginning Jacobsson took a very rigid and conservative approach to India’s problems. He went to the extent of saying that India could not expect the Fund’s Executive Board to approve of a third tranche drawing if the Government borrowed a single rupee from the Reserve Bank and the Reserve Bank extended credit by a single rupee to commercial banks for financing investment. He did not think it was possible to bring any substantial unemployed resources into production by deficit finance. In any case, such resources would require complementary resources from abroad and in the absence of any other arrangements for obtaining them they would lead to a pressure on the reserves. He was convinced that his theory was amply vindicated by the statistics he had before him. He was also not prepared to consider the wider implications of following a policy of no-development without either internal savings or external resources. He felt that that was irrelevant. Towards the end of his stay, however, it appeared that he realised that the problems were not quite so simple. He stated that he would think over all that he had seen and heard in India and that what he was saying here were his first hurried impressions. He was, however, frank enough to say that he did not think his basic ideas would change very much.

(3) Jacobsson’s ideas as to what the Fund would do in relation to (1) and (2) above have already been briefly mentioned above. It seems pretty certain that if we were to approach the Fund for a third tranche drawing he would insist on a number of conditions as in the case of the French drawing. Jacobsson, in fact, made a good deal of use of these conditions and the role played by the Fund in working them out. He
also frequently likened the Indian situation to the French situation although we did our best to point out the striking differences between the two. He was, however, so taken up by the French example—particularly as he had played a prominent part in it—that it is doubtful if he ever gave up the comparison in his own mind. The fact that the French were waging the Algerian war and so using all their resources in a reckless manner, the instability of the French government, the substantial rate of investment in the French economy as compared to the national income, the high level of national income: none of these factors appeared to make much difference to him between the Indian and the French case. His conception was that both the French and the Indians tried to live beyond their resources. It did not matter whether the French were at a high level of prosperity and had indulged in over-investment or whether the Indians had a low level of per capita income, a high rate of population increase and an extremely low rate of investment in relation to national income. He did not think that the financing methods as outlined in the Plan would bring about the desired increase in investment in India. He thought that we should make efforts to induce more foreign investment and go in for long-term credits at governmental levels and from institutions like the International Bank for Reconstruction and Development. He thought there was a good chance of the volume of credits of the second type increasing substantially in future. He thought, moreover, that with the investment boom coming to an end in Europe and elsewhere Europe would be in a position to supply the much needed capital to the under-developed countries. This would, in fact, be one way of counteracting the present recessionary tendencies. He also thought that public opinion in the U.S.A. was considerably against giving further aid to Europe and as a result it would be possible for that country to divert more of its funds to under-developed countries. The pre-eminent condition for the success of under-developed countries in obtaining such external resources would, however, be the maintenance of monetary stability and the creation of a favourable climate for private foreign investment.

Reserve Bank of India, Bombay.
Dated the 18th February 1958.

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SECRET

D.O.No.[...]

My dear Bijju,

This is about the smuggling of gold from the Persian Gulf area. You did not like either of the solutions I suggested and I did not like the one you put forward and there was a danger of our getting completely stuck, helplessly watching the leakage of Sterling. When I was in Delhi last week, I had a chat with the Secretary-General and discovered that he was not happy either at the suggestion that we should pull our currency out from the Gulf. He said he would prefer something less drastic. I left with the Secretary-General the suggestion that we should send a team of two officers, one from the Bank and one from the Finance Ministry to make a rapid tour of the Gulf, ostensibly to study smuggling but in reality to advise us about the question of pulling our currency out. It occurred to me that an on-the-spot study might yield suggestions
about less drastic remedies which we have not yet thought of. I expect the Foreign Secretary will discuss this with you and A.K. Roy soon. In this connection, I enclose a copy of a letter I wrote to Dutt yesterday [not reproduced]. It seems to me that by the time I go to London we may not have any cut and dried solution in our mind. I am wondering whether there would be any objection to my verbally and discreetly posing the problem to the Bank of England and asking if they have any solution to offer. I would merely say that we are bothered by the mounting dimensions of the problem, and ask how they would have met it if they were in our place. This might (or might not) lead to something useful. Would you please think this over? I would like you to consult the Secretary-General and perhaps we could have a chat when I come to Delhi next week. I am likely to be there for a day on Thursday or Friday.

Yours sincerely,
H.V.R. IENGAR

Shri B.K. Nehru, I.C.S.
Ministry of Finance
Government of India

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RESERVE BANK OF INDIA
BOMBAY
June 28, 1958

Dear Shri Morarji Desai,

During the last few days there have been all kinds of rumours in Bombay and Calcutta about the devaluation of the rupee, and in fact I have seen three editorials in newspapers commenting about the futility of such a move. The result of these rumours has been to cause a rush for the purchase of Sterling on the part of those who would normally have waited for some time to do so. The dock strike has also created a technical situation in the exchange market which has accentuated the purchase of Sterling through the Reserve Bank. I fear therefore that the drop in the Sterling balances during the current week will be unusually heavy.

2. You will recollect my having told you that I proposed to speak on the foreign exchange situation to the Bombay Progressive Group on Monday, the 30th. I propose to take this opportunity to try and steady the situation by putting the facts in the, I hope, correct perspective. I enclose herewith for your information a copy of the text which I have proposed to use for my speech [not reproduced]. I have deliberately used guarded language but I hope you will agree that the tenor is helpful and is likely to have the desired effect.

3. I wanted to meet you personally at the airport, but I was afraid that if I did so the rumours in the market would have got accentuated.

4. I hope you are feeling better now and will have a pleasant journey to Delhi.

Yours sincerely,
H.V.R. IENGAR

Shri Morarji R. Desai
Finance Minister
Government of India
Camp: Bombay

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[My dear TT,]

I was delighted to get your letter of the 8th August, amongst other things for the indication it gave—the first one since your resignation—that you have again begun to take some interest in affairs of which you were the centre—I should say the storm centre—for quite some time. It is because I was doubtful as to whether you would take interest in our publications that I did not have any copy sent to you. I have now asked my office to put you on the mailing list and you will regularly get our publications, including the Bank’s Bulletin.

So far as the foreign exchange position is concerned, perhaps it is best to take the situation from the point where you left off last September in the United States. You remember that you had worked out that we would need 1,400 million dollars up to the end of the Second Five Year Plan in order to meet our commitments. It was assumed in these calculations that we would retain at the end of the Second Plan period a Sterling reserve of [Rs] 200 crores. Since then, certain changes have occurred. We got an American loan of 225 million dollars. The World Bank have given some money for the ports. The Japanese have given a credit of [Rs] 25 million. On the other hand, there has been some increase in defence commitments. Altogether the position as was worked out by the Department of Economic Affairs some four months ago was that we would need till the end of the Plan period an additional [Rs] 560 crores, again on the assumption that we would keep a Sterling reserve of [Rs] 200 crores. So far as the quantum of assistance is concerned, there has been no basic change in the situation since last September. The Ways and Means position, however, has become more difficult. Recent calculations show that the payments to be made during the next 12 months are so heavy that, without further assistance, we shall run through all our Sterling balances and yet be compelled to default. The problem, therefore, now is (a) of finding a total of 560 crores, and (b) of finding a good part of it within the next few months so that we would not default in our obligations.

I do not think there is any evidence of a flight of capital. Some people talk about it but I have seen no evidence of this. I am however having a closer analysis made with a view to seeking whether the ‘leads and lags’ have been aggravated, but I should be surprised to find if this has happened to any substantial extent.

So far as hire purchase is concerned, the position is that the State Bank of India Act was amended in your time with the express purpose, amongst others, of enabling the bank to finance hire purchase transactions. So far as I know all that the State Bank has done is to advance some money to the T.V.S. finance group for the hire purchase of trucks.

You have asked to what extent I am carrying Government with me. So far as asking for external assistance is concerned, the Finance Minister is in complete agreement with the view that nothing else would save the immediate situation. He is greatly looking forward to his visit abroad. You may have heard that B.K. Nehru has been appointed Commissioner-General with the status of an Ambassador and having
jurisdiction over America, Canada and Japan. His job is to help in the matter of getting credits. Swamimathan is being appointed Commissioner-General in Europe with a similar object. I believe the Prime Minister is also convinced of the pressing need of external assistance at this stage. I had sent him a copy of my speech on the Foreign Exchange situation and met him subsequently, but he made no comment about it. I see that our friend V.K.R.V. Rao has been writing articles to the effect that we are all wrong in asking for foreign assistance and that if we adopt the Gandhian way of life, everything would be bright and serene. Fortunately V.K.R.V. Rao is not in Government—at any rate not yet. There have been frequent reports that his target is the Finance Ministership, and I do not know whether he is indulging in subtle flattery of the Prime Minister who has a temperamental aversion to ask anybody for help.

You have asked about the boycott in Bombay. Quite frankly, I have ceased to be interested in it and I have ordered my own life in such a way that I could not possibly care less. I do not think that I have accepted a single invitation from any business magnate since January and it seems to be generally known that I am averse to accepting such invitations. I feel much happier because I am getting great deal more time which I devote partly to reading economic literature and partly with my family; the latter is a pleasure which I have unfortunately denied myself for many many years.

There has been no progress with the Germans so far. Blessing himself has throughout been sympathetic. B.K.Nehru got the same impression when he called on him last month at Frankfurt. His impression of the Government however was that they were very cold. However, we shall know how their mind is working after the conclusion of the Conference in Washington convened by Eugene Black.

I am thinking of coming to Madras and Bangalore for 2 or 3 weeks towards the end of October. I hope I will be able to see you in Madras then. If you are still in Kodaikanal, I could easily run up for the weekend. I wonder what shape your cottage has now taken.

You may have heard that Blue has been down with typhoid here in Bombay. (She has now shaken off her fever.) S.R. has been here for the last 3 days. They are both going back to Delhi on Monday. I believe her intention is to return to Bombay after a week’s convalescence.

My wife joins me in sending you her kindest regards.

Yours sincerely,

H.V.R. IENGAR

Shri T.T. Krishnamachari
'Blue Cairn'
Kodaikanal

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[6-11-1959]

I discussed with Shri Jagannathan this morning the following questions raised in E.C.D.:

1) re-introduction of a basic quota for travel,
2) the question of a possible liberalisation of facilities to students, and
3) the reduction of the emigration quota to Rs 75,000 per family.

On the question of a basic travel quota, I pointed out that we must either do what the Japanese have done, viz., to prevent people going out altogether except in cases where travel is considered to be of real national value, or to introduce a basic travel quota. As it is, we have fallen between two stools. We have maintained restrictions, but these restrictions are being evaded wholesale; the only people who suffer from them are the decent law-abiding citizens. I did not myself foresee that the foreign exchange situation would ease for several years to come.- A decision will, therefore, have to be taken not on the basis of the exigencies of any particular year, but as a general proposition covering, perhaps, the next decade. On a balance of all the considerations, I had come to the conclusion that the recommendation communicated to Government by E.C.D. was sound and I recommended it for Government's adoption. Shri Jagannathan said he would put this to the Minister for orders.

Shri Jagannathan explained to me the reasons why restrictions had been imposed, for example, on students going abroad for undergraduate training in medicine, although students were allowed to go for undergraduate training in other subjects. On the whole, we came to the conclusion that no particular change was called for, at the present time, in the existing regulations. In the particular case of Kumari Lall, which gave rise to a discussion of the student problem in E.C.D., Shri Jagannathan said that the Ministry would formally ratify the decision for a grant of foreign exchange. He thought there was danger of abuse where students were allowed exchange merely for part-time courses in languages but not where, as in this case, exceptional promise was shown in music.

We had a general discussion on the possibility of delegating wider powers to the Reserve Bank in the matter of releasing foreign exchange. We came to the conclusion that, on the whole, this was not desirable in the interests of the Bank itself. There might well be appeals to the Ministry and the paper work may not really be reduced. Shri Jagannathan promised, however, to examine whether any of the decisions taken over a period of time could be codified into instructions which the Reserve Bank could follow.

On the question of the emigration quota, I pointed out that while I had no sympathy at all with rich people who wanted to settle down in places such as the South of France or U.K., I had in mind, in dealing with this problem, the travel of persons between India and countries such as Kenya, Tanganyika, Uganda and the Fiji Islands. There was a constant traffic both ways; people who had retired were coming back and people were going out from India to take their place. I did not think it would be wise to put any restrictions on this traffic; and on an examination of the figures, I was satisfied that the ceiling of Rs 75,000 which has been suggested was fair. Incidentally, this figure would really make it difficult for well-to-do persons to settle down in the U.K. or the South of France.

I also discussed with Shri Jagannathan the following problem concerning the E.C.D., although this is not one of the briefs given to me. This was the question of transfers of capital to individuals in the non-Sterling area. A concrete case of this type was that of Mrs. Wenzel. Another case of the same type had been mentioned to me by Shri A.D. Shroff as having been put to him at a meeting of businessmen at San
Francisco. If the sum involved in the case of non-Sterling area individuals was large, I obviously could not recommend that they should be treated in the same way as Sterling area nationals, but if the sum was small, perhaps something could be done to liberalise the existing regulations. During the course of the discussion on this subject, Shri Jagannathan pointed out that if a non-Sterling area national held Indian Government Securities, he would be entitled to repatriate them at the end of 5 years. He thought that probably a satisfactory solution would be to raise the ceiling of 1½ lakhs. I would like the office to examine this. Is there likely to be any sizeable liability if we raised the ceiling to, say, (a) 2½ lakhs and (b) 5 lakhs?

H.V.R. IENGAR
6.11.1959

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CONFIDENTIAL

BOMBAY
June 13, 1962
Jyaistha 23, 1884

My dear L.K.,

I enclose herewith for your information a note prepared by Pendharkar, copy of which has been sent by Madan to Anjaria.

Yours sincerely,

P.C. BHATTACHARYYA

Shri L.K. Jha, I.C.S.
Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

SECRET

The question as to whether the present exchange parity of the Indian rupee needs adjustment if raised at all at this juncture would be raised primarily with reference to our present difficult balance of payments situation. Before discussing this question, however, it would be as well to mention that the question could conceivably arise in the near future in another context: this is the acute balance of payments position of our neighbours who are also our chief competitors in the three important export commodities tea, jute manufactures and cotton textiles. Both Pakistan and Ceylon are in serious balance of payments difficulties. The former has actually resorted to a form of multiple currency practice besides stringent exchange control, and the latter has had to progressively tighten up its control over imports and other payments. If their difficulties persist for any length of time, as they apparently seem likely to be, and if they are forced to adjust their parities, we too shall have to take serious notice of the problem. A fortiori any steps we may take on our own initiative will have important repercussions on them and in any estimates regarding the consequences of our action we shall have to make suitable allowance for an appropriate defensive action on their part.
Those who might suggest an alteration of the parity in the interests of our balance of payments are likely to argue on the following lines. During the Second Five Year Plan domestic prices have risen by nearly 35 per cent (average of wholesale price index numbers for 1960–61 compared with that of 1955–56). Even if allowances are made for a part of the price rise being in the nature of a correction to an unusual price fall during 1954–55 and 1955–56, and for a part being in conformity with rise in prices in world economy, there is still a substantial portion of the price increase during the Second Five Year Plan that can only be regarded as of inflationary origin. This price rise has made the parity fixed in 1949 unrealistic. An idea of the extent to which this has happened can be obtained by comparing price increases in India with those in other important countries. By expressing the index number of prices in India for a given year as a percentage of the price index number for a particular country and adjusting for the changes in the par value of the currency of the country we get an index of over-valuation of the Indian rupee. The following table shows that in terms of this index such over-valuation varied between 3 and 28 per cent for 1961.

Over-valuation/under-valuation ratio of Indian Rupee vis-a-vis main Currencies Abroad
(Based on wholesale prices)
Source: International Financial Statistics

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<td>100</td>
<td>108</td>
<td>112</td>
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<tr>
<td>Mexico</td>
<td>101</td>
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<td>110</td>
<td>106</td>
<td>110</td>
<td>112</td>
<td>117</td>
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<tr>
<td>France</td>
<td>89</td>
<td>95</td>
<td>99</td>
<td>103</td>
<td>122</td>
<td>127</td>
<td>128</td>
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<tr>
<td>West Germany</td>
<td>86</td>
<td>94</td>
<td>98</td>
<td>98</td>
<td>104</td>
<td>108</td>
<td>103</td>
</tr>
<tr>
<td>Italy</td>
<td>87</td>
<td>95</td>
<td>100</td>
<td>103</td>
<td>111</td>
<td>119</td>
<td>122</td>
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<tr>
<td>Switzerland</td>
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<td>98</td>
<td>102</td>
<td>109</td>
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<td>120</td>
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<tr>
<td>Australia</td>
<td>85</td>
<td>92</td>
<td>96</td>
<td>99</td>
<td>103</td>
<td>104</td>
<td>112</td>
</tr>
<tr>
<td>Japan</td>
<td>89</td>
<td>95</td>
<td>98</td>
<td>106</td>
<td>110</td>
<td>115</td>
<td>115</td>
</tr>
</tbody>
</table>

N.B. The Indian wholesale prices have been expressed as a percentage of the foreign wholesale prices.

The argument then would be that this domestic price rise has inhibited India’s exports. During the Second Five Year Plan India’s export performance was not too good. Though the Plan target was slightly exceeded in terms of value the quantum of exports in 1960–61 was only about 3 per cent higher than that in 1955–56. A part of this indifferent performance of exports was due, no doubt, to the impact of recessionary tendencies in the world economy during 1957–59. However, even when these disappeared exports failed to show any spectacular improvement.

Moreover, it would be argued, such improvement in exports as has taken place since 1958–59 has required the assistance of a number of special devices like the bilateral trade and payments agreements with the East European countries and the various aids and incentives given to exports. These devices generally resulted in a
certain amount of distortion of the normal pattern of trade. They do not provide a
permanent solution of the problem of exports which is uncompetitiveness due to high
prices. The remedy to this would be to adjust the parity. In further support of this
suggestion it would be argued that such a remedy is particularly relevant in connection
with the exports of products of new industries. Often these industries have a high cost
structure in their initial stages. The scale of operations is not large enough, the degree
of skill is low and so on. They have, therefore, little incentive to export especially as
the domestic market, which is sheltered by severe import restrictions, exerts a great
pull on them. One way of making exports of these items attractive would be to adjust
the parity. Since these products are sold in highly competitive markets they have
fairly high price elasticities. An adjustment in their foreign prices would be more than
recouped by increased sales.

The argument could be extended to the invisibles account also. Receipts on
invisibles account have in the past few years progressively dwindled. Some part of
this diminution can be attributed to special factors such as restrictions placed by other
governments (for balance of payments reasons) on remittances to India, and a decrease
in maintenance remittances to families of emigrants when the families also migrate.
But, by and large, the decrease is due to the possibilities of acquiring far more rupees
by selling foreign exchange in the free markets, where the rupee is quoted at discounts
ranging upto 35 per cent, than through official channels. An adjustment of the parity
would bring back some of this foreign exchange to official channels.

Moreover, as regards control on imports and other payments it could be argued
that if there were a proper adjustment of the parity it would not be necessary to
maintain control with such a high degree of restrictiveness as at present. The demand
for imports would be restricted indirectly as a result of the higher costs of imports.
Along with a reduction in the degree of restrictiveness there would also be less need
to alter the detailed commodity composition of imports through control. Similarly, in
the case of some payments like foreign travel, the increased cost would exercise a
check of its own.

This would be the core of the argument. It has been spelled out in some detail in
order to enable a proper appreciation of it. It would be seen that as it stands it looks
fairly formidable at first sight. The facts regarding prices and exports can hardly be
disputed. However, the real question is, is this the only proper remedy to the situation?
An adjustment of parity is indeed a grave step. It is capable of doing serious mischief
to a country’s economy if it is ill-conceived, as it undermines the confidence in the
currency to some extent. Moreover, it has to be accompanied by a series of
complementary measures so that the full benefit of devaluation can accrue to the
economy. Chief amongst these are measures which will counteract its possible
inflationary consequences. Before we discuss this question it might be advantageous
to dispose of the arguments concerning the utility of a parity change in relation to
imports and other payments in our present context.

As far as restrictions on imports and other payments are concerned, they perform
two basically distinct functions. In the first place they are designed to restrict the use
of foreign exchange. But more important than that in the present context is their
function of rationing foreign exchange among the different uses. For instance, foreign
exchange is severely rationed for importing consumer goods. This is in line with the principle that in a period of rapid investment it is necessary to restrict the use of resources for domestic consumption. The uses for which foreign exchange is made available are those which are considered essential in the context of our development Plans. In other words, in this sense they become a part of the whole apparatus of planning. The object in working out these restrictions is to ensure investment projects getting foreign exchange according to their order of priority. Since the priorities change from time to time depending on the availability of domestically produced goods a certain amount of change in details of commodity composition of imports is inevitable. It is, therefore doubtful whether except in some marginal cases a change in parity will succeed in reducing the degree of restrictiveness or the frequency of change in controls in this sphere.

We now come to the discussions of the arguments relating to exports. Now there is a general consensus of opinion that where exports have become incompetent due to inflationary tendencies in the domestic economy, the first priority should be given to checking these tendencies rather than to an adjustment of the parity. It follows that a really effective argument against an adjustment of the parity has to proceed from the assumption that all the necessary steps will have been taken in this regard. At this point one can refer with some satisfaction to the fact that the continuously accelerating price rise which was such a disturbing feature of the Second Five Year Plan has been halted for the best part of a year now. In other words, to the extent the arguments for an adjustment in parity are based on an assumption of continued price inflation, they now apply with much less force. However, the relative price stability enjoyed so far should not lull us into slackening our efforts in this matter. For, the course of prices is still too much dependent on the agricultural situation and although considerable efforts have been and are currently being made to reduce the dependence of agriculture on the vagaries of the monsoon, the situation is still liable to go out of gear.

The size of the overall government deficit and more particularly the manner of its financing are other main targets of criticism. The taxation proposals in the Government of India Budget for 1962-63 would to some extent reduce the force of this criticism. It would be still better if the State Governments also showed equal awareness of their responsibilities and did their share of raising resources through taxation. The resort to deficit financing (net total Reserve Bank credit to the Government) during 1961-62 has been of the order of Rs 166 crores. The figure for overall bank financing of Government deficit during the same period is Rs 210 crores. It will be necessary to restrict the quantum of such finance so that the target specified in the Plan of Rs 550 crores is not exceeded. Any slackening of effort in this direction would only strengthen the case for a change in the parity. There is also the point about the cost of such finance—particularly in relation to its cost to the private sector. It could, of course, be pointed out that in recent years there has been a certain amount of levering up of yields on Government debt. Further determination along the same lines would clearly be necessary.

As far as monetary policy is concerned, the record so far has been well appreciated by bodies, such as, the I.M.F. and the I.B.R.D. The Bank has in its armoury a wide array of weapons to meet the needs of the situation. Besides, there are the proposals
relating to the maintenance of minimum standards of liquidity by banks which will enable still greater control on bank credit extension.

Given a right 'mix' of taxation, government debt and monetary policies and with satisfactory behaviour on the part of the weather, there is no reason why the price stability achieved in the recent past should not be maintained. As far as exports as such are concerned, the performance during the first year of the Third Five Year Plan has been promising. Exports during 1961–62 are estimated at Rs 660–665 crores (E.C.D. data), an increase of Rs 28–33 crores or about 5 per cent over the previous year. More important, the performance in each of the three quarters of 1961–62 for which data are available has been definitely better than in the corresponding quarter of the previous year.

Quarterly Exports (f.o.b.; Rupees crores)
(E.C.D. data)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>1960–61</th>
<th>1961–62</th>
</tr>
</thead>
<tbody>
<tr>
<td>April–June</td>
<td>153.6</td>
<td>160.0</td>
</tr>
<tr>
<td>July–September</td>
<td>146.7</td>
<td>160.3</td>
</tr>
<tr>
<td>October–December</td>
<td>171.6</td>
<td>179.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>471.9</td>
<td>500.0</td>
</tr>
</tbody>
</table>

Analysing exports commodity-wise it is easily seen that except for groundnut oil in which Indian prices have generally always been high and cotton textiles, which are subject to extremely keen competition as well as discriminatory restrictions in several developed and under-developed countries, a number of commodities have done a little better than last year.

Commodity Composition of Exports
(D.G.C.I. & S. data; Rupees crores)

<table>
<thead>
<tr>
<th>Commodity</th>
<th>1960–61</th>
<th>1961–62</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tea</td>
<td>124</td>
<td>121</td>
</tr>
<tr>
<td>Jute Manufactures</td>
<td>134</td>
<td>140</td>
</tr>
<tr>
<td>Cotton Textiles</td>
<td>58</td>
<td>48</td>
</tr>
<tr>
<td>Raw Cotton</td>
<td>9</td>
<td>14</td>
</tr>
<tr>
<td>Vegetable Oils</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Oil Cakes</td>
<td>14</td>
<td>17</td>
</tr>
<tr>
<td>Cashew Kernels</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>Coffee</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Sugar</td>
<td>3</td>
<td>15</td>
</tr>
<tr>
<td>Ores</td>
<td>39</td>
<td>37</td>
</tr>
<tr>
<td>Hides and Skins and Leather Manufactures</td>
<td>34</td>
<td>34</td>
</tr>
<tr>
<td>New Manufactures and Others</td>
<td>183</td>
<td>203</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>633</td>
<td>662</td>
</tr>
</tbody>
</table>
Since the improvement is fairly widespread it throws considerable doubt on the hypothesis of price resistance to India's exports as a whole which is at the root of the suggestion of alteration in the parity. As for the part played by special aids and incentives it may be mentioned that over the past two or three years the scope of these schemes in terms of percentage of exports covered has not materially altered. Including textiles they cover about 18–19 per cent of total exports by value. However, the incentives for textiles are reported to have been of not much value. Excluding this item they cover only 8–9 per cent of the exports. It must be admitted, however, that a sizeable part of the improvement in exports in 1961–62 is attributable to the bilateral trade and payments agreements. The D.G.C.I. & S. data indicate that exports (including re-exports) to the East European countries increased from Rs 49.6 crores in 1960–61 to Rs 63.7 crores in 1961–62.

While a change in parity does not appear necessary to prevent a fall in exports brought about by price-resistance—exports have on the contrary increased albeit moderately—it might still be urged that on a longer-term view of exports an adjustment now may prove beneficial. Three general observations need to be made in this connection. First, it must be recognised that the scope for expansion of exports through cheapening them to the foreign buyer is governed (a) by obstacles placed by importing countries in the way of these exports and (b) by the supply and demand factors. The obstacles consist of straightforward quota restrictions and discriminatory tariffs and internal duties having a similar effect. A list of some of the important of these is given in the appendix. Since in several of the important industrial countries there is a strong prejudice against allowing imports of manufactured items from low income countries, it is obvious that attempts to further cheapen them would merely be wasted on them. As regards exports to the under-developed countries the difficulty is that in many of them their own development plans are designed to produce goods of the type we are able to export. Any measures to reduce the cost of our exports to them are, therefore, not likely to yield fruit as they would be met with appropriate restrictive measures on the part of these countries. Second, the major proportion of India's exports are based on agriculture. Here the main problem is not so much one of price incentives as of stabilising and securing a steady rate of growth of agriculture. In the case of jute manufactures, for instance, the output of raw jute has fluctuated in the past from 29 lakh bales in 1954–55 to 63 lakh bales in 1961–62. Lack of attention in the matter of price policy for raw jute has been one of the most important factors responsible for this enormous range of variation. The part played by weather too has not been insignificant. The production of cotton is another case in point. This again has varied from 29 lakh bales in 1950–51 to 54 lakh bales in 1960–61, and has made it difficult to adopt a stable export policy for raw cotton. It also introduces fluctuations in prices of cotton textiles. Besides the uncertainties of Indian agriculture, transport and other bottlenecks are much more significant than prices in a number of important items. Third, even if it can be established that a cheapening of exports would result in larger foreign exchange receipts, an alteration of parity is not the only way to achieve it. The use of appropriate production and price policies coupled with a judicious use of excise duties can achieve much the same result.
These general considerations apart it will be useful to spend some time on the commodity composition of our exports in relation to the Plan targets. The Plan envisages total exports of Rs 3,700 crores or an average of Rs 740 crores per year. Since exports in the first year of the Plan are estimated to have been of the order of Rs 665 crores, for the remaining four years of the Plan exports have to total Rs 3035 crores or an average of Rs 760 crores per year. An important assumption in the Plan was that the invisibles account would completely balance itself. This assumption has to be changed to one of a net deficit of invisibles of the order of Rs 250 crores during the Plan period. Failing a rise in external assistance of that order, this deficit will have to be distributed between further cuts in imports or increase in exports. However, in what follows we have not taken this into account and confined ourselves to the original target.

The commodity breakdown of the export target is not available in the published Plan. The figures in the following table are, therefore, taken from Exports in the Third Plan—Programme and Measures prepared for the Cabinet by the Additional Secretary, Planning Commission. This table shows for the several commodities (i) the actuals for 1961–62, (ii) the Plan annual average and (iii) the shortfall or the excess for the Plan as a whole if the 1961–62 rates are maintained.

<table>
<thead>
<tr>
<th>India’s Exports of Principal Commodities during the Third Plan Period (Estimates)</th>
<th>(Rs crores)</th>
<th>Actual Exports in 1961–62</th>
<th>III Plan Target (annual average)</th>
<th>5 years’ exports at the rate of 1961–62 actuals</th>
<th>III Plan Targets (total exports during 5 years)</th>
<th>Shortfall(−) or excess (+) (based on exports at 1961–62 actuals)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tea</td>
<td>121</td>
<td>140</td>
<td>605</td>
<td>700</td>
<td>−95</td>
<td></td>
</tr>
<tr>
<td>Jute Manufactures</td>
<td>140</td>
<td>121</td>
<td>700</td>
<td>605</td>
<td>+95</td>
<td></td>
</tr>
<tr>
<td>Cotton Textiles</td>
<td>48</td>
<td>65</td>
<td>240</td>
<td>325</td>
<td>−85</td>
<td></td>
</tr>
<tr>
<td>Raw Cotton</td>
<td>14</td>
<td>10</td>
<td>70</td>
<td>50</td>
<td>+20</td>
<td></td>
</tr>
<tr>
<td>Vegetable Oils</td>
<td>6</td>
<td>22</td>
<td>30</td>
<td>110</td>
<td>−80</td>
<td></td>
</tr>
<tr>
<td>Oil Cakes</td>
<td>17</td>
<td>24</td>
<td>85</td>
<td>120</td>
<td>−35</td>
<td></td>
</tr>
<tr>
<td>Cashew Kernels</td>
<td>18</td>
<td>22</td>
<td>90</td>
<td>110</td>
<td>−20</td>
<td></td>
</tr>
<tr>
<td>Coffee</td>
<td>9</td>
<td>12</td>
<td>45</td>
<td>60</td>
<td>−15</td>
<td></td>
</tr>
<tr>
<td>Sugar</td>
<td>15</td>
<td>5</td>
<td>75</td>
<td>25</td>
<td>+50</td>
<td></td>
</tr>
<tr>
<td>Ores</td>
<td>37</td>
<td>52</td>
<td>185</td>
<td>260</td>
<td>−75</td>
<td></td>
</tr>
<tr>
<td>Hides &amp; Skins and Leather Manufactures</td>
<td>34</td>
<td>30</td>
<td>170</td>
<td>150</td>
<td>+20</td>
<td></td>
</tr>
<tr>
<td>New Manufactures and others</td>
<td>203</td>
<td>262</td>
<td>1015</td>
<td>1310</td>
<td>−295</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>662</td>
<td>765</td>
<td>3310</td>
<td>3825</td>
<td>−515</td>
<td></td>
</tr>
</tbody>
</table>
It is not possible to discuss in detail the prospects of reaching each of these targets. However, a few brief observations in respect of the important ones would be useful to understand the nature of the problem.

**Tea:** Given favourable weather conditions there are not many difficulties as regards increasing domestic production. Even then it seems rather difficult to attain the export target. This is so because of the competition from other countries. It is of course assumed here that any price incentive that may be given by us is bound to be matched by appropriate incentives to their tea exports by other countries.

**Jute Manufactures:** The performance of jute manufactures during the current year has been quite satisfactory. It must be remembered, however, that a part of this was due to the rather high prices for jute manufactures obtaining during the early part of last year. However, one promising feature of the situation is that raw jute prices, which, thanks to a very good crop, have receded from the high levels of last year, will from now on be stabilised through the operations of the buffer stock agency in such a way as to assure a steady supply of the raw material to the industry. Assuming a reasonable degree of success in these operations and appropriate response on the part of the industry one can hope for a good export performance in respect of jute manufactures. It does not look as if jute manufactures are in need of a price incentive at this stage. However, one has to take into account the actions by Pakistan in respect of her export incentive scheme and planned increases in productive capacity of which pose a serious threat to us. Any price incentive that we may give will, of course, be matched by Pakistan.

**Cotton Textiles:** As regards cotton textiles, the future is not very hopeful. A price incentive may have only a limited effect in view of the reluctance of industrialised countries to allow substantially larger exports of textiles from countries, such as, India, the ever-growing competition from other countries in our export markets and the import restrictions which one can expect from under-developed countries to which we are at present exporting and which may begin their development with the establishment of textile mills.

**Raw Cotton:** During 1961–62 exports of raw cotton have been quite satisfactory. The real problem here is that of organising raw cotton production in such a way that a sufficient and steady volume of raw cotton exports will take place. For this purpose it would be necessary to make up our mind and announce a quota much before the annual crop comes in. Since these exports are of a special type of cotton, it is not really necessary to give any price incentive to this commodity.

**Ores:** Here the difficulty is one of inelastic supply in the wider sense of the term, i.e., production of ore and its transportation to the export points. A price incentive is, therefore, not of much help.

**Vegetable Oils:** In these items we are priced out of international markets. The reason is the high domestic demand. It appears, however, that rather than give a price incentive in the export market, which is likely to be negatived by a further rise of prices in the domestic market, it would be necessary to give priority to the production of oilseeds.

**Oilcakes:** Much the same comment applies to this commodity also.
Coffee: Normally there should be no difficulty in reaching the target for coffee except for the fact that the international price of coffee is highly variable.

Sugar: As far as sugar is concerned, more than the export target was reached even in 1961–62. However, this was achieved only with the help of heavy subsidies. The effect of a parity change will mainly be to alter the amount of subsidies. It is not likely to result in substantially greater exports.

Hides and Skins: As regards hides and skins, the difficulty is mainly one of inelastic supply. The item does not require any price incentive as the demand is quite strong.

New Manufactures: It will be seen from the table that the Plan places a major reliance for achieving the overall export target on increase in exports of this group, which consists mostly of products of newly established industries. In many cases the costs are rather high because of initial difficulties, the scale of operation being small, etc. These are also items the exports of which have to be made in highly competitive markets. There is competition not only as regards prices as well as credit facilities but also in such matters as packaging, advertising, etc. Besides, there is the problem of overcoming brand name resistance. As regards credit facilities appropriate steps are being taken through the agency of the Refinance Corporation of India to provide the necessary credit facilities. However, in view of the other factors mentioned it is obvious that a mere price incentive will not be adequate.

The sum and substance of this brief examination is that a price incentive, provided by a change in parity, has a somewhat limited role to play in the present context of our export problem. The more important need of the hour is to devote attention to the supply side of the picture. Since a large proportion of exports is agriculturally based, it is essential to ensure that the agricultural part of the Plan is successful in raising the output, particularly of those crops which have an important bearing on exports.

The arguments in the foregoing paragraphs may be summed up as under:

(i) During the Second Five Year Plan prices showed a rise of 35 per cent while exports remained more or less static. However, in the first year of the Third Plan both these trends were reversed; prices have showed a welcome degree of stability for the best part of a year and exports have shown an improvement of some 5 per cent over the previous year’s level. The part played by special export incentives in this improvement appears to be marginal.

(ii) As far as the fiscal and monetary policies are concerned the authorities have shown a determination to hold inflationary pressures in check. More could and should be done in this direction.

(iii) Insofar as the case for a change in parity is based on an assumption of continuing inflation it loses a considerable amount of its force in view of what has been stated in (i) and (ii) above.

(iv) The kind of price incentive a change in parity offers is for a number of reasons likely to be of a limited benefit only to our exports. For, in the first place, several of them are subject to quota and tariff restrictions. The price advantage that a parity change can give is likely to be neutralised by obstacles of this type. Secondly, as our exports are heavily dependent on agriculture, it is the supply side of the picture that needs to be set right. Thirdly, in a number of cases success in exports depends upon
success in removing various bottlenecks, such as transport and power, or upon developing the requisite skill in packaging, advertising, salesmanship, etc.
(v) Finally, a change in parity is not the only way of giving a price incentive to exports. The same effect can be achieved through appropriate production and price policies. The latter type of measures are preferable to the former as not only do they not have the adverse psychological effects which a change in parity brings about but what is more important is they are the basic determinants of the success of the Plan. A change in parity should be regarded as a measure of the last resort to be adopted when costs have become so high and rigid that it is the only way left to bring about the desired changes in the balance of payments or alternatively when similar action on the part of a country’s competitor threatens its balance of payments.

[V.G. P(EN)DARKAR.]
11.6.1962

APPENDIX

Quota restrictions in certain overseas markets of India
(Mainly European & American)

Cotton Textiles: There is a voluntary ceiling on imports of cotton textiles of 195 million sq. yards for the year 1962 into the United Kingdom. France, West Germany and Austria are the other three countries who impose import quota restrictions on cotton textiles. They are as follows:
France: upto 1200 tons
West Germany: 5 million D’marks
Austria: 125 tons

Vegetable Oils: Quantitative restrictions—Government controlled imports, mixing regulations and other non-tariff devices are in force in West Germany, France and Italy. Imports of castor oils restricted by Belgium and Netherlands.

Carpets: Quota restrictions in France.

Sewing Machines: Quota restrictions in France and West Germany.

Coir Manufactures: Quota restrictions in France and West Germany.

Cashew Kernels: Indirect restrictions in Italy to support almonds.

Spices: High revenue duties. Quota restrictions in France for pepper.

Tobacco: (i) High revenue duties.
(ii) Monopoly purchases in France and Italy.

Jute goods: In most cases of Common Market countries, apart from Benelux, they enjoyed the benefit of a highly protected home market. Italy, however, relaxed import curbs considerably during 1960 and West Germany will end all quantitative restrictions after 1964.

Although the duty is ‘nil’ in the U.K. for imports from India, the Jute Controller, who is the sole importer for certain types of jute goods applies a uniform mark up of 20 per cent in respect of common hessian cloth (40" 10 oz. hessian in 40" at 36" widths and 45", 11 oz. hessian in 45" width used for making bags, are still subject to a mark up of 40 per cent).
My dear Krishna Moorthi,

This is in continuation of my talk with you regarding Anjaria’s cable dated 24th November on the subject of quota increases and gold subscriptions.

While I agree generally with the line of action proposed by Anjaria in paragraph 12 of the cable, I would suggest the following modification. We should announce like the U.S.A. that even if a waiver is granted, we would be prepared to pay 25 per cent of our quota increase in gold subscription. This should not be difficult with the stock that Government has at its disposal. Our argument for a complete waiver of gold subscription can then be made to appear as a disinterested and objective argument based on the merits of the case.

Outright payment of gold by us at this stage has, in my view, several advantages. Firstly, it would strengthen our position as a member of the First Five on the Fund Board. Secondly, it would help us as regards the tranche position and therefore as regards a drawing on the Fund. This should be of considerable help to us in the immediate future if we have to undertake next year an operation of the 1961 type to fulfil our current repurchase obligations. Moreover as I have already said above, our advocacy of the use of Article III, Section 4(a) would be strengthened when it is known that we ourselves are not interested in availing of it, but it may help us on the next occasion of a quota increase. If Government agrees with this line, would you kindly issue the necessary instructions to Anjaria and send a copy to me? I shall not send anything to him from here.

With kind regards,

Yours sincerely,

P.C. BHATTACHARYYA

Shri C.S. Krishna Moorthi
Joint Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

***

Dear Mr. Schweitzer,

I am afraid we have run into a little snag in our negotiations regarding our proposed request for a standby arrangement with the Fund. I would have myself come to Washington to represent our point of view to the Management. But both my wife and I are not keeping well so that it is rather difficult for me to leave India at short notice.

Yours sincerely,

P.C. BHATTACHARYYA

Shri C.S. Krishna Moorthi
Joint Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
notice. I am taking this opportunity, therefore, of writing to you and I am requesting I.G. Patel who has been associated with the discussions here with the Fund team to meet you. He will be able to answer any questions that you may have.

2. Our approach in these negotiations from the beginning has been that we should ourselves take whatever measures are necessary in our own interest and that we welcome assistance from the Fund in this respect. Accordingly, we welcomed the suggestion of the Fund team that apart from the fiscal and monetary measures we have already taken—including higher interest rates, a balanced budget, general fiscal restraint on imports and promotion of exports—we should have a monetary budget to guide our course of action during the coming months. We were able on this basis to work out a mutually agreed programme with the Fund team. We also agreed that since we ourselves would want to adhere to policies which we consider in our own interest, there might be a clause in the standby agreement that we should consult the Fund in case unforeseen circumstances lead us to depart from any of the policies or intentions outlined in the letter of intent and that, if necessary, we would arrive at fresh understandings before making further drawings.

3. We were given to understand, however, that we must specifically undertake in the standby agreement to consult the Fund and refrain from further drawings if the credit ceilings mentioned as part of our intentions in the letter of intent are exceeded at any time. Our view is that while we would consider any such eventuality as a shift in policy calling for consultations and renegotiation of understandings, if called upon, a direct link between credit limits only and further drawings would be unfortunate.

4. In the ultimate analysis, relations between the Fund and its members have to be based on mutual trust and the policies that the Fund considers appropriate can be made acceptable only to the extent that member countries consider them as their own rather than those stipulated by the Fund as a precondition to drawings. As you can well imagine, there is criticism here that some of the measures we have taken must be at the request of the Fund and political susceptibilities within member countries cannot be ignored when, as in our case, the Fund and the member are agreed on the substantive issue. In the present standby, we have agreed to go much further in our letter of intent than we had done in the past; and we are rather at a loss to understand why a specific binding in regard to credit ceilings is considered more important than our express intention to consult and come to mutual agreement regarding further drawings, if required, whenever a shift in any aspect of policy outlined in our letter of intent becomes necessary.

5. There is also a further point about the phasing of the standby. We ourselves would not like to draw more than is absolutely necessary and we are prepared, in view of the latest trends in reserves, to agree that we would not draw more than $125 million before the end of April, 1965. But, if as is suggested, we cannot draw more than $125 million before the end of May, the very purpose of the standby is likely to be defeated as we cannot be sure that the present position in which we are just able to avoid suspending legal foreign exchange reserve requirements will not appear again in May. From the point of view of restoring confidence also, it is desirable that we have a little more freedom in drawing than what might be absolutely necessary in relation to our minimum foreseen needs.
6. We are deeply conscious of the helpful spirit in which the Fund management and staff have approached our proposed request for a standby. But perhaps the importance of the point of view I have mentioned, viz. that the policies being adopted by a member in its own interest should not be made to appear as if they are stipulated by the Fund as a precondition to drawing, might not be fully appreciated from a distance. I have every confidence that you would suggest an arrangement which would meet our point of view as well as the requirements of the Fund.

With best regards,

Yours sincerely,

P.C. BHATTACHARYYA

Mr. P.P. Schweitzer
Managing Director
International Monetary Fund
Washington D.C.

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TOP SECRET

Discussions with the I.M.F. and the World Bank
(February 1 to 8, 1966)

Dr. I.G. Patel and I visited Washington D.C. to explore the possibility of a drawing from the International Monetary Fund and to discuss in a preliminary way with the World Bank the time-table for meetings of the Aid-India Consortium. We had a clear brief for our discussions with the Fund. As for the Bank, it became clear very soon that a Consortium meeting to consider our needs for the Fourth Plan could not take place before the autumn of 1966. It was also doubtful if our requirements for 1966–67 could be considered earlier in their entirety. Accordingly we decided to explore with the Bank whether an approach could not be made to the leading members of the Consortium during the next few weeks regarding some relief in respect of our heavy debt repayment obligations to them during 1966–67 so that we could have a better basis on which to frame our policy for import licensing for the coming fiscal year.

2. Mr. Schweitzer, the Managing Director of the Fund, was most anxious to help from the outset, particularly in view of the fact that the drought has added to our balance of payments difficulties. However, in view of the opposition he had met from the Fund Board in the past—particularly in respect of a drawing from the U.A.R.—he was hesitant to commit himself to a normal drawing by us without a fundamental reform of our exchange system. He accordingly proposed at first temporary relief to us in the near future to be followed by a substantial line of credit of the order of 300 to 400 million dollars at a later stage on the basis of an agreed programme in regard to fiscal, monetary and exchange policies. The temporary relief could take two alternative forms, viz., postponement of the repayment of $75 million due in March to July or a credit of $100 million or so to be repaid in one year. Even this temporary relief, Mr. Schweitzer argued, will have to be justified as emergency relief to meet the difficulty created by the drought. A normal drawing or standby would not be feasible as our
budgetary and general monetary outlook was not such as to commend itself to the Fund Board.

3. We resisted these suggestions and argued in favour of a normal drawing in the near future for a number of reasons. A drawing repayable in one year as distinct from a drawing repayable normally within three to five years was not consistent with our status as one of the Big Five in the Fund; and, like the postponement of $75 million till July, a short-term drawing might raise speculation regarding our future intentions. We were also not in favour of linking a fundamental reform of the exchange system with a drawing from the Fund in view of the fact that this matter had received considerable comment in the Indian press. While our needs were larger than the drawing of $200 million requested, we were not in favour of a large drawing from the Fund, as in our circumstances, we needed long-term money for import liberalisation. It was for this reason that we were discussing simultaneously the question of postponement of some of our debt obligations with the Bank. At the back of our mind, there was also the consideration that agreement with the Fund on a programme relating to fiscal and monetary matters might prove difficult as long as we have not been able to make satisfactory arrangements to ensure greater fiscal discipline on the part of the State Governments. We, therefore, pressed strongly in favour of a straight drawing or standby in the near future for an amount of approximately $200 million.

4. It is, I think, mainly a reflection of the goodwill and statesmanship of Mr. Schweitzer that ultimately he agreed to recommend to the Fund Board a straight drawing on our part in the near future. The preference for drawing rather than a standby is in view of the fact that we were not in a position to agree to any quantitative ceilings on the budgetary deficit or on monetary expansion. The drawing will have to be justified essentially in terms of the impact of the drought on the balance of payments. It will be a normal drawing repayable within three to five years. Mr. Schweitzer, however, was unable to indicate to us the exact amount of the drawing as he wished to consult the Executive Directors from important countries before making up his own mind. He indicated that the drawing will be larger than $125 million which we have to repay to the Fund between now and July 1966. While he was unable to commit himself at this stage to a drawing of $200 million, he assured us that he would like to see that we were left with a sufficient margin after meeting our dues to the Fund. We can, therefore, reasonably expect a drawing of the order of $150 or 175 million if not $200 million. The exact amount will be made known to our Executive Director Mr. Anjaria in a week or two.

5. Our request for the drawing will have to be made as usual in the form of a letter from the Finance Minister to Mr. Schweitzer. Apart from justifying our needs for an immediate drawing in terms of the effect of the drought on the balance of payments the letter should specify the policies we are pursuing to deal with our agricultural, fiscal and monetary problems. We will also have to say that we recognise that we have a continuing foreign exchange problem, that we are examining ways and means of solving our chronic difficulties and that we propose to remain in continuous touch with the Fund in our search for an enduring solution.

6. It would also be necessary for our Executive Director to inform Mr. Schweitzer
orally at the time that he transmits our formal request for a drawing to him that the Government of India have decided in favour of a formal change in the par value of the Indian Rupee to be made in June 1966. In view of the brief already given to me, I have authorised Mr. Anjaria to make the necessary statement orally to Mr. Schweitzer at the appropriate time. After the drawing but well before June, Mr. Schweitzer would also like us to discuss with him and the Fund staff the question of the adequacy of the measure we propose to take in June and the accompanying adjustments we propose to make in fiscal and other related matters. I have agreed that we shall do so.

7. On this basis we can count on a drawing from the Fund in March 1966. If need be, we could also request the Fund for another drawing later in the year. I have kept the door open for such a request to guard against the possibility that our attempt to refinance debts and to get other aid that we need may not succeed to the extent desired.

8. The suggestion was made that we might repay the $75 million due in March a little earlier—say, three or four weeks before the drawing; and I have agreed that we shall be prepared to do so if the Fund informs Mr. Anjaria that this would be desirable.

9. Throughout our discussions, the Bank and the Fund were in continuous touch with each other. At first, there was some question whether the Bank or the Fund should take the initiative regarding the refinancing or postponement of our debt obligations. It was, however, agreed that the Bank will take initiative in this regard. The bulk of our debt repayments next year are due to the World Bank, the United States, the United Kingdom, West Germany, Japan and Canada—i.e. the original members of the Aid-India Consortium. It was also agreed that the approach should be made to only these countries as inclusion of other countries to whom we owe smaller amounts might raise unnecessary arguments. There was also some question whether the refinancing should be in respect of repayment of principal only or should include interest repayments as well. We have suggested that, to the extent possible, we would like both principal and interest to be covered in any arrangement for postponement or refinancing. Our preference is also for new loans which would enable us to repay the amounts due rather than an actual postponement of the amounts due. What is feasible, however, would only emerge in the course of discussions with the countries concerned. I was assured that it was not the intention of the Bank to insist on a uniform response from all the countries.

10. We also put it up to the Bank that although our obligations to the Bank cannot be refinanced directly, the Bank should consider giving us a loan for the import of industrial components and materials, as such a loan would serve the same essential purpose as refinancing, namely, that it will enable us to import on a more adequate scale. It was agreed that the World Bank would give us a loan of $50 million for the import of industrial components, particularly for capital goods industries. This would be in addition to normal Bank financing of this nature. The figure of $50 million represents the amount we owe to the Bank in 1966–67 by way of repayment of principal. The loan will be on terms which will avoid any repayment obligations during the Fourth Plan.

11. As for the five countries mentioned earlier, the Bank has agreed to get in touch with the Governments concerned immediately to explore the possibility of debt
refinancing or postponement of debt obligations. Simultaneously, we ourselves should also get in touch with the Governments concerned through their representatives in New Delhi to explain what we are after. After the preliminary soundings of the Governments concerned, the Bank will either convene a meeting of the representatives of the five countries to secure the necessary pledges or advise us to open bilateral negotiations with the Governments concerned.

12. In a general way, we also discussed with the Bank our requirements for assistance in all forms during 1966–67. In a sense, we need immediately assurance not only in regard to debt refinancing but also in regard to non-project assistance as well as assistance for continuing projects where this has not been already fully arranged. While assistance for taking up new projects may not be considered before the full-fledged consortium for the Fourth Plan as a whole which may not take place till the autumn of 1966, it may well be that an earlier meeting of the Consortium will be necessary to consider our total requirements for 1966–67. We have advised the Bank that, apart from debt refinancing, we would need non-project assistance for 1966–67, at least on the same scale as in the recent past and that we shall consult them further on this point when the debt-refinancing problem for 1966–67 is out of the way.

13. We have given the Fund and the Bank such information as was readily available with us. The Fund has, however, given us a questionnaire to which replies have to be sent in the near future. The Bank will also send a similar questionnaire as soon as possible. They have, however, indicated to us that they will require information from us not only in regard to debt repayments but also in regard to our general balance of payments position in 1966–67, the impact on the economy and on the level of imports of debt refinancing and any other relief we get simultaneously from the Fund, and an explanation of why any relief thus secured without a corresponding relief from the Soviet Union and other East European countries would not work to the detriment of consortium members. Above all, the impact of the emergency on balance of payments will have to be clearly spelt out. While we have given tentative answers to all these questions, more formal answers will have to be given in the near future.

14. It remains for me to say that both Mr. Schweitzer and Mr. Woods were extremely friendly and sympathetic. But for their determination to be helpful to us and to override the objections of their own staff, we would not have been as successful in our negotiations as we have been. We have reason to believe that apart from the assistance from the Fund on the scale already indicated, we shall also be able to have a significant part of our debt obligations for the next year postponed or refinanced.

P.C. BHATTACHARYYA
12.2.1966
My dear Bhoothalingam,

This is with reference to your D.O.No.[...] dated [...] regarding the problem of insulating our Sterling balances against any unilateral action by the U.K. As desired by you, a self-contained note containing a description of the present position etc. has been prepared and is enclosed herewith.

The broad conclusion of the note is that the action we have taken recently has resulted in a considerable running down of the Sterling component of our foreign exchange reserves and to that extent has reduced the importance of the problem of any unilateral action on our foreign exchange reserves. Sterling balances are now less than 50% of these reserves whereas in recent years they used to be 70–85%. This trend will continue so long as the arrangements referred to also continue.

An attempt has been made in the note to assess the prospect during the rest of the financial year. In the absence of details regarding foreign exchange budget prepared by Government from time to time this assessment is rather incomplete. On the basis of such information as is available with us in the Bank, it seems to me that we have now come to a stage where the highly liquid portion of our Sterling balances e.g. cash and Treasury Bills are in fact inadequate to meet the expected net outgo during September to November. According to our calculations, payments in non-Sterling currencies during this period are likely to amount to as much as Rs 27.6 crores while payments in Sterling would be Rs 66.5 crores. In terms of the present policy of meeting all payments obligations from the Sterling balances, therefore, this would involve some liquidation of the holdings of the dated securities whether by us or by the High Commission and in fact we have already initiated some action to liquidate a small portion of our dated security holdings.

To meet the payments liabilities during September to November of Rs 27.6 crores in non-Sterling currencies, the best way would be to convert the requisite amount of Sterling in the spot market into dollars or the actual currency required for repayment. This operation should be spread over a period of three to four weeks. Unless the U.K. position deteriorates very seriously, there may not be much opposition from the U.K. authorities to it.

As to the commitments in non-Sterling currencies during the period December–March, there is considerable amount of difficulty. The normal way to make arrangements for such payment would be to buy the required currencies forward. However, at this juncture the U.K. authorities would be considerably perturbed if we were to make purchases in forward market of such large amounts. There is a dilemma here. If the unilateral action by the U.K. is expected to come in the immediate future, then the transaction would be too large even to be handled through the market let alone the question of its being acquiesced in by the U.K. authorities. But even if it were possible to put it through the market there is still the question whether the U.K. authorities will allow it. In fact, I understand that they have already taken action to check the pressure on forward Sterling by directing all foreign exchange dealers to bring about a sharp reduction in their holdings, of
foreign currencies. This would reduce their ability to take up bear positions. This is a departure from their earlier practice of controlling the forward market through judicious intervention. In other words, from a market device they have moved on to a more direct control. I doubt, therefore, whether they will agree to our purchasing such large amounts of forward dollars. Insulating our holdings in the form of securities poses an even greater degree of difficulty for here there is the problem of liquidation of the securities in an orderly manner so as not to incur excessive capital loss, as well as the problem of insulating the value of the Sterling proceeds through the forward market.

My view, therefore, is that we may continue the present policy and try to insulate as much of the non-Sterling commitments as we can through the spot market as possible taking care at the same time not to upset the market. The first action should be to transfer Rs 27.6 crores required to meet non-Sterling obligations from September to November. Thereafter balance Sterling available in liquid form should be so transferred. In addition, proceeds of such of the securities that can be liquidated without attracting notice could also be transferred to U.S.A. and invested there. If you agree, I suggest that you initiate action on this behalf.

It will not be advisable to force the pace too much. Even if we are left with some Rs 100–115 crores worth of Sterling on which we have to take a loss in the event of any unilateral action, such Sterling could be utilised to make payments within the Sterling area. In fact, because of the responsibility placed on the Reserve Bank of India under Section 40 of the Reserve Bank of India Act and the order made by the Government under it the Bank is required to buy or sell spot Sterling from any authorised person in India and therefore it requires a fairly large working balance in order to be able to do this. Such a position is likely to continue because of certain natural factors irrespective of whether the U.K. takes any unilateral action or not.

Before concluding this letter I should like to say a word or two about the Sterling area arrangements as well as the legal and other responsibilities of the Reserve Bank in the matter of foreign exchange reserves. As far as the Sterling area arrangements are concerned, it seems to me that their importance to us has diminished very considerably after the acceptance by the U.K. of the convertibility obligation under Article VIII of the I.M.F. and more importantly because of the steps we have taken in recent years to diversify our foreign exchange reserves. Pro tanto the significance of the understandings between ourselves and the U.K. would also seem to have diminished. This is not to say, however, that the U.K. authorities will not raise any questions at all regarding our current policy of conserving non-Sterling currencies and using Sterling for meeting non-Sterling obligations and thus causing a pressure on the Central Reserves. As they get more and more into a tight corner, they may try to persuade us to reduce our resort to the central reserves. If this is done, we may accommodate them upto a point as it certainly is not in our interest that the U.K. should take the unilateral action. We can afford to be a little accommodating because we have already reduced the proportion of our Sterling in our foreign exchange reserves to a small amount and we should normally have to make large payments in Sterling.

On the question of management of foreign exchange, it seems to me that both in terms of the law as well as in terms of the actual practice, it is the Government
which has the primary responsibility in this matter. Both under the Reserve Bank of India Act as well as the Foreign Exchange Regulation Act, certain obligations are placed on the RBI by the Central Government and it is the Central Government which has the powers to suspend them. Indeed, it appears that except for the foreign exchange that we hold in order to fulfil the requirements under Section 33(2) of the Reserve Bank of India Act regarding the assets of the Issue Department, all other foreign exchange is held by us on behalf of the Central Government in terms of the Foreign Exchange Regulation Act. This apart, the actual management of the foreign exchange is really done by the Government. The foreign exchange budget is prepared by the Government and the import licences and foreign exchange sanctions to various Government departments are given by the Government. We are not fully informed of the detailed break-up of such payments obligations to be in a position to make previous arrangements currencywise for payments. Further, the broad features of exchange control policy are also decided by the Government albeit in consultation with the Reserve Bank. Any shortfall in the foreign exchange is also made good by the Government through short- or long-term borrowing. Even as regards the week-to-week management of the Bank’s foreign assets the mechanism of H.C.I.’s Special Investment Account and the ISM account is used by Government to absorb fluctuations and maintain them at a predetermined level. In view of all this, I think you will agree that it is only the Finance Ministry who can take a comprehensive view and decide on the appropriate line of action from time to time. We, of course, will continue to bring to the notice of Government any features in the world economic situation which, in our view, would warrant a review of the situation.

Yours sincerely,

P.C. BHATTACHARYYA

Shri S. Bhoothalingam
Economic Secretary
Ministry of Finance
Government of India
New Delhi

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VII. THE BANK AND GOVERNMENTS

A. RESIGNATION OF B. Rama Rau

PERSONAL

FINANCE MINISTER

INDIA

NEW DELHI

March 15, 1955

My dear Rama Rau,

As I explained to you personally, both the Prime Minister and I have come to the conclusion that it would be an advantage to call off the arrangements made about your relief. The Prime Minister will find it very difficult to spare Pillai. In the circumstances I felt that I should request you to continue as Governor for a couple of years more. You know what great importance we attach to the recommendations of the Committee of Direction: All-India Rural Credit Survey. You have been so closely associated with their work that I am quite certain it will be a gain from the point of view of both the Reserve Bank of India and Government if we could have your assistance when these recommendations are in the process of being implemented. This is, therefore, to request you in writing, as I have done so verbally, to agree to continue as Governor for a couple of years more. I have spoken to the Prime Minister about this and he agrees with me that you should be prevailed upon to continue. If this should necessitate any reconsideration of some of your present terms, we shall be glad to have your suggestions in the matter, but both the Prime Minister and I do hope that it will be possible for you to accede to this request.

Yours sincerely,

[C.D. DESHMUKH]

Shri B. Rama Rau
Governor
Reserve Bank of India
Central Office
Bombay

SECRET

NEW DELHI

D.O.No.[...]

December 12, 1956

My dear Rama Rau,

The Finance Ministry have sent me your letter dated 10th December addressed to H.M. Patel with which you have sent a memorandum issued by you on the 10th December to the Central Board of the Reserve Bank. In this memorandum you have examined the implications of certain provisions of the Finance Bill, 1956. I have read this memorandum with great surprise. Apart from the contents of the memorandum, the whole approach appears to me to be improper. It is, if I may use the words, an agitational approach against the Central Government. To address your Directors in this way seems to me extraordinary.
Further, it has also surprised me that you should refer in a memorandum of this kind to a private talk with the Finance Minister. I am told that the report of that talk is not accurate. But whether it is accurate or not, this kind of reference to a private talk in a memorandum of this kind appears to me to be against all conventions and practice.

When you talked to me, I pointed out to you that it was for the Central Government to lay down policies and the Reserve Bank could not obviously have policies contrary to those of the Central Government. You agreed with this. And yet I find in your memorandum a different viewpoint expressed.

The Central Government, as you know, is directing its policy to attain certain objectives laid down in the Five Year Plan. It would be completely absurd if the Reserve Bank followed a different policy because it did not agree with those objectives or with the methods of achieving them.

You have laid stress on the autonomy of the Reserve Bank. Certainly it is autonomous, but it is also subject to the Central Government's directions. The question of fixing the bank rate is a matter for the Reserve Bank to consider. The stamp duty proposed by the Central Government is not the same thing as varying the bank rate, although it has certain effects upon it. That decision in regard to stamp duty was taken by the Cabinet after full consideration and I cannot accept any plea that Cabinet should not do so till the Reserve Bank approved. It is certainly desirable that the Reserve Bank's views on such matters should be obtained for us to consider. In fact, even according to your letter, this matter was mentioned to you six days before the Bill was introduced in Parliament and you were asked to advise as to what the rate should be.

Monetary policies must necessarily depend upon the larger policies which a government pursues. It is in the ambit of those larger policies that the Reserve Bank can advise. It cannot challenge the main objectives and policies of Government.

There are apparently some sections of the business community who disapprove of our basic policies and who have in fact criticised them. They have every right to do so. But it is surprising that the Reserve Bank should encourage this criticism and indirectly participate in it itself.

Yours sincerely,

[JAWAHARLAL NEHRU]

December 13, 1956

SECRET
D.O.No.[...]

Shri H.M. Patel, I.C.S.
Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
Dear Sir,

I am directed to forward herewith a copy of the Governor's memorandum No.[...] dated the 10th December 1956 regarding the implications of certain provisions of the Finance Bill, 1956. This memorandum was discussed by the Central Board of Directors
at an emergency meeting held at Bombay on Wednesday, 12th December 1956. A copy of the resolution passed by the Board is also attached.

Yours faithfully,
Secretary

MEMORANDUM TO THE CENTRAL BOARD

Implications of certain provisions of the Finance Bill, 1956

Under Section 49 of the Reserve Bank of India Act, the Bank is required “to make public from time to time the standard rate (commonly referred to as the Bank Rate) at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act”. A change in the Bank rate is one of the important methods by which the central banks of most countries control the credit structure and one of the most important statutory duties of the Board of the Reserve Bank is to determine this rate in accordance with market conditions and the state of the economy in general. The Committee of the Central Board of Directors, which has all the powers of the Board announces this rate at its weekly meeting every Wednesday.

2. Until the end of 1951, the Reserve Bank did not buy or rediscount bills of exchange on any appreciable scale and the Bank rate was in practice the rate at which advances were made by the Reserve Bank to scheduled banks against Government securities held by them. In January 1952, with a view to introducing an element of elasticity in the credit structure, the Reserve Bank introduced the Bill Market Scheme, under which banks could borrow from the Reserve Bank against usance bills created “on the basis of bonafide commercial or trade transactions bearing two or more good signatures one of which is that of a scheduled bank”. It was thus possible for the bank concerned to borrow money not only against Government securities but against these usance bills. The Bill Market Scheme which had originally been confined to a few big banks was subsequently extended to all licensed banks.

3. When the Bill Market Scheme was first introduced in 1952, advances against these usance bills were granted at a concessional rate, i.e. ½ per cent below the Bank rate, and the Reserve Bank also paid half the stamp duty. These concessions were made in order to encourage the banks to make use of the Bill Market Scheme for financing themselves during the busy season. The Scheme, however, proved to be a phenomenal success and the advances obtained by the licensed banks under the Bill Market Scheme since January 1956 have amounted to nearly Rs 354 crores. The concession of ½ per cent was, therefore, no longer necessary, and it was withdrawn in two stages during recent months. The rate at which advances against these bills are given at present is therefore the standard Bank rate of 3½ per cent (per annum) and the banks also pay the stamp duty on these usance bills, which until the introduction of the recent Finance Bill was only 2 annas per Rs 1,000.

It is now proposed to increase the stamp duty to Rs 10 per Rs 1,000 for bills of one year’s maturity, i.e. the new ceiling rate will be 80 times the present rate. It was, however, announced that the present intention was to operate on the basis of half
these rates. In other words, the rate for usance bills will be Rs 5 per Rs 1,000 or 8 annas per Rs 100 per annum. The banks will thus be required to pay 3½ per cent per annum to the Reserve Bank as interest on the advances and ½ per cent per annum extra in the form of stamp duty. The increase in the duty in respect of bills will in effect be equivalent to an increase in the Bank rate by ½ per cent per annum.

4. This increase was decided upon without any prior consultation with the Governor or the Board of the Reserve Bank, on whom rests the statutory responsibility for altering the Bank rate. The decision of the Government was announced to the Governor and senior officers of the Bank six days before the introduction of the Bill, but it was made quite clear that it was a definite decision of Government on which the views of the Bank were not invited. The Bank’s opinion was asked for only on the question whether the immediate increase be Rs 5 per Rs 1,000 or Rs 10 per Rs 1,000. A few days after the introduction of the bill, I attempted to discuss the implications of this measure with the Finance Minister, but he stated that he took full responsibility for the Government decision, that the Bank was a “section” of the Finance Ministry of the Government of India and that we would have to accept the decision whether we liked it or not.

5. The decision of the Government and the procedure adopted raise important issues. As the Board is aware great importance is attached to the independence of the central banks in most democratic countries, for it is expected to consider economic problems dispassionately and offer considered advice to the Government. The independence of the Reserve Bank of India has been safeguarded in the Act, and it has been emphasised by the convention that the Governor and the Deputy Governors should retire from Government service, if they are Government servants at the time of their appointment. The relations between the Government of India and the Reserve Bank of India have also been clearly defined in the Act. The Government can, under section 7 of the Act, “give such directions as it may, after consultation with the Governor of the Bank, consider necessary in the public interest”. “Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank.” In actual practice, however, no directive has been issued to the Bank since nationalisation in 1949. The relationship between the Reserve Bank of India and the Ministry of Finance has since its establishment, and certainly during my tenure of office, been one of the closest and most harmonious co-operation. In view of the responsibility imposed on the Reserve Bank for deciding monetary policies and other matters, it is hardly necessary for me to emphasise the grave consequences of treating the Bank as a department of the Government of India.

6. The Finance Minister stated in Parliament in regard to the stamp duty that the proposal was a fiscal measure “with a monetary intent”. As I have explained already, the immediate increase of the stamp duty on bills to Rs 5 per Rs 1,000 or 40 times the present rate will in effect be equivalent to an increase in the Bank rate of ½ per cent per annum. Actually, there has, however, been no difference of opinion between the Government and the Reserve Bank on this question. After detailed discussion with the Reserve Bank, the Government have recently agreed that it would not be desirable to raise the Bank rate at present.
7. If the Finance Bill were passed, there would be two authorities who would operate the Bank rate—the Reserve Bank in the usual manner under section 49 of the Act, and the Government by variation of the stamp duty by executive order of the Finance Ministry. The consequences of this dual control of the Bank rate need hardly be emphasised.

8. The new measure would also seriously affect the working of the Bill Market Scheme, which has been regarded by the banks and the business community as one of the outstanding achievements of the Reserve Bank in recent years. At the recent meetings the Finance Minister and I had with the bankers in Calcutta and Bombay, the banks pressed for further liberalisation of the Bill Market Scheme, and we have been considering at the request of the Finance Minister the question of increased facilities under the Scheme. Far from liberalising the Scheme, the present proposal will severely discourage the creation of usance bills for Bank advances. Banks would now obtain funds as far as possible either by borrowing against Government securities in their portfolio or by selling them. This would not be a desirable tendency, for an adequate portfolio of unencumbered Government securities is an important safeguard for the depositors, if there should be a run on any bank.

In this connection I may explain why the duty on bills was imposed at a nominal rate of 2 annas per Rs 1,000. In December 1938, the Reserve Bank advised the Government of India that the development of the bill habit was essential if the Reserve Bank was to fulfil its role of assisting and regulating banking development in India and, as the incidence of stamp duty on usance bills had been an obstacle to the use of time bills, it was suggested that early steps should be taken to reduce the stamp duty. After careful consideration of the issue, the Government of India agreed to the suggestion and issued a notification in 1940 reducing the duty on usance bills with a maturity not exceeding one year to 2 annas for every thousand rupees. The duty has now been increased 40 times and the Government have taken powers to raise it to 80 times.

9. For the information of the Board I may state that in a letter dated December 3rd, the Chairman of the State Bank, which has used the Bill Market Scheme to the extent of Rs 212 crores in the present year has, after consulting his experts, stated that “with the stamp duty enhanced as proposed by the new Finance Bill the cost will, of course, be increased substantially and the bank could no longer make use of the Bill Market Scheme without loss to themselves”. I have also just received a copy of a telegram sent by the Indian Banks Association to the Government of India in which they have expressed their strong feeling that the “unprecedented increase in stamp duty will prove of great harm to functioning of banks and increase cost of credit facilities for business and industry”.

10. In view of the facts stated above, I consider that we should explain to the Government the full implications of this proposal and request them to reconsider it.

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY
10th December 1956

B. RAMA RAU
GOVERNOR
Resolution passed at the emergency meeting of the Central Board of Directors of the Reserve Bank of India held in Bombay on Wednesday, 12th December 1956

"The attention of the Board has been drawn to the implications of the steep revision of the stamp duty proposed by the Finance Minister. Although this may be claimed to be a fiscal matter it has, as stated by the Finance Minister, monetary implications which cannot be ignored. The views of the Reserve Bank should, therefore, have been sought on the subject. The Board feels that the revision of the stamp duty on the scale announced, apart from the general repercussions on the credit facilities available to trade, industry and commerce, in effect adds substantially to the Bank rate, which it is the statutory responsibility of the Reserve Bank to fix every week. The Board requests the Government to consult the Reserve Bank in advance on all matters which significantly affect the monetary structure and policy."

SECRET

NEW DELHI

D.O.No.[...]

My dear Shri Rama Rau,

The Finance Minister has seen the minutes of the meeting of the Central Board of the Reserve Bank held at Bombay on the 12th December, 1956. He would be glad if he could have, for his confidential information, a brief summary of the discussion that took place at the meeting with reference to the item 7 of the agenda with a copy of the draft resolution as originally placed before the Board by the Governor and of the amendments, if any, which might have been proposed and discussed, leading up to the resolution as passed by the Board.

Yours sincerely,

[G. SWAMINATHAN]

SECRET

BOMBAY

D.O.No. [...]

My dear Swaminathan,

Your letter No. D.O. [...] of December 17th 1956 reached me just as I was leaving my house to catch the plane for Calcutta, and since the papers were all in Bombay, I could not reply earlier.

We do not keep any record of the discussions at Board meetings except the memoranda circulated to the Board and the resolutions finally passed. If any member dissents from the resolution and desires that his dissent should be recorded, his views are recorded briefly in his own words. This has been the invariable practice from the inception of the Bank. Members sometimes express an opinion, which they change after hearing the other members. Their final views are embodied in the resolution, which in this case was unanimous.

No draft approved by the Governor was circulated with the memorandum to the members of the Board in this case. To facilitate discussion, I asked the office
to prepare a draft more or less on the basis of the views I had expressed in my memorandum to the Board. This was prepared and circulated to the Board at the meeting as a basis for discussion. One or two members did not like this draft, and two of the members present were requested to submit alternative drafts. One of these drafts was accepted by me and it was adopted unanimously. I enclose herewith copies of the original office draft circulated for discussion and of the final resolution.

Yours sincerely,

[B. Rama Rau]

Shri G. Swaminathan
Government of India
Ministry of Finance
New Delhi

SECRET

BOMBAY
December 29, 1956

My dear Srinivasan,

I enclose herewith a letter for the Prime Minister. I should be grateful if you would place the letter in his hands when he has sufficiently rested after his strenuous tour abroad. If by any chance, he wishes to see me in this connection, kindly telephone or write to my Calcutta address —

C/o Reserve Bank of India
8, Council House Street
Calcutta
Tel. No. 23–6111

Yours sincerely,

[B. Rama Rau]

Shri C.R. Srinivasan
Private Secretary to the Prime Minister
New Delhi

SECRET

BOMBAY
December 29, 1956

My dear Prime Minister,

I am puzzled—and pained—by the tone and contents of your letter of December 12th, which reached me after you had left Bombay. As you know, after the Finance Minister’s remarks to me, it was my intention to resign, but I refrained from doing so only because of my personal regard for you and your expressed wish that I should stay. After having given you (and subsequently to Pantji) my assurance that I would not go against your wishes, is it conceivable that I could be adopting an “agitational approach” in placing the facts before the Board? I have never in all my life resorted to underhand tactics. Strict privacy has always been maintained in regard to the proceedings of the Board meetings. In the course of the last 7½ years that I have been
in charge of the Bank, the Board had differed—sometimes strongly—from the
government on several issues, but absolutely nothing has ever leaked out regarding
such differences of opinion. It is now nearly three weeks since my memorandum was
circulated to the Board, but so far there has not been any reference to any difference
of opinion in this matter between the Bank and the Government in any of the
newspapers or financial journals as a result of the reference to the Board. The Board
consists of very responsible businessmen and eminent economists, who are fully
aware of the importance of secrecy.

After explaining all the circumstances to the Board, I stated in the concluding
paragraph of my memorandum that “in view of the facts stated above, I consider that
we should explain to the Government the full implications of the proposal and request
them to reconsider it”. After discussion, the Board passed the following resolution.

“That the attention of the Board has been drawn to the implications of the
steep revision of the stamp duty proposed by the Finance Minister. Although
this may be claimed to be a fiscal matter it has, as stated by the Finance
Minister, monetary implications which cannot be ignored. The views of the
Reserve Bank should, therefore, have been sought on the subject. The Board
feels that the revision of the stamp duty on the scale announced, apart from
the general repercussions on the credit facilities available to trade, industry
and commerce, in effect adds substantially to the Bank rate, which it is the
statutory responsibility of the Reserve Bank to fix every week. The Board
requests the Government to consult the Reserve Bank in advance on all
matters which significantly affect the monetary structure and policy.”

I may add, for your information, that one or two members, who knew the facts,
wanted to discuss the issue of the Finance Minister’s rude behaviour to me, as they
thought this affected the dignity and status of the Governor. I, however, refused to let
the Board discuss this issue and stated that it was entirely a matter between the
Finance Minister and myself. I ruled that the Board should only discuss the proposals
of the Government and their implications. I leave it to you to judge whether it would
be fair to draw any inference that there has been any “agitational approach” in the
consideration of the issues by the Board.

2. After I had seen you in Delhi in the evening on December 6th and given you an
assurance that I would not go against your wishes, I had to face a very difficult
problem. Before my interview with you I had, of course, taken into confidence two or
three of my trusted friends and two prominent members of the Board. The general
consensus of opinion before the interview was that I could not with any self-respect
continue in office. Under the Act, the general superintendence and direction of the
affairs and business of the Bank is entrusted to the Central Board of Directors. It was,
therefore, my statutory duty to explain the implications of the proposal to them and
draw their attention to the fact that I had not been consulted before the decision had
been taken. It was suggested to me that the best course under the circumstances
would be to place all the facts before the Board, and after careful consideration I
decided to convene a special meeting of the Board to consider the matter and to give
them an opportunity of making such representations to the Government as they
considered necessary. I have worked with the Board harmoniously for nearly 7½
years and I was confident that whatever the provocative nature of the Finance Minister’s remarks as to the status of the Bank, etc. I could guide the deliberations of the Board in such a way that no embarrassment would be caused, especially as I had agreed at your request to continue in office. You must trust my judgement in such matters and judge me by the results. The Board have had their say and the result was quite satisfactory from every point of view. Nothing has leaked out about any difference of opinion.

The very recent public attacks by the Finance Minister in Parliament and outside on the Reserve Bank have, however, provoked a lot of comment and speculation. I refer to these in the last portion of my letter.

3. As you are naturally not acquainted fully with the past working of the Reserve Bank, I may explain that the Bank have on several occasions considered it to be their duty to offer objectively their comments even on issues on which the Government had already come to a decision—not, of course, with the intention of raising an agitation but entirely with the object of placing their views before the Government. I will mention one issue which you had to deal with as Finance Minister a few months ago. In December 1954, the Government had announced their decision in Parliament in connection with the nationalisation of the Imperial Bank that it was their intention to take over the State-Associated Banks in course of time. The Board considered the question and expressed their opinion by a majority that it was undesirable to take over these banks (most of which were working satisfactorily) and that if for constitutional reasons it was absolutely necessary, only the banks owned or completely controlled by the State Governments might be absorbed. I had myself considerable sympathy with the views of the majority and Deshmukh agreed to this compromise. Since the Constitution was subsequently amended, you as Finance Minister asked me whether there were any other reasons for taking over the State-owned banks, except the Hyderabad State Bank. After discussion with me, you agreed with the views of the Board, although the Government had made a statement in Parliament at an earlier stage as to the Government’s policy in regard to this matter.

To give you another instance, (which is rather relevant in the present context) the Government suggested over two years ago that, while it was absolutely necessary that the Governor of the Bank should not be a serving official, the convention which requires even the Deputy Governors to retire from service should be relaxed, since it was becoming difficult to get suitable non-officials, and officials were reluctant to resign unless they were on the verge of retirement. The Board unanimously turned down the request, since they strongly felt that the independent status of the Bank under the Statute would be affected, if the Deputy Governors were serving officials. The Government acquiesced in this view.

4. You have stated that my reference in the memorandum circulated to the Board to a private conversation with the Finance Minister was against all conventions and practice and that my statement was inaccurate. I had seen him in order to discuss an important official matter and the conversation was ‘private’ only in the sense that no one else was present and my version was inaccurate only in one respect—and that is, I refrained from reproducing in the memorandum the very rude language in which the Finance Minister’s remarks were couched. He has not concealed his view that the
Reserve Bank is only “a section of the Finance Ministry”. He has repeated this statement to several people and two well-known and responsible non-officials (one of them a member of our Board) have repeated this expression to me. In one case, the expression used was “a department” and in the other case it was “a section” of the Finance Ministry. It seemed obvious that his failure to consult the Reserve Bank on an important matter that impinged on the statutory responsibilities of the Bank was not due to an oversight but to his definite view that as a mere department of the Finance Ministry, the Reserve Bank was not entitled to be consulted. Was it not my duty to bring this issue to the notice of the Board, especially as the definite intention of the Reserve Bank Act was to establish an autonomous body, which was to discharge its functions subject only to such directives as may be issued by Government in consultation with the Governor? The authors of the Act (which was passed by your Government in 1949) obviously attached great importance to the autonomous status of the body, especially as it was expected to maintain the stability of the currency, examine financial problems and to give its advice dispassionately whatever the party in power. The Government have, of course, the right to reject the advice but the important point is that the Reserve Bank should be given an opportunity of placing all the facts and of expressing their views to the Government before they come to a decision on technical and sometimes complicated monetary issues.

5. In the course of your letter you have made the following statements which have puzzled and hurt me very considerably:

(1) “The Central Government, as you know, is directing its policy to attain certain objectives laid down in the Five Year Plan. It would be completely absurd if the Reserve Bank followed a different policy because it did not agree with those objectives or with the methods of achieving them.”

(2) “Monetary policies must necessarily depend upon the larger policies which a government pursues. It is in the ambit of those larger policies that the Reserve Bank can advise. It cannot challenge the main objectives and policies of Government.”

(3) “There are apparently some sections of the business community who disapprove our basic policies and who have in fact criticised them. They have every right to do so. But it is surprising that the Reserve Bank should encourage this criticism and indirectly participate in it itself.”

If I may say so with all respect, I take strong exception to these statements, which are absolutely unwarranted and not justified by the facts of the case. May I request you to read again my memorandum to the Board (or if you have not got the time ask one of your Secretaries to read it) and point out a single sentence which could justify these inferences. You have in the course of your letter admitted that the Reserve Bank is certainly an autonomous body and that it is certainly desirable that the Reserve Bank’s views on such economic matters should be obtained for the Government to consider. It has never been disputed by me or by the Board that the Government have the power, after consulting the Reserve Bank, to come to any decision they like in the interests of the country. These are the only two points which have been raised in the memorandum. In the case of the stamp duty, the Government had come to a decision before the Finance Minister met me and the senior officers of the Bank. In announcing
this decision, he made it quite clear that the Reserve Bank was not being consulted on
the proposal and that he was seeking our advice only on the question whether the rate
should be 40 times or 80 times the previous rate. This can hardly be regarded as
consultation.

I am, however, more disturbed by your remarks on the other points. In the
memorandum to the Board there is no reference whatever to the Five Year Plan. You
may remember that when you were Finance Minister you asked me to send you my
observations on a memorandum circulated by the Finance Ministry to the Cabinet on
the inflationary and other aspects of the Second Five Year Plan. In my letter to you
D.O. No.[...] dated August 28, 1956, I have explained my views in regard to the Plan.
To enable you to refresh your memory, I quote below the relevant paragraph from
this letter:

"This statement is not, of course, intended to be a criticism of the economic
policy of the Government or of the magnitude and structure of the Plan. My
object is to emphasise that all development expenditure must inevitably
result in a certain measure of inflation in the initial stages though the pressure
is, of course, comparatively greater in the case of deficit financing. Indeed,
my definite view is that in the present circumstances we would be fully
justified in proceeding with our development plans by taking calculated
risks in regard to inflation. As I stated last year at the International Bank
meeting in Istanbul in reply to certain indirect comments of President Black
on India's economic policy, we have to demonstrate that within the frame-
work of a democratic structure we can develop at a pace comparable to that
in totalitarian countries. The target for a higher standard of living in the
Second Five Year Plan is comparatively modest, and unless we reach this
target, we should not be surprised if our people, the vast majority of whom
are ill-fed and ill-clothed, turn their attention to some other economic or
political creed which offers at any rate hopes of a better existence. Democracy
and freedom cannot have any significance for these classes unless they
result in some relief for them from the life-long struggle to satisfy their
elementary physical requirements. Development is imperative if the
democratic system is to survive. We must, therefore, be prepared to face a
certain measure of inflation and must devise appropriate monetary, fiscal
and possibly administrative measures, to ensure that the inflationary situation
does not get out of control. The utmost vigilance in regard to economic
development will, of course, be necessary in the next few years."

I have strongly supported the Plan as a whole, both in India and abroad, though
I have differed on minor details. When there was a suggestion at the meeting of the
World Bank last September that we were embarking on too ambitious a Plan, I
vehemently defended the Government policy in undertaking a Plan of this magnitude.
I attach a brief extract from my speech at the World Bank meeting. I have certainly
not opposed the Government's economic policy based on a socialist pattern of society.
I am also strongly of the view that as much of the money required for the Plan as
possible should be met from increased taxation and borrowing. I have certainly no
sympathy with any sections of the business community which are not functioning in
the national interests and which have opposed the Government's basic policies. I am very astonished by the allegation that the Reserve Bank has encouraged this criticism and indirectly participated in it itself. I do not know what justification there is for such a serious allegation and I am sure after what I have said you will recognise that it was not a fair statement to make about the Reserve Bank's outlook.

6. When you prevailed upon me not to submit my resignation, I had made up my mind to forget all that had happened and to co-operate wholeheartedly with the Finance Ministry in the solution of the very difficult economic problems that they will be faced with in the immediate future. I expected, however, that there would be some reciprocity in this matter, but the recent public outbursts from the Finance Minister against the Reserve Bank both in Parliament and outside have created a very difficult situation. You have stated in your letter that my reference to a private conversation with the Finance Minister in a secret memorandum circulated to the Board was against all "conventions and practice". I do not know how you will describe the unprecedented attacks of a Finance Minister on the Central Bank of the country, not on a question of policy but on its capacity or competence to discharge the functions imposed by the Statute. I need hardly explain that such statements by a responsible Minister of Government on the authority responsible for the stability of the currency would shake the confidence in India and outside in the currency of the country. Nor need I point out the gross impropriety of such an attack on a public institution which cannot reply publicly to such criticism.

The Reserve Bank has to its credit a record of which it can be proud. India has today one of the stablest currencies in the world in spite of the enormous expenditure on development in the First Five Year Plan. The price level at the end of the First Five Year Plan period was actually slightly lower than the price level in 1951 when the Plan was put into operation. The part played by the Reserve Bank has received wide appreciation from World Bank and I.M.F. Missions and from well-known foreign financial journals such as the London 'Economist'.

The Finance Minister has described the Reserve Bank as 'reserved' and has expressed doubts in Parliament as to whether it is capable of doing any thinking. He has stated that the Bank has a 'clerical' mentality and that it believes in a policy of 'stay put'. We have today a very high status among the central banks of the world. Like all other central banks we are 'reserved' and do not publicise our achievements. Since you have not been directly in touch with the working of the Reserve Bank, may I summarise briefly some of our major achievements, which have sometime been described as "revolutionary" in regard to the working of the Bank? Apart from the maintenance of the stability of the currency, our achievements are briefly as follows.

1. The institution of a system of regular and periodical inspection of all banks has contributed enormously to the standard of integrity in, and the stability of the banking system in India according to observers both in India and abroad. There has been no failure of any scheduled bank since 1951.

2. The monetary policy of the Bank during the last 5 or 6 years has not only contributed to the remarkable stability of the currency but also to the maintenance of a remarkably steady level of prices. The economists attached to the I.M.F. and World Bank have appreciatively referred to this as
One Central Bank has cited India’s monetary administration as a model for undeveloped countries in Asia.

(3) The introduction of a self-liquidating credit instrument under the Bill Market Scheme which has been regarded both by the business and financial communities as a ‘memorable’ and outstanding achievement. During the present year the advances obtained by banks amounted to over Rs 364 crores.

(4) The nationalisation of the Imperial Bank of India with a view to a wide extension of credit facilities all over India, the mobilisation of the rural and semi-urban savings all over the country for development purposes, and the provision of credit facilities for co-operative organisations. It need hardly be explained that no large-scale development of agriculture and small industries can take place without credit facilities.

(5) We have during the last 2 years evolved with the assistance of the Rural Credit Survey Committee a colossal plan for the provision of credit facilities in rural areas with a view to the rapid development of agriculture and small-scale industries. This has been described by eminent observers as a revolutionary measure designed to promote the rapid development of Rural India.

I have only mentioned some of the major achievements with a view to enabling you to assess the truth of the Finance Minister’s remarks that the Reserve Bank is “clerical-minded” and believes in a policy of “stay put”.

7. I assured you that I would not go against your wishes in regard to my resignation, but the public attacks of the Finance Minister on the Reserve Bank have created a new situation in which it will be absolutely impossible for me to continue in office. I hope you will appreciate my position and allow me to submit my formal resignation through the Finance Ministry. I am leaving for Calcutta by plane on Sunday, December 30th, and expect to be there for a week or two. I will await your reply there.

8. I must apologise for the length of this letter, but the observations in your letter are very serious and require detailed reply. When I am quitting office, I cannot possibly let you be under the impression that I could be in any way disloyal to you or to your Government.

Yours sincerely,

B. RAMA RAU

Shri Jawaharlal Nehru
Prime Minister
New Delhi

SECRET

D.O.No.[...]

NEW DELHI

January 1, 1957

My dear Rama Rau,

I have received your letter of the 29th December. I wrote to you on December 12th on the basis of the note you had circulated to the members of your Board. That
note appeared to me to be improperly worded and did convey an impression to me of,
what I called, “an agitational approach”. I did not say anything about underhand
tactics, nor did I refer to any previous incident or complaint. So far as I am concerned,
I had no reason to complain previously of your not working in co-ordination with the
Government. I have not of course been in intimate touch with these matters.
2. My letter was, therefore, confined to this particular instance and I thought that I
should let you know what my own reactions were to the memorandum circulated to
the Board. I still think that that was not a proper memorandum.
3. You refer to the Finance Minister using the expressions “a Department” and “a
Section”, in regard to the Reserve Bank. I think that these expressions can only be
understood in a larger context. Obviously the Reserve Bank is a part of the various
activities of the Government. Obviously also it has a high status and responsibility. It
has to advise Government, but it has also to keep in line with Government.
4. You have quoted some sentences from my letter and say that you take strong
exceptions to those statements. Those statements lay down a policy which I think the
Reserve Bank and the Government of India should follow. I think the tone of the
memorandum you issued was not in keeping with these broad policies.
5. I agree with you that it is not desirable to carry on such controversies in public.
6. When you spoke to me about your resignation on the previous occasion, I asked
you not to resign. I did not think that any need for such a resignation had arisen. But
since you feel now that it is absolutely impossible for you to continue in office, I do
not know what further advice I can give you. If you so wish, you can submit your
formal resignation to the Finance Ministry.

Yours sincerely,

[JAWAHARLAL NEHRU]

BOMBAY
January 7, 1957

My dear Prime Minister,

With reference to your letter No.[...] dated January 1st 1957, I enclose herewith
for your information a copy of my letter of resignation which I have sent to the
Finance Minister.

Unless there is fresh provocation, I do not propose to issue any public statement
even after I relinquish office for obviously any public controversy between the Reserve
Bank and the Finance Ministry might have repercussions in this country and abroad.

Yours sincerely,

[B. RAMA RAU]

BOMBAY
January 7, 1957

Dear Shri Krishnamachari,

I was shocked to read the reports of the unwarranted and insulting remarks about
the Reserve Bank in the recent public speeches you delivered at the South Indian
Chamber of Commerce at Madras and elsewhere. Such attacks by the Finance Minister on the Central Bank of the country are absolutely unprecedented and grossly unfair, especially as requirements of propriety do not permit me publicly to reply to these criticisms so long as I am in office. Such a reply is perhaps unnecessary at any stage, since the Reserve Bank has a record of achievement of which the country could be proud and which is well-known to all sections of the public who are interested in finance and development.

2. While maintaining the independent status assigned to the Reserve Bank by statute, I have always considered it my duty to co-operate fully with the Government in the implementation of their national policies in the economic sphere. I have worked in complete harmony with the Finance Ministry for 7½ years in the course of which we had to deal with very difficult monetary and other economic problems. I have more than once protested against your personal rudeness in the past, but I was prevailed upon to overlook it. Since, however, you have now thought it necessary to make public attacks on the Reserve Bank, it is not possible for any self-respecting Governor to offer that wholehearted co-operation with the Finance Ministry, which is absolutely necessary in the interests of the country during the critical times ahead of us.

3. Therefore, submit herewith my resignation of the office of Governor. I should be obliged if you would make arrangements for my relief as early as possible.

Yours sincerely,

[B. RAMA RAU]

PURSHOTAMDAS THAKURDAS

Dear Mr. Governor,

The happenings in the last couple of weeks in the relation between the Board of the Reserve Bank and the Central Finance Ministry are so extraordinary, one-sided and unprovoked that I feel it is not to the interest of the country that any non-official should avoidably keep up his connection with the Reserve Bank. I therefore hereby request you to do the needful, so that I may not be re-nominated after what has been happening lately.

I wish to thank you most cordially for all the courtesy you have shown to me during your term of office as Governor and wish you complete happiness and peace of mind hereafter.

Yours sincerely,

[PURSHOTAMDAS THAKURDAS]
SECRET

D.O.No.[...]

From : Shri H.M. Patel, I.C.S.
Secretary to the Government of India

To : Shri B. Rama Rau
Governor, Reserve Bank of India, Bombay

Dear Sir,

I am desired to acknowledge receipt of your D.O. letter of January 7, 1957 addressed to the Finance Minister in which you have tendered resignation of your appointment as Governor, Reserve Bank of India. I am to convey Government's acceptance of your resignation.

2. The Finance Minister does not wish to offer any comments on the reasons which have led you to take the decision to resign except to say that his views on the working of the Reserve Bank generally were explained by him to you when you last met him in Delhi.

Yours faithfully,
[H.M. Patel]

SECRET

D.O.No.[...]

My dear Ambegaokar,

Since I am handing over charge to you on Monday next, I shall not, of course, be present at the special meeting of the Central Board to be held on Wednesday, January 16th. The members of the Board are entitled to know why I have resigned and they may naturally ask you to explain the facts. You may, therefore, read the contents of this letter at the Board meeting.

2. The members of the Board have, no doubt, seen the reports of the unwarranted and rather offensive remarks about the Reserve Bank in the recent public speeches of the Finance Minister at the South Indian Chamber of Commerce in Madras and elsewhere. Such public attacks by the Finance Minister on the Central Bank of the country are without precedent and extremely unfair, especially as it would not be proper for the Reserve Bank to enter into a public controversy with the Government by replying publicly to these criticisms. While maintaining the independent status assigned to the Reserve Bank by statute, I have always considered it my duty to co-operate fully with the Government in the implementation of their national policies in the economic sphere. Throughout the period I have been Governor of the Bank, I have worked in complete harmony with the Finance Ministry. It will be realised that in view of these public attacks it would be difficult for the Finance Ministry and myself to maintain the harmonious co-operation that is absolutely necessary in the interest of the country. I, therefore, decided to submit my resignation, which has been accepted by the Government.
3. I have refused to make any statement to the press about the reasons which have led to my resignation and I have no doubt that the members of the Board will, as they have done in the past, in such cases treat this statement as strictly confidential.

4. I would like to take this opportunity of conveying to the members of the Board, individually and collectively, my deep appreciation of the valuable advice and unfailing support they have always given to me during the last 7½ years. My association with the Board has been one of the pleasantest experiences in my career and I cannot adequately express my gratitude to them.

Yours sincerely,

[B. RAMA RAU]

Shri K.G. Ambegaokar
Reserve Bank of India
Bombay

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B. AFTERMATH OF THE MUNDHRA AFFAIR

MEMORANDUM TO THE CENTRAL BOARD

Representation of the Reserve Bank on Statutory and other Organisations

Recent developments have underlined the need for a more precise definition of the functions and responsibilities of statutory corporations and suggested the advisability, in this context, of reviewing the relationship of the Reserve Bank with various Boards and Committees, statutory and otherwise, on which it is at present represented. The objective of such re-examination should be to minimise the scope for possible misunderstanding of its position in the interest of upholding the highest public confidence in the monetary management of the country. It is necessary at the same time constantly to bear in mind, in carrying out such a review, that the Reserve Bank of India, as it has developed historically, has acquired a wider conception of central banking functions than similar institutions in the more industrially advanced countries. Thus the Bank takes a great deal of initiative not only in the field of economic research and advice but also in the improvement of the systems of agricultural and industrial finance. It is necessary therefore that the Bank should not, on the one hand, remain in an "ivory tower"; on the other, its functions should not be so diffused as to jeopardise its ability to carry out its primary responsibility as the monetary authority of the country.

2. The organisations on which the Bank is represented or to which its officials are nominated may be broadly classified into the following:

(1) Institutions engaged in the provision of financial accommodation. This category may be further sub-divided as under:

(a) Institutions on which the Bank's representation is statutory, e.g., the Industrial Finance Corporation, the National Co-operative Development and Warehousing Board, the Central Warehousing Corporation, the State Bank of India, the State Bank of Hyderabad, etc.,
(b) Institutions with which our association is non-statutory and arises from contractual arrangements, e.g., the Bank of Mysore which is working as our banker in the territories of the former Mysore State under the agreement executed between the Reserve Bank and the Bank.

(2) Institutions which formulate, or assist in the formulation of policies, such as the Small-Scale Industries Board, the Standing Advisory Committee on Agricultural Credit, the Central Committee for Co-operative Training, the Bombay State Advisory Council for Small Savings, the Small Savings Board of the Government of India, Governing Board of the Indian Statistical Institute, etc.

(3) Miscellaneous official bodies and committees such as the Co-ordination Committee of the Central Government for economic questions, the Working Group on Small-Scale Industries appointed by the Government of India, the Central and Local Co-ordination Committees and the Central Working Party constituted for working the Pilot Schemes of the State Bank, etc. The Bank’s representation on the Central Statistical Organisations and Conferences of Central and State statisticians may also be mentioned, which reflect a wider interest on the part of the Bank in the organisation of the country’s statistical services than could perhaps be justified in terms of a strict interpretation of the Bank’s own sphere of operations. The attendance of the Bank’s London Manager on the Commonwealth Liaison Committee could also be classified similarly. In the same category would fall numerous Committees appointed from time to time by the Government of India on which staff members of the Bank serve, such as the Foodgrains Enquiry Committee and Working Party on Fiscal Monopolies, to mention only two recent instances.

(4) Organisations or associations constituted by or with the approval of Government to administer specific fields of financial activity or operations such as (i) the Export Risks Insurance Corporation, (ii) the Board of Referees to decide on appeals under the Income Tax (Amendment) Act, 1957, regarding deposits of company reserves, (iii) the Bombay Bullion Association, (iv) the Boards of the Stock Exchanges in Bombay, Calcutta and Madras and (v) the East India Cotton Association and the Oilseeds Exchanges, Bombay and Madras.

(5) In a fifth category may be placed the proposed association of the Bank with two bodies—one statutory and another non-statutory. The former is the proposed Investment Board of the Life Insurance Corporation, a bill in respect of which has been introduced in the Lok Sabha on 30th August 1957; the latter is the proposed Refinance Corporation which is intended to be a private company under the Companies Act for the purpose of channelling funds to the extent of Rs 26 crores (equivalent to $55 million) which are being made available to it out of the counterpart funds of the P.L.480 imports of commodities from the U.S.

3. Reference has been made above to the broad distinction between the Bank’s relationship with institutions which derives from statute and that which is non-statutory. The statutory relationship is based either on the Bank’s own statute or on statutes
under which various other institutions are established; it may alternatively be divided into that relating to organisations for rural credit on the one hand and industrial finance on the other. The non-statutory representation may be further split up into representation of its staff members on the Boards of bodies like, e.g., Stock Exchanges, which function under or administer specific statutes and rules and regulations thereunder, or representation on Committees, etc. set up in the course of executive discharge of Government’s functions in fields where the Bank either has coterminous operational responsibility (e.g., small-scale industries) or has special ability to assist by virtue of its being equipped in its technical Departments to take a wider view of the Central Bank’s responsibility in policy formulation (e.g., small savings policy).

4. To consider first the statutory representation. The association of the Reserve Bank with organisations engaged in the business of agricultural credit and with State co-operative banks, or latterly with the Board of National Co-operative Development and Warehousing or the Warehousing Corporation or other co-operative institutions flows from the special responsibility of the Reserve Bank in relation to agricultural credit under its own statute, progressively extended from time to time since the Bank’s establishment. As such it does not require any re-examination in the present context.

In the field of industrial finance, our association with the Industrial Finance Corporation and the State Financial Corporations derives from the respective statutes under which the various Corporations are established. We are represented on their Boards by virtue of financial participation in the share capital of these Corporations. The State Financial Corporations are required to consult us regarding the issue or sale of bonds, the deposit of their funds with banks, and in other ways. Our advice on conditions in the money market is thus available to these institutions and the demands made on the money market by the different institutions are co-ordinated. The statute also provides for periodical inspection of the State Financial Corporations by the Reserve Bank. The efforts of the Reserve Bank are directed in general to assisting in the establishment of an adequate institutional structure for meeting the medium and long-term credit requirements of industries and to co-ordinating the credit operations of different agencies catering to the needs of small-scale industries, the development of which has been assigned an important place in the Second Five Year Plan. The advice which is sought from the Reserve Bank could no doubt be made available even without the Bank being represented on the Boards of the Corporations. But our representation on the Boards gives us a sound working knowledge of the functioning of the Corporations and puts us in a better position to tender advice. Therefore no change in the present arrangements seems called for.

5. Our representation on the State Bank of India, the State Bank of Hyderabad, the Bank of Mysore, the Bank of Patiala and other banks hardly calls for comment, as the Bank rather than Government is obviously better able to co-ordinate the activities of State-owned and State-partnered banks. It is in recognition of this fact that the State Bank of India Act provided that the Reserve Bank shall always have a minimum shareholding of 55 per cent in the paid-up capital of the State Bank. Also, the State Bank and State-associated banks act as agencies of the Reserve Bank.

6. Our association with the Small Savings schemes derives from our interest in the promotion of these schemes in our capacity as banker to Government and manager of
the country's public debt. We are also managing two of the small savings scrips, namely, 10-year Treasury Savings Deposit Certificates and 15-year Annuity Certificates. Our representation on the Small Savings Board is intended to assist Government in reorganising the Postal Savings Bank system on banking lines.

7. It is hardly necessary to explain the Bank's participation in respect of boards, committees and other bodies mentioned in the third category. The Bank's representation on these bodies is of considerable benefit to the Bank in coming to an understanding of the economic policies of Government and no doubt, Government themselves find the participation of the Bank of value in reaching their decisions.

8. The fourth category relating to the administration of specific economic legislation or operation of stock and commodity markets can be broadly divided into administration and regulation of the working of markets like stock, bullion and commodity markets and administration of other schemes. To take the other schemes first, the Bank's representation on the Export Risks Insurance Corporation (through the Director, Division of International Finance) followed a phase of assistance to Government rendered through the same official in the completion of the preparatory work for setting up the Corporation. The Bank was specially well equipped to render such cooperation owing to the specialised attention given in its Division of International Finance to problems of international trade and balance of payments, with particular reference to the country's export trade, owing to its importance as a foreign exchange earner and contributor to the country's monetary reserves. The participation of the Bank's nominee is understood to have been found of special value to the Corporation in arranging consideration of proposals to stimulate the export trade which involve the co-operation of the banking system. Now that the Corporation has had a start, it is perhaps not essential for the Bank's representative to continue on the Board. This point may be examined further in consultation with the Commerce and Industry Ministry. The work of the Board of Referees under the Income Tax Act appears to have devolved on an officer of the Bank for personal reasons by virtue of the special assistance rendered by him in the examination of rules for deposits of company reserves. There is little in the administration of the Rules which could be said to be of direct concern to the Bank, particularly as banks are excluded from the obligation to deposit any part of their reserves. The association of the Bank through a senior officer with the administration of the Rules for deposit of company reserves can only be said to have some justification from the point of view—to which the Government attach importance—of creating confidence in the reasonable operation of these Rules with due regard to the salutary functioning of the corporate sector rather than in the narrow context of revenue or related considerations which are likely to weigh with tax officials; the Bank official concerned in turn gains an intimate view of the working of corporate enterprise in the country from the vantage angle of the use of its reserves. On the whole, though there would appear good grounds for suggesting that the Reserve Bank as such should not be represented on the Board, I would suggest no change for the present as it might embarrass Government a great deal if our nominees were withdrawn.

9. It is when we consider the association of the Bank's officers with the working of stock, bullion and commodity exchanges, however, that the disadvantages of such
relationship appear to outweigh the advantages. With the exception of the Bombay Bullion Association, the association of the Reserve Bank with the management of stock and commodity markets is of very recent origin. Since its establishment in the latter part of 1948, one of the two Bombay Government directors on the Board of the Bombay Bullion Association has been an officer of the Reserve Bank. The Bombay Government was keen that the Reserve Bank should be associated in the running of the Bullion Association. As regards the other commodity markets, the Bombay Government did not ask for the services of the Bank officers to work as directors. Even after the regulation of futures trading passed into the hands of the Government of India in 1953, in terms of the Forward Contracts (Regulation) Act, 1952, the Reserve Bank did not come into the picture. It is only since March 1957 that officers of the Bank have been nominated, by the Government of India at the instance of the Forward Markets Commission, on the Boards of East India Cotton Association, Bombay, and the Boards of the Bombay and Madras Oilseeds Exchanges. As regards stock exchanges, the all-India legislation came into force only about a year ago and the recognition of stock exchanges under this Act is being granted only since September last. So our officers have been serving on the Boards of Stock Exchanges at Bombay, Calcutta, Madras, Delhi and Ahmedabad only since very recently. In all cases, the officers of the Bank have been serving as nominees of (the Union) Government with the Bank’s approval.

10. The main benefit to the Bank presumed to flow from the association of its officers with the organised markets in stocks and commodities is that it gives the Bank an intimate and up-to-date knowledge of the developments in these markets, which is of some help to the Bank in performing its role of regulator of credit in the economy. However, the importance of this link from the point of view of the Bank could be exaggerated. By virtue of its acting as the fiscal agent of Government and also on account of its own open market operations the Bank receives daily visits from important stock brokers who furnish it with detailed information regarding the happenings in the stock markets. It is primarily from the point of view of Government that the association of Reserve Bank officers with the Boards of the Stock Exchanges has been suggested to assist in their proper administration in terms of the respective statutes and rules and bye-laws. It is, however, when the association of Bank officials with the Exchanges is considered in terms of assistance in the administration of the Exchanges, rather than in fashioning the broad framework of their operation, that the disadvantages of such intimate association with the affairs of the Exchange come into relief. Though the Bank officials attend the Boards as nominees of Government, they are naturally presumed by the public to represent the Bank. There are, therefore, chances of the Bank’s name being occasionally drawn into controversy when action to deal with crises which are liable to occur is called for. It is desirable in the interest of maintaining the implicit confidence of the public in the absolute impartiality of the Bank’s administration of the monetary affairs of the country on broad national considerations that no opportunity is afforded for any possible misunderstanding of the Bank’s part in relation to specific markets, such as might have occurred, for instance, if a Bank official were associated with the Board of the East India Cotton Association during the eventful winter of 1955–56. It is as important for Government
as for the Bank that such a possibility of the Bank being embroiled in controversy is avoided. That it is necessary in such a matter to take a long view would be apparent if we visualise a situation in which the Bank did not see eye to eye with Government in regard to a particular measure of regulation in the operation of an exchange, say, in regard to imposition of margins, requirement of deposits by operators, suspension of a bye-law, etc. In such a situation the outcome might be equally embarrassing if the Bank official acquiesced in Government’s action or if he did not and openly expressed his disapproval. This clearly points to the need, in the interest of proper allocation of responsibility, of one authority—and, therefore, Government—being entrusted with the function of administration of the Exchanges. The Exchanges are distinguished from other Boards and Committees, such as have been mentioned, by the fact that the monetary interest of large numbers of operators is affected by particular measures of regulation, because of which possible differences of views in regard to the manner of handling particular situations have larger implications than similar differences in the course of work of other Committees and Boards. I would, therefore, suggest that the Board approve the proposal that the Bank’s officers nominated to the Boards of the Stock and Commodity Exchanges may be replaced by Government by other persons.

11. The above reasoning applies \textit{pari passu} to the bullion exchange as well. In fact, the bullion exchange furnishes the longest experience of working of the arrangement by which a Bank officer nominated by Government (in this instance the Bombay Government) has held a watching brief on the Bank’s behalf in the management of market in which, because of its implications for monetary management, traditional and otherwise, the Bank has a greater measure of interest than in other commodities; the Bank’s nominee has also made his contribution to the salutary functioning of the bullion market. Although, by and large, the Bank’s ‘representation’ has not given cause for embarrassment—the Bank’s representative has, as a convention, always stood above contending market forces and never exercised his vote—there have been occasions for dissatisfaction, in howsoever slight a measure, with the role in which the Bank has been made to appear. In one instance, our nominee on the Exchange failed to report proceedings in the Exchange promptly enough to the Bank to enable the Bank in turn to report them to Government—the Bank nominee is treated in effect as the eyes and ears of the Central Government who are not otherwise represented on the Exchange—at the time of the famous Mudgal affair. This was also reflected in the evidence before the Enquiry by the Bank nominee (Shri B.R. Shenoy). During the crisis in March 1955, again, the Bank was not happy with the line of action adopted by the Bombay Government to deal with the election of the President which led our nominee to propose that the Bank should discontinue its association with the Exchange. This was, however, continued at the request of the Bombay Government after the incident. The working of the bullion exchange has now been tightened up in a manner which leaves much less scope for embarrassing situations. On the other hand, the position regarding Government supervision of the affairs of the Exchange is not satisfactory. The Forward Markets Commission started considering from 1955 the question of extension of the Forward Markets Act to bullion. The Commission carried out during 1956 an enquiry with a view to determining the scope of forward trading to be permitted in the country and the exchanges which should be recognised. The
Bombay Government in the meantime—partly in view of the impending shift in responsibility for supervision—has considerably relaxed its supervision of the affairs of the exchange to the point when the only ‘Government’ Director usually attending the Board meetings is the Reserve Bank official. This is obviously not a very desirable position for the Bank nominee to be placed in.

12. There remains the question of our proposed representation on the Refinance Corporation and the Investment Board of the Life Insurance Corporation. The proposed Refinance Corporation in which the Reserve Bank would participate by contributing to share capital to the extent of Rs 5 crores (40% of the capital), will have a Board of seven Directors with the Governor of the Reserve Bank as Chairman and a Deputy Governor as a member; the other members would be the Chairman, Life Insurance Corporation, the Chairman, State Bank of India and three Directors representing other participating banks. In addition, the Chief Officer of the Industrial Finance Department will be the General Manager of the Corporation, the affairs of which will be looked after by the Industrial Finance Department of the Bank. The constitution of the Corporation is based on its close integration in operation with the Reserve Bank. In fact, the alternative of its funds being vested in the Reserve Bank and lent out by the Industrial Finance Department of the Bank was also considered, but the present form of arrangement under which the Corporation remains a separate entity with other participating institutions entitled to a say in the management, was preferred. Inasmuch as the Corporation will be dealing with lending to commercial banks and would have the advantage through the proposed arrangement of drawing on the knowledge and experience of the Reserve Bank’s various Departments (including the Department of Banking Operations), there is much to be said for the Bank’s association with the Corporation in the manner proposed.

13. Lastly, we come to the proposed “Investment Board” for the Life Insurance Corporation. Under the Life Insurance Corporation (Second Amendment) Bill, 1957, it is proposed to entrust the work of investment of the funds of the Life Insurance Corporation to an Investment Board, so that, according to the Statement of Objects and Reasons of the Bill, “the Life Insurance Corporation may be able to devote greater attention to its primary task of acquiring new business”. The Investment Board would consist of the Governor of the Reserve Bank as Chairman, the Chairman of the Central Board of the State Bank of India and the Chairman of the Life Insurance Corporation as members. Apart from the merits of this proposal which would divest the Life Insurance Corporation of responsibility for investment of its funds, the association with the Board of the Governor of the Reserve Bank as its Chairman is likely to lead to difficulties. The Board would presumably be responsible for investment of the funds of the Corporation primarily in the interest of policy-holders of the Corporation. The Bank and its Governor, on the other hand, are charged “generally to operate the currency and credit system of the country to its advantage” viz., to the advantage of the whole economy and “to secure monetary stability”. The dichotomy of responsibility of the Governor in his capacity as Chairman of the Investment Board and as head of the country’s Central Bank is thus apparent, and the proposed arrangement is likely to lead to complications. Any alternative arrangement under which a Deputy Governor or other senior staff member of the Bank might represent the Bank is also not likely to be free from objection.
14. In the result I make the following recommendations:
   (a) Government should be advised to nominate their own officials, rather than Reserve Bank officials on the Boards of the Stock Exchanges and the Commodity Exchanges including the Bullion Exchange.
   (b) Government should be advised to revise the Life Insurance Corporation (Second Amendment) Bill so as to exclude the Governor of the Reserve Bank from any responsibility for investment of the funds of the Corporation.
   (c) For the rest the present arrangements may continue subject to a further examination of the Bank's representation on the Export Risks Insurance Corporation.

H.V.R. IENGAR
GOVERNOR

RESERVE BANK OF INDIA
CENTRAL OFFICE, BOMBAY
27th February, 1958

My dear Roy,

I have had some correspondence with Shri T.T. Krishnamachari on the Life Insurance Corporation (Second Amendment) Bill insofar as it concerns the inclusion of the Governor of the Reserve Bank as a member of the proposed Investment Board and also on the subject of the nomination of officers of the Reserve Bank on boards of the stock exchanges and the commodity exchanges. In my last letter I had informed him that, in view of recent developments, I had considerable doubts about the wisdom of the representation of the Reserve Bank on the abovementioned bodies and that I proposed to consult my Board.

2. I enclose for the information of government a copy of the memorandum which I submitted to the Board on this subject and which they discussed at a meeting a couple of days ago. The Board generally approved of the approach contained in the memorandum, that is to say, that the Reserve Bank should not isolate itself in an "ivory tower"; that insofar as its statutory responsibilities are concerned either in the field of agricultural credit or finance to small-scale industries, it should continue, as it has been doing hitherto, to function on a liberal rather than on a narrow interpretation of its functions and responsibilities; but on the other hand, it would be anomalous and might well lead to embarrassment, both to the Bank and Government, if officers of the Bank were nominated on behalf of Government on statutory bodies like the stock exchanges and commodity exchanges. Insofar as the Life Insurance Corporation (Second Amendment) Bill is concerned, the Board specifically accepted the view put forward in the memorandum that it would be undesirable for the Governor to be included as a member of the proposed Investment Board.

3. The Board approved of the proposals contained in paragraph 14 of the memorandum subject to the change that they saw no objection to the Bank being represented on the Export Risks Insurance Corporation.
4. I shall be grateful if Government will now take steps to nominate their own officials rather than Reserve Bank officials on the Boards of the stock exchanges and the commodity exchanges and revise the Life Insurance Corporation (Second Amendment) Bill in such a manner as to leave the Governor of the Reserve Bank out of any proposed Investment Board. In the ordinary course I would have felt some embarrassment in making this request because I had personally expressed concurrence with the decisions previously taken by the Finance Minister. But in view of the proceedings before the Chagla Commission neither Government nor the Reserve Bank need feel any hesitation in examining afresh the whole issue of the relationship between the Bank and Government. I am now quite clear in my mind that the views expressed by the Board are in the public interest from the point of view of enabling the Reserve Bank to function, in an atmosphere free of possible controversies, as the instrument charged with preserving the country’s monetary stability.

Yours sincerely,

[ H.V.R. IENGAR ]

Shri A.K. Roy
Ministry of Finance
Government of India
New Delhi

D.O.No.[...]
My dear Iengar,

Please refer to your letter dated the 10th March 1958 regarding the representation of the Reserve Bank of India on certain bodies like the investment board of the Life Insurance Corporation and the commodity and stock exchanges. As far as the Life Insurance Corporation is concerned, the question is now only academic, as the Life Insurance Corporation (Second Amendment) Bill, 1957 is being withdrawn. The Reserve Bank’s representation on the Bombay Bullion Association, as you have pointed out, is not very recent, and it is not also a matter with which we are directly concerned. The Bank, I believe, is in correspondence with the Bombay Government on this matter. This leaves for consideration only the question of the Bank’s representation on the recognised stock and commodity exchanges, including the East India Cotton Association and the Oil Seeds Exchanges.

2. Without prejudice to the general question of the relations of the Reserve Bank with the Government of India and the State Governments and their executive organisations, the Finance Minister is prepared to agree that the Reserve Bank of India may be allowed to withdraw its representatives from the bodies or associations mentioned below:

(i) the Stock Exchanges at Bombay, Delhi, Calcutta, Ahmedabad and Madras;
(ii) the East India Cotton Association;
(iii) the Oilseeds Exchanges at Bombay and Madras.
3. We shall be nominating other representatives in respect of the organisations mentioned at (i) and have asked the Ministry of Commerce and Industry to take similar action in regard to (ii) and (iii). We hope, however, that the Bank will be able to continue its present nominees on these bodies till alternative arrangements can be made in each case.

Yours sincerely,

B.K. NEHRU

Shri H.V.R. Iengar

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